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MFRS Hot Topics

Costs of an initial public offering

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Issue

How should the costs of an initial public offering (IPO) that involves both issuing new shares and a stock market listing be accounted for?

Relevant IFRSs
MFRS 132 Financial Instruments: Presentation

Guidance

The costs of an IPO that involves both issuing new shares and a stock market listing should be accounted for as follows:

- incremental costs that are directly attributable to issuing new shares should be deducted from equity (MFRS 132.37); and
- costs that relate to the stock market listing, or are otherwise not incremental and directly attributable to issuing new shares, should be recorded as an expense in the income statement.

Costs that relate to both share issuance and listing should be allocated between those functions on a rational and consistent basis (MFRS 132.38). In the absence of a more specific basis for apportionment, an allocation of common costs based on the proportion of new shares issued to the total number of (new and existing) shares listed is an acceptable approach.

Discussion

Entities commonly raise additional equity through a public offer of shares and concurrently list new and existing shares on a stock exchange (an exercise referred to as an IPO). The listing creates an active market in the shares and thereby provides liquidity to new and existing shareholders (along with other benefits and obligations).

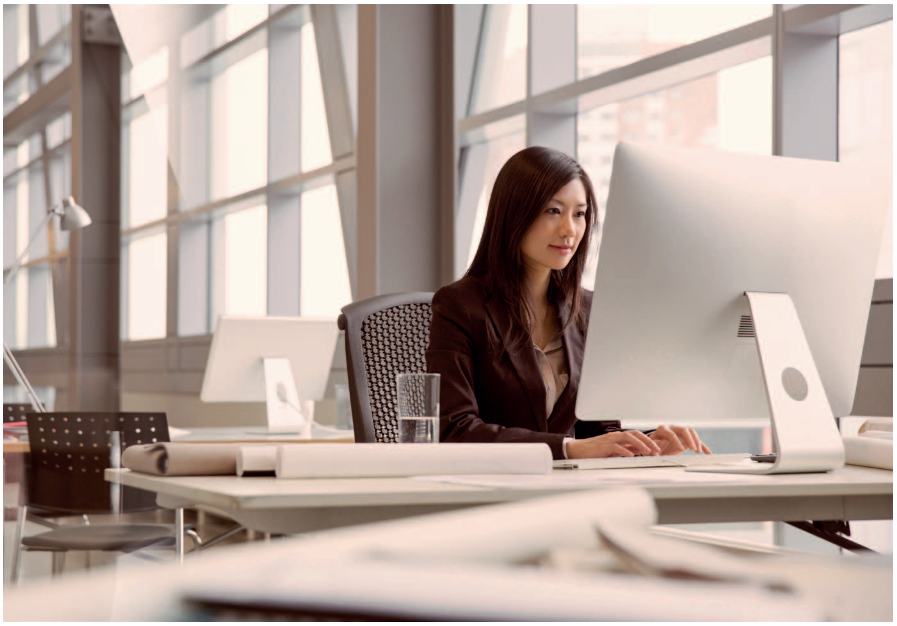
MFRS 132.37 requires that: "the transaction costs of an equity transaction are accounted for as a deduction from equity to the extent that they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided…". Raising additional equity through the offering and issuance of new shares is an equity transaction for this purpose, but the listing procedure is not. Only costs attributable to the offer of new shares are deducted from equity.

In practice, the offering and listing are usually a combined exercise. Certain costs, such as stamp duties and underwriters' fees, are clearly attributable to raising additional equity. Other costs, such as listing fees, relate only to the listing and should be expensed. However, costs such as:

- legal fees
- accountants' fees
- other professional advisers' costs
- prospectus design and printing costs

are likely to relate to both functions. Such shared costs should be allocated on a systematic basis between the share issue and the listing and then recorded in part as an equity deduction and in part as an expense.

The following table provides a general indication as to some of the costs incurred in an IPO, and the basis on which they might be allocated. The requirements and practices for issuing and listing shares differ significantly between jurisdictions and stock markets, and the costs incurred and their allocation will also therefore vary depending on the specific facts and circumstances.



Type of cost	Allocation (share-issue, listing or both)
Stamp duties	Share issue
Underwriting fees	Share issue
Listing fees	Listing
Accountants' fees relating to prospectus	Common - a prospectus type document may be required for an offer without a listing and vice versa, but in practice IPO documents typically relate both to the offer and the listing
Legal fees	Common - legal advice is typically required both for the offer of shares to the public and for the listing procedures to comply with the requirements established by the relevant securities regulator/exchange
Prospectus design and printing costs	Common - although in cases where most prospectus copies are sent to potential new shareholders the majority of such costs might relate to the share issue
Sponsor's fees	Common - to the extent the sponsor's activities relate to identifying potential new shareholders and persuading them to invest, the cost relate to the share issue. The activities of the sponsor related to compliance with the relevant stock exchange requirements should be expensed.
Public relations consultant's fees	Expense - companies typically engage PR consultants to raise the company's profile which contributes to the ability to issue new shares. However, PR costs generally relate to general company promotion and are not therefore directly attributable to the share issue.
'Roadshow' costs	Expense - although the 'roadshow' might help to sell the offer to potential investors and hence contributes to raising equity, it is usually a general promotional activity. Hence the associated costs may not be not sufficiently directly related to the share issues to justify deduction from equity. Further, a significant portion of any costs may not be incremental (e.g. management time).

Example

Entity A undertakes an IPO in which 500,000 new shares are issued and a total of 750,000 new and existing shares are listed. Costs incurred include:

- underwriting fees of CU200,000
- listing fee of CU100,000
- accountant’s and legal fees of CU300,000 relating to the offer and listing
- roadshow costs and fees paid to PR consultants of CU150,000

Ignoring tax effects, how should these costs be accounted for?

The underwriting fees should be deducted from equity. The listing fee and roadshow/PR consultants’ charges should be expensed. Accountants’ and legal fees should be allocated between the offer and the listing, one basis being in proportion to the new/existing shares as follows:

Allocated to new share issues (equity):	(500,000/750,000) x CU300,000 = CU200,000
Allocated to listing (expense):	(250,000/750,000) x CU300,000 = CU100,000

The respective entries for the IPO costs are as follows:

Ledger entry	Debit 000s	Credit 000s
Equity (underwriting = allocation of legal/accountant’s fees	CU400	
Income statement (listing + allocation of legal/accountant’s fees + roadshow/PR consultancy)	CU350	
Cash/creditors		CU750

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