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# Heads Up
## Financial reporting issues to consider on IPO

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**"In summary"**

- Initial public offerings ('IPOs') are often undertaken in conjunction with corporate restructures or other transactions and can be, and often are, complex from an accounting perspective.

- Some of the key financial reporting issues that entities should consider in the IPO process include:

  1. Corporate restructures
  2. Transaction costs
  3. General purpose financial report requirements
  4. Half year reporting requirements
  5. Share-based payments
  6. Earnings per share and segment reporting
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**Introduction**

In the wake of the global financial crisis, IPO activity all but ceased to exist. However, in recent years there has been a significant increase in the number of IPOs in Australia. These transactions are complex and each transaction has different facts and circumstances. This *Heads Up* provides some key financial reporting issues to be aware of during an IPO process.

## 1. Corporate restructures

Companies often restructure in preparation for an IPO. A common method of restructuring is by adding a new parent entity (hereafter referred to as 'Newco') however, restructures can take various forms (which include those variously described as top-hatting, side-cars and sale co's). Accounting for these transactions, whether or not performed in contemplation of an IPO, has resulted in much debate since the implementation of International Financial Reporting Standards (IFRS), both globally and in Australia. Corporate restructures are complex in nature. Furthermore, the accounting treatment and associated disclosures can be extremely sensitive to the facts and circumstances and slight variations in structures may have fundamentally different accounting outcomes. For example, in certain scenarios acquisition accounting is appropriate while in other scenarios it is more appropriate to treat the transaction as a continuation of the existing group i.e. book value accounting is applied. Below are some matters to consider in this regard.

*Group reorganisation versus a business combination*

Consideration needs to be given as to whether the restructure represents a business combination under AASB 3 *Business Combinations* ('AASB 3') or a group reorganisation. Where the restructure represents a business combination, acquisition accounting under AASB 3 will generally apply requiring identifiable assets and liabilities acquired to be recognised at fair value and goodwill or a bargain purchase to be recognised. Book value accounting will generally apply to a group reorganisation.

When assessing whether the transaction is a business combination under AASB 3, it is necessary to identify an acquirer and an acquiree. Whether a Newco formed to facilitate an IPO is capable of being identified as an acquirer depends on the facts and circumstances and ultimately requires judgement and consideration of the substance of the transaction. Whether the transaction is conditional or unconditional, whether there is a controlling shareholder before and after the transaction, and any broader restructure before the IPO all impact the analysis. In addition to identifying an acquirer and acquiree, in order for the transaction to be a business combination under AASB 3 both the acquirer and the acquiree need to be a business as defined under AASB 3 (AASB3.B7-B12 defines a business as "*an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.").* For example, if an entity, which meets the definition of a business acquires a shell company, which doesn't meet the definition of a business, the transaction as a whole would not be a business combination under AASB 3.

*Business combination under common control*

Where a group is restructured and the transaction represents a business combination i.e. there is a combination of two businesses, it is necessary to consider whether the transaction is a business combination under common control. Whilst AASB 3 sets out the accounting requirements for business combinations and requires the use of the acquisition method, it gives a scope exemption for a combination of entities or businesses under common control (AASB 3.B1 defines a business combination involving entities or businesses under common control as "a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory"). Limited guidance is available in respect of these scoped out transactions and much of the accounting debate has centered on entitlement to this scope exemption, particularly in respect of group reorganisations. This distinction is important because it will determine whether acquisition accounting or book value accounting should be applied, or whether entities are able to choose (as an accounting policy choice) between the two options.

*Back-door listings*

Another way that entities may list is through a reverse restructure with an existing non-operating listed entity that has few assets or liabilities (i.e. a shell company). Under these circumstances where a private entity is 'acquired' by the listed entity, this is commonly referred to as a back-door listing. Since the listed non-operating entity is not a business, the transaction is not a business combination. Normally such transactions are accounted for similar to reverse acquisitions. However, because the accounting acquiree is not a business the transaction is considered a share-based payment. That is, the private entity is deemed to have issued shares to obtain control of the listed entity and to the extent their fair value exceeds the fair value of the listed entity's identifiable net assets an expense will arise.

*Disclosure of key judgements*

Determining the appropriate accounting treatment of corporate restructures often involves judgements. Therefore entities need to ensure that they comply with the disclosure requirements of AASB 101 *Presentation of Financial Statements* ('AASB 101'), specifically paragraph 122. This requires disclosure of judgements made by management in the process of applying an entity's accounting policies that have a significant effect on the amounts recognised in the financial statements. It is important to note that disclosures regarding significant judgements (and key assumptions and sources of estimation uncertainty) in applying accounting policies (AASB 101.122 and 125) are a key focus area for the Australian Securities and Investment Commission ('ASIC').

**2. Transaction costs**

As part of an IPO it is common for an entity to issue new shares and then list the new and existing shares. Existing shares may also be sold to the public at the time of listing (this would occur when existing shareholders wish to dispose of their interest in the entity). Various costs are incurred when listing and issuing shares. The nature of these costs needs to be determined to ensure that the costs are correctly accounted for either through equity or profit or loss, namely:

- Transaction costs directly attributable to the issuance of new shares that otherwise would have been avoided are deducted from equity;
- Transaction costs relating to the listing of shares, whether new or existing, should be expensed through profit or loss;
- Where transaction costs relate jointly to more than one transaction (e.g. the issue of new shares, the sale of existing shares and listing all the shares), the costs should be appropriately allocated to each activity [AASB 132:38].

When preparing the accompanying cash flow statement, costs which have been expensed should be included in operating cash flows while costs deducted from equity should be included as financing cash flows.

**3. General purpose financial report requirements**

In our view, entities that are in the process of an IPO should be considered reporting entities (for example, entities who have a Board of Directors resolution to proceed with the listing or who have appointed advisors to advise on the listing process and the listing has a more likely than not outcome). This is because such entities meet the definition of having dependent users and are considered publicly accountable under AASB 1053 *Application of Tiers of Australian Accounting Standards* ('AASB 1053'). Therefore, full general purpose financial reports ('GPFR Tier 1') will be required, including compliance with AASB 133 *Earnings per Share* and AASB 8 *Operating Segments*.

When transitioning from a special purpose financial report ('SPFR') to GPFR Tier 1/Tier 2 (Reduced Disclosure Requirements) or from GPFR Tier 2 to GPFR Tier 1, the question arises whether any adjustments will be required. AASB 1053 provides guidance as to whether an entity should apply AASB 1 *First-time Adoption of Australian Accounting Standards* ('AASB 1') or AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* when transitioning.

It should be noted that there are opportunities and risks attached to the transition options. For example, a number of options exist in AASB 1 on transition. Some of these options are voluntary and, depending on the operations of the entity and any desire for certain accounting outcomes, these options can be applied differently to achieve different outcomes. Areas of particular focus should include first-time consolidation, business combinations, foreign currency translation reserves and one off revaluations.

## 4. Half year reporting requirements

As highlighted in section one above, it is common practice for a new parent entity to be incorporated prior to an IPO. The Corporations Act (the 'Act') requires the new parent, as the new disclosing entity, to prepare a half year financial report six months after the date of incorporation [s.323D(5)]. Relief is provided under ASIC class order 08/15 where the first financial year is eight months or less, provided certain conditions are satisfied.

In cases where this general relief is not available entities may consider specifically requesting relief from ASIC. We are aware this relief has been granted in cases where the insertion of the new parent has been accounted for as a group reorganisation. This is on the basis that an alternative half year reporting period is adopted to reflect the continuation of the existing group. For example, Company B which is incorporated on 1 April 2016 and has a 31 December year end is inserted as the new parent entity of an existing group (Company A) on IPO of the group. Under the Act Company B is required to prepare a half year financial report as at 30 September, six months after the date of incorporation. General relief under the class order would not be available to Company B as its first financial year is longer than eight months. However, Company B could request relief from ASIC by requesting to prepare half year accounts as a continuation of Company A, namely as at 30 June 2016.

If relief is not sought/granted entities should consider what comparatives are required and also liaise with the Australian Securities Exchange as it may expect reporting at specific dates.

As discussed in section three above, in our view, entities that are in the process of an IPO will be required to prepare full general purpose financial reports. Entities transitioning to Tier 1 GPFR will need to consider the level of detail to be disclosed in their first half year financial report in accordance with AASB 134 *Interim Financial Reporting*. The limited disclosures provided in the entity's most recent financial report may mean that additional disclosure may be required in its half year financial report as a result of the information not being disclosed in the most recent annual financial report. In addition, consideration needs to be given to what extent the most recent annual financial report is accessible to users of the half year financial report. To the extent to which the report is not considered accessible an entity may need to include additional disclosures in their half year financial report in order for users to fully understand an entity's business.

## 5. Share-based payments

It is common for companies to issue new share options or amend existing employee share options prior to an IPO. An example includes the issue of options which vest upon the successful completion of an IPO together with a specified service requirement (i.e. an employee is required to be employed at the time an IPO is successfully completed).

The key issue is whether a requirement for an IPO to occur for an award to vest is a vesting condition or a non-vesting condition, as the distinction has different impacts on the accounting treatment, and depends on any related service condition. For example, non-vesting conditions are reflected in the grant-date fair value however, there is no true-up for failure to satisfy the condition. In comparison, vesting conditions with a non-market performance condition are not reflected in the grant-date fair value however, there is a true-up for failure to satisfy the condition.

In determining whether the requirement for an IPO to occur is a vesting or non-vesting condition one needs to consider the service requirement. Where there is no service requirement or the service period is shorter than the period to the IPO then the IPO should be treated as a non-vesting condition. However, where the service period is the same or longer than the period to the IPO then the IPO should be treated as a vesting condition.

In the event that an IPO condition is considered to be a vesting condition, should the IPO not take place resulting in the option not vesting, any expense recognised to date in terms of AASB 2 *Share-based Payment* will need to be reversed. However, if an IPO condition is considered to be a non-vesting condition and an IPO is not successful any expense recognised in terms of AASB 2 will not be reversed.

Furthermore, in circumstances where existing share options are amended in anticipation of an IPO, entities need to consider both the accounting and tax consequences of these amendments. Where an amendment of share options is treated as a cancellation this results in an acceleration of vesting. The amount that would otherwise have been recognised for services received over the remainder of the vesting period is, therefore, recognised immediately.

### 6. Earnings per share and segment reporting

As discussed in section three above, where an entity is in the process of an IPO it should be considered a reporting entity and apply AASB 133 *Earnings per Share* ('AASB 133') and AASB 8 *Operating Segments* ('AASB 8'). As part of the IPO process it is common for entities to do a share split. In such instances, as required by AASB 133 paragraph 64 all per share calculations (e.g. basic and diluted EPS) should be adjusted retrospectively for all periods presented.

As part of applying AASB 8, entities will need to identify their operating segments which should be identified and measured on the same basis as financial information that is reported internally for the purpose of allocating resources between segments and assessing their performance.

The identification of operating segments often requires management to exercise judgement. Where these judgements could have a significant effect on the amounts recognised in the financial statements entities need to consider the disclosure requirements in AASB 101.

### 7. Income tax considerations

As discussed previously in section one above, companies often restructure in preparation for an IPO. Where the restructure results in a new tax consolidated group, the tax values of the assets and liabilities may need to be reset. If an entity has not applied AASB 3 acquisition accounting for the restructure, any adjustments to the tax bases of assets and liabilities will need to be recognised in profit or loss. Where an entity applies AASB 3 acquisition accounting the adjustments would affect the amount of goodwill/bargain purchase recognised.

Income tax impacts can also arise on the corporatisation of trusts prior to IPO.

### 8. Other reporting considerations

Once an entity lists it will have additional reporting obligations which include the following:

*Remuneration reports*

Section 300A of the Act requires listed disclosing entities to prepare a remuneration report. Furthermore, regulation 2M.3.03 of the Act requires disclosure of comparative information for certain disclosures required in the remuneration report. The regulation specifies that comparative information is not required to be disclosed in the first period of reporting on a specified individual. Where a new parent has been used as the listing vehicle and it has been accounted for as a continuation of the existing group, the question arises whether comparative information is required in the first period that the entity lists. There is no specific guidance in the Act (or regulations) and there appears to be different views in practice. It is our preference that comparative information is provided.

*Continuous disclosure*

Listed entities must ensure that they satisfy the continuous disclosure requirements under the Australian Stock Exchange ('ASX') Listing Rules 3.1 and 3.1A. These rules require a listed entity to inform ASX of information concerning the entity that would be expected to have a material effect on the price or value of its securities (except in the situations described in 3.1A of the rules).

*Non-IFRS financial information*

Section 299A of the Act requires listed entities to provide an operating and financial review ('OFR') in the directors' report. If the directors consider it appropriate to include non-IFRS financial information in the OFR, the directors' report or another document in the annual report, the guidelines in Section D of Regulatory Guide 230 '*Disclosing non-IFRS financial information*' should be followed to assist in reducing the risk of non-IFRS financial information being misleading.

Important considerations include the following:

- IFRS financial information should be given equal or greater prominence compared to non-IFRS financial information, in particular IFRS profit;
- Non-IFRS information should:
    - be explained and reconciled to IFRS financial information;
    - be calculated consistently from period to period; and
    - be unbiased and not used to remove 'bad news'.

**Next steps**

Entities going through the process of an IPO are subject to increased scrutiny of their financial reporting. Due to the complex nature of these transactions and the nuances that may exist with the various scenarios, the accounting outcomes can look quite different depending on specific facts and circumstances. It takes time to work through these issues and entities should start planning and preparing early. Consideration must also be given of the wider implications such as resource availability, stakeholder communication and any required changes to systems and processes.


**Contacts:**

***Accounting Technical***

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|---|---|---|
| **Anna Crawford, Partner** | **acrawford@deloitte.com.au** | **+61 (2) 9322 7177** |
| **Melissa Sim, Principal** | **msim@deloitte.com.au** | **+61 (2) 9322 7934** |
| **Carol Warden, Director** | **cwarden@deloitte.com.au** | **+61 (2) 9322 5038** |
| **Rosie Ware, Director** | **roware@deloitte.com.au** | **+61 (2) 9322 4025** |

***Transaction Services***

| | | |
|---|---|---|
| **Ian Turner, Partner** | **iaturner@deloitte.com.au** | **+61 (2) 9322 7048** |
| **Tapan Verma, Director** | **tapanverma@deloitte.com.au** | **+61 (2) 9322 7252** |