# Accounting Challenges of an IPO Exercise

5 Things you need to know before going for an IPO

Audit / Tax / Advisory

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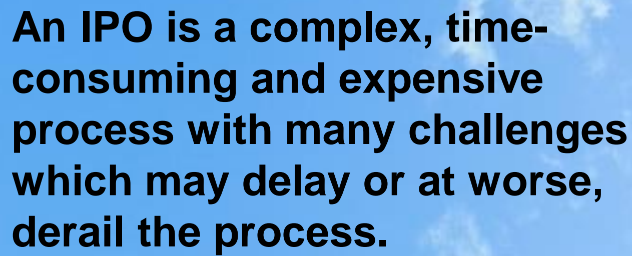

**An IPO is a complex, time-consuming and expensive process with many challenges which may delay or at worse, derail the process.**

These challenges are wide-ranging and include compliance with legal, financial reporting and governance requirements. Management's readiness to provide timely and accurate information to the professionals is a significant factor in an IPO's success.

In this article, we will share some of the common accounting issues and challenges which an IPO candidate may face in its IPO journey.

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# Share-based Payments

A share-based payment is when a company uses its shares to pay for goods or services. Listing candidates may face more complex issues when shares are issued at a discount to new investors, advisors or business associates. These discounts may be treated as expenses in the financial statements and will reduce a company's profit. Malaysian Financial Reporting Standards 2 - Share-based Payment ("MFRS 2") provides guidance on the treatment of share-based payments.

Companies which are going for IPO may raise pre-IPO funds by issuing shares to early investors to fund their business expansion or pay for IPO expenses. In addition, it is common for these companies to provide incentives to employees in the form of share options as part of the IPO exercise. Such issuance of shares may fall within the ambit of share-based payment under MFRS 2.

MFRS 2 states that such share discounts represent a cost to the company and should be taken up as an expense in the income statement.

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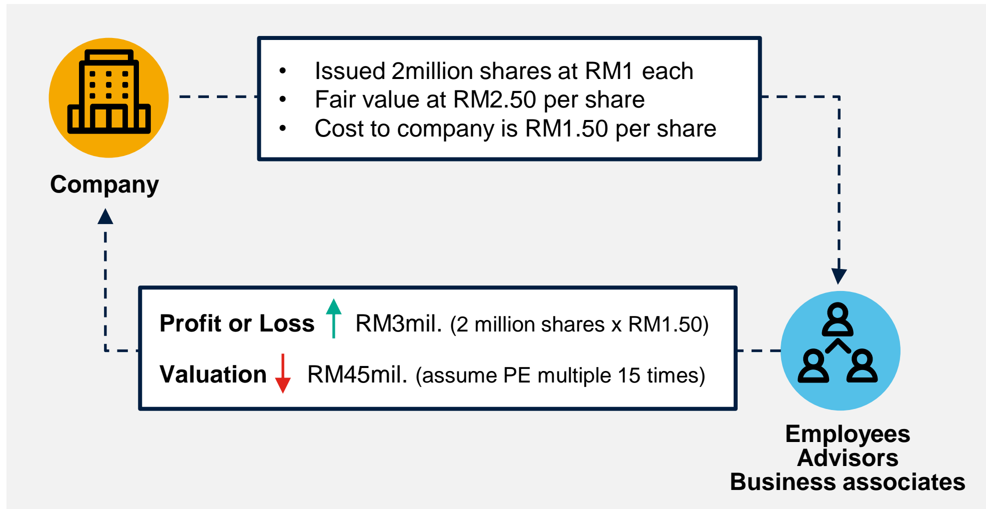
# Share-based Payments (cont.)

The example below illustrates the effects to the shareholders of a company going for listing with such an arrangement.




In this example the company issued 2 million shares at RM1 each to its employees, advisors and business associates as part of an IPO exercise. Although the IPO shares are issued to the public at RM2.50 per share, the company is offering a RM1.50 discount to the employees, advisors and business associates. MFRS 2 requires this RM1.50 discount to be expensed to the profit and loss account as share-based payment expenses. The additional cost to the company is RM3 million, calculated at 2 million shares multiplied by RM1.50 each.

This accounting treatment reduces the profit of the company by RM3mil and will have an adverse effect on the company's valuation. For example, if the company is going for the IPO at a valuation of 15 times Price Earnings Multiple, the impact on the valuation of the company is RM45 mil - a significant impact indeed on the shareholders of the Company.

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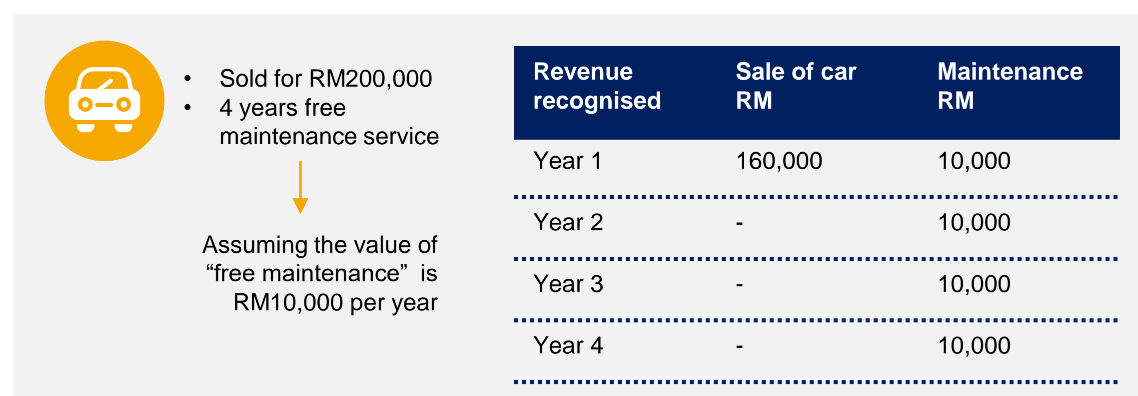
# Revenue from Contracts with Customers

Revenue from Contracts with Customers is also commonly referred to as revenue accounting and affects companies with a large number of customers' contracts with different terms and services. Each service may require a different method to recognise revenue. In a nutshell, where a company offers a combination of services that are bundled together, this standard requires each of the service to be separately identified. Thereafter the revenue from each of the service is recognised based on the nature of that service.

Malaysian Financial Reporting Standards 15 – Revenue From Contracts with Customers ("MFRS15") provides guidance on how each of this revenue should be recognised.




| Revenue recognised | Sale of car RM | Maintenance RM |
|---|---|---|
| Year 1 | 160,000 | 10,000 |
| Year 2 | - | 10,000 |
| Year 3 | - | 10,000 |
| Year 4 | - | 10,000 |

An automobile company sells a car for RM200,000 which includes 4 years of free maintenance. In the past, the company would recognise the RM200,000 as revenue without accounting for the free maintenance in the financial statements. However, under MFRS 15, the company is required to value the "free maintenance" and reflect this as a separate revenue stream in the financial statements.

In this example, assuming that the free maintenance is valued at RM10,000 a year, then the sale of the car needs to be unbundled into two different performance obligations / revenue streams. The revenue streams are the sale of car and the maintenance revenue. Since the maintenance is valued at RM40,000, the actual revenue from the sale of car is only RM160,000, which is recognized in Year 1. The revenue from maintenance will be recognized over the 4 years maintenance period.

Therefore, the effects of MFRS 15 can be significant as it may reduce a company's revenue significantly or delay the timing of revenue recognition. It can also result in the restatement of revenue in previous years especially in companies with large contracts with customers which cover a few services or products with different terms.

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# Taxation

### Tax Investigation

A tax investigation on a company preparing for an IPO is a major challenge especially if it results in significant penalties. Where the penalties relate to tax submissions over a few years, a prior year restatement of financial statements and disclosure in the IPO submission to Bursa Malaysia may be required.

It is therefore important for companies preparing for an IPO to ensure that its tax submissions are up to date and outstanding tax issues are resolved. A tax investigation can cause significant delays to an IPO submission.

### Restatement of Financial Statements

Changes in accounting standards such as MFRS 15 mentioned earlier may result in the restatement of results of previous financial years. The question then arises as to whether the taxes of the previous years need to be re-computed. If yes, the re-computation may result in penalties. As this is a very technical tax matter, it will require the advice of tax experts to ensure that these issues are properly dealt with.

### Transfer Pricing

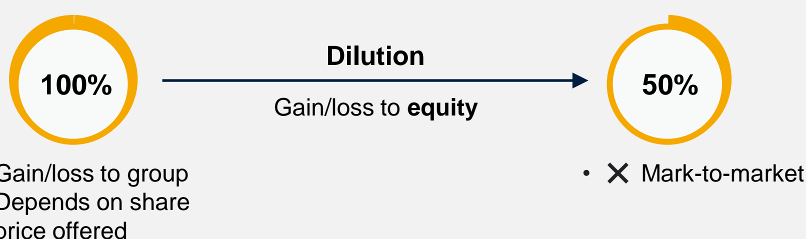
Companies with significant related party transactions should undergo a transfer pricing review by tax experts to ensure that all transactions between group companies are undertaken at arm’s length prices. Transfer pricing issues, if not dealt with early, may result in tax penalties which can be significant.

# Listing of a subsidiary and its impact to the holding company

This situation is less common and will only apply to a group which intends to list one of its subsidiaries. In this situation, it is important to understand the effects of the subsidiary's IPO on the financial position and results of the group as it can be material. It is important especially if the holding company itself is listed or if the group has loan or other covenants.

There are two common scenarios when a group lists its subsidiary.

**Scenario 1:** Where the group retains control over the subsidiary
*For example, the group still holds more than 50% shares in the subsidiary*.




In this scenario, the dilution of the group's interest in the subsidiary will result in a dilution gain (it can result in a dilution loss but this is very unlikely). This dilution gain will be taken up directly in equity and does not affect the Group's results.

The remaining investment in the 51% subsidiary will continue to be accounted for in the Group's financial statements based on existing policy.

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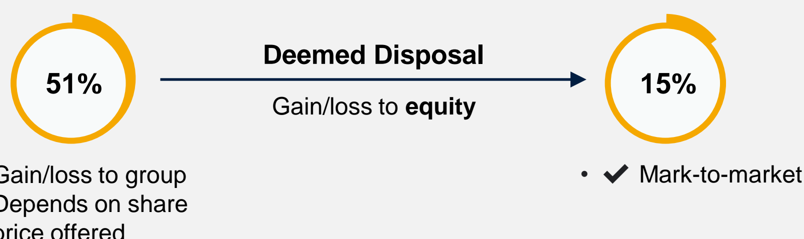
# Listing of a subsidiary and its impact to the holding company (cont.)

**Scenario 2:** Where the group cedes control of the subsidiary
*For example, the Group retains only 15% equity interest in the former subsidiary.*




- Gain/loss to group
- Depends on share price offered

- ✔ Mark-to-market

In this scenario, the effect of the dilution is treated very differently from the first scenario. The dilution gain will be reflected in the profit and loss account of the group.

Hence, if the dilution is significant, which is normally the case, the Group will show a significant increase in its profit in the year the IPO takes place.

In addition, the remaining 15% investment in the former subsidiary will be classified as investments in quoted shares and are required to be marked to market. The changes in the market value are taken to the profit or loss account or other comprehensive income depending on the Group's accounting policies. This can cause volatility in the results of the group.

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# Conclusion

There are various issues and challenges affecting an IPO exercise. As companies often invest significant resources into an IPO exercise, it is important that they plan their IPO exercises properly to anticipate these issues and deal with them on a timely and appropriate basis.

Putting in place a competent team of senior management to drive the process and the appointment of competent and experienced professionals will ensure that the process is smooth and successful.

*This article was written by **Lee Kok Wai**, a Partner at Crowe Malaysia PLT. Kok Wai currently heads the Audit and Assurance department. He is directly responsible for the audits of the firm's major clients, which include public-listed companies, multinationals and large SMEs.*

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