Summer **2025**

CapitalQuarter

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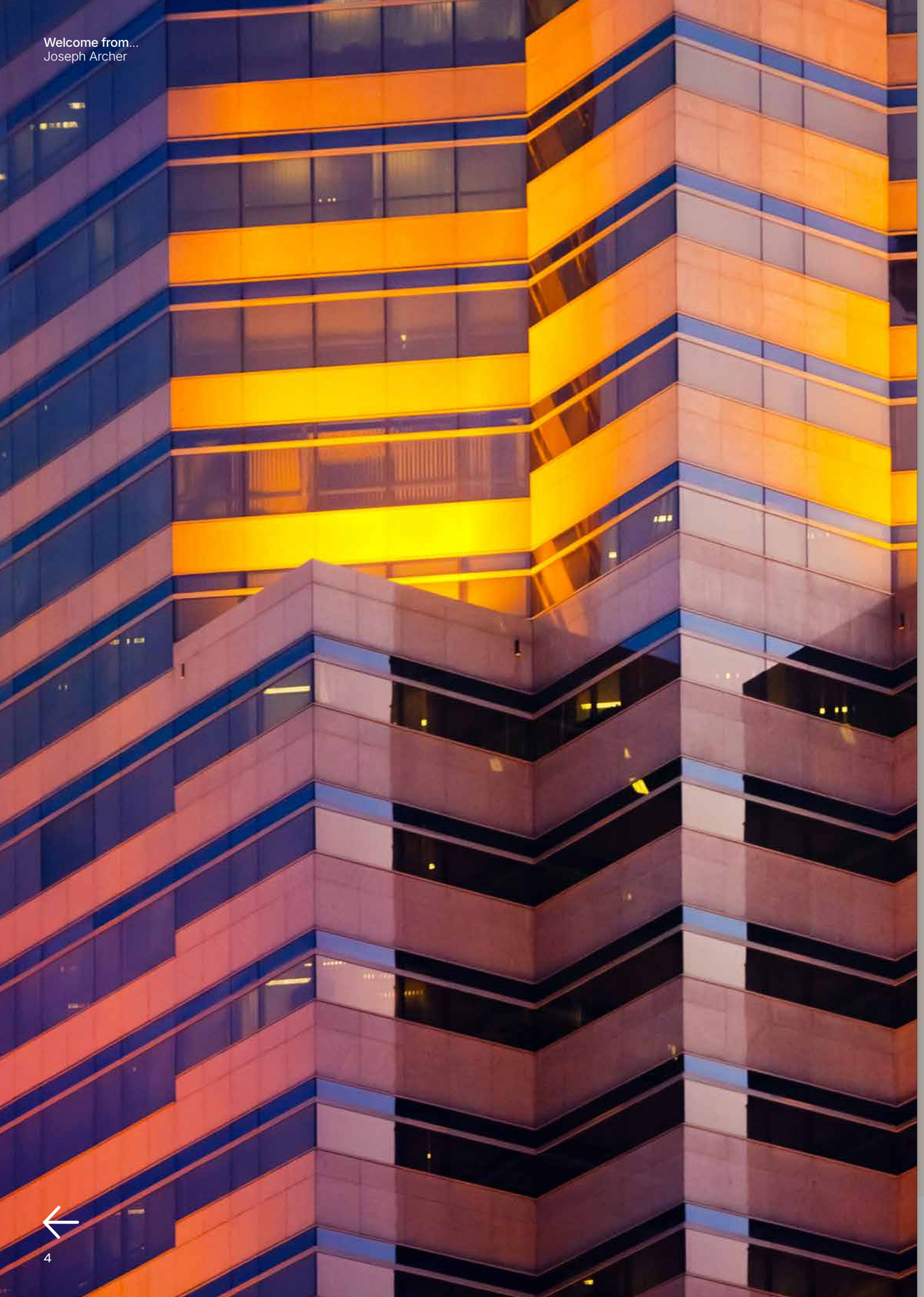


Welcome to the Summer issue of **CapitalQuarter...**

Convertible notes are a common financing tool for entities seeking to fund their operations. Although they bring many benefits, classification and valuation of convertible loans can be complicated. In this edition, we provide a step-by-step guide to what companies need to consider from an accounting perspective when issuing convertible loans. So, what are the tax implications when considering convertible loans notes arrangements? We explain.

Given their ability to enhance internal productivity and help with revenue-generative activities, AI tools and applications are quickly becoming critical strategic assets for organisations. We explore the associated costs and explain how these can be capitalised.

Although AI presents a huge opportunity for organisations to re-design their operations, it also presents challenges when implementing new AI systems whilst ensuring compliance with existing regulations and ethical standards. We look at how to build a tailored AI governance framework to suit your organisation.

Reverse takeovers (RTOs) are common transactions on capital markets, however accounting for them isn't always straightforward. Here we look at the pros and cons of an RTO, and explain the opportunities and challenges they bring.

We hope you find this edition useful. We are always keen to hear your comments and suggestions for future articles, so please do get in touch.

Joseph Archer
Partner

+44 (0)20 7516 2495
jarcher@pkf-l.com

Understanding convertible notes: advantages and accounting

Though they bring many benefits, classification and valuation of convertible loans can be a minefield. We provide a step-by-step guide to what companies need to consider.

Convertible notes are a common financing tool for entities seeking to fund their operations.

A company issues debt to an investor with the option of converting this into equity, usually subject to certain conditions being met.

This gives investors a share in potential equity growth. It also often provides a cash settlement option to protect against downside risks when the conversion is 'out of the money'.

What are the benefits?

For companies, there are a number of key motivations for issuing convertible loans in place of going down the traditional equity/debt route:

1. Flexible financing option

   Convertible notes allow companies, especially those in the start-up or early stage, to raise funding without immediately determining a valuation. We often see these transactions in cash shells, exploration entities and early-stage development companies, where the company's value is expected to increase in the future as the company develops. So there is a built-in incentive to the investor within the conversion element of the convertible note.

2. Deferred equity dilution

   Instead of issuing shares right away, the company delays equity dilution. The loan converts into equity later, typically during a future funding round. This is often at a discount or with a valuation cap, and therefore maintains value to shareholders.

3. Speed and reduced upfront costs

   Convertible notes are generally quicker and cheaper to issue than equity financing. They require less mediation and legal complexity, making them ideal for fast-moving funding rounds.

What are the accounting requirements?

Accounting for convertible notes is a challenging technical process. Because of the complex standard, the variability between agreements, niche terms and required valuation approaches, we often find errors in the classification and valuation of these notes.

Classification:
The Standard states that a convertible instrument is treated as having two components:

1. a liability host; and
2. a conversion feature, which may or may not qualify as equity.

If there are multiple components, they should be analysed individually to decide how to classify them.

Where an entity has a contractual obligation that will or may require settlement in the entity's own equity instruments, the liability classification requirements are different for non-derivatives and derivatives. These are split as follows:

- Non-derivative contracts that involve delivering a variable number of shares are classified as financial liabilities. That's because the company doesn't have control over the number of shares it will issue
- Derivative contracts (such as conversion options in convertible notes) are classified as financial liabilities unless they meet the 'fixed-for-fixed criterion' under IAS 32. If not, they are treated as derivative liabilities.

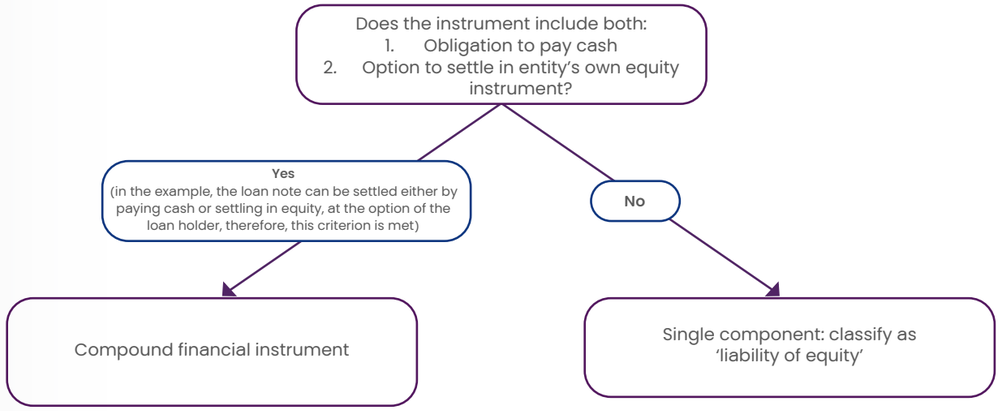
On the other hand, equity instruments are those where the issuer is not obliged to deliver cash or another financial asset, and the settlement involves issuing a fixed number of shares for a fixed amount of cash (referred to as the fixed-for-fixed criterion we mentioned above).

Conversion features in convertible notes (which are often derivatives) can only be classified as equity if they meet the fixed-for-fixed criterion. If not, they are considered derivative liabilities.

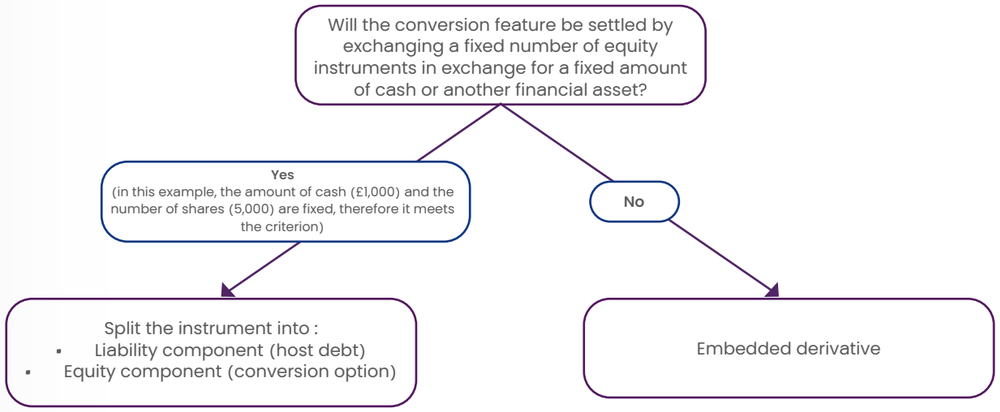
Convertible into a Fixed Number of Shares

Example 1: A UK-based company, Entity A, issues a £1,000 convertible note to fund the development of a new project. The note has a three-year maturity and pays a 10% annual coupon. At maturity, the holder can either receive £1,000 in cash or convert the note into 5,000 shares of Entity A. The market interest rate for a similar non-convertible note would have been 12%. Entity A also incurred £100 in transaction costs.

Step 1 : Identifying the instrument



Step 2 : Assessing fixed-for-fixed criterion



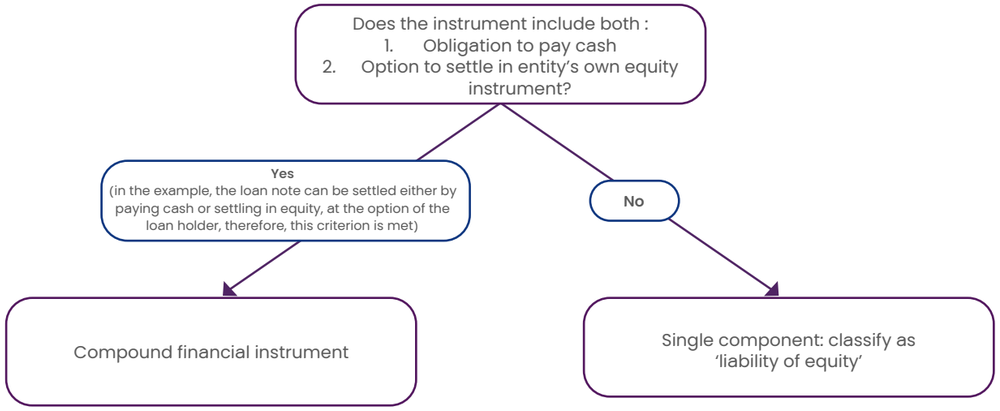
To summarise, the loan is classified as a compound financial instrument with two components:

- *Liability component: the obligation to pay the 10% annual coupon and the £1,000 principal is classified as a liability because Entity A has a contractual obligation to deliver cash.*
- *Equity component: the option to convert the £1,000 into 5,000 shares is classified as equity since it meets the 'fixed-for-fixed' criterion' (a fixed amount of cash is exchanged for a fixed number of shares).*

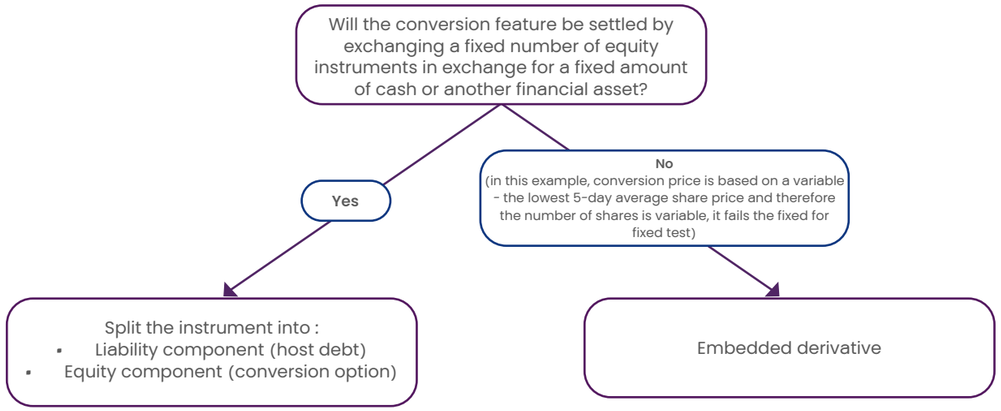
Convertible into a variable number of shares

Example 2: Entity B, another UK company, issues a £1,000 convertible note. The note matures in three years, pays a 10% annual coupon, and allows the holder to convert the note into shares of Entity B. The conversion price is variable, based on the lowest 5-day average share price in the 30 days before conversion. Transaction costs of £100 were incurred.

Step 1 : Identifying the instrument



Step 2: Assessing fixed-for-fixed criterion



To summarise, the above convertible note contains two components:

- *Liability component: the cash repayment of the £1,000 principal and coupon payments is classified as a liability.*
- *Derivative liability component: the conversion option, because it is settled with a variable number of shares - conversion price is based on a variable - the lowest 5-day average share price, which fails the fixed-for-fixed criterion. So the conversion option is classified as a derivative liability rather than equity.*

Measurement Principles:

1. Compound Financial Instrument

For a convertible instrument classified as having both a liability and an equity component, the liability is measured first. This is done by calculating the present value of future cash flows, discounted using the interest rate applicable to an equivalent instrument without the conversion feature (ie a standard loan).

The equity component is the residual value, calculated by subtracting the liability value from the total fair value of the instrument. This approach aligns with the definition of equity as a residual interest.

In most cases, the fair value of the instrument at initial recognition is the transaction price. But if it is quoted in an active market, or issued for non-monetary consideration, then the fair value of the whole instrument may need to be worked out. After initial recognition, the liability is measured at amortised cost, while the equity component is not remeasured.

In Example 1 above, the liability component is initially measured at the present value of the future cash flows, discounted using the market interest rate of 12% (the rate applicable to a non-convertible instrument).

The equity component is measured as the residual amount, calculated by deducting the liability's fair value from the total transaction price (£1,000).

2. Convertible Note with embedded derivative liability

When a convertible note has a conversion feature classified as a derivative liability, this is accounted for separately from the host instrument under IFRS 9. This applies when the economic characteristics of the embedded derivative differ significantly from those of the host debt instrument. Then the derivative must be separated, unless the entire instrument is measured at fair value through profit or loss (FVTPL). In this case, the derivative's fair value is calculated first, with the remaining value assigned to the liability component.

After initial recognition, the derivative liability is measured at fair value through profit or loss, while the host liability is accounted for at amortised cost. Alternatively, under IFRS 9, an entity can choose the fair value option to account for the entire contract at fair value. This simplifies the accounting process but potentially increases volatility in reported profit or loss because of changes in factors like interest rates or the issuer's credit rating.

In Example 2, the conversion feature is classified as a derivative component. It is measured first at its fair value, with the residual value allocated to the host liability. The instrument is subsequently remeasured at fair value at each reporting date.

Should you consider the involvement of valuation experts?

Identifying and measuring the derivative component of a convertible note is usually highly complex. These components are often linked to variables such as share price volatility, foreign exchange movements, and non-standard conversion features, such as down-round protection, caps or floors. All this means they typically require advanced valuation techniques such as Monte Carlo simulations or option pricing models.

These models incorporate a range of inputs, including:

- share price volatility
- risk-free interest rates
- expected life of the instrument
- conversion terms and conditions
- embedded features like anti-dilution clauses.

Given the technical nature of these valuations, we strongly recommend that entities engage qualified valuation experts early in the process. Ideally, this should be at the time the instrument is issued.

As auditors, one of the most common and critical issues we encounter is the misclassification of convertible instruments or lack of involvement of valuation specialists. This can lead to material errors in the financial statements or delays in reporting.

Our valuations team has significant expertise in determining both the classification and the valuation of complex convertible notes. To find out more about how we could support you, please contact our experts.

Cheryl Court
Partner
+44 (0)20 7516 2279
ccourt@pkf-l.com

Lakshmi Upadhyaya
Director
+44 (0)20 7509 6619
lupadhyaya@pkf-l.com

Convertible loan notes: don't forget tax

In this quarter's edition, we've already looked at convertible loan notes (CLNs) from the accounting point of view, but what about the tax implications? Head of Tax, Catherine Heyes explains.

Embedded Derivatives

When a non-derivative contract contains features that function the same way as a derivative, this is known as an 'embedded derivative'. They can be accounted for separately from the host contract under IFRS 9. See our first article on CLNs. This can be known as bifurcation.

Loan relationships may contain embedded derivatives. Convertible and exchangeable securities are the most common ones. If a security can be converted into shares of the issuing company, or exchanged for shares in another company, it has the feature of both debt and equity. The tax implications depend on the accounting treatment.

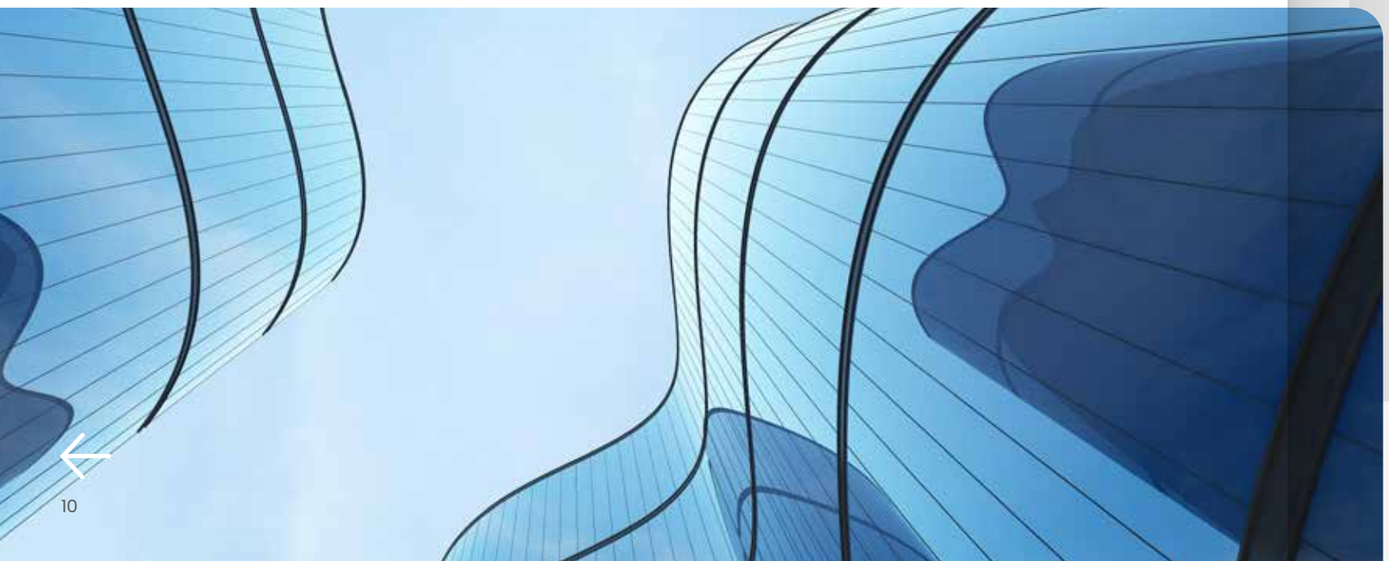
Special rules

For debtor loan relationships which are bifurcated in a company's accounts, special rules apply. Where an embedded derivative is treated as an equity instrument in the company's accounts, the equity instrument is disregarded for tax purposes.

But tax relief can still be obtained for the discount recognised in respect of the host contract. It's also possible for a company to obtain relief as a capital loss, where it redeems a convertible security at a premium.

Where the embedded derivative is treated as an option in a company's accounts, profits or losses which the company recognises can, in certain circumstances, be disregarded.

Instead, the gain or loss arising on the embedded derivative is determined when the company ceases to be a party to the loan relationship. In the case of a convertible security where these provisions apply and conversion takes place, no non-trading credits or debits are recognised in respect of the embedded derivative.



What is the tax treatment for holders?

For companies required to bifurcate under an applicable accounting standard, the host contract is taxed as a loan relationship and the embedded derivative is taxed as if it were a derivative contract.

For companies that don't need to bifurcate, the whole contract, including the embedded derivative, falls within the loan relationship rules. Where there are two or more embedded derivatives of different types, the position is more complicated.

In the financial statements, if an embedded derivative is separated from a loan relationship, the profits and losses arising on the embedded derivative are usually taxed as income.

In some exceptions, the embedded derivative is subject to tax as capital. In particular, for listed companies, these exceptions apply in two cases. Firstly, where it is treated as an option under s.585(3) CTA 2009 in respect of ordinary shares of a listed company. And, secondly, where it is treated as a contract for differences (under the same section of the Act) and is an exactly tracking contract, whose underlying subject matter is ordinary shares of a listed company.

Interest – don't forget withholding tax

Often a CLN will include a provision to accrue interest to the noteholder. If the conversion includes any accrued interest being settled by issuing shares, this constitutes effective payment of the interest.

A UK tax resident company must withhold 20% on payments of interest unless it's possible to reduce this. This means that when payment takes place through a share issue, a dry tax charge may arise for the paying company. Other countries also have withholding tax rules on payments of interest.

It's important to be aware of wider situations related to the 20% withholding:

- No withholding is required on 'short' loans or on payments between UK companies that are UK tax resident or have a UK permanent establishment through which they trade if resident overseas
- Payments made to UK tax resident individuals will always be withheld at 20%
- The 20% rate can be reduced or eliminated where the noteholder is resident in a country which has a suitable Double Taxation Agreement with the UK
- If the CLN is listed on a recognised stock exchange or admitted to a multilateral trading facility it will be exempt from withholding. This can be achieved for example by listing the debt on LSE or the AQSE Main Market. Note that AIM does not qualify for this purpose.

Sometimes a gross-up clause is included in a CLN agreement. This requires interest to be physically paid to the noteholder as if no withholding were applicable. This ensures that the noteholder receives an amount after taxes equivalent to what they would have done if no withholding was imposed.
It's important to consider and discuss this scenario when entering into any agreements, in order to plan cash flow implications.

If you are looking at potential CLN arrangements, or have existing ones that you would like to discuss, please contact our expert.

Catherine Heyes
Partner & Head of Tax

+44 (0)20 7516 2237
cheyes@pkf-l.com

Capitalisation of AI tools

More and more companies are buying and developing software that uses AI tools. We look at the kinds of associated costs and when these can be capitalised in accordance with IAS 38 Intangible Assets.

IAS 38 Intangible Assets provides a comprehensive framework for the recognition, measurement and disclosure of intangible assets. Artificial intelligence (AI) applications and software are an emerging consideration for many companies, and have a multi-faceted impact on the accounting profession.

AI refers to the development of computer systems that can perform tasks that usually require human intelligence, such as learning, problem-solving, and decision-making. It is an overarching term for various technologies that enable machines to simulate human-like cognitive abilities. Core technologies behind AI include:

- Machine learning (ML): algorithms that allow systems to learn from data sets
- Deep learning: a subset of ML using neural networks
- Natural language processing (NLP): enabling machines to understand and subsequently generate human languages
- Computer vision: allowing machines to interpret and process visual information
- Robotics: combining AI with mechanical systems to perform physical tasks.

Given their ability to enhance internal productivity and help with revenue generating activities, and their widespread application in numerous sectors, AI tools and applications are quickly becoming critical strategic assets for organisations.
As the level of investment in AI technologies grows, its impact on accounting is rapidly becoming an area of focus for industry experts and the professional services sector alike.

Research and development phases – what to expect

AI applications and technologies are by their nature equivalent in function to software. This means the general considerations for the appropriateness and capitalisation of software-related costs under IAS 38 are applicable to AI applications and technologies too. So the expenditure must be a directly attributable cost of preparing the software/asset for its intended use by management.

One common pitfall when assessing whether an intangible asset qualifies for initial recognition is when an entity cannot identify when there is an identifiable asset that will generate future economic benefits. Another is the inability to reliably determine costs associated with the asset.

The key here is being able to distinguish between internal costs associated with the development of the AI application and technology, and costs of maintaining the asset or day-to-day operational running costs.

Costs – internally or externally generated?

So which costs incurred for AI technologies can be capitalised? IAS 38 provides guidance that covers both internally and externally generated intangible assets.

The development of AI technologies and applications may involve traditional software development costs (ie internal labour or external developer or contractor costs). But some applications may be more advanced and could incur additional types of cost not previously considered in scope. As well as these costs subject to IAS 38, companies need to carefully consider and identify costs that are tangible in nature. These would be within the remit of ***IAS 16 Property, plant and equipment.***

Where an organisation has or is intending to develop AI applications and technologies, what kind of costs might be incurred? They could include:

- **Software developer costs**
  A mixture of internal labour costs such as employees and other staff, or external subcontractor labour costs related to development of the asset.
- **Data acquisition costs**
  AI technologies are often developed and used to access and process vast amounts of data. Developers will often incur costs to acquire large data reservoirs needed to develop models that perform various NLP tasks.
- **Computational resources**
  AI applications and technologies require computational resources, which can affect costs. These resources include high-performance CPUs (central processing units), GPUs (graphics processing units), or TPUs (tensor processing units) for training and running machine learning models. There are also large-scale storage systems for managing vast datasets. Cloud-based platforms like AWS, Google Cloud, and Azure offer scalable computing options, but costs can accumulate based on usage, especially for tasks like deep learning model training. On-premises infrastructure may involve upfront capital expenditure for servers, cooling systems, and maintenance.
- **Storage costs**
  Given the volume of data needed to train an AI application, entities may incur storage costs. Options range from a lease arrangement for hardware to the purchase of cloud storage services from third party providers.
- **Installation fees**
  The installation costs for AI applications and technologies can vary widely depending on the scale, complexity, and specific use. For SMEs initial costs may include purchasing or subscribing to AI software, acquiring hardware (such as GPUs or edge devices), and integrating the AI system with existing IT infrastructure. For larger enterprises or custom AI solutions, costs can escalate due to the need for specialised development.
- **Configuration costs**
  A critical element of the implementation budget, these costs include the customisation of AI models to suit specific business needs, involving the integration with existing systems, and the setup of data pipelines to ensure high quality input.
- **Testing costs**
  This involves validating the AI system's performance through rigorous trials, which may include simulated environments, A/B testing, and real-world pilot programmes. Expenses can also arise from hiring or contracting data scientists, ML engineers, and quality assurance specialists. Iterative tuning and debugging may also be needed to optimise the model, further increasing costs. These phases are essential to ensure the AI solution functions correctly before full-scale deployment.
  There could also be identified inefficiencies and preliminary operating losses before the strategic asset achieves planned performance.
- **Staff training**
  There will be costs associated with staff training in order to use the strategic asset effectively.

Research phase

Under IAS 38, to assess whether an internally generated asset meets the criteria for recognition, an entity must classify the generation of the asset into a research phase and a development phase.

Where an entity cannot easily separate the research phase and development phase of a project to generate an intangible asset, all expenditure is classified under the research phase only.

All expenditure incurred in the research phase of an internal AI application or technology project is expensed and charged through the statement of comprehensive income. This treatment under IAS 38 is driven by the idea that future economic benefits from a project in the research stage cannot yet be readily demonstrated because of uncertainties.

But AI projects often take longer than other software projects to demonstrate future economic benefits, given the greater risks surrounding a successful outcome. So while each project is different in scope and duration, AI-related projects are usually expected to have extended research phases compared to other intangible assets.

At the end of the planning phase and start of development, companies must carefully track and record all internal and external costs associated with building the AI system, including new procedures like employee training and time-tracking.

Development phase

Costs arising during the development phase of a project may be capitalised as an intangible asset where an entity can demonstrate all of the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale
- its intention to complete the intangible asset and use or sell it
- its ability to use or sell the intangible asset
- how the intangible asset will generate probable future economic benefits. Among other things, showing the existence of a market for the output of the intangible asset or the intangible asset itself or, if to be used internally, the usefulness of the intangible asset
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset, ie a technical business plan or a lender's indication of its willingness to fund a plan
- its ability to measure the expenditure attributable to the intangible asset during its development.

To work out whether an asset will generate probable future economic benefits, an organisation must apply the principles set out in ***IAS 36 Impairment of Assets.***

Relevant development activities may include:

- prototype design and testing – developing and refining AI models, algorithms and pilot systems
- AI integration – coding and embedding AI modules into existing platforms
- infrastructure development – building back-end systems to support AI tools
- UI/UX and visualisation – designing interfaces (eg dashboards or chatbots) and visual tools for AI outputs
- data preparation – creating training datasets or synthetic data for model development
- model validation – conducting simulations, stress tests and fine tuning for production readiness and deployment.

For AI-related projects and other intangible assets, the following costs of an internally generated asset cannot be capitalised, so should instead be incurred as expenditure:

- Selling, administrative and other general overhead expenditure
- Identified inefficiencies and initial operating losses
- Expenditure on training staff to operate the asset.

Useful economic life and amortisation

AI applications and related technologies are inherently susceptible to technological obsolescence over a short period of time and therefore should be treated as a finite intangible asset.

The accounting of AI-related intangible assets is based on their 'useful life', as judged by an entity. Any AI-related intangible asset is amortised over its useful life, and that period is reviewed annually by the entity per IAS 38. Amortisation periods are subject to change where the management amends the corresponding accounting estimate under IAS 8. In these cases the amortisation method is adjusted and accounted for prospectively to reflect the newly chosen amortisation period.

It's important to consider a range of factors when assigning an appropriate useful economic life of an AI-related intangible asset. For example:

- How the entity plans to use the asset and whether another team could manage it better
- How long similar assets usually last and what public sources say about their typical lifespan
- Whether the asset might become outdated due to new technology, market changes, or for other reasons
- How stable the industry is and whether demand for the asset's output is changing
- What competitors or new market players might do that could affect the asset's value and other general market trends
- How much maintenance is needed to keep the asset working well and whether the company plans to do it
- How long the organisation can legally use the asset, including lease end dates or other restrictions
- Whether the asset's useful life depends on the life of other assets the company owns.

In the same way as AI applications and technology, software-related intangible assets are susceptible to technological obsolescence and finite useful lives too. Given they are similar in nature to AI applications, they can give entities a steer as to appropriate useful lives for AI-related intangible assets.

Typical economic lives for software range from 3 to 10 years. But it's important to remember that this period may vary depending on the nature of the AI tool, its integration into the business process, and the speed at which underlying models and programmes become outdated.

If you would like further information or advice on any of the issues raised in this article, please contact our experts.

Imogen Massey
Partner

+44 (0)20 7516 2363
imassey@pkf-l.com

Calum McChrystal
Manager

+44 (0)20 7516 2468
cmcchrystal@pkf-l.com

AI: how to build a governance framework

There's no doubt artificial intelligence (AI) brings exciting potential to any organisation. But it's all about balance.

AI presents a huge opportunity for organisations to re-design their operations. As it becomes increasingly integrated into their business, they face the challenge of implementing the new AI systems while ensuring compliance with existing regulations and ethical standards.

But rather than thinking of effective AI governance as just a regulatory hurdle, we see it as a catalyst for innovation. By building trust, ensuring ethical development, mitigating risks, sharing results and raising awareness of the opportunities, good governance provides a solid foundation from which to grasp the benefits it offers us all.

The UK has adopted a principles-based approach to AI regulation, avoiding blanket statutory requirements that might stand in the way of innovation.

The framework relies on existing legislation such as GDPR. It also follows guidance from regulators like the National Cyber Security Centre (NCSC) and the UK's AI regulatory principles outlined in the Government's AI white paper. A UK AI Bill is expected to be published soon.

International standards like ISO 42001 and ISO 42006 also provide valuable frameworks for AI governance. This approach allows AI development to flourish. But it also means maintaining appropriate oversight through sector-specific regulators who enforce guidelines based on established consumer protection and market legislation.

AI governance and oversight – what to consider

Policies and procedures

Effective AI governance begins with robust policy documentation – and this must align with regulatory expectations. Organisations need clear procedures covering data protection and cybersecurity, and continuous monitoring processes.

This includes governance arrangements for effective oversight and risk management that identify both potential risks and benefits of AI implementation. Feedback mechanisms are expected too, so that users can contribute to the continuous improvement of AI systems.

Transparency and accountability

Organisations must communicate clearly about use of AI strategy, explain how data is used, which algorithms are involved, and the purpose of AI operations.

Regular reporting on AI use, data processing practices, and adherence to ethical guidelines, demonstrates accountability and builds trust with stakeholders.

Protecting end user rights

For organisations whose AI systems impact individuals, the priority should be to protect their rights. This means establishing a sound legal basis for data processing. It's also important to comply with GDPR principles such as access to personal data, rectification of inaccuracies, data erasure, and data portability.

Particularly critical are the need for informed consent and the right to explanation, ensuring users understand the logic and consequences of automated decision-making (where applicable).

Information security

The technical foundation of AI governance includes robust access management controls to prevent unauthorised access and data poisoning attacks. Two requirements are having a specific incident response plan to deal with AI-related breaches and comprehensive third-party management for any outsourced AI services.

When it comes to project management, 'privacy by design' principles and data impact assessments should also incorporate the impact of AI on any new or ongoing projects.

User education and awareness

Building AI literacy among users is crucial for successful governance. This means understanding AI technologies, their potential risks and benefits, policy awareness, and recognition of potential bias in AI systems.

Be responsible

Effective AI governance requires a comprehensive approach that balances innovation with responsibility. Organisations must regularly assess whether their risk registers adequately reflect AI-related risks. So it's important that governance frameworks evolve alongside technological developments.

Properly prepared AI governance frameworks allow organisations to benefit from AI while still complying with existing regulations and ethical standards. Only then can they position themselves for success in an AI-driven future while also protecting the interests of all stakeholders.

Please get in touch with our experts if you would like to discuss how we can support you with a tailored AI governance programme to suit your organisation.

Phil Broadbery
Partner

+44 (0)20 7516 2235
pbroadbery@pkf-l.com

Lubna Al-Majeed
Senior Manager

+44 (0)20 7516 2336
lal-majeed@pkf-l.com

Reverse takeovers: are they for you?

Why are RTOs popular in the UK? We look at the opportunities and challenges they bring.

A reverse takeover (RTO) or reverse acquisition is a transaction which often involves a larger, private company acquiring a smaller, publicly listed company as a means of becoming listed itself. RTOs have been common for many years. The reason for this is that shell companies, or special acquisition companies (SPACs), have been required to complete an RTO or similar transaction to maintain their listed status. Conversely, non-listed operating entities have seen SPACs as an easier route to public markets.

But why are they called 'reverse'? Because commercially, the larger entity is initiating the transaction and seeking the listing. So it could be considered the acquirer but legally the smaller entity is paying the consideration and acquiring the shares of the larger entity. Therefore, the legal and commercial 'acquirers' are reversed.

In other words, legally, small guy acquires big guy. In reality (and in accounting terms), big guy acquires small guy.

Why undergo an RTO?

Hopping across the pond, RTOs in the US are often sought by private companies to obtain funding from capital markets quickly, without the need for a formal IPO process.

For better or for worse, in the UK, an RTO transaction frequently triggers the need for readmission of the listed entity to one of the relevant markets (Main Market, AIM or Aquis). It also requires publication of a relevant listing document (prospectus or admission document). In fact the timing, cost and practicalities are often equivalent to the IPO process.

The pros of RTOs

- Coverage of the listed entity – as the entity is already listed, it may have some existing analyst coverage or an investor following.
- Management – the management of the private entity theoretically takes over in the combined entity. But often certain directors in the listed entity are kept on for their skills and knowledge, or their experience with capital markets and the running of a public listed entity.
- Resilience in bear markets – there is some evidence that RTOs remain resilient during bearish market conditions, when IPOs all but cease. When the listed entity has ample cash reserves and limited (or nil) funds are being raised in the transaction, there is a rise in RTO activity.

The cons of RTOs

- Similar burden to an IPO – in the UK, there is usually the same regulatory, time and cost burden as with an IPO. So it may be better to pursue an IPO or create a clean, new Listco.
- Financial or operational past – there may be historical elements of the publicly listed entity that need attention before, at or post completion. Common examples are liabilities, litigation, operational issues and residual or legacy equity instruments or capital restructuring.
- Management – there can be tensions or disagreements between management teams in the process of the RTO. Removing certain directors or other management in the accounting acquiree may not be simple.

RTO accounting

Class tests

An RTO from a UK market perspective is so defined if the transaction produces a fundamental change in its business, board or voting control or if it exceeds 100% in any of the class tests. The class tests are shown below (as defined in Schedule Three of the AIM rules*):

Test name	Test
Gross Assets test	(Gross assets of the subject of the transaction ÷ Gross assets of the listed company) × 100
Profits test	(Profits attributable to the subject of the transactions ÷ Profits of the listed company) × 100
Consideration test	(Consideration for the transaction ÷ Market capitalisation of the listed company) × 100
Gross Capital test	(Gross capital of the subject of the transaction ÷ Gross capital of the listed company) × 100
Turnover test	(Turnover of the subject of the transaction ÷ Turnover of the listed company) × 100

**The Main Market follows the UK Listing Rules (UKLR) which have slightly different definitions and only include three of the class tests (gross assets, consideration and gross capital tests).*

Accounting treatment

There are two key questions in RTO accounting that dictate the relevant accounting treatment:

- Is the entity being acquired a 'business'?
- Which entity is the acquirer for the purposes of accounting?

Both questions seem very basic, but there are certain nuances to consider.

a) Who is the acquirer?

This question is simple from a legal viewpoint. But from an accounting perspective, it must be decided which entity obtains control. In an RTO, the legal acquiree takes control over the legal acquirer (typically through the exchange of shares). Some telltale signs of this are when:

- the owners of the legal acquiree have the largest share of voting rights in the new combined entity
- the management and governance of the new combined entity is performed by the legal acquiree.

The other test is as outlined in the class tests above: a comparison of the size of each entity. In an RTO the legal acquiree is typically larger (revenues, assets, profits) than the legal acquirer.

b) Is the entity a business?

Once the accounting acquirer has been identified, we must determine if the entity being acquired (the accounting acquiree) constitutes a 'business'. Businesses must have inputs, processes to transform those inputs and, ultimately, outputs.

This decision can involve significant judgement. It should include a thorough review of:

- inputs (fixed assets, right of use assets, IP, intangible assets);
- processes (operational, resource management or strategic); and
- outputs (revenue, product or service, investment income).

To determine the entity's status as a business, the concentration test can be applied. If the acquisition passes the test, it's an asset acquisition. If it fails, the decision is whether the acquisition is a business in the prescribed way. To pass the test, substantially all the fair value of the gross assets acquired must be concentrated in a single identifiable asset or a group of similar identifiable assets.

To decide this, you need to ask the following questions:

- Has a single identifiable asset or a group of similar identifiable assets been acquired?
- Is substantially all the fair value of the gross assets acquired concentrated in a single identifiable asset or a group of similar identifiable assets?
- Does the acquired set of activities and assets have outputs?
- If there are no outputs, when is the acquired process considered substantive?
- If there are outputs, when is the acquired process considered substantive?

The accounting acquiree must meet the definition of a 'business' in order to be accounted for as a 'business combination' under IFRS 3 for the RTO.

Otherwise, the acquisition is treated as an asset acquisition, and as a share-based payment under IFRS 2 for the accounting acquirer.

How PKF can help

Although RTOs are common transactions on capital markets, accounting for them isn't straightforward. PKF's Capital Markets team are experts in identifying and accounting for both RTOs and IPOs and can guide you through the process.

To find out more, please contact our experts.

Joseph Baulf
Partner

+44 (0)20 7516 2216
jbaulf@pkf-l.com

Adam Humphreys
Partner

+44 (0)20 7516 2393
ahumphreys@pkf-l.com

Jack Devlin
Manager

+44 (0)20 7516 2405
jdevlin@pkf-l.com

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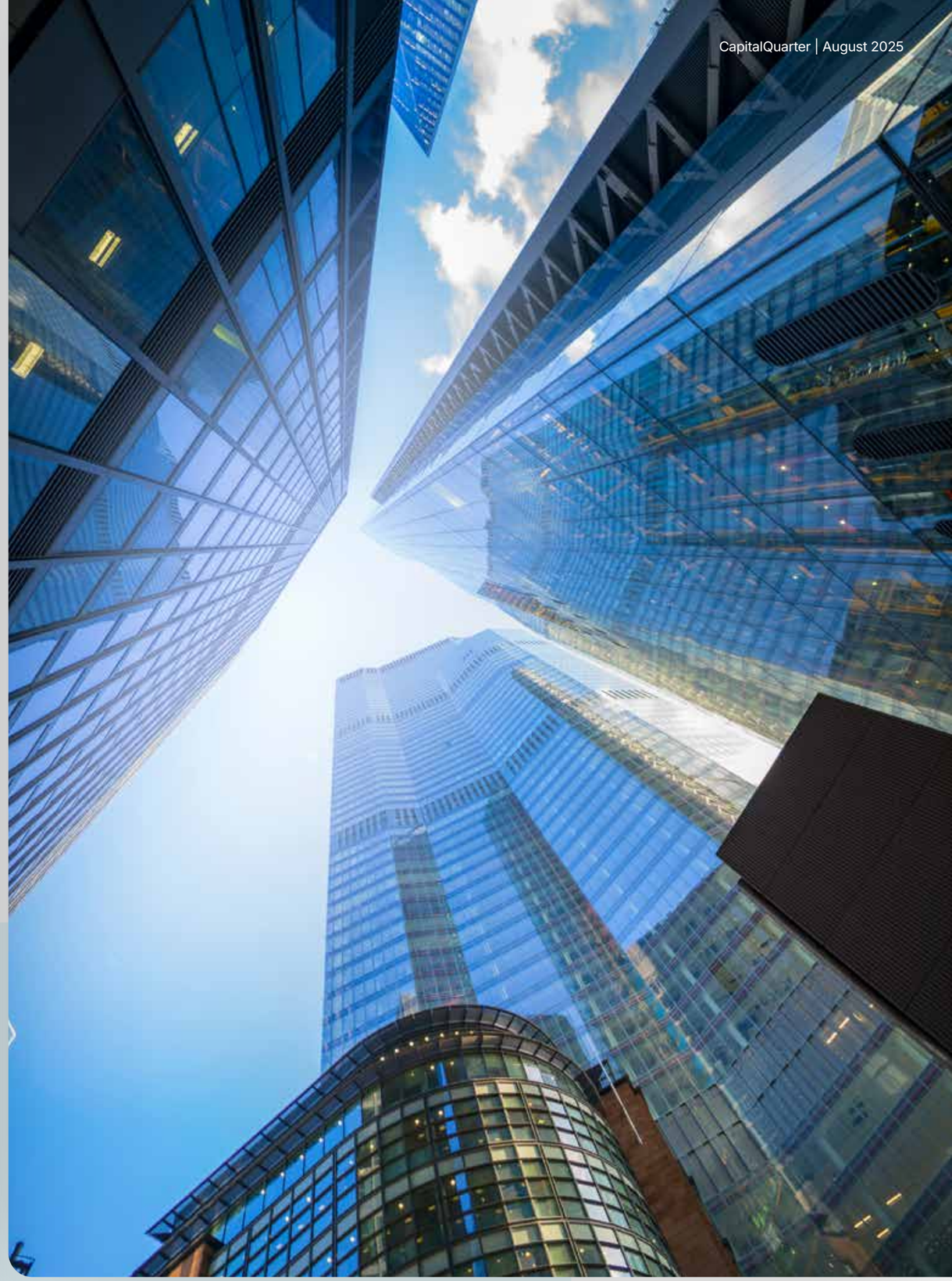

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Get in touch today

To see how we can help...

Joseph Archer
Partner - Capital Markets

+44 (0)20 7516 2495
jarcher@pkf-l.com

Joseph Baulf
Partner - Capital Markets

+44 (0)20 7516 2216
jbaulf@pkf-l.com

Jonathan Bradley-Hoare
Partner - Capital Markets

+44 (0)20 7516 2203
jbradley-hoare@pkf-l.com

Karen Egan
Partner - Capital Markets

+44 (0)20 7516 2248
kegan@pkf-l.com

Adam Humphreys
Partner - Capital Markets

+44 (0)20 7516 2393
ahumphreys@pkf-l.com

Daniel Hutson
Partner - Capital Markets

+44 (0)20 7516 2290
dhutson@pkf-l.com

Nicholas Joel
Partner - Capital Markets

+44 (0)20 7516 2373
njoel@pkf-l.com

Zahir Khaki
Partner - Capital Markets

+44 (0)20 7516 2394
zkhaki@pkf-l.com

Wendy Liang
Partner - Capital Markets

+44 (0)20 7516 2312
wliang@pkf-l.com

Imogen Massey
Partner - Capital Markets

+44 (0)20 7516 2363
imassey@pkf-l.com

Dominic Roberts
Partner - Capital Markets

+44 (0)20 7516 2219
dominicroberts@pkf-l.com

Andrew Simpson
Partner - Capital Markets

+44 (0)20 7516 2200
asimpson@pkf-l.com

Dave Thompson
Partner - Capital Markets

+44 (0)20 7516 2293
dthompson@pkf-l.com

Hannes Verwey
Partner - Capital Markets

+44 (0)20 7516 2313
hverwey@pkf-l.com

Cheryl Court
Partner - Capital Markets

+44 (0)20 7516 2279
ccourt@pkf-l.com

PKF Littlejohn LLP
www.pkf-l.com

London
15 Westferry Circus
Canary Wharf
London E14 4HD
+44 (0)20 7516 2200

Leeds
4th Floor
Kings Court, 12 King St
Leeds LS1 2HL
+44 (0)113 244 5141

Manchester
11 York Street
Manchester M2 2AW
+44 (0)161 552 4220