# Accounting Considerations in IPOs

Laird H. Simons III
Fenwick & West LLP

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# Overview

- Accountant’s Role in Registration Process
- Registrant Financial Requirements
- Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions
- Accounting Hot Buttons
- Accounting Due Diligence
- Miscellaneous Issues

# Accountant's Role in Registration Process

- Bring accountants in early in IPO process
  - Some auditing firms choose not to serve SEC clients
  - PCAOB-registered independent public accountant required to audit registrant
  - Audited financial statements of acquired companies may be needed
  - Revenue recognition, compensation issues, etc.
  - Accounting implications of security being registered

# Accountant's Role in Registration Process (*cont'd*)

- Pre-filing conferences with SEC staff
  - Complexity determines how formal conference has to be
  - Discuss a unique transaction or aggressive position with staff before filing?
    - — SEC protocol for submissions – on SEC website
  - Very reluctant to respond to inquiries on "no names" basis
    - — Non-written = non-binding

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# Accountant's Role in Registration Process (*cont'd*)

- Read S-1, which includes audited financials
  - Consistency with financials?
- Responding to comment letters – accountants should play an active role in drafting responses
  - Generally understand what concerns need to be alleviated or compromises offered
  - Can evaluate the comments to isolate what is really being asked
  - Quality of first response crucial

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# Registrant Financial Requirements

- Registrant financial statements
  - General rule – company must include audited consolidated balance sheets (as of the end of the last two fiscal years) and statements of income, cash flows and changes in stockholders' equity (covering the last three fiscal years), Regulation S-X compliant
    - Exception for "smaller reporting companies" – GAAP (not full Regulation S-X) and need statements covering only last two fiscal years
    - Exception for companies in existence less than one fiscal year - need one "recent" audited balance sheet and audited income/cash flow statements for life of company prior to balance sheet date
    - Exception for filings within 45 days of fiscal year-end, need only unaudited interim financials as recent as end of third quarter
  - General rule – the most recent financial statements must be as of a date within 135 days of filing and effective dates – if not true for audited statements, need interim (stub period) unaudited financials within 135 days
  - Possibly predecessor financial statements
  - Possibly financial statement schedules – included in Item 16 of Part II of Form S-1

# Registrant Financial Requirements *(cont'd)*

- Other registrant financial information
  - Selected financial data
  - Summary financial data
  - Capsule financial information
  - Capitalization
  - Dilution
  - Non-GAAP financial information
  - Management's discussion and analysis ("MD&A")
  - Compensation

# Registrant Financial Requirements *(cont'd)*

- Selected financial data
  - Item 301 of Regulation S-K – highlight trends
  - At least last five fiscal years, plus more recent interims – most recent periods on the right
  - At least the required income statement and balance sheet line items
  - Typically full income statement and additional balance sheet line items
  - Sometimes operating data or non-GAAP financial information
  - Introduction to table indicating sources of data
  - Mention of accounting changes, acquisitions, dispositions, shift in tax status, etc.

# Registrant Financial Requirements (*cont'd*)

- Summary financial data
  - No SEC requirements, but liability constraints
  - Oftentimes mirrors "Selected Financial Data"
  - Can be more abbreviated (e.g., fewer years, fewer line items)
  - Driven by what the underwriters think will best "sell" the company
- Capsule financial information
  - Used shortly after a quarter end

## Registrant Financial Requirements (*cont'd*)

- Capitalization
  - There is no SEC requirement for this section
  - The capitalization table typically includes:
    - Long-term obligations
    - Entire stockholders' equity section
    - Oftentimes cash and cash equivalents
  - Usually at least as much detail as the filed balance sheets and as of most recent balance sheet date
  - Ordinarily three numerical columns (actual, pro forma and pro forma as adjusted)
  - Bullet points on equity that is not shown in table

# Registrant Financial Requirements (*cont'd*)

- Dilution
  - Item 506 of Regulation S-K
  - Two tables
    - First – calculates dilution, the difference between the IPO price and the pro forma net tangible book value (tangible assets less liabilities) per share after the offering
    - Second – shows total shares purchased, total amount paid and average price per share paid by existing stockholders and by new investors
  - Footnote or textual discussion of impact of over-allotment option and/or option and warrant exercises

# Registrant Financial Requirements *(cont'd)*

- Non-GAAP financial information
  - Not popular with the SEC
  - Use heavily conditioned by regulation. Item 10(e) of Regulation S-K
  - Definition – Numerical measure of financial performance, financial position or cash flows that excludes (includes) amounts, or is subject to adjustments that have the effect of excluding (including) amounts, that are included (excluded) in the most directly comparable GAAP financial measure in the financial statements
  - Definition explicitly excludes:
    - — Operating and other statistical measures
    - — Ratios or statistical measures calculated using exclusively one or both of GAAP financial measures and operating measures or other measures that are not non-GAAP financial measures

# Registrant Financial Requirements *(cont'd)*

- Disclosures required if non-GAAP financial measure presented
  - Equally prominent presentation of most directly comparable GAAP financial measure
  - Reconciliation of differences between GAAP and non-GAAP financial measures
  - Reasons why the non-GAAP financial measure is useful to investors
  - Any additional company uses of non-GAAP financial measure

# Registrant Financial Requirements *(cont'd)*

- Prohibitions on registrant use of non-GAAP information
  - Eliminating/smoothing items identified as non-recurring or unusual that have occurred (or are reasonably likely to occur) within two years
  - Including non-GAAP financial measure in GAAP financial statements or notes
  - Including non-GAAP financial measure in Article 11 pro forma financial statements
  - Describing non-GAAP financial measure with a title similar to GAAP measure
  - Excluding charges requiring cash settlement other than in EBIT and EBITDA

# Registrant Financial Requirements *(cont'd)*

- Management's Discussion and Analysis
  - A critical section of analysis written by company, bankers, lawyers and accountants
    - — Identifies what happened in the past and why
    - — Addresses known trends for the future
  - See Item 303 of Regulation S-K and Rule 408 of Regulation C

# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Additional sources
    - — SEC Release 33-6835 (May 18, 1989)
    - — Caterpillar enforcement action
    - — SEC Disclosure Guidance of December 12, 2001 and January 22, 2002 and proposed rules in SEC Release 33-8098 (May 10, 2002)
    - — SEC Release 33-8350 (December 19, 2003)
  - Lead-in regarding forward-looking statements
    - — "Bespeaks caution" doctrine

# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Overview
    - Explains the company's history of operations
    - Explains any unusual events (acquisitions, divestitures, tax status changes, etc.)
    - Addresses significant company or industry issues that may affect financial results
    - Explains how the company derives revenue, defines expense categories
  - Key business metrics
  - Critical accounting policies and estimates

# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Results of operations
    - — Compares stub period results with results for same period of prior year
    - — Compares most recent year-end results with results for prior year
    - — Compares prior year's results with results for year prior to that

# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Results of operations
    - Covers each significant line item
    - Explains reasons for changes (in order of importance) – does not just recite numeric changes.  Requires extensive diligence discussions with the company
    - Addresses changes as a percentage of revenues
    - Addresses known trends and uncertainties

## Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Quarterly results of operations
    - — See Item 302 of Regulation S-K – applies only after company goes public, but typically included in IPO prospectus
    - — Rule requires at least eight quarters of data (each quarter within two most recent fiscal years plus any stub quarters) – bankers and company may choose to present fewer quarters for IPO
    - — Explains significant changes from quarter to quarter and unusual events
    - — Explains trends

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# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Liquidity and capital resources
    - — Addresses sources and uses of cash from operating, investing and financing activities
      - — see company's statement of cash flows
    - — Addresses significant changes in balance sheet items
    - — Addresses future cash commitments and needs and ways to finance them

# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Contractual obligations and commitments
    - — Long-term debt obligations
    - — Capital lease obligations
    - — Operating lease obligations
    - — Purchase obligations
    - — Other long-term liabilities reflected on GAAP balance sheet
  - Off-balance sheet arrangements

# Registrant Financial Requirements (*cont'd*)

- Management's Discussion and Analysis (*cont'd*)
  - Recently issued accounting pronouncements
  - Quantitative and qualitative disclosures about market risk
    - See Item 305 of Regulation S-K
    - Sensitivity to interest rate fluctuations
    - Foreign currency exchange risk
    - Hedging activities

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions

- Acquiree financial statements and pro formas are required where significant businesses have been acquired or where an acquisition is **probable**
- What does "probable" mean?
  - Materiality of transaction becomes a factor
    - "Acquisition is probable where registrant's financial statements alone would not provide adequate financial information to make an investment decision"
  - SEC presumption that even non-binding letters of intent are indicative that a transaction is probable

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Acquiree financial statements and pro formas are required only if the assets acquired are a **business** as defined in Rule 11-01(d) of Regulation S-X (or there is a purchase of an interest in a business accounted for under the equity method)
- The term "business" should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquiree's operations prior to and after the transaction so that disclosure of prior financial information is material to an understanding of future operations
  - Presumption that the following are businesses:
    - — a separate entity
    - — a subsidiary
    - — a division
  - But, lesser components of an entity may constitute a business

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Evaluating a "lesser component"
  - Is component's revenue-producing activity generally the same as before the acquisition
  - Have any of the following attributes remained with the component after the acquisition
    - — Physical facilities
    - — Employee base
    - — Market distribution system
    - — Sales force
    - — Customer base
    - — Operating rights
    - — Production techniques
    - — Trade names

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Pro formas and financial statements are required for **significant** businesses that have been acquired or are probable
- "Significant" means one or more of the following three tests exceeds 20%
  - The asset test
    - — Acquiree's total assets (book value) divided by registrant's consolidated total assets
  - The investment and advances test
    - — Total consideration paid for the acquisition divided by registrant's consolidated total assets
  - The income test
    - — The acquiree's income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle divided by that of the registrant
      - Use absolute values if one entity has a loss and the other does not
      - If registrant's income for last year is at least 10% lower than its average income over the last five fiscal years, then the average may be used. Loss years are treated as zero in averaging

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Largest percentage determines financials required for significant acquisitions
  - Does not exceed 20%
    - Generally no pro formas or financial statements are required (exception if multiple recent "insignificant" acquisitions aggregate to at least 50%)
  - Exceeds 20% but not 40%
    - If the transaction was consummated 75 or more days prior to filing, then acquiree historical financials for last full fiscal year and stub period (for current and prior year) and pro formas for last full fiscal year and stub period (for current year) are required
    - If the transaction was not consummated 75 or more days prior to filing, then no pro formas or financial statements are required
  - Exceeds 40% but not 50%
    - If the transaction was consummated 75 or more days prior to filing, then acquiree historical financials for last two full fiscal years and stub period (for current and prior year) and pro formas for last full fiscal year and stub period (for current year) are required
    - If the transaction was not consummated 75 or more days prior to filing, then no pro formas or financial statements are required
  - Exceeds 50%
    - Acquiree historical financials for last three full fiscal years and stub period (for current and prior year) and pro formas for last full fiscal year and stub period (for current year) are required – limited to two fiscal years if acquiree's revenues under $50 million

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Special significance test for IPOs
  - SAB 80 – the "60/80/90" test
    - Provides an alternative test for IPOs involving a business that has been built by the aggregation of discrete unrelated businesses that remain substantially intact after the acquisition
    - Designed to ensure that there are three years of audited financials for at least 60% of the business, two years for 80% and one year for 90% (significance calculated on pro forma basis)
  - SAB 97 – "put-together" IPOs
    - Where entities are combining at the time of the IPO, significance is based on the accounting acquirer

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# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Pro forma financial statements - acquisitions
  - No pro formas if no acquiree financial statements required
  - Balance sheet as of date of registrant's most recent one
    - Not required if acquisition already reflected in registrant's balance sheet
  - Income statement – most recent fiscal year, and stub period up to most recent pro forma balance sheet (if required)
  - Adjustments – factually supportable items directly attributable to the acquisition

# Pro Forma and Financial Statement Requirements Arising from Acquisitions and Dispositions *(cont'd)*

- Dispositions
  - Tests and results for dispositions are similar but different from acquisitions
  - Financial statements of the business being disposed of are not required, but SFAS 144 (ASC 205-20) requires registrant financial statements to be restated to reflect discontinued operations
  - Pro formas for last full fiscal year and the interim period generally are required if one or more of three tests exceeds 10%

# Accounting Hot Buttons

- Revenue recognition
  - SAB 101/104
    - Customer acceptance
    - Required installation
    - Set-up fees
  - Multiple element arrangements
  - Gross/net
    - Principal/agent
  - Industry specific – software, heavy equipment, telecom

# Accounting Hot Buttons *(cont'd)*

- Common stock option valuation
  - Staff views
    - Best evidence is concurrent common stock transactions
    - Hindsight from IPO price
    - Focus on 12-18 months pre IPO, but not limited to that
    - No set discount (i.e., 90%)
    - Liquidation value unacceptable
  - Accounting
    - No set discount
    - Facts and circumstances evaluation based on stage of business evolution
    - Contemporaneous independent valuations most meaningful absent common stock transactions
  - SFAS 123(R) [ASC 718]
  - AICPA Audit and Accounting Practice Aid (2004) – Valuation of Privately-Held-Company Equity Securities Issued as Compensation
- Goodwill/impairment

# Accounting Due Diligence

- Underwriters have a duty to conduct an independent investigation to verify information
- Accounting due diligence plays key role in underwriters' independent investigation to verify financial statements
  - Discussion with accountants/audit committee
  - Comfort letter
- Accounting fraud is a growing source of litigation
- Purpose behind accounting due diligence
  - Accurate disclosure document – safeguard franchise and avoid risk to reputation
  - Support underwriter due diligence and provide defense if future litigation arises

# Accounting Due Diligence (*cont'd*)

- New dynamics in accounting due diligence
- Effect of major corporate securities scandals in past few years
  - No one has escaped the resulting blame and litigation

    BUT
  - Accountants feel particularly under siege

**Result:**

Accountants are increasingly unwilling to participate in due diligence meetings and render the same forms of comfort letters they historically have

# Accounting Due Diligence *(cont'd)*

- Litigation context as background to risk analysis
- Plaintiffs sue everyone when deals sour
  - Underwriters have historically not asserted claims against accountants based on due diligence meetings or comfort letters
  - Focus instead on shifting blame, finding fault with other defendants
- Underwriters and their counsel try to have a separate discussion with the accountants outside the presence of management
  - **Previously:** accountants would routinely meet with the underwriters without management present
  - **Now:** varied fact patterns
    - — Accountants meet separately with the underwriters
    - — Accountants refuse to meet with the underwriters without management present
    - — Accountants meet with the underwriters provided that management is present but insist that management answers the questions instead
    - — Accountants will not meet with the underwriters at all

# Miscellaneous Issues

- Audit committee diligence
- Lawyer review of financial statements
- Management letters – material weaknesses, significant deficiencies
- Accountants involvement in MD&A
- Use of “plain English” in financial statements
- Comfort letters