Initial Public Offerings:

Considerations for Business Owners and Executives Taking Their Company Public

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ABOUT THE AUTHORS

Joshua Ford Bonnie is a partner in the New York and Washington D.C. offices of the law firm Simpson Thacher & Bartlett LLP. Josh is one of the preeminent IPO lawyers in the nation and regularly counsels public companies on spin-offs and other significant strategic transactions, capital markets offerings and general corporate and securities law matters. Josh has extensive experience with complex IPOs, including those employing UP-C and other multiple-tier umbrella partnership structures.

Mike Gould is a Capital Markets partner and U.S. Public Offerings Leader in the PricewaterhouseCoopers (PwC) Deals Practice. Mike is based in Chicago and has more than 25 years of experience helping his clients access the debt and equity capital markets in the U.S. by providing them with technical and project management advice on accounting and financial reporting issues associated with the SEC registration process, Initial Public Offerings, 144a debt and equity offerings, divestitures and carve-outs. Mike has worked on more than 100 IPOs and similar transactions, for large companies as well as IPOs for smaller and mid-cap privately-held companies for private equity and other sponsors.

Kevin P. Kennedy is a partner in the Palo Alto office of Simpson Thacher & Bartlett LLP, specializing in securities and corporate governance matters. Kevin has served as primary outside counsel for a number of public and private companies and has represented issuers and underwriters in a variety of securities transactions, with a particular focus on initial public offerings. As of the date of this publication, Kevin has acted as primary outside counsel on over 30 successfully completed IPOs.

Meredith Strong is a director in PwC's Transaction Services practice in Silicon Valley, providing capital markets and accounting advisory services to clients, with specialization in the technology sector. Meredith advises clients in connection with various forms of capital markets transactions, including initial public offerings, divestitures, carve-outs and M&A transactions, as well as with continuing registration statements with the SEC. Meredith has helped her clients through many complex accounting and financial reporting matters in anticipation of capital markets transactions and with evaluations of systems and processes required to become a publicly traded company in the United States. Meredith has deep technical accounting and financial reporting knowledge, including the SEC registration process, pro forma financial statements, carve-out accounting, earnings per share computations, stock-based compensation and accounting for business combinations.

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ABOUT PWC

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When you're pursuing an IPO, public debt issuance or another type of capital market event, having an advisor with the right experience and insight can make the difference in helping you achieve your objectives. You can focus on other crucial decisions and be ready when the capital market window opens.

The IPO is a transformational event, requiring many different parts of the business to work together toward a common goal. There will be multiple workstreams, from drafting the registration statement, to preparing and auditing financial information, structuring, creating new governance structures, preparing for the roadshow, and preparing the organization for life as a public company. For many companies this will present a significant cultural shift and adjustment period. As parts of the company start to collaborate on getting ready, management can't allow itself to be distracted from day-to-day operational execution. Improved business fundamentals will improve your chances for a successful transaction.

We advise clients throughout the life cycle of the IPO process, from pre-IPO readiness preparation to the offering process and beyond.

ABOUT SIMPSON THACHER & BARTLETT LLP

Simpson Thacher & Bartlett LLP is widely recognized as one of the world's top law firms. With more than 900 lawyers across eleven offices worldwide, we help our clients address complex matters across the spectrum of corporate and litigation matters.

Having advised on more than 370 IPOs over the past decade, we have unsurpassed experience guiding issuers and underwriters through the process of going public. We have been ranked #1 as counsel to the issuer or underwriters in U.S. IPOs in 10 of the last 11 years and have served as counsel in connection with many of the largest and most complex IPOs in the world, including LINE Corporation (largest U.S. IPO of 2016), First Data (largest U.S. IPO of 2015), Alibaba (the largest IPO in history (2014)), Hilton Worldwide (2nd largest U.S. IPO of 2013), Facebook (largest U.S. IPO of 2012), HCA Holdings (largest U.S. IPO of 2011), Blackstone (largest U.S. IPO of 2007), MasterCard (largest U.S. IPO of 2006) and Google (largest U.S. IPO of 2004).

Clients value our broad expertise in preparing companies, their founders and equity sponsors for their IPOs, navigating the complexities of the offering process and dealing effectively with the myriad issues that arise in public offerings, the stock exchange listing process and issuers' ongoing reporting obligations and investor relations issues. In addition, we have deep experience advising underwriters and benefit from long and established relationships with most of the world's major and mid-market investment banks.

For more information, please visit us at www.simpsonthacher.com.

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I. INTRODUCTION

If you are picking up this book you may be contemplating an initial public offering of your company. The authors have each been advising companies on going (and being) public for decades—Mike and Meredith at PricewaterhouseCoopers (PwC) and Josh and Kevin at a law firm (Simpson Thacher) in New York and Palo Alto, respectively. Over the years we have met with countless business owners and executives who are considering an IPO and have found that they ask many of the same questions regardless of the size of their company or the industry in which it competes.

- What is the basic process for an IPO?
- How long does it take?
- How much does it cost?
- What things should I be thinking about now, when a possible IPO is still a fair way off?
- What kinds of changes to my finance and accounting organization will I need to make?
- What kinds of things does the SEC care about and how can I anticipate these?
- How will my company be valued and how will the stock actually get sold?

We wrote this short book to answer these kinds of questions directly and without a lot of technical jargon.

This book is not, however, a "how to" manual written for other practitioners or a comprehensive survey of the myriad legal and accounting rules that apply. If you choose to move forward with taking your company public, you should engage advisors who have the practical, real world experience to guide you through the thicket. For example, we have not identified the relatively limited number of places where the topics discussed would vary if your company is organized outside of the United States and qualifies as a "foreign private issuer" or if it has annual revenues of less than $50 million (or, as the threshold has recently been proposed to be changed by the SEC, $100 million) and qualifies as a "smaller reporting company". Readers who are nonetheless interested in the detailed nuts and bolts will find that there is already a fairly extensive catalogue of multi-volume treatises out there that have been written covering the technical aspects of the process.

The founders, CEOs, CFOs and GCs who are far enough along in their thinking about an IPO to come in to meet with us are typically quite familiar with the anticipated benefits—enhancing their company's access to capital, providing it with a publicly traded stock that can be used as an acquisition currency and compensation tool, enhancing its brand and market profile and providing a public market valuation and path to liquidity for its owners. On the other hand, and apart from a general understanding that it will result in a lot of additional cost and hassle, we have found that the disadvantages of becoming a public company are frequently more hazy. If only to avoid IPO clients later saying "how could you have let me do this!?", we always go over with them not only the hard dollar costs of becoming and being a public company, but also the less tangible risks that going public could adversely impact the company's culture, distract its leadership from effectively managing to its long-term objectives, decrease the "nimbleness" of its strategic decision-making, expose it to a much greater level of public scrutiny (including heightened attention from regulators and enforced public disclosure of competitively and otherwise sensitive information) and erode its existing owners' control. Public companies here in the United States, and especially newly public companies, are also potentially subject to class action lawsuits (many of dubious merit) if their stock drops. It may reveal an interesting and humorous insight into human nature that this lecture has never once either dissuaded a client from proceeding with an IPO or prevented the very same client from subsequently expressing shock at the consequences.

The "initial public offering" in one form or another has been around since ancient Rome and its development can be traced through the invention of the joint-stock company in 16th century Europe to the introduction of broad corporate limited liability laws in New York in the early 1800s. But one thing about the new issue market has been true throughout its history—it opens and closes sporadically and without much warning. While the IPO market is correlated with demand for equities generally as reflected in the broader stock price indices, it is also uniquely tied to market psychology as to whether new offerings are considered "hot". As you will learn in the following pages, the process of preparing for and executing an IPO typically takes anywhere from 6 months to two years or even longer. Where a company has made the strategic decision to become publicly traded, the standard approach—which the authors endorse—is to move forward with preparations without being distracted by the day to day gyrations of the stock markets so that it is in a position to execute its debut at a time of its choosing when the markets are receptive.

We have tried to distill our experience into straightforward answers to your questions in the following pages—we hope that you find it useful. However, to avoid burying the lede, our principal messages to those contemplating an IPO are:

- start to prepare early;
- engage experienced advisors;
- objectively assess your readiness not only for the IPO process itself (Going Public) but also for life as a public company (Being Public), including the attendant demands on your company's finance organization;
- develop realistic work plans based on that assessment to redress gaps or areas of weakness in addition to the execution of the IPO itself; and
- methodically and efficiently implement these plans.

II. OVERVIEW OF THE IPO PROCESS

A. What are the principal phases of the IPO process? How long does it take?

An IPO may be thought of as having several principal phases—the preparatory period prior to the formal engagement of underwriters and kicking off the transaction, the period between the transaction kick-off and the initial submission of the registration statement to the SEC, the period during which the staff of the SEC reviews the company's registration statement, and the exciting final few weeks where the transaction is launched and marketed to investors and, at the conclusion of the roadshow, priced and the company's stock begins trading.

Pre-transaction preparation. Initially, from six to 18 or even 24 months or more prior to making an initial submission of a registration statement to the SEC, you will prepare for the IPO process and for life as a public company thereafter. One of the most important parts of this preparation will involve beginning to prepare the SEC-compliant financial statements to be included in the IPO registration statement itself and upgrading and enhancing your financial reporting capabilities so as to permit your company to produce SEC-compliant financial reporting on a timely and recurring basis going forward. During this phase, you should evaluate the capabilities and independence of your outside audit firm and assess whether any changes are warranted, and begin to prepare auditor reviewed (albeit not audited) quarterly financial statements in addition to your annual audited statements, if you do not already do so. In addition to your auditors, many companies also engage accounting advisors to help, which we'll discuss in greater detail in Chapter III (Planning Ahead—What Should I Be Thinking About Now?).

The preparation of SEC-compliant financials and the development of the capability to produce these in a timely way going forward is almost without exception always the "longest pole" in the IPO timeline and the area most demanding of the up-front investment of resources. Public company reporting requirements often require an organization to add and retain employees who possess skill sets a private company does not typically have. For example, 78 percent of recently public firms participating in a PwC survey hired between one and five new staff members, specifically to increase their SEC reporting capabilities.

It will also be crucial for you to develop, to the extent that you do not already have it, a robust financial planning and analysis (FP&A) capability. It would be difficult to overemphasize the importance to the IPO process (and to a happy life as a public company thereafter) of being able to produce a reliable financial forecasting model. Chapter IV (Building a Public Company Finance Organization) provides a deeper dive into this most important area.

In addition to building out its finance capabilities, a company preparing for an IPO will often benefit from endeavoring to understand how it will be viewed and valued by the market and prepare itself to be positioned appropriately. You should also think about whether there are changes to your corporate or tax structures or ownership or compensation arrangements that will be desirable or necessitated as a result of the IPO—sometimes it can be less costly to implement these types of changes in advance rather than on the eve of the transaction itself. A company should also evaluate its internal controls and prepare processes and controls to enable public company compliance. Finally, you should also perform the difficult task of taking a fresh look at your company and consider whether you should revisit the historical approaches you have taken to risk and to practices and arrangements that may be less suitable for a public company than a private one. Chapter III (Planning Ahead—What Should I Be Thinking About Now?) discusses in greater detail selected areas that we have found from past experience to be productive objects of focus for companies preparing for an IPO.

Post kick-off/Pre-submission. Two to six months prior to the initial submission of the IPO registration statement to the SEC, you will typically engage underwriters and kick in to high gear preparation of the registration statement itself, including developing and refining the investment thesis for the offering. The preparation of the registration statement, discussed below in somewhat greater length, is a major undertaking, entailing a cooperative effort by the company and its counsel and its auditors working with the lead underwriters and their counsel.

During this phase the lead underwriters and the legal counsels will conduct a thorough review of the company, referred to as a "due diligence" investigation, involving items such as intensive meetings with management and review of the company's legal documentation to background checks on its leadership and calls with a selection of the company's important customers or other counterparties.

The CEO and CFO will also typically have initial meetings with the analysts who cover the company's sector at the lead underwriting firms. The views of the analysts on the company and its industry will not only be an important input into the decision by the "commitment committees" of the underwriting firms to proceed with the transaction and have their firms' names appear in the company's registration statement to be submitted to the SEC, but will also be a critical factor in the success of the offering and subsequent trading as the analysts share these views with investors.

SEC review. Once the registration statement is in shape for SEC review you will submit it to the SEC. “Emerging growth companies”, or EGCs—i.e., companies with total gross revenues of less than $1 billion during their most recently completed fiscal year—may make this submission confidentially. Other companies “unfortunate” enough to have top lines in excess of $1 billion will find their initial submissions publicly available to all on the SEC’s website. The SEC staff will take approximately 30 days to perform their initial review of the registration statement and issue their initial comment letter (although it’s worth giving a shout out to the SEC staff here because, unlike government reviews in some other contexts, they really try to adhere to a 30-day time frame or even a few days less than that).

> An “emerging growth company” is any issuer that had total annual gross revenues of less than $1 billion (adjusted for inflation every five years) during its most recently completed fiscal year. A company that is an emerging growth company on the first day of its fiscal year will no longer qualify as an emerging growth company upon the earliest of:
>
> - the last day of its fiscal year following the fifth anniversary of the first sale of its common equity securities in a public offering;
> - the last day of a fiscal year during which it had total annual gross revenues of $1 billion (adjusted for inflation every five years);
> - the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or
> - the date on which it is deemed to be a “large accelerated filer” (a company that has been public for at least twelve months, has filed one Form 10-K, and has a public float of at least $700 million).

Following receipt of the initial SEC staff comment letter, you will respond by resubmitting your registration statement, revised to reflect the SEC staff’s comments and accompanied by your own letter (politely!) explaining your responses to each of the staff ’s comments. In an IPO there will typically be several rounds of SEC staff comments and resubmissions of the registration statement in response thereto, with the overall time required for this phase taking from two-and-a-half to four months, or even longer if problematic SEC staff comments are encountered or if the company lollygags in moving forward. Chapter V (Dealing with the SEC) provides a more in-depth look at the SEC review process.

During the SEC review period, you and the underwriters (and your respective counsels) will work on the presentation to be used during the “roadshow” described below. It is also during the SEC review period that you, with the assistance of the investment bankers at the lead underwriters, will refine your financial model and then separately conduct more intensive meetings with the underwriting firms’ analysts. Informed by the company’s model, these analysts will build their own financial models that will form the basis for their views on valuation and their future research coverage following completion of the IPO.

During this phase your counsel will also typically prepare and submit the company's application to list on the relevant stock exchange, with the listing process thereafter proceeding in parallel with the SEC review process. Generally speaking, the stock exchange listing process is much less onerous than the SEC review process. The major stock exchanges compete vigorously for listings and are keen to make the listing process as efficient as it can be. Your counsel will also use this time to prepare amendments to the company's organizational documents and plans and policies so that they are appropriate for a public company.

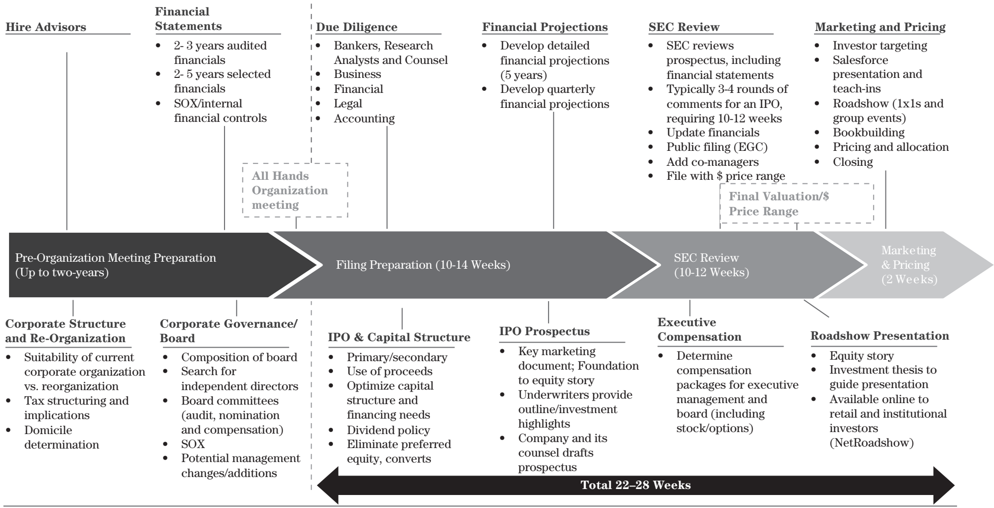
Your and the underwriters' legal counsels will also prepare the form of the underwriting agreement, which is the relatively standardized contract between the underwriters, the company and any selling stockholders whereby the underwriters actually agree to buy the stock being sold. The underwriting agreement is only executed at the time of the pricing of the offering following the conclusion of the roadshow. It's an odd aspect of these transactions that a working group can work together for months and even years without any form of written agreement between the parties. A multi-year IPO that doesn't price will almost universally result in all of the parties retreating to their corners to lick their respective wounds—and paying all of their own respective expenses. It is only when the transaction actually prices that there is a contract between you and the underwriters setting out your obligations to pay and indemnify each other.

During this phase your auditors will also work with the underwriters' counsel to prepare the form of "comfort letter" that the auditors will deliver to the underwriters. A comfort letter is a letter that is delivered by the auditors to the underwriters (and typically also is addressed to the company's board of directors) that confirms matters relating to the financial statements themselves and also addresses specified financial information that appears in the registration statement outside of the financial statements. So, for example, a statement in the MD&A saying that your revenue increased 15% year-over year wouldn't technically be "in" the financial statements but it is derived from them, and so the underwriters would get "comfort" on that number from the accountants through having that number referenced in the letter. Typically, two comfort letters are issued to the underwriters—one at the time the underwriting agreement is signed (generally the pricing date), and one (an updated letter or "bring-down letter") at the closing date.

Marketing and pricing. Once the company has largely (if not entirely) cleared the SEC staff comments, it is in a position to commence the active marketing of the IPO, which typically starts with meetings with the sales forces of the lead underwriting firms and is followed by at least a week-and-a-half roadshow where company management (typically the CEO and the CFO and, if multiple roadshow teams will be deployed, other senior members of management), accompanied by the lead underwriters, meet with prospective investors in cities throughout the United States and also sometimes internationally. A recorded version of the roadshow presentation is also ordinarily made publicly available on the internet at retailroadshow.com, a website that has specialized bells and whistles that enables it to comply with the applicable SEC rules.

Note that if the company has availed itself of the ability to submit its registration statement to the SEC staff on a confidential basis, the registration statement must have been publicly filed at least 15 days prior to the commencement of the roadshow. Typically, on the day that the roadshow concludes, your counsel arranges for the registration statement to be declared “effective” by the SEC and, after the market close on that date, the IPO will be priced and the company will enter into the underwriting agreement with the underwriters. On the following trading day the company’s stock will open for trading on the relevant stock exchange and your life as a public company will begin. Several trading days thereafter the IPO will close, with the stock being delivered to the underwriters in exchange for the offering proceeds, net of underwriting discounts. Chapter VI (Marketing and Distribution) describes in greater detail the process by which the company is valued and the stock is sold.

Illustrative IPO timeline overview



Source: PwC

B. What goes in the registration statement? What financial statements are required?

In the United States, the basic regulatory framework governing IPOs has been in place since the early 1930s, when Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 in reaction to the stock market crash of 1929. The Securities Act and the Exchange Act to this day continue to undergird the process by which companies conduct public offerings of their securities and provide ongoing public reporting thereafter. The Securities Act requires a company to file a registration statement with the SEC, and have that registration statement be declared "effective" by the SEC, prior to its shares being publicly distributed in the United States for the first time.

The far and away most common type of registration statement for an IPO in the United States is Form S-1. (While real estate investment trusts use Form S-11 and most non-Canadian foreign companies use Form F-1 (there being special forms available to certain Canadian companies), the basic concepts are the same.) The applicable SEC form specifies the information that must be included in the registration statement and refers to specific SEC regulations (Regulation S-K and Regulation S-X) that provide instructions on what information must be presented and how.

You will almost certainly have looked at the IPO registration statements (or the "prospectus" that constitutes the most important part of these filings) of other companies in your industry before having gotten so far as reading this book—and if you have not you are encouraged to do so! We will not go through chapter and verse on the specific requirements for the content of the registration statement, but suffice it to say that the registration statement is intended to be a comprehensive narrative document prepared in plain English that gives investors a balanced view of the company ("balance" being an incredibly important concept to the SEC staff—a prospectus that is filled with only sunshine and light has a very long review in front of it). In addition to describing the terms of the offering itself, it includes financial statements and a discussion and analysis of the company's results of operations and financial condition, a description of the company's business, disclosure regarding the material risks relating to the company's business and an investment in its stock and information relating to the company's directors and executive officers and significant stockholders. Although the rules can be quite technical, you should assume that the registration statement will be required to disclose any dealings in which the company is a participant that also directly or indirectly involve any its directors, officers or significant stockholders.

The SEC also has specific and sometimes complex rules regarding the content and age of the financial statements that must be presented in a registration statement. In a Form S-1 registration statement, a company must generally present:

- *Audited balance sheets* as of the end of the two most recent fiscal years. The latest audited financial statements cannot be more than one year and 45 days old at the date the registration statement becomes effective.
- *Audited statements of income*, *cash flows*, *and changes in shareholders' equity* for each of the past three fiscal years. EGCs may present such information for two years only.
- *Interim financial statements* are required if the fiscal year-end financial statements are more than 134 days old, except for third-quarter financial statements, which are timely in an IPO only through the 45th day after the most recent fiscal year end. After the 45th day, audited financial statements for the most recently-complete fiscal year must be included. (This is the reason why there is typically a dead period for IPOs each year starting in the middle-of February until the second half of March.) Interim financial statements can be presented in a condensed format and generally are not audited. However, a review of the interim financial statements is typically performed by the company's independent auditors.

- *Selected financial information* (summarized from the balance sheets and income statements) for the past five fiscal years. EGCs need not present selected financial data for any period prior to the earliest audited period presented.

Audited Financial Statement Requirements	**Form S-1**	**Form S-1 (for EGCs)**
Income statement	3 years	2 years
Balance sheet	2 years	2 years
Statement of cash flows	3 years	2 years
Statement of shareholders equity	3 years	2 years
Earnings per share	3 years (corresponding to income statement)	2 years (corresponding to income statement)

One question that is frequently asked is—"do I really have to go back and audit 'Year A' for purposes of including it in the initial submission of the registration statement when the requirement to include 'Year A' is going to roll off due to the eventual inclusion of 'Year C' or 'Year D' prior to the registration statement actually being circulated to potential investors or becoming effective?" The frustrating answer, until very recently, has always been "Yes". Except in truly extraordinary and rare circumstances and where the SEC staff has been consulted in advance and agreed to a different approach, each submission of the registration statement has historically needed to include a complete financial presentation as if it were going to be used that very day. However, buried (literally) in the 1,009 page transportation bill which Congress passed, and the President signed, in December of 2015 was a truly wonderful goodie for EGCs. The law now permits an EGC that files a registration statement (or submits a registration statement for confidential review) to omit financial information for otherwise required historical periods if (1) the omitted financial information relates to a historical period that the EGC reasonably believes will not be required to be included in its registration statement at the time of the contemplated offering and (2) prior to the distribution of a preliminary prospectus to investors, the registration statement is amended to include all the required financial information. The SEC has confirmed that this provision permits an EGC to omit not only an earlier year of its own audited annual financial statements from filings or submissions where the requirement to include such year will roll off before the circulation of the preliminary prospectus, but also financial statements of other entities (such as acquired businesses) if it reasonably believes that those financial statements will not be required at the time of the offering. The only sour note is that the SEC has also stated that an EGC may not omit financial statements for an interim period that will be included within required financial statements for a longer interim or annual period at the time of the offering, even though the shorter period will not be presented separately at that time. Unfortunately, this relief is only available at this point to EGCs, so those companies "unfortunate" enough to have more than $1 billion of revenue are still in the old world where every submission of the registration statement is required to have a complete set of audited financials, even if an old year will roll off before the offering actually happens.

In addition to the financial statements of the company itself, separate financial statements of businesses that the company has acquired or is probable to acquire may also be required to be included in the registration statement if the acquisition rises to specified levels of "significance" to the company as measured by the SEC's rules. If required, these separate financial statements will cover from one to three years (or one to two years for EGCs) depending on the "significance" of the acquisition and generally must also be SEC-compliant as to form and content, although the financial statements of a non-public entity need not include public company disclosures, such as segment information, pensions, and earnings per share. While the technicalities of measuring "significance" are beyond the scope of this book, the relevant SEC rules not infrequently produce wildly counter-intuitive outcomes where a relatively small acquisition may be deemed "significant" for purposes of the acquired business financial presentation requirements. Accordingly, this is an area where close consultation with the company's auditors and accounting advisors early in the process is crucial. The requirement to include separate financial statements of acquired and to be acquired businesses can be a major stumbling block in the IPO process, particularly where the acquired businesses do not have financial statements that have been audited by accounting firms that are registered with the Public Company Accounting Oversight Board (PCAOB). It is not at all uncommon for companies to freeze their acquisition activity in the run up to an IPO to avoid the challenges presented by the requirement to present acquired business financial statements.

In addition, the registration statement may be required to include the separate financial statements of "significant" equity investees of the company as of the same dates and for the same periods as the company's financial statements. These financial statements only need to be audited for periods in which the equity investment is deemed to be "significant".

Further, a company may be required to present separate, standalone (unconsolidated) financial statements in instances where restrictions prevent its subsidiaries from freely transferring funds to the company.

The registration statement for an IPO may also be required to, and frequently does, contain "pro forma" financial statements or financial tables, with accompanying footnote disclosure, giving pro forma effect to certain transactions or events as if they had already occurred. While the need for pro forma financial information most obviously occurs in connection with business combinations, the requirement can also arise in other circumstances if pro forma financial information would be material to investors. For example, the use of proceeds from the IPO to repay outstanding debt obligations, the payment of extraordinary dividends, the conversion of debt or preferred stock or other changes in capitalization may necessitate the presentation of pro forma financial information, as could other situations in which the company's historical financial statements are not indicative of the ongoing entity.

The basic guidelines for pro forma adjustments are as follows:

- Balance Sheet: Pro forma presentation should be based on the latest historical balance sheet included in the filing, and presented as if the transaction or transactions being given pro forma effect had occurred on the date of the balance sheet. A pro forma balance sheet is not required if the transaction is already reflected in a historical balance sheet. Pro forma adjustments to the balance sheet must be directly attributable to the transaction or transactions being given pro forma effect and factually supportable.
- Income Statement: Pro forma presentation should be based on the latest fiscal year and latest interim period (and, if you wish, the corresponding interim period from the prior year) included in the filing and presented as if the transaction or transactions being given pro forma effect had occurred on the first date of the earliest pro forma period presented. Pro forma adjustments to the income statement must be directly attributable to the transaction or transactions being given pro forma effect, factually supportable and expected to have ongoing impact.

C. How much does going public cost?

IPOs are expensive. Indeed, it is frequently remarked that the dollars raised in a company's IPO are the most expensive capital it will ever raise. There are significant costs relating to the transaction itself, as well as incremental costs to operate as a public company going forward. The following chart provides a summary of the different types of costs associated with going public and being a public company:

<table>
<tr><th>Going public</th><th>Being public</th></tr>
<tr><td>Directly attributable to the offering (reported as netted against gross proceeds)
Underwriter discount, which based on public registration statements, results in fees equal to 4%-7% of gross proceeds for most average sized offerings
Legal, accounting and printing fees associated with drafting the registration statement and comfort letter
Roadshow expenses
Excluding the underwriter discount, on average companies incur $3.9 million of costs directly attributable to their IPO</td><td>One-time costs to convert the organization to a public company (expensed as incurred)
Costs to implement new financial reporting systems and processes
Initial costs to document internal controls and comply with SOX
Costs to identify and recruit a new board of directors
Costs to implement new executive and employee compensation plans
Typically, PwC estimates companies incur more than $1 million of one-time costs to convert their organization to a public company</td></tr>
<tr><td>Other incremental organizational costs (expensed as incurred)
Tax and legal entity restructuring costs in anticipation of the IPO
Additional audit, interim/quarterly review costs, advisory accounting and other costs to make the financial statements S-X compliant
Valuation reports
Costs to draft new articles of incorporation, audit committee charter, by-laws and other agreements</td><td>Recurring incremental costs of being a public company (expensed as incurred)
Incremental internal staffing costs (accounting, tax, legal, human resources, technology, internal audit and investor relations)
Professional fees for legal and accounting advice
Based on PwC survey results, approximately 60% of respondents spent more than $1 million on annually recurring costs as a result of being public</td></tr>
</table>

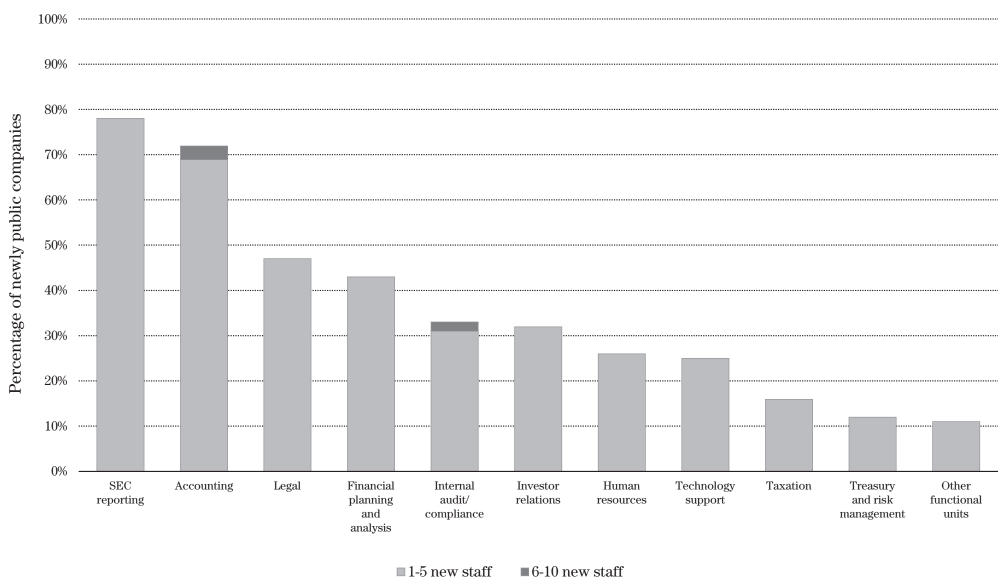
Transaction-related costs. The largest transaction cost is typically the underwriting discount (i.e., the difference between the amount the underwriters pay for the stock being sold and the initial public offering price at which they sell this stock to investors), which is borne by the company in a primary offering and typically borne by selling stockholders in a secondary offering where they are the ones receiving the proceeds. The underwriting discount is almost always calculated as a percentage of the gross proceeds and typically ranges from 5.5 percent to 7 percent (with 7 percent being the norm for average-sized IPOs) but may be a lower percentage in the case of large offerings.

The most significant other offering expenses tend to be the cost of the company's outside counsel, its auditors and the cost of the financial printer. The company will also be required to pay a registration fee to the SEC, which is calculated based on the offering size and varies from year to year based on the funding requirements of the SEC, as well as fees to the relevant stock exchange. We note, however, that these non-underwriting discount transaction-related expenses typically range upwards from $3 million in the aggregate and are frequently significantly higher. Offering costs also, perhaps unsurprisingly, tend to be higher for larger offerings and larger companies. In particular, legal and accounting costs, areas where larger companies may face additional complexities in preparing for an IPO, increase significantly for larger companies. Printing costs also trend upward for larger deals, likely as a result of larger filings and demands on printer resources. SEC registration fees also increase in proportion with increases in gross proceeds, but are a relatively minimal cost of an IPO.

Incremental going forward costs. After the IPO, companies incur incremental expenses on an ongoing basis to be a public company, including expanded accounting, investor relations and legal capabilities, higher levels of professional fees for auditors, outside counsel and other advisers, annual stock exchange listing fees, as well as director fees and directors' and officers' insurance coverage.

Additional staff requirements account for a significant portion of the cost differential between public and private companies. Accounting, legal, financial planning and analysis, and internal audit and compliance departments within public companies often have to hire staff to acquire new capabilities, according to PwC's survey (see figure below). Other areas where newly public companies may need to hire people include investor relations, human resources, technology, taxation, and treasury and risk management. While the actual costs incurred are highly dependent on the size and complexity of the company and the expertise of its existing personnel, it is clear that the costs of these additional hires can add up quickly.

Functional areas where newly public companies need to add staff



Source: PwC/Oxford Economics Survey

D. How do I select lead underwriters?

A private company that is viewed as an attractive IPO candidate is usually already being called on by coverage bankers at investment banking firms. Investment banks in fact devote an incredible amount of resources to finding and cultivating pre-IPO companies. The idea being that if a company has a long-standing and close relationship with a particular banker and his or her firm, that may well be enough to ensure that bank a seat at the table. But sadly for most investment banks, being the first doesn't necessarily mean being alone. In fact, it is not uncommon for even very small IPOs to have more than one lead underwriter, and this has become almost ubiquitous in large transactions. The idea from the company's perspective is that, since the banks will just share the gross spread, it won't cost you any more to add another bank (and it may in fact help you foster stronger ties to multiple banks and to their research analysts).

So how should you go about selecting these banks? Without wishing to be overly dramatic, the lead underwriters are highly significant to the ultimate success of the IPO. In addition to taking a guiding role in the overall process and, most importantly, actually selling the stock, they will provide insights into how investors will view the company and its industry and how the company should best be positioned, guide the company in crafting and communicating its investment thesis and structuring the offering, assess investor demand and provide recommendations on valuation. Given this critical and multifaceted role, it is not surprising that companies will often interview a number of banks before selecting the leads. In addition to considering the institutional and personal relationships they have with the banks and bankers and these institutions' reputations and track record successfully lead managing other IPOs in the sector, companies will focus intently on the quality and views of the banks' analysts, their familiarity with the company and its industry and their ideas for how the company can be best positioned to achieve a favorable valuation. You should also pay attention to the percentage of deals the lead manager launches that actually price. Not all investment banks are equal in this regard—not by a long shot. Finally, if the company has other financing needs you should also consider what institutions are able to be helpful in this area as well. For example, it may be possible for your company to refinance its bank debt or bonds on favorable terms in connection with the IPO.

Preparing to engage investment banks—Underwriter selection criteria

Sector Expertise and Track Record	• IPO experience and expertise, particularly in the sector • Number of IPOs worked on in a senior capacity—deals where bank took a lead role particularly relevant • Track record of successful tactical leadership
Research Capability	• Respected research analysts in the sector and market • Clear understanding of the value drivers and peer group differentiation • Credibility of valuation methodology
Distribution Capability	• Breadth and depth of relationships with target investor base • Sector market share, generalist sales teams, specialist sales, etc.
Strength of Deal Team	• Experience, quality and senior commitment of overall deal team in the sector and region • Chemistry with, and trust in, the key individuals

Although it is by no means universal, a company pursuing an IPO may also engage an independent capital markets advisor to assist it in selecting and awarding roles and economics to its underwriters and then guide it in interacting with the underwriters going forward, such as by participating in investor targeting and launch, pricing and allocation decisions. These advisors are typically boutiques that field experienced former equity capital markets (ECM) hands from the major investment banks who will tout their ability to redress the information asymmetry that can arise when the company's management team does not have experience dealing with the equity capital markets and their ability to help the company get more out of its investment banks. In addition to contributing their practical and technical expertise, capital markets advisors can also help mitigate concerns that the investment banks may prioritize the interests of their institutional investor clients over the interests of the company.

E. Do I need to switch my accounting firm?

Although a somewhat awkward topic, the authors have found that CFOs of companies that are not already using one of the "Big Four" firms inevitably ask whether they need to switch accountants if they decide to pursue an IPO.

To start with, let us note that there are hundreds and hundreds of audit firms that are registered with the Public Company Accounting Oversight Board and permitted to audit the financial statements of an SEC-registered company. But let us also say that year in and year out the Big Four firms audit more than 75-80% of all of the companies going public in the United States, a percentage which approaches 90% if you exclude very small transactions. If you add to these the next five or six major accounting firms in terms of IPO experience you will have captured almost the entire IPO market. Simply put, the Big Four firms, plus a select handful of others, audit the vast majority of IPO companies. This means that if you are not using one of these firms your auditor will not have significant experience with the process and may well not have the requisite technical expertise in SEC requirements to effectively advise you on preparing the registration statement and obtaining SEC clearance. Guidance on the identification of potentially sensitive or problematic accounting issues, financial disclosure issues and the overall transparency of financial reporting is particularly important.

You should also ask your underwriters if you have a desire to deviate from the norm here as well, as they may also say that use of a lesser known auditor will adversely impact marketing as certain investors will simply choose to pass. In addition, a number of the bulge bracket investment banks will simply refuse to take a company public unless they are using an independent auditor that they believe has the requisite experience and expertise. We have seen a number of deals derailed by investment banking commitment committees who decided that either the company must re-audit its financials with a new firm or move forward with another investment bank—a frustrating, time-consuming and expensive exercise to say the least. Our own personal view is that it is well, well worth it to engage one of the bigger firms that has the depth of experience, and to bring them on board early enough that they can do at least one if not all of the years of audit that are required to be presented in the registration statement—often this audit can reveal financial reporting issues that must be resolved before the registration statement can be submitted to the SEC. (Although admittedly entirely self-serving to say, Kevin and Josh would also suggest that a similar analysis applies when considering whether to hire new legal counsel—the bottom line is that you will save time and reduce execution risk if you have someone in this role that does it for a living.)

One additional note on the use of an accounting advisory firm. While auditors have always had to be independent of their audit clients, this requirement has been applied more stringently since the passage of the Sarbanes-Oxley Act in 2002. Sarbanes-Oxley, among other things, put in place a number of absolute rules relating to what an audit firm can and cannot do for a client and still be considered "independent". The days when a SWAT team from its accounting firm would parachute in and really do everything for a private company to help it get SEC-compliant financial statements together are long gone. But, the needs that companies have for assistance in this area have actually become even more acute. A company may well have a truly magnificent accounting team but without SEC and transactional-accounting experience they will struggle to do what is needed to get the company through the IPO process and beyond. As a result, it has become increasingly common for companies to seek transaction support and advisory services from a second accounting firm that is not restricted by professional and statutory independence standards. Among other things, an advisory accountant with significant relevant experience can provide project management, advice and assistance with complex financial reporting matters and the design, documentation and testing of internal controls over financial reporting and training of accounting and finance staff.

F. NYSE or Nasdaq?

The vast majority of companies pursuing an IPO in the United States list their stock on either the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq), although there are other venues. Generally, the two exchanges are quite similar. For example, the NYSE and Nasdaq both require that an IPO company satisfy certain earnings, income or market value tests and although historically the NYSE imposed a higher bar on these quantitative requirements it has in recent years lowered the relevant thresholds in order to better compete with Nasdaq for smaller, growth companies. Similarly, while each exchange has its own corporate governance requirements, these requirements, too, have converged over the years and are now fairly similar. Indeed, even the distinctive ticker symbols that used to identify a company as listed on one exchange or the other (four or five letters for Nasdaq versus three or fewer for the NYSE) have fallen by the wayside, with the NYSE listing four letter tickers and Nasdaq shorter ones.

Given the relative convergence of the more concrete distinctions between the two exchanges and the fact that underwriters will typically say that there is not a meaningful marketing impact on the IPO that will result from selecting one versus the other, many companies simply approach it by looking where their comps are listed and doing the same. Nasdaq has traditionally attracted more technology and biotechnology issuers while the NYSE found itself home to more financial, industrial and energy companies. These lines have blurred significantly over the years, but smaller technology companies still tend to gravitate towards Nasdaq and larger financial services firms continue to be largely found on the NYSE. The two exchanges also still do have somewhat different brands, with the NYSE associated more with blue chips and Nasdaq with the technology world, although even here you have seen the NYSE recently attract high profile technology listings while the Nasdaq has induced some old line brand name companies to switch to it. Finally, both exchanges are extremely competitive in seeking to attract new listings and will often enhance their bid for a desirable listing by offering the company ancillary services and marketing spend.

III. PLANNING AHEAD—What should I be thinking about now?

As noted in Chapter 2, companies may take six, twelve, 18 or even 24 or more months to prepare for their IPOs before formally engaging underwriters and kicking off the actual transaction. What are they doing during all this time? And, perhaps more to the point, what should you be doing now if you have the bee in your bonnet that you may be going public at some point in the near or medium term future?

A. Look at your company the way investors will

As discussed in Chapter 6, every company (and we mean every company) that pursues an IPO is going to be compared by analysts and investors with other companies that are already public. As off-putting as this may be for the founders and leadership of a private company that is almost certainly wonderfully unique in many ways, it is a reality. And, rather than fight it, it makes sense to understand it and to the maximum extent possible use this knowledge to take the steps necessary to ensure that your company is positioned correctly.

Think about the different lines of business your company is in—what publicly traded companies are in these or similar areas? How do the research analysts and the investment community value these peers? What metrics are used to evaluate these peers' performance? Are there different peer sets, approaches to valuation and multiples(!) applied to your company's different business lines? By reading the analyst reports on potential peers and even taking the time to meet with investors and analysts and thinking about these questions, you can start to understand how your company will be viewed.

Having done this work, step back and think about how your company looks when viewed in this way. Do you have the ability today to capture and report the metrics that the market is used to seeing? Are you able to isolate information about separate lines of business that are valued differently by the market? If not, does it make sense to rework your internal and even external financial reporting so as to be able to do this? Effecting these types of changes in reporting can take time.

Having accessed the information that will allow you to view your own company like a public market investor, what does this data say? For example, if you will want your company to be viewed as primarily belonging with, and valued like, a particular peer set—is that a true reflection of your company's business? (Everyone involved should want the company to be valued appropriately in its IPO—even without the potential liability that could arise from resulting shareholder lawsuits, there is perhaps nothing more painful for a company that has recently completed an IPO than being revalued downward by the market afterwards.) Are there acquisitions or new products (or, conversely, dispositions or discontinuances) that are on the whiteboard in any event that may make sense to accelerate during this pre-transaction phase in order to bolster the intended investment thesis? As another example, how do your company's results, whether in terms of top line growth or margins or otherwise, compare to the peer set? Do they differ materially and, if so, why? Are there initiatives that may be desirable to undertake now to enhance your company's future relative performance as it will be measured by the market?

Although no one without a deep understanding of your business can predict what specific insights may be gained from going through the exercise of understanding how the market values potential peers and then viewing your own company through the same lens or lenses, it would be quite surprising if such an exercise fails to uncover areas where an investment of your time and attention, and perhaps even dollars, in advance of an IPO will yield attractive returns.

B. Prepare to be a public company

Running a private company with a small number of shareholders or investors can be very different than operating a public company. Private companies often lack a public company finance infrastructure, almost certainly will not have an investor relations capability and may require additional resources within their legal function. They may also need to expand or reconfigure their management team to ensure that they have senior officers with the skill set to interact with public company investors.

During the pre-transaction preparatory phase, you should make yourself aware of the public company requirements to which you will be subjected, and particularly those related to finance and accounting (i.e., public company accounting, internal audit and financial modeling and forecasting) and then evaluate your internal capabilities to identify deficiencies. Some of the key questions to ask include:

- Do we currently have a repeatable monthly and quarterly close process? Do we have the ability to close our books accurately each quarter, and to review and report the results to the public on a timely basis and in accordance with SEC guidelines?
- Do we have a finance department with expertise in SEC accounting and reporting requirements? As we will discuss more in the next chapter, many private companies looking to be public companies have inadequate skill sets within their finance departments and hire additional internal staff in connection with going public.

- Do we have a finance team comfortable preparing forecasts and projections and able to analyze current period results for reporting purposes?
- Do we have a plan to comply with Sarbanes-Oxley requirements? Are our processes and controls adequately documented and tested?
- Does our technology infrastructure adequately support our compliance efforts?

Having performed this IPO readiness assessment, create—and then execute on—a realistic work plan that addresses internal gaps and details necessary internal staff hires. It can take many months to address areas of deficiency or weakness, and you should build in to your plans the time and cost of evaluating and implementing policies, building the necessary infrastructure and making critical hires. Private companies often underestimate the time it takes to get a private business ready to be a public company—a transformation that needs to take place before, not after, the IPO.

C. Revisit risk with a public company mindset

Every company, whether public or private, makes risk management decisions every day. Whether consciously, such as by deciding to undertake an enterprise wide risk assessment exercise, or unconsciously, such as by deciding not to approve the hire of that additional resource in the compliance function. One way or the other, your company has decided what balance to strike in terms of accepting and mitigating risk.

Undertaking an IPO alters a company's risk profile. First, and somewhat self-evidently, a company that has gone public is exposed to entirely new types of risk—SEC enforcement actions, insider trading scandals and stock drop lawsuits, for example. But somewhat less obviously, a company that becomes publicly traded it is likely to find that this changes the cost-benefit equation it has previously used to decide what the right levels of risk appetite and investment in risk mitigation are.

To see why this may be the case, consider a private company that faces an unfortunate regulatory spanking. This is obviously not good, and the company in this hypothetical may be required to pay a fine and potentially be subject to new limitations or constraints on its business as a result. But consider the same circumstances arising in respect of a company that is publicly-traded. This company may be required to publicly disclose to all and sundry the unfortunate event and the fine and other sanctions, potentially impairing its reputation in a way that would not have otherwise been the case, increasing the level of distraction for management and even attracting class action lawsuits if the stock drops as a result of the disclosure or even drops around the same time period for a totally unrelated reason. Moreover, the independent directors of the publicly-traded company may also not be sanguine about these developments. In any event, you can see how the costs to the company of a misstep may be higher following its IPO than would have been the case before. This implies, of course, that the right balance for the company's risk profile also changes.

For this reason, consider conducting a thoughtful assessment of your company's risk exposure during the pre-transaction preparatory phase and identify whether there are areas that should be tightened up. Indeed, putting aside the fact that post-IPO the cost to the company of a misstep can be meaningfully higher, it will make the IPO process itself go more smoothly if you have thoughtfully assessed the risks of your business and consciously decided on the appropriate level of investment in risk mitigation. It can be unpleasant for everyone involved if as part of the IPO due diligence process the company's management appears less than fully conversant with the risks to its business or unable to convincingly articulate its approach to addressing these. Indeed, investors themselves are increasingly focused on how well the companies they invest in manage risk.

A crucial part of any IPO process is deciding if, in fact, you really want to go public at this moment in time. Are the near term risks simply too great and would it make sense for those to be behind you before putting yourself under the harsh spotlight of public reporting? A management team that is about to embark on an ambitious international expansion, for example, may face a significant amount of uncertainty. That is without taking into account the cost and difficulty of penetrating these markets and facing an entirely new set of competitors. Is this really the right time to embark on publicly quarterly reporting? The irony, of course, is that "ambitious international expansion" may be precisely the type of thing IPO investors want to see. Very, very few IPOs are valued based on what the company currently "is" rather than what it may become. Indeed, the ability to convincingly articulate a compelling growth strategy may be a predicate for a company to achieve the valuation it seeks.

D. Consider how you will get to the desired tax and organizational structure

It is far beyond the scope of this book (or, indeed, any book) to discuss the countless factors that may go in to deciding whether this tax structure, or that compensatory arrangement, is the right one for you. What can be said is that it is sometimes more costly (and perhaps even impossible) to effect changes on the eve of an IPO rather than well in advance. For this reason, consider during the preparatory phase whether any significant restructuring will be desirable and then whether any advantage to doing this earlier in the process outweighs any associated disruption or risk of "buyer's remorse" in the event the IPO fails to occur as anticipated. Moreover, the adoption of a complex tax or organizational structure can lead to complex accounting, legal and presentational challenges and may introduce the need to take additional time to educate the SEC staff and the market. We cannot overemphasize the importance of evaluating your tax and organizational structure early in the going public process so that unnecessary costs and delays can be avoided.

E. How many independent directors do I need to have and when? And what makes a director "independent" anyway?

The answer to the first question is "at least three—one at the time of the IPO, a second 90 days later and a third (and possibly even a few more) within a year, but it may be a good thing for marketing to have three identified at the time of the IPO itself". The answer to the second question is "there are a lot of technical rules relating to relationships a potential director can or cannot have with the company, including relationships with companies that do business with the company, so ask your lawyer to vet these issues before asking a new director to join your board". And the answer to the third, unasked, question is "it takes a long time to find good directors so even though you may not want to formally add them to the board until the IPO actually happens, you should at least start thinking about it now." Having thus ensured that we did not bury the lede, we will spend the next few pages going over this in a little more detail—given the number of questions we get on this topic we thought it made sense to fly down to 3,000 feet or so here. Those who are content with the takeaways should feel free to flip ahead since we captured them earlier in this paragraph.

How many independents are needed and when. The general rule for both NYSE- and Nasdaq-listed companies is that a majority of their board must be "independent", and they must have fully independent audit, compensation and nominating committees (although the Nasdaq does not require a separate nominating committee if this function is performed by a majority of the independent directors). However, both exchanges have a transition rule for IPO companies that requires that they have at least one independent director on each of the three requisite committees at the time of the listing, majority independent committees (i.e., at least two independent directors) within 90 days of the listing and only become fully compliant—with a majority independent board and fully independent committees (i.e., at least three independent directors)—within one year after listing.

In addition, there is also an exception for "controlled companies"—companies where a person or group holds a majority of the voting power for the election of directors. A controlled company is only required to comply with the audit committee requirements and accordingly need not have a majority of its board be independent or have a compensation or nominating committee at all. When taken together with the transition rule for IPO companies, this still means that a controlled company that undertakes an IPO must have one independent director at the time of listing, a second 90 days thereafter and a third by the time the first year is up. A company that loses its status as a controlled company (perhaps because its controlling stockholder has sold down below 50%) has the benefit of a one-year transition rule, similar to that available to IPO companies, to come in to compliance.

All this being said about what the requirements are, it is standard operating procedure for underwriters to advise companies they are taking public that it is preferable to be able to disclose to the market at the time of the launch of the marketing for the IPO that the company will have a real audit committee coming out of the gate. Accordingly, it is worth the investment of some time before and during the IPO process to identify at least two or three independent directors. The job of identifying and finding independent directors can be a difficult and time consuming one. In addition to the fact that an audit committee member must meet heightened independence requirements as described below, they must also be "financially literate" and at least one member of the audit committee needs to have real finance and accounting expertise (typically a former public company CFO or partner of an accounting firm). Putting aside the technicalities, one of the independent directors is going to have to be able (and willing!) to serve as the chair of the audit committee, which is a tremendous (and we mean tremendous) amount of work. The audit committee has the critically important but unglamorous job of overseeing the company's financial reporting. (Conversely, at least one of the authors has frequently mused that he would like to come back in his next life as a professional nominating committee member.) And all this is on top of the fact that you want individuals on your board who understand your industry, can add value by bringing useful skills and insights to bear and work constructively with the other board members and management. It also helps if they are not so busy that the occasional special meeting of the board can be scheduled with less than six months advance notice.

What makes a director "independent". The NYSE and Nasdaq both require that public companies that list with them have, with a few exceptions (such as for controlled companies), a majority of independent board members. While the exchanges still have some minor differences in how they define "independence", these standards have converged to the extent that their material provisions are now substantially identical. Both exchanges require the board to determine that the director in question has no relationship with the company that would jeopardize his or her ability to act independently. The NYSE has stated that "as the concern is independence from management, [it] does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding". In addition to this "determination" requirement, both exchanges impose a number of bright line tests that bar a board from determining an individual to be independent—the most important of which being that the board member cannot have been an employee of the company within the past three years and cannot have received compensation from the company (excluding board fees) in excess of $120,000 in any of the last three years. Similar prohibitions apply to the director's immediate family members. The rules also limit how much business the company can do with the board member's employer—designed to

For purposes of the NYSE rules, a director qualifies as "independent" if the board of directors of the company has affirmatively determined that she or he has no material relationship, direct or indirect, with the company. In making this determination, the board of directors should broadly consider all of the relevant facts and circumstances surrounding a director's relationships with the company from the standpoint of the director as well as that of persons or organizations with which the director has an affiliation. The NYSE rules preclude a director from being determined independent if the director or an immediate family member:

- is (or was in the last three fiscal years) an employee of the company (or, in the case of an immediate family member, an executive officer of the company);
- received more than $120,000 per any twelve-month period in the last three fiscal years in direct compensation from the company, other than in director and committee fees or pension or other deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);
- is a current partner of the company's internal or external auditor or was in the last three fiscal years a partner of such firm and personally worked on the company's audit;
- is a current employee of the company's internal or external auditor (and, in the case of an immediate family member, personally works on the company's audit) or was in the last three fiscal years an employee of such firm and personally worked on the company's audit;
- is (or was in the last three fiscal years) an executive officer of a company that has a compensation committee on which any of the company's present executive officers serves or served; or
- is a current employee (or, in the case of an immediate family member, a current executive officer) of another company that makes payments to, or receives payments from, the company for property or services in an amount that exceeds (in any single fiscal year in the last three fiscal years) the greater of $1 million or 2% of such other company's consolidated gross revenues.

avoid the classic “You scratch my back, I’ll scratch yours” problem. To broadly paraphrase Upton Sinclair, it’s difficult to for a director to be independent if his livelihood depends on him not being so.

For purposes of the Nasdaq rules, a director qualifies as “independent” if the board of directors has affirmatively determined that such director has no relationship with the company which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The Nasdaq rules preclude a director from being determined independent if the director or an immediate family member:

- is (or was in the last three fiscal years) an employee of the company (or, in the case of an immediate family member, an executive officer of the company);
- accepted more than $120,000 per any twelve-month period in the last three fiscal years in compensation from the company, other than in director and committee fees, compensation paid to a family member who is an employee (other than an executive officer) of the company or benefits under a tax-qualified retirement plan, or non-discretionary compensation;
- is a current partner of the company’s outside auditor or was in the last three fiscal years a partner or employee of such firm and personally worked on the company’s audit;
- is an executive officer of a company that has a compensation committee on which any of the company’s executive officers served at any time during the last three fiscal years; or
- is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company has made, or from which the company has received, payments for property or services in the current year or any of the past three fiscal years, in an amount that exceeds the greater of 5% of the recipient’s consolidated gross revenues for a particular year or $200,000, other than payments arising solely from investments in the company’s securities or payments under non-discretionary charitable contribution matching programs.

Additional requirements for audit committee members. Audit committee members must qualify under an enhanced independence analysis that imposes additional, stricter independence standards above and beyond those outlined above. So while a board member can be "independent" for purposes of the rules requiring that a company have a majority of independent directors if they receive less than $120,000 in annual compensation from the company, for example, even a single dollar in compensation can disqualify this board member from being deemed independent for purposes of serving on the audit committee. An audit committee member must also not be an "affiliated person" of the company or any of its subsidiaries.

> To be independent for audit committee purposes, a committee member must meet the general NYSE or Nasdaq independence standards for directors described above and also the following additional SEC requirements for audit committee members. SEC rules define an "independent" director, for purposes of serving on an audit committee, as a director who, except in his or her capacity as a director or board committee member: (1) does not accept directly or indirectly any consulting, advisory or other compensatory fee from the company or any of its subsidiaries; and (2) is not an "affiliated person" of the company or any of its subsidiaries. Direct or indirect acceptance of a compensatory fee by a director includes acceptance of such a fee by (1) an entity (a) in which the director is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and (b) that provides accounting, consulting, legal, investment banking or financial advisory services to the company or any of its subsidiaries or (2) a spouse, a minor child or stepchild or a child or stepchild sharing a home with the director.

In addition to these additional independence standards, members of the audit committee must also satisfy the substantive standard that they are "financially literate" (as such qualification is determined by the board). Also, the NYSE requires that at least one member of the audit committee have "accounting or related financial management experience" while the Nasdaq requires that at least one member have "past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities." Under both sets of stock exchange rules, a director who qualifies as an "Audit Committee financial expert" (as defined by the SEC) is presumed to satisfy this financial sophistication requirement—public companies are required to disclose whether they have an "Audit Committee financial expert" and, if not, explain the reasons why not.

Additional requirements for compensation committee members. You might also consider constituting a compensation committee with directors who are "outside directors" for purposes of Section 162(m) of the Internal Revenue Code to enable the committee to approve bonuses and equity-based awards that will qualify as "performance-based compensation" within the meaning of Section 162(m) (assuming the other regulatory requirements under Section 162(m) are met), and thereby exempt such compensation from the $1 million cap on deductible compensation paid to the company's top executives. It can also be helpful if the directors serving on the compensation committee are "non-employee directors" for purposes of Rule 16b-3 under the Exchange Act, and thereby able to exempt equity awards to directors and officers from the short-swing profit recovery provisions of Section 16 of the Exchange Act.

> To qualify as a "outside director", the director cannot:
>
> - Be a current employee of the corporation.
> - Be a former employee who receives compensation for prior service other than benefits under a qualified plan.
> - Be a former officer of the corporation (see Officer).
> - Receive remuneration directly or indirectly from the corporation in any capacity other than as a director.
>
> In addition, certain remuneration received as a director also disqualifies the individual from being an outside director if it is paid in the:
>
> - Current year, to an entity in which the director has a more than 50% ownership interest.
> - Preceding year, to an entity in which the director has a more than 5% but less than 50% ownership interest (unless the remuneration is *de minimis*).
> - Preceding year, to an entity by which the director is employed or self-employed other than as a director (unless the remuneration is *de minimis*).

> A "non-employee director" is a director who:
>
> - is not currently an officer or employee of the issuer or a parent or subsidiary of the issuer;
> - does not receive compensation in excess of the amount that would be required to be disclosed under Item 404(a) of Regulation S-K (currently $120,000), either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director; and
> - does not possess an interest in any other transaction for which disclosure would be required under Item 404(a) of Regulation S-K.

F. Review related party transactions

The SEC requires companies wishing to go public to include a separate section in their registration statement that details the company's transactions involving its related parties. The overarching disclosure rule is relatively simple: provide the details for any transaction in the last three years involving more than $120,000 in which the company is a participant and any director, executive officer or 5% stockholder (or their immediate family members) had or has a direct or indirect material interest. The rule's complexity comes from its exceptions, which go on for several pages, but suffice it to say that if the company is a participant in a transaction in which a director or officer is interested, even indirectly, and involves more than $120,000, you will probably need to disclose it. In addition, you may also need to disclose transactions with your independent directors even if they involve $120,000 or less to the extent that these transactions are considered by the board in determining their independence.

With a few exceptions, the SEC rules do not preclude you from doing whatever you want as long as you lay it all out for investors. Does your CEO personally own your corporate jet and rent it to the company for use by the executive officers? Does your CFO own a business that rents bouncy castles and margarita machines and do you hire his company for your annual office picnic? No problem at all. If it crosses the dollar disclosure threshold (and admittedly we're talking about a lot of margaritas here) just put that in your SEC filings and you are all set. Of course, the reality is that this disclosure regime has a not so subtle objective of eliminating these related party transactions. Many companies decide that they would rather forego these arrangements than have them disclosed in SEC filings and then picked up by the press or become the subject of water cooler conversation in the office. In addition, the existence of these types of arrangements can negatively affect the voting recommendations of proxy advisory firms. If the arrangement looks unusual or off-market, it can garner negative public attention.

However, some things are flat out prohibited whether you disclose them or not. In response to the accounting scandals of the early part of the last decade, Congress passed a law that prohibits public companies from extending credit to their directors and executive officers or arranging for third parties to do this. Previously, it had been quite common for public companies to lend money to their executive officers to either buy company stock or a home in a new city and these loans are still quite common for private companies. Then the WorldCom board decided it would be a good idea to lend its CEO, Bernie Ebbers, $408 million to cover margin calls on loans against his WorldCom stock, which turned out to not be a great investment after all, and the rest is history. One of the bigger traps in preparing to go public relates to the timing of this prohibition. The limitations and restrictions to which public companies are subject typically begin to apply when the company actually sells its stock to public investors. This insider lending prohibition, by contrast, applies from the time of the first public filing of the registration statement. As a result, these arrangements need to be cleaned up before you publicly file with the SEC. Needless to say, it is not a great way to start your life as a public company by getting this wrong.

During the preparatory phase, consider reviewing the transactions and arrangements your company has with management and stockholders and see whether these are compatible with your anticipated future public company disclosures. It may be that some level of disclosure in the IPO registration statement cannot be avoided, given that these disclosure requirements look back three years, but it may be more appealing to be able to say that they were wound up prior to the eve of the IPO. Also, it can frequently take time to unravel arrangements so giving all concerned some runway to do this can make it less painful.

G. Shareholder arrangements

Another area that makes sense to focus on well in advance of an IPO is arrangements with and among the company's shareholders, to be sure that these are not incompatible with the IPO or existence as a public company.

For example, it is standard operating procedure in an IPO for the underwriters to seek to "lock up" all of the pre-IPO shareholders until 180 days following the date of the pricing of the IPO. So called "lock-up letters" are agreements directly between the pre-IPO shareholders and the underwriters whereby the shareholders agree they won't sell their shares, lend them, margin them or really do anything with them that involves putting money in the shareholders' pockets or shifting away from them the economic consequences of ownership of the shares until the lock-up period has expired. Underwriters will frequently express an interest in locking up "all" of the pre-IPO shares if they can. And while in our experience if this is not practicable it need not be a show stopper, the underwriters do have a legitimate concern that it could impede the successful marketing of the offering if IPO investors are not able to be assured that there will not be a large volume of stock from pre-IPO holders being dumped into the market shortly after trading starts. Accordingly, in anticipation of making the IPO process run more smoothly, you may wish to consider whether your arrangements with existing shareholders, including employee shareholders, can be designed in such a way that they will prevent these holders from selling during the anticipated IPO lock-up period and even requiring them to enter into customary lock-up letters directly with the underwriters.

Similarly, and more broadly, it may make sense to take a sweep through all of the shareholder arrangements to identify if there are consent, participation or other rights shareholders have that may directly or indirectly impede the transaction. This need not be an explicit right to consent to or to participate as a seller in an IPO—if a shareholder has the ability to block amendments to charter documents or corporate reorganizations, this may itself effectively give that shareholder hold up value. Even soft items such as governance rights can be a problem. For example, as discussed above, following an IPO a company's board will be required to ultimately have at least three and possibly more independent directors, and it may not be consistent with the anticipated composition of the company's post-IPO board to include designees of smaller shareholders who may have been granted the right to a seat on the board of the company as a private company. Depending on the dynamics, it can be a tricky thing to ask for consents or take rights away from a stockholder on the eve of a transaction, so consider on a case by case basis whether, if your company has afforded shareholders rights that could be problematic, it makes sense to revisit these arrangements in advance.

H. Anti-takeover protections

It is worth considering as part of the lead-up to an IPO whether to implement "anti-takeover" protections that will impede hostile acquirers who may seek to gain control of your company without negotiating with your board. Given that investors may suspect that management is attempting to use such protections to entrench its own position at the expense of shareholders, a company should be thoughtful about its approach to such protections.

A number of devices and protections are available to IPO issuers. The most straightforward, and powerful, anti-takeover protection seen with some level of frequency is a dual-class high vote/low vote structure, which affords the holders of a high vote class of stock (typically selected pre-IPO owners or insiders) with voting power sufficient to control the election of directors even when public investors, who hold a separate low vote class of stock, own a majority of the economic interests in the company. Another such device is a "classified board", which is a board of directors divided into multiple classes (almost always three), each of which serves a staggered multi-year term (almost always three years), which prevents a hostile acquirer from replacing more than a specified percentage (almost always one-third) of the directors at any single annual meeting. The prospect of having to conduct successful proxy fights at two successive annual meetings in order to gain control of a company's board can in and of itself be a significant deterrent to a hostile bidder. In contrast to the use of a high vote/low vote structure, which remains less common outside of specific industries and can attract investor resistance, the significant majority of IPO issuers have classified boards, although among larger publicly traded companies it is becoming increasingly rare for this board structure to be retained over the long-term in the face of high levels of support from shareholders for proposals to declassify boards.

There are also a welter of additional measures that are nearly universally implemented without significant investor resistance. For example, an IPO issuer's certificate of incorporation typically prohibits stockholder action by written consent, which prevents a majority of the shareholders of the company from taking pre-emptive, unilateral action in lieu of a meeting. The certificate will also typically be drafted to include provisions restricting stockholders' ability to call a special stockholders' meeting, thus further inhibiting their ability to take extraordinary action. A company's bylaws will also almost always require timely advance notice to the company from stockholders before such stockholders may nominate new directors or propose other matters for consideration at a shareholders' meeting. A supermajority of shareholders' votes may also be required in order to amend the company's certificate of incorporation or bylaws.

It is also almost universal for IPO issuers to authorize in their certificate of incorporation what is referred to as "blank check" preferred stock, which enables a board to create and issue new series of preferred stock with whatever rights and preferences the board may desire at a given time. The board may use this ability to take certain anti-takeover actions, including the implementation of a stockholder rights plan, or "poison pill", without further stockholder approval. A poison pill generally allows stockholders to purchase a company's common stock at a highly discounted price, triggered upon the acquisition of a large block of stock by a third-party who has not been pre-approved the board, the effect of which is to dilute the third-party's value. In recent years poison pills have become rare in IPO issuers due to the negative reaction they tend to engender among investors and the fact that the board may deploy a poison pill later when needed.

You should also be aware that unless you take affirmative action to opt out, Delaware's anti-takeover statute (section 203 of the Delaware General Corporation Law) will apply to companies incorporated in that state (which is the jurisdiction of most publicly-traded U.S. companies). This statute provides that, subject to certain exceptions specified in the law, a publicly held Delaware corporation may not engage in certain "business combinations" with any "interested stockholder" for three years after the date of the transaction on which the person became an interested stockholder. These provisions generally prohibit or delay the accomplishment of mergers, assets or stock sales or other takeover or change-in-control attempts that are not approved by a company's board of directors. Other states have adopted similar statutes. Some entities, such as companies controlled by financial sponsors, opt out of these anti-takeover statutes to avoid impeding the sponsors' ability to sell off its stake following the IPO.

IV. BUILDING A PUBLIC COMPANY FINANCE ORGANIZATION

The first few quarters of life as a public company are critical. There is uncertainty among investors and analysts because the company is relatively unknown and the consequences of not meeting expectations can be severe. The newly established public company is also unfamiliar with communicating with the investment community about its results and performance. An inability to communicate effectively with analysts and investors to manage expectations in those first few quarters can be damaging to shareholder value and compromise credibility.

As a result, getting the right finance organization, with the right capabilities to deliver quality financial reporting at the right time, is an important factor to a successful IPO and to being public. This is typically achieved by first focusing on reducing the monthly financial close to a reasonable amount of time for a public company and then preparing the quarterly financial information in a timely manner and with the level of detail and accuracy that is expected of a public company.

Questions to ask about your finance organization

- Will we have the time and capacity to focus on ongoing operations and marketing the IPO?
- Are there any data gaps in the financial information?
- Do we have sufficient technical accounting expertise to handle the additional external reporting requirements?
- Do we have sufficient documentation and policies to support external audits?
- Does sufficient reporting exist to form the basis for management's discussion and analysis (MD&A) and the business section?
- Have we identified the accounting implications of any changes to the legal entity structures that may occur prior to the IPO?
- Is our closing process sufficient to support our organization as a public company?
- Can we provide the right information at the right time to investors, regulators, and management?
- Can we accurately forecast and meet budget?

A good IPO plan will identify the critical aspects of the finance function that need to be in place before starting the IPO preparation process, such as the CFO and controllership functions. Others, such as SEC reporting, can be built up during the IPO preparation process, initially relying on external resources and migrating the SEC and external reporting functions to internal personnel as the IPO launch date approaches. The key is getting the appropriate resources in place at the right time without over-investing in making changes before the IPO is certain.

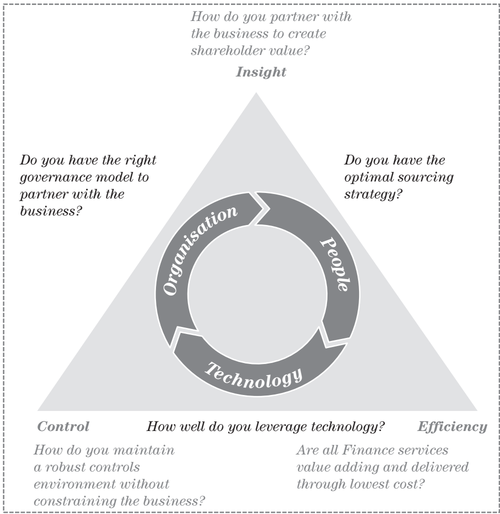
A. What is uniquely different for public company finance functions?

Running a public company finance organization is a delicate balancing act that involves three core roles:

- delivering business insights—provide proactive, insightful decision support;
- maintaining compliance and controls—manage risk and ensure regulatory and control compliance; and
- achieving transaction efficiency—provide efficient transaction processing and reporting.

Finance process framework

PwC Framework for Finance



Finance Processes

Business Insight	**Strategy to Execution** (S2E)	• Strategic Planning • Target Setting • Budgeting and Forecasting • Business Analysis & Reporting
Transaction Efficiency	**Purchase to Pay** (P2P)	• Procurement/Purchasing • Accounts Payable & Outgoing Payments (incl. T&E Accounting)
	Order to Cash (O2C)	• Credit Management • Customer Billing • Accounts Receivable & Incoming Payments
	Record to Report (R2R)	• General Accounting & Sub-ledger close • G/L Close & Consolidation • Reporting & Analysis
Compliance & Control	**Risk, Compliance & Control**	• Treasury • Corporate Tax • Risk Management • Internal Control • Investor Relations

Source: PwC

While the overall responsibilities of the finance organization are largely the same for private and public companies, the specifics will differ, as will the skill sets required to fulfil them. In preparing for the transition, you will need to pay particular attention to the following areas:

- record to report process;
- financial planning and analysis;
- finance structure;
- finance processes and controls;
- finance systems; and
- finance talent.

We will now explore each of these areas in greater detail.

B. Record-to-report process

The most significant change for many companies is the need to close and publicly report their financial results on a rigorous timeline. See Chapter VII (Life as a Public Company) for a discussion of the filing deadlines for a public company's ongoing periodic reports. The inability to meet these requirements can shake investor confidence and potentially prohibit the company from completing capital market transactions while out of compliance. For most private companies, these are changes that take some time to implement.

Common closing and reporting issues for pre-IPO companies include:

- inability to gather data from different business units in a timely fashion;
- poor quality of financial reporting data;
- policies and procedures are inadequate, poorly documented, or not documented at all;
- no formalized process for preparing month-end results;
- overreliance on manual consolidation;
- ongoing need for late adjustments and corrections; and
- lack of resources or inadequate skill sets within finance department, including lack of public company accounting and reporting expertise.

Most companies will need to dramatically accelerate the closing and reporting cycle once they go public, eliminating bottlenecks and waste, simplifying and standardizing processes, sequencing dependent activities, focusing on control and accountability, analyzing and eliminating post-close adjustments, and ensuring first-time accuracy.

In our experience, companies with successful five-day close processes achieve milestones within the following timeframe, using a series of common practices:

Streamline, simplify and standardize processes with a focus on control, accountability and first time accuracy.

Close and consolidation

Leading Practices

Milestone	Work Day[1]
Payroll/AP/fixed assets	-1
Inter-company processing	-1
SG&A accruals	1
Accounts receivable	1-2
Operational costs	2-3
Division sub-ledger close	2-3
Corporate ledger close	3-4
Consolidation activities	4-5
Analytic review	5
Management reporting	6-7

Common Solutions

- Intelligent use of accruals and estimates
- Proactive issue resolution and error correction
- Streamline transaction processes
- Automate or eliminate manual entries
- Eliminate non-value-added activities
- Automate reconciliations
- Eliminate duplicate data entry
- Utilize materiality thresholds
- Distribute workload away from period-end
- Establish governance structure to enforce deadlines and improve accountability
- Publish the closing calendar and track status
- Cross-train finance personnel
- Provide clear and regular communication
- Implement culture of continuous process improvement

[1] *Leading Practice based on PwC experience with successful 5 Day closes at large multi-national companies using legacy financial systems.*

Source: PwC

Eliminate duplication of effort and non-value added activities that do not directly support external reporting requirements or provide effective decision support.

Analysis and Reporting

Leading Practices

Milestone	Work Day[1]
10-Q Draft (w/out final numbers)	-5
Inter-company Eliminations	2-3
Flash Reporting	3-5
Consolidation Activities	4-5
Variance Analysis	5-8
Compile Supplemental Data	10
Disclosures and MD&A	13-15
Sub-certification	17-19
Disclosure Review Committee	20-22
Earnings Release	18-20
SEC Filing	24-28

Common Solutions

- Validate reporting requirements, stakeholder needs and the underlying data structure
- Leverage consolidation tools to automate eliminations, currency translation, top-side adjustments and data capture/promotion
- Automate roll forward analysis and the preparation of cash flow statements
- Run consolidations daily to facilitate flash reporting and support early error identification
- Automate the collection of support material through supplemental accounts
- Standardize monthly variance analysis to identify key business drivers & support MD&A
- Utilize a Controller's Questionnaire to identify disclosures and support sub-certifications
- Leverage reporting tools to automate and standardize segment, regional, legal entity, tax and other internal and external reports

[1] *Leading Practice based on PwC experience with successful 5 Day closes at large multi-national companies using legacy financial systems.*

Source: PwC

Most companies do become more efficient in closing and reporting once they become public as they add resources and standardize processes. For example, one recent survey reported that pre-IPO, 84% of companies took more than 10 calendar days to close a quarter, and 48% were taking more than 16 days. Once public, just half (50%) were taking more than 10 days and just 14% needed more than 16 days. Streamlining the record-to-report process through automation and standardized procedures will free up much-needed staff for other activities.

C. Financial planning and analysis

Financial planning and analysis, or FP&A, includes budgeting/forecasting, target setting and strategic planning, capital investment and risk analysis, and performance measurement.

Budgeting and forecasting, in particular, will become an increasingly important task in your life as a public company. Research analysts rely on this information, and a public company's ability to meet its own earnings estimates and "The Street's" estimates can have a significant impact on its stock performance. Accurate budgeting and forecasting is critical for a successful IPO and for the ongoing life of a public company. Therefore, it is paramount that the company has a well-functioning FP&A team. The FP&A team is responsible for developing realistic budgets and forecasts and must be able to articulate why variances have occurred.

Common FP&A issues for pre-IPO companies include:

- organizational silos that get in the way of collaboration;
- lack of standardized/consistent processes;
- lack of consistent metrics and reports to analyze business results;
- poorly defined budgeting and forecasting materiality levels;
- lengthy budgeting and forecasting cycle time;
- disconnect between strategic plan and operational plan;
- too many people involved in budgeting/forecasting processes;
- limited ability to perform scenario modeling/what-if analysis;
- disintegrated balance sheet and income statement planning; and
- lack of common terminology and hierarchies.

Companies with high-performing FP&A functions often exhibit the following capabilities:

Strategic Planning/ Target-Setting	Capital Investment & Risk Analysis	Budgeting, Forecasting, and Analysis	Value-Based/ Performance Measurement
• Determines critical success factors/value drivers and aligns them with the organization's vision and strategic objectives • Creates joint responsibility between strategic planning and FP&A for the integrity and analysis that supports the strategic plan • Establishes realistic targets for budgeting and forecasting processes; sets targets for key measures of accountability • Mitigates the impact of market and operational risk	• Evaluates capital investment, special projects, and market risk • Analyzes risk scenarios and exposures via modeling, monitoring, and external research • Enables more effective capital allocation and allocation of resources to balance risk appropriately • Evaluates return on investment and results of specific organizational endeavors against the risk involved	• Drives planning activities and processes and supports audits/ performance reviews • Creates responsibility for integrity of reported results and internal management reports • Supports functions related to the investment community (e.g. investor relations, board of directors, etc.), divisions, products, and customer segments as they relate to profitability reporting	• Conducts shareholder value analysis, identifying where value is being created or destroyed • Ensures value-based analysis and monitoring of risk is being used to evaluate current business, new products, and M&A opportunities • Drives performance management (e.g. business intelligence and scorecards) and analytics process across the entire corporation • Monitor key measures of business performance

Source: PwC

D. Finance structure

You may need to make adjustments to the structure of your finance organization in order to streamline processes and increase efficiency, particularly in the external reporting and controllership areas. For transactional-type processes, many high-functioning public finance organizations have adopted shared-services models that centralize these activities internally or with an outsourced third party. Compliance and control activities are also best addressed through centralization so that they can be managed by people with deep functional knowledge of the area.

Activities that involve support for business decisions such as investments, new business ventures, new products, or other general management decisions may call for a more distributed finance organization model in which finance professionals are co-located in the businesses where these decisions are made. The following table depicts the three core roles of the finance organization and the common practices we see public companies follow to structure the organization.

Common Practices of Public Company Finance Organizations

	Insight *Provide proactive, insightful decision support*	**Compliance and Control** *Manage risk and ensure regulatory and control compliance*	**Transaction Processing** *Provide efficient transaction processing and reporting*
Organization Structure	• Organized "By Customer" • Centralized governance • Direct line to Finance and dotted line to business units • Single contact for customer	• Organized "By Product or Service" • Senior level reporting relationships • Small groups, flat span of control • Deep functional knowledge	• Organized "By Activity" • Economies of scale through centralization or shared services • Outsourcing when further savings available and control not sacrificed
Process	• Customized analysis to satisfy customer needs • Standardized and integrated planning and forecasting • Standardized metrics and reporting	• Structured recurring compliance activities • Other value-added activities are more flexible • Involves a high degree of analysis	• Highly standardized • Highly automated • Continuous improvement program
People	• Highly skilled in financial analysis • Deep business knowledge • Strong interpersonal skills	• Deep functional knowledge • Ongoing training to stay current in area of specialization	• Non-automated activities performed by lower-skilled employees • Continuous improvement mindset

	Insight *Provide proactive, insightful decision support*	Compliance and Control *Manage risk and ensure regulatory and control compliance*	Transaction Processing *Provide efficient transaction processing and reporting*
	• Rotated throughout company • Ongoing training to stay current on the industry and analysis tools	• Source additional expertise when not a core competency	• Possible high span of control • Highly cross-trained
Technology	• Automates standard reporting • Supports ad hoc analysis • Performs scenario planning • Integrated financial systems	• Specialty data and analysis • Perform scenario planning • Integrates with overall financial systems	• Automation of high volumes of transactions • Automated, built-in controls • Self-service functionality

Source: PwC

E. Finance processes and controls

Good internal controls are no longer just best practice—Section 404 of Sarbanes-Oxley requires that public companies have in place an internal control framework to prevent and/or detect material misstatements to the financial statements. This control framework should include documentation of the controls, associated policies and procedures that contribute to the control framework and documentation, which can be relied on as part of a validation procedure to ensure that the controls are operating as designed. Sarbanes-Oxley also requires the CEO and CFO to certify in each annual report on Form 10-K and quarterly report on Form 10-Q that:

- the report (10-K or 10-Q) neither contains any untrue statement of a material fact nor omits to state a material fact;
- the financial statements and other information in the report fairly present, in all material respects, the company's financial condition and results of operations;

- disclosure controls and procedures are established and maintained;
- certain disclosures about the company's internal control over financial reporting have been made to the issuer's auditors and the audit committee, including disclosures about significant deficiencies, material weaknesses, and any fraud;
- the report includes information about their conclusion on the effectiveness of disclosure controls and procedures and whether there have been changes in internal control over financial reporting during the most recent period; and
- the report fully complies with the Exchange Act.

F. Finance systems

You cannot run a public company on the back of Excel spreadsheets. Most companies heading into an IPO spend considerable time and resources upgrading their finance IT infrastructure. Specifically, you will need to ensure that your systems and processes are documented and tested to comply with Sarbanes-Oxley requirements and that your technology infrastructure adequately supports compliance efforts. The accelerated financial reporting requirements and increased investor relations demands of newly public companies reinforce the need for a strong technology environment.

You will also need to submit XBRL-formatted financial statements and financial statement schedules in an "XBRL Exhibit" for annual, quarterly filings, and certain registration statements (in addition to posting the XBRL Exhibit on your corporate website).

Issuers are required to tag the following:

- each significant accounting policy within the significant accounting policies footnote tagged as a single block of text;
- each table within each footnote and schedule tagged as a separate block of text; and
- each quantitative amount (i.e., monetary value, percentage, and number) separately tagged within each footnote and schedule.

G. Finance talent

Public company reporting requirements often require organizations to add and retain employees who possess skill sets a private company does not typically have. For example, 78 percent of newly public firms participating in a PwC survey hired between one and five new staff members, specifically to increase their SEC reporting capabilities (see figure on page 16).

Other areas where companies typically need to add staff include accounting, legal, financial planning and analysis, and internal audit and compliance, as well as investor relations, human resources, technology, taxation, and treasury and risk management.

Common talent issues for pre-IPO companies include:

- knowledge gaps in the area of external reporting, FP&A, and tax;
- accounting organization focused primarily on transaction processing (e.g., AP, AR, monthly close) at the exclusion of other critical areas, such as forecasting, delivering business insights, or control and risk management;
- poor understanding of operational reasons for finance variances;
- significant number of post-close adjustments (e.g., due to lack of adequate review processes and teams); and
- challenges meeting press release, quarter-end, and tax compliance timelines.

Specific areas where you may need to add staff to your finance organization include:

SEC financial reporting: A typical SEC financial reporting team includes a director of SEC financial reporting and additional personnel commensurate with the size and complexity of the company and its financial reporting objectives. Your existing accounting and financial reporting team may need to hire additional personnel to handle the incremental annual and quarterly reporting requirements and the compressed timeline for completing these tasks.

Taxation: Once you become public, there will be more emphasis on your income tax provision and tax planning strategies; therefore, it is common to increase the size of the taxation team. A typical taxation team includes a tax director, one or more tax managers, and additional personnel commensurate with the size and complexity of the company.

The taxation group is typically responsible for ensuring compliance with all federal, state, and international tax requirements, as well as compliance with indirect taxes including sales/use taxes, property taxes, and value-added taxes. In addition, a public company's taxation group is subject to shorter quarter and year-end close cycles, specific interim reporting rules that govern the quarterly tax provision preparation process, and more robust disclosure requirements for year-end reporting.

Furthermore, your overall tax planning function will become increasingly important. Effective tax planning is essential as it will drive enhancements in shareholder value through management of your effective tax rate and its impact on earnings per share (EPS).

Internal audit: NYSE-listed companies are required to establish an Internal Audit (IA) function as part of becoming a public company. While companies that list on the Nasdaq do not have the same requirement, we believe it is best practice to establish an IA function. The typical IA function is structured as an independent assurance and consulting department that can have varied responsibilities, which may include assessing the company's internal controls and their ability to support the achievement of defined strategic objectives, mitigate key risks, ensure compliance with internal policies, and support financial reporting requirements. The role of IA usually involves assisting management in performing tests and procedures designed to verify the company's compliance with Section 404 of Sarbanes-Oxley, as well as providing comfort to the CEO and CFO when they sign the 302 certification attesting to the accuracy of financial information and operating results published in periodic reports.

Given the cost and time needed to hire the company's IA resources, many companies will engage external resources to help support their IA function rather than hiring additional staff. These external resources can work in tandem with the company's existing IA resources through a co-sourcing arrangement, or if the company does not have any IA resources, it may consider a fully outsourced IA function. The cost to engage external resources could be higher than the cost to hire IA resources internally, but this option has several advantages. Using external resources allows the company to scale up or down rapidly without having to hire or dismiss internal resources. External providers may also have topical specialists who can provide significant value to the IA function and who can transfer additional knowledge to internal resources.

Treasury and financial risk management: A dedicated treasury and financial risk management group is also a requisite for a public company. Often, newly public companies struggle to adequately manage their liquidity, foreign currency exposure, and derivatives used to hedge interest rates and other risks to their business. An experienced treasury and financial risk management function can mitigate the growing pains that come with being a newly public company.

V. DEALING WITH THE SEC—What do they care about and how can we navigate the process as smoothly as possible?

A. Overview of the SEC review process

The Division of Corporation Finance (and that is not a typo—it is "Corporation" and not "Corporate") within the SEC is, among other burdens, tasked with reviewing the registration statements of IPO companies as well as the SEC filings of the approximately 9,000 already reporting companies. (Sarbanes-Oxley requires that some level of review of each reporting company be undertaken at least once every three years, and the SEC reviews a significant number of companies more frequently.)

"Corp Fin" assigns filings by companies based on their industry to one of 11 offices, each headed by an Assistant Director (such as the Assistant Director office for Consumer Products or the Assistant Director office for Natural Resources and so on). Generally, each Assistant Director office is staffed with 25 to 35 professionals, primarily accountants and lawyers but also those with specialized expertise such as mining or petroleum engineers who may be involved with the reviews of companies in specific industries. (When you take a moment to reflect on it, you realize that these folks have an awful lot on their plates, particularly when markets are active and there are lots of transactional filings in addition to the ongoing reports that public companies must file.)

It is important to understand that when the SEC staff reviews filings, they are not doing so to say whether or not any IPO or other investment is a good one. Rather, they are primarily focused on ensuring that the SEC's disclosure requirements for the registration statement are being adhered to and that the financial presentation complies with applicable authoritative accounting literature and SEC staff interpretations and policies dealing with accounting and auditing issues—and even here, the SEC does not pass on whether the registration statement is adequate or accurate (indeed, it is against the law to say that they have).

When your IPO registration statement is first submitted to the SEC (publicly or, if you are an EGC, confidentially if you choose), they will take about a week to assign the filing to a review team. Typically, this will include a lawyer and an accountant who are the primary examiners, and a more senior lawyer and accountant who are the reviewers. This team will be overseen by the relevant Assistant Director to the extent he or she is not already a part of that team. After the team is assigned, the legal examiner ordinarily will reach out to your outside counsel to let them know that the filing will be subjected to a full review and obtain the appropriate email addresses for where the staff should eventually send their initial comment letter and subsequent correspondence. Your counsel thereafter ordinarily maintains open lines of communication with the SEC staff while the registration statement is being reviewed.

A word on the level of review—the SEC staff does not review each and every SEC filing and, for those filings that are pulled for review, the staff conducts one of three levels of review: a full, cover-to-cover review; a review only of the financial statements and related disclosures (including MD&A); or a review targeted only on compliance with one or more specific accounting standards or disclosure requirements. However, although the SEC does not reveal the criteria that it uses to select filings for review, IPO registration statements almost without exception always get a full review (with the rare exceptions relating to those companies who have publicly traded debt, already have their common stock registered under the Exchange Act for compensation or other reasons or who were recently public and are re-registering).

The SEC staff will take approximately 30 days to perform their initial review of the registration statement and issue their first comment letter. When this is received (sadly, frequently on a Friday afternoon….) it is usually the catalyst for a frenzy of activity as the company and its counsel and auditors, in consultation with the underwriters and their counsel, rush to prepare appropriate responses and, where required due to staleness, to update the financial statements contained in the registration statement. The basic format is to resubmit an amended version of the registration statement that has been revised to reflect the SEC staff's comments accompanied by a letter explaining the company's responses to each of the staff's comments. In the authors' experience it usually takes at least a week and a half to two weeks (or more) to do this in a thoughtful way and allow time for internal layers of review both within the company and its auditors (including the auditors' experts in their national office). Different practitioners have different approaches to the process, but the authors' general advice is to comply with the staff's comments on specific disclosures where possible, notwithstanding that this may result in some mangling of words that were painstakingly written as part of the drafting process leading up to the initial filing or, when the comment is simply inapposite, to explain clearly and respectfully in the response letter why this is the case. Where staff comments relate to accounting matters, the participation and advice of the company's auditors and accounting advisors are critical—the experienced firms will have a wealth of practical experience on just about every issue that the SEC staff may raise (indeed, the big firms each have partners in their national offices who have backgrounds working in senior capacities at the SEC). Generally speaking, however, it is safe to say that when the SEC staff has issued a comment questioning or seeking to understand the company's accounting in a particular area it is important to respond in a way that is explicitly grounded in the relevant accounting standards and literature. Note that the SEC staff's comment letters and the company's responses will eventually become publicly available on the SEC's website after the IPO occurs (or is withdrawn).

In an IPO there will typically be several rounds of SEC staff comments and resubmissions of the registration statement in response thereto, with the overall time required for the SEC review phase commonly taking from two-and-a-half to four months. Statistically, studies have shown that in recent years the median time from initial submission to effectiveness for IPO registration statements (which time period also includes the marketing phase as effectiveness of the registration statement occurs after the roadshow just prior to pricing) is approximately 15-16 weeks. (For purposes of blocking out timetables, the authors generally assume that the SEC staff will take four weeks/30 days to respond to the submission of the initial registration statement, two weeks to respond to the submission of the first amendment, one week to respond to the submission of the second amendment, and several days for subsequent amendments thereafter, although with the exception of the staff's response to the initial submission (which almost invariably appears somewhere close to the four week/30 day time frame), response times can vary significantly based on the workload of the review team and other factors, including the difficulty of any specific issues that are raised.) To the extent that the overall review period takes longer than this, it is usually due either to the fact that the company has decided for whatever reason not to move as quickly as it might have (or perhaps chosen to take a "resistant" posture to staff comments) or because problematic questions relating to its historical accounting have been raised. While "legal" comments on the disclosure can usually ultimately be resolved by revising the relevant disclosure, comments relating to historical accounting may result in the need to restate the financial statements included in the registration statement, a process which can take time and result in a great deal of attention from the company's auditors. Avoiding this unfortunate situation should be a key objective of the company as it is preparing the financial statements to be included in the registration statement and, in the authors' view, is yet another reason why it is advisable to engage auditors and accounting advisors with significant relevant experience. Indeed, in order to make the SEC review process as expeditious as possible a company should draw on the well of experience of its counsel, accounting advisors and auditors when preparing the entire registration statement to anticipate the areas that will be of particular interest and concern to the SEC staff.

In some cases, the appropriate application of generally accepted accounting principles may not be clear or there may be questions concerning the age, form or content of financial statements required to be included in a filing. In these circumstances, it may make sense to consult with the accounting staff of the SEC (generally, the SEC's Office of the Chief Accountant addresses the former types of questions while the accounting staff within Corp Fin resolves the latter) prior to the initial submission of the registration statement, which although it may take additional time on the front end can save time and aggravation overall. Analogously, albeit less frequently, there may be uncertainty about a legal aspect of the proposed transaction and pre-filing consultation with the legal staff of the SEC may be warranted. The SEC has published specific guidelines as to how such consultations should be handled, and your counsel and auditors should have practical experience in doing so. Certainly, one way or the other it should be on your pre-filing work plan to at least expressly consider with your auditors and counsel whether there are any items that warrant such a pre-filing consultation with the SEC staff.

To give you a little bit of a sense of the back and forth of the SEC comment process, below is a table that lays out some of the metrics regarding the back and forth between a real (but anonymous) IPO issuer and the SEC during the review of the registration statement for that company's IPO. The SEC review process for this transaction, while speedier than average, was not atypical for a well-managed and well-advised company in terms of the number, and number of rounds, of comments received and the overall time taken.

Example of SEC comment letter process

Area (# of comments)	**1st**	**2nd**	**3rd**	**Total**
Summary	2	—	—	2
Risk factors	5	—	—	5
Business and industry	3	—	—	3
MD&A	5	—	—	5
Compensation Discussion and Analysis (CD&A)	—	—	1	1
Financial statements	10	2	—	12
Pro forma financial statements	—	—	1	1
Other legal	8	1	—	9
Other financial	2	—	—	2
Total	**35**	**3**	**2**	**40**
Number of days between filings and SEC staff comments	28 days	20 days	19 days	
Total number of days between first filing and the date the SEC declared the registration statement effective				**90 days**

B. Typical areas of SEC comment

Outside of the accounting area, the SEC staff tends to focus on the overall quality of the disclosure, with particular attention paid to the risk disclosures and the "Summary" portion of the registration statement and on ensuring adherence to the specific requirements of the SEC relating to the description of the company's business itself. Ideally, your counsel will be thoroughly familiar not only with the specific formal SEC requirements for the content of the registration statement but also facile with writing the disclosures in a plain English, factual and "fair and balanced" (with apologies to FOX News and its supporters and detractors) manner that is less likely to draw fire during the review process. Unlike an understanding of the common and recurring areas of SEC staff comment in the accounting area, which can be vitally important to understand as you first start to put together your financial statements and think through the financial metrics that you will be presenting to investors, there is less advantage to be gained from a deep dive into the SEC staff's precedent activity on legal comments until you reach the stage of putting pen to paper on your registration statement.

The SEC staff comments that can be the most problematic for an IPO are those that call into question the company's historical accounting or how its financial statements or pro forma financial information have been presented, those regarding recent or anticipated acquisitions and those relating to complex tax and organizational structures. We touch on several of the most common areas of accounting comment below—segment reporting, business combinations, revenue recognition, stock-based compensation, income taxes and presentation of earnings per share (EPS). The SEC accounting staff also frequently focuses on the presentation of pro forma financial information and the use of non-GAAP financial measures (NGFMs), as well as "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A), and we touch briefly on these as well.

Segment reporting. Private companies are not required to report financial information about their segments, so this is usually a major change for companies undertaking an IPO. Segment reporting has been an area of recurrent comments from the SEC, which frequently challenges the identification and aggregation of operating segments. Reporting only one segment is considered a "red flag" that will frequently attract a comment. Companies should be prepared for the SEC to request a copy of the internal reporting package received by the chief operating decision maker (CODM)—this is usually the CEO or a combination of the CEO and the CFO. Segment reporting is based on the information included in the internal reporting package, and it is presumed that all information made available to the CODM is actually used to assess the performance of the business and make decisions about the allocation of resources. The objective is for investors to have the benefit of seeing the business in the same level of detail as management. The SEC will also remind registrants that they are required to disclose certain enterprise-wide information, such as disaggregated revenue by products or services (unless it is impractical to do so, which they should state) and geographical disclosures (revenues and assets) by country, if they are greater than 10 percent of the consolidated totals. When operating segments are aggregated, questions often center on the application of the "similar economic characteristics" criterion, with special attention paid to the similarity of long-term average gross margins.

Typical areas of SEC comment relating to segment reporting include:

- how the CODM has been determined, particularly when it includes more than a single individual;
- exclusion of components of a business as a segment when the CODM receives reports of that component's operating results on a regular basis;

- aggregation of operating segments into one reportable segment (the SEC has noted that aggregation represents a "high hurdle" that is only suitable in certain limited situations); and
- inconsistencies in the manner in which the summary box, the business section and MD&A are written. Note that the SEC staff will also routinely look at the company's website and press releases and news coverage, so care should be taken to ensure that the business is not presented in these settings in a way that is inconsistent with the presentation in the MD&A and financial statements.

Business combinations. U.S. GAAP requires that the purchase price allocation in a purchase business combination begin with an analysis to identify all tangible and intangible assets acquired. You will need to identify intangible assets, such as patents, copyrights, brand names, customer lists, and above/below-market contracts and estimate the fair value of each asset. The total purchase cost is allocated based on the relative fair values of the individual assets. It is important for both you and your auditors to test and challenge the underlying assumptions and data used to develop the valuations. In addition to providing the acquisition disclosures required under ASC 805, you need to evaluate the significance of any acquisitions completed up to three fiscal years prior to the filing of the registration statement. As noted above, you may be required to provide audited historical financial statements of the acquiree(s) and pro forma financial information.

Typical areas of SEC comment relating to business combinations include:

- appropriateness of the fair values used to record assets and liabilities acquired;
- the accounting for changes in a valuation allowance for acquired deferred tax assets and the resolution of uncertain tax positions; and
- disclosures associated with contingent consideration and related accounting.

Revenue recognition. Revenue recognition still receives a great deal of attention from the SEC. Some of the most common topics include:

- software revenue recognition;
- multiple-element arrangements;
- gross versus net revenue presentation;
- reseller arrangements;
- collaboration agreements;
- barter transactions;

- bill and hold/consignment sales; and
- upfront fees.

Note that revenue recognition guidance issued by the Financial Accounting Standards Board (FASB) in 2014 will affect almost all entities and significantly increase required disclosures. While current guidance is often industry-specific and spread across various pieces of accounting literature, *Revenue from Contracts with Customers* provides a single, comprehensive model to be applied in all industries. For public companies, this new revenue recognition standard will be effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application of this standard is not permitted. For non-public companies, this standard will be effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. However, a non-public company may elect to apply the standard earlier under certain circumstances. If you are contemplating an IPO, you should begin an assessment of the impact of the new standard on your organization so you can articulate to investors, bankers, and other stakeholders the potential impact of adopting the new guidance.

Typical areas of SEC comment relating to revenue recognition include:

- the level of detail in the disclosure surrounding revenue recognition policies in the notes to the financial statements;
- the registrant's determination of separate units of accounting, allocation of arrangement consideration to separate deliverables, and application of fair value criteria;
- detailed analysis of the gross and net indicators as they pertain to specific arrangements and the use of this analysis to assess the appropriateness of a company's conclusion regarding the presentation of revenue; and
- up-front versus over-time recognition and the appropriate period over which revenue should be recognized.

Stock-based compensation. "Cheap stock" refers to an equity security (e.g., options, warrants, common stock, or restricted stock) issued during the months preceding an IPO where the value of the underlying stock at the date of grant is lower than the ultimate IPO price. Typically, this issue arises in connection with the granting of employee stock options. The SEC staff's view is that a company's IPO pricing range is indicative of the fair value of its stock leading up to the IPO, and they are, therefore, skeptical of valuations in the 12 to 18 months prior.

The SEC expects that companies will discuss each significant factor (e.g., significant intervening events and changes in the business) contributing to the change in fair value at each valuation date in the three years leading up to the IPO. This discussion should also highlight the exact timing of contemporaneous valuations and any liquidity events. With respect to valuations performed, the "Critical Accounting Policies and Estimates" section should include a detailed discussion of the specific assumptions used in the income approach, the comparable companies used in the market approach (including why the specific companies were selected and any adjustments made to account for significant differences), the weighting of the different models used, and any significant changes in the weighting over time. Certain companies have elected to submit this information in a supplemental letter to the SEC outside of the registration statement.

As you prepare for your IPO, you should carefully review your option pricing history. Where option exercise prices are significantly less than the price of any other equity instruments sold near the dates of option grants, there will be close scrutiny by the SEC, and the closer the grant dates are to the IPO, the more intense the review. A contemporaneous common stock valuation report from a third-party valuation expert can not only ease SEC scrutiny, it can also be used for computation of stock-based compensation and for safe harbor purposes under Section 409A of the Internal Revenue Code.

Typical areas of SEC comment relating to stock-based compensation include:

- factors, assumptions, and methodologies used to determine the fair value of the underlying common stock;
- whether a contemporaneous valuation by an unrelated valuation specialist was performed;
- the valuation range determined by various methodologies and the combination or weighting of those methods;
- significant factors contributing to the difference between the fair value as of the date of each grant and the estimated IPO price range;
- explanations for why or whether marketability discounts, illiquidity discounts, and common stock discounts (due to preferential rights of preferred stock) were used; and
- determination of comparable companies used.

Income taxes. The accounting for income taxes, including related disclosure requirements, is often complex and involves significant judgment.

Typical areas of SEC comment relating to income taxes include:

- disaggregation in the income tax provision disclosure;
- sufficiency and consistency of indefinite reinvestment disclosures;
- incremental disclosure of how the results of operation are impacted by having proportionately higher or lower earnings in jurisdictions with different tax rates;
- interplay between indefinite reinvestment assertion and liquidity; and
- sufficiency of valuation reserves and uncertain tax provisions.

Earnings per share (EPS). Private companies are not required to present EPS, and for companies with complex capital structures—including multiple types of equity, different types of potential common shares, and various classes of common stock—this calculation can be complex. To further complicate matters, companies may have participating securities that are required to be included in the calculation of basic EPS using the two-class method (under which EPS is calculated separately for each class of common stock and any participating securities).

Common shares (securities or other contracts that may entitle their holders to obtain common stock, such as options, warrants, forwards, or other contracts) may be participating securities if, in their current form, they are entitled to receive dividends when declared on common stock. For example, an unvested, share-based payment award that includes non-forfeitable rights to dividends or dividend equivalents meets the definition of a participating security. Lastly, dividends declared in the year preceding an IPO are presumed to be in contemplation of the IPO.

When the dividends declared in the latest year exceed earnings for the previous 12 months, the SEC presumes they will be funded with proceeds from the IPO and, therefore, registrants are required to present pro forma earnings per share on the face of the income statement. This requirement applies to dividends declared after the latest balance sheet included in the registration statement, as well as planned but not yet declared dividends.

Typical areas of SEC comment relating to EPS include:

- treatment of nominal issuance/penny warrants; and
- inclusion of pro forma EPS on the face of historical financial statements due to automatic conversion of preferred stock upon IPO.

Pro forma financial information. The objective of pro forma financial information is to provide investors with an understanding of the continuing impact of particular transactions by indicating how they might have affected the historical balance sheet and income statement had they occurred at an earlier date. Companies with significant business combinations or dispositions, previous history as part of another entity, material repayment of debt, changes in capitalization at the effectiveness or close of an IPO, or other events and transactions that have had or will have a discrete material impact on the financial statements are required to include pro forma financial statements in the registration statement.

Typical areas of SEC comment relating to pro forma financial include:

- whether adjustments are directly attributable to the transaction;
- the level of reliable, documented evidence in support of the adjustments; and
- whether adjustments to the pro forma income statement have a continuing impact.

Non-GAAP financial metrics. Among the many choices you will need to make is whether and how to utilize non-GAAP financial measures (NGFMs) in your IPO filing and in discussions with potential investors. Use of the right NGFMs allows companies to highlight key facts and circumstances and position themselves to the investment community. However, while NGFMs can be a key tool during an IPO, you should carefully consider the costs and benefits associated with their use. The SEC will closely review the basis of calculation and level of disclosure, and the investment community will expect consistent usage of the NGFMs, both during and following the IPO. For example, the first quarterly earnings release following the IPO should ideally not use entirely new NGFMs that management now claims to be crucial to the understanding of the company's operating performance.

Typical areas of SEC comment relating to NGFMs include:

- a company's decision to give equal or greater prominence to NGFMs relative to the equivalent GAAP measure;
- reasons why management believes NGFMs provide useful information to investors;
- permitted adjustments that may still result in a NGFM that is misleading;

- labeling of items as non-recurring, infrequent, or unusual when a similar item has occurred in the prior two years and/or it is reasonably likely to occur again; and
- labeling NGFMs as "pro forma" when they do not comply with the provisions of Article 11 of Regulation S-X.

Management disclosure and analysis (MD&A). MD&A is intended to give the reader information about the quality of a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. You will need to describe in depth such items as changes in sales volumes and cost structures, liquidity and capital resources, sources and uses of cash flows, vendor relationships, employee compensation, unusual non-recurring charges, significant environmental exposures, off-balance sheet arrangements, contractual obligations, and other risks and uncertainties. As you complete your year-end and quarterly financial statements, you should take adequate time to write your MD&A. It can be very difficult to remember, three years after the fact, why insurance costs went up or when a marketing campaign commenced. The practice of writing a quality, comprehensive MD&A will expedite your registration process and be a major step toward operating like a public company. The comment letter process has reinforced the well-established MD&A objectives that disclosures should be transparent in providing relevant information, tailored to the company's facts and circumstances, consistent with the financial statements and other public communications, and comprehensive in addressing the many business risks that exist in today's economic environment.

Typical areas of SEC comment relating to MD&A include:

- the addition of an executive overview section;
- reasons for and specific quantification of significant underlying variances, even when they offset each other;
- the discussion and quantification of the impact of pricing changes on results of operations;
- material known trends and uncertainties that may impact future results of operations and liquidity;
- the quantified impact of foreign currency fluctuations on revenues, expenses, and margins;
- the quantified impact of acquired or disposed businesses on results of operations;

- disclosure of sources and uses of cash and drivers of cash flows that go beyond what can already be found on the face of the cash flow statement;
- a description of the covenants in the company's debt agreements and an indication regarding the company's compliance with those covenants; and
- amounts of cash held overseas, especially when a company has asserted that it will permanently reinvest foreign earnings.

C. Publicity—Do I really need to take a vow of silence?

There tends to be a lot of agita about the constraints on publicity applicable to companies undertaking an IPO, much of which is in the authors' view quite unnecessary. Below is a discussion of the rules themselves, which is of necessity a little bit technical, followed by some practical observations.

Under the relevant legal framework in the United States, a company that is pursuing an IPO is generally not allowed to offer to sell its stock before filing a registration statement (and this, mind you, is the <u>public</u> filing as opposed to a confidential submission). During the period between the public filing of the registration statement and the time it becomes effective at the conclusion of the roadshow, oral offers are permitted and written offers through the use of the preliminary (or "red herring") prospectus included in the registration statement may be made once an anticipated price range has been included. (While SEC rules permit written offers other than the traditional prospectus, referred to as "free-writing prospectuses", in certain circumstances, IPO issuers are subject to significant constraints on the use of these non-traditional offering documents and counsel should be consulted if consideration is being given to the use of any such documents.) Only once the registration statement becomes effective at the conclusion of the roadshow and prior to pricing, however, may buy orders be accepted and the stock actually sold.

We would be remiss if we did not note that a limited exception to these rules permits EGCs and their representatives to "test the waters" by communicating with certain institutional investors, either prior to or following the filing of the registration statement, in order to determine whether such investors might have an interest in the offering. The permissibility to EGCs of testing the waters, which should be carefully vetted in advance by counsel if it is undertaken, does not obviate the need to comply with the more generally applicable constraint on offers, however.

"What is all the fuss about?", you might well ask. "I had not intended to run around selling the stock before the roadshow in any event and was not planning on sending out written offers either?" The rub is that the SEC and the courts construe an "offer to sell" broadly to include the publication of information and publicity efforts made in advance of a proposed offering that have the effect of "conditioning the public mind" or "arousing public interest" in the company or in its securities. Indeed, a communication may be construed as an "offer to sell" even if it does not make reference to either the securities being offered or the offering itself. Moreover, the term "writing" is similarly broadly construed, and can include television and press coverage where there has been company involvement.

That being said, your initial reaction is not really wrong. First, the SEC rules specifically state that communications by a company made more than 30 days prior to filing the registration statement that do not reference the proposed offering are generally permissible, provided that the issuer takes reasonable steps to prevent further distribution or publication of the communication within the 30-day period. Second, the SEC's rules also expressly permit a company, subject to a number of limitations, to continue to release factual (but not forward-looking) information about its business in a manner consistent with past practice to persons (such as customers) other than in their capacities as investors or potential investors in the issuer's securities. These express rules, taken together with the general principle that only communications that are "offers" (even as broadly defined) are problematic in the first place, should give companies significant comfort that they can go about their day to day business throughout the IPO process. Indeed, you will substantially mitigate the risk of a problem in this area if you simply avoid:

- public references to the IPO prior to the public filing of the registration statement or outside of legally compliant communications after filing, including via press interviews (whether on or off the record), speeches or conferences;
- communications with analysts not in the underwriting syndicate;
- communications with potential investors prior to the public filing (except for legally compliant testing the water by an EGC) or outside legally compliant process after the filing;
- public disclosure of forward-looking information regarding the company's financial or operational results; and
- unduly "hyping" statements about the company or its prospects.

More detailed guidelines for specific situations:

- *Employees.* Continue to communicate with employees in accordance with established pre-existing practices. Be careful, however, to avoid any written communications (including by video, voice mail, the Internet, email and replay of conference calls, all of which may be viewed as written) outside of the IPO working group that discuss the IPO. Counsel should be consulted regarding communications with employees if the company is considering implementing a directed share or "friends and family" program in which employees may participate.
- *Media.* Except for communications constituting ordinary business activities consistent with established pre-existing practices that do not relate to the IPO or to the company's performance or prospects, all requests from the media should be met with a statement that the company is unable to comment or respond to inquiries. Counsel should be consulted prior to any communications with the media.
- *Website.* The SEC now routinely reviews a company's website in connection with its review of that company's registration statement and has urged "issuers to take special care in what they put on their websites during the pre-filing and waiting periods." Review the company's website to confirm that it does not contain or link to information that is problematic. Information relating to the company's services, products and factual business developments that are directed at customers, potential customers and business partners in accordance with past practice should not pose any problems so long as they are not inconsistent with the statements made in the IPO registration statement. Projections or other forward-looking information and information promoting the company's business and financial prospects should be avoided.
- *Press releases.* Continue to issue press releases regarding factual business developments in accordance with established pre-existing practices. It may be prudent to implement a protocol during the IPO process where counsel is consulted before the issuance of press releases.
- *Speeches.* Senior company personnel should consult with counsel before accepting invitations to speak or giving a speech pursuant to a pre-existing obligation. Of particular concern are speeches given at financial conferences or those made with the financial press in attendance.

VI. MARKETING AND DISTRIBUTION

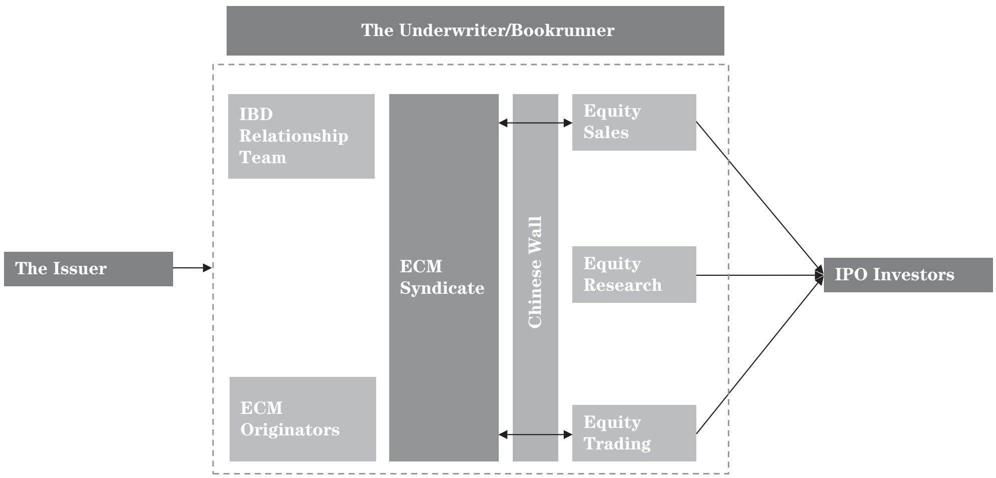
A. The underwriting syndicate and syndicate economics

As noted in Chapter II (Overview of the IPO Process), the lead underwriters (sometimes also referred to as the "lead managers" or "bookrunners") are critical to the success of an IPO, with a role that extends well beyond simply distributing the offered stock. Among their many contributions, the lead underwriters will analyze the company's industry to assess potential investor demand and advise the company and its shareholders on market positioning, investor receptivity and valuation and assist the company in developing the investment story necessary to market the issue. The lead underwriters will also advise on transaction structure and provide an overall level of coordination to the market-facing aspects of the process.

It may be worth reviewing for a moment what the various members of the team at an investment bank actually do on an IPO. The lead managers' investment bankers are the company's principal points of contact with all of the underwriters throughout the IPO process—they conduct due diligence, help the company define its investment proposition and market positioning, participate in the preparation of the registration statement, develop valuation models, manage the roadshow, and collaborate with equity capital markets and syndicate personnel to price and size the offering. These banks are sometimes referred to as the "bookrunners" because (at least before the advent of computers) they would assemble all of the orders from the various institutions and other investors in the IPO in a "book", which would tell them how many shares each investor was willing to purchase and at what price. The bank whose name appears in the top left position in the list of underwriters appearing on the cover page of the prospectus is the "lead left bookrunner", or if there are no other bookrunners in the deal, just "the bookrunner". The research analysts, who due to regulatory constraints imposed on the banks typically no longer appear with any frequency alongside the investment bankers, also conduct due diligence, develop financial models and forecasts of the company's future operating results, educate the sales force about the company and its investment merits, and express their views about the offering to investment banking commitment committees (who ultimately are the ones who decide whether their bank will participate in or "commit" to the offering). The research analysts also communicate with institutional investors during the marketing phase. Equity capital markets and syndicate personnel are the "product specialists" on IPOs and recommend the offering price, size, and timing based on market conditions, company metrics, and investor demand. They also arrange the underwriting syndicate (which is to say, help coordinate bringing in the various investment banks who will be participating in the offering and helping manage the logistical side of their interactions), manage the book-building process, interact with the sales forces in assessing investor feedback during the roadshow, participate in discussions of the offering terms, allocate the shares to investors, and assist with aftermarket price support. And, last but not least, members of the sales force do exactly what you would expect—interacting with investors during the marketing phase and soliciting indications of interest to buy the stock.

The following chart illustrates how the underwriter team connects the company with the IPO investors:

How the investment banks/Bookrunners fit in – Syndicate & distribution



You should consider several factors when selecting a lead managing underwriter:

- reputation—a top-tier underwriter can lend credibility to an offering;
- experience—the more issues an underwriter has successfully managed, both in total and within the company's sector, the more likely it will be to understand and execute successfully the elements required for the IPO to succeed. Pay particular attention to the bank's track record in executing IPOs; a lot of banks will initiate an IPO process but do not necessarily have the pull to get the deal done in the face of tough market conditions. You should look at how many deals the bank has initiated and compare that to the number of deals successfully completed—it should give you some insights as to the strengths and potential weaknesses of any particular lead bank;

- industry expertise—an underwriter with industry knowledge can provide an edge when launching and marketing an offering;
- team focus—since the IPO process is time intensive, it is important to select a lead underwriter with adequate resources for meeting important deadlines;
- distribution capabilities—some underwriters have better connections within the investment community than others. Some underwriters have broad retail distribution capabilities (the ability to reach a lot of individual investors) and some have particularly strong relationships with the large institutional investors who tend to be the ones who set the valuations and determine the success of the individual deal. Some banks, of course, have both. In general the top tier underwriters (sometimes referred to as the "Bulge Bracket" banks) tend to focus most heavily on the institutional investors;
- range of services—an underwriter with a full platform of products and services, such as equity, debt and advisory capabilities, foreign exchange management and prime brokerage, can assist an issuer with its IPO and also with other products and services as the company grows; and
- potential for research coverage.

The responsibility of a co-manager is to focus on supporting the deal throughout the IPO process and to help market the transaction to their own web of investors. Co-managing banks conduct due diligence, provide additional research coverage and aid in market making after the public offering. They are also responsible for helping to build an order book.

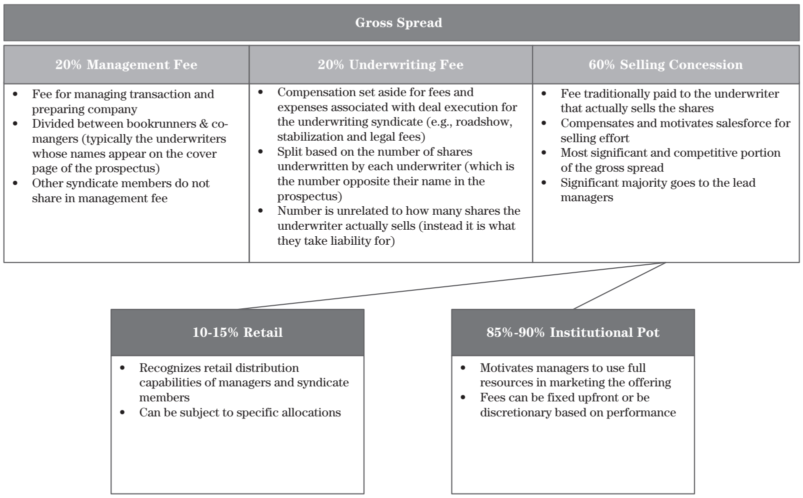
The legal contract between the company going public (and any selling stockholders) and the underwriters is called an underwriting agreement, which is signed at the time the company agrees to the price at which to sell the shares to the IPO investors (i.e., at the very end of the IPO roadshow). Until that time the parties work together based on trust and mutual expectations, and generally at their own risk and expense.

As memorialized in the underwriting agreement, the typical arrangement in the U.S. between the company and the banks takes on the form of a "firm commitment," in which the underwriters pledge to buy all of the stock offered in the IPO and resell it to the public. This arrangement offers the company the most security because the owners know they will receive the full sales price of the issue at the time the underwriting agreement is executed, absent something going dramatically wrong. In theory a firm commitment underwriting gives the bank significant exposure since they have just agreed to purchase all of the IPO stock regardless of whether they can place it with retail or institutional investors. In practice, this exposure is quite minimal since the banks do not sign the underwriting agreement (and hence "firmly commit" to purchase the stock) until after they have lined up buyers for every share—and typically significantly more than every share. If something goes dramatically wrong enough for all of these investors to back out of their agreements to buy the stock from the investment bank, then presumably something has gone sufficiently wrong with the issuer or the markets that the banks could also cancel the underwriting agreement. Hence the minimal nature of the exposure from a practical perspective.

But what are the instances where "something wrong" can occur and the banks can cancel the underwriting agreement? In theory again this can take various forms. It can occur if the underwriters determine between the signing and closing that the Company's representations in the underwriting agreement were materially false at the time made. It can occur if some event happens between signing and closing that makes the reps that were true at signing no longer true at closing; essentially that the Company has suffered an unexpected material adverse event (natural disaster, loss of a founder/visionary, significant adverse regulatory event, etc.). And finally it can occur if some circumstance arises in the broader market that makes it inadvisable, typically in the underwriters' sole opinion, to consummate the transaction. All of these are exceedingly rare, which is to say that almost all IPOs that get to the stage where the underwriting agreement has been executed ultimately close. For the underwriters, it would be a significant blow to not only their relationship with their client (the IPO issuer), its board members and its backers, but also to the banks' reputation in the industry to not consummate an IPO once it prices. A cancelled IPO is so rare in fact that all of the instances where this has occurred are somewhat famous in the world of securities offerings. The most famous examples are that of the first IPOs of Eagle Computer in 1983 and of BATS Global Markets in 2012. In the case of Eagle Computer, the president of the company (accompanied by the owner of the local yacht company) crashed his new Ferrari at high speed and was killed on the day the offering priced, resulting in the underwriters cancelling the transaction hours after it was inked. In the case of BATS Global Markets, BATS, which operates a securities exchange, was attempting to make its own IPO the first IPO to list on its exchange, when on the first day of trading a spectacular glitch in the company's trading systems caused a halt to trading in a number of stocks, including the stock of BATS itself. Given the circumstances, the company and its underwriters decided to cancel the offering. Tragic and tragicomic outcomes, but ones that gives you a sense of how rare and how extreme a situation the underwriters typically need to face before they pull the plug on an IPO that has already priced.

The underwriters are compensated by purchasing the company's shares at a discount to the IPO price, which is called the "underwriting discount" or "gross spread." The underwriting discount is almost always calculated as a percentage of the gross proceeds and typically ranges from 5.5 percent to 7 percent for an IPO but may be a lower percentage in the case of large offerings. The gross spread is, in turn, divided into three separate components—the management fee, the underwriting fee and the selling concession. The following figure depicts the economics of the underwriting syndicate.

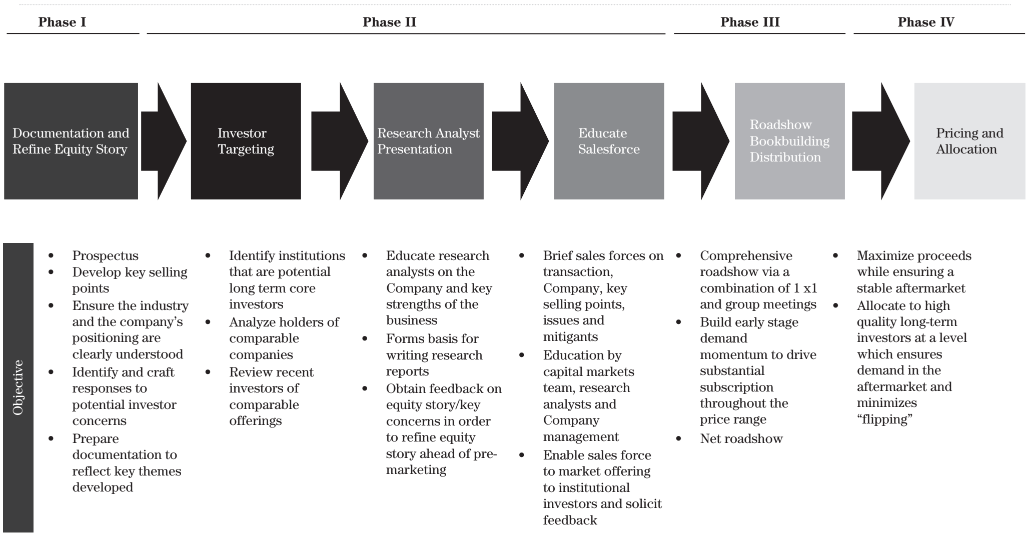
Syndicate economics



B. The marketing process

In some respects the marketing process begins in the earliest meetings between the company and the prospective underwriters when the company's investment strategy, market positioning and valuation and target investor mix are discussed. The lead underwriters assist the company in developing a comprehensive marketing plan for the offering, taking into consideration the company's investment themes and targeting specific investors. Later in the IPO process, the company will meet with the research analysts, the underwriting sales force and ultimately with prospective investors in what is called a roadshow. The marketing process can be thought of having various phases, as depicted in the following diagram.

IPO marketing process



After the underwriters have been hired, the company will host a diligence session with the respective research analyst(s) from each underwriter. Typically the investment bankers will not be in attendance at this session due to legal restrictions. If the bankers are in attendance, the meeting will need to be "chaperoned" (usually by underwriter's counsel) who will ensure that the analysts are able to freely interface with the company without any form of censorship or guidance by the investment bankers. At this meeting, the management team will provide an overview of its business, strategy and financial model. This session is necessary for the research analysts to build their financial models. The company should expect ongoing follow-up work after the session as the analysts develop and finalize their financial models and assumptions. All of this work will also form the basis for the research reports the analysts will issue after the IPO.

In addition, when the company is finally ready to launch the IPO and before the roadshow begins, the company's management conducts a presentation to the underwriter's global equity sales force. The presentation signifies the launch of the IPO and the start of the roadshow. The initial management presentation is traditionally recorded and then available for viewing on www.retailroadshow.com. The presentation can be viewed online by potential investors until the offering is priced.

A roadshow consists of a series of meetings with potential investors in key cities across the country; in certain cases these may extend outside the United States. Top company executives deliver a management presentation covering the company's business and financial performance, along with its products, services and markets. A typical roadshow can include 80 or more one-on-one meetings and several large group presentations with potential investors.

The lead underwriter/bookrunner also assists management in a roadshow's preparation by helping to prepare the slides, rehearsing the presentation with management and preparing educational materials for the sales force. Management presentations should include a summary of the offering and an overview of the company, its financial performance and business strategy, the competitive landscape and investment highlights. You likely have looked at the IPO roadshows of other companies going public—and if you have not you are encouraged to do so at www.retailroadshow.com. It can be a great way to get a sense of how other companies (and even your competitors) are marketing their vision to potential investors.

At the start of the roadshow, equity capital markets and institutional sales force personnel will target investors for you to meet with and begin scheduling one-on-on meetings. The lead underwriter and the company's management team conduct a roadshow to meet with potential investors. Management on the roadshow will always include the CEO and CFO and may or may not include one or two other members of the management team, depending on the nature of the business. A biotechnology company, for example, may occasionally include the company's chief science officer on the trip; a fashion company may include their lead designer. Roadshows typically run for between eight and 12 days, with the longer runs typically occurring if meetings are scheduled overseas. The very largest IPOs will sometimes have two or even three roadshow teams simultaneously conducting meetings on different continents.

During the course of the roadshow, the sales force builds a book of orders. "Book building" refers to the process of assessing institutional and retail demand for the issue from investors. Throughout this stage, the lead underwriter determines the appropriate size and price of the offering (as discussed in greater detail below).

The lead underwriter will also assist in determining the cities to visit and mapping the roadshow itinerary and logistics. A traditional roadshow consists of a combination of meetings in the following regions/cities:

- New York;
- mid-Atlantic (Philadelphia, Baltimore);
- mid-West (Chicago, Minneapolis, Denver);
- Texas (Dallas, Houston);
- West Coast (San Francisco, Los Angeles, Seattle); and
- in certain circumstances, London and other European cities.

Typically a roadshow day involves five to seven one-on-one meetings and/or conference calls, a group breakfast and/or lunch, and travel to the following day's city. For meetings in the mid-Atlantic region, and in certain other densely populated areas, it is not uncommon to visit multiple cities in a single day.

During the book building process, the underwriters identify indications of interest, for those that have not set price limits for their orders, as well as investors with scaled orders at different prices. The latter category involves investors who, for example, will take up to 5% of the offering if the IPO is priced at $11, but only 2% if the IPO is priced at $13 and nothing at a higher price. There is a fair amount of gamesmanship on both sides with the institutional investors seeking to discover the minimum price they can pay to get the allocation they want and the underwriters seeking to discover whether the institutional investors will actually walk away from the trade if the price is above a certain point or are merely threatening to do so. Each side's position on what would constitute an "acceptable" price can shift multiple times during the day and sometimes even within a single conversation. As a convention, the most interested institutional investors for a particular deal will place a 10% order (meaning they would take up to 10% of the offered shares) with no price limit. Interestingly, this rarely means these investors want or expect this large of an allocation. They are rather indicating to the underwriters that they would like as much of the shares as they can get (which for a hot IPO is never going to be 10% of the issue going to a single investor). These investors would be quite surprised (and usually negatively so) were they actually given 10% of the deal.

During this process, the underwriters also will "scrub" the orders, seeking to eliminate any quick-flip institutional investors that they believe have not demonstrated a commitment to support the company over the long term (i.e. those investors who will probably hold the shares for a day or even an hour and look to sell to pocket the short term price pop that typically is associated with an IPO). What underwriters are looking for are institutional investors who will not only hold onto their IPO allocation but will look to add to their position once the stock starts publicly trading (called the aftermarket), thereby helping to drive the momentum in the stock and keeping it from dipping below the IPO price.

In addition to generating demand from institutional investors, the underwriters will solicit demand from retail investors. Retail investors have the ability to generate substantial demand and are less price sensitive than institutions, but they are rarely assumed to be long-term investors. In fact, the lead underwriters will typically assume that all of the retail investors are quick-flip investors and will make sure the market can absorb their shares, which sometimes will change hands multiple times in the first day of trading. Retail investors are also more typically price takers and their decisions are more binary—they are either in the offering at a certain price or they are out but they rarely have the ability to influence the price of the IPO itself.

C. Price and Allocation

The lead underwriter attempts to achieve the most appropriate price for the company, while building a high-quality shareholder base. High-quality investors are sought in order to achieve an attractive valuation for the company as well as to provide the best framework for the stock to trade well when the IPO prices and onward. Generally the goal in setting the IPO price is to achieve a valuation that is at a discount to the price the stock will sell for in the public market once it opens for trading. Depending on the level of uncertainty surrounding the valuation of the company and the peer-company volatility, such IPO discount could be up to 10 percent or greater. The IPO discount is designed to reward the initial investors in an IPO for accepting the risk associated with the new issue of stock that does not have an established trading market or a track record of reporting earnings, filing documents with the SEC and conducting earnings calls as well as to generate the impression of a successful IPO and interest in subsequent offerings of the company's stock.

Once a company prices its IPO, the lead underwriter begins the process of identifying those investors that will receive shares and the amount allocated to each. The allocation of shares at the IPO represents the core of a company's shareholder base. A high-quality initial shareholder base creates long-term partnerships and attracts other quality investors. Typically between 80% and 90% of shares in an IPO are allocated to institutions, with the remaining 10% to 20% going to retail investors.

At the conclusion of the allocation process and before the market opens, the lead underwriter contacts the investors to let them know how many shares they will receive and at what price. This is known as "confirming the trade." Each investor must confirm that it will take delivery of the shares at the price offered. Investors who subsequently back out of the trade are said to have "DKed"—short for Don't Know the trade. This usually occurs with retail investors who will attempt to back out of the trade between the date the IPO prices and the date it settles (usually three to four business days later), particularly in circumstances where the stock trades down below the IPO price before settlement.

After all the IPO shares have been allocated and confirmed with accounts, the underwriters break the syndicate and the deal begins trading the next day.

D. Stabilization and the overallotment (or greenshoe) option

To achieve efficient execution, the stock exchange typically assigns opening time slots for IPO clients. On the first day of trading, the stabilization agent, on behalf of the lead underwriter, requests a time slot. During the 15-minute window before the assigned time slot, buy and sell orders begin flowing to the trading desk. The trader pairs up these orders to arrive at an appropriate market opening price for the stock to start trading (where buy and sell orders are roughly equal). For instance, while the offering price may be $10, an issue may actually start trading at $10.50.

In a typical IPO, the underwriters will allocate more shares to investors than are being sold by the company. This is called creating a short. So if the IPO offering is for 10,000,000 shares, the underwriters will typically allocate 11,500,000 shares to institutional and retail investors at pricing, thereby creating a 15% short position. To cover this short position, the underwriters have two options. First they can buy the shares in the open market after the stock starts trading—this is called stabilizing the stock and is undertaken on behalf of the underwriting syndicate by one of the banks who will act as the stabilization agent. It is a way to protect the IPO price and gives investors some comfort that the stock won't immediately go below the IPO price once it opens for trading. Second, the underwriters can exercise their over-allotment option to purchase stock directly from the company. This option is called the "greenshoe"; so named because it was first used in the stock offering for Green Shoe Manufacturing (now called Stride Rite Corporation). In an IPO, the greenshoe will be for 15% of the offering, as in the example given above. If the underwriters do not have to purchase stock in the open market to stabilize the offering, or do not have to purchase all 15% of the shorted shares, they can exercise the greenshoe in whole or in part to cover their short for up to 30 days after the IPO is completed.

In circumstances where the underwriters believe the stock may come under intense selling pressure after the IPO because of market conditions, the underwriters may sell more than 115% of the offering in the initial allocation to institutional and retail investors. This is called creating a naked short. Naked because the underwriters have to purchase at least some shares in the market to cover their short (they are selling more shares than what they are buying from the company under the underwriting agreement, including the greenshoe) so the underwriters are exposed for any losses should the stock trade up after the offering prices. Needless to say, underwriters are loathe to create naked shorts unless they strongly believe they can cover this short at or below the IPO price.

VII. LIFE AS A PUBLIC COMPANY

A. Only the beginning

The IPO is not the end of the story—it is only the beginning. At least one of the authors likens going public to preparing for and running a marathon—except that after finishing the grueling 26.2 miles, instead of feasting on bananas and other post-race goodies and relaxing after wrapping yourself in one of those foil blankets, you then have the pleasure of immediately embarking upon a regimen of running quarterly wind sprints where a crowd of analysts and the media are waiting at the finish line of each race to punch you in the gut. Thus is the reality for a company going public.

As discussed in Chapter III (Planning Ahead—What Should I Be Thinking About Now), the preparation for going public should happen in parallel with the IPO. Take stock of your processes and infrastructure so that you can address any gaps well in advance of the IPO date. This preparation process can often be lengthy, depending on the maturity of existing processes. How significant the required improvements are will determine the number of resources required. Many companies have resource constraints during the going public process, where there is so much attention being paid to the IPO filings and marketing efforts that other efforts may find themselves de-prioritized. Find a way to keep these efforts at the forefront!

Oceans of ink have been spilled on treatises, guides, manuals and other materials about the myriad requirements that apply to public companies and how to comply with them, and a comprehensive discussion of that subject is well beyond the scope of this book. But, we do think it helpful to cover briefly the basics of the ongoing public reporting obligations, as an understanding of these informs to a significant degree the work that is entailed in preparing your company's finance organization and other functions for the rigors of being public.

B. Ongoing reporting

Annual and quarterly reporting. The SEC requires public companies to file quarterly reports on Form 10-Q and annual reports on Form 10-K (these 10-Qs and 10-Ks sometimes being referred to collectively as "periodic reports"), with current information regarding the company's business and financial condition. In a way, these reporting obligations can essentially be viewed as a requirement to periodically update the registration statement that the company used in the IPO. For example, just as the registration statement used in the IPO included the company's financial statements, the company's periodic reports must update those financial statements. Thus, the company's annual report on Form 10-K will need to contain an updated audited balance sheet and audited statement of income, cash flows and changes in shareholders' equity. And for the quarterly reports on Form 10-Q, the company will need to provide the public with its interim financial statements (not generally audited but a review by the outside auditors is typically performed).

> A "large accelerated filer" is any issuer meeting the following conditions as of the end of its fiscal year:
>
> 1. the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of the issuer was $700 million or more as of the last business day of the issuer's most recently completed second quarter;
> 2. the issuer has been subject to reporting requirements under the Exchange Act for at least 12 calendar months;
> 3. the issuer has filed at least one annual report under the Exchange Act; and
> 4. the issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.
>
> An "accelerated filer" is any issuer meeting the following conditions as of the end of its fiscal year:
>
> 1. the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of the issuer was $75 million or more, but less than $700 million, as of the last business day of the issuer's most recently completed second quarter; and
> 2. it meets conditions (2)—(4) of the definition of "large accelerated filer."

A new issuer has 90 days after the completion of its fiscal year to file its first annual report on Form 10-K with the SEC. Thereafter, the timetable for a "large accelerated filer" (generally, a company that has been reporting with the SEC for at least a year and has a public float of at least $700 million) is 60 days and the timetable for an "accelerated filer" (generally, a company that has been reporting with the SEC for at least a year and has a public float of at least $75 million (but less than $700 million)) is 75 days. A new issuer has 45 days after the completion of each of the first three fiscal quarters of the year to file its quarterly reports on Form 10-Q prior to its second annual report on Form 10-K. Thereafter, the timetable for a large accelerated filer and an accelerated filer is 40 days. We should point out that a new issuer is permitted to file its very first quarterly report within 45 days following the effective date of its registration statement if this is later than the due date for the report that would otherwise have applied.

> ***Public float***: For purposes of determining accelerated filer and large accelerated filer status, public float represents the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the principal market for such common equity, as of the last business day of the issuer's most recently completed second fiscal quarter.

Category of filer	Form 10-K deadline	Form 10-Q deadline
Large accelerated filer (Public float of $700 million or more at most recently completed second quarter)	60 days	40 days
Accelerated filer (Public float of $75 million to less than $700 million at most recently completed second quarter)	75 days	40 days
Non-accelerated filer (Public float of less than $75 million at most recently completed second quarter)	90 days	45 days

Sarbanes-Oxley requires the chief executive officer and chief financial officer of an issuer to make certifications pursuant to Sections 302 and 906 of Sarbanes-Oxley with respect to its annual reports on Form 10-K and quarterly reports on Form 10-Q. These certifications relate to the accuracy of the annual report, including financial statements. The 906 certifications also cover compliance with applicable SEC rules and the 302 certifications also cover the issuer's internal control over financial reporting and disclosure controls and procedures. These certifications must be filed as exhibits to such reports.

Commencing with their first quarterly report on Form 10-Q, issuers must submit with their periodic reports (and any current report on Form 8-K that contains a revised version of previously filed audited annual financial statements) specified financial information in such financial statements in an interactive data format known as eXtensible Business Reporting Language (XBRL). XBRL consists of computer-readable tags which are used to identify each piece of financial data with the goal of enabling more efficient retrieval and analysis of the information.

Earnings releases. As part of the periodic process for reporting earnings, many companies will issue quarterly earnings releases and conduct related conference calls with investors. Companies should carefully consider the process they adopt for releasing earnings to ensure it comports with all applicable regulatory requirements. Among other things, earnings releases are required to be furnished on a Form 8-K report to the SEC and must satisfy SEC rules relating to the use of non-GAAP financial measures. Particular care should be taken with respect to the initial quarterly earnings releases and conference calls following the IPO, as any "surprises" can be used as the basis for a lawsuit under Section 11 of the Securities Act that the IPO prospectus contained a material misstatement or omission.

Current reporting. A public company is also required to file a current report on Form 8-K (generally within four business days) when certain specified events occur. The quick reference guide below summarizes these events, which many are surprised to learn do not include a "catch-all" requirement that the company file a Form 8-K whenever something "material" happens. Rather, the list includes a grab bag of enumerated matters, some of which may fairly be said to be plainly not material.

Form 8-K Quick Reference Guide

Triggering Events[1]

Business and Operations

- Execution, amendment or termination of a material definitive agreement not made in the ordinary course of business (Items 1.01/1.02).
- Bankruptcy or receivership; court or governmental order confirming plan of reorganization, arrangement or liquidation (Item 1.03).

Financial Information

- Acquisition or disposition of a significant amount of assets other than in the ordinary course of business (Item 2.01).
- Public announcement or release (including any update to earlier announcement or release) disclosing material non-public information regarding results of operations and financial condition for a completed quarterly or annual fiscal period (Item 2.02).
- Creation of a material (i) direct financial obligation or (ii) direct or contingent obligation arising out of an off-balance sheet arrangement (Item 2.03).
- A triggering event causing (i) the increase or acceleration of (A) a direct financial obligation or (B) an obligation under an off-balance sheet arrangement or (ii) a contingent obligation under an off-balance sheet arrangement to become a direct financial obligation, and such events under (i) and (ii) having material consequences (Item 2.04).
- Committing to an exit or disposal plan or otherwise disposing of a long-lived asset or terminating employees under certain plans that results in a material charge under GAAP (Item 2.05).
- Conclusion that a material impairment charge to assets is required under GAAP (unless conclusion is made as part of a quarter/year-end process and is disclosed in the next periodic report); includes impairments of securities or goodwill (Item 2.06).

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1 This guide is only a summary and does not include all situations under which a Current Report on Form 8-K is required to be filed.

	Triggering Events
Securities and Trading Markets	• With respect to a national securities exchange/ association: (i) notice therefrom of non-satisfaction of a listing rule/standard or of delisting; (ii) notice thereto of a material noncompliance with a listing rule/standard; (iii) a public reprimand letter or similar communication therefrom for a violation of a listing rule/standard; or (iv) the taking of definitive action to delist therefrom or transfer listing to another securities exchange/ association (Item 3.01). • Unregistered sales of equity securities that in the aggregate constitute 1% or more of the outstanding shares of the class sold (Item 3.02). • Material modifications, limitations or qualifications to the rights of holders of any class of registered securities (Item 3.03).
Accountants and Financial Statements	• Resignation or dismissal of an independent accountant or engagement of a new independent accountant (Item 4.01). • Concluding (or being advised by or receiving notice from the independent accountant) that previously issued financial statements should no longer be relied upon (Item 4.02).
Corporate Governance and Management	• Change in control (Item 5.01). • Director's or certain executive officers' resignation, retirement, termination or removal or director's refusal to stand for reelection. Election of new director or appointment of certain new executive officers. Entry into or adoption of a material compensatory plan, contract or arrangement to which the principal executive officer, principal financial officer, or a named executive officer is a party or participates; all material amendments to such plan, contract or arrangement; or material grants or awards thereunder to any such persons. Calculations of compensation figures for named executive officers if omitted from Summary Compensation Table (Item 5.02).

	Triggering Events
	• Amendments to the articles of incorporation or bylaws (not disclosed in a proxy statement) or a change in fiscal year (Item 5.03). • Temporary suspension of trading under an employee benefit plan (Item 5.04). • Amendment to, or waiver from, a provision of the code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions (Item 5.05). • Submission of matters to a vote of security holders (Item 5.07). • Shareholder director nominations (Item 5.08)
Regulation FD	• Disclosure of information pursuant to Regulation FD (Item 7.01).
Other Events	• Optional disclosure of other events deemed of importance to security holders (Item 8.01).
Financial Statements and Exhibits	• Disclosure of financial statements, pro forma financial information and exhibits, if any, filed as part of the 8-K (Item 9.01).

In addition to the obligation to file current reports on Form 8-K with the SEC, the NYSE and Nasdaq expect listed companies to release quickly to the public any information which might reasonably be expected to materially affect the market for their securities, except under very limited circumstances where it is possible to maintain confidentiality of the information and immediate public disclosure would prejudice the ability of the company to pursue its legitimate corporate objectives. In the case of NYSE-listed companies, when the announcement of news of a material event or a statement dealing with a rumor which calls for immediate release is made between 7:00 a.m. and 4:00 p.m., New York time, the company must notify the NYSE by telephone at least ten minutes prior to release of the announcement. Nasdaq-listed companies must notify Nasdaq at least ten minutes prior to the release to the public of material information that involves certain events, such as financial-related disclosure, corporate reorganizations and acquisitions and senior management changes, if the public release of the information is made between 7:00 a.m. and 8:00 p.m., New York time; if the information is released between 8:00 p.m. and 7:00 a.m., New York time, companies must notify Nasdaq of the material information prior to 6:50 a.m., New York time.

Proxy statements. A proxy statement contains information provided to shareholders so they can decide how to vote in connection with a company's shareholder meeting. Stock exchange rules and, typically, state law require a company to hold an annual shareholder meeting, and stock exchange rules require a company to solicit proxies for all meetings of shareholders. In connection with such solicitation, a proxy statement must be prepared, filed with the SEC and disseminated to the shareholders. In cases where a company's stockholders vote or act by written consent without the solicitation of proxies, SEC rules require the company to provide stockholders with an information statement, which contains disclosure substantially similar to that required in a proxy statement. Certain information required to be disclosed (including the required compensation disclosures) in an issuer's annual report on Form 10-K may be incorporated by reference to the issuer's later-filed proxy statement as long as the proxy statement is filed within 120 days after the end of the issuer's fiscal year.

Internal control over financial reporting and other disclosure controls and procedures. A public company must maintain internal control over financial reporting, which is a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

The company must include in its annual reports on Form 10-K a management's assessment of the effectiveness of its internal control over financial reporting. Thankfully, the rules provide that companies are exempt from this requirement for their first annual report on Form 10-K, so it first kicks in with the second annual report on Form 10-K that is filed. In addition, companies that are accelerated filers or large accelerated filers must also, starting with their second annual report on Form 10-K (if the company is an accelerated filer or large accelerated filer for purposes of that report), include an opinion from the issuer's outside auditors on the effectiveness of the issuer's internal control over financial reporting. Notwithstanding the foregoing, however, under the JOBS Act a company that qualifies as an EGC is excepted from the requirement to include the opinion from the issuer's outside auditors on the effectiveness of the company's internal control over financial reporting.

A public company must also disclose in its quarterly reports on Form 10-Q and annual reports on Form 10-K any change materially affecting its internal control over financial reporting that occurred during the issuer's last fiscal quarter, beginning with its first periodic report following its IPO. The issuer's principal executive officer and principal financial officer must certify that they have disclosed to the issuer's auditors and audit committee all significant deficiencies or material weaknesses in the design or operation of internal controls.

In addition, a public company must maintain disclosure controls and procedures, which are controls and other procedures of the issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. An issuer must evaluate the effectiveness of its disclosure controls and procedures and describe its evaluation quarterly in its quarterly reports on Form 10-Q and annual reports on Form 10-K.

Regulation FD. Whenever a public company, or any person acting on its behalf, discloses, whether intentionally or not, any material non-public information regarding that issuer or its securities to securities market professionals or securityholders (if it is reasonably foreseeable that the securityholder will trade on the basis of the information), Regulation FD requires the issuer to make general public disclosure of the information. Public disclosure must be made simultaneously for intentional disclosures and promptly (but in no event after the later of 24 hours or the commencement of the next day's trading) in the case of inadvertent disclosures. Regulation FD does not apply to disclosures made to persons who owe a duty of trust or confidence to the issuer, persons with a confidentiality obligation or to certain offering-related communications. Regulation FD also does not apply to communications to employees, but for any broadly-based employee communications, a company should consider whether public disclosure is prudent under Regulation FD.

C. Parting thoughts

The authors wrote this short book to answer the questions we are most commonly asked by business owners and executives who are contemplating an initial public offering of their company. As we noted in our introduction, however, this book is not a “how to” manual and, if you choose to move forward with an IPO, we encourage you to add to your team experienced advisors who know all of the ins and outs and advise companies going public for a living. It takes time to prepare a private company to go and be public, and this process will be much more manageable if you start early, objectively assess the areas where your company’s capabilities need to be enhanced and then develop and methodically implement a realistic plan to address these.

We hope you found this book helpful and wish you the very best of luck! Please do not hesitate to contact any of us with any questions.

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HB IPO Considerations 2016

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