What you need to know

• IPO activity has increased in recent years, and the vast majority of new public companies have been taking advantage of relief provided by the JOBS Act.

• Companies beginning the IPO process should consider the numerous financial statement accounting and disclosure requirements they must meet in IPO registration statements and subsequent periodic filings.

Overview

Initial public offering (IPO) activity has increased over the past several years, with 2014 US activity hitting the highest level in more than a decade. The Jumpstart Our Business Startups Act (JOBS Act) has played a role by easing regulatory requirements for a category of issuer called an emerging growth company (EGC).

EGCs account for approximately 85% of IPOs that have gone effective since the law was enacted in 2012. Many of them take advantage of the relief provided under the JOBS Act, including the confidential review accommodation, reduced executive compensation disclosures and the ability to provide only two years of audited financial statements.

Companies embarking on the IPO process have to comply with many accounting and disclosure requirements that don’t apply to private companies. Many are dictated by US GAAP. Others are required by Securities and Exchange Commission (SEC) rules and regulations.
The SEC, the Financial Accounting Standards Board (FASB) and other accounting standard setters have determined that the recognition and measurement provisions of US GAAP should not differ based on the size of a company. However, some SEC rules and interpretations may require public companies to apply certain recognition and measurement principles differently than private companies.

Public companies also must disclose much more than nonpublic companies in their financial statements. Before filing an IPO with the SEC, nonpublic companies should review whether their accounting policies and practices are appropriate, and they should include the required additional financial statement disclosures in annual and interim financial statements.

This Technical Line reviews the more significant accounting and disclosure considerations for financial statements included in IPO SEC filings on Form S-1 and in subsequent periodic reports (e.g., Forms 10-K and 10-Q), including requirements for EGCs under the JOBS Act. This publication updates our 14 June 2012 edition.

Public company accounting

Public versus nonpublic company transition periods

New accounting standards often contain different transition provisions for public and nonpublic companies. Nonpublic companies generally have more time to adopt new standards than public companies. For example, public business entities will be required to adopt the new consolidation guidance in Accounting Standards Update (ASU) 2015-02, *Amendments to the Consolidation Analysis*, for periods beginning after 15 December 2015. Nonpublic entities have to adopt this guidance for annual reporting periods beginning after 15 December 2016, and for interim periods within annual reporting periods beginning after 15 December 2017.

When a nonpublic company files with the SEC to become a public company, it should apply all accounting standards – even new standards – as if it had always been a public company. Using the example above, a calendar year-end nonpublic company completing an IPO in June 2017 would retrospectively revise its financial statements in the IPO to reflect the adoption of the new consolidation standard in the 2016 annual and 2017 interim financial statements. The retroactive revision would be required even though the nonpublic company may have previously provided 2016 audited financial statements to banks or other third parties.

EGCs are an exception. The JOBS Act exempts them from being required to adopt new or revised accounting standards on the effective date for public companies if private companies have a delayed effective date. That is, the private company effective date would apply. However, an EGC can opt out of the extended private company transition period and apply the public company effective dates. If an EGC initially decides to take advantage of the extended transition period, the SEC staff has indicated that it will not object to an EGC subsequently electing to follow the requirements for public companies. If an EGC decides to opt out, that election is irrevocable and applies to all new or revised accounting standards.

It is important to highlight that the JOBS Act addresses only new or revised standards that have different effective dates for public and private companies. No accommodation is provided to EGCs for a new or revised accounting standard that applies only to public companies (e.g., if a revised standard on segment disclosures or earnings per share were to be issued). EGCs also are not able to take advantage of other private company relief (e.g., private company accounting alternatives developed by the Private Company Council (PCC), certain disclosure relief). We discuss certain accounting standards that apply only to public companies later in this publication.
Only 16% of EGCs that filed IPO registration statements since the JOBS Act became enacted have decided to use the delayed effective dates provided for private companies. Many EGCs are using public company effective dates because they want their financial statements to be comparable with those of other public companies.

If an EGC elects to use private company transition, the SEC staff expects it to disclose an additional risk factor explaining that the election allows the company to delay adoption of new or revised accounting standards that have different transition dates for public and private companies and, as a result, the company’s financial statements may not be comparable to those of companies that comply with public company effective dates.

Staff Accounting Bulletins
Staff Accounting Bulletins (SABs) are accounting interpretations and practices followed by the SEC’s Division of Corporation Finance and Office of the Chief Accountant. Below are some SABs with potential effects on financial statements that are included in IPO registration statements and in subsequent public interim and annual reports:

SAB Topic 4.C, Change in Capital Structure — This guidance discusses the accounting for a change in capital structure from a stock dividend, stock split or reverse split that occurs after the date of the last reported balance sheet but before the release of the financial statements or the effective date of a registration statement. The SEC staff has indicated that such changes in capital structure require retroactive effect in the balance sheet, with appropriate footnote disclosure.

SAB Topic 4.E, Receivables from Sale of Stock — Under SEC rules, receivables from the sale of capital stock constitute unpaid capital subscriptions and are reported as deductions from stockholders’ equity, rather than as assets. However, in SAB Topic 4.E, the SEC staff indicated that a receivable from the sale of stock to officers or directors may be reflected as an asset if the receivable was paid in cash before the financial statements were issued and the payment date is disclosed in a note to the financial statements.

SAB Topic 5.A, Expenses of Offering — This guidance notes that specific costs directly attributable to a proposed or actual offering of securities may properly be deferred and applied to the gross proceeds of the offering through additional paid-in capital. However, management salaries and other general and administrative expenses may not be allocated as costs of the offering. Deferred costs of an aborted offering, which would include a postponement of 90 days or greater, should be expensed.

How we see it
A company must determine whether expenses are incremental and directly attributable to an offering and, if so, may defer and record them as a reduction of the offering proceeds. These expenses must be specific to the offering, rather than the costs of being a public company. For example, we generally don’t believe that costs related to the audit of financial statements included in the registration statement are directly related to the IPO and incremental to the company. In addition, a company often may need to apply judgment when determining whether an offering was aborted. We believe the duration of the postponement should be considered in relation to the company’s IPO activities, rather than the period when a company last submitted its IPO registration statement.

SAB Topic 5.T, Accounting for Expenses or Liabilities Paid by Principal Stockholder(s) — According to this guidance, when a company’s principal shareholder transfers shares to a plaintiff to settle litigation against the company, the settlement should be recognized as an expense in the registrant’s financial statements with a corresponding credit to paid-in capital. Other transactions when a principal shareholder pays an expense for the company require similar accounting treatment, unless the shareholder’s action is caused by a relationship or obligation unrelated to his or her position as shareholder or clearly does not benefit the company.
SAB Topic 1.B, Allocation of Expenses and Related Disclosure in Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity – Sometimes a public company will “spin off” or “carve out” a company in an IPO.

The SEC staff generally believes that the historical income statements of a registrant should reflect all of its costs of doing business. The staff requires subsidiary financial statements to include expenses incurred by the parent on its behalf. Such expenses may include officer and employee salaries, rent or depreciation, advertising, accounting and legal services, and other general, selling and administrative expenses. The SEC staff expects that any expenses that clearly apply to the subsidiary should be reflected in the subsidiary’s income statement.

Because it is difficult to distinguish the elements of a subsidiary’s capital structure, the SEC staff will not insist that an interest charge for intercompany debt be included in the income statement if that charge was not previously recorded. However, an interest charge is required if the parent is servicing debt specifically related to the subsidiary’s operations.

In addition, the SEC staff believes that the preferable method for determining income taxes in the separate financial statements of subsidiaries that file a consolidated tax return is a computation based on a separate return (i.e., as if the subsidiary had not been included in a consolidated income tax return with its parent). If income taxes have been computed on some other basis in the historical financial statements, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on a separate return basis.

The SEC staff understands that in some situations, an entity must choose a reasonable method of allocating common expenses to the subsidiary (such as incremental or proportional cost allocation) when it isn’t practical to identify specific expenses. In these circumstances, the staff has required the subsidiary to explain the allocation method used in the notes to the financial statements and for management to assert that the method used is reasonable.

Because agreements with related parties are by definition not at arm’s length, the SEC staff requires footnote disclosure of management’s estimate of what expenses would have been on a standalone basis (e.g., the cost that would have been incurred if the subsidiary had operated as an unaffiliated entity).

**Stock compensation**

Many companies completing an IPO have stock-based compensation strategies for their key executives, board members and other employees, such as stock options and outright grants of non-vested stock that vest over several years. Accounting Standards Codification (ASC) 718, *Compensation – Stock Compensation*, and SAB Topic 14, *Share-Based Payment*, specify accounting considerations for private companies entering the public markets and for financial reporting subsequent to the IPO.

**Equity award fair value and related expense**

With IPO prices in many cases significantly exceeding the fair value of equity securities shortly before the IPO (resulting in the pre-IPO grants called “cheap stock”), the SEC staff routinely challenges the fair value of pre-IPO equity securities.

Management needs to support its judgments and estimates about the fair value of its securities anytime it grants significant share-based payments. The SEC staff generally presumes that the IPO price provides the best evidence of fair value. The SEC staff will be skeptical of valuations in the 12 months before the offering that indicate the securities’ fair value was significantly lower than the anticipated IPO price.
The SEC staff has included suggested disclosures in Section 9520, Share-based Compensation in IPOs, in the Division of Corporation Finance Financial Reporting Manual (FRM). Companies should discuss the material assumptions, methodology and judgments used, noting that they may be complex and subjective. However, the FRM states that, while the SEC staff may issue comments about unusual valuations, it does not expect registrants to expand their disclosures in management’s discussion and analysis (MD&A) about the underlying events and business developments that affected such valuations. However, to respond to SEC staff comments, companies should obtain evidence of milestones and significant events that support changes in fair value at each grant date within the 12 months leading up to the IPO.

**SEC comment letter example – Pre-IPO stock valuation**

This is the language the SEC staff used in a recent comment letter requesting additional information about a company’s pre-IPO stock valuation.

“Please reconcile and explain any difference between the fair value of the underlying units recently granted by your Board of Directors and the midpoint of your estimated IPO offering range. This reconciliation should describe significant intervening events within the Partnership and changes in assumptions as well as weighting and selection of valuation methodologies employed that explain the changes in the fair value of your common unit up to the filing of the registration statement.”

The AICPA’s Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation (the Guide), provides a framework and describes best practices for valuing private company securities. The SEC staff expects companies contemplating IPOs to apply the Guide’s valuation guidance when valuing share-based payments they grant.

The Guide recommends that private companies obtain contemporaneous valuations from independent valuation specialists to determine the fair value of securities issued as compensation. The Guide asserts that such a valuation is more objective and provides more persuasive evidence of fair value than a retrospective valuation or one that is performed by a related party (e.g., director, officer, investor, employee, IPO underwriter).

The SEC staff frequently asks about estimates of the fair value of share-based payments issued before the IPO, even if a contemporaneous independent valuation was obtained. A well-documented timeline of significant intervening events, with contemporaneous valuations supporting grants throughout the 12-month period before an IPO, will be important for a registrant to support its judgments and assumptions.

The SEC staff also expects private companies to consider other relevant data when valuing equity securities. For example, private companies may sell equity securities to third parties, or employees and other stockholders may sell shares in secondary markets. The SEC staff expects registrants to provide an analysis of the weightings assigned to any stock sale transactions on or before the valuation date.

**Equity award valuation models and liability awards**

ASC 718 requires both public and nonpublic entities to measure compensation cost associated with equity awards using the fair-value-based method. However, ASC 718 provides an exception for nonpublic entities that cannot estimate fair value because it is not practicable to estimate the expected volatility of the entity’s share price (input into an option-pricing model).

In these cases, the private company may account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the nonpublic company’s share price (the calculated value). If a private company used the calculated value and it becomes a public entity,
the fair-value-based method must be applied on a prospective basis (i.e., deemed to be a change in estimate under ASC 250, Accounting Changes and Error Corrections). Compensation costs for non-vested awards granted before obtaining public company status must continue to be recognized based on the calculated value that was measured on the date of grant, unless the equity instruments are modified, repurchased or canceled. All share-based payments granted after a company initially files (or submits confidentially) with the SEC must be measured using the fair-value-based method.

ASC 718 states that the measurement objective for liability awards is the same as for equity awards. Nonpublic companies may elect to account for liability awards using (1) the fair-value-based method (or the calculated-value method described above, if the company cannot reasonably estimate its own volatility) or (2) the intrinsic-value method. If a nonpublic company used the intrinsic-value method for its liability awards and becomes a public entity, it should measure the liability awards using the fair-value-based method upon initially filing (or submitting confidentially) with the SEC. In that period, there would be an incremental amount of compensation cost to recognize for the liability awards based on the difference between the fair-value-based method and the previous measurement of intrinsic value (or calculated value).

An entity required to modify its accounting policies (from calculated- or intrinsic-value to fair-value-based method) because it becomes a public entity should disclose the change in accounting policy that will be required by ASC 718 and the reasonably likely material future effects. The IPO registration statement should include the disclosures, within MD&A for example. In subsequent filings, such as Forms 10-K and 10-Q, a new public company should provide financial statement disclosure of the effects of the changes in accounting policy (i.e., disclosures required by ASC 250).

**Redeemable equity securities**

The SEC has specific guidance related to the classification, measurement and presentation of redeemable equity securities, such as redeemable preferred stock, common stock or noncontrolling interests. Those positions are included in Financial Reporting Release Section 211, *Redeemable Preferred Stock*, (ASR 268), SAB No. 64 Topic 3-C, *Redeemable Preferred Stock*, and Emerging Issues Task Force Topic D-98, “Classification and Measurement of Redeemable Securities (Topic D-98),” excerpts of which have been codified in ASC 480-10-S99, *Classification and Measurement of Redeemable Securities*. That guidance reflects the SEC staff’s belief that redeemable equity securities are significantly different from conventional equity capital. Those securities should, in the opinion of the SEC staff, be distinguished from permanent equity in order to highlight the future cash obligations of the instruments.

ASC 480-10-S99 generally requires entities to classify equity instruments (those that are not otherwise required to be classified as liabilities pursuant to ASC 480 and for which redemption could be required outside the control of the issuer) as temporary equity (between liabilities and stockholders’ equity on the balance sheet, often referred to as the “mezzanine” section). That guidance applies to all redeemable equity instruments, including common stock, preferred stock, noncontrolling interests and equity components of certain financial instruments, such as convertible debt, and provides subsequent measurement guidance as well.

ASC 480-10-S99 applies to financial statements included in SEC filings (e.g., periodic reports on Forms 10-K and 10-Q, registration statements including Form S-1) and in annual reports to shareholders. ASC 480-10-S99 also applies to companies that are not SEC registrants, but whose financial statements are presented separately in an SEC filing (e.g., a significant acquired business or significant equity investee). Because this guidance applies only to SEC filers, when filing financial statements with the SEC, nonpublic companies should follow the SEC guidance for all years presented and classify those redeemable equity instruments in temporary equity, including in an IPO registration statement.
How we see it

Although ASC 480-10-S99 applies only to financial statements included in an SEC filing, many private companies also apply this guidance. Although this practice is not required, we generally believe that it is preferable for the financial statements of nonpublic companies not included in SEC filings and may provide for easier transition during an IPO.

Public company accounting disclosures

Public entity definitions

The FASB defined a public business entity in ASU 2013-12, Definition of a Public Business Entity, and is using the definition to consider whether an entity can adopt accounting alternatives developed by the PCC or use other types of private company relief (e.g., disclosure, transition, effective date differences) the FASB provides.

Other US GAAP standards (e.g., earnings per share, segment reporting) define a public entity differently. A company filing an IPO registration statement would be considered a public entity under any of these definitions. Therefore, if a company previously elected to apply PCC accounting alternatives (e.g., related to goodwill, hedge accounting), it would need to retrospectively revise its financial statements to apply public company accounting standards in the IPO filing. In addition, the company must consider other public company accounting and disclosure requirements, including earnings per share and segment reporting.

Earnings per share

ASC 260, Earnings Per Share, requires public companies to present earnings per share (EPS) in their annual and interim financial statements, including those in the IPO registration statement. Computing EPS often is complicated, particularly for companies with complex capital structures that have recently issued several types of equity. ASC 260 requires public entities to disclose two EPS calculations:

• Basic EPS, which is calculated by dividing income available to common stockholders (i.e., net income or loss adjusted for preferred stock dividends) by the weighted average number of common shares outstanding

• Diluted EPS, which is calculated by taking basic EPS and adjusting for the assumed issuance of all potentially dilutive securities such as options, warrants, share-based payments, convertible debt and convertible preferred stock for each period since they were issued

Contingently issuable shares are included in diluted EPS if those shares would be issuable as of the end of the reporting period assuming the end of the reporting period was also the end of the contingency period.

In some cases, IPOs are structured to issue a second class of common stock. Under ASC 260, entities that have multiple classes of common stock or have issued securities other than common stock that participate in dividends with common stock, also known as participating securities, are required to apply the two-class method to compute EPS. The two-class method is an earnings allocation method under which EPS is calculated for each class of common stock and participating security. This calculation considers both dividends declared (or accumulated) and participation rights in undistributed earnings, as if all such earnings had been distributed during the period.
Public companies must disclose EPS for each period that a statement of operations is presented. Companies that report discontinued operations, extraordinary items or the cumulative effect of accounting changes must present basic and diluted per-share amounts for those line items either on the face of the statement of operations or in the notes to the financial statements.

In addition, certain circumstances may arise in connection with an IPO that warrant the presentation of pro forma EPS. Refer to the “Pro forma financial information” section below for further discussion on presenting pro forma EPS on the face of the historical income statement in an IPO registration statement.

**Segment reporting**

Under ASC 280, *Segment Reporting*, public companies may have to make disaggregated disclosures about individual (or groups of) business units (e.g., divisions, brands, regions) in both annual and interim financial statements. Determining a company’s reportable segments requires careful consideration of the facts and circumstances.

The segment disclosure rules require a company to present disaggregated information in the notes to financial statements using a "management approach." The management approach requires segment information to be reported based on how management evaluates the operating performance of its business units or segments (i.e., its management reporting structure).

The disaggregated financial information about each operating segment to be reported may be aggregated into one or more reportable segments based upon several criteria, including economic similarity. ASC 280 also requires certain narrative disclosures, reconciliations of certain financial measures for reportable segments (combined) to the related consolidated amounts and certain other disclosures about products or services, foreign operations and major customers.

**How we see it**

At the 2014 AICPA Conference, a senior SEC staff member indicated that the SEC staff will be taking a “refreshed approach” to reviewing segment disclosures. The staff member encouraged registrants to adopt a similar approach when reaching their conclusions on segment reporting.

Companies should challenge any conclusions they reach on operating segments that are inconsistent with their basic organizational structure, and the level of disaggregation used by the chief operating decision maker (CODM) in making key operating decisions. In addition, companies should consider the processes employed by the CODM to evaluate performance and allocate resources, including the interaction with his/her direct reports and the basis on which budgets and forecasts are prepared and how executive compensation is determined (e.g., performance criteria underlying compensation plans).

Companies also should evaluate whether it is appropriate to aggregate operating segments into reportable segments. To be eligible to aggregate operating segments, companies must consider whether each of the criteria in ASC 280 demonstrates that the operating segments are similar, which often is challenged by the SEC staff.
SEC comment letter example – Segments

This is an example of the language used by the SEC staff in recent comment letters requesting additional information about a company’s determination of reportable segments.

“Please tell us who your chief operating decision maker (CODM) is and provide us with your analysis in determining the CODM. As part of your response, please provide us with an organizational chart that includes the titles and roles of the individuals who report directly to the CODM. In doing so, specifically explain to us the responsibilities of these individuals and the manner in which they typically interact with the CODM. In addition, please respond to the following:

- Describe the process through which your CODM reviews performance and makes decisions about the allocation of resources.
- Please elaborate on your budget process and tell us the methodology used to prepare the operating budget (e.g., top-down approach or bottom up approach), who approves the budget (including intra-period changes) and the nature of communications that address budget variances, including when and how the CODM is informed of these variances.
- Provide us with a detailed discussion of the financial and nonfinancial performance metrics utilized by the company to determine compensation for the CODM and segment managers.”

Other public company enhanced disclosures

A public company’s financial statements, including those in the IPO registration statement, require more disclosures on the face of the financial statements and in the notes to the financial statements for various other ASC topics and SEC rules, including:

- Income taxes, such as a reconciliation of income tax expense at the statutory rate to the amount reported for income tax expense attributable to continuing operations
- Defined benefit pension plans and postretirement plans (e.g., a reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects attributable to service cost, interest cost, contributions by plan participants, actuarial gains and losses, benefits paid, curtailments)
- Fair value disclosures, such as information about any transfers between Level 1 and Level 2 of the fair value hierarchy and a narrative description of the sensitivity of Level 3 fair value measurements to changes in unobservable inputs
- Business combinations, such as supplemental pro forma disclosures in the footnotes
- Balance sheet disclosure of equity securities (e.g., number of shares of common stock issued and outstanding on the face of the balance sheet)

SEC disclosure and reporting requirements

Financial statements of other entities

Financial statements of significant acquired businesses

Audited financial statements of significant acquired businesses and probable business acquisitions must be reported in SEC registration statements, including IPOs. Rule 3-05 of Regulation S-X, Financial Statements of Businesses Acquired or to be Acquired, describes the SEC’s requirements for registrants to provide audited financial statements of acquired or to-be-acquired businesses.
The number of years (i.e., one, two or three years) of audited financial statements that must be presented generally depends on the significance of the acquired business, based on the following significance tests:

- **Asset test**: Compare the registrant’s share of the acquired business’s total assets to the registrant’s consolidated total assets
- **Investment test**: Compare the total consideration transferred for the acquired business to the registrant’s consolidated total assets
- **Income test**: Compare registrant’s equity in the pretax income from continuing operations, net of noncontrolling interests in such income, to the comparable income of the registrant

Significance is determined by comparing the most recent annual pre-acquisition financial statements of the acquired or to-be-acquired business, or group of related businesses, to the acquirer’s most recent annual pre-acquisition audited financial statements. If the acquirer or acquiree has existed for less than one year, the registrant or acquiree should not annualize its historical financial statements.

The number of years of audited financial statements that entities must present for the acquired or to-be-acquired business depends on the highest level of significance for that business:

<table>
<thead>
<tr>
<th>Highest significance level</th>
<th>Number of years of audited annual financial statements of acquired entity in IPO registration statement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Other reporting company</td>
</tr>
<tr>
<td>Completed acquisition is less than 20% significant</td>
<td>None</td>
</tr>
<tr>
<td>Completed acquisition is greater than 20% significant, but no more than 40%</td>
<td>One</td>
</tr>
<tr>
<td>Completed acquisition is greater than 40% significant, but no more than 50%</td>
<td>Two</td>
</tr>
<tr>
<td>Completed or probable acquisition is greater than 50% significant</td>
<td>Three</td>
</tr>
</tbody>
</table>

**Exception**: Financial statements for the earliest of the three fiscal years may be omitted if net revenues of the acquired business in its most recent fiscal year are less than $50 million.

In all cases, the financial statements would include a balance sheet (except when the acquisition is already reflected in an audited balance sheet of the registrant), statement of income, statement of cash flows and related disclosures for the annual and the most recent interim periods. The interim financial statements also would include statements of income and cash flows for the corresponding interim period of the prior fiscal year. When the acquired business does not meet the definition of a public company in the applicable US GAAP guidance (e.g., because it does not have listed equity securities), it is not required to comply with the GAAP disclosure requirements of a public company, including EPS and segment disclosures.

However, an entity whose financial statements are included in a registrant’s SEC filing under Rule 3-05 of Regulation S-X meets the definition of a public business entity under ASU 2013-12. Therefore, an entity that elected to use PCC accounting alternatives would need to retrospectively apply public company accounting and reporting requirements to financial statements.
provided under Rule 3-05 of Regulation S-X. The financial statements also must comply with Regulation S-X but do not need to be audited in accordance with standards issued by the Public Company Accounting Oversight Board.

To reduce the length of time that pre-acquisition income statements must cover, companies filing initial registration statements may apply the period of time that the acquirer’s audited income statements include the operations of an acquired business. However, companies applying such an approach can have no gap between the audited pre-acquisition and audited post-acquisition periods.

**Illustration – Use of pre-acquisition and post-acquisition periods in an IPO**

If an acquisition was consummated on 15 April 2014 and the acquiree’s highest level of significance was 45%, S-X Rule 3-05 would require the acquiree’s audited annual financial statements to be filed for the two years ended 31 December 2013 and interim financials for the three months ended 31 March 2014 and 2013 (assuming both the registrant and acquiree have calendar year ends). In lieu of financial statements for those periods, the SEC staff would accept audited financial statements of the acquiree for the year ended 31 December 2013 and the period from 1 January 2014 through 14 April 2014, provided that audited financial statements of the registrant for the year ended 31 December 2014 have been filed.

There also are requirements for registration statements to include the financial statements of the majority of individually insignificant acquisitions if they are significant in the aggregate (i.e., greater than 50% of any of the significance tests).

**SAB Topic 1.J, Application of Rule 3-05 in Initial Public Offerings**

The SEC staff has recognized that if S-X Rule 3-05 were applied literally, financial statements could be required in IPO registration statements for several acquired businesses that were immaterial to investors because of substantial growth in the registrant’s assets and earnings in recent years. Therefore, applying SAB Topic 1.J may reduce the IPO company’s acquired business financial statement requirements, either by eliminating the audit requirements altogether for relatively minor acquisitions, or by reducing the number of years required for acquired-business audited financial statements.

SAB Topic 1.J can be used by IPO companies that have been built by the aggregation of discrete businesses that remain substantially intact after the acquisition, such as nursing homes, hospitals or cable TV systems. SAB Topic 1.J does not apply to (1) companies that alter the significance of the acquired business relative to that of the company or to the other acquired business through post-acquisition decisions (e.g., changing the allocation of incoming orders between plants or locations) or (2) acquired businesses for which the post-acquisition results are not available on a standalone basis. The latter often occurs in amalgamations in which independently owned and operated acquired businesses are organized as branches or product lines immediately after the acquisition and the acquiring company immediately centralizes management and financial reporting. In addition, the SEC staff may challenge whether the acquired business has remained autonomous when there are significant intercompany transactions between the registrant and the acquired business.

**Significance test**

To determine significance, SAB Topic 1.J requires registrants to apply the significant subsidiary tests. However, in contrast to S-X Rule 3-05, SAB Topic 1.J allows IPO companies to consider the significance of recently acquired and to-be-acquired businesses. That consideration is based on the registrant’s pro forma financial information3 for the most recent audited fiscal year at the filing or submission date of the IPO registration statement, as opposed to historical financial information at the time of the respective acquisitions.
SAB Topic 1.J states that “the pro forma balance sheet should be as of the date of the registrant’s latest balance sheet included in the registration statement.” However, the SEC staff has indicated that the investment and asset test should be applied to the registrant’s pro forma balance sheet as of the date of the registrant’s latest audited balance sheet included in the IPO registration statement. Therefore, when the most recent pro forma balance sheet included in the IPO registration statement is as of an interim date, the registrant must prepare a pro forma balance sheet as of the most recent audited balance sheet date included in the IPO registration statement. However, the registrant need not include this pro forma balance sheet in the IPO registration statement.

**Financial statement requirements**

The SEC staff’s policy is intended to ensure that the IPO registration statement will include at least one, two and three years of audited financial statements for at least 90%, 80% and 60%, respectively, of the constituent businesses that will comprise the registrant on an ongoing basis. These percentages are more stringent than the significance thresholds in S-X Rule 3-05.

The requirement to provide audited financial statements of the acquired business in the IPO registration statement is satisfied if the business is included in the registrant's post-acquisition audited financial statements. If additional periods are required to meet the aggregate pro forma significance tests, pre-acquisition audited financial statements of the acquired or to-be-acquired business must be provided. When required, pre-acquisition audited financial statements must be filed for the period up to the acquisition date. There can be no gap or overlap between pre-acquisition and post-acquisition audited periods.

For the pre-acquisition audited financial statements of an acquired business to be omitted from the IPO registration statement, the following conditions must be met:

<table>
<thead>
<tr>
<th>Acquired and to-be-acquired businesses</th>
<th>Pre-acquisition financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>Not included in the registrant’s audited financial statements for 9 months</td>
</tr>
<tr>
<td>Year 2</td>
<td>Not included in the registrant’s audited financial statements for 21 months</td>
</tr>
<tr>
<td>Year 3</td>
<td>Not included in the registrant’s audited financial statements for 33 months</td>
</tr>
</tbody>
</table>

**Illustration – Application of SAB Topic 1.J**

A calendar-year company initially files an IPO registration statement on 1 April 2015. Registrant acquired Company A, a non-accelerated filer, on 1 August 2014. Company A has a calendar year end. Registrant meets the conditions and applies SAB Topic 1.J, which results in Company A being significant at the 25% level using 2014 pro forma financial information. Under the regular significance test based on 2013 financial information, Company A was significant at the 35% level.

**Years 1 & 2:** Registrant must provide a combination of pre-acquisition and post-acquisition periods that result in a continuous audited period of at least 21 months.
Because Registrant's post-acquisition audited results do not include Company A for at least 21 months, the registrant would be required to provide pre-acquisition audited financial statements of Company A for a period covering at least 1 April 2013 through 31 December 2013 and 1 January 2014 through 31 July 2014 (i.e., 16 months pre-acquisition plus 5 months post-acquisition). Of course, based on the availability of pre-acquisition audited financial statements of Company A, the registrant could provide the audited financial statements of Company A for the year ended 31 December 2013 and for the period 1 January 2014 through 31 July 2014.

**Year 3:** Because the aggregate significance of Company A of 25% does not exceed 40%, pre-acquisition financial statements for Year 3 may be omitted.

This is an example of when the application of SAB Topic 1.J could be more onerous than the application of S-X Rule 3-05. Under S-X Rule 3-05, because Company A is between 20% and 40% significance, the IPO registration statement must include only (1) audited financial statements of Company A as of and for the year ended 31 December 2013, and (2) unaudited interim financial statements as of and for the six months ended 30 June 2014 and statements of income and cash flows for the corresponding period of the prior fiscal year.

**How we see it**

Because of the effort required to obtain audited financial statements for an acquired or to-be-acquired business, companies should consider these requirements in their IPO planning. If an IPO company believes that the tests require financial statements beyond those reasonably necessary to inform investors, the registrant may make a written request to the SEC Division of Corporation Finance Chief Accountant's Office for a waiver. In evaluating such requests, the staff considers the specific facts and circumstances, and grants waivers only in unique circumstances.

**Financial statements of significant investee**

Rule 3-09 of Regulation S-X, *Separate Financial Statements of Subsidiaries not Consolidated and 50 Percent or Less Owned Persons*, requires that registration statements and annual SEC reporting forms, such as Form 10-K, contain separate financial statements for investees accounted for by the equity method, when such entities are individually significant. Equity method investees are considered to be individually significant if they meet either the investment test or the income test at the 20% level. S-X Rule 3-09 applies to all investees, regardless of whether the investment is held by the registrant, a subsidiary or another investee. Accordingly, separate financial statements are required for any lower-tier investee in which the registrant's proportionate share of such investee meets the 20% test relative to the consolidated financial statements of the registrant. While the number of periods provided under S-X Rule 3-09 must match the registrant, only periods when the investee is significant are required to be audited. Separate S-X Rule 3-09 financial statements are not required in filings by smaller reporting companies.

**Summarized financial information about equity method investees**

Annual financial statements in SEC filings, including IPO registration statements, require summarized financial information about equity method investees if, individually or in the aggregate, they exceed 10% significance under any one of the SEC's three significant subsidiary tests. Registrants must present summarized financial information, which may be presented in aggregate for all significant investees, for the same periods as consolidated financial statements. Thus, registrants must present the summarized balance sheet information for the most recent two fiscal years and the summarized income statement.
information for the most recent three years, unless the entity qualifies as a smaller reporting company or as an EGC in the IPO, in which case summarized income statement information is only required for the most recent two years. No explanatory notes need to accompany the summarized information. Entities may include separate audited financial statements for equity method investees in SEC filings, in lieu of the summarized financial information required in the notes to the financial statements, provided that the financial statements are prepared in accordance with US GAAP, IFRS as issued by the International Accounting Standards Board, or are reconciled to US GAAP.

On an interim basis, SEC rules require only summarized year-to-date income statement information for equity method investees that meet either the investment test or the income test at the 20% level. Smaller reporting companies have alternative tests that can be used to measure the significance of investees.

**Pro forma financial information**

Pro forma financial information is the historical balance sheet and income statement information adjusted “as if” a transaction had occurred at an earlier date. It is intended to help investors understand the effect of a significant transaction, such as a business combination or disposition, by showing how the transaction might have affected the historical financial statements.

Article 11 of Regulation S-X describes the SEC’s requirements for registrants to provide pro forma financial information. Pro forma financial information may be required in an IPO registration statement for various reasons. It may reflect a significant business combination that has been consummated or is probable. It may show the use of proceeds for a particular transaction, or show the registrant as an autonomous entity when it previously was part of another entity, when such a presentation is necessary to reflect the operations and financial position of the registrant.

Pro forma financial information is not required if the transaction is already fully reflected in the historical financial statements, such as when discontinued operations have been reclassified for all periods presented.

While these guidelines make pro forma financial information a requirement in certain instances, they are not all-inclusive. Management must determine whether pro forma financial information will be meaningful to investors in other situations based on the facts and circumstances.

A pro forma balance sheet must be presented as if the transaction occurred as of the date of the latest balance sheet in the filing. However, if the transaction is reflected in the latest consolidated balance sheet in the filing, a pro forma balance sheet is not required.

A company must file pro forma income statements for the most recent fiscal year and for any subsequent interim period to the date of the latest interim balance sheet presented. The pro forma income statements should be prepared as if the transaction occurred at the beginning of the full fiscal year presented. A pro forma income statement for the corresponding interim period of the preceding fiscal year is optional. However, once the transaction has been reflected in the issuer’s consolidated income statement for an entire fiscal year, a pro forma income statement should not be presented.

Some registrants have proposed presenting more than one full year of pro forma results of operations because they believe such information would be useful to investors. The SEC staff generally does not permit such a presentation, except when a reorganization of entities under common control is probable (ASC 805, *Business Combinations*, paragraphs D14-D18), or operations have been discontinued (ASC 205, *Presentation of Financial Statements*), but are not yet reflected in the historical financial statements. In some cases, retroactive presentation of revenues and costs of revenues may be meaningful for discussion in MD&A.
Pro forma adjustments are material charges, credits and related tax effects that are directly attributable to the transaction and are factually supportable. Only those items with a “continuing impact” should be presented as adjustments when preparing the pro forma income statement. Generally, pro forma adjustments should be presented gross on the face of the pro forma statements. Alternatively, components of the adjustments should be broken out in sufficient detail in the notes to the pro forma statements.

**How we see it**

Because pro forma adjustments are often a source of confusion and diversity in practice, the SEC staff has continued to focus on them. Companies should carefully consider and be able to support any pro forma adjustments as factually supportable and directly attributable to the transaction being reflected.

A company completing an IPO often plans activities that require pro forma financial information in the IPO registration statement. In certain cases, the SEC staff requires companies to present additional pro forma disclosures, labeled as unaudited in or alongside the historical financial statements in their IPO registration statements. Examples include:

- A significant planned distribution to owners or promoters that is not reflected in the latest historical balance sheet
- Distributions in excess of earnings
- Changes in capitalization
- Changes in tax status

**A significant planned distribution to owners or promoters that is not reflected in the latest historical balance sheet**

When dividends are declared or a distribution to prior owners, promoters and/or parents is planned after the date of the latest balance sheet presented, pro forma disclosures may be required in accordance with SAB Topic 1.B.3. The SEC staff believes that dividends declared by a registrant after the balance sheet date should be reflected in a pro forma balance sheet in the IPO filing. If a planned distribution is not reflected in the latest balance sheet but would be significant to the reported equity, a pro forma balance sheet reflecting accrual of the subsequent distribution (but not giving effect to the offering proceeds) should be presented alongside the historical balance sheet in the filing, regardless of whether the distribution has been declared or is to be paid from proceeds.

**Distributions in excess of earnings**

The SEC staff also provided its views in SAB Topic 1.B.3 about the presentation of pro forma EPS when dividends paid or planned exceed current earnings. It is important for registrants to consider this guidance when calculating pro forma EPS, even when the stated use of proceeds in the capitalization table of the IPO registration statement does not include payment of such dividends. Registrants have to apply the pro forma presentation requirements of this SAB Topic when dividends paid at or prior to the IPO's closing are greater than the current year’s earnings. The SEC staff assumes that offering proceeds will be used to replenish capital used to pay dividends within 12 months of the offering if those dividends exceed earnings during the prior 12 months.

The purpose of reflecting these dividends in pro forma EPS is to include the effect of common shares for which a registrant would have to raise proceeds to pay the portion of dividends exceeding net income in the current year (which has been interpreted as the most recent 12 months). The shares that are assumed issued are added to historical shares outstanding in
the denominator of the pro forma EPS calculation. The number of shares added to historical shares outstanding in the denominator should not exceed the total number of shares issued in the IPO.

**Changes in capitalization**

Pro forma financial information may be required if reorganizations, unusual asset exchanges, debt restructurings, debt refinancing or other changes in capitalization (e.g., redeemable preferred stock, debt convertible to common stock) occur at the effective date or the close of an offering, including an IPO. Generally, the historical balance sheet and statement of operations (including EPS) should not be revised to reflect modifications of the terms of outstanding securities that become effective after the latest balance sheet date, although pro forma data may be necessary to reflect these transactions.

**Changes in tax status**

Many private companies are organized as nontaxable entities (e.g., S-corporations, LLCs, partnerships) to minimize the tax burden on the equity owners. However, before the closing of an IPO, these companies often convert to C-corporations, which are taxable entities. In these cases, the SEC staff expects IPO registrants to present pro forma income tax and pro forma EPS on the face of the historical statement of operations.

Pro forma income tax expense should be calculated using statutory tax rates in effect in prior periods. Presentation is generally limited to the most recent annual and interim period included in the IPO registration statement. However, if the pro forma adjustments relate to only income taxes (i.e., the IPO registration statement does not include any other pro forma information for other events or transactions), the SEC staff encourages registrants to present pro forma income tax and pro forma EPS for all periods included in the historical financial statements.

**Newcos, predecessors and carve-out reporting matters**

IPO structures in recent years have become more complex. For example, “Up-C” structures have become more common in IPOs when the company historically operated as a partnership or limited liability corporation (LLC). The Up-C structure, which is similar to the UPREIT structure commonly used by companies in the real estate industry, is effected by forming a new C-corporation that, as the registrant, uses the IPO proceeds to acquire a majority of the operating partnership or LLC. This structure often is used to retain or create tax benefits for existing investors.

Other complex IPO structures involve the combination of multiple entities in a “put-together” transaction or the carve-out or spin-off of operations from another company. These transactions require a careful evaluation of the facts and circumstances and frequently result in preclearance of the proposed financial statement presentation with the SEC staff.

In certain cases, the IPO registrant may be a newly formed entity, or Newco, that has no significant activities but will acquire a business considered the predecessor entity when or before an IPO becomes effective. The determination whether an acquisition represents a predecessor, as defined in Rule 405 of Regulation C, is a matter of judgment and is based on whether the acquired business will constitute the main thrust of the business or operations of the combined entities.

Although the definition of “predecessor” is very broad, the SEC staff generally believes there is a predecessor when a registrant succeeds to substantially all of the business (or separately identifiable line of business) of another entity (or group of entities), and the registrant’s own operations before the succession appear insignificant relative to the operations assumed or acquired. In limited situations, a registrant may conclude that more than one predecessor entity exists. Each situation must be evaluated based on its specific facts and circumstances.
In IPO filings, registrants generally include financial statements of Newco before its acquisition of the predecessor, which may reflect an initial capitalization, or “seed,” balance sheet if Newco was formed within 135 days of the filing date. In addition, financial information of a registrant's predecessor prepared in accordance with Regulation S-X is required for all periods before the date of succession, with no gaps in audited information.

That is, the predecessor’s financial statements for any interim periods prior to being subsumed by the registrant should be audited when audited financial statements for the period including the succession are presented. The financial statements of the period of succession should include the predecessor stub period from the beginning of the fiscal year through the acquisition or succession date and a successor stub period from the acquisition or succession date through the end of the fiscal year reflecting any new basis of accounting. No comparative period for either stub period is necessary.

In addition, more information must be provided for a predecessor (i.e., the same as for a registrant) than for an acquired business under Rule 3-05 of Regulation S-X. For example, separate schedules, selected financial data, MD&A and other disclosures required under Regulation S-K must be provided for each predecessor but not for a significant acquisition under Rule 3-05.

**Draft audit reports**

A transaction may occur immediately before effectiveness of an IPO registration statement that will require retrospective revision of the financial statements included in the registration statement (e.g., a stock split or reorganization of entities under common control). In these cases, the SEC staff will accept the filing of a draft or “legended” report, which includes an unsigned audit report in the form that it will be presented at effectiveness and a signed legend beneath the unsigned audit report. The transaction must occur, the legend must be removed and the audit report must be signed before the SEC staff will declare the registration statement effective.

**Quarterly financial data**

While selected quarterly financial data is not required in the IPO registration statement, it is required in the first annual report or transactional filing after the effective date of the IPO. It also is common for IPO companies to voluntarily provide the quarterly financial data in the IPO.

All companies that include the disclosure, whether voluntarily or as required, should present quarterly financial data for the most recent two years as supplementary information outside of the financial statements (or in an unaudited note to the financial statements, if so desired). In addition to the line items required to be disclosed, registrants must disclose the effect of any disposals, or unusual or infrequent items, in any quarterly period presented.

**Other IPO considerations**

A nonpublic company contemplating an IPO has many other considerations beyond the financial statements and related disclosures and the SEC’s various Regulation S-X requirements discussed above, including:

- Auditor independence
- Readiness for internal control over financial reporting assessment (and related attestation, if applicable) under Section 404 of the Sarbanes-Oxley Act of 2002, which applies in the second annual report on Form 10-K (EGCs get relief from the auditor attestation requirements)
Financial statement schedules required by Rule 5-04 of Regulation S-X (e.g., schedule of valuation and qualifying accounts)

SEC Regulation S-K requirements for nonfinancial information (e.g., MD&A disclosures)

Required XBRL reporting after the IPO, which begins with the first quarterly report filed (or first annual report filed by a foreign private issuer that is not required to file quarterly reports)

Next steps

Companies planning an IPO should work with internal and external legal counsel, accountants and underwriters to consider all IPO requirements as early in the process as possible.

Endnotes:


2 There are three computational notes to the income test. The second computational note indicates that if the registrant’s income for the most recent fiscal year is 10% or more lower than the average of the registrant’s income for the last five fiscal years, the average income of the registrant should be used for this computation. This computational note also applies if the registrant reported a loss, rather than income. If the registrant reported a loss, the registrant should compare the absolute value of its reported loss to its average income for the last five fiscal years to determine whether the registrant is required to use average income. In computing the registrant’s average income for the last five fiscal years, loss years should be assigned a value of zero in computing the numerator for this average, but the denominator should be “5.” Also, the acquiree’s income may not be averaged.

3 The pro forma financial statements of the registrant should be prepared in a manner consistent with Article 11 of Regulation S-X, which is discussed in this publication.