

# Technical Line

## IPO financial statement accounting and disclosure considerations

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### What you need to know

- ▶ Many companies have completed initial public offerings over the past two years, and the JOBS Act, which eases regulatory requirements for emerging growth companies, could encourage even more IPOs.
- ▶ 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

The number of companies completing initial public offerings (IPOs) over the past two years has increased. Even more IPOs could follow due to the Jumpstart Our Business Startups Act (JOBS Act), which was enacted in April 2012 and eases regulatory requirements for a new category of issuer called an emerging growth company (EGC).

Companies embarking on the IPO process have to comply with many accounting and disclosure requirements that don't apply to private companies. Many of the additional requirements for public companies are dictated by US GAAP. Others are required by 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.

## Ernst & Young resources

- ▶ [To the Point, JOBS Act to promote capital formation](#) (SCORE No. CC0345)
- ▶ [Technical Line, Implementing the JOBS Act](#) (SCORE No. CC0348)

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.

## 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 companies were required to adopt Accounting Standards Update No. 2011-5, *Presentation of Comprehensive Income*, for periods beginning after 15 December 2011. Nonpublic companies have to adopt ASU 2011-5 for fiscal years ending after 15 December 2012.

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. One exception to this rule is when the SEC staff issues specific transition guidance. Using the example above, a calendar year-end nonpublic company completing an IPO in 2012 would retrospectively revise its financial statements in the IPO to reflect the adoption of ASU 2011-5 in the 2011 annual and 2012 interim financial statements. The retroactive revision would be required even though the nonpublic company may have previously provided 2011 audited financial statements to banks or other third parties.

EGCs are another exception. The JOBS Act exempts them from being required to adopt new or revised accounting standards effective for public companies if private companies have a delayed effective date. If that's the case, the effective date for private companies will 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 if an EGC subsequently elects 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.

The accounting standards provision applies only to new or revised accounting standards issued after the JOBS Act was enacted on 5 April 2012. That means that an EGC must comply as a public company with all accounting standards issued before 5 April 2012, even if the effective date of a particular standard is after 5 April 2012.

It is also 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). We discuss these accounting standards that apply only to public companies later in this publication.

## How we see it

Given the significance of the pending joint projects of the FASB and the International Accounting Standards Board (IASB), an EGC may find it more appealing to initially elect extended private company transition. This would give the company the flexibility to subsequently opt out and follow the transition dates for public companies to maintain comparability. We believe EGCs that have chosen private company transition could choose early adoption of any individual standards that provide the option for private companies. But the SEC staff has not yet expressed a view on this point.

### Staff Accounting Bulletins

Staff Accounting Bulletins (SABs) are written 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, Changes 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 incremental 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.

*SAB Topic 5.J, New Basis of Accounting Required in Certain Circumstances* – This SAB generally requires "push-down" accounting whenever separate financial statement information is presented in a filing for a "substantially wholly owned" (more than 95%), acquired subsidiary. Push-down accounting reflects the parent company's basis in the net assets of the subsidiary in the separate financial statements of that subsidiary. The subsidiary's financial statements and summarized financial information reflect any new basis recorded by the parent as of the date that push-down accounting is applied, which may result in predecessor and successor periods. Companies also should evaluate whether to apply push-down accounting if they became substantially wholly owned by a group of investors that acted as a "collaborative group," as required by ASC 805-55-S99-2, *SEC Staff Announcement: Push-down Accounting*.

SABs are not official SEC rules or regulations, but they reflect positions of the SEC staff that should be applied by public companies, including companies in an IPO.

*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 term "spin-off" describes the practice of distributing some or all the shares of stock of an entity to the parent company's shareholders. The entity may have been a subsidiary, a division, or a group of subsidiaries and divisions. Because of the stock distribution, the spun-off entity becomes a new SEC registrant. A new public company through a carve-out is similar, except that the shares are sold in a public offering instead of distributed to shareholders.

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.

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.

Additionally, since agreements with related parties are by definition not at arm's length and may change at any time, the SEC staff requires footnote disclosure of management's estimate of what expenses would have been on a stand-alone basis (e.g., the cost that would have been incurred if the subsidiary had operated as an unaffiliated entity).

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### **Ernst & Young resources**

- ▶ [Technical Line, Avoiding 'cheap stock' issues](#) (SCORE No. BB2305)
- ▶ [Financial Reporting Developments, Share-based payment](#) (SCORE No. BB1172)
- ▶ [Financial Reporting Developments, Business combinations](#) (SCORE No. BB1616)

### **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 termed "cheap stock"), the SEC staff routinely challenges such valuations and the related financial statement and Management Discussion and Analysis (MD&A) disclosures.

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. Companies should provide sufficient disclosure to describe milestones and significant events that support changes in fair value at each grant date within the 12 months leading up to the IPO. The SEC staff has included suggested disclosures in Section 9520, *Stock-based Compensation in IPOs*, in the Division of Corporation Finance Financial Reporting Manual.<sup>1</sup>

#### **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.*

*"When you know your estimated IPO price and include it in your registration statement, please reconcile and explain the difference between the fair value of the underlying stock as of the most recent valuation date and the midpoint of your IPO offering range. Tell us when you first initiated discussions with underwriters and when the underwriters first communicated their estimated price range and amount for your stock."*

Companies contemplating IPOs should obtain contemporaneous independent valuations whenever they grant significant share-based payments. Contemporaneous independent valuations are particularly critical when the ultimate IPO price might be significantly higher than the estimated fair value of the stock at the grant date.

We have seen the SEC staff vigorously challenge management's estimates of the common stock fair value before the IPO when management did not obtain contemporaneous independent valuations. The SEC staff has been more skeptical of valuation estimates that were not performed by an independent valuation specialist, even when such estimates reflected increases from a prior independent valuation.

#### ***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). Under these circumstances, 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 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 with the SEC. In the period in which a company files with the SEC, there would be an incremental amount of measured cost of 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 EITF 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.

Determining whether an issuer controls the redemption of an equity security, and whether that security can be classified as permanent equity, can be complex.

## 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

### 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.

### Ernst & Young resources

- ▶ [Financial Reporting Developments, Earnings per share](#) (SCORE No. BB1971)

### Ernst & Young resources

- ▶ [Financial Reporting Developments, Income taxes](#) (SCORE No. BB1150)
- ▶ [Financial Reporting Developments, Fair value measurement](#) (SCORE No. BB1462)
- ▶ [Financial Reporting Developments, Business Combinations](#) (SCORE No. BB1616)
- ▶ [Ernst & Young GAAP Disclosure Checklist](#) (EY Form A13)

## Ernst & Young resources

- ▶ [Financial Reporting Developments, Segment reporting](#) (SCORE No. BB0698)
- ▶ [SEC Comments and Trends](#) (SCORE No. CC0334)

## 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 whether a company has separately 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 (or in the Description of Business section of registration statements and periodic filings) 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 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, a reconciliation of total income and assets for all reporting segments (combined) to total consolidated net income and assets and certain other disclosures about products, markets and foreign operations.

### How we see it

The SEC staff continues to focus on segment reporting. The staff frequently challenges registrants' conclusions on identifying and aggregating operating segments. In evaluating segment reporting, companies should consider the level of information that is provided to and regularly reviewed by their chief operating decision makers (CODMs) as well as the metrics used in assessing performance and allocating resources, as well as evaluating economic similarity between operating segments.

### SEC comment letter example – Segments

*This is the language the SEC staff used in a recent comment letter requesting additional information about a company's determination of reportable segments.*

"Please explain to us in more detail how you determined that you have one reportable segment. Please address in your response whether your operating segments are the same as your reportable segments or whether you have aggregated multiple operating segments into your reportable segments. Please also provide the reports that are provided to and reviewed by your CODM in assessing performance."

### 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 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<sup>2</sup>

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:

Highest significance level	Number of years of audited annual financial statements of acquired entity in IPO registration statement	
	Other reporting company	Smaller reporting company and EGC
Completed acquisition is less than 20% significant	None	None
Completed acquisition is greater than 20% significant, but no more than 40%	One	One
Completed acquisition is greater than 40% significant, but no more than 50%	Two	Two
Completed or probable acquisition is greater than 50% significant	Three <b>Exception:</b> 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	Two

In all cases, the financial statements would include a balance sheet, 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. The financial statements must comply with Regulation S-X, but need not include US GAAP disclosure required for a public company, nor must they be audited in accordance with standards issued by the Public Company Accounting Oversight Board (PCAOB).

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 2011 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 2010 and interim financials for the three months ended 31 March 2011 and 2010 (assuming both 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 2010 and the period from 1 January 2011 through 14 April 2011, provided that audited financial statements of the registrant for the year ended 31 December 2011 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 statements<sup>3</sup> for the most recent audited fiscal year at the initial filing 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.

SAB Topic 1.J need not be applied if its application would be more burdensome than a strict application of Rule 3-05 of Regulation S-X.

### **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 lower 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 to the extent that 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:

	Acquired and to-be-acquired businesses	Pre-acquisition financial statements
Year 1	Not included in the registrant's audited financial statements for 9 months	May be omitted if combined pro forma significance is no more than 10%
Year 2	Not included in the registrant's audited financial statements for 21 months	May be omitted if combined pro forma significance is no more than 20%
Year 3	Not included in the registrant's audited financial statements for 33 months	May be omitted if combined pro forma significance is no more than 40%

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

A calendar-year company initially files an IPO registration statement on 1 April 2012. Registrant acquired Company A, a non-accelerated filer, on 1 August 2011. 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 2011 pro forma financial information. Under the regular significance test based on 2010 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.

#### Illustration – Application of SAB Topic 1.J (continued)

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 2010 through 31 December 2010 and 1 January 2011 through 31 July 2011 (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 2010 and for the period 1 January 2011 through 31 July 2011.

**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 2010, and (2) unaudited interim financial statements as of and for the six months ended 30 June 2011 and statements of income and cash flows for the corresponding period of the prior fiscal year.

#### Ernst & Young resources

- ▶ SEC Reporting Series, 2011 SEC annual reports – Form 10-K (SCORE No. CC0337)
- ▶ SEC Reporting Series, 2012 SEC quarterly reports – Form 10-Q (SCORE No. CC0338)

#### 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 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 IASB, 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.

SEC's pro forma rules are intentionally broad and focus on providing disclosure that is material to investors.

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 recently focused 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 sometimes plans activities that require pro forma financial information in the IPO registration statement. In certain cases, instead of a separate statement, the resulting pro forma disclosures may be presented on the face of the historical balance sheet or income statement and labeled as unaudited. Examples include:

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

In addition, when the dividends are to be paid from the proceeds of the offering, the SEC staff believes it is appropriate to include pro forma per share data (for the latest year and interim period only) giving effect to the number of shares whose proceeds will be used to pay the dividend. A similar presentation is appropriate when dividends (including dividends declared) exceed earnings in the current year or in the most recent 12 months, even though the stated use of proceeds is other than for the payment of dividends. In these situations, pro forma per share data should give effect to the increase in the number of shares which, when multiplied by the offering price, would be sufficient to replace the capital being withdrawn in excess of earnings.

- ▶ Terms of outstanding equity securities will change after the date of the latest balance sheet, and the new terms will result in a material reduction of permanent equity
- ▶ The registrant's historical financial statements are not indicative of the ongoing entity because tax or other cost-sharing arrangements will be terminated or materially amended

### **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.

The SEC does not require selected quarterly financial data in an IPO registration statement.

### **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 assessments (and related attestation, if applicable) under Section 404 of the Sarbanes-Oxley Act of 2002
- ▶ 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

### **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:

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- <sup>1</sup> The Division of Corporation Finance Financial Reporting Manual is available at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf>.
- <sup>2</sup> 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.
- <sup>3</sup> 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.

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