Ready for the IPO spotlight? Preparing to perform at a higher standard

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Entrepreneurs dream of the day their companies go public. They mentally rehearse their speeches to their loyal employees. They picture the smiling faces of their early investors. They see themselves ringing the bell to signal the opening of the day's trading at the exchange where their stock will be listed.

Many of these executives do more than dream. They also plan. But even those who plan often underestimate what it takes for a company to succeed once it goes public. That's because many executives see preparing for an IPO as focused mainly on getting the company's stock registered and sold. Those are, of course, essential tasks. But both before and after the IPO, the company must be prepared to perform in the glare of the public spotlight.

This means understanding:

- What capabilities are required to function as a public company, particularly in areas such as compliance, auditing, reporting, governance, and risk management
- What it takes to develop those capabilities in terms of time, expertise, staff, technology, and other resources
- How to develop the needed capabilities in the most effective and efficient manner
- What benefits flow from preparing to operate at the required level—and what consequences result from failing to do so

That last point is key. Potential consequences of poor pre-IPO planning include higher expenses to implement processes after the fact, restated financial statements, increased risk, and diminished stakeholder confidence. In addition, failure to comply with regulatory standards or investor expectations can distract management from key tasks during a critical time. In contrast, the benefits of well planned IPO preparation include lower costs, stronger controls, smoother operations, compelling presentations to potential investors, and a potentially higher valuation for the IPO.

In sum, going public requires a company to operate at higher standards, with public-company capabilities that drive higher levels of performance in key areas. Failure to meet those requirements can bring unexpectedly swift and severe consequences, which could result in regulatory violations, anticipated financial or cash tax issues, delisting of the company's stock, or, ultimately, failure of the company.

Given this, pre-IPO planning focused mainly on the stock issue is too narrowly focused. Proper planning must establish or expand capabilities that few private companies have fully developed. Without those capabilities, a newly public company will be unprepared to operate at the expected level.

Great expectations

Preparing to go public goes beyond having audited financial statements, meeting with investment bankers, and telling the company's story to prospective investors. It involves developing the capabilities that will enable the company to succeed after it goes public. It takes careful, comprehensive planning to identify all areas and tasks that require attention, the processes and systems that must be established or upgraded, and the resources required to support the ongoing public entity.

Yet when preparing to go public, many executives attend mainly to the stock offering. That's understandable. You must prepare audited financial statements, file the registration forms, meet with investment bankers, and conduct a road show for the investment community. But after going public, the expectations placed on the company will never be the same for the following reasons:

- The enterprise will require far more formal and rigorous accounting practices, financial controls, compliance systems, governance, and risk management.
- Management will face new demands for disclosure and transparency in reporting on financial performance, compensation, risks, and drivers of performance.
- Public company requirements will put the enterprise into a new compliance, regulatory, and tax environment.
- The company will have to establish ongoing communications with shareholders and the investment community.

Executives may underestimate the pressures of managing to quarterly performance expectations, and the effort required to establish and maintain governance and risk management practices along with management-board relationships.

Some misjudge the extent of systems requirements for robust reporting and communications, overestimating the tolerance for errors in reporting results and projections.

These realities often signal the need to significantly upgrade finance, accounting, tax, governance, and risk management practices and processes. These are often rudimentary in private companies relative to what they will need after they go public, particularly in the areas of governance and risk management. For instance, as a public company, most entities need a more rigorous process for identifying and assessing strategic, operational, financial reporting, and other risks and for communicating them to the board.

What's needed, and When?

Planning, preparation, expertise, and teamwork—well in advance of registering the stock—are the ingredients of a smooth IPO. To avoid confusion, chaos, and unnecessary costs:

- Consider the ways in which going public will affect every area of the company. Also understand *what* you can communicate about going public and *when* you can—and can't—communicate it.
- Analyze required public company capabilities and identify gaps between current and required capabilities, and the resources needed to close the critical gaps.
- Access expertise you will need beyond the legal and investment banking areas to develop the needed accounting, auditing, tax, governance, and risk management capabilities.
- Position the company to go public well in advance, so you can issue the offering at an advantageous time rather than rushing to hit the market when it's hot—and risk missing it.
- Adopt certain public company practices beforehand to reduce pressure and the unpleasant surprises and costs that pressure creates.

Much of this preparation contributes to the compelling business case that a company must develop for its IPO if it is to maximize its value. When grounded in true and tested capabilities, the business case can be presented with confidence to analysts and investors, who have low tolerances for risk and uncertainty. A good business case and the preparation that goes into it provide a strong foundation for managing the company well once it has gone public. In addition, a company that presents well to investment bankers and analysts is better positioned for a higher valuation.

A company reduces the risks in going public when it has established capabilities that will enable it to operate in a mature and predictable manner in the public arena. Although every company has limited resources, proper pre-IPO planning allocates those resources in cost-effective ways both before and after the company goes public.

Preparation is never wasted

Going public presents an opportunity—and the need—to improve capabilities. Some companies improve their financial controls, upgrade their infrastructure, have their financial reports audited, empower their board of directors, and formalize their risk management years before going public. Through early adoption of public company policies and practices, they prepare themselves for a smooth and cost-effective public offering.

Even if such a company chooses to remain private, the effort isn't wasted. Most of the actions taken to prepare to succeed as a public company also position it to succeed if it stays private. Operational, financial, and managerial performance improve with upgrades to policies, processes, controls, governance, and risk management. The company will also find it easier to work with suppliers, obtain private capital, and attract venture partners, if it remains private.

Six steps to success in public

To identify what your enterprise will need as a public company, consider the need to:

- Establish good corporate governance
- Upgrade the finance organization
- Prepare for rigorous financial reporting
- Improve financial systems, processes, and controls
- Develop risk management capabilities
- Address legal and tax matters

In each of these areas, communication between and among all involved and affected parties is paramount. By that we mean that communication mechanisms, practices, and schedules must be formalized in ways that private companies typically do not require. This applies to management-board, company-investor, company-regulator, management-media, management-employee, and all other communications.

Establish good corporate governance

Many pre-public companies must upgrade their governance structures, policies and practices. Boards of public companies must review goals and strategies, hire and compensate management, and oversee risk—among other duties. In turn, selecting the right board and instituting robust governance processes are also in the best interest of management. These and other expectations fall under good governance, which are demanded by investors and regulators.

Among others, good governance requires that:

- The board oversees management's goals, strategies, plans, initiatives, and decisions
- Board members understand the industry and the challenges management faces, but also give management their objective viewpoints and opinions
- Management and the board interact to establish and maintain strong communication and workable governance practices
- The board represents the shareholders in matters such as management hiring, compensation, and performance review

Many private companies don't anticipate the time and effort required to achieve the cooperation, oversight, transparency, and formality that good governance entails. They typically lack a governance framework, resources, and experience. A corporate governance framework helps management and the board identify their responsibilities and define their respective roles. The leaders can then set and reach governance goals, even with limited resources and experience and despite competing claims on their attention.

A good framework guides the team in mapping governance processes, practices, and policies. It specifies the skills required on the board, and details the recruiting and training of directors. It also assists in creating a timeline for drafting documents, defining the corporate secretary and investor relations positions, and developing communication protocols. All of these are necessary steps in establishing governance at the level expected of a public company.

Upgrade the finance function

A successful public company needs a sound finance function with well-qualified people (preferably with public company experience) and well-documented processes that can fulfill the demands of public company compliance and reporting regulations. To support the transition from private to public company, the finance function will need time and resources, another reason to start preparing early.

The goal is to have the upgraded finance function in place on the day of the IPO. That way, the company has the people, processes, and systems it needs to enable the needed controls and reporting mechanisms right from the start.

To go public, a private company's finance function will typically need:

- Process standardization and automation and data management capabilities equal to the financial compliance and reporting demands placed upon public companies
- Capacity and capabilities that support the control environment and optimize finance operations
- Processes that include a calendar of filings (quarterly and annual financial reports and necessary proxy filings), as well as scorecards
- Methods of working with business unit heads to leverage strategic opportunities associated with having access to the public equity markets and to the base of investors and amounts of capital which that access affords

For most privately held companies, addressing these needs calls for changes to the finance function. It's best to consider these changes a reasonable cost of doing business, given the potential value of access to the public capital markets. In other words, an upgrade to the finance function is part of the price a company pays for access to the public equity market.

Prepare for rigorous financial reporting

The SEC requires information on capitalization before and after the IPO and on the uses of that capital. To meet this need, and the ongoing need for financial statements, the company must assess its financial reporting capabilities against SEC criteria. For instance, financial reports must be prepared in accordance with generally accepted accounting principles (GAAP) and include disclosures specific to SEC registrants. Such disclosures include segment reporting, management's basis for accounting judgments, rationale for any non-GAAP measures, and reconciliation to equivalent GAAP measures.

Key activities for financial reporting include:

- Assessing the availability and quality of financial data in light of GAAP and identifying what new data will be required and the sources for that data and the costs of developing it
- Developing processes to draft financial reports and the registration statement according to GAAP, and developing the resources to support those processes
- Considering the competencies—and competing commitments—of staff and how best to address any shortcomings or needs
- Integrating financial reporting with compliance, governance, and risk management to generate information that not only meets reporting requirements but also guides management decisions and drives performance improvements

Most entrepreneurs find public company financial reporting to be far more formal and rigorous than that of private companies. Thus, this area usually requires serious attention.

Improve financial systems, processes, and controls

Most private companies must upgrade their financial systems, processes, and controls to meet new reporting, compliance, operational, and risk management demands. This includes the treasury and cash management function as well as financial planning and forecasting. Again, these capabilities are needed in order to meet external reporting and disclosure requirements for detail and timelines, and given the lack of tolerance for errors.

A company whose financial, accounting, and tax staff lacks experience in the public realm will typically require external expertise to scope the project, identify standards, and coordinate activities. External experts can also design, document, test, and certify controls and help the company to meet Sarbanes-Oxley (SOX) certification and other regulatory requirements.

One mistake is to take a piecemeal approach rather than considering the comprehensive needs of the business in this area. A comprehensive approach positions the company to address its needs systematically—and to save money—by:

- Identifying control gaps, and analyzing the potential costs and likely effectiveness of fixes
- Envisioning the future-state and defining both initial improvements and a timetable for later improvements
- Establishing or improving the control environment, risk management, and governance as well as, if necessary, an internal audit function

Systems investments need not be onerous or overwhelming. Rather they need to fit the needs of the company now and support future growth. Improvements should therefore aim to address gaps while building scale, reducing costs, and positioning finance to partner with business units. Although funding can be an issue, particularly when a need is perceived as longer term, investments made later often far exceed the costs of laying the groundwork in advance.

Develop risk management capabilities

Newly public companies face numerous new risks in areas such as compliance and reporting and with regard to legislation that applies only to public companies, notably SOX. Public companies also face an audience of investors, regulators, analysts, and journalists who have become sensitized to risk issues. This generates greater risks to reputation, which can jeopardize the company's base of customers and investors.

Therefore, a public company requires:

- Formal risk management (and governance) structures and practices
- Ways for management to identify, assess, and manage risk and to communicate with the board about risks and risk management
- Mechanisms for disclosing risks and risk management methods to the public, particularly in light of new requirements regarding risk disclosures
- Ways of systematically prioritizing risks and of allocating risk management resources and management time and attention to specific risks

Even when an executive team and a board of directors have been working together for years, they must actively develop policies and practices that address risk. In addition, they must demonstrate to regulators, analysts, investors, and the public that risks have been both identified and managed.

This means having a board that exercises its oversight role by guiding management to identify all relevant risks and that—through appropriate review—obtains assurance that all risks have been managed. This sets a tone at the top that fosters effective risk management and positive but realistic internal and external communication about risk.

Address legal and tax matters

Quite often one or more aspects of the legal or capital structure of a company must change before it goes public, for instance from an S Corporation or limited liability company to a C Corporation. Specific tasks may include reorganizing for entity conversion, choosing the best conversion method, creating a tax agreement between the former entity and its owners, and perhaps moving the entity to a "friendlier" state. This calls for expertise in IPO tax issues, which become even more complex when foreign jurisdictions are involved.

Readying the enterprise to address public company tax issues typically entails:

- Implementing pre-filing changes to the entity, capital and tax structure, preparing the tax discussion and reviewing the tax-sensitive MD&A statements expected within the prospectus, and preparing for due diligence
- Considering the tax consequences of the anticipated use and flow of IPO proceeds
- Readying the tax function with qualified staff and appropriate tax return and tax financial statement reporting processes and supporting IT systems
- Benchmarking against comparable public companies' tax-related internal controls and resetting as appropriate
- Considering the tax and ERISA implications of changes to compensation and benefit plans, particularly for the executive team, given that issues such as changes to the legal entity, deferred compensation, share transfers, and secondary offerings can significantly affect their net worth and the employer's compliance processes

The legal and tax implications of becoming a public company can significantly impact its reporting requirements and financial statement risks as well as its cash flow and profits and the executives' net worth. Therefore, issues related to legal structure and taxes are key considerations to address before and after the IPO, and they must be considered sooner in the process than many executives realize.

Are you ready for an IPO?

The market for IPOs can be volatile. Favorable conditions for taking a company public can vanish as quickly as they arise. Careful planning is critical. Outlining an IPO readiness assessment can be used as a roadmap to define a company's strategy and critical requirements. Minimally, these "short list" items should be in place.

- Business plan to sell the company's story to the public markets
- Financial contingencies and audited financial statements
- Adequate reporting systems, and documented processes
- Corporate governance policies and practices required for a public company
- Information required for the preparation of an IPO prospectus
- Highly specialized IPO advisory team: attorneys, auditors, underwriters, accounting advisors, financial printers, public relations, transfer agents, registrars, etc.

Ready for rave reviews?

One key to success as a public company is to start to operate as a public company well in advance of the IPO. That way, the people and processes are in place on Day One. This makes for an efficient IPO and a smooth transition to public company operations. It also enables management to focus solely on operating the company and not be distracted by the need to troubleshoot or to implement changes after the fact. Moreover, it helps create the competence, confidence, and performance that maximize the value of the IPO.

Again, many of these changes are worthwhile even if the company stays private. Public company practices may make the company more attractive to employees, customers, suppliers, and alliance partners—and to current and potential investors. Improved governance, finance organization, financial reporting, financial systems and processes, risk management, and tax and legal processes may boost the company's performance.

Also, having a properly conceived workplan for going public positions the company to enter the market at the best time rather than having to scramble to make it through a small, temporary window. Thus, a private company preparing for an IPO can realize immediate benefits in many areas, and make money, save money, and defer costs as appropriate to its IPO timeline.

This document only hints at the amount of time and effort that goes into a successful IPO. The process places new and significant demands on senior executives when they are already working full-tilt to maintain the growth that has positioned the company to go public. Those demands are not only those associated with the IPO process, but also with preparing to succeed after that process is complete.

Pre-IPO planning must therefore start with full knowledge of what is involved in preparing to go public and to operate as a public company. The IPO team must integrate senior executives with the auditors, accounting advisors, tax specialists, attorneys, underwriters, and public relations professionals needed to advise them. The plan must consider the tasks and the timing of the tasks required to go public and operate in public. Given the number of tasks and technicalities involved, planning should begin at least a year before the planned IPO—and preferably earlier. If you are even considering taking your company public, or playing a role in an initial public offering, consider the full impact on all areas of the company.

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