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Preface

August 2019

To the clients, friends, and people of Deloitte:

We are pleased to present the second edition of *A Roadmap to Initial Public Offerings*. Preparing for an IPO can be a complex, time-consuming, and often costly process. Accordingly, this Roadmap addresses financial reporting, accounting, and auditing considerations to help companies navigate challenges related to preparing an IPO registration statement and ultimately going public.

Promoting the U.S. IPO market has been a priority for SEC Chairman Jay Clayton. On September 26, 2017, Chairman Clayton made the following statement before the U.S. Senate Committee on Banking, Housing, and Urban Affairs:

> It is clear to me that companies that go through the U.S. IPO process emerge as better companies, with better disclosure. We want to encourage and preserve that dynamic. Overall, the SEC will strive for efficiency in our processes to encourage more companies to consider going public, which will result in more choices for investors, job creation and a stronger U.S. economy.

As further evidence of its commitment to promoting the U.S. IPO market, the SEC issued a proposed rule on February 19, 2019, which would expand the “test-the-waters” accommodation and allow all prospective issuers to gauge market interest in a possible IPO by permitting discussions with certain investors before the filing of a registration statement. Previously, the test-the-waters accommodation was only available to emerging growth companies (EGCs). In the press release on the proposed rule, SEC Chairman Jay Clayton noted the following:

> Extending the test-the-waters reform to a broader range of issuers is designed to enhance their ability to conduct successful public securities offerings and lower their cost of capital, and ultimately to provide investors with more opportunities to invest in public companies . . . . I have seen first-hand how the modernization reforms of the JOBS Act have helped companies and investors. The proposed rules would allow companies to more effectively consult with investors and better identify information that is important to them in advance of a public offering.

In addition, as part of its disclosure effectiveness initiative, the SEC has been exploring ways to make going public in the U.S. markets more attractive while still protecting investors.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.
We hope you find this Roadmap useful as you prepare for your IPO.¹ Should you have questions or concerns, please visit Deloitte’s IPO Center of Excellence or contact a Deloitte Partner listed in the contacts section of this publication.

Sincerely,

Deloitte & Touche LLP

¹ Note that this Roadmap is not a substitute for consulting with professional advisers on complex accounting and reporting questions and transactions associated with an IPO.
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Chapter 1 — Introduction to Initial Public Offerings

1.1 Key Laws That Govern the Securities Industry

Public companies are subject to a number of complex securities laws, many of which also affect the IPO process. The sections below introduce certain key securities laws relevant to securities offerings and public-company reporting.

1.1.1 Securities Act of 1933

The first major federal securities regulation passed was the Securities Act of 1933 (the “Securities Act” or the “1933 Act”). According to the SEC’s Web site, the two main goals of the Securities Act are to (1) “require that investors receive financial and other significant information concerning securities being offered for public sale” and (2) “prohibit deceit, misrepresentations, and other fraud in the sale of securities.” To accomplish those objectives, the 1933 Act addresses the registration requirements for securities and required disclosures in registration statements. Generally, an entity must register with the SEC all securities offered in the United States (i.e., a public offering) or “must qualify for an exemption from the registration requirements” (i.e., a private offering). Under the Securities Act, essential information must be provided to investors in a public offering. Such information includes (1) descriptions of “the company’s properties and business” and of “the security to be offered for sale” and (2) the company’s management and financial information (e.g., financial statements certified by an independent registered public accounting firm). The Securities Act also establishes a legal liability framework to protect investors from losses when there is “incomplete or inaccurate disclosure” of material information.

1.1.2 Securities Exchange Act of 1934

Shortly after the 1933 Act was signed into law, Congress passed the Securities Exchange Act of 1934 (the “Exchange Act” or the “1934 Act”). The Exchange Act resulted in the creation of the SEC, an independent body whose mission, as stated on its Web site, is to (1) “protect investors”; (2) “maintain fair, orderly, and efficient markets”; and (3) “facilitate capital formation.” The SEC is responsible for overseeing the U.S. securities markets and certain primary participants. Further, under the Exchange Act, the SEC has the power to enact and enforce securities regulations, including disciplinary rights (e.g., prosecution of insider trading), as well as to require that companies with publicly traded securities periodically report certain information.

Both the Securities Act and the Exchange Act have been subject to interpretation and numerous amendments since their enactment. For example, some amendments have resulted from legislation released in response to a financial crisis, such as the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). Other amendments, such as those related to the Jumpstart Our Business Startups (JOBS) Act (enacted in 2012), are intended to open access to the public markets. Such additional legislation is summarized below.
1.1.3 Sarbanes-Oxley Act

Sarbanes-Oxley was passed in the wake of a number of large, public financial scandals, including those at Enron and WorldCom. On its Web site, the SEC states that Sarbanes-Oxley “mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud.” Among the most significant changes were mandating personal liability for certain executive officers; implementing protections for whistleblowers; and requiring management — and, in many circumstances, the external auditor — to report on the adequacy of a company’s internal control over financial reporting (ICFR). Sarbanes-Oxley also established the PCAOB to oversee and regulate the activities of the auditing profession.

1.1.4 Dodd-Frank Act

Dodd-Frank was enacted in response to a financial crisis that culminated in 2008. As discussed on the SEC’s Web site, the purpose of Dodd-Frank is to protect consumers from abusive financial services practices by reshaping various aspects of the U.S. regulatory system, including, but not limited to, “consumer protection, trading restrictions, credit ratings, regulation of financial products, corporate governance and disclosure, and transparency.”

1.1.5 JOBS Act

The JOBS Act, signed into law on April 5, 2012, significantly affects the financial markets and IPOs. The act indicates that its objective is to “increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies [EGCs].” The most notable change brought about by the JOBS Act is the creation of the EGC, a new type of issuer that may take advantage of numerous regulatory and reporting accommodations. The JOBS Act was subsequently amended by the Fixing America’s Surface Transportation (FAST) Act of 2015, which, among other provisions, expanded the accommodations given to EGCs. See Section 1.6 for more information about EGCs and Appendix C for a summary of key accommodations available to EGCs.

1.2 Types of Issuers

The requirements for an IPO can vary from company to company. Factors that may affect the requirements include:

- **Whether the company is a domestic issuer or a foreign private issuer** — This publication focuses on the IPO requirements for domestic issuers. The requirements for foreign private issuers considering an IPO may significantly differ from those for their domestic counterparts. However, foreign private issuers can elect to file under domestic rules if they wish. A U.S.-based company issuing shares will always be considered a domestic issuer; however, a foreign-based company may not always qualify as a foreign private issuer. For a summary of criteria for qualifying as a foreign private issuer and related accommodations, see Section 6100 of the FRM.

- **Whether the company qualifies as a smaller reporting company (SRC)** — A company may qualify as an SRC on the basis of its public float and its annual revenue. Because a company undertaking an IPO has a public float of zero, it will typically qualify as an SRC if it had annual revenues of less than $100 million in its most recent fiscal year. The SEC filing requirements for SRCs are significantly scaled back from those for larger companies. Section 1.5 and Appendix B include an overview of SRCs and the related accommodations. Other sections of this Roadmap generally do not specifically address the unique requirements for SRCs.
Chapter 1 — Introduction to Initial Public Offerings

• Whether the company qualifies as an EGC — A private company undertaking an IPO will generally qualify as an EGC if it (1) has total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year and (2) has not issued more than $1 billion of nonconvertible debt over the past three years. As discussed above, EGCs are afforded many accommodations that can assist with the IPO process, many of which are addressed in the applicable sections of this Roadmap. Section 1.6 and Appendix C summarize these accommodations.

Once a company completes a public offering and becomes an SEC registrant, it will also need to determine its SEC filer status as a large accelerated filer, an accelerated filer, or a nonaccelerated filer, which will further affect the company's filing obligations and deadlines. See Chapter 7 for further discussion of filer status and considerations related to the post-IPO impacts of each filer status.

1.3 Types of IPOs

An IPO represents a private company's initial registration of debt or equity securities with the SEC. However, there are many ways in which a company can become public, including:

• Sale of newly issued common shares to the public — The most common type of IPO is the registration and sale of common stock to the public by filing a registration statement on Form S-1 under the 1933 Act. This type of IPO will typically generate offering proceeds for the issuer and result in the registration and public trading of the issuer's shares once the IPO is completed.

• The exchange of debt securities previously issued in a private transaction for registered debt securities — Debt securities initially sold through a private placement offering (e.g., under the SEC's Rule 144A) are subject to certain resale restrictions in accordance with the Securities Act. To facilitate greater liquidity, the securities issued in a private placement may include registration rights, which require the issuer to exchange the private securities for registered securities within a set period of time. This is often referred to as an “A/B” exchange offer, and the new securities are typically registered on Form S-4.

• The registering of currently outstanding equity securities — In a manner similar to the scenario described above, registration may be a means of achieving liquidity for shares previously issued through private placements, such as Regulation A or D offerings. Under Section 12(b) of the Exchange Act, for a class of security to trade on a national securities exchange, it must be registered. Or, in contrast to a voluntary registration, an entity might otherwise be compelled to register outstanding shares under Section 12(g) of the Exchange Act, which contains certain size thresholds that trigger mandatory registration. In either circumstance, the class of securities is typically registered on Form 10.

• The distribution of shares in a spin-off transaction by a public company — When a public company issues a subsidiary's shares to its shareholders via a dividend, the subsidiary (or “spinnee”) becomes an independent entity. To facilitate the subsequent trading of the spinnee's shares on a national securities exchange, a Form 10 may be used to register these shares.

• The registering of securities that are issued by real estate investment trusts (REITs), including “blind pool” offerings — A Form S-11 may be used to register shares in an SEC filing by REITs, whose business is acquiring or holding real estate for investment purposes. REITs may also file “blind pool” registration statements (typically also on a Form S-11) to sell securities to purchase real estate operations that are not identified.

1 For a list of the titles of standards and other literature referred to in this publication, see Appendix E.

2 Registration of a class of security is generally required when (1) there are 2,000 or more record holders of an equity security (or, alternatively, 500 or more nonaccredited investors) and (2) a company has over $10 million in total assets.
• The registering of securities that are issued by a special-purpose acquisition company (SPAC) — A Form S-1 may be used for the initial registration and sale of shares of a SPAC, a newly formed company that will use the proceeds from the IPO to acquire a private operating company (which generally has not been identified at the time of the IPO). To complete the acquisition of a private operating company, the SPAC may file a proxy or registration statement (see Section 1.7). Within four days of the consummation of the private operating company, the SPAC must file a “super Form 8-K” that includes all of the information required in a Form 10 registration statement of the private operating company.

Other related transactions, including reverse mergers, put-together transactions, drop-down transactions, and split-offs, can similarly result in the registering of securities. When considering registering securities with the SEC for the first time, companies are encouraged to consult with their SEC legal counsel to determine the appropriate SEC form to use to register such securities. Regardless of the nature of the IPO transaction or the type of securities registered, upon effectiveness, the issuer will be “public” and will therefore be required to begin complying with the periodic reporting requirements of the Exchange Act (e.g., filing of Forms 10-K, 10-Q, and 8-K).

1.4 The IPO Registration Statement

1.4.1 Registration Statement Filing and Review Process

While the nature of the IPO may vary, before an entity may commence a public offering of securities, the entity, or “registrant,” must file a registration statement with the SEC under the applicable securities laws. The registration statement contains extensive financial and business-related disclosures about the entity and the securities being offered. Common disclosures required in a typical IPO registration statement are summarized in Appendix A. Once submitted to or filed with the SEC, an IPO registration statement is processed and reviewed by the staff of the SEC’s Division of Corporation Finance. The purpose of the review is to determine whether the registration statement complies with the SEC disclosure requirements. The SEC does not evaluate the merits of securities offerings or reach a conclusion about whether they are “good” investments. A company can generally expect the staff to complete its initial review and furnish the first set of comments within 30 calendar days. The company would then respond to each of the SEC’s comments and reflect requested edits, as well as any other updates, in an amended IPO registration statement, which the SEC will also review. After the initial filing, the SEC’s review time can vary significantly but typically is within two weeks. A company can expect several rounds of comment letters with follow-up questions on responses to original comments as well as additional comments on new information included in the amended registration statement.

Depending on the length of time between amendments, financial statements and other information included in the registration statement may need to be updated to reflect subsequent periods. Certain information, such as estimated pricing of the IPO and related disclosures, may not be known as of the initial filing date and therefore is not added until a later amendment. However, the SEC expects each draft of the registration statement to be substantially complete at the time of its submission, unless there are specific accommodations for omitting otherwise required information.

Once all the staff’s comments are cleared, a company will typically print a preliminary prospectus, commonly referred to as a “red herring,” and go on a “road show” to meet with and present to prospective investors. After the road show, the company and its counsel may request that the SEC declare the registration statement “effective” at a certain date and time, after which the securities will be registered and, if listed on an exchange, begin trading.
While most registration statements will only become effective after the SEC comment process has been completed and an effective date has been requested by the company and granted by the SEC, registration statements on Form 10 filed in accordance with Section 12(b) of the 1934 Act are automatically effective 30 days after certification by an applicable securities exchange. Registration statements on Form 10 filed in accordance with Section 12(g) of the 1934 Act are automatically effective 60 days after the initial filing. Because a company will be required to begin complying with the periodic reporting requirements of the 1934 Act after effectiveness, it is critical to understand and plan for the effective date of any IPO registration statement.

Connecting the Dots
To avoid unnecessary surprises during the SEC's review process, management may want to establish a detailed response plan and filing calendar. Because financial statements “go stale” after certain dates, it is important to understand when this will happen and to establish contingency plans in case the timing of amendments crosses over stale dates. It may also be beneficial to engage all interested parties (e.g., auditors, underwriters, legal counsel) in planning the timeline. Management should anticipate various circumstances and be realistic about the internal resources available to complete the registration statement and respond to comment letters.

1.4.2 Nonpublic Review Process for Draft Registration Statements
Historically, registration statements filed with the SEC were immediately accessible to the public via EDGAR, the SEC's online public database. However, as discussed in Section 1.6, EGCs may confidentially submit certain IPO registration statements to the SEC. In 2017, the SEC extended a similar confidential benefit to non-EGCs, allowing them to also voluntarily submit draft IPO registration statements to the SEC staff for nonpublic review. The ability to file nonpublicly is a significant benefit because it allows companies to keep potentially sensitive information from customers or competitors until later in the IPO process. It also lets companies confidentially respond to SEC comments, update the draft registration statement, and continue to assess market conditions throughout the IPO process and enables them to delay or withdraw the IPO, if desired, without public scrutiny.

While draft registration statements may be initially submitted nonpublicly, a company will eventually be required to publicly file all previously submitted drafts unless it elects to withdraw the IPO. All confidential submissions must be filed publicly no later than 15 days before (1) a road show or (2) the requested effective date of the registration statement, if no road show is planned.

When filing a draft registration statement for nonpublic review, companies should consider the following:

- The draft registration statement must be “substantially complete.” It must contain a signed audit report from the company’s independent registered public accounting firm and meet all line item requirements applicable to the registration statement, unless a company is using certain permitted accommodations for omitting otherwise required information.

- For a draft registration statement, companies do not need to include items such as the required signatures of executives and directors, the auditor’s consent, and the filing fee.
At the time of a company's initial public filing, the registration statement should be:

- Devoid of any indications that the document is nonpublic.
- Complete (e.g., it should include signatures, signed audit reports, consents, exhibits, and any required filing fees).
- Accompanied by the contemporaneous filing of any previously submitted nonpublic draft registration statements.

### 1.5 Smaller Reporting Companies

#### 1.5.1 What Are SRCs?

A registrant may qualify as an SRC on the basis of either a public float test or a revenue test. The thresholds for qualification as an SRC are as follows:

<table>
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<th>Criteria</th>
<th>Definition</th>
</tr>
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<tbody>
<tr>
<td>Public float</td>
<td>Less than $250 million of public float as of the last business day of the registrant's second fiscal quarter.</td>
</tr>
</tbody>
</table>
| Revenue      | Less than $100 million of revenue as of the most recently completed fiscal year for which audited financial statements are available and either of the following:  
  - No public float.  
  - Public float less than $700 million as of the last business day of the registrant's second fiscal quarter. |

For initial 1933 Act or 1934 Act registration statements, public float is measured as of a date within 30 days of the filing. A company may qualify as both an SRC and an EGC (see Section 1.6); however, unlike the five-year limit for qualifying as an EGC, there is no time limit for qualifying as an SRC. Investment companies, asset-backed issuers, and subsidiaries that are majority-owned by non-SRC registrants cannot qualify as SRCs. Registrants should consider consulting with their legal counsel when determining whether they qualify as SRCs.

#### 1.5.2 Accommodations Applicable to SRCs

A key feature of reducing the reporting burden on SRCs is the scaling back of the requirements in both Regulation S-X and Regulation S-K.

SRCs may be eligible to apply the scaled disclosure requirements as part of their IPO. Under those requirements, SRCs do not have to disclose as many years of audited financial statements and MD&A as non-SRCs. In addition, SRCs are not required to disclose selected financial data, unaudited quarterly financial information, contractual obligations, or qualitative and quantitative information about market risk. For a more detailed analysis of the scaled disclosure requirements for SRCs, see Appendix B. Topic 5 of the FRM also discusses the SEC staff’s views on many SRC-related issues. Other than within this section and the related appendix, this Roadmap generally does not specifically address SRC requirements.

Companies that qualify as SRCs may choose to apply the scaled disclosure requirements on an item-by-item (or an “a la carte”) basis. However, their disclosures should be consistent from year to year and must comply with federal securities laws, including those that require disclosures not to be misleading.
Connecting the Dots

In determining which scaled disclosure requirements to apply, eligible companies may wish to conduct outreach and consider the information needs of their investors and other financial statement users. Thus, eligible companies may consider weighing any potential cost savings associated with the scaled disclosure requirements against not disclosing information that investors may consider valuable.

1.6 EGCs

1.6.1 What Are EGCs?

An EGC is a category of issuer that was established in 2012 under the JOBS Act and was granted additional accommodations in 2015 under the FAST Act. The less stringent regulatory and reporting requirements for EGCs are intended to encourage such companies to undertake public offerings. A private company undertaking an IPO will generally qualify as an EGC if it (1) “has total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year” and (2) has not issued more than $1 billion of nonconvertible debt over the past three years. Once a company completes its IPO, it must meet additional criteria to retain EGC status.

1.6.2 Accommodations Applicable to EGCs

There are many potential benefits for registrants that file an IPO as an EGC. For example, EGCs:

• Need only two years of audited financial statements in an IPO of common equity.\(^3\)
• Are not required to present selected financial data for periods before the first year of financial statements presented in the IPO.
• May omit financial information (including audited financial statements) from an IPO registration statement if that financial information is related to periods that are not reasonably expected to be required at the time the registration statement becomes effective.
• May elect not to adopt new or revised accounting standards until they become effective for private companies (i.e., nonissuers).
• Are eligible for reduced executive compensation disclosures.
• May submit a draft IPO registration statement to the SEC for confidential review.

EGCs are not required to apply the above accommodations and may choose to provide some scaled disclosures but not others. However, if an EGC has elected to opt out of the extended transition period for complying with new or revised accounting standards, this election is irrevocable. Therefore, the registrant, its advisers, and the underwriters should consider which EGC accommodations to use early in the IPO process. The SEC expects EGCs to disclose, in their IPO registration statements, their EGC status and to address related topics, such as the exemptions available to them, risks related to the use of those exemptions, and how and when they may lose EGC status.

Certain scaled disclosure provisions that apply to EGCs are also related to other SEC rules. For example, the accommodations listed above can typically also be applied to the requirement to include any other entities’ financial statements required under Regulation S-X, Rules 3-05 and 3-09. For more information, see Chapter 2.

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\(^3\) This accommodation is limited to an IPO of common equity. As the SEC clarifies in paragraph 10220.1 of the FRM, an entity will generally need to include three years of audited financial statements when entering into an IPO of debt securities or filing an Exchange Act registration statement, such as a Form 10, to register securities.
In addition, an issuer that was an EGC at the time it initially submitted its IPO registration statement for SEC review but that subsequently ceased to be an EGC is allowed to continue to use the accommodations provided to EGCs until the earlier of either the date it completes its IPO under that registration statement or one year after it ceased to be an EGC.

If an EGC elects to confidentially submit its IPO registration statements to the SEC, the submission will not immediately be posted on EDGAR (unlike most non-EGC registration statements, which are released on EDGAR shortly after being filed). However, the IPO registration statement must be “publicly” filed at least 15 days before the EGC’s road show. In addition, any draft registration statements and related comment letters and responses that the EGC submitted to the SEC staff for confidential review will be publicly released on EDGAR by the staff after the IPO registration statement becomes effective.

After its IPO, provided that a registrant retains its EGC status, additional accommodations are available for its ongoing reporting obligations. One of the most significant of these accommodations exempts EGCs from the requirement to obtain, from the entity’s independent registered public accounting firm, an auditor’s report on the entity’s ICFR. EGCs are also exempt, unless the SEC deems it is necessary, from any future PCAOB rules that may require (1) rotation of independent registered public accounting firms or (2) supplements to the auditor’s report, such as communications regarding critical audit matters, which are required for certain other issuers beginning in 2019. See Chapter 7 for further discussion of the ongoing requirements a registrant must comply with after its IPO is effective and the related EGC accommodations.

After going public, a registrant will retain its EGC status until the earliest of:

- The last day of the fiscal year in which its total annual gross revenues exceed $1.07 billion.
- The date on which it has issued more than $1 billion in nonconvertible debt securities during the previous three years.
- The date on which it becomes a large accelerated filer (which is an annual assessment performed on the last day of the fiscal year).
- The last day of the fiscal year after the fifth anniversary of the date of the first sale of common equity securities under an effective Securities Act registration statement for an EGC.

Topic 10 of the FRM summarizes many of the SEC staff’s views on EGC-related issues. To further assist registrants, the Division of Corporation Finance has issued FAQs on numerous aspects of the JOBS Act, many of which address matters related to qualifying for EGC status and the filing requirements for EGCs.

1.7 Special-Purpose Acquisition Companies

A SPAC is a newly created company that raises cash in an IPO and uses it to fund the acquisition of one or more private operating companies. After the IPO, the SPAC’s management looks to complete an acquisition of a target company within the period specified in its governing documents (e.g., 24 months). If an acquisition cannot be completed within this time frame, the cash raised in the IPO must generally be returned to investors. Because SPACs hold no assets other than cash before completing an acquisition, they are nonoperating public “shell companies” as defined by the SEC. If a target is identified and the SPAC is able to successfully complete the acquisition transaction, the merger may often be treated as a reverse recapitalization or reverse merger. In this type of transaction, the private operating company target succeeds to the SPAC’s filing status through the reverse merger or recapitalization. On the date the acquisition closes, the former private operating company, as the predecessor to the SPAC registrant, becomes a public company and must be able to meet all the public-company reporting requirements applicable to the combined company.
A SPAC’s shareholders are often required to vote on the merger transaction, so the SPAC may file a proxy or Form S-4 to effect the transaction. These documents usually must include audited financial statements of the private operating target. At the September 12, 2018, joint meeting between the CAQ SEC Regulations Committee and the SEC staff, the SEC indicated that private operating company SPAC target financial statements are expected to comply with public-company GAAP disclosure requirements, including those related to segments and earnings per share, and should include any required financial statements for significant probable and consummated acquisitions under SEC Regulation S-X, Rule 3-05, “as if it were the private operating company’s IPO.” The SPAC and its target must also comply with the requirements related to the age of financial statements in SEC filings. (See Section 1.11 of Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations* for further interpretive guidance on the age of financial statements.) Further, because the private operating company is considered the predecessor to the registrant, financial statements included in Form S-4 or the merger proxy must be audited in accordance with PCAOB standards. Chapter 3 provides further guidance on financial statement requirements.

Within four days of the closing of the acquisition, the combined company must file a Form 8-K (referred to as a “Super Form 8-K”) that includes all the information that would be required if the former private operating company had registered securities on Form 10. There is no 71-day grace period for providing audited financial statements of the formerly private operating company in the Super Form 8-K, as there may have been if the acquisition had been between two operating companies. Accordingly, the SPAC and the private operating target should take care to ensure that the acquisition is not closed until all the financial information required for the Super Form 8-K is available, including financial statements that comply with the SEC’s age requirements, audited in accordance with PCAOB standards. Paragraph 12220.1 of the FRM provides more information about the requirements related to the Super Form 8-K.

It can be complex to determine the ICFR attestation requirements that apply to management and the auditor after the close of a SPAC transaction. The phase-in exception in Regulation S-K, Item 308, for an IPO, under which management’s report and the auditor’s attestation on ICFR are not required before the second annual report, typically does not apply in a transaction with a SPAC. Further, if the SPAC is an EGC, the EGC status of the combined entity would also have to be assessed after the close of the transaction to determine whether the combined company could continue to qualify for the scaled disclosure requirements applicable to EGCs, including relief from the auditor’s attestation report. These transactions often involve a change in auditors, and if the SPAC’s year-end differs from that of the target, they may also involve a change in fiscal year-end. Given the complex reporting requirements associated with SPAC acquisitions, private operating companies contemplating such transactions should consider consulting with legal and financial reporting advisers as early as possible.

### 1.8 Offerings Made in Accordance With Regulation A

Regulation A, as amended in 2015 (also referred to Reg A or Reg A+), provides an exemption from the ordinary requirements of the Securities Act. This exemption allows U.S. and Canadian companies to raise up to $50 million in a 12-month period by issuing certain types of securities, including equity securities. Regulation A requires that certain disclosure documents be submitted via EDGAR and allows for the confidential review of offering documents. Two tiers of offerings are provided under Regulation A:

- **Tier 1**, which consists of securities offerings of up to $20 million in any 12-month period, including no more than $6 million on behalf of the selling securities holders that are affiliates.
- **Tier 2**, which consists of securities offerings of up to $50 million in any 12-month period, including no more than $15 million on behalf of the selling securities holders that are affiliates.

\(^4\) Under Item 2.01 of Form 8-K, a registrant is required to file a Form 8-K to announce a significant business acquisition within four business days of consummation and to include the required financial statements within 71 calendar days.
For offerings of up to $20 million, the issuer can elect whether to proceed under Tier 1 or Tier 2. All issuers that pursue offerings in accordance with Regulation A are required to submit an offering statement on EDGAR that may be reviewed by the SEC staff. Before an issuer can begin selling securities, its offering statement must be “qualified” by the SEC and the issuer must receive a “notice of qualification,” which is similar to a notice of effectiveness in registered offerings. The offering statement includes a disclosure document and financial statements. While disclosures required in the offering statement are “scaled” or reduced to be in line with the size of the company, many are similar in nature to disclosures required under Form S-1.

Tier 2 issuers are required to include audited financial statements in their offering documents and to file annual, semiannual, and current reports with the Commission on an ongoing basis. In accordance with the form requirements for Regulation A, separate forms are used for offerings (Form 1-A) and ongoing reporting requirements (Form 1-K, Form 1-SA, and Form 1-U for annual, semiannual, and current reports, respectively). Except for securities that will be listed on a national securities exchange upon qualification, purchasers in Tier 2 offerings must be either accredited investors or be subject to certain limitations on their investment. More information about Regulation A offerings is available on the SEC's Web site at the “Amendments to Regulation A: A Small Entity Compliance Guide” page.

5 While a Regulation A Tier 1 issuer must provide financial statements in its offering document, such financial statements do not need be audited unless the issuer’s financial statements were already audited for other purposes. Regulation A Tier 1 issuers are not subject to ongoing reporting requirements.
Chapter 2 — Identifying the Required Financial Statements for the Registration Statement

One of the more challenging aspects of preparing for an IPO is ensuring that the entity has identified the appropriate financial statements to include in the filing. There are many considerations related to determining the appropriate financial statements to include in the IPO registration statement. For example, management will need to identify and prepare the financial statements both for the registrant and for any predecessor entities (see Section 2.2). In addition to the complexities associated with identifying the required financial statements for the registrant and its predecessor(s), management must consider other potential financial statement requirements that may result in additional meaningful historical financial information for investors in the IPO. The specific requirements, discussed in greater detail below, could be related to significant business acquisitions, equity method investments, guarantors of registered securities, or entities that collateralize registered securities.

Changing Lanes
On May 3, 2019, the SEC issued a proposed rule that would amend the financial statement requirements for (1) acquired or to be acquired businesses in Rule 3-05, (2) real estate operations in Rule 3-14, and (3) pro forma financial information in Article 11. The proposal would also make certain modifications to the significance tests in Rule 1-02(w). Registrants affected by such requirements should closely monitor the status of this rulemaking activity.

Before preparing the registration statement, entities are strongly advised to consult with their independent auditors and legal counsel to determine the appropriate financial statements to include. When the circumstances are particularly complex, registrants may wish to submit a prefiling letter to the SEC’s Division of Corporation Finance (the “Division”) to preclear the planned financial statement presentation and avoid surprises or potential delays during the SEC’s review of their IPO filing. Registrants may wish to seek modifications to their financial reporting requirements when the application of a rule results in the requirement to provide more information than the registrant believes is necessary. For example, a registrant may submit a prefiling letter, referred to herein as a Rule 3-13 waiver, in which it requests to omit the financial statements for a significant acquired business, real estate acquisition, or equity method investment. See Section 2.3.5 for more information about Rule 3-13 waivers.

2.1 Registrant Financial Statements
The first step in determining the financial statement requirements in an IPO is to determine the registrant. The registrant is typically the entity that is issuing securities in the IPO and filing the registration statement. Further, after the IPO, the registrant will need to comply with the ongoing public reporting requirements (e.g., annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K), as described in Chapter 7.
In many cases, an existing operating entity may proceed with an IPO in its current legal form and would be identified as the registrant. Alternatively, the existing operating entity may undergo a corporate reorganization before filing an IPO or before becoming a registrant. In other situations, a recently organized entity may be formed as the registrant, and there may be a plan to combine it with one or more operating entities before an IPO. All of these factors can affect which reporting entities’ financial statements are required in the IPO.

Although the registrant’s financial statements generally should be included in the IPO registration statement, sometimes they will not be sufficient. An entity may need to carefully evaluate the formation, history, and legal structure of the entities or businesses involved in the IPO to determine which financial statements are required. For example, an entity may need to consider recently organized registrants, predecessor entities, carve-outs of existing legal entities, and “put-together” or “roll-up” transactions, all of which are discussed in more detail below.

2.1.1 Recently Organized Registrant Financial Statements

A recently organized entity (sometimes referred to as a shell company) with few or no historical operations may be formed as the registrant for the purpose of acquiring one or more operating companies upon or before the consummation of its IPO.

Generally, the financial statements of a recently organized registrant must be presented in the IPO registration statement even if it has no historical operations. In these cases, an audited “seed money” balance sheet of the newly formed registrant is presented, typically as of the date of incorporation, to show the initial capitalization of the entity. Statements of operations, comprehensive income, and cash flows may be omitted if there has been no activity other than the formation transaction. However, such financial statements must still comply with the form, content, and updating requirements of Regulation S-X. When a recently organized registrant’s financial statements are included in an IPO filing, additional financial statements, such as those described in the paragraphs below, will almost always be required. In some circumstances, a recently organized registrant’s financial statements may be omitted from a filing; in such cases, the registrant would provide a statement indicating that the recently organized entity has not commenced operations and has no (or nominal) assets or liabilities. For more information, see Section 1160 of the FRM.

One type of shell company is a SPAC, which is a newly created company that raises cash in an IPO to fund the acquisition of one or more private operating companies within a specified period. Generally, the companies to be acquired will not be identified until later and the financial statements of the operating companies therefore are not included in the IPO of the SPAC. Financial statements of the operating companies will be included in a post-IPO filing. See Section 1.7 for more information regarding SPACs.

2.2 Predecessor Financial Statements

If a registrant has not had substantive operations for all periods presented in an IPO registration statement, it is important to consider whether the registrant has a “predecessor” company or business.
Section 1170 of the FRM indicates that the designation of an acquired business as a predecessor is based on both of the following criteria:

- The registrant “succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities).”
- “[T]he registrant’s own operations before the succession appear insignificant relative to the operations assumed or acquired.”

A predecessor’s historical financial information is considered important to an investing decision. As a result, the registrant’s financial statements and those of its predecessor together should typically cover all periods required by Regulation S-X, with no lapse in audited periods. Further, the predecessor financial statements must be audited in accordance with PCAOB, not AICPA, standards and will be required not only in the IPO but also in subsequent periodic reports.

The SEC staff believes that when a newly formed company (i.e., a “newco”) is formed to acquire multiple entities in conjunction with an IPO, instances in which there is no predecessor would generally be rare, even if the newco is substantive and was deemed the accounting acquirer. The staff highlighted a number of factors for registrants to consider in determining the predecessor, including (but not limited to) (1) the order in which the entities are acquired, (2) the size of the entities, (3) the fair value of the entities, and (4) the ongoing management structure. The staff indicated that no one item is determinative on its own and that there could also be more than one predecessor.

Carve-outs and entities in roll-up transactions frequently meet the criteria to be identified as predecessors and are discussed below in more detail.

### 2.2.1 Carve-Out Financial Statements

As described in Section 2.4.2.2, “carve-out financial statements” is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. A carve-out situation occurs when a parent company segregates a portion of its operations and prepares a distinct set of financial statements for the segregated portion in preparation of a sale, spin-off, or IPO of the “carve-out business.” Examples of a carve-out business include an operating segment or multiple segments, all or part of a subsidiary, or even a division or line of business of a larger parent company. The carve-out business is frequently not in a separate, preexisting legal entity and thus is often merged into a recently organized entity in an IPO.

In an IPO, it is critical that carve-out financial statements reflect the appropriate assets and operations of the registrant or its predecessor so that the financial statements include all the costs of doing business. Frequently, a carve-out business will involve multiple legal entities and include operations that have not historically been reported separately. In determining the composition of the carve-out financial statements, an entity should consider its specific facts and circumstances and may need to use significant judgment. Carve-out financial statements should present information about all aspects of the carve-out business’s historical results and operations (i.e., provide balanced and transparent financial information that reflects all of the operation’s historical successes and failures). As a result, the carve-out financial statements may even include certain assets or operations that are not part of the IPO transaction. These financial statements may therefore reflect more than the entity in which the investor ultimately invests. However, in this situation, a registrant would provide pro forma financial information to adjust the historical carve-out financial statements to reflect only the net assets and operations included in the IPO.
The SEC staff has acknowledged that determining which carve-out financial statements to include in a registration statement can be complex. Registrants therefore need to use judgment in making this determination, particularly because (1) there may not be directly applicable SEC guidance on this topic and (2) the accounting guidance (e.g., the guidance in ASC 505-60 on determining the accounting spinor and spinnee) may not be completely consistent with the SEC’s reporting requirements. The SEC staff has also indicated that financial reporting differences may arise depending on the legal form of the transaction. Therefore, the form and content of these financial statements may vary depending on the circumstances.

In determining what to include in the carve-out financial statements, registrants may need to consider issues such as the parent’s existing reporting structure (e.g., segments and reporting units), the nature and size of the operations being carved out compared with the operations being retained by the parent, and the legal structure of the carve-out. Registrants should also consider the information in the “description of business” and MD&A sections of their registration statements and whether such information, along with the financial statements, provides a consistent, full, and transparent picture for investors.

Carve-out entities in an IPO will need to consider their compliance with regulations governing other entities’ financial statements, including those in Rules 3-05 and 3-09 related to acquisitions and equity method investments, respectively. Such regulations will have to be considered on a stand-alone basis because the level of significance of acquisitions and the equity method investments to the carve-out entity may differ significantly from the level of significance to its parent.

For additional considerations related to carve-out transactions, see Deloitte’s *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*.

### 2.2.2 Put-Together or Roll-Up Transactions

Regulation S-K, Item 901(c)(1), defines a “roll-up” transaction as “a transaction involving the combination or reorganization of one or more partnerships, directly or indirectly, in which some or all of the investors in any of such partnerships will receive new securities, or securities in another entity.” A “put-together” is not specifically defined by the SEC but is discussed in paragraph 2025.12 of the FRM as a transaction in which more than two previously unrelated businesses combine concurrently with an IPO. Such a transaction normally occurs when a shell company is formed to purchase two or more businesses or an operating entity acquires several entities at once. The proceeds from the IPO are generally used to fund the acquisitions.

The terms “put-together” and “roll-up” are also sometimes used generically for other transactions in which two or more smaller companies are combined to form a larger company before an IPO transaction. One common example would be a scenario in which investors (often private equity firms) acquire multiple smaller companies within the same market and combine them to form a larger company, with a goal of achieving economies of scale or combining companies with complementary capabilities. Regardless of the form of the transaction, there are many unique considerations related to an IPO of an entity created through a “put-together” or “roll-up” transaction. Such considerations may include:

- The timing of the mergers, which can range from acquisitions over a multiyear period before an IPO to acquisitions concurrent with, and contingent on, the closing of an IPO.
- Any preexisting commonality of ownership between the combining entities.
• Whether the combining entities are considered “related businesses” under SEC guidance.¹
• Who the accounting acquirer is and how the mergers will be accounted for.
• Identifying the registrant and whether there is a predecessor (or potentially multiple predecessors).
• Whether financial statements of any combining entities may be required under Rule 3-05 in addition to the financial statements of the registrant and its predecessor(s).

2.3 Financial Statement Periods Presented

An entity must include in its registration statement audited annual financial statements and related footnote disclosures for both the registrant and any predecessor(s). The number of periods to be included depends on the registrant’s status as an EGC or non-EGC. In addition, depending on the time that has elapsed between the most recent fiscal year-end and the filing of the registration statement, an entity may be required to include unaudited interim financial statements and related footnote disclosures. The periods to be presented for both annual and interim financial statements are summarized in the table below. See Sections 1110 and 1120 of the FRM for more information about the financial statement requirements for annual and interim reporting periods, respectively.

<table>
<thead>
<tr>
<th>Financial Statement Requirement</th>
<th>Non-EGCs</th>
<th>EGCs²</th>
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<tbody>
<tr>
<td><strong>Annual Financial Statements (Audited)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance sheet</td>
<td>2 years</td>
<td>2 years</td>
</tr>
<tr>
<td>Income statement</td>
<td>3 years</td>
<td>2 years³</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>3 years</td>
<td>2 years⁴</td>
</tr>
<tr>
<td>Cash flows</td>
<td>3 years</td>
<td>2 years⁵</td>
</tr>
<tr>
<td>Changes in shareholders’ equity</td>
<td>3 years</td>
<td>2 years⁶</td>
</tr>
<tr>
<td><strong>Interim Financial Statements (Unaudited)</strong></td>
<td></td>
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<tr>
<td>Balance sheet</td>
<td>As of the end of the most recent interim period after the latest fiscal year-end</td>
<td>As of the end of the most recent interim period after the latest fiscal year-end</td>
</tr>
<tr>
<td>Income statement</td>
<td>The period from the latest fiscal year-end to the interim balance sheet date and the corresponding period in the prior fiscal year</td>
<td>The period from the latest fiscal year-end to the interim balance sheet date and the corresponding period in the prior fiscal year</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>Same as income statement</td>
<td>Same as income statement</td>
</tr>
<tr>
<td>Cash flows</td>
<td>Same as income statement</td>
<td>Same as income statement</td>
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</table>

¹ Businesses are related if (1) they are under common control or management or (2) their acquisitions depend on each other or on a single common event or condition. See paragraph 2015.12 of the FRM for more information.

² Some EGCs may also qualify as smaller reporting companies. See Section 1.5 and Regulation S-X, Article 8, for information and reporting requirements for smaller reporting companies.

³ The two-year accommodation for EGCs is limited to an IPO of common equity. As clarified by the SEC in paragraph 10220.1 of the FRM, in an IPO of debt securities or the filing of an Exchange Act registration statement (e.g., a Form 10) to register securities, three years of audited financial statements will generally be required.

⁴ See footnote 3.

⁵ See footnote 3.

⁶ See footnote 3.
2.3.1 Periods Required for Predecessor Entities

As indicated in paragraph 1170.2 of the FRM, the annual and interim financial statements for the registrant and its predecessor should collectively be “as of” all dates and “for” all periods required by Regulation S-X, Articles 3 and 10, as shown in the table above. When the registrant and its predecessor have already combined as of the IPO filing, the predecessor’s financial statements are required for all periods before the succession (i.e., up to the date of the combination), with no lapse or gap in audited periods. However, if the registrant and predecessor have not yet combined as of the IPO filing, the predecessor would present all periods required as if it was the registrant.

2.3.2 Interim Financial Statements

Regulation S-X, Article 10, outlines the financial statement requirements for interim reporting. The interim financial statements and related footnotes may be presented on a condensed basis in a level of detail allowed by Article 10 but will always need to contain disclosure of any material matters that were not disclosed in the most recent annual financial statements. While the interim financial statements may be unaudited, they are subject to a review under PCAOB standards by the registrant’s independent registered public accounting firm. The interim-period information may be combined with the audited annual financial statements, with the interim information clearly marked as unaudited. Alternatively, the interim-period information may be presented as a separate set of unaudited financial statements. Because a company undergoing an IPO may not have historically prepared interim financial statements, the company should ensure that it has established proper controls and procedures for accurately preparing such information.

2.3.3 Age of Financial Statements

In accordance with Regulation S-X, Rule 3-12, the financial statements in an IPO must meet certain age requirements as of each registration-statement filing date as well as when the registration is declared effective; otherwise, the financial statements will be considered “stale.” In general, the financial statements in an IPO filing must not be more than 134 days old (i.e., the gap between the date of filing or effectiveness and the date of the latest balance sheet cannot be more than 134 days). However, third-quarter financial statements are considered timely through the 45th day after the most recent fiscal year-end, after which the audited financial statements for the most recent fiscal year are required. See Section 1220 of the FRM for additional details.

2.3.4 Omission of Certain Financial Information From Draft Registration Statements

While each draft of a registration statement is generally expected to contain all information required by SEC regulations, there is an accommodation available to companies that allows them to omit financial statement periods in certain circumstances. This accommodation was initially granted to EGCs as part of the JOBS Act but was subsequently expanded by the SEC to include non-EGCs as well. Specifically, under

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7 May be presented in a footnote to the financial statements. We believe that the analysis of changes in shareholders’ equity is required for each period for which an income statement is presented and that therefore both the year to date and corresponding interim period of the prior fiscal year are required. For more information, see the SEC’s August 2018 final rule on updating and simplifying disclosures.

8 See footnote 7.
the accommodation, a company may omit financial information from a nonpublic draft registration statement (see Section 1.4.2) for historical periods currently required if the company reasonably believes that it will not be required to include these historical periods at the time of the public filing. This provision is likely to apply when the SEC’s review process extends through a financial statement stale date. When a company files publicly for the first time, it must include all financial information required as of the public filing date.

**Example 2-1**

A non-EGC calendar-year-end company submits a draft registration statement in December 20X7 and reasonably expects to file publicly for the first time in April 20X8 when annual financial statements for 20X7, 20X6, and 20X5 will be required. In such a case, the company may omit its 20X4 annual financial statements (and include only 20X5 and 20X6 annual periods) from its nonpublic draft registration statement because the 20X4 annual financial statements will not be required at the time of the first public filing.

For non-EGCs, Question 101.05 of the SEC’s C&DIs on the Securities Act Forms clarifies that when evaluating which interim periods to include in a draft registration statement, companies may omit interim financial information if they reasonably believe that they will not be required to separately present such information at the time they publicly file their registration statement. As a result, many initial draft registration statements may not need to include interim financial statements when they are submitted nonpublicly.

**Example 2-2**

A non-EGC calendar-year-end company submits a draft registration statement in December 20X7 and reasonably expects to file publicly for the first time in April 20X8 when annual financial statements for 20X7, 20X6, and 20X5 will be required. In such a case, the company may omit its nine-month 20X7 and 20X6 interim financial statements from its nonpublic draft registration statement because the company will not be required to separately present those periods when it first publicly files its registration statement in April 20X8. The annual financial statements for 20X7, 20X6, and 20X5 will be required when the registration statement is filed publicly for the first time in April 20X8.

**Example 2-3**

A non-EGC calendar-year-end company submits a draft registration statement in late August 20X7 and reasonably expects to file publicly for the first time in December 20X7 when nine-month 20X7 and 20X6 interim financial statements will be required. In such a case, the company may omit its six-month 20X7 and 20X6 interim financial statements from its nonpublic draft registration statement because the company will not be required to separately present those periods when it first publicly files its registration statement in December 20X7. The nine-month 20X7 and 20X6 interim financial statements will be required when the registration statement is filed publicly for the first time in December 20X7.

In addition, the Division updated Question 1 of its C&DIs on the FAST Act, and added a corresponding C&DI (Question 101.04) to the Securities Act Forms C&DIs, to clarify the interim financial information required in draft registration statements submitted by an EGC. Under the updated guidance, an EGC that submits a draft registration statement can omit interim financial information that it reasonably believes it will not be required to separately present at the time of the contemplated offering. However, the appropriate interim financial information would still be required in a registration statement that is publicly filed.
Connecting the Dots

Non-EGC registrants would need to include all financial information required at the time the registration statement is publicly filed, and the SEC will not process a publicly filed registration statement if such financial information is omitted. This guidance differs from the relief provided by Section 71003 of the FAST Act, which allows EGCs to omit financial information (on Form S-1) that they reasonably believe they will not be required to include in the registration statement “at the time of the contemplated offering” (emphasis added).

A company that does not take advantage of the Division’s nonpublic review process and elects to publicly file its initial registration statement would not be allowed to omit from its initial registration statement financial information that it reasonably believes will not be required at the time of the contemplated offering. If a company believes that an accommodation would be appropriate in a registration statement that is publicly filed, reasonable requests for such an accommodation may be directed to the relevant assistant director office in the Division that is responsible for performing the review.

See Appendix C for a summary of benefits available to EGCs and non-EGCs.

2.3.5 Rule 3-13 Waivers and Other Requests

Regulation S-X, Rule 3-13, has historically given the SEC staff the authority to permit the omission or substitution of certain financial statements otherwise required under Regulation S-X when doing so is “consistent with the protection of investors.” For example, in an IPO, the registrant's historical financial statements may exhibit significant growth. In this case, certain acquisitions, such as a business acquired in the earliest year, may not be material to the registrant's current operations. Therefore, when a registrant believes that the literal application of the significance test leads to the provision of financial statements for an acquired business under Rule 3-05 (or another requirement such as that for a significant equity method investment under Rule 3-09) that are not material, not relevant, or not meaningful to investors, the registrant is encouraged to submit — to the Division's Office of the Chief Accountant — a Rule 3-13 waiver request to omit or substitute certain financial statements otherwise required by Regulation S-X. The staff has indicated that it is also available to discuss potential waiver fact patterns by phone before a registrant submits a waiver request. For additional guidance on Rule 3-13 waivers and other requests, see Appendix B of Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights and December 16, 2018, Heads Up.

2.4 Financial Statements of Businesses Acquired or to Be Acquired (Rule 3-05)

When a significant business acquisition is consummated, or it is probable that it will be consummated, the registrant may be required to file certain financial statements of the acquired business or to be acquired business (acquiree) in accordance with Rule 3-05. While existing registrants are subject to periodic reporting requirements for significant acquisitions, a company is not subject to such requirements before an IPO. Therefore, in the context of an initial registration statement, a company must evaluate all acquisitions since the beginning of the earliest financial statement period presented (see examples below). As a result, a registrant could be required to prepare and file preacquisition financial statements for an acquiree that was purchased several years before the IPO.

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9 Under Item 2.01 of Form 8-K, a registrant is required to file a Form 8-K to announce a significant business acquisition within four business days of consummation and to include the required financial statements within 71 calendar days.
The following factors govern whether and, if so, for what period, the acquiree’s financial statements are required for a consummated or probable acquisition:

- **Definition of a business** — Rule 3-05 applies to an acquisition of a business. The definition of a “business” for SEC reporting purposes differs from the definition under ASC 805 for U.S. GAAP purposes and focuses primarily on the continuity of revenue-producing activities.\(^\text{10}\) Note that an acquisition can take many forms (i.e., acquisition of assets vs. acquisition of a legal entity) and that such forms typically will not affect the determination of whether the acquiree is a business.

- **Significance** — The highest level of significance based on the following three tests is used to determine the financial statements, if any, that an entity is required to provide in the registration statement:
  
  - **Investment test** — The GAAP purchase price is compared with the total assets of the registrant on the basis of its most recent preacquisition annual financial statements.
  
  - **Asset test** — The acquiree’s total assets are compared with the registrant’s total assets on the basis of the most recent preacquisition annual financial statements of each company.
  
  - **Income test** — The acquiree’s pretax income from continuing operations\(^\text{11}\) is compared with the registrant’s pretax income from continuing operations on the basis of the most recent preacquisition annual financial statements of each company.

The significance tests in Regulation S-X, Rule 1-02(w), can be quite complex. For more information on the significance tests and other related issues, see Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations*.

### 2.4.1 Periods of Financial Statements Required

The significance of an acquisition is based on the highest individual percentage generated when a registrant performs the three tests described above. The following table summarizes the financial statement requirements at various significance thresholds for a business acquired:\(^\text{12}\)

<table>
<thead>
<tr>
<th>Highest Level of Significance</th>
<th>Financial Statements Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 20 percent</td>
<td>• Acquisition is not individually significant; no financial statements are required.</td>
</tr>
<tr>
<td></td>
<td>• For acquisitions after the most recent audited balance sheet date included in the registration statement, individually insignificant acquisitions are evaluated in the aggregate.(^\text{13})</td>
</tr>
</tbody>
</table>

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\(^{10}\) Regulation S-X, Rule 11-01(d), states, in part, “[T]he term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity’s operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business.”

\(^{11}\) Rule 1-02(w) indicates that pretax income from continuing operations is “income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle — exclusive of amounts attributable to any noncontrolling interests.”

\(^{12}\) A company may be able to omit the financial statements of an acquired business from its draft registration statement for certain periods. See Section 2.4.4 for more information. Also see Section 2.4.3, which addresses other considerations such as probable acquisitions.

\(^{13}\) Separate financial statements of individually insignificant businesses acquired since a registrant’s latest audited year-end balance sheet are not required if their aggregate significance does not exceed 50 percent. If the aggregate significance exceeds 50 percent, audited financial statements for the mathematical majority of the businesses must be provided for only the most recent fiscal year. See Section 2035 of the FRM for further reporting considerations and other circumstances in which the rule may apply.
(Table continued)

<table>
<thead>
<tr>
<th>Highest Level of Significance</th>
<th>Financial Statements Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 percent–40 percent</td>
<td>• Audited balance sheet as of the end of the most recent fiscal year. &lt;br&gt; • Audited statements of operations, comprehensive income, cash flows, and changes in stockholders’ equity for the most recent fiscal year. &lt;br&gt; • Unaudited financial statements as of and for the appropriate interim period preceding the acquisition and the corresponding interim period in the prior year, if applicable.</td>
</tr>
<tr>
<td>40 percent–50 percent</td>
<td>• Audited balance sheets as of the end of the two most recent fiscal years. &lt;br&gt; • Audited statements of operations, comprehensive income, cash flows, and changes in stockholders’ equity for the two most recent fiscal years. &lt;br&gt; • Unaudited financial statements as of and for the appropriate interim period preceding the acquisition and the corresponding interim period in the prior year, if applicable.</td>
</tr>
<tr>
<td>Greater than 50 percent</td>
<td>• Audited balance sheets as of the end of the two most recent fiscal years. &lt;br&gt; • Audited statements of operations, comprehensive income, cash flows, and changes in stockholders’ equity for the three most recent fiscal years. &lt;br&gt; • Unaudited financial statements as of and for the appropriate interim period preceding the acquisition and the corresponding interim period in the prior year, if applicable. &lt;br&gt; • Exceptions: &lt;br&gt;   ○ If revenues of the acquired business are less than $100 million in the most recent fiscal year, the earliest year can be omitted. &lt;br&gt;   ○ If the acquiring company qualifies as an EGC, no more than two years of financial statements are required in an IPO for common equity.</td>
</tr>
</tbody>
</table>

While the requirements in the table above generally refer to preacquisition periods, in an IPO, it is also possible to use postacquisition periods (which are included in the registrant’s historical financial statements) to satisfy the requirements of Rule 3-05, as discussed further below. Preacquisition financial statements of the acquired business are generally prepared on the same basis as if the acquired company were a registrant, except that the level of significance is used to determine the number of years of audited financial statements. In addition, if the acquiree is not public, it does not need to comply with certain accounting principles or disclosure requirements that only apply to public companies, such as those related to segments or earnings per share (EPS). However, some accounting standards differentiate between disclosure requirements or adoption dates for public business entities (PBEs) and those for nonpublic entities. Significant acquirees whose financial statements are

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14 For consummated acquisitions, this generally results in interim financial statements as of the acquiree’s last fiscal quarter-end completed before the closing of the acquisition and for the year-to-date interim period ending on this date, along with the corresponding interim period in the prior fiscal year.
15 See footnote 14.
16 See footnote 14.
17 See Question 16 of the SEC’s “Jumpstart Our Business Startups Act Frequently Asked Questions,” which states, in part, “If the significance test results in a requirement to present three years of financial statements for these other entities, we would not object if the emerging growth company presents only two years of financial statements for these other entities in its registration statement.”
included in a registrant’s filing under Rule 3-05 are considered PBEs under U.S. GAAP. Therefore, such acquirees should use PBE adoption dates and disclosure requirements when preparing their financial statements. Generally, the financial statements for a significant acquisition may be audited in accordance with AICPA standards. SEC regulations do not require registrants to audit or review interim financial statements provided under Rule 3-05. However, the company’s underwriters will often require that the interim information be reviewed by an independent registered public accounting firm for due-diligence or comfort-letter purposes.

2.4.2 Form of Financial Statements

2.4.2.1 Full Financial Statements

If the acquired asset or group of assets represents substantially all of an entity, the entire entity’s full audited financial statements are generally required. Paragraph 2065.1 of the FRM states that in these circumstances, “full audited financial statements of the entity are presumed to be necessary in order to provide investors with the complete and comprehensive financial history of the acquired business.”

2.4.2.2 Carve-Out Financial Statements

Paragraph 2065.2 of the FRM notes that if the acquired asset or group of assets does not represent substantially all of the selling entity, “financial statements of the larger entity of which the acquired business was a part may not be informative.” Therefore, the audited financial statements should only represent the selected parts of the entity acquired, excluding the operations retained by the seller. These financial statements are often referred to as carve-out financial statements. Carve-out financial statements include, for the appropriate periods, balance sheets; statements of operations, comprehensive income, and cash flows; changes in stockholders’ equity; and the respective notes to the financial statements. The SEC staff believes that carve-out financial statements should reflect (1) all assets and liabilities of the acquired business even if they are not acquired or assumed as part of the acquisition and (2) all costs of doing business. For further discussion, see Deloitte’s A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions. Also see SAB Topic 1.B as well as Sections 7200 and 7400 of the FRM.

2.4.2.3 Abbreviated Financial Statements

In certain circumstances, carve-out financial statements may not be practicable to prepare, such as when the acquired asset or group of assets is a small portion or a product line of a much larger business and is not a stand-alone entity; distinct and separate accounts necessary to present the full financial statements of the business were not maintained; and separate audited financial statements have never been prepared. In such instances, the SEC staff may allow registrants to provide abbreviated financial information — that is, audited statements of assets acquired and liabilities assumed (in lieu of a full balance sheet) and audited statements of revenues and direct expenses (in lieu of a full statement of operations) — to meet the financial statement requirements in Regulation S-X, Rule 3-05. Except for acquisitions of certain oil and gas properties (discussed in paragraph 2065.11 of the FRM), the use of this abbreviated financial information in lieu of carve-out financial statements is not permitted without prior written request to the Division’s Office of the Chief Accountant.

18 Paragraph BC12 of ASU 2013-12 states that an entity meets the definition of a PBE when it “is required by the SEC to file or furnish financial statements or does file or furnish financial statements with the SEC” (e.g., its “financial statements or financial information that is required to be or is included in a filing with the SEC [such as the information required under Regulation S-X, Rules 3-09, 3-05, and 4-08(g)])”.

19 Regarding the FASB’s standards on revenue (ASC 606) and leases (ASC 842), the SEC staff announced that it would not object to elections by certain PBEs to use the non-PBE effective dates for the sole purpose of adopting these two standards.

20 In certain cases, if an acquired company is identified as a predecessor (see Section 2.2), the audit must be performed in accordance with PCAOB standards.
For additional information about carve-out financial statements, including abbreviated financial statements, see Section 2065 of the FRM.

### 2.4.3 Other Considerations

In addition to the general financial statement requirements related to the consummation of a significant business acquisition, other considerations might affect the reporting requirements. The following table summarizes such potential considerations:

<table>
<thead>
<tr>
<th>Topic</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use of postacquisition results</td>
<td>In an initial registration statement, the registrant's audited financial statements may include postacquisition results of an acquired business. The SEC staff allows audited postacquisition results to satisfy the financial statement requirements for the acquired business. This may be most useful for acquisitions that occurred in the earlier years presented in the registration statement, since substantial postacquisition results would be included in the registrant's financial statements. If a registrant relies on a combination of preacquisition and postacquisition results, the acquiree's preacquisition and postacquisition audited periods must be consecutive, with no gap or overlap in audited information. (See paragraph 2030.4 of the FRM.)</td>
</tr>
<tr>
<td>Omitting the balance sheet</td>
<td>When the registrant's audited balance sheet is for a date after the consummation of the acquisition, a separate balance sheet of the acquiree is not required, since the acquiree's balances are included in the acquiring company's balance sheet. (See paragraph 2030.2 of the FRM.)</td>
</tr>
<tr>
<td>Audited period less than a year</td>
<td>Regulation S-X, Rule 3-06, permits the use of audited financial statements of an acquired business for a period of nine to twelve months to satisfy one year of financial statement requirements.</td>
</tr>
</tbody>
</table>
### Chapter 2 — Identifying the Required Financial Statements for the Registration Statement

<table>
<thead>
<tr>
<th>Topic</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recently consummated business acquisitions</td>
<td>Financial statements of a significant acquired business that are not more than 50 percent significant (on the basis of any of the three tests) are not required in a registration statement that is filed or declared effective before the 75th day after the consummation of the acquisition. (See paragraph 2040.1 of the FRM.)</td>
</tr>
<tr>
<td>Probable business acquisitions</td>
<td>If a probable business acquisition does not exceed the 50 percent significance level (on the basis of any of the three tests), financial statements of that business may be excluded. (See paragraph 2040.1 of the FRM.)</td>
</tr>
<tr>
<td>Related businesses</td>
<td>Related businesses must be treated as a single business acquisition in the assessment of significance. Businesses are related if (1) they are under common control or management or (2) their acquisitions depend on each other or on a single common event or condition. (See paragraph 2015.12 of the FRM.)</td>
</tr>
<tr>
<td>Acquisition of selected parts of an entity</td>
<td>If substantially all of an entity is acquired, the entity's full financial statements are generally presented. If less than substantially all of an entity is acquired, audited carve-out financial statements of the component acquired may be appropriate.</td>
</tr>
<tr>
<td>Put-together transactions</td>
<td>When a put-together transaction(^{21}) occurs concurrently with an initial registration statement, a registrant must first determine which entity is the acquiring entity. It must then measure the significance of all other businesses in the put-together transaction against that of the acquiring entity. Since these acquired businesses are considered related under Rule 3-05(a)(3), a registrant must aggregate all the other businesses (besides the acquiring entity) in the put-together transaction and measure their significance against that of the acquiring entity as if they were a single acquisition.</td>
</tr>
<tr>
<td><strong>SAB Topic 1.J — application of Rule 3-05 in an IPO</strong></td>
<td>Although not often used in practice, SAB Topic 1.J (SAB 80) may be applied to the evaluation of the significance of multiple acquisitions in periods preceding an IPO. SAB 80 allows a registrant to measure the significance of businesses acquired or to be acquired by using its pro forma financial statements rather than its historical financial statements for the fiscal year that ended before the acquisition. SAB 80 is often not practicable, since it requires that the acquired businesses remain substantially intact (e.g., not integrated into the acquirer's operations) after acquisition. In addition, while SAB 80 and Rule 3-05 prescribe the same three significance tests, the significance thresholds are lower under SAB 80, further limiting circumstances in which the use of SAB 80 would be beneficial. (See Section 2070 of the FRM.)</td>
</tr>
</tbody>
</table>

\(^{21}\) See Section 2.2.2 for more information.
Example 2-4

Assume the following:

- Registrant A, a calendar-year-end company, is planning to file its initial registration statement on or around September 15, 20X6.
- Registrant A does not qualify as an EGC.
- Registrant A will include its historical financial statements for the following periods in its initial registration statement:
  - Audited balance sheets as of December 31, 20X5, and December 31, 20X4.
  - Audited statements of operations, comprehensive income, cash flows, and changes in stockholders’ equity for each of the three years in the period ended December 31, 20X5.
  - Unaudited financial statements as of and for the periods ended June 30, 20X6, and June 30, 20X5.
- Registrant A made the following acquisitions, all of which have calendar year-ends and had annual revenues exceeding $100 million:
## Example 2-4 (continued)

<table>
<thead>
<tr>
<th>Company</th>
<th>Acquisition Date</th>
<th>Highest Level of Significance</th>
<th>Years Required</th>
<th>Financial Statements Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>December 15, 20X3</td>
<td>41%</td>
<td>2</td>
<td>Because Company B is included in A’s audited results for all of 20X4 and 20X5, A may rely solely on the postacquisition results rather than providing B’s preacquisition financial statements.</td>
</tr>
<tr>
<td>C</td>
<td>June 15, 20X4</td>
<td>55%</td>
<td>3</td>
<td>If postacquisition financial results are not used, Company C’s financial statements as of December 31, 20X3, and December 31, 20X2, and for each of the three years ended December 31, 20X3, as well as unaudited interim information as of March 31, 20X4, and for the periods ended March 31, 20X4, and March 31, 20X3, should be included. Alternatively, since C is included in A’s audited results for a portion of 20X4 and all of 20X5, A may rely on a combination of preacquisition and postacquisition information. To satisfy the requirement, A would provide audited financial statements as of and for the year ended December 31, 20X3, as well as audited financial statements for the period from January 1, 20X4, through June 15, 20X4 (to provide a continuous audited period of three years with no gap between the audited preacquisition and postacquisition periods). No unaudited interim information would be required when a combination of preacquisition and postacquisition audited results is used.</td>
</tr>
<tr>
<td>D</td>
<td>July 15, 20X6</td>
<td>45%</td>
<td>2</td>
<td>While two years of audited financial statements will eventually be needed, as of the initial filing date no financial statements of Company D are required on the basis of the accommodation for recently consummated business acquisitions, discussed in the table above. In any amendment to the IPO registration statement filed 75 or more days after the consummation, audited financial statements as of and for the years ended December 31, 20X5 and 20X4, as well as unaudited interim information as of March 31, 20X6, and for the periods ended March 31, 20X6, and March 31, 20X5, would be required.</td>
</tr>
</tbody>
</table>

22 Assumes that all acquired companies are calendar-year-end companies and that the registrant is not using the accommodation to omit the acquiree’s balance sheet date, when applicable.
2.4.4 Omission of Financial Statements of Acquired Entities From Draft Registration Statements

In a manner consistent with the accommodations discussed in Section 2.3.4, a company may omit from its draft registration statement Rule 3-05 financial statements (and the related pro forma financial information discussed in Section 4.1) if the company reasonably believes that those financial statements will not be required at the time of the public filing or contemplated offering, as applicable.

Example 2-5

A calendar-year-end company that plans to submit a draft registration statement in the fall of 20X7 completes a significant acquisition in the fourth quarter of 20X6. The acquisition is significant in such a way that one year of the acquiree's financial statements would generally be required under Rule 3-05. The company plans to update its draft registration statement to include its 20X7 annual financial statements before a public filing in 20X8. Thus, after that update, the acquired business will have been part of the company's financial statements for a sufficient amount of time to eliminate the need for separate financial statements. In this scenario, the staff of the Division will not delay its review of the draft registration statement in the fall of 20X7 even though the acquiree's financial statements and the related pro forma financial information are omitted from the submission.

2.5 Financial Statements of Real Estate Operations Acquired or to Be Acquired (Rule 3-14)

When a registrant consummates, or it is probable that it will consummate, a significant acquisition of real estate operations, the registrant may be required to file abbreviated income statements for the acquired or to be acquired real estate operations (acquiree) in accordance with Regulation S-X, Rule 3-14. Because the information requirements under Rule 3-14 are different from those under Rule 3-05 (discussed above), it is critical to identify whether an actual or planned acquisition is a real estate operation. While existing registrants are subject to periodic reporting requirements for significant acquisitions, an entity is not subject to such requirements before an IPO. Therefore, in the context of an initial registration statement, a company must evaluate all acquisitions of real estate operations since the beginning of the earliest financial statement period presented. While Rule 3-14 only requires inclusion of preacquisition financial statements for a significant real estate operation for the most recent year and applicable interim period when the real estate operations were acquired from an unrelated party, a registrant cannot use postacquisition results to satisfy its Rule 3-14 requirement unless the property has been consolidated for the entire audited period. As indicated in paragraph 2330.4 of the FRM and clarified by the SEC in the highlights of the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff, this could result in preacquisition financial statements for the individually significant property that predate the registrant's financial statements.

The following factors govern whether and, if so, for what period, the acquiree's abbreviated financial statements are required for a consummated or probable acquisition:

- **Definition of real estate operations** — Rule 3-14 applies to an acquisition of a real estate operation. The definition of a real estate operation is distinct from the determination of a business for SEC reporting purposes. Under Rule 3-14, as indicated in paragraph 2305.2 of the FRM, “the term ‘real estate operations’ refers to properties that generate revenues solely through leasing,” such as (1) office, apartment, and industrial buildings and (2) shopping centers and malls. Conversely, operations that “are more susceptible to variations in costs and revenues over shorter periods” as a result of “market and managerial factors” (e.g., golf courses, hotels, parking garages, nursing homes, assisted living facilities, automobile dealerships, equipment rental operations) are
subject to the requirements of Rule 3-05. The abbreviated income statement(s) required by Rule 3-14 are “premised on the continuity and predictability of cash flows ordinarily associated with leasing real property.”

- **Significance** — There is only one significance test for Rule 3-14, the investment test, under which the GAAP purchase price is compared with the total assets of the registrant on the basis of its most recent preacquisition annual financial statements. The investment includes any debt secured by the property that is assumed by the purchaser.

Paragraph 2305.3 of the FRM states that “[w]hen a registrant acquires an equity interest in a pre-existing legal entity (such as a partnership, LLC or corporation) . . . that engages in [activities other than leasing], such as property management or development, financial statements of that entity meeting the requirements of [Rule] 3-05 generally are required if the acquisition is significant [at 20 percent or greater].” However, a registrant should present Rule 3-14 financial statements of the real estate properties in lieu of Rule 3-05 financial statements when the entity has no operations other than holding real estate and related debt and the significance of the acquisition is 10 percent or greater. Further, paragraph 2305.3 of the FRM states that a “registrant should consult with [the SEC’s Division of Corporation Finance, Office of the Chief Accountant (CF-OCA),] to the extent it believes [Rule] 3-14 financial statements are more appropriate than [Rule] 3-05 financial statements due to the limited degree of operations other than leasing real estate. If [Rule] 3-14 financial statements are more appropriate due to the limited degree of operations other than leasing real estate, financial statements are required if the 10% or more significance level applicable to [Rule] 3-14 financial statements is met.”

Below are two examples illustrating how an entity may distinguish between a real estate operation that is required to present Rule 3-14 financial statements and one that must present Rule 3-05 financial statements.

### Example 2-6

Assume the following:
- Registrant A owns several apartment buildings for which it also serves as leasing agent and manager.
- Registrant A acquires Apartment Complex X from Company Y, which owns several apartment complexes.

In this example, X qualifies as a real estate operation to A; therefore, A reports the acquisition in accordance with Rule 3-14. Rentals are the principal source of X's revenue before the acquisition.

Assume instead that X was held by a limited partnership that had no operations other than holding X and related debt. If A acquired the limited partnership, the same conclusion would apply.

### Example 2-7

Assume the following:
- Registrant G owns and operates several golf courses.
- Registrant G acquires Golf Course Complex R, which consists of a golf course, hotel, and restaurant.
- In addition to charging greens fees for the use of the course, R obtains revenues from cart rentals, food and beverage sales, golf equipment sales, and hotel rooms.

Although the acquisition involves real estate and rental revenue (i.e., greens fees and cart rental fees), R's revenues include food and beverage sales, sales of golf equipment, and hotel room charges, which are highly susceptible to variations attributable to market and managerial factors. In this example, the acquisition of R does not qualify as an acquisition of a real estate operation. Therefore, G reports the acquisition in accordance with Rule 3-05.
2.5.1 Periods of Financial Statements Required

The significance of an acquisition is based on whether the GAAP purchase price is more than 10 percent of the acquirer’s total assets. For significant acquisitions of real estate operations from unrelated parties, an entity must include preacquisition abbreviated income statements for one year and the subsequent year-to-date interim period. If the acquisition is from a related party, the entity must present three years (two years if an EGC) of preacquisition financial information plus information for any applicable interim period. If the entity’s related parties owned the real estate operation for less than three years (two years if an EGC), the entity must present the greater of one year of financial information or the period in which the entity held the real estate operation. Generally, the financial statements for a significant acquisition of real estate operations may be audited in accordance with AICPA standards.

Example 2-8

Registrant A acquires real estate operations from unrelated third parties on May 5, 20X4 (Property B); September 21, 20X3 (Property C); and December 1, 20X2 (Property D). Each acquisition was individually significant at the 10 percent level or higher. All entities have December 31 fiscal year-ends. Registrant A plans to file an initial registration statement on March 1, 20X5.

Given that each property was individually significant at the 10 percent level or higher, A is required to provide Rule 3-14 abbreviated financial statements for:

- Property B for the year ended December 31, 20X3 (audited), and the three months ended March 31, 20X4 (unaudited).
- Property C for the year ended December 31, 20X2 (audited), and the six months ended June 30, 20X3 (unaudited).
- Property D for the year ended December 31, 20X1 (audited), and the nine months ended September 30, 20X2 (unaudited).

2.5.2 Other Considerations

If the significance of the aggregate of individually insignificant real estate properties that are acquired, or whose acquisition is probable, after the end of the most recently completed fiscal year for which the registrant’s financial statement are presented exceeds 10 percent, audited abbreviated income statements must be provided for the mathematical majority of individually insignificant acquired real estate operations. In addition, audited abbreviated income statements for the mathematical majority must include all insignificant properties that are individually more than 5 percent significant. Property acquisitions for which Rule 3-14 financial statements would not be required even if they are individually significant, such as triple-net-leased properties covered by Section 2340 of the FRM and newly constructed properties covered by paragraph 2330.10 of the FRM, should be excluded from the aggregate significance calculations.

Under Rule 3-05, a registrant may exclude from a registration statement financial statements of certain business acquisitions consummated less than 75 days before the registration statement is filed or declared effective unless the registrant has previously filed these financial statements. This option is not available under Rule 3-14, except for blind-pool offerings. Therefore, a registrant must include abbreviated income statements of significant real estate operations acquired even if they were acquired less than 75 days before the registration statement is filed or declared effective.

“Blind pool” offerings subject to SEC Industry Guide 5 have completely different Securities Act and Exchange Act reporting requirements with respect to real estate acquisitions both during and after the distribution period, as discussed in Section 2325 of the FRM.
For companies using, and acquisitions subject to, triple-net leases, significant asset concentration tests need to be analyzed, as addressed in Section 2340 of the FRM.

### 2.5.3 Test of Significance in an IPO for a Newly Formed Real Estate Investment Trust (REIT)

Paragraph 2335.1 of the FRM states that a newly formed REIT that has “no significant operations may acquire operating properties immediately prior to filing an IPO, or may identify properties to be acquired upon closing the IPO.” This paragraph further states:

The [SEC] staff recognizes in these circumstances that the literal application of [Rule] 3-14 could result in the registrant providing financial statements of properties that are clearly insignificant to investors. In identifying the financial statements required to be included in the initial registration statement, the staff has allowed registrants to compute significance using a denominator equal to the total cost of the properties acquired immediately prior to filing an initial registration statement, properties to be acquired upon closing the IPO, and properties identified as probable future acquisitions.

### 2.5.4 Reporting Requirements for REIT Spins and REIT Conversions

At the “SEC Speaks in 2015” Conference hosted by the Practising Law Institute in February 2015, the staff in the Division observed that there has been an increase in REIT transactions in which an operating company (1) spins off its real estate assets and leases them back (a “REIT spin”) or (2) is converted entirely into a REIT (a “REIT conversion”).

For a REIT spin, the staff indicated that registrants should consider providing the following financial statements in their initial registration statement:

- An audited opening balance sheet (i.e., a “seed money” balance sheet) for the registrant.
- Carve-out financial statements when a rental history exists; alternatively, a schedule of investments may be appropriate if there is no rental history.
- Significant tenant financial statements when the operating company leases back the real estate assets. The staff noted that if the operating company (which is the significant tenant) is an SEC reporting entity, it would be sufficient for the entity to explicitly refer to its periodic reports.
- Pro forma financial statements prepared in accordance with Regulation S-X, Article 11, or a forecasted income statement.
- Nonregistrant financial statements (or other entities’ financial statements) in accordance with the guidance in Regulation S-X, Rule 3-05 or Rule 3-14, on acquisitions of businesses or real estate operations, respectively. Such financial statements may need to be provided, for example, if some of the spun-off assets were acquired recently. The staff reminded registrants that in these circumstances, the measurement basis for the significance test under Rule 3-05 or Rule 3-14 would be the carve-out financial statements and not the prior entity.

The SEC staff also discussed the filing requirements of Schedule III under which registrants must present detailed supplemental information about real estate investments and accumulated depreciation. The staff observed that many registrants have had difficulties in obtaining some of the required information. In these cases, the SEC has considered waiver requests to (1) disclose certain cost

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23 On its Web site, the SEC defines a REIT as follows: “A [REIT], generally, is a company that owns — and typically operates — income-producing real estate or real estate-related assets. REITs provide a way for individual investors to earn a share of the income produced through commercial real estate ownership — without actually having to go out and buy commercial real estate. The income-producing real estate assets owned by a REIT may include office buildings, shopping malls, apartments, hotels, resorts, self-storage facilities, warehouses, and mortgages or loans.”

24 The schedule is required for certain real estate companies in accordance with Regulation S-X, Rule 12-28.
information prospectively or (2) provide levels of aggregated information when a significant number of assets would otherwise need to be disclosed separately.

The staff also has observed a higher frequency of REIT transactions in industries other than real estate (e.g., involving assets such as cell towers, data centers, and billboards). Further, for REIT conversions that do not involve traditional real estate companies, the staff noted that the disclosure requirements for real estate assets have not been appropriately considered. The staff suggested that such registrants should strive to comply with the spirit of the disclosure requirements when considering their unique assets (e.g., portfolio occupancy, effective rents, material tenant concentrations, category and physical location of the assets, significant lease types, and lease expiration dates).

Because REIT transactions (including REIT spin and REIT conversion transactions) can be complex, the SEC staff has encouraged registrants that are contemplating such transactions to consult with the Division's Office of the Chief Accountant.

2.6 Reporting Requirements for Equity Method Investees

Registrants with investments accounted for under the equity method (“equity method investees”) should consider the reporting and disclosure requirements in Regulation S-X, Rules 3-09, 4-08(g), and 10-01(b). These requirements ensure that investors receive relevant financial information about significant equity method investments. For SEC staff interpretations of Rules 3-09, 4-08(g), and 10-01(b), see Section 2400 of the FRM.

2.6.1 Separate Financial Statements (Rule 3-09)

If the registrant holds an interest in an equity method investee that is considered significant, the investee’s separate financial statements must be included in the IPO registration statement. An interest in an equity method investee is considered significant if the results of either the investment test or the income test under Rule 1-02(w) exceed 20 percent for any annual period presented in the registrant’s financial statements. The following is a description of the investment test and income test:

- **Investment test** — The registrant’s investments in, and advances to, the investee are compared with the registrant’s total assets as of the end of each fiscal year.
- **Income test** — The registrant’s equity in the investee’s pretax income from continuing operations is compared with the registrant’s pretax income from continuing operations for each fiscal year.

If the equity method investee’s financial statements must be included in the registration statement, they should be as of the same dates and for the same periods as the audited consolidated financial statements that the registrant is required to file (if the equity method investee and the registrant have the same year-end) and they must be audited for each year for which the results of either significance test exceed 20 percent. The financial statements for any years for which significance did not exceed 20 percent under either test must still be presented, but they may be unaudited.

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25 Pretax income from continuing operations refers to “income from continuing operations before income taxes . . . exclusive of amounts attributable to any noncontrolling interests,” as defined in Rule 1-02(w).

26 In accordance with Rule 3-09(b)(2), if the equity method investee and the registrant have different fiscal year-ends, the separate financial statements of the equity method investee may be as of the investee’s year-end.
Example 2-9

Assume the following:

- Registrant A has a nonpublic equity method investee, Company B.
- In 20X5, 20X6, and 20X7, B was significant at the 15 percent, 18 percent, and 30 percent levels, respectively.
- Registrant A and Company B both have December 31 year-ends.

Registrant A is required to present audited financial statements for B as of and for the year ended December 31, 20X7, and either audited or unaudited financial statements as of December 31, 20X6, and for the years ended December 31, 20X6, and December 31, 20X5.

2.6.2 Summarized Financial Information (Rule 4-08(g))

Under Rule 4-08(g), a registrant must disclose summarized financial information in the footnotes to its annual financial statements for all equity method investees whose significance, individually or in the aggregate, exceeds 10 percent in accordance with any of the three significance tests in Rule 1-02(w).

In addition to the income test and the investment test (described above), the third test required is the asset test, in which the registrant's proportionate share of the total assets of the equity method investee(s) is compared with the registrant's total assets.

Under Rule 1-02(bb), summarized financial information should include, at a minimum:

- Current and noncurrent assets, current and noncurrent liabilities, and (if applicable) redeemable preferred stock and noncontrolling interests.
- “Net sales or gross revenues, gross profit (or . . . expenses applicable to net sales or gross revenues), income or loss from continuing operations . . . , net income or loss, and net income or loss attributable to the entity.”

Additional line items may be appropriate depending on the equity method investee’s industry as well as its specific facts and circumstances.

Summarized financial information must be included in the notes to the financial statements for all periods presented and may not be labeled as “unaudited.”

2.6.3 Summarized Interim Financial Information (Rule 10-01(b))

A registrant is not required to include separate financial statements of significant equity method investees for interim periods. However, if the individual significance of any equity method investees is greater than 20 percent under the investment test or the income test as of and for the appropriate periods presented, the registrant must disclose summarized income statement information under Rule 10-01(b) (as described in Section 2.6.2) in its interim financial statements.
2.7 Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered (Rule 3-10)

Under the Securities Act, guarantees of securities are considered to be securities themselves. Therefore, all offerings of securities, as well as the guarantees of such securities, must either be registered with the SEC or be exempt from registration. Regulation S-X, Rule 3-10, provides guidance on this topic, specifying that a registrant must provide separate financial statements of each subsidiary issuer or guarantor of debt securities registered or being registered unless certain criteria are met (discussed below).

Obtaining such separate financial statements could be expensive and difficult. Therefore, in the context of an initial registration statement related to guaranteed debt securities, a company must carefully evaluate the reporting requirements in Rule 3-10. Rule 3-10 contains certain exceptions under which a registrant may provide more limited financial information in lieu of full financial statements. If the registrant qualifies for one of these exceptions, it may be eligible to provide, in a footnote to the financial statements of the parent company that issued or guaranteed the security, either of the following types of modified financial information in lieu of separate financial statements:

- Condensed consolidating financial information.
- Narrative disclosures about each subsidiary issuer or guarantor.

While each of the exceptions in Rule 3-10 specifies additional conditions that must be met for a registrant to qualify for the relief, all of them require that (1) the subsidiary issuer and guarantors be “100 percent owned” by the registrant and (2) the guarantee be “full and unconditional.” For additional SEC staff interpretations of Rule 3-10 and circumstances in which a registrant may provide condensed consolidating financial information or narrative disclosures, see Section 2500 of the FRM.

For its initial registration statement, a registrant should evaluate the guarantor structure as of the filing date of the registration statement to determine what financial information is required by Rule 3-10. If the registrant provides full financial statements or condensed consolidating financial information, the periods presented should generally be the same as those of the issuer for both annual and interim periods.

Rule 3-10 does not apply to private (nonregistered) securities, bank debt, or other private financings. Thus, a private offering under Securities Act Rule 144A is not subject to Rule 3-10. However, if the private 144A offering of a guaranteed debt security includes registration rights, the issuer will need to comply with Rule 3-10 at the time the private debt is exchanged for public debt.

Changing Lanes

On July 24, 2018, the SEC issued a proposed rule that would simplify the disclosure requirements related to registered debt securities under Regulation S-X, Rules 3-10 and 3-16. At the 2018 AICPA Conference on Current SEC and PCAOB Developments, the Division indicated that it will strive to help the SEC finalize the proposed rule in 2019. Registrants affected by Rule 3-10 or Rule 3-16 should closely monitor the status of this rulemaking activity.

2.7.1 Condensed Consolidating Financial Information

Condensed consolidating financial information presented in lieu of full financial statements should be prepared in accordance with Regulation S-X, Rule 10-01. As part of such presentation, a registrant should provide a condensed balance sheet, statement of operations, and statement of cash flows for the appropriate periods. Rule 3-10(i)(1) indicates that this information should be presented “in sufficient detail to allow investors to determine the assets, results of operations and cash flows of each of the consolidating [entities or] groups.” The condensed consolidating financial information should be presented in accordance with U.S. GAAP, except for investments in subsidiaries, which should be presented under the equity method of accounting.
The condensed consolidating financial information should be presented in a columnar format, with separate columns for the parent, issuer (if it is not the parent), combined guarantor subsidiaries, combined nonguarantor subsidiaries, and eliminations, as appropriate. The totals of the columns in the condensed consolidating financial information should equal the applicable totals in the registrant’s consolidated financial statements.

2.7.2 Narrative Disclosures About Each Subsidiary Issuer or Guarantor

Narrative-only disclosures are permitted in lieu of condensed consolidating financial information only in certain circumstances. While the specific requirements depend on the guarantor structure, they generally apply to circumstances in which all substantive entities are in the same legal position with respect to the registered securities (i.e., all are co-issuers or all are guarantors).

2.7.3 Recently Acquired Guarantors

A company should also be aware of the requirements of Rule 3-10(g), which applies to recently acquired subsidiary issuers or subsidiary guarantors. These requirements are assessed independently from those in Rule 3-05 (discussed in Section 2.6.1). Under Rule 3-10(g), a registrant must provide separate financial statements of a significant subsidiary issuer or guarantor if the subsidiary’s historical results have not been included in the parent’s audited financial statements “for at least nine months of the most recent fiscal year.” To determine significance under Rule 3-10(g), a registrant should compare the subsidiary’s net book value or purchase price (whichever is greater) with the “principal amount of the securities being registered.” If the test result equals or exceeds 20 percent, the registrant must file separate financial statements of the acquired subsidiary for the (1) most recent fiscal year and (2) appropriate interim period preceding the acquisition. The registrant may also be required to provide financial statements for the recently acquired guarantor in accordance with Rule 3-05. Note that annual financial statements required by Rule 3-10(g) must be audited in accordance with PCAOB standards, while financial statements required by Rule 3-05 may be audited in accordance with AICPA standards. See Section 2530 of the FRM for more information about the financial statement requirements for recently acquired guarantor subsidiaries.

2.8 Issuers of Securities That Collateralize Registered Securities (Rule 3-16)

Under Regulation S-X, Rule 3-16, a registrant must file full audited financial statements for each of its affiliates whose securities constitute a “substantial portion of the collateral” for any class of securities registered or being registered. In the context of an initial registration statement related to an IPO of debt securities, this requirement may apply when the capital stock (i.e., securities) of some or all of the registrant’s subsidiaries (i.e., affiliates) is pledged as collateral for the debt securities being registered.

The SEC believes that if the subsidiary’s capital stock constitutes a substantial portion of the collateral, the investor will need the subsidiary’s full financial statements to make an informed decision regarding whether to purchase the collateralized debt. The determination of whether an issuer’s pledge of subsidiary capital stock constitutes a collateralization under Rule 3-16 may be complex. For SEC staff interpretations of Rule 3-16, see Section 2600 of the FRM. Also see the Changing Lanes in Section 2.7 for information about a proposed rule that would simplify the disclosure requirements related to registered debt securities under Regulation S-X, Rules 3-10 and 3-16.
2.8.1 Determining What Constitutes a “Substantial Portion of the Collateral”

In determining whether a subsidiary's capital stock constitutes a substantial portion of the collateral under Rule 3-16, a registrant must calculate the principal amount, par value, and book value of the subsidiary's capital stock as well as the market value of the stock. If the greatest of such amounts exceeds 20 percent of the principal amount of the securities that are to be registered, the subsidiary’s capital stock is considered a substantial portion of the collateral. Accordingly, in such cases, the registrant would be required to file financial statements for the subsidiary.

Paragraph 2610.2 of the FRM states that registrants should perform the “substantial portion of collateral” test by “using information as of the end of the most recent fiscal year for which audited financial statements would be required in the filing.” Further, paragraph 2610.3 indicates that registrants must also perform the test “at the time of effectiveness of a registration statement.” After completing its initial offering process, a registrant should continue to perform the “substantial portion of the collateral” test and comply with Rule 3-16 as it begins reporting under the Exchange Act.

2.8.2 Subsidiary Financial Statement Requirements

If separate subsidiary financial statements are required under Rule 3-16, they should be as of the same dates and for the same periods as the audited consolidated financial statements that the registrant is required to file, which may include periods before the collateralized securities were issued. In addition, interim financial statements of those subsidiaries must also be provided in the registration statement for periods consistent with those of the registrant.
Chapter 3 — Financial Statement Preparation and Disclosure Requirements

3.1 Introduction
Certain provisions of U.S. GAAP for public entities differ from those for nonpublic entities. Further, public entities are subject to various SEC rules and regulations that may affect the financial statements and related disclosures (e.g., the additional disclosure requirements of Regulation S-X). Therefore, a nonpublic entity's previously issued financial statements are generally not sufficient for an IPO and the financial statements will typically need to be revised for all periods presented to reflect the public-entity accounting principles and additional SEC disclosure requirements. In addition, audits for a private company are subject to the auditing standards issued by the AICPA’s Auditing Standards Board; however, for an IPO, the audit of the issuer must be performed in accordance with PCAOB auditing standards. Therefore, the auditor will need to perform additional procedures and issue a new auditor’s report that refers to PCAOB standards. In a filing submitted for confidential review, the auditor’s report will typically refer to both AICPA and PCAOB auditing standards, as described in Section 6.7.1. See Chapter 6 for discussion of audit considerations under a PCAOB audit compared with an AICPA audit.

Adopting public-entity U.S. GAAP and providing SEC-required disclosures do not constitute the correction of an accounting error under ASC 250. Therefore, financial statements that are revised to meet public-company requirements are not considered “restated.” However, if an error is identified in previously issued financial statements and corrected as part of an IPO, the disclosure requirements in ASC 250 should be considered. See Section 3.7 below for additional discussion of the correction of errors and related considerations associated with internal controls.

3.2 U.S. GAAP for Public Entities
The term “public entity” generally refers to an entity that files its financial statements with the SEC. However, there are multiple definitions of this term in U.S. GAAP. In an attempt to reduce complexity and diversity in practice related to this term, the FASB issued ASU 2013-12 in December 2013. The ASU adds the following definition of public business entity to the ASC master glossary:

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

At the time ASU 2013-12 was issued, this definition of a PBE did not supersede any similar existing definitions in the FASB Codification (e.g., “public entity” or “publicly traded company”). It first applied to the U.S. GAAP amendments made as part of the FASB’s private-company decision-making framework developed in collaboration with the Private Company Council (PCC). Since that time, the FASB, EITF, and PCC have begun using this new PBE definition in newly issued accounting and reporting guidance that affects public entities differently from private entities or for which the required effective date for PBEs differs from that for entities other than PBEs.

In an IPO, a registrant must present financial statements that are consistent with public-entity accounting principles and must comply with disclosure requirements for public entities for all periods presented. Examples of topics for which the accounting principles or disclosures may apply to public entities but do not apply to nonpublic entities include EPS, segment reporting, temporary equity classification of redeemable securities, certain income-tax-related disclosures, certain disclosures related to pensions and other postretirement benefits, and disclosure of the date through which subsequent events are evaluated. For a more detailed discussion of accounting considerations for entities preparing for an IPO, see Chapter 5.

**Connecting the Dots**

Entities should consider using a GAAP checklist that incorporates SEC requirements in assessing the completeness and accuracy of disclosures. Using an SEC-compliant GAAP checklist well in advance of preparing financial statements may make it easier for an entity to draft new required disclosures and to document management’s judgments in preparing such disclosures.

### 3.3 Transition to New Accounting Standards

The transition provisions related to the adoption of a new accounting standard for PBEs may differ from those for nonpublic entities, resulting in an earlier effective date for PBEs. Since entities, other than EGCs, undertaking an IPO must apply public-entity guidance for all periods presented in the financial statements, a nonpublic entity may be required to retroactively change and accelerate its adoption date of a new accounting standard to that required for a PBE.

EGCs are not required to accelerate the adoption of new accounting standards and are allowed to adopt the new or revised accounting pronouncements as of the effective dates for private companies or nonissuers (i.e., non-PBEs), provided that such standards apply to nonissuers. See Section 1.6 for more information about EGCs.
Entities considering an IPO should review recently issued or adopted accounting standards as early as possible to determine the required PBE implementation date, because the required adoption dates for PBEs are often earlier than for non-PBEs. For example, if a non-EGC calendar-year-end private entity adopts ASC 842 on January 1, 2020 (the required adoption date for nonpublic entities), but subsequently elects to file an IPO, the entity would be required to retrospectively adjust its financial statements to reflect an adoption date of January 1, 2019, the required adoption date for PBEs. Similarly, if an EGC loses its EGC status shortly after going public, the entity may be required to retrospectively adjust its financial statements to reflect the required adoption date for PBEs to the extent that the nonpublic adoption date was previously applied under the accommodations provided for EGCs.

3.4 PCC Accounting Standards

The PCC uses the private-company decision-making framework to advise the FASB on the appropriate accounting treatment for private companies. Nonpublic companies may have elected to apply alternative accounting standards developed by the PCC and issued by the FASB. On its Web site, the FASB states that the PCC was formed in 2012 and is an advisory body whose mission is to “review and propose alternatives within GAAP to address the needs of users of private company financial statements.” As a result of the PCC’s activities, the FASB has issued accounting standards that have allowed private entities to elect alternative accounting policies intended to reduce the complexity and cost of financial reporting while maintaining decision-useful information for investors. Once a company (even if it qualifies as an EGC) is considered a PBE, it is no longer permitted to apply private-company accounting alternatives. Therefore, any previously elected private-company alternatives would need to be retrospectively eliminated from the company’s historical financial statements before such statements can be included in its IPO registration statement.

Because the accounting pronouncements initiated by the PCC are relatively new, there is not yet much experience with the process for undoing the application of these private-company standards. Therefore, an entity should use caution in implementing the alternative accounting policies applicable to private entities if it expects that it may undergo an IPO or that its financial statements may be included in another company’s IPO in the future.

3.5 Changes in Accounting Principles

While it is possible for an entity to make a discretionary change in an accounting policy after becoming an issuer, such a change may be more challenging from a practical standpoint than it is for a nonpublic entity. The presumption that an entity should not change an accounting principle, once adopted, in accounting for events and transactions of a similar type is basic to the preparation of financial statements. An entity may change an accounting principle only if management can justify that the newly adopted accounting principle is both acceptable and preferable. Factors that may justify that an accounting treatment is preferable include authoritative literature, changes in the structure and economics of principal transactions, industry practice, business judgment, and business planning. However, industry practice, in and of itself, may not always demonstrate that an alternative principle is preferable. Ultimately, whether a change is preferable depends on the entity’s facts and circumstances, and the burden of justification rests with the reporting entity.
Once a company is public, a change in accounting policy generally also results in the need for a preferability letter. A preferability letter is a letter issued by the entity's independent auditors and included in an SEC filing stating that the auditor has also concluded that the accounting change is preferable. If a change in accounting is made in conjunction with an IPO, the preferability letter is not required because the entity was not yet public on the date the change was made. The determination of whether a change in accounting policy is a change in accounting principle involves judgment and careful consideration of the facts and circumstances.

### 3.6 Regulation S-X

Regulation S-X contains many requirements related to providing specific disclosures on the face of the financial statements or in the footnotes thereto. Some of these requirements are broadly applicable, and some apply only to entities in certain industries. The most significant broadly applicable requirements are contained in Article 4, which addresses disclosures related to topics that include, but are not limited to, restrictions that limit the payment of dividends by the registrant, summarized financial information of subsidiaries not consolidated, income taxes, and related-party transactions.

Industry requirements may also apply. These requirements can affect both presentation (e.g., specific financial statement line items) and disclosures (e.g., requirements to include supplemental schedules). The following sections of Regulation S-X contain the bulk of the industry-specific requirements:

- Article 4, “Rules of General Application” (includes specific requirements for oil- and gas-producing activities).
- Article 5, “Commercial and Industrial Companies.”
- Article 6, “Registered Investment Companies and Business Development Companies.”
- Article 7, “Insurance Companies.”
- Article 9, “Bank Holding Companies.”

By default, an entity is subject to the requirements for commercial and industrial companies in Article 5, unless another article applies. Under Article 5, a registrant must provide various line items and disclosures, when applicable, in its balance sheet and income statement. For example, under Article 5, Rule 5-03(b), an entity is generally required to state separately, on the face of the income statement, revenues (and associated cost of revenues) related to (1) product sales, (2) rentals, (3) services, and (4) other revenue activities. A registrant must comply with these SEC requirements in addition to any GAAP requirements.

#### 3.6.1 Financial Statement Schedules

As discussed above, a registrant may need to include certain financial statement schedules in its initial registration statement in accordance with Regulation S-X. Article 12 covers the form and content requirements for these schedules. For example, a registrant under Article 5 may need to include Schedule II, “Valuation and Qualifying Accounts,” to illustrate, by major asset class, a rollforward of all valuation and qualifying accounts and reserves (e.g., allowances for bad debt) for each period for which an income statement is presented. While they may be presented separately, any required schedules are considered part of the financial statements and must be audited. Many registrants prefer to include the schedule information in the footnotes to the financial statements in lieu of furnishing separate schedules. A registrant also needs to provide any schedules applicable to predecessor entities in the registration statement. Financial statement schedules are not needed for financial statements that are
required under Rule 3-05 for business acquisitions. However, when a registrant is required to provide financial statements for equity method investees to satisfy the requirements of Rule 3-09, the form and content of those financial statements must comply with Regulation S-X, including the requirement to include financial statements schedules, if applicable.

### 3.6.2 Article 8 — Financial Statements of Smaller Reporting Companies

As explained in Section 1.5.2, SRCs may be eligible to apply scaled disclosure requirements. The scaled financial statement disclosure requirements for SRCs are set forth in Regulation S-X, Article 8. SRCs are generally not required to apply the disclosure provisions of Regulation S-X in their entirety except when Article 8 specifically indicates otherwise. However, SRCs are expected to provide all information required by any applicable industry guides. Further, although Article 8 does not contain any explicit disclosure requirements that apply to the financial statement schedules described in Article 5, Topic 5 of the FRM, contains disclosure guidance for SRCs. This guidance advises issuers to consider whether additional disclosure in MD&A may be appropriate if, for example, the restricted net assets\(^1\) of an SRC’s consolidated subsidiaries are a significant proportion of consolidated net assets and the amount and nature of those restrictions have a material impact on liquidity. See Appendix B for more information about the disclosure requirements for SRCs.

### 3.7 Restatements and Corrections of Accounting Errors

Financial statement restatements can be expensive and time-consuming. However, the level of effort and cost required to restate financial statements is often dwarfed by the loss of public confidence that can result from such restatements. An entity that is preparing its initial registration statement or another initial public filing for submission to the SEC will benefit from designing a thorough set of processes and internal controls that ensure the completeness and accuracy of its financial statements and from working with its auditors to provide assurance that the financial statements are free from material misstatement. This section discusses the evaluation of potential accounting errors, alternative responses to such errors, and other matters that apply to entities filing with the SEC for the first time.

#### 3.7.1 Identifying Accounting Errors

ASC 250-10-20 defines a restatement as “[t]he process of revising previously issued financial statements to reflect the correction of an error in those financial statements.” Further, an error in previously issued financial statements is defined as follows:

> An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in [applying GAAP], or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

If the amount, presentation, or disclosure was not in accordance with the applicable financial reporting framework, the SEC’s rules, or the applicable basis of presentation in the originally issued financial statements, a misstatement exists. However, as stated in Section 3.1, adopting public-entity GAAP and providing SEC-required disclosures for the first time do not constitute the correction of an accounting error under ASC 250.

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\(^1\) Restricted net assets are defined in Regulation S-X, Rule 1-02(dd).
3.7.2 Evaluating Accounting Errors

In evaluating accounting errors, an entity must consider the materiality of such errors, including the omission of required disclosures and accounting information, to determine whether the financial statements need to be restated. If a misstatement does not have a material effect on prior-period financial statements (i.e., the evaluation under the “rollover” approach) and its correction in the current period would not have a material effect on the current-period financial statements (i.e., the evaluation under the “iron-curtain” approach), the prior-period financial statements ordinarily would not be restated. For additional details related to the evaluation of errors under the iron-curtain and rollover approaches, see Section 6.7.7.2.

When assessing materiality, an entity must consider all facts and circumstances related to a misstatement. SAB Topic 1.M (codified in ASC 250-10-599-1) indicates that “[i]n the context of a misstatement of a financial statement item,” while the relevant facts and circumstances include “the size in numerical or percentage terms of the misstatement, [they also include] the factual context in which the user of financial statements would view the financial statement item” (e.g., disclosures). Therefore, both quantitative and qualitative factors are important to assessing an item’s materiality. An entity evaluates whether a restatement is necessary or appropriate on the basis of such factors.

3.7.3 Corrective Action

Upon evaluating an accounting error (or errors) and deciding whether a restatement is necessary or appropriate, an entity must determine whether the error is material or immaterial. This determination should include evaluation of both quantitative and qualitative factors. For material errors, the entity must restate the prior-period financial statements. When preparing the restatement, the entity must comply with the following requirements in ASC 250-10-45-23:

- “The cumulative effect of the error on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.”
- “An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.”
- “Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error.”

The following list comprises the primary disclosure and communication requirements for material restatements:

- Inclusion, in the auditor’s report, of an additional paragraph referring to the restatement.
- Individual financial statements labeled as “restated.”
- Disclosures in the financial statements in accordance with ASC 250.

SAB Topic 1.N (SAB 108) also addresses “immaterial restatements,” which may be necessary if a prior-period error (or errors) identified is not material to the prior periods presented but is material to the current period if the prior-period error (or accumulated errors) is corrected in the current period. In this instance, the immaterial errors are corrected the next time the current-period comparative financial statements are issued. The disclosure and communication requirements for immaterial restatements differ from those described above in the following ways:

- Financial statement column headings do not have to be labeled as “restated.”
- An additional paragraph in the auditor’s report is typically not necessary.
3.7.4 Impact on Internal Control

An entity must evaluate financial statement misstatements to determine whether they are indicative of a deficiency in internal control. Further, a deficiency in internal control must be assessed to determine whether it is related to a design or operating deficiency.

Once the control deficiency has been identified, its severity must be evaluated to determine the disclosure requirements, communication requirements, or both. Appendix A of PCAOB AS 2201 provides the following definitions to assist entities with this evaluation:

- **Deficiency** in [ICFR] exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- **Significant deficiency** is a deficiency, or a combination of deficiencies, in [ICFR] that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.
- **Material weakness** is a deficiency, or a combination of deficiencies, in [ICFR], such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

Registrants are not required to make a written assertion on ICFR in their initial registration statement filing or in the first filing of a Form 10-K after going public. However, the auditor’s requirement to communicate significant deficiencies and material weaknesses to those charged with governance still applies. In addition, after consulting with SEC counsel, it is likely that a registrant may need to disclose an identified material weakness in internal control in the risk factors section of the registration statement. For more information, see Chapter 6.

3.7.5 Additional IPO Considerations

Entities preparing an initial registration statement or another initial public filing for submission to the SEC should also be aware of the following additional considerations:

- As stated in Section 1.4.1, depending on the length of time between amendments, financial statements and other information included in the registration statement may need to be updated to reflect subsequent periods. Such an update may include adding an additional year of audited financial statements. In some cases, an error or errors may be identified during the audit. Depending on the materiality of the error(s), figures may be restated after the initial registration statement has been submitted to the SEC. Once the effects of a correction of an error on prior periods have been disclosed in issued annual financial statements, disclosure of the restatement does not need to be repeated when the restated amounts are presented as prior-period comparative amounts in subsequently issued annual financial statements. In this context, interim financial information is not considered the equivalent of issued annual financial statements. In addition, the reissuance of financial statements that do not include any additional annual periods (e.g., a subsequent registration statement amendment that does not yet include an additional annual period of audited financial statements) does not meet this requirement, and the “as restated” or similar language should be retained to identify the period(s) restated. The restatement language may be removed once the subsequent issuance of annual audited financial statements is completed.
• CEOs and CFOs of newly public companies are subject to certain provisions of Sarbanes-Oxley and Dodd-Frank that may compel them to disgorge bonuses or other compensation earned during periods for which related financial information is subsequently restated. Specifically, under Section 304 of Sarbanes-Oxley, CEOs and CFOs may be required to return compensation received within the 12-month period following the public release of financial information if there is a restatement of such financial information because of material noncompliance, due to misconduct, with financial reporting requirements under the federal securities laws. In addition, in the event of a restatement, Section 954 of Dodd-Frank requires that public companies develop and implement policies under which excess incentive-based compensation received by executives during a three-year look-back period can be recovered, regardless of whether misconduct occurred.

• Restatements can prolong the registration process because each amendment can result in additional SEC comments.
Chapter 4 — Other Registration Statement Reporting

Many additional disclosures other than those included in the financial statements must be included in an IPO registration statement. These disclosure requirements are summarized in Appendix A. Some of the more significant financial-related disclosures are summarized below. For certain scaled disclosure requirements for SRCs, see Appendix B.

4.1 Selected Financial Data

Under Regulation S-K, Item 301, a non-EGC registrant is required to present, in columnar form, selected financial data (SFD) for each of the past five years (or for the life of the registrant and its predecessors, if less) in the IPO registration statement. For an EGC, the oldest year for which SFD is presented may be limited to the earliest audited period presented in the IPO registration statement (i.e., if an EGC presents audited financial statements for two years, it is not required to present SFD for the three earliest years). Information for the latest interim and comparable prior-year period should also be presented when interim-period financial statements are included in the IPO registration statement. The purpose of the SFD table is to highlight significant trends in the registrant's financial condition and results of operations. The SFD must include:

- Net sales or operating revenues.
- Income (loss) from continuing operations.
- Income (loss) from continuing operations per common share.
- Total assets.
- Long-term obligations and redeemable preferred stock (including long-term debt, capital leases, and redeemable preferred stock).
- Cash dividends declared per common share.

The information presented may vary depending on the nature of the registrant's business and may include additional items that enhance the understanding of, and highlight other trends in, the registrant's financial condition and results of operations. A registrant should also describe any factors that materially affect the comparability of the information presented from period to period (e.g., a significant business acquisition).

The SFD for the most recent years is derived from the audited financial statements included in the IPO registration statement. Generally, information for all prior years must be presented on an accounting basis consistent with such financial statements. Such information would include the impact of any retrospective changes, such as discontinued operations, or any new accounting pronouncements implemented retrospectively. However, the financial data for the prior years may be based on unaudited financial information.
In limited situations, the SEC has waived the requirement to adjust all SFD periods to reflect new accounting principles. For example, at the 2015 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff indicated that it would not object if a registrant’s SFD table is consistent with its adoption of the revenue recognition guidance in ASC 606, as reflected in its financial statements. Accordingly, for registrants using the full retrospective method to adopt the new revenue standard, application of the standard in the five-year table could be limited to the three most recent years presented (i.e., years 4 and 5 do not need to be presented on the same basis as the annual financial statements). For registrants using the modified retrospective method, only the most recent fiscal year presented would be presented under the new standard. Regardless of the transition method adopted, a registrant would be expected to disclose:

- The method used to reflect the information (e.g., how the periods are affected).
- The fact that not all periods in the five-year table are comparable.

The SEC staff has advised registrants seeking to omit SFD to contact either CF-OCA or their respective associate director industry review office to discuss whether such information may be omitted without comment or objection from the staff.

### 4.2 Selected Quarterly Financial Data

Under Regulation S-K, Item 302, registrants that have securities registered under Section 12(b) or 12(g) of the Exchange Act must disclose selected quarterly financial data for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are presented. Quarterly financial data does not need to be provided in an IPO registration statement because the entity’s securities are not yet registered; however, it is frequently included voluntarily, often at the request of underwriters. If presented, the quarterly financial data typically includes, at a minimum:

- Net sales.
- Gross profit (net sales less costs and expenses associated directly with or allocated to products sold or services rendered).
- Income (loss) from continuing operations.
- Income (loss) from continuing operations per share.
- Net income (loss).
- Net income (loss) per share.
- Net income (loss) attributable to the registrant.

In addition, a registrant should disclose the effect of any discontinued operations and material unusual or infrequent items occurring in each quarter. The quarterly financial data may be included in an unaudited footnote to the annual financial statements or in a separate table elsewhere in the registration statement.

**Connecting the Dots**

While selected quarterly financial data does not need to be provided in an IPO, a new registrant will be required to furnish such data in its first Form 10-K and may also need to do so in a secondary or follow-up offering initiated before the filing of the first Form 10-K. Many companies therefore voluntarily provide such information in the IPO registration statement.
4.3 Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

The purpose of MD&A is to give readers the information they need to understand a company’s financial condition, changes in financial condition, liquidity and capital resources, and results of operations (collectively, “financial condition and operating performance”), as well as its prospects for the future. Since the initial adoption of the MD&A disclosure requirements in 1980, the SEC has issued numerous rules and interpretive guidance intended to enhance the overall quality of MD&A disclosures. General disclosure requirements for domestic companies can be found in Regulation S-K, Item 303, as interpreted in Section 501 of the SEC’s Codification of Financial Reporting Policies and Topic 9 of the FRM.

Paragraph 9110.1 of the FRM states that the “objectives of MD&A are:

a. To provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
b. To enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
c. To provide information about the quality of, and potential variability of, a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance.”

An MD&A section typically includes an overview section about the company and its business, an analysis of results of operations that addresses period-to-period changes in income statement line items, a discussion of liquidity and capital resources that focuses on the company’s financial position and cash flows, a summary of the company’s critical accounting policies intended to highlight financial statement items for which significant management estimates and judgment are required, a tabular disclosure of contractual obligations, and disclosures about off-balance-sheet arrangements. In addition to the discussion and analysis of historical information, MD&A requires companies to disclose any known trends, events, or uncertainties that are reasonably likely to have a material effect on their future liquidity, capital resources, or results of operations.

4.4 Pro Forma Financial Information

A registrant in an IPO may have consummated a transaction, or be contemplating a probable transaction, in which presentation of pro forma financial information is required. The objective of providing pro forma financial information is to enable investors to understand and evaluate the continuing impact of a transaction (or a group of transactions) by showing how the transaction might have affected the historical financial position and results of operations of the registrant had it been consummated at an earlier date.

The requirements related to the presentation and preparation of pro forma financial information are addressed in Regulation S-X, Article 11, as well as Topic 3 of the FRM. See also Chapter 3 of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations for interpretive guidance related to pro forma financial information. Note that the requirements for pro forma financial information under Article 11 are separate and distinct from the requirements to present supplementary pro forma information for a business combination under ASC 805. For more information about the pro forma information disclosures that ASC 805 requires for a completed business combination, see Section 5.4.
Changing Lanes
On May 3, 2019, the SEC issued a proposed rule that would, among other items, amend the financial statement requirements for pro forma financial information in Article 11. The proposed amendments would require registrants to make, and provide certain disclosures about, (1) “Transaction Accounting Adjustments” and (2) “Management’s Adjustments” (e.g., reasonably estimable synergies and other impacts related to the acquisition). Registrants that would be affected by these proposed requirements should closely monitor the status of this rulemaking activity.

4.4.1 Circumstances in Which Presentation of Pro Forma Information Is Required
Article 11 lists several circumstances in which a registrant may need to provide pro forma financial information. Such information is most commonly required when a significant business combination or a disposition of a significant portion of a business has occurred or is probable. As part of an IPO, corporate reorganizations, changes in capitalization, and the use of proceeds are frequently reflected in pro forma financial information; however, a registrant needs to consider whether any other significant events or transactions have occurred or are probable that would also be meaningful to investors on a pro forma basis. Factors that may affect whether a registrant needs to provide pro forma financial information in a registration statement include (1) whether the event or transaction is significant; (2) whether it is already reflected in the historical financial statements; (3) if the event has not yet occurred, whether it is probable; and (4) in the case of the acquisition of a business, whether the separate financial statements of the acquiree are included in the registration statement.

4.4.2 Basic Presentation Requirements
Pro forma financial information, which is unaudited, typically includes an introductory paragraph, a pro forma balance sheet, pro forma income statements, and accompanying explanatory notes. The introductory paragraph briefly describes the transaction(s), the entities involved, the periods for which the pro forma financial information is presented, and any other information that may help readers understand the content of the pro forma information. Ordinarily, the pro forma balance sheet and income statement are presented in a columnar format that shows historical financial information of the registrant (and the acquiree in the case of a business combination), pro forma adjustments, and pro forma totals. Further, each pro forma adjustment should include a reference to an explanatory note that clearly discusses the assumptions involved and how the adjustments are derived or calculated. In the limited cases in which only a few adjustments are required and those adjustments are easily understood, a registrant may include a narrative presentation of the pro forma effects of a transaction in lieu of full pro forma financial information.

4.4.3 Pro Forma Periods Presented
A pro forma balance sheet is required as of the same date as the registrant’s most recent balance sheet included in the IPO registration statement (i.e., one pro forma balance sheet as of the end of the fiscal year or the subsequent interim period, whichever is later). In the computation of pro forma balance sheet adjustments, it is assumed that the transaction was consummated on the balance sheet date. A pro forma balance sheet is not required if the transaction is already reflected in the historical balance sheet.
Pro forma income statements are required for both the registrant’s most recent fiscal year and any subsequent year-to-date interim period included in the IPO registration statement. In the computation of pro forma income statement adjustments, it is assumed that the transaction was consummated at the beginning of the most recently completed fiscal year (and carried forward to the interim period, if presented). The SEC normally does not permit registrants to prepare pro forma information for more than one complete fiscal year. However, a registrant must provide pro forma information for all periods presented in its historical financial statements if the pro forma information reflects the impact of a discontinued operation or a reorganization of entities under common control. A pro forma income statement is not required if the transaction is included in the historical financial statements for the full period covered by the pro forma income statement. Depending on the facts and circumstances, a registrant may need to include a pro forma income statement (or statements) but would not be required to include a pro forma balance sheet.

4.4.4 Pro Forma Adjustments

Pro forma financial information should only give effect to events that are (1) directly attributable to the transaction; (2) factually supportable; and (3) with respect to the pro forma income statement, are expected to have a continuing impact on the registrant. Common pro forma adjustments include the allocation of purchase price related to a business acquisition on a pro forma balance sheet and the related adjustments to depreciation and amortization in the pro forma income statement, the issuance or repayment of debt and the related impact on interest expense, the effects of new contractual arrangements, and any related income tax impact (see paragraph 3230.4 and Section 3250 of the FRM for various examples of pro forma adjustments). The requirement to have a continuing impact applies only to the pro forma income statement, which can cause the same item to be treated differently on the pro forma balance sheet than it is in the pro forma income statement. For example, the pro forma income statement may include a pro forma adjustment to remove direct acquisition costs reflected in the historical income statement but would not include a pro forma adjustment to record similar costs that are anticipated but have not yet been incurred. Although these costs are directly attributable to the acquisition, because they are nonrecurring, they would not be considered to have a continuing impact and therefore should not be reflected in the pro forma totals for the income statement. Conversely, on the pro forma balance sheet, any accrued direct acquisition costs in the historical balance sheet would not be reversed and a pro forma adjustment would be recorded to accrue for any additional direct acquisition costs anticipated, provided that the amount was factually supportable.

Pro forma adjustments would normally not be made to (1) reflect actions planned or taken by management after a business combination (e.g., restructuring or integration costs), (2) reverse the impact of unusual costs in the historical results (e.g., a goodwill impairment), or (3) project future synergies or cost savings. In such cases, one or both of the “directly attributable” and “factually supportable” requirements typically would not be met.

Connecting the Dots

A common question about IPOs is whether the incremental cost of being a public company should be included as a pro forma adjustment. Pro forma disclosure in an initial registration statement would typically not include the expected incremental costs of being a public company because it is unlikely that such costs would meet the criteria for being factually supportable.
4.4.5 Other Common IPO Considerations Related to Pro Forma Information

In addition to the pro forma financial information discussed above, which is typically presented in a separate section of the IPO document, certain pro forma information may need to be included on the face of the historical financial statements. Such pro forma information is required only in specific situations described in Section 3400 of the FRM and typically involves a change in corporate structure or capitalization at or before the closing of an IPO. The pro forma information should not reflect other transactions for which a registrant may have prepared full pro forma financial statements under Regulation S-X, Article 11. Accordingly, pro forma amounts presented in the historical financial statements may differ from pro forma financial information included elsewhere in the registration statement. For additional information on changes in capitalization and related matters, see Sections 5.6.5 and 5.6.6.

4.4.5.1 Distributions to Owners

If a planned distribution to owners or promoters, regardless of whether it has been declared or whether it will be paid from proceeds, is not reflected in the latest balance sheet but would be significant to reported equity, pro forma balance sheet information should be presented alongside the most recent historical balance sheet to reflect the distribution accrual (without giving effect to the offering proceeds) and the impact on equity. In addition, if a distribution to owners is to be paid out of proceeds of the offering rather than from the current year’s earnings, pro forma per-share data (pro forma EPS) should be presented, for the latest fiscal year and interim period only, in the historical income statement. The SEC staff considers dividends declared in the year before the IPO to be in contemplation of the IPO and therefore paid out of offering proceeds if they exceed earnings during the preceding 12 months. Pro forma EPS should be calculated by including an incremental number of shares (not to exceed the number of shares being offered in the IPO) that, on the basis of the offering price, would be needed to pay the portion of the dividend that exceeds earnings for the previous year.

4.4.5.2 Conversion of Outstanding Securities

Pro forma EPS for the latest fiscal year and interim period is also required if outstanding securities will be converted after the latest balance sheet date and the conversion will result in a material reduction of historical EPS. A common example of this scenario is the mandatory conversion of preferred stock into common stock in conjunction with an IPO. In this case, pro forma basic EPS would include the preferred stock on an as-converted basis (but would not give effect to the offering). This type of conversion is also typically reflected on a pro forma basis alongside the latest historical balance sheet.

4.4.5.3 Changes in Terms of Outstanding Equity

Pro forma balance sheet information may also be required alongside the historical balance sheet to give effect to a change in capitalization when (1) the terms of a registrant’s outstanding equity securities will change after the date of the latest historical balance sheet and the new terms result in a material reduction of permanent equity or (2) a material amount of equity securities will be redeemed in conjunction with the offering.
4.4.5.4 Changes in Tax Status

If the registrant is organized as a nontaxable entity (e.g., partnerships, LLCs, S corporations), and expects to be converted to a taxable entity (e.g., a C corporation) in conjunction with the IPO, pro forma income taxes and EPS should be presented in the historical income statement to reflect the impact of the conversion. This presentation is required for the latest fiscal year and interim period, but if the pro forma adjustments are limited to income taxes, pro forma information for all periods presented is permitted. See Section 5.9.5.1 for additional information on changes in tax status.

4.5 Non-GAAP Financial Measures

While a company’s financial statements must be prepared in accordance with GAAP, many companies also elect to disclose non-GAAP financial measures1 — that is, numerical measures of a company’s financial performance, financial position, or cash flows for which the GAAP counterparts are adjusted in some fashion. Examples of common non-GAAP financial measures include EBITDA, adjusted EBITDA, adjusted earnings or adjusted EPS, and free cash flow.

When using non-GAAP financial measures, a registrant must be aware of certain SEC requirements, including the rules in Regulation G and Regulation S-K, Item10(e). In addition, the SEC staff has published a number of C&DI (which are updated periodically) to clarify its views on many non-GAAP presentation issues. SEC officials have indicated in public forums that the SEC is looking for full compliance with the C&DI in IPO registration statements.

The key requirements for disclosure of non-GAAP information in SEC filings, including press releases, are related to the following:

- **Prominence** — The most directly comparable GAAP measure should be presented with equal or greater prominence.
- **Not misleading** — A non-GAAP measure should not be presented in a misleading manner.
- **Reconciliation** — Registrants should present a quantitative reconciliation of the non-GAAP measure to the most directly comparable GAAP measure and should transparently describe all adjustments.
- **Clear labeling** — Registrants should clearly label and describe non-GAAP measures and adjustments but should not, for example, use titles or descriptions that are confusingly similar to those used for GAAP financial measures.
- **Usefulness and purpose** — Registrants should disclose why they believe the non-GAAP measure provides useful information to investors and, to the extent material, a statement disclosing how management uses the non-GAAP measure.

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1 Regulation S-K, Item 10(e)(2), defines a non-GAAP financial measure as “a numerical measure of a registrant’s historical or future financial performance, financial position, or cash flow that: (i) Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or (ii) Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.”
The SEC has frequently cited its C&DI on prominence, Question 102.10, when commenting on non-GAAP measures. Accordingly, it may be helpful for a registrant to note the following:

- If GAAP and non-GAAP measures are presented in a particular section of a document, the GAAP measures should be presented before the non-GAAP measures. For example, if a registrant wants to use certain non-GAAP measures in its discussion of results of operations, it should consider the order of presentation and discuss the GAAP results before the non-GAAP measures.
- When a registrant reconciles a non-GAAP measure to the most comparable GAAP measure, it should start with the GAAP measure.
- The registrant should not present a non-GAAP measure in more detail, or emphasize it more, than the comparable GAAP measure.
- The disclosures related to non-GAAP purpose and use should not state or imply that the non-GAAP measures are superior to, provide better information about, or more accurately represent the results of operations than GAAP measures.
- Certain presentations that give undue prominence to non-GAAP information, such as a full non-GAAP income statement, are prohibited.

An overriding theme of the SEC’s guidance on the use of or references to non-GAAP measures in public statements or disclosures is that they should not be misleading. Section 100 of the C&DIs also provides examples of potentially misleading non-GAAP measures, including those that:

- Exclude normal, recurring cash operating expenses necessary for business operations.
- Are presented inconsistently between periods, such as by adjusting an item in the current reporting period, but not a similar item in the prior period, without appropriate disclosure about the change and an explanation of the reasons for it.
- Exclude certain nonrecurring charges but do not exclude nonrecurring gains (e.g., “cherry picking” non-GAAP adjustments to achieve the most positive measure).
- Are based on individually tailored accounting principles, including certain adjusted revenue measures.

In addition to the examples discussed in the C&DIs, various other presentations could be considered misleading depending on the facts and circumstances.

During the IPO process, these concepts should be carefully considered in the determination of which non-GAAP measures to present in the IPO filing. Because non-GAAP measures are widely used in IPOs and the SEC staff is focusing on disclosures related to such measures, such disclosures are expected to continue to receive significant attention during the registration-statement comment-letter process. See Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights for the SEC staff’s recent comments on this topic.

In addition, for additional background and guidance on the presentation and use of non-GAAP measures, see Deloitte’s A Roadmap to Non-GAAP Financial Measures.
4.6 Metrics and Key Performance Indicators

Financial or operational metrics, sometimes called key performance indicators or KPIs, may also be included in an IPO registration statement to illustrate the size, profitability, and growth of the business or other relevant trends such as customer acceptance or retention. Although such customized metrics are generally not considered non-GAAP measures, disclosures about metrics are often similar to the disclosures that would be required under the non-GAAP rules. Examples of metrics include number of Web page views, customer retention rates, occupancy percentage, and same-store sales.

The SEC staff will often closely review the use of KPIs in IPOs and registrants are advised to consider doing the following when using KPIs to describe their business or results of operations:

- Clearly defining the KPIs and disclosing how they are calculated.
- Explaining to investors why the KPIs are important (i.e., the purpose and use of the KPIs).
- Tying the KPIs in to the registrants’ strategy and describing how they are related to current or future results of operations.
- Presenting metrics within a balanced discussion that includes a description of material changes in the metrics from period to period.
- Describing any important assumptions and limitations associated with the metrics (e.g., whether they are “hard” amounts or estimates).
- Providing metrics on a disaggregated basis (i.e., by segment or geography), when appropriate.
Chapter 5 — Accounting Matters

5.1 Introduction

This section highlights common accounting issues addressed in preparing financial statements for inclusion in an IPO registration statement. While some of the guidance may be directly applicable, some of it may be applied to IPO registration statements by analogy, may be complex, and may require significant judgment. Understanding the structure and substance of the transactions to effect the IPO is critical to making sound and reasonable judgments. During its comment process, the SEC staff will frequently ask management to explain those judgments, alternatives considered, and why the information provided to the user is representationally faithful. For additional observations related to frequently issued SEC staff comments, see Deloitte’s *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*.

5.2 Structure of the IPO Transaction

5.2.1 Carve-Out Considerations

“Carve-out financial statements” is a general term used to describe financial statements derived from the financial statements of a larger parent company. Carve-out financial statements may be included in an initial registration statement for a registrant and its predecessor when a portion of a larger parent company is sold to the public in an initial equity offering or when a public entity plans to spin off a business or group of businesses to shareholders as a separate public company (see Section 5.2.2). When a portion of a larger parent company is sold to the public in an IPO, carve-out financial statements that comply with the general financial statement requirements in Regulation S-X, Rules 3-01 through 3-04, are generally required for a registrant and its predecessor in an initial registration statement (e.g., Form 10, Form S-1). In addition, carve-out financial statements of the registrant and its predecessor for the comparative periods must be included in Forms 10-K and 10-Q after the initial registration statement is declared effective.

The form and content of the carve-out financial statements depends on the needs or requirements of financial statement users and any regulatory requirements applicable to the transaction for which the carve-out financial statements are being prepared. See Deloitte’s *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions* for more information about preparing carve-out financial statements.

5.2.2 Spin-Off Transactions

ASC 505 defines a spin-off as “[t]he transfer of assets that constitute a business by an entity (the spinor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinor.” Entities that want to streamline their operations might enter into spin-offs as an alternative to selling those parts of the business since a spin-off may provide certain tax advantages that a sale does not.
ASC 845 provides guidance on accounting for a spin-off. The accounting for the distribution of nonmonetary assets to owners in a pro rata spin-off is based on recorded amounts (after reduction, if appropriate, for an indicated impairment of value). Generally, a pro rata distribution to existing shareholders does not result in a change in control of the distributed business and a change in accounting basis therefore would not be appropriate.

Often, a spin-off will be executed concurrently with an IPO of the shares of the spinnee. For a spinnee's securities to be listed on public exchanges such as Nasdaq or the NYSE, its shares must be registered via Form 10 in a 1934 Act filing. In addition, a spinnee may initiate a 1933 Act filing, such as a Form S-1 or its equivalent, to register the sale of additional securities in the future.

Preparing financial statements for the spinnee can be complex. Both Form 10 and Form S-1 (or its equivalent) require audited historical financial statements of the spinnee; pro forma financial information; and, depending on the timing of the filing during the fiscal year, interim financial information.

Determining reporting requirements may be further complicated in a spin-off transaction accounted for as a reverse spin-off in which the legal form of the transaction differs from its substance to such a degree that the financial statements of the spinnee will be the historical financial statements of the legal spinnor. In a spin-off transaction, an entity must consider the factors in ASC 505-60-25-8 when identifying the accounting spinnor and spinnee, which may differ from the legal spinnor and spinnee. At the 2014 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff cautioned that significant judgment must be used in the determination of the accounting spinnor and spinnee and the related financial statement presentation and SEC reporting requirements for a reverse spin-off transaction:

When the spinoff is determined to be a reverse spin under Subtopic 505-60, some registrants have assumed that this conclusion dictates the financial statements that are presented in a registration statement that is filed to effect the spinoff. Specifically, some registrants have concluded that when a transaction is accounted for as a reverse spin, the financial statements of the existing registrant (i.e. — the legal spinnor) can be used to satisfy the financial statement requirements of the entity that will be spun off (i.e. — the accounting spinnor/legal spinnee). On this point, our colleagues in the Division of Corporation Finance view this as an assessment that is based on the unique facts and circumstances of each transaction, and there may be situations in which carveout financial statements are required for the accounting spinnor/legal spinnee in a registration statement relating to a reverse spin. Overall, the separation of an existing registrant into two or more registrants in a spinoff transaction may present a number of reporting questions, both with respect to the registration statement as well as the subsequent Exchange Act reports for each continuing entity. Given the significant judgments involved in determining the accounting spinnor as well as the appropriate financial statement presentation, the staff encourages registrants to continue to consult on their accounting and reporting conclusions relating to spinoffs, particularly when the transaction is expected to be accounted for as a reverse spin.

If management has concluded that a spin-off transaction is expected to be accounted for as a reverse spin-off, or if the determination is subject to a high degree of judgment, management should consider (1) consulting with its auditors and other professional advisers and (2) preclearing its conclusions about the accounting and reporting requirements with the SEC staff.
5.2.3 Reorganization in Anticipation of a Transaction

In anticipation of a spin-off or IPO of a portion of a larger parent entity, a parent entity may reorganize its business by transferring certain assets or liabilities to a newly formed or existing subsidiary that will be used to effect the transaction (the “receiving entity”). Because the assets and liabilities are under the control of the parent entity both before and after the reorganization, the transfer is accounted for as a common-control transaction and there is generally no change in basis in the assets and liabilities. However, sometimes the carrying amounts of the net assets in the accounts of the subsidiary that transfers the net assets differ from the carrying amounts in the parent entity's consolidated financial statements. This can occur, for example, if the net assets being transferred were acquired in a business combination but the transferring entity has not applied pushdown accounting in its accounts. Under ASC 805-50-30-5, “the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.” As a result, the receiving entity is effectively required to apply pushdown accounting in its separate financial statements even if the transferring entity had not.

For more information about accounting for common-control transactions, see Deloitte’s A Roadmap to Accounting for Business Combinations.

5.3 Related-Party Transactions

All related-party transactions, including those that arise as a result of the IPO process, need to be identified to ensure that they are properly disclosed as well as to identify those transactions that are modified or terminated, such as (1) shareholder agreements that provide rights of first refusal, (2) loans to directors or executive officers that may not be allowed under Sarbanes-Oxley, and (3) stock option or award plans and stock purchase plans.

5.3.1 Definition of a Related Party

Although both public and nonpublic entities are required to include related-party disclosures in their financial statements under U.S. GAAP, an SEC registrant’s financial statements in an IPO must comply with incremental SEC guidance. Therefore, when preparing for an IPO, management should be aware of the differences between the U.S. GAAP definition of “related party” and the SEC’s definition of the term to ensure that disclosures are compliant with SEC guidance.

ASC 850 defines a related party as follows:

- Related parties include:
  a. Affiliates of the entity
  b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
  c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
  d. Principal owners of the entity and members of their immediate families
  e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Although the SEC’s definition of a related party is similar to the FASB’s, the SEC has established its own definition of a “related person” in Regulation S-K, Item 404(a). This definition includes:

• “Any director or executive officer of the registrant.”

• “Any nominee for director, when the information . . . is being presented in a proxy or information statement relating to the election of that nominee for director.”

• Any beneficial owner of more than 5 percent of any class of the company’s voting securities (see Regulation S-K, Item 403(a)).

• “Any immediate family member” of the people listed above (i.e., “any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law” of such people) “and any person (other than a tenant or employee) sharing the household” of such people.

The example below highlights the need to consider what constitutes a related party under both U.S. GAAP and Regulation S-K.

Example 5-1

Under U.S. GAAP, a principal owner is considered a related party. ASC 850 defines the term “principal owners” as “[o]wners of record . . . of more than 10 percent of the voting interests of the entity.” Under the SEC definition, this amount is decreased to 5 percent of any class of voting securities. If a shareholder holds a 7 percent interest in an entity both before and after an IPO, that individual would not represent a related party for U.S. GAAP purposes but would be considered a related party under Regulation S-K, in which case additional disclosures would be required.

5.3.2 Presentation and Disclosures Associated With Related-Party Transactions

The SEC considers disclosures about related-party transactions an integral part of the financial statements and other disclosures in the registration statement. Management must therefore provide detailed disclosures about these transactions in registration statements.
5.3.3 Related-Party Disclosures Under U.S. GAAP

ASC 850-10-50 provides the following guidance on related-party disclosures (this guidance applies to both public and nonpublic entities):

<table>
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| 50-1 Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:
  a. The nature of the relationship(s) involved
  b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
  c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
  d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement
  e. The information required by paragraph 740-10-50-17.\(^1\) |
| 50-2 Notes or accounts receivable from officers, employees, or affiliated entities must be shown separately and not included under a general heading such as notes receivable or accounts receivable.\(^2\) |
| 50-3 In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party shall be disclosed. |
| 50-4 It is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another entity (the primary reporting entity) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report. |
| **Disclosures About Arm’s-Length Bases of Transactions** |
| 50-5 Transactions involving related parties cannot be presumed to be carried out on an arm’s-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm’s-length transactions unless such representations can be substantiated. |
| **Control Relationships** |
| 50-6 If the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities. |

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1 ASC 740-10-50-17 states, “An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:
   a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented
   b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented.”

2 As discussed above, loans to directors or executive officers may not be allowed under Sarbanes-Oxley.
5.3.3.1 Related-Party Disclosures for SEC Registrants

In addition to meeting the disclosure requirements under U.S. GAAP, a registrant’s financial statements should comply with the applicable requirements of Regulation S-X. The SEC staff frequently requests additional related-party disclosures.

Regulation S-X prescribes the types, form, and content of the financial information that registrants must file. Many of these requirements expand on the disclosure requirements in U.S. GAAP. Under Regulation S-X, Rule 4-08(k):

- Registrants must state the amounts of related-party transactions on the face of the balance sheet, statement of comprehensive income, or statement of cash flows.
- When separate financial statements are presented for a registrant, certain investees, or subsidiaries, registrants must separately disclose in such statements any historical intercompany profits or losses resulting from transactions with related parties and the effects thereof.

In addition, Regulation S-X, Rule 5-02(3)(a), requires entities to state separately, on the face of the balance sheet, amounts receivable from (1) customers; (2) related parties; (3) underwriters, promoters, and employees (other than related parties) that “arose in other than the ordinary course of business”; and (4) others.

Further, Regulation S-K, Item 404(a), requires registrants to disclose transactions with related parties they participated in, or will participate in, in which the “amount involved exceeds $120,000, and [the related party] had or will have a direct or indirect material interest.” This disclosure should include information such as:

- “The name of the related person and the basis on which the person is a related person.”
- “The related person’s interest in the transaction with the registrant.”
- “The approximate dollar value of the . . . transaction.”
- Any additional information about the transaction “that is material to investors in light of the circumstances of the particular transaction.”

5.3.4 Identifying Related-Party Transactions

In identifying related-party transactions, registrants should consider consulting with legal counsel and reviewing the instructions to Regulation S-K, Item 404(a), to better understand the definition of a “related person” and the types of transactions a registrant needs to disclose. As part of this process, a master list of all related parties should be maintained and communicated to employees so that they are aware of them. Additional information about related parties may be obtained in various ways, including an annual questionnaire distributed to directors and officers through which an entity obtains basic information about transactions between directors and officers, their family members, and the entity. Other potential sources that may help identify related parties include, but are not limited to:

- Disclosures on the entity’s Web site.
- Tax filings and related correspondence.
- Invoices from professional advisers.
- Conflicts-of-interest statements from management and others.
- Shareholder registers that identify the entity’s principal shareholders.
- Life insurance policies purchased by the entity.
• Records of investments, pension funds, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, pension plans, and other trusts.

• Contracts or other agreements (e.g., partnership agreements) with management.

• The entity’s organizational charts.

• Records from a whistleblower program.

• Expense reimbursement documents for executive management.

Connecting the Dots
PCAOB auditing standards require the auditor to perform certain procedures to audit related-party transactions and the related internal controls. See Section 6.7.5 for more information.

5.3.5 Focus of SEC
Types of related-party transactions that the SEC staff often comments on during the registration process include (1) sales and loans between related parties and (2) the entity’s policies and procedures for reviewing, approving, or ratifying transactions with related persons. For additional observations related to frequently issued SEC staff comments, see Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights.

5.3.6 Regulation S-K, Item 404(a)(5) — Transactions With Related Persons
Regulation S-K, Item 404(a)(5), indicates that registrants should disclose the major terms of related-party indebtedness, including the amounts involved, the largest principal amount outstanding during the period and as of the latest practicable date, principal and interest payments made during the period, and the interest rate or the interest-payable amount as of the end of the period. The SEC staff often asks registrants to expand disclosures related to these requirements.

5.3.7 Regulation S-K, Item 404(b) — Review, Approval, or Ratification of Transactions With Related Persons
Regulation S-K, Item 404(b), requires a registrant to develop and disclose its “policies and procedures for the review, approval, or ratification of any transaction” with related persons. These policies and procedures are essential to providing information to investors regarding how related-party transactions will be addressed. Recent SEC comment letters have indicated that although the SEC may ask for additional information regarding these policies, registrants often disclose the existence, or a general summary, of such policies and procedures but exclude material features such as the types of transactions covered, the standards to be applied to the transactions, and the persons or group of persons responsible for applying the policies and procedures.

5.4 Business Combinations
In addition to the pro forma financial information that must be disclosed for a business combination or probable business combination (discussed in Section 4.1), when a business combination is completed, an entity must disclose pro forma financial information in the notes to the financial statements in accordance with ASC 805.
Chapter 5 — Accounting Matters

ASC 805-10-50-2(h) requires an acquirer that meets the definition of a public entity to disclose the following:

- “The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.”
- “[T]he revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period.”
- “The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings.”

ASC 805 pro forma information must be disclosed (1) in the period in which a business combination occurs or (2) if a business combination is completed after the reporting date but before the financial statements are issued. Further, if multiple immaterial business combinations that are material in the aggregate occur in a reporting period, ASC 805 pro forma information should be disclosed in the aggregate for those business combinations.

The ASC 805 pro forma disclosures are required only for public entities. Therefore, an entity may not have provided these disclosures in its financial statements before becoming a public entity. However, if a material business combination or multiple immaterial business combinations that are material in the aggregate have occurred in any of the reporting periods presented in the registration statement, the entity would be required to provide these disclosures in its registration statement.

For more information about presenting pro forma financial information under ASC 805, see Deloitte’s *A Roadmap to Accounting for Business Combinations*.

5.5 Financial Instruments

5.5.1 Valuation of Financial Instruments

Fair value has become an integral part of financial reporting and is often cited by investors as the most relevant measurement attribute for financial instruments. Under U.S. GAAP, derivatives, whether freestanding or bifurcated from host instruments, generally must be reported at fair value in the balance sheet. Consequently, the SEC staff often comments on how freestanding derivatives and bifurcated embedded derivatives have been measured and reported in the balance sheet. For example, the staff has frequently requested issuers to expand fair value disclosures to include quantitative information about significant unobservable inputs used in fair value measurements. Some additional topics related to financial instrument valuation that the SEC staff has focused on include the following:

- Significant assumptions, factors, and methods used to determine fair value.
- Changes in valuation of the instruments over time.
- Categorization of instruments in the fair value hierarchy.
- Whether an independent valuation was performed contemporaneously.
- Explanations of any discounts (e.g., marketability, liquidity).

For additional observations related to frequently issued SEC staff comments, see Deloitte’s *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*. 
Because of the complexity of financial instruments, simple valuation models often are not appropriate for measuring fair value. At the Forum on Auditing in the Small Business Environment hosted by the PCAOB in 2012, the staff in the SEC's Division of Corporation Finance noted that errors in valuation of financial instruments often result from entities' failure to carefully consider and evaluate the accounting implications of contractual provisions. Prospective registrants are strongly encouraged to evaluate such provisions, paying attention to the identification of any embedded features that may affect an instrument's valuation. Such features may affect the settlement amount (and thus the fair value) of the instrument or embedded feature, and the valuation method or methods selected should appropriately incorporate all relevant terms.

The value of freestanding financial instruments (e.g., warrants) and bifurcated derivatives (e.g., conversion options bifurcated from debt or preferred stock) can fluctuate significantly with changes in the value of the underlying stock or underlying assumptions used in determining the instruments' fair value. As is generally the case for a prospective registrant, when no active market exists for the underlying stock associated with the financial instrument, the entity must establish appropriate valuation processes and controls related to determining the fair value of both the stock underlying the financial instrument and the financial instrument in its entirety.

**Connecting the Dots**

Issuers often need to determine the fair value of the stock into which a financial instrument is convertible, because either the financial instrument in its entirety must be accounted for at fair value or an embedded conversion feature must be bifurcated and accounted for separately at fair value. However, even if the instrument is not accounted for at fair value in its entirety and no embedded derivative is bifurcated, it is still important to determine an appropriate measure of fair value for the stock into which a financial instrument is convertible when it is not actively traded. This fair value will be used to determine whether a beneficial conversion feature (BCF) exists upon issuance. See Section 5.6 below for a discussion of BCFs.

As the complexity of financial instruments increases, an entity may be required to use significant judgment in measuring fair value. Prospective registrants should ensure that their disclosures include the information investors need to understand how management determined fair value. Furthermore, depending on the complexity and terms of the instrument, an independent valuation specialist may need to be engaged to assess the instrument's fair value. Section 7(a) of the 1933 Act requires that a written consent be obtained from an independent valuation firm that is “named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement.”

[Section 5.5.2 has been deleted.]

**5.6 Liabilities, Equity, and Temporary Equity**

The SEC historically has focused on the classification of liabilities and equity in the balance sheet when equity instruments have redemption provisions or financial instruments possess characteristics of both liabilities and equity. For example, classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.

Prospective registrants may have previously outstanding instruments with characteristics of both liabilities and equity at the time they are approaching a potential IPO, or an entity may issue new instruments in connection with a potential IPO. Even if certain instruments are already outstanding before an IPO, when public financial statements are initially filed, it may be appropriate for an instrument

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3 For more information, see the slide presentation from the forum.
to be classified outside of permanent equity in accordance with SEC rules. Further, for an entity that becomes publicly traded, there can be other accounting consequences that did not exist while the entity was private.

For more information about the classification of liabilities and equity, see Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

In addition, certain debt and equity instruments may be convertible into other instruments (i.e., hybrid instruments) and may contain BCFs. The SEC staff frequently questions whether BCFs exist by comparing the contractual conversion price in the convertible instruments with the IPO price, particularly when the convertible instrument is issued within one year of an IPO filing. If the prospective registrant believes that the conversion price represented the stock’s fair value at the time the instrument was issued, it should be prepared to present sufficient evidence to support its assertion. In the absence of sufficient evidence, when the contractual conversion price is lower than the IPO price, the SEC staff may require that the IPO price be used as a base in measuring the BCF. This could result in the recognition of increased interest cost for convertible debt instruments or the recognition of dividends for convertible equity instruments in the pre-IPO period.

For more information about accounting for convertible debt and about identifying and accounting for BCFs, see Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

[Sections 5.6.1 through 5.6.4 have been deleted, including Examples 5-2 through 5-7.]

### 5.6.5 Distributions to Owners Under SAB Topic 1.B.3

While planning for an IPO, entities may make distributions to pre-IPO owners as compensation or as a return of capital. The SEC provides explicit guidance on reporting planned distributions to owners at or before the closing of an IPO.

Distributions are generally paid out of earnings. However, if the planned distribution exceeds earnings for the previous 12-month period, the amount of the distribution in excess of earnings is deemed by the SEC to be paid out of the proceeds of the offering.

Regardless of the source from which the planned distributions will be made to owners, if such planned distributions are not reflected in the latest balance sheet and the amount is significant in relation to reported equity, a pro forma balance sheet should be presented to reflect an accrual for the planned distribution and the impact on equity. However, the offering proceeds should not be included in the pro forma presentation. This pro forma information may be presented alongside the historical balance sheet or in an appropriate footnote disclosure.

In addition, if a planned or actual distribution to owners is deemed to be paid out of proceeds of the offering rather than from the current year’s earnings, pro forma per-share data (pro forma EPS) should be presented for the latest fiscal year and interim period only. Pro forma EPS should be calculated by including an incremental number of shares, not to exceed the number of shares being offered in the IPO that, on the basis of the offering price, would be needed to pay the portion of the distribution that exceeds earnings for the previous 12-month period.
5.6.6 Changes in Capitalization

Changes in an entity’s capitalization or revisions to the capital structure often occur before, or concurrently with, the effective date or closing of an IPO. Such changes are frequently associated with the complex equity structures of many pre-IPO entities and are made to ensure that the entity has an appropriate capital structure to go public.

Changes in capitalization take various forms, including amendments to an entity’s articles of incorporation, stock splits, redemptions of preferred stock, and conversions of preferred stock or debt into common stock. Some changes, such as stock splits, are reflected retrospectively in all periods presented in the financial statements. Most other changes, if they occurred after the latest balance sheet date, are only recorded prospectively and may not be reflected in the historical financial statements presented in an IPO filing. However, such changes in capitalization may need to be presented as part of pro forma information.

5.6.6.1 Stock Splits in Contemplation of the IPO

Stock splits (or reverse stock splits) may be declared during the pre-IPO process with the intent to be effected shortly before the effective date of the registration statement (i.e., just before the closing of the IPO). A stock split is often executed to establish an outstanding share count that will result in an offering price that is within a preferred range based on the estimated post-IPO valuation. If the stock split is both declared and effected before an amendment to the registration statement is filed, the impact must be retrospectively reflected in the historical financial statements. The related footnote disclosures should describe:

- A description of the change.
- The retroactive presentation.
- The date the change became effective.

When a prospective stock split has been declared but is not yet effected, it is still typical to retrospectively reflect the stock split in the historical financial statements. Because the stock split is not yet effective as of the issuance of the financial statements, but those financial statements retroactively reflect the impact of the stock split, the registration statement must include a “to-be-issued” auditor’s report (i.e., a draft report in the form that will be issued at a future date). Such an auditor’s report would include a preface (or legend) signed by the auditor stating that it expects to be in a position to issue the report in the form presented when the stock split is legally effected. The highlights of the June 2014 CAQ SEC Regulations Committee joint meeting with the SEC staff discuss the following situations related to such a presentation:

In certain situations, a registrant’s financial statements included in a registration statement may reflect a transaction that has not yet occurred but (a) will occur just prior to or at effectiveness and (b) will be reflected retrospectively in the historical financial statements in accordance with US GAAP. Examples are a stock split or a legal reorganization. In those circumstances, the staff will commence a review of a registration statement that includes a “to-be-issued” audit report on financial statements that have already been revised to reflect the transaction retrospectively (see FRM Section 4710).

Note that the registration statement cannot be declared effective until the legend is removed and the auditor’s report is finalized. Entities are encouraged to consult with their independent registered public accounting firms if they believe they meet the requirements described above.

4 These disclosures are required by SAB Topic 4.C (codified as ASC 505-10-S99-4) as well as for changes in capital structure that involve a stock dividend.
5.6.6.2 Redemption or Conversion of Preferred Stock to Common Stock and Conversion of Debt

In many instances, preferred stock or convertible debt will automatically convert to common stock upon an IPO. If the original terms of outstanding convertible preferred stock do not provide for automatic conversion into common stock upon an IPO, an entity may, before commencing the IPO process, seek to obtain the agreement of the preferred stockholders to convert their preferred stock into common stock at the time of the IPO or to modify existing provisions in organizational documents to incorporate an automatic conversion feature. As a result, a change in capitalization may occur after the date of the most recent balance sheet presented. Similarly, changes in capitalization can result from conversion of debt into equity after the date of the latest balance sheet presented.

Paragraph 3430.1 of the FRM points out that the historical financial statements, including EPS data, generally “should not be revised to reflect modifications of the terms of outstanding securities that become effective after the latest balance sheet date.” However, a registrant may need to provide pro forma information, as discussed further below.

5.6.6.3 Presentation of Pro Forma Information Related to Changes in Capitalization

The registration statement may need to include pro forma financial information related to changes in capitalization that occur around the same time as an IPO.

The SEC staff often asks registrants to present pro forma information when changes in capitalization will occur after the date of the latest balance sheet. Paragraph 3430.2 of the FRM indicates that when such changes (1) will “result in a material reduction of permanent equity” or (2) result from “redemption of a material amount of equity securities . . . in conjunction with the offering,” a pro forma balance sheet should be included in the filing (presented alongside the historical balance sheet) that takes into account the change in capitalization but not the effects of the offering proceeds. While not a reduction in permanent equity, the conversion of preferred stock to common stock in conjunction with an IPO is also typically reflected in pro forma balance sheet information.

A prospective registrant should also present pro forma EPS when outstanding securities are or will be converted after the latest balance sheet date and this conversion will cause a material reduction in EPS (excluding the effects of the offering). The pro forma EPS should reflect the securities conversion but not the effects of the offering. Such pro forma EPS should be presented for the latest fiscal year and interim period presented in the registration statement.

5.6.7 SAB Topic 4.E — Treatment of Receivables From the Sale of Stock

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<td><strong>45-2</strong> An entity may receive a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital. Reporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is substantial evidence of ability and intent to pay within a reasonably short period of time, for example, as discussed for public entities in paragraph 210-10-599-1 (paragraphs 27 through 29), which requires a deduction of the receivable from equity. However, such notes may be recorded as an asset if collected in cash before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).</td>
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Generally, receivables that result from the issuance of shares classified as permanent or mezzanine equity should be presented as a reduction of each respective class of stock (i.e., contra-equity). That is, receivables that result from the issuance of shares classified as permanent equity generally should be presented as a reduction of permanent equity in accordance with ASC 505-10-45-2. Similarly, receivables that result from the issuance of shares classified as mezzanine equity should be presented as a reduction of mezzanine equity by analogy to the guidance in EITF Issue 89-11 (not codified in the ASC), which states, in part, that “when ASR 268 . . . requires some or all of the value of the securities to be classified outside of permanent equity, a proportional amount of the debit in the equity section . . . if any, should be similarly classified.”

Under SAB Topic 4.E (codified in ASC 310-10-S99-2), outstanding receivables from officers or other employees related to the issuance of stock to officers or other employees must generally be presented as a deduction from stockholders’ equity rather than as an asset.

Asset classification of such receivables may be appropriate only when the receivable is fully repaid in cash before the financial statements are issued. The date of payment must be disclosed in the notes to the financial statements.

SAB Topic 4.E cautions, however, that the SEC staff would consider any subsequent return of cash to the officer or employee as potentially representing an effort “to evade the registration or reporting requirements of the securities laws.” Although the receivable may be settled before the effective date of the IPO, receivables of this nature must be disclosed separately, regardless of whether they are classified as an asset or as a deduction from equity.

In addition, an entity that allows an employee to finance the purchase of shares should consider whether recourse or nonrecourse notes have been tendered. Nonrecourse notes are not recognized because such a financing is accounted for, in substance, as a stock option.

Connecting the Dots
Entities preparing to file a registration statement with the SEC should be particularly cognizant of the potential legal ramifications that may arise as a result of such loans and should address any issues with their legal counsel well in advance of becoming public. Section 402 of Sarbanes-Oxley generally precludes certain loans with officers and directors. Before going public, prospective registrants should consult with legal counsel regarding potential settlement of such loans.

[Section 5.6.8 has been deleted.]

5.7 Accounting for Offering Costs — SAB Topic 5.A
Expenses incurred during an IPO can be divided into those that occur as a direct result of an IPO and those that occur as part of an entity's ordinary operations. SAB Topic 5.A (codified in ASC 340-10-S99-1) indicates that “[s]pecific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering.” Therefore, entities undertaking an IPO should ensure that all costs earmarked for deferral are incremental costs directly resulting from the IPO as opposed to costs that are part of an entity's ongoing operations and that would have been incurred regardless of whether the IPO takes place.
Costs incurred during an IPO may be significant. Therefore, the appropriate identification of 
costs that qualify for deferral is particularly important given the potential impact on reported 
profit or loss if such costs are incorrectly allocated. Similarly, entities should be cognizant of the 
risk of deferring costs that do not qualify for such treatment. In certain cases, management may 
need to exercise judgment to appropriately allocate costs and should consider consulting with 
professional advisers and auditors before making a final determination.

Costs that may qualify for deferral include registration fees, filing fees, listing fees, specific legal and 
accounting costs, and transfer agent and registrar fees. However, in accordance with SAB Topic 5.A, 
costs such as management salaries or other general and administrative expenses generally are not 
considered incremental or directly attributable to the IPO. Such costs should be accounted for under 
other accounting standards.

In rare instances, an IPO could consist solely of selling shareholders, with no new shares being issued 
by the entity. In such cases, offering costs should be expensed because there are no proceeds against 
which to offset the costs.

5.7.1 Aborting or Postponing an Offering

An entity that aborts an IPO can no longer defer offering costs that otherwise qualified for deferral; 
rather, such deferred costs should be immediately expensed. However, as indicated in SAB Topic 
5.A, “[a] short postponement (up to 90 days) does not represent an aborted offering.” In practice, 
postponements regularly occur in response to market fluctuations or entity-specific circumstances 
(e.g., delays in the finalization of a contract that is intended to form the foundation of an entity’s IPO). 
Judgment should be used in the determination of whether a postponement of more than 90 days 
represents an aborted offering.

When a delay or postponement occurs, the determination of whether costs should continue to be 
deferred as a result of a delay or postponement depends on whether the costs are associated with a 
probable, successful future offering of securities. To the extent that a cost will be incurred a second time 
or not provide a future benefit, it should be charged to expense.

In determining the actual postponement date, an entity may be required to use significant judgment and 
consider the facts and circumstances. For example, if an offering is delayed beyond 90 days because 
market conditions would not yield an acceptable return, the delay would generally be considered an 
aborted offering and previously deferred offering costs would be charged to expense. Conversely, a 
delay of more than 90 days could be considered a short postponement, rather than an aborted offering, 
in certain circumstances. Sufficient and appropriate evidence should exist to support the assertion that 
the delay of an offering of securities does not constitute an aborted offering. Factors that may indicate 
that an offering has not been aborted include, but are not limited to:

* The resolution of the items causing the delay (e.g., accounting, legal, or operational matters) is 
  necessary for the completion of the offering. Such resolution may include:
  - Completing new (or revising existing) contractual arrangements with shareholders or other 
    parties.
  - Obtaining audited financial statements for other required entities (e.g., significant 
    acquisitions under Regulation S-X, Rule 3-05; significant equity method investments under 
    Regulation S-X, Rule 3-09).
• A plan for resolving the delay, including a revised timetable detailing the necessary steps to achieve a registration; such a plan should be approved by the board of directors or management.

• Continuing to undertake substantive activities in accordance with the plan, demonstrating an intent to proceed with the offering.

• Continuing to prepare financial information or updating the registration statement either to respond to SEC staff review comments or because information may become stale.

Management will need to use significant judgment in determining whether a delay is a short postponement or an aborted offering and may need to consult with accounting and legal advisers.

5.8 Share-Based Compensation

An entity that is preparing for an IPO may have a share-based compensation strategy designed to retain and attract employees. Share-based compensation often is in the form of stock options, stock appreciation rights, restricted stock, restricted stock units, or an employee stock purchase plan (ESPP). In addition, an entity may use share-based compensation to purchase goods or services from third-party vendors or service providers. Management should consider the financial reporting implications associated with each of the various types of share-based compensation arrangements that an entity may enter into with employees and nonemployees. Additional topics that an entity undergoing an IPO often must consider include the valuation of share-based compensation, repurchase features, certain profit-sharing arrangements, performance conditions associated with liquidity events, modifications, employee loans, escrowed stock arrangements, EPS, and disclosures.

This section focuses on share-based compensation granted to employees under ASC 718. Entities that have not adopted ASU 2018-07 and grant share-based compensation to nonemployees should apply ASC 505-50 to account for such transactions.

Changing Lanes

In June 2018, the FASB issued ASU 2018-07, which simplifies the accounting for share-based payments granted to nonemployees for goods and services. ASU 2018-07 aligns most of the guidance on accounting for payments to nonemployees with the accounting requirements for share-based payments granted to employees.

Before the adoption of ASU 2018-07, share-based payment arrangements with employees are accounted for under ASC 718 while nonemployee share-based payments issued for goods and services are accounted for under ASC 505-50. In addition, ASC 505-50 differs significantly from ASC 718 before the ASU’s amendments. Differences include, but are not limited to, guidance on (1) determining the measurement date (which generally is the date on which the measurement of equity-classified share-based payments becomes fixed); (2) accounting for performance conditions; (3) the ability of a nonpublic entity to use certain practical expedients for measurement; and (4) accounting for (including measurement and classification) share-based payments after vesting.

For public business entities, the amendments in ASU 2018-07 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. An entity is permitted to early adopt the amendments in ASU 2018-17; however, the adoption of ASU 2018-17 can
be no earlier than the date on which ASC 606 is adopted. For more information about ASU 2018-07, see Appendix E and Appendix F of Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards*.

As a reminder, share-based payment awards accounted for under ASC 718 must be either (1) settled by issuing the entity’s equity shares or other equity instruments or (2) indexed, at least in part, to the value of the entity’s equity shares or other equity instruments. Generally, equity-classified share-based payment awards are measured by using a fair-value-based measure on their grant date. Liability-classified share-based payment awards are also generally measured by using a fair-value-based measurement; however, they are remeasured in each subsequent reporting period until settlement. The fair-value-based measure for share-based payment awards is recognized over the requisite service period, provided that the vesting conditions are met.

### 5.8.1 Valuation

One of the most significant inputs related to measuring share-based compensation is the underlying valuation of the entity’s shares. A pre-IPO entity should become familiar with the U.S. GAAP and SEC valuation requirements, including differences between valuation methods for public entities and those for nonpublic entities. The sections below summarize some of the more significant considerations related to share-based compensation for an entity contemplating an IPO.

#### 5.8.1.1 Pre-IPO Valuation Considerations

<table>
<thead>
<tr>
<th>ASC 718-10</th>
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<tbody>
<tr>
<td><strong>30-2</strong> A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this Topic, a calculated value or intrinsic value) of the equity instruments issued.</td>
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<th>Pending Content (Transition Guidance: ASC 718-10-65-11)</th>
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ASC 718 identifies three ways for nonpublic entities to measure share-based payment awards (the terms below are defined in ASC 718-20):

- By using fair value, which is the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties — that is, other than in a forced or liquidation sale.
- By using a calculated value, which is a measure of the value of a stock option or similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity’s share price in an option-pricing model.
- By using intrinsic value, which is the amount by which the fair value of the underlying stock exceeds the exercise price of an option or similar instrument.
5.8.1.1.1 Fair-Value-Based Measurement

Nonpublic entities should make an effort to value their equity-classified awards by using a fair-value-based measure. A nonpublic entity may look to recent sales of its common stock directly to investors or common-stock transactions in secondary markets. However, observable market prices for a nonpublic entity’s equity shares may not exist. In such an instance, a nonpublic entity could apply many of the principles of ASC 820 to determine the fair value of its common stock, often by using either a market approach or an income approach (or both). A “top-down method” may be applied, which involves first valuing the entity, then subtracting the fair value of debt, and then using the resulting equity valuation as a basis for allocating the equity value among the entity’s equity securities. While not authoritative, the AICPA Accounting and Valuation Guide Valuation of Privately-Held-Company Equity Securities Issued as Compensation (the “AICPA Valuation Guide”) emphasizes the importance of using contemporaneous valuations from independent valuation specialists to determine the fair value of equity securities.

5.8.1.1.2 Calculated Value

When stock options or similar instruments are granted by a nonpublic entity, the entity should try to use a fair-value-based measure to value those equity-classified awards. However, in certain instances, a nonpublic entity may not be able to reasonably estimate the fair-value-based measure of its options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In these cases, the nonpublic entity should substitute the historical volatility of an appropriate industry sector index for the expected volatility of its own share price. In assessing whether it is practicable to estimate the expected volatility of its own share price, the entity should consider the following factors:

- Whether the entity has an internal market for its shares (e.g., investors or employees can purchase and sell shares).
- Previous issuances of equity in a private transaction or convertible debt provide indications of the historical or implied volatility of the entity’s share price.
- Whether there are similarly sized public entities (including those within an index) in the same industry whose historical or implied volatilities could be used as a substitute for the nonpublic entity’s expected volatility.

If, after considering the relevant factors, the nonpublic entity determines that estimating the expected volatility of its own share price is not practicable, it should use the historical volatility of an appropriate industry sector index as a substitute in estimating the fair-value-based measure of its awards.

An appropriate industry sector index would be one that is narrow enough to reflect the nonpublic entity’s nature and size (if possible). For example, the use of the Philadelphia Exchange (PHLX) Semiconductor Sector Index is not an appropriate industry sector index for a small nonpublic software development entity because it represents neither the industry in which the nonpublic entity operates nor the size of the entity. The volatility of an index of smaller software entities would be a more appropriate substitute for the entity’s expected volatility of its own share price.
Under ASC 718-10-55-58, an entity that uses an industry sector index to determine the expected volatility of its own share price must use the index’s historical volatility (rather than its implied volatility). However, ASC 718-10-55-56 states that “in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000, or Dow Jones Wilshire 5000” (emphasis added).

A nonpublic entity’s conclusion that estimating the expected volatility of its own share price is not practicable may be subject to scrutiny. We would typically expect a nonpublic entity that can identify an appropriate industry sector index to be able to identify similar entities from the selected index to estimate the expected volatility of its own share price and would therefore be required to use the fair-value-based measurement method.

In measuring awards, a nonpublic entity should switch from using a calculated value to using a fair-value-based measure when it (1) can subsequently estimate the expected volatility of its own share price or (2) becomes a public entity. ASC 718-10-55-27 states that the “valuation technique an entity selects . . . shall be used consistently and shall not be changed unless a different valuation technique is expected to produce a better estimate” of a fair-value-based measure (or, in this case, a change to a fair-value-based measure). The guidance goes on to state that a change in valuation technique should be accounted for as a change in accounting estimate under ASC 250 and should be applied prospectively to new awards. Therefore, for existing equity-classified awards (i.e., unvested equity awards that were granted before an entity switched from the calculated value method to a fair-value-based measure), an entity would continue to recognize compensation cost on the basis of the calculated value determined as of the grant date unless the award is subsequently modified. An entity should use the fair-value-based method to measure all awards granted after it switches from the calculated value method.

ASC 718-20-55-76 through 55-83 provide an example of when it may be appropriate for a nonpublic entity to use the calculated value method.

5.8.1.1.3 Intrinsic Value

Nonpublic entities can make a policy election to measure all liability-classified awards at intrinsic value (instead of at their fair-value-based measure or calculated value) as of the end of each reporting period until the award is settled. However, it is preferable for an entity to use the fair-value-based method to justify a change in accounting principle under ASC 250. Therefore, a nonpublic entity that has elected to measure its liability-classified awards at a fair-value-based measure (or calculated value) would not be permitted to subsequently change to the intrinsic-value method other than upon adoption of ASU 2016-09.

ASC 718-30-55-12 through 55-20 illustrate the application of the intrinsic value method for liability-classified awards granted by a nonpublic entity.

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5 A nonpublic entity’s use of calculated value does not represent an accounting policy election, since a nonpublic entity must use calculated value to measure its awards if it is not practicable for it to estimate the expected volatility of its share price. Thus, once an entity is able to estimate the expected volatility of its own share price or it becomes a public entity, the entity should switch from using a calculated value to using a fair-value-based measure and should account for the change as a change in accounting estimate under ASC 250.

6 Under ASU 2016-09, nonpublic entities can make a one-time election, without demonstrating preferability, to switch from a fair-value-based (or calculated value) measurement to an intrinsic value for all liability-classified awards. This election must be made upon adoption of the ASU. Any subsequent changes to the measurement method would need to be evaluated for preferability in accordance with ASC 250.
5.8.1.1.4 Cheap Stock

The SEC often focuses on “cheap stock” issues in connection with a nonpublic entity’s preparation for an IPO. The SEC staff is interested in the rationale for any difference between the fair value measurements of the underlying common stock of share-based payment awards and the anticipated IPO price. In addition, the staff will challenge valuations that are significantly lower than prices paid by investors to acquire similar stock. If the differences cannot be reconciled, a nonpublic entity may be required to record a cheap-stock charge. Since share-based payments are often a compensation tool to attract and retain employees, a cheap-stock charge could be material and, in some cases, lead to a restatement of the financial statements.

An entity preparing for an IPO should refer to paragraph 7520.1 of the FRM, which outlines considerations registrants should take into account when the “estimated fair value of the stock is substantially below the IPO price.” In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

The AICPA Valuation Guide highlights differences between pre-IPO and post-IPO valuations. One significant difference is that the valuation of nonpublic-entity securities often includes a discount for lack of marketability. Several quantitative methods have been developed to estimate that discount. Since the discounts could be significant, the SEC staff has frequently inquired about a registrant’s pre-IPO valuations. Specifically, during the registration statement process, the staff may ask an entity to (1) reconcile recent fair values with the anticipated IPO price, (2) describe valuation methods, (3) justify significant valuation assumptions, (4) outline significant intervening events, and (5) discuss the weight given to stock sale transactions.

In addition to considerations related to cheap stock, entities commonly face issues caused by obtaining independent valuations infrequently, because the dates of those valuations do not always coincide with the grant dates for share-based payment awards. As a result, management will need to assess the current fair value of the underlying shares as of the grant date. Further, an entity could evaluate the use of an interpolation or extrapolation framework to estimate the fair value of the underlying shares when equity is granted (1) on dates between two independent valuations or (2) after the date of an independent valuation. For details on interpolation and extrapolation methods, including examples, see Deloitte’s March 17, 2017, Financial Reporting Alert.

We encourage entities planning an IPO in the foreseeable future to use the AICPA Valuation Guide and to consult with their valuation specialists. Further, entities should ensure that their pre-IPO valuations are appropriate and that they are prepared to respond to questions the SEC may have during the registration statement process. For further discussion of disclosures related to cheap stock, see Section 5.8.4.1.
5.8.1.1.5 Internal Revenue Code Section 409A

When granting share-based payment awards, a nonpublic entity should be mindful of the tax treatment of such awards and the related implications. Section 409A of the Internal Revenue Code (IRC) contains requirements related to nonqualified deferred compensation plans that can affect the taxability of holders of share-based payment awards. If a nonqualified deferred compensation plan (e.g., one issued in the form of share-based payments) fails to comply with certain IRC rules, the tax implications and penalties at the federal level (and potentially the state level) can be significant for holders.

Under U.S. tax law, stock option awards can generally be categorized into two groups:

- Statutory options, including incentive stock options (ISOs) and ESPPs that are qualified under IRC Sections 422 and 423, respectively. The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the issuing entity unless the employee or former employee makes a disqualifying disposition.

- Nonstatutory options, also known as NQSOs or NSOs. The exercise of an NQSO results in a tax deduction for the issuing entity that is equal to the intrinsic value of the option when exercised.

The ISOs and ESPPs described in IRC Sections 422 and 423, respectively, are specifically exempt from the requirements of IRC Section 409A. Other NQSOs are outside the scope of Section 409A if certain requirements are met. One significant requirement is that the exercise price must not be below the fair market value of the underlying stock as of the grant date. Accordingly, it is imperative to establish a supportable fair market value of the stock to avoid unintended tax consequences to the issuer and holder. While Section 409A also applies to public entities, the valuation of share-based payment awards for such entities is subject to less scrutiny because the market prices of their shares are generally observable. Entities should consult with their tax advisers about the implications of nonqualified deferred compensation plans. Among other details, entities should ensure that they understand (1) which of their compensation plans and awards are subject to the provisions of Section 409A and (2) how to ensure that those plans and awards remain compliant with Section 409A so that unintended tax consequences of noncompliance are avoided.

5.8.1.1.6 Purchase of Stock From Employees

To give their employees liquidity (or for other reasons), entities may sometimes repurchase vested common stock from them. In some cases, the price paid for the shares exceeds their fair value at the time of the transaction, and the excess would generally be recognized as additional compensation cost in accordance with ASC 718-20-35-7. In addition, an entity’s practice of repurchasing shares, or an arrangement that permits repurchase, could affect the classification of share-based payment awards.

On occasion, investors (such as private equity or venture capital investors) intending to increase their stake in an emerging nonpublic entity may undertake transactions with other shareholders in connection with or separately from a recent financing round. These transactions may include the purchase of shares of common or preferred stock by investors from the founders of the nonpublic entity or other individuals who are also considered employees. Because the transactions are between employees of the nonpublic entity and existing shareholders and are related to the transfer of outstanding shares, the nonpublic entity may not be directly involved in them (though it may be indirectly involved by facilitating the exchange or not exercising a right of first refusal). Sometimes, if there is sufficient evidence that a transaction is an arm’s-length fair value transaction, it may be necessary to treat the transaction as a data point in the estimation of the fair-value-based measurement of share-based payment awards. Other times, particularly when a transaction involves founders or a
few select key employees, it may be difficult to demonstrate that the transaction is not compensatory. If the price paid for the shares exceeds their fair value at the time of the transaction, it is likely that the nonpublic entity will be required to recognize compensation cost for the excess, even if the entity is not directly involved in the transaction. It is important for a nonpublic entity to recognize that such a transaction may be subject to the guidance in ASC 718 because the investors are considered holders of an economic interest in the entity.

Although the presumption in such transactions is that any consideration in excess of the fair value of the shares is compensation paid to employees, under ASC 718, an entity should consider whether the amount paid is related to an existing relationship or to an obligation that is unrelated to the employees’ services to the entity in assessing whether the payment is “clearly for a purpose other than compensation for services to the reporting entity.” It is difficult to demonstrate that a non–fair value transaction with employees is clearly for other purposes. However, AIN-APB 25 (superseded by FASB Statement 123(R)) describes situations in which it may be possible to do so, including those in which:

- “[T]he relationship between the stockholder and the corporation’s employee is one which would normally result in generosity (i.e., an immediate family relationship).”
- “[T]he stockholder has an obligation to the employee which is completely unrelated to the latter’s employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation).”

In all situations, the determination of whether a transaction should be accounted for under ASC 718 should be based on an entity’s specific facts and circumstances.

### 5.8.1.2 Valuation Considerations for Public Entities

#### 5.8.1.2.1 SAB Topic 14 — Share-Based Payment

In 2011, the SEC issued SAB Topic 14 (codified in ASC 718-10-S99-1) to “assist issuers in their initial implementation of FASB ASC Topic 718 and enhance the information received by investors and other users of financial statements.” SAB Topic 14 contains interpretive guidance related to share-based payment transactions (e.g., guidance on the transition from nonpublic-entity to public-entity status and valuation methods, including assumptions such as expected volatility and expected term).

#### 5.8.1.2.2 Transition From Nonpublic-Entity to Public-Entity Status

The measurement alternatives available to a nonpublic entity (calculated value and intrinsic value) are no longer appropriate once the entity is considered a public entity.\(^7\) In addition, the practical expedient related to determining the expected term of certain options and similar instruments is used differently by public entities than it is by nonpublic entities. To estimate the expected term as a midpoint between the requisite service period and the contractual term of an award, entities will need to comply with the requirements of the SEC’s simplified method.

\(^7\) The definition of “public entity” in ASC 718 encompasses entities that make “a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market.” The definition therefore includes entities that have filed an initial registration statement with the SEC before the effective date of an IPO.
In SAB Topic 14.B, the SEC discusses various transition issues associated with valuing share-based payment awards related to an entity's becoming public (e.g., when the entity files its initial registration statement with the SEC), including the following:

- If a nonpublic entity historically measured equity-classified share-based payment awards at their calculated value, the entity should continue to use that approach for share-based payment awards granted before the date it became a public entity unless those awards are subsequently modified, repurchased, or canceled.

- If a nonpublic entity historically measured liability-classified share-based payment awards on the basis of their intrinsic value and the awards are still outstanding, the measurement of those liability awards should be fair-value-based when the entity becomes a public entity.

- Upon becoming a public entity, the entity is prohibited from retrospectively applying the fair-value-based measurement to its awards if it used calculated value or intrinsic value before the date it became a public entity.

- Upon becoming a public entity, the entity should clearly describe in its MD&A the change in accounting policy that ASC 718 will require in subsequent periods and any reasonably likely material future effects of the change.

The SEC's guidance does not address how an entity should account for a change from the intrinsic value method for measuring liability-classified awards to the fair-value-based method. In informal discussions, the SEC staff indicated that it would be acceptable to record the effect of such a change as compensation cost in the current period or to record it as the cumulative effect of a change in accounting principle in accordance with ASC 250. While the preferred approach is to treat the effect of the change as a change in accounting principle under ASC 250, with the cumulative effect of the change recorded accordingly, recording it as compensation cost is not objectionable given the SEC's position. Under either approach, entities' financial statements should include the appropriate disclosures.

ASC 250-10-45-5 states that an "entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so." Retrospective application of the effects of a change from intrinsic value to fair value would be impracticable because objectively determining the assumptions an entity would have used for the prior periods would be difficult without the use of hindsight. Therefore, the change would be recorded as a cumulative-effect adjustment to retained earnings and applied prospectively, as discussed in ASC 250-10-45-6 and 45-7. This conclusion is consistent with the guidance in SAB Topic 14.B that states that entities changing from nonpublic to public status are not permitted to apply the fair-value-based method retrospectively.

5.8.1.2.3 Valuation Assumptions

The sections below discuss two significant share-based compensation valuation assumptions addressed in SAB Topic 14.D, including those related to expected term and expected volatility.
5.8.1.2.3.1 Expected Term

ASC 718-10-55-30 states, in part:

The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement).

Although ASC 718 does not specify a required method for estimating the expected term of an award, such a method must be objectively supportable. Similarly, historical observations should be accompanied by information about why future observations are not expected to change, and any adjustments to these observations should be supported by objective data. ASC 718-10-55-31 identifies the following factors an entity may consider in estimating the expected term of an award:

- **The vesting period of the award** — Options generally cannot be exercised before vesting; thus, an option's expected term cannot be less than its vesting period.

- **Employees' historical exercise and postvesting employment termination behavior for similar grants** — Historical experience should be an entity's starting point for determining expectations of future employee exercise and postvesting termination behavior. Historical exercise patterns should be modified when current information suggests that future behavior will differ from past behavior. For example, rapid increases in an entity's stock price after the release of a new product in the past could have caused more employees to exercise their options as soon as the options vested. If a similar increase in the entity's stock price is not expected, the entity should consider whether adjusting the historical exercise patterns is appropriate.

- **Expected volatility of the underlying share price** — An increase in the volatility of the underlying share price tends to result in an increase in exercise activity because more employees take advantage of increases in an entity's share price to realize potential gains on the exercise of the option and subsequent sale of the underlying shares. ASC 718-10-55-31(c) states, “An entity also might consider whether the evolution of the share price affects an employee's exercise behavior (for example, an employee may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time).” The exercise behavior based on the evolution of an entity's share price can be more easily incorporated into a lattice model than into a closed-form model.

- **Blackout periods** — A blackout period is a period during which exercise of an option is contractually or legally prohibited. Blackout periods and other arrangements that affect the exercise behavior associated with options can be included in a lattice model. Unlike a closed-form model, a lattice model can be used to calculate the expected term of an option by taking into account restrictions on exercises and other postvesting exercise behavior.

- **Employees' ages, lengths of service, and home jurisdictions** — Historical exercise information could have been affected by the profile of the employee group. For example, during a bull market, some entities are more likely to have greater turnover of employees since more opportunities are available. Many such employees will exercise their options as early as possible. These historical exercise patterns should be adjusted if similar turnover rates are not expected to recur in the future.
If historical exercise and postvesting employment termination behavior are not readily available or do not provide a reasonable basis on which to estimate the expected term, alternative sources of information may be used. For example, an entity may use a lattice model to estimate the expected term (the expected term is not an input in the lattice model but rather is inferred on the basis of the output of the lattice model). In addition, an entity may consider using other relevant and supportable information such as industry averages or published academic research. When an entity takes external peer group information into account, there should be evidence that such information has been sourced from entities with comparable facts and circumstances. Further, entities may use practical expedients to estimate the expected term for certain awards. Question 5 of SEC SAB Topic 14.D.2 notes that if a public entity concludes that “its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term,” the entity may use what the SEC staff describes as a “simplified method” to develop the expected-term estimate. Under the simplified method, the public entity uses an average of the vesting term and the original contractual term of an award. The method applies only to awards that qualify as “plain-vanilla” options.

As the SEC states in SAB Topic 14.D.2, the simplified method applies only to awards that qualify as plain-vanilla options. A share-based payment award must possess all of the following characteristics to qualify as a plain-vanilla option:

- “The share options are granted at-the-money.”
- “Exercisability is conditional only on performing service through the vesting date” (i.e., the requisite service period equals the vesting period).
- “If an employee terminates service prior to vesting, the employee would forfeit the share options.”
- “If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days).”
- “The share options are nontransferable and nonhedgeable.”

If an award has a performance or market condition, it would not be considered a plain-vanilla option. Entities should evaluate all awards to determine whether they qualify as plain-vanilla options.

The SEC staff believes that public entities should stop using the simplified method for stock option grants if more detailed external information about exercise behavior becomes available. In addition, the staff frequently comments on the use of the simplified method and, in certain instances, asks registrants to explain why they believe that they were unable to reasonably estimate the expected term on the basis of their historical stock option exercise information.

In accordance with the SEC’s guidance in Question 6 of SAB Topic 14.D.2, a registrant that uses the simplified method should disclose in the notes to its financial statements (1) that the simplified method was used, (2) the reason the method was used, (3) the types of stock option grants for which the simplified method was used if it was not used for all stock option grants, and (4) the period(s) for which the simplified method was used if it was not used in all periods presented.

5.8.1.2.3.2 Expected Volatility

ASC 718-10-55-36 states, in part:

Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the shares can be expected to vary — up or down.
ASC 718 does not require entities to use a single method for estimating the expected volatility of the underlying share price; rather, ASC 718-10-55-35 states that the objective of estimating such volatility is “to determine the assumption about expected volatility that marketplace participants would be likely to use in determining an exchange price for an option.” ASC 718-10-55-37 lists factors that entities would consider in estimating the expected volatility of the underlying share price. The method selected to perform the estimation should be applied consistently from period to period, and entities should adjust the factors or assign more weight to an individual factor only on the basis of objective information that supports such adjustments. The interpretive response to Question 1 of SAB Topic 14.D.1 notes that entities should incorporate into the estimate any relevant new or different information that would be useful. Further, they should “make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility” of the underlying share price.

- **Historical volatility of the underlying share price** — Entities typically value employee stock options by using the historical volatility of the underlying share price. Under a closed-form model, such volatility is based on the most recent volatility of the share price over the expected term of the option; under a lattice model, it is based on the contractual term. ASC 718-10-55-37(a) states that an entity may disregard the volatility of the share price for an identifiable period if the volatility resulted from a condition (e.g., a failed takeover bid) specific to the entity and the condition “is not expected to recur during the expected or contractual term.” If the condition is not specific to the entity (e.g., general market declines), the entity generally would not be allowed to disregard or place less weight on the volatility of its share price during that period unless objectively verifiable evidence supports the expectation that market volatility will revert to a mean that will differ materially from the volatility during the specified period. The SEC staff believes that an entity's decision to disregard a period of historical volatility should be based on one or more discrete and specific historical events that are not expected to occur again during the term of the option. In addition, the entity should not give recent periods more weight than earlier periods.

In certain circumstances, an entity may rely exclusively on historical volatility. However, because the objective of estimating expected volatility is to ascertain the assumptions that marketplace participants are likely to use, exclusive reliance may not be appropriate if there are future events that could reasonably affect expected volatility (e.g., a future merger that was recently announced).

- **Implied volatility of the underlying share price** — The implied volatility of the underlying share price is not the same as the historical volatility of the underlying share price because it is derived from the market prices of an entity's traded options or other traded financial instruments with option-like features and not from the entity's own shares. Entities can use the Black-Scholes-Merton formula to calculate implied volatility by including the fair value of the option (i.e., the market price of the traded option) and other inputs (stock price, exercise price, expected term, dividend rate, and risk-free interest rate) in the calculation and solving for volatility. When valuing employee stock options, entities should carefully consider whether the implied volatility of a traded option is an appropriate basis for the expected volatility of the underlying share price. For example, traded options usually have much shorter terms than employee stock options, and the calculated implied volatility may not take into account the possibility of mean reversion. To compensate for mean reversion, entities use statistical tools for calculating a long-term implied volatility. For example, entities with traded options whose terms range from 2 to 12 months can plot the volatility of these options on a curve and use statistical tools to plot a long-term implied volatility for a traded option with an expected or a contractual term equal to an employee stock option.
Generally, entities that can observe sufficiently extensive trading of options and can therefore plot an accurate long-term implied volatility curve should place greater weight on implied volatility than on the historical volatility of their own share price (particularly if they do not meet the SEC’s conditions for relying exclusively on historical volatility). That is, a traded option’s volatility is more informative in the determination of expected volatility of an entity’s stock price than historical stock price volatility, since option prices take into account the option trader’s forecasts of future stock price volatility. In determining the extent of reliance on implied volatility, an entity should consider the volume of trading in its traded options and its underlying shares, the ability to synchronize the variables used to derive implied volatility (as close to the grant date of employee stock options as reasonably practicable), the similarity of the exercise prices of its traded options to its employee stock options, and the length of the terms of its traded options and employee stock options.

- Limitations on availability of historical data — Public entities should compare the length of time an entity’s shares have been publicly traded with the expected or contractual term of the option. A newly public entity may also consider the expected volatility of the share prices of similar public entities. In determining comparable public entities, the newly public entity would consider factors such as industry, stage of life cycle, size, and financial leverage.

Nonpublic entities may also base the expected volatility of their share prices on the expected volatility of similar public entities’ share prices, and they may consider the same factors as those described above for a newly public entity. When a nonpublic entity is unable to reasonably estimate its entity-specific volatility or that of similar public entities, it may use a calculated value.

- Data intervals — An entity that considers the historical volatility of its share price when estimating the expected volatility of its share price should use intervals for price observations that (1) are appropriate on the basis of its facts and circumstances (e.g., given the frequency of its trades and the length of its trading history) and (2) provide a basis for a reasonable estimate of a fair-value-based measure. Daily, weekly, or monthly price observations may be sufficient; however, if an entity’s shares are thinly traded, weekly or monthly price observations may be more appropriate than daily price observations.

- Changes in corporate and capital structure — An entity’s corporate and capital structure could affect the expected volatility of its share price (e.g., share price volatility tends to be higher for highly leveraged entities). In estimating expected volatility, an entity should take into account significant changes to its corporate and capital structure, since the historical volatility of a share price for a period in which the entity was, for example, highly leveraged may not represent future periods in which the entity is not expected to be highly leveraged (or vice versa).

The SEC staff believes entities that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure. Further, depending on the extent to which these financial instruments are actively traded, more reliance or exclusive reliance on implied volatility may be appropriate because implied volatility reflects market expectations of future volatility.

SAB Topic 14.D.1 also addresses circumstances in which it is acceptable to rely exclusively on either historical volatility or implied volatility. To rely exclusively on historical volatility, an entity must:

- Have “no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past.”
- Perform the computation by using a “simple average calculation method.”
- Use a “sequential period of historical data at least equal to the expected or contractual term . . . , as applicable.”
• Apply “[a] reasonably sufficient number of price observations . . . , measured at a consistent point throughout the applicable historical period.”
• Consistently apply this approach.

To rely exclusively on implied volatility, an entity must:
• Use a valuation model for employee stock options “that is based upon a constant volatility assumption.”
• Derive the implied volatility from “options that are actively traded.”
• Measure the “market prices . . . of both the traded options and underlying shares . . . at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options.”
• Use traded options whose (1) exercise prices “are both . . . near-the-money and . . . close to the exercise price of the employee share options” and (2) “remaining maturities . . . are at least one year.”
• Consistently apply this approach.

If an entity is newly public or nonpublic, it may have limited historical data and no other traded financial instruments from which to estimate expected volatility. In such cases, as discussed in the SEC guidance in SAB Topic 14.D.1, it may be appropriate for the entity to base its estimate of expected volatility on the historical, expected, or implied volatility of comparable entities.

5.8.2 Other Pre-IPO Issues

5.8.2.1 Repurchase Features

Because a nonpublic entity’s common stock is not publicly traded, share-based payment awards often include repurchase features related to the underlying stock to provide employees with liquidity and to limit the number of holders of stock before an IPO. These features typically are in the form of a (1) call right, in which a nonpublic entity has the right (but not the obligation) to repurchase stock from an employee for cash, or (2) put right, which gives the employee the right to sell stock to the nonpublic entity for cash. The repurchase price associated with the call and put options can vary (e.g., fair value, fixed amount, cost, formula value). In addition, repurchase features often expire or are otherwise eliminated upon an IPO (i.e., when the underlying stock is liquid). An entity should evaluate repurchase features to determine whether they affect the classification of share-based payment awards as either a liability or equity award.
**25-9** Topic 480 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met:

- The repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued. An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered. A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee’s control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.

- It is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

**25-9** Topic 480 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the grantee the right to require the grantor to repurchase them for cash equal to their fair value (puttable shares). A put right may be granted to the grantee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. A puttable (or callable) share awarded to a grantee as compensation shall be classified as a liability if either of the following conditions is met:

- The repurchase feature permits the grantee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the good is delivered or the service is rendered and the share is issued. A grantee begins to bear the risks and rewards normally associated with equity share ownership when all the goods are delivered or all the service has been rendered and the share is issued. A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the grantee’s control (such as an initial public offering) would not meet this condition until it becomes probable that the event will occur within the reasonable period of time.

- It is probable that the grantor would prevent the grantee from bearing those risks and rewards for a reasonable period of time from the date the share is issued.

For this purpose, a period of six months or more is a reasonable period of time.

An award with a call right is classified as a liability if it is probable that the employer would prevent the employee from bearing the risks and rewards of equity ownership for at least six months from the date the requisite service is rendered and the share is issued or issuable. Similarly, an award with a put right is classified as a liability if it permits an employee to avoid bearing the risks and rewards of equity ownership for at least six months from the date the requisite service is rendered and the share is issued or issuable. Unlike a call right, the probability that a put right will be exercised is generally not considered (i.e., exercise is generally assumed).
The classification analysis could be complex and depends on whether the repurchase price is at fair value or another amount; if the repurchase price is not at fair value, the six-month holding period is not relevant and the repurchase feature should generally be considered for as long as it is outstanding and liability classification is more likely. In addition, repurchase features are often exercisable only upon the occurrence of a specified future event (i.e., a triggering event), such as termination of employment. While the probability of the triggering event is analyzed in the determination of the appropriate classification, if the triggering event is within the employee’s control (e.g., voluntary termination) and is related to a put right, that triggering event is generally ignored. See Sections 5.3 and 5.4 of Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards* for considerations related to the impact of repurchase features on the classification of share-based payment awards.

For put rights, an entity undergoing an IPO must consider the requirements of ASC 480-10-S99-3A and SAB Topic 14.E. SAB Topic 14.E requires that an SEC registrant present share-based payment awards (otherwise classified as equity) subject to redemption features not solely within the control of the issuer as temporary (or “mezzanine”) equity. Temporary equity classification is required even if the awards qualify for equity classification under ASC 718 (e.g., an award that is contingently puttable by the employee at the then-current fair value more than six months after vesting or share issuance). Puttable awards classified as temporary equity should be recognized at their redemption value over the requisite service period. Such awards are remeasured at the end of each reporting period unless exercise is contingent on an event whose occurrence is not probable.

### 5.8.2.2 Substantive Classes of Equity

Nonpublic entities (often limited partnerships or limited liability companies) may grant special classes of equity, frequently referred to as “profits interests.” In many cases, a waterfall calculation is used to determine the payout to the different classes of shares or units. While arrangements vary, the waterfall calculation often is performed to allocate distributions and proceeds to the profits interests only after specified amounts (e.g., multiple of invested capital) or specified returns (e.g., internal rate of return on invested capital) are first allocated to the other classes of equity. In certain cases, distributions on and realization of value from profits interests are expected only from the proceeds from a liquidity event such as a sale or IPO of the entity, provided that the sale or IPO exceeds a target hurdle rate.

While the legal and economic form of these awards can vary, they should be accounted for on the basis of their substance. If an award has the characteristics of an equity interest, it represents a substantive class of equity and should be accounted for under ASC 718; however, an award that is, in substance, a performance bonus or a profit-sharing arrangement would be accounted for as such, typically in accordance with ASC 710 and ASC 450.

In a speech at the 2006 AICPA National Conference on Current SEC and PCAOB Developments, Joseph Ucuzoglu, then a professional accounting fellow in the SEC’s Office of the Chief Accountant, discussed the SEC staff’s observations related to special classes of equity and associated financial reporting considerations. Specifically, he stated:

> Public companies often create special classes of stock to more closely align the compensation of an employee with the operating performance of a portion of the business with which he or she has oversight responsibility. That is, rather than granting an equity interest in the parent company, employees are granted instruments whose value is based predominantly on the operations of a particular subset of the parent’s operations. The staff has observed the use of these arrangements in diverse industries, ranging from the grant of an interest in a group of restaurants that an employee oversees, to the grant of an interest in a particular investment fund that an employee manages.
Similarly, pre-IPO companies often create special classes of stock to provide employees with an opportunity to participate in any appreciation realized through a future initial public offering or sale of the company, with limited opportunity for gain if no liquidity event occurs. In order to accomplish this objective, the special class is often subordinate in both dividend rights and liquidation preference to the company's main class of stock, and may have little or no claim to the underlying net assets of the company. In many cases, the terms of these instruments mandate conversion into the entity's main class of common stock upon the completion of an IPO.

Several accounting issues arise when a special class of stock is granted to employees. First and foremost, one must look through the legal form of the instrument to determine whether the instrument is in fact a substantive class of equity for accounting purposes, or is instead similar to a performance bonus or profit sharing arrangement. When making this determination, all relevant features of the special class must be considered. There are no bright lines or litmus tests. When few if any assets underlie the special class, or the holder's claim to those assets is heavily subordinated, the arrangement often has characteristics of a performance bonus or profit-sharing arrangement. Instruments that provide the holder with substantive voting rights and pari passu dividend rights are at times indicative of an equity interest. Consideration should also be given to any investment required and any put and call rights that may limit the employee's downside risk or provide for cash settlement. Many of these factors were contained in Issues 28 and 40 of EITF Issue 00-23, which provided guidance on the accounting under Opinion 25 for certain of these arrangements.

When the substance of the instrument is that of a performance bonus or profit sharing arrangement, it should be accounted for as such. In those circumstances, any returns to the employee should be reflected as compensation expense, not as equity distributions or minority interest expense. Further, if the employee remitted consideration at the outset of the arrangement in exchange for the instrument, such consideration should generally be reflected in the balance sheet as a deposit liability.

On the other hand, when the substance of the arrangement is in fact that of a substantive class of equity, questions often arise as to the appropriate valuation of the instrument for the purpose of recording compensation expense pursuant to FASB Statement No. 123R. These instruments, by design, often derive all or substantially all of their value from the right to participate in future share price appreciation or profits. Accordingly, the staff has rejected the use of valuation methodologies that focus predominantly on the amount that would be realized by the holder in a current liquidation, as such an approach fails to capture the substantial upside potential of the security. [Footnotes omitted]

Although Issues 28 and 40 of EITF Issue 00-23 (referred to in the speech above) were superseded and nullified by FASB Statement 123(R) (codified in ASC 718), the indicators provided in them are useful in the determination of whether profits interests represent a substantive class of equity. Such indicators include, but are not limited to, the legal form of the instrument (a profits interest can only be a substantive class of equity if it is legal-form equity); distribution rights, particularly after vesting; claims to the residual assets of the entity upon liquidation; substantive net assets underlying the interest; retention of vested interests upon termination; any investment required to purchase the shares or units; transferability after vesting; voting rights commensurate with those of other substantive equity holders; an entity's intent in issuing the interest (i.e., whether the entity is attempting to align the holder's interests with those of other substantive equity holders); provisions for realization of value; and repurchase features that may affect exposure to risks and rewards.

A key focus in the determination of whether profits interests represent a substantive class of equity is the ability to retain residual interests upon vesting, including after termination of employment. This includes the ability to realize value that is tied to the underlying value of the entity's net assets, through distributions that are based on an entity's profitability and operations as well as on any liquidity event (even if through a lower level of waterfall distributions). By contrast, in a profit-sharing arrangement, an employee typically is only able to participate in the entity's profits while employed and a residual interest is not retained upon termination of employment.
In addition, not all the indicators described above are given equal weight. While voting rights and transferability may be indicative of an equity interest, the absence of such features would not preclude the interest from being considered a substantive class of equity. Nonpublic entities frequently issue equity interests that lack voting rights (particularly to noncontrolling interest holders) and have transferability restrictions. Further, if an employee does not make an initial investment to purchase an equity interest, the equity interest may still be a substantive class of equity. In that circumstance, consideration for the shares or units is in the form of employee services.

In determining whether a vested residual interest is retained after termination of employment, an entity typically focuses on what happens to a vested interest if an employee voluntarily terminates employment without good reason. For example, if the award is legally vested but is substantively forfeited upon voluntary termination without good reason (e.g., the entity can repurchase the legally vested award at the lower of cost or fair value upon such a termination event), the award will most likely be a profit-sharing arrangement. By contrast, if an award is legally vested but substantively forfeited only upon termination for cause (e.g., the entity can repurchase the legally vested award at the lower of cost or fair value upon such termination event), that feature would not affect the analysis since it functions as a clawback provision.

An entity should consider the substance of an award rather than its form. For example, an award may legally vest immediately under an agreement; however, the vesting may not be substantive if the award cannot be transferred or otherwise monetized until an IPO occurs and the entity can repurchase the award for no consideration if the employee terminates employment before the IPO. We would most likely conclude that such an award has a substantive performance condition that affects vesting (i.e., an IPO is a vesting condition) even though the award was deemed “immediately vested.”

From a valuation standpoint, nonpublic entities might consider whether the profits interests that represent a substantive class of equity have no value on the grant date. For example, if the entity were liquidated on the grant date, the waterfall calculation would result in no payment to the special class. However, in a manner consistent with the SEC staff’s speech above, the profits interests generally have a fair value because of the upside potential of the equity.

Further, from a classification standpoint, even if a nonpublic entity concludes that the profits interests are subject to the guidance in ASC 718 because they represent a substantive class of equity, the entity would still need to assess the conditions in ASC 718-10-25-6 through 25-19A to determine whether the award is equity- or liability-classified.

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8 A significant demotion, a significant reduction in compensation, or a significant relocation are commonly considered “good reasons” for termination.
5.8.2.3 **IPO Vesting Conditions**

Certain share-based payment awards may vest only upon the occurrence of an IPO, which represents a performance condition. If the employee terminates service before an IPO, the awards are forfeited.\(^3\)

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<thead>
<tr>
<th><strong>ASC 718-10 — Glossary</strong></th>
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<td>a. An employee’s rendering service for a specified (either explicitly or implicitly) period of time</td>
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<td>b. Achieving a specified performance target that is defined solely by reference to the employer’s own operations (or activities).</td>
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<td>Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share (EPS) that exceeds the average growth rate in EPS of other entities in the same industry is a performance condition. A performance target might pertain either to the performance of the entity as a whole or to some part of the entity, such as a division or an individual employee.</td>
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**Note:** The following definition is Pending Content; see Transition Guidance in 718-10-65-11.

**Performance Condition**

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both of the following:

a. Rendering service or delivering goods for a specified (either explicitly or implicitly) period of time

b. Achieving a specified performance target that is defined solely by reference to the grantor’s own operations (or activities) or by reference to the grantee’s performance related to the grantor’s own operations (or activities).

Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share (EPS) that exceeds the average growth rate in EPS of other entities in the same industry is a performance condition. A performance target might pertain either to the performance of the entity as a whole or to some part of the entity, such as a division, or to the performance of the grantee if such performance is in accordance with the terms of the award and solely relates to the grantor’s own operations (or activities).

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\(^3\) Some share-based payment awards allow an employee to vest upon an IPO even if that employee has terminated employment before the IPO occurs. In this case, even though the performance target (occurrence of an IPO) can be achieved after an employee’s requisite service, it is accounted for as a performance condition.
ASC 718-10

25-20 Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition — compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions. Example 2 (see paragraph 718-20-55-35) provides an illustration of how to account for awards with multiple performance conditions.

Pending Content (Transition Guidance: ASC 718-10-65-11)

25-20 Accruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition — compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares a grantee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions. Example 2 (see paragraph 718-20-55-35) provides an illustration of how to account for awards with multiple performance conditions.

In accordance with ASC 718, compensation cost should be recorded for a share-based payment award only if an entity determines that the achievement of the performance condition is probable. Generally, compensation cost is not recognized for awards that vest upon certain liquidity events, such as a change in control or an IPO, until the event takes place. That is, a change in control or an IPO is generally not probable until it actually occurs. This position is consistent with the guidance in ASC 805-20-55-50 and 55-51 on liabilities that are triggered upon the consummation of a business combination. Therefore, compensation cost is not recognized for an award that only vests upon an IPO until the IPO occurs.

ASC 718-10 — Glossary

Market Condition
A condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of either of the following:

a. A specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares
b. A specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities). The term similar as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

An award may vest on the basis of the occurrence of both an IPO and a specified rate of return on the entity's stock. For example, an award vests upon an IPO as long as the IPO price results in an internal rate of return (IRR) of a certain percentage on certain shareholders' initial investment in the entity. This type of award contains both a performance condition (IPO) and a market condition (achievement of a specified rate of return on the entity's stock). Although performance conditions are assessed for
probability, with compensation cost recognized on the basis of whether the performance condition is
achieved, market conditions are factored into the grant-date fair-value-based measurement of an award
and do not affect whether compensation cost is recognized because a market condition is not a vesting
condition.

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| **25-21** If an award requires satisfaction of one or more market, performance, or service conditions (or any
combination thereof), compensation cost shall be recognized if the requisite service is rendered, and no
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through 55-63 provide guidance on applying this provision to awards with market, performance, or service
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rendered. Paragraphs 718-10-55-60 through 55-63 provide guidance on applying this provision to awards
with market, performance, or service conditions (or any combination thereof).

Therefore, in such cases, if an IPO occurs but the IRR does not exceed the benchmark, the awards
are not earned. However, as long as the employee provides the required service, the grant-date fair-
value-based measurement would still be recognized as compensation cost upon the IPO, regardless
of whether the market condition is achieved, because (1) the requisite service is rendered and the
performance condition is met and (2) the risk of not attaining the market condition was already
considered in the grant-date fair-value-based calculation.

### 5.8.2.4 Escrowed Stock Arrangements

As part of completing an IPO or other financing, certain shareholders who are also key employees of
an entity may agree to place in escrow a portion of their shares, which will be released to them upon
the satisfaction of a specified condition. In many of these arrangements, the shares are released only if
the employee shareholders remain employed for a certain period or the company achieves a specified
performance target, and services from the employee shareholders may be explicitly stated in the
arrangement or implicitly required in accordance with a performance target.

As indicated in ASC 718-10-599-2, the SEC staff has historically expressed the view that escrowed share
arrangements such as these are presumed to be compensatory and equivalent to reverse stock splits
followed by the grant of restricted stock, subject to certain conditions (e.g., service, performance, or
market conditions). If the release of shares is tied to continued employment, the presumption cannot
be overcome. In addition, even if the entity is not directly a party to the arrangement (e.g., when the
arrangement is only between shareholders and new investors), the arrangement should be reflected in
the entity’s financial statements.
However, the SEC staff has stated that in certain circumstances, the presumption that an arrangement is compensation can be overcome. To identify those circumstances, an entity should assess the substance of the escrowed share arrangement to determine whether it was “entered into for purposes unrelated to, and not contingent upon, continued employment.” For example, as a result of concerns related to the entity’s value, investors may require certain shareholders to participate in an escrowed share arrangement before the entity can raise financing. Further, investors may require the entity to achieve certain performance targets (e.g., an EBITDA target over a specified period) before the shares can be released. If the arrangement also requires continued employment, the arrangement is considered compensatory. However, if continued employment is not required (either explicitly or implicitly), the entity should consider all relevant facts and circumstances to determine whether the substance of the arrangement is unrelated to employee compensation.

5.8.3 Modifications

Share-based payment awards are frequently modified in anticipation of an IPO. Any change in the terms or conditions of a share-based payment award represents a modification. Modified awards are viewed as an exchange of the original award for a new award. For an equity award measured at intrinsic value, the change in compensation cost should be measured by comparing the intrinsic value of the award immediately after the modification to the intrinsic value immediately before the modification. When an equity-classified award is modified and the original award was expected to vest on the modification date, an entity must compare the fair-value-based measurement of the award immediately before the modification with the fair-value-based measurement of the award immediately after the modification. Any incremental compensation cost must be recognized over the remaining vesting period. In addition, at a minimum, the original grant-date fair-value-based measure must be recognized. Therefore, total recognized compensation cost attributable to an award that has been modified is (1) the grant-date fair-value-based measure of the original award for which the required service has been provided (i.e., the number of awards that have been earned) or is expected to be provided and (2) any incremental compensation cost conveyed to the holder of the award as a result of the modification. In contrast, if the original award was not expected to vest on the modification date, the original grant-date fair-value-based measure is ignored and compensation cost is recognized on the basis of the fair-value-based measure of the new award on the modification date.

For entities that have adopted ASU 2017-09, modification accounting is not applied if the fair-value-based measure, vesting conditions, and classification of an award are the same immediately before and after the modification.
35-3 Except as described in paragraph 718-20-35-2A, a modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Topic over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 718-10-30-20, references to fair value throughout this Topic shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

1. The portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date
2. The incremental cost resulting from the modification.

Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 718-20-35-1 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.
Except as described in paragraph 718-20-35-2A, a modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Topic over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date. As indicated in paragraph 718-10-30-20, references to fair value throughout this Topic shall be read also to encompass calculated value. The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-1D or 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be the sum of the following:

1. The portion of the grant-date fair value of the original award for which the promised good is expected to be delivered (or has already been delivered) or the service is expected to be rendered (or has already been rendered) at that date

2. The incremental cost resulting from the modification.

Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraph 718-10-35-1D or 718-10-35-3 and other guidance in Examples 14 through 15 (see paragraphs 718-20-55-107 through 55-121).

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 718-20-35-1 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

Many modifications are made before an IPO occurs but are not effective unless the IPO occurs. While the date on which the contingent modification is made is generally the modification date in the measurement of compensation cost, the accounting consequence may not be recognized until the IPO's effective date if the modification depends on the occurrence of the IPO. For example, an award could be modified to increase the quantity of shares underlying the award upon a successful IPO. In this circumstance, any additional compensation cost would not be recognized until the IPO is effective since IPOs are generally not considered probable until they occur.

In addition, there could be circumstances in which changes associated with an award that are not modifications result in accounting consequences. For example, an entity could grant an award with a repurchase feature that causes the award to be liability-classified. If the original terms contain a provision that the repurchase feature will expire upon an IPO, however, the award would be reclassified from liability to equity upon the IPO.
5.8.4 Disclosures

**ASC 718-10**

**50-1** An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:

- a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders
- b. The effect of compensation cost arising from share-based payment arrangements on the income statement
- c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period
- d. The cash flow effects resulting from share-based payment arrangements.

This disclosure is not required for interim reporting. For interim reporting see Topic 270. See Example 9 (paragraphs 718-10-55-134 through 55-137) for an illustration of this guidance.

**Pending Content (Transition Guidance: ASC 718-10-55-1)**

**50-1** An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:

- a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders
- b. The effect of compensation cost arising from share-based payment arrangements on the income statement
- c. The method of estimating the fair value of the equity instruments granted (or offered to grant), during the period
- d. The cash flow effects resulting from share-based payment arrangements.

This disclosure is not required for interim reporting. For interim reporting see Topic 270. See Example 9 (paragraphs 718-10-55-134 through 55-137) for an illustration of this guidance.

ASC 718-10-50-1 highlights disclosure objectives related to share-based compensation arrangements and ASC 718-10-50-2 lists the minimum information needed to achieve these objectives. The SEC staff frequently comments on the disclosures associated with share-based compensation, including the minimum disclosure requirements and significant valuation assumptions. For additional observations related to frequently issued SEC staff comments, see Deloitte’s *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*.

### 5.8.4.1 Cheap Stock Disclosures

Typically, a registrant undergoing an IPO identifies share-based compensation as a critical accounting estimate because the lack of a public market for the pre-IPO shares makes the estimation process complex and subjective. For additional information, see Section 5.8.1.1.4 above.

Further, paragraph 7520.1 of the FRM outlines considerations related to the “estimated fair value of [stock that] is substantially below the IPO price” (often referred to as “cheap stock”). Registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.
The SEC staff had historically asked registrants to expand the disclosures in their critical accounting estimates to add information about the valuation methods and assumptions used for share-based compensation in an IPO. In 2014, however, the staff updated Section 9520 of the FRM to indicate that registrants should significantly reduce, in the critical accounting estimates section of MD&A, their disclosures about share-based compensation and the valuation of pre-IPO common stock. Nevertheless, paragraph 9520.2 of the FRM notes that the SEC staff may continue to request that entities “explain the reasons for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO).” Such requests are meant to ensure that a registrant's analysis and assessment support its accounting for share-based compensation; they do not necessarily indicate that the registrant’s disclosures need to be enhanced.

At the Practising Law Institute’s “SEC Speaks in 2014” Conference, the SEC staff discussed the types of detailed disclosures it had observed in IPO registration statements that had prompted the updates to Section 9520 of the FRM. The staff noted that registrants have historically included:

- A table of equity instruments issued during the past 12 months.
- A description of the methods used to value the registrant’s pre-IPO common stock (i.e., income approach or market approach).
- Detailed disclosures about certain select assumptions used in the valuation.
- Discussion of changes in the fair value of the entity’s pre-IPO common stock. Such discussion included each grant leading up to the IPO and resulted in repetitive disclosures.

The staff indicated that despite the volume of share-based compensation information included in IPO filings, disclosures of such information were typically incomplete because registrants did not discuss all assumptions related to their common-stock valuations. Further, disclosures about registrants’ pre-IPO common-stock valuations were not relevant after an IPO and were generally removed from their periodic filings after the IPO. The SEC staff expressed the view that streamlined share-based compensation disclosures also reduce the volume of information and make reporting more meaningful. The staff also indicated that by eliminating unnecessary information, registrants could reduce many of their prior disclosures “down to one paragraph.”

At the conference, the SEC staff also provided insights into how registrants would be expected to apply the guidance in paragraph 9520.1 of the FRM and thereby reduce the share-based compensation disclosures in their IPO registration statements:

- The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares. A registrant need only state that it used the income approach, the market approach, or a combination of both.

Further, while registrants are expected to discuss the nature of the material assumptions they used, they would not be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a statement indicating that a discounted cash flow method was used and involved cash flow projections that were discounted at an appropriate rate. No additional details would be needed.

- Registrants would have to include a statement indicating that the estimates in their share-based compensation valuations are highly complex and subjective but would not need to provide additional details about the estimates. Registrants would also need to include a statement disclosing that such valuations and estimates will no longer be necessary once the entity goes public because it will then rely on the market price to determine the fair value of its common stock.
The staff emphasized that its ultimate concern is whether registrants correctly accounted for pre-IPO share-based compensation. Accordingly, the staff will continue to ask them for supplemental information to support their valuations and accounting conclusions — especially when the fair value of an entity's pre-IPO common stock is significantly less than the expected IPO price. 

5.9 Income Taxes

An IPO typically increases the complexity of accounting for income taxes. For example, in an IPO involving a carved-out portion of a larger entity, the tax provision may be prepared for the first time for multiple periods, in which case an entity may be required to use significant judgment in assessing the accounting and presentation of income taxes. Irrespective of whether the registrant is a carve-out or an existing business, however, changes in tax status, predecessor/successor issues, and other transactions with shareholders in connection with an IPO result in complexities in the calculation and presentation of the income tax provision for the pre- and post-IPO periods. In addition, for interim reporting, possible limitations on future deductions may need to be assessed as well as additional disclosure requirements. The sections below discuss each of these topics in further detail.

5.9.1 Carve-Out Financial Statements

As discussed in Section 5.2.1, an entity that becomes a public registrant may comprise a carve-out (e.g., one or more segments or divisions) of a larger entity that historically filed a consolidated income tax return. The newly formed entity may be required to prepare historical, stand-alone financial statements that will be included in an SEC filing. In these situations, the operations that will constitute the new entity may (1) have been held in multiple legal entities and be presented on a combined basis, (2) have been operated as multiple divisions of one or more legal entities and be presented as a single set of carve-out financial statements, or (3) both.

Understanding the legal structure of the operations to be carved out is critical to determining the income tax balances that should be included in the carve-out financial statements. The accounting and financial reporting information associated with the carve-out entity may be compiled differently from the information used in tax returns, which are prepared on a legal-entity basis. It is necessary, therefore, to first determine which legal entities make up the business to be carved out. Management can then determine the extent to which relevant tax information exists for these legal entities and the best way to extract the data needed for the carve-out financial statements.

The relevant legal entities may include certain assets that will be carved out and certain assets that will stay behind. By identifying these assets, management can determine the best way to allocate, if necessary, the deferred-tax-related items associated with the net assets to be bifurcated. Further, by carefully examining the carve-out entity’s legal-entity structure, management may be able to identify the particular jurisdictions — both state and foreign — where the carve-out entity operates. To the extent that these jurisdictions differ from the locations of the consolidated group's remaining operations, statutory tax rates and compliance with applicable tax laws may affect the recorded amounts of income taxes in carve-out financial statements. It is also important to consider the intended funding of the federal, state, and foreign tax liabilities because such funding may affect the balance sheet presentation of tax amounts within the carve-out financial statements.

At the conference, the SEC staff noted that valuations that appear unusual may be attributable to the peer companies selected when a market approach is used. Specifically, the staff indicated that there are often inconsistencies between the peer companies used by registrants and those used by the underwriters, which result in differences in the valuations. Accordingly, the staff encouraged registrants to talk to the underwriters “early and often” to avoid such inconsistencies.

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Regardless of the legal structure, current and deferred income taxes must be allocated to carve-out financial statements in accordance with ASC 740-10-30-27, SAB Topic 1.B.1, or both. In determining the income tax amounts to include in the carve-out financial statements, management may need to:

- Establish an inventory of temporary differences that corresponds to the assets and liabilities that are being carved out.
- Consider whether to record a valuation allowance to offset deferred tax assets (DTAs) in the carve-out financial statements.
- Determine whether it is necessary to record unrecognized tax benefits in the carve-out financial statements.
- Identify existing records and whether those records must be augmented to support the carve-out financial statements.

Examples of adjustments that entities may need to make in calculating the carve-out tax provision include IRC Section 199 deductions, research and development credits, and foreign tax credits.

### 5.9.1.1 Separate-Return Method

While ASC 740-10-30-27 allows for different ways to perform this allocation, SAB Topic 1.B.1 indicates that the SEC prefers the “separate-return” approach. Further, Question 3 of SAB Topic 1.B.1 states, in part:

Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. . . . When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.

Accordingly, most companies elect to simply apply the separate-return method to the financial statements rather than calculating two separate provisions and presenting a reconciliation between the two.

Under the separate-return method of allocation, entities determine current and deferred income tax expense or benefit for each member of a consolidated group (e.g., the entity that will become the SEC registrant) by applying the requirements of ASC 740 as if each member were filing a separate tax return. This method can lead to inconsistencies between the income tax expense or benefit in the parent’s consolidated financial statements and the expense or benefit reflected in the carve-out entity’s separate financial statements. For example, the separate financial statements may include a valuation allowance with respect to certain DTAs because there is insufficient taxable income on a hypothetical separate-return basis; on the other hand, a valuation allowance would not be needed for such amounts in the consolidated financial statements because the consolidated entity may have sufficient income as a group. ASC 740 acknowledges that the sum of the amounts allocated to the individual group members sometimes may not equal the total current and deferred income tax expense or benefit of the consolidated group.
5.9.2 Change in Tax Status

In connection with an IPO, a preexisting entity may be converted from a nontaxable entity (e.g., a partnership) to a taxable entity (e.g., a taxable C corporation). Upon such a change in tax status, DTAs and deferred tax liabilities (DTLs) should be recognized for any temporary differences that exist on the recognition date, unless such temporary differences are subject to one of the recognition exceptions in ASC 740-10-25-3. Such deferred taxes should be recognized on the date the entity becomes taxable (i.e., either the approval date or the filing date of the election if approval is not necessary). The amount of deferred tax expense or benefit from recognizing deferred taxes as a result of the change in tax status should be included in income from continuing operations, as indicated in ASC 740-10-45-19.

In addition to the initial recognition of DTAs and DTLs, depending on the nature of the predecessor and successor entities and the resulting structure, other adjustments to the recorded amount of DTAs and DTLs may also be made. For example, upon a change in tax status from a nontaxable partnership to a taxable C corporation, a step-up in tax basis may be recognized as a DTA in an amount equivalent to the tax effect of a gain recognized by the former partners. Because this step-up in tax basis results from a transaction with or among shareholders, the tax benefit attributable to an increase in the tax basis of the entity's assets should generally be allocated to equity.

We are aware of an alternative approach in practice under which all of the tax effects arising in connection with a change in tax status (including the deferred tax effect of any incremental step-up in tax basis related to the shareholder gain) would be allocated to income from continuing operations in accordance with ASC 740-10-45-19. This approach is based on the previous discussion in EITF Issue 94-10, which noted that the guidance contained therein did not address shareholder transactions that involve a change in the tax status of a company (such as a change from nontaxable S-corporation status to taxable C-corporation status). While it is not clear whether this statement was intended to address any incremental step-up afforded the partnership as a result of income being recognized by its partners, we would also accept this approach.

A change in tax status may also trigger a requirement for pro forma disclosures. See Section 5.9.5.1 for more information.

5.9.2.1 Predecessor/Successor Issues — Creation or Elimination of Layer of Tax

In connection with an IPO, the historical partners in a partnership (the “founders”) may establish a C corporation that will (1) invest in the partnership and (2) serve as the IPO vehicle that will ultimately issue its shares to the public and, therefore, will ultimately become an SEC registrant. These transactions are often referred to in the marketplace as “Up-C” transactions.

The founders typically control the C corporation after the IPO but will sell an economic interest to the public while retaining shares with voting control but no economic interest. The C corporation will then use the IPO proceeds to purchase an economic interest in the partnership along with a controlling, voting interest. Accordingly, the C corporation will consolidate the partnership for book purposes. Because the C corporation is taxable, deferred taxes will need to be recorded in connection with its investment in the partnership. The C corporation will typically have an outside basis difference in the partnership because it will have a tax basis in the partnership units that is equal to the amount paid for the units at fair value, but will have carryover basis in the assets of the partnership for U.S. GAAP reporting (because the transaction is a transaction among entities under common control).

11 The former partners must recognize a taxable gain when the liabilities being assumed by the corporation exceed the tax basis of the assets being transferred to the corporation.
Typically, the original partnership is the C corporation’s predecessor entity and the C corporation is the successor entity and the registrant. After the transaction becomes effective, the registrant's initial financial statements will reflect the predecessor entity’s operations through the effective date and the successor entity's post-effective operations in a single set of financial statements (i.e., the predecessor and successor financial statements will be presented contiguously). Since no step-up in basis will occur for financial statement purposes because of the common-control nature of the transaction, the income statement and balance sheet will be presented without use of a “black line.” However, in the registrant's post-effective financial statements, the equity statement will reflect the recognition of a noncontrolling interest as of the effective date of the IPO. In addition, the C corporation must recognize deferred taxes upon investing in the partnership, which typically will occur on the effective date.

While the formation of a C corporation will result in a change in reporting entity, the predecessor entity's tax status does not change in such circumstances. In fact, in the situation described above, the predecessor entity was formerly structured as a partnership and will continue to exist as a partnership after the effective date. The founders will continue to own an interest in the partnership, which will remain a “flow-through” entity to them both before and after the effective date, even though the successor entity's financial statements will be presented contiguously with the predecessor entity's financial statements, albeit with the introduction of a noncontrolling interest.

Accordingly, in these instances, a new layer of deferred taxes related to the C corporation's investment in the partnership is recognized via a direct adjustment to equity, as if the former partners in that partnership are contributing their investments (along with the corresponding tax basis) to the C corporation.

In other instances, a parent may plan to contribute the “unincorporated” assets, liabilities, and operations of a division or disregarded entity to a new company (i.e., a “newco”) that will serve as the IPO vehicle and will ultimately issue its shares to the public as an SEC registrant.

Typically, the division or disregarded entity is determined to be the newco's predecessor entity and the newco is determined to be the successor entity. After the transaction becomes effective, the successor’s initial financial statements will reflect the predecessor entity's operations through the effective date and the successor entity's operations after the effective date in a single set of financial statements. The predecessor and successor financial statements will be presented contiguously. Because of the common-control nature of the transaction, the income statement and balance sheet will typically be presented without the use of a “black line” since no step-up in basis will occur for financial statement purposes.

If the predecessor entity's financial statements are filed publicly, those financial statements will generally include income tax expense because SAB Topic 1.B.1 requires that both members (i.e., corporate subsidiaries) and nonmembers (i.e., divisions or disregarded entities) of a group that are part of a consolidated tax return include an allocation of taxes when those members or nonmembers issue stand-alone financial statements. However, when the successor entity is nontaxable (e.g., a master limited partnership), upon effectiveness, any deferred taxes that were previously allocated to the predecessor entity will need to be eliminated.

Although a portion of the parent's consolidated income tax expense is allocated to the predecessor entity, the predecessor entity typically comprises unincorporated or disregarded entities that are not individually considered to be taxpayers under U.S. tax law (i.e., the parent was, and continues to be, the taxpayer). The predecessor entity's tax status has not changed. Rather, upon the effective date of the transaction, the parent retains previously allocated deferred taxes, resulting in the predecessor’s elimination of such amounts through equity. Alternatively, elimination of the net deferred tax accounts
on the predecessor’s financial statements on the effective date of the transaction, particularly in the case of a net DTL, might be analogous to the extinguishment or forgiveness of intra-entity debt. Thus, on the effective date of the transaction, a layer of deferred tax has been eliminated with respect to the stand-alone successor financial statements and the elimination of deferred income taxes that were previously allocated to the predecessor entity are recognized as a direct adjustment to the successor entity’s equity.

5.9.2.2 Tax Consequences of Transactions With Shareholders

In addition to the changes described above, certain transactions between an entity and its shareholders that occur during an IPO will affect an entity's tax attributes and may also change the tax bases of its assets and liabilities.

Changes in valuation allowances, write-offs of DTAs, and tax consequences of changes in tax bases of assets and liabilities resulting from transactions among or with shareholders may be recognized either in the income statement or directly in equity, depending on the nature of the change.

In accordance with ASC 740-10-45-21, the following should be charged to reported earnings:

- “Changes in valuation allowances due to changed expectations about the realization of [DTAs] caused by transactions among or with shareholders.”
- “A write-off of a preexisting [DTA] that an entity can no longer realize as a result of a transaction among or with its shareholders.”

In addition, in accordance with ASC 740-20-45-11(g), the following should be charged directly to equity:

- The effects of “changes in the tax bases of assets and liabilities caused by transactions among or with shareholders.”
- The “effect of valuation allowances initially required upon recognition of any related” DTAs as a result of “changes in the tax bases of assets and liabilities caused by transactions among or with shareholders.” However, subsequent changes in valuation allowances should be charged to the income statement.

Because ASC 740-20-45-11 applies to all changes in the tax bases of assets and liabilities, it also applies to tax-deductible goodwill.

Connecting the Dots

An IPO may significantly change the composition of shareholders. IRC Section 382 imposes limitations on the ability of corporations to offset net operating loss carryforwards and certain built-in losses against income in the years after an “ownership change.” In this context, an ownership change occurs when a corporation’s 5 percent shareholders increase their aggregate ownership by more than 50 percentage points (generally within a rolling three-year period) — for example, an increase from 6 percent ownership to 60 percent ownership. Monitoring for an ownership change is a continuous and sometimes complex process.

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12 ASC 470-50-40-2 provides guidance on such situations, noting that “extinguishment transactions between related entities may be in essence capital transactions.”

13 The elimination of deferred taxes via an adjustment to equity is also consistent with an SEC staff speech by Leslie Overton, associate chief accountant in the SEC’s Division of Corporation Finance, at the 2001 AICPA Conference on Current SEC Developments. Ms. Overton discussed a fact pattern in which the staff believed that certain operations that would be left behind upon a spin-off (i.e., retained by the parent) still needed to be included in the historical carve-out financial statements of the predecessor entity to best illustrate management’s track record with respect to the business operations being spun off. However, Ms. Overton concluded her speech by noting that “[a]ssets and operations that are included in the carve-out financial statements, but not transferred to Newco should be reflected as a distribution to the Parent at the date Newco is formed.”
5.9.3 **Interim Reporting**

Before an IPO, an entity may not have been subject to interim reporting requirements and therefore may be unfamiliar with the guidance in ASC 740-270. (For detailed guidance on interim reporting requirements, see Chapter 9 of Deloitte’s *A Roadmap to Accounting for Income Taxes*.) The core principle of ASC 740-270 is that the interim period is integral to the entire financial reporting year. Thus, annual income tax expense must be allocated to an entity’s interim financial statements. A major part of the allocation process is estimating the annual effective tax rate (AETR), which will need to be updated in each interim reporting period.

AETR estimates include income by jurisdiction, the impact of operating losses, changes in valuation allowances, and utilization of tax credits. These estimates are further complicated when a change in tax law or income tax rates occurs in an interim period. Taxable transactions outside of ordinary income must also be considered when an entity estimates discrete tax consequences or benefits. Such transactions must be recognized in the interim period in which they occur and presented in appropriate components of the financial statements.

5.9.4 **Possible Limitations on Future Deductions**

5.9.4.1 **Compensation Deductions**

IRC Section 162(m) limits the tax deductibility of certain types of compensation paid to the CEO as well as a company’s four other highest paid officers (referred to collectively as the “covered employees”). Specifically, only the first $1 million in compensation paid to a covered employee is deductible for tax purposes in a given year, whether paid in cash or shares. Compensation that is performance-based has not historically been subject to this limitation; however, this is no longer the case under the Tax Cuts and Jobs Act (the “Tax Act”), which was signed into law on December 22, 2017 (see below).

Historically, IRC Section 162(m) also contained transition relief (i.e., grandfathering of pre-IPO agreements), provided that an entity included certain disclosures in its registration statement filed with the SEC. However, the Tax Act modified Section 162(m) in such a way that transition relief is no longer available for awards granted or modified on or after November 2, 2017.

Specifically, the Tax Act modifies IRC Section 162(m) by (1) expanding which employees are considered covered employees by including the chief financial officer; (2) indicating that if an individual is a covered employee for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years; and (3) removing the exceptions for commissions and performance-based compensation.

These changes do not apply to compensation stemming from contracts entered into on or before November 2, 2017, unless such contracts were materially modified on or after that date. Compensation agreements entered into, and share-based payment awards granted, after this date will be subject to the revised terms of IRC Section 162(m).
5.9.4.2 Share-Based Compensation

The tax treatment of share-based payment awards is another potentially significant change for new public entities that could have substantial tax effects on an entity and its employees. These implications affect both (1) entities that have not historically offered share-based compensation but expect to do so and (2) entities that have historically granted such compensation. For example, IRC Section 409A contains requirements related to nonqualified deferred compensation plans that may affect how the fair value of existing and future share-based compensation is determined. If the requirements of IRC Section 409A are not carefully considered, recipients of share-based compensation may be subject to negative tax implications. Specifically, if an entity does not comply with the requirements in IRC Section 409A, recipients will be required to include the compensation in the calculation of their taxable income at an earlier point in time (usually upon vesting) and recipients will be subject to an additional 20 percent tax on the amount included in their taxable income. Interest charges will also apply. Although the tax is imposed on the individuals receiving the compensation, an entity often pays the additional tax liabilities on behalf of its employees. It is therefore critical that an entity establish the fair value of its shares to avoid unintended tax consequences. Incentive stock options and employee stock purchase plans, as described in IRC Sections 422 and 423, respectively, are exempt from the requirements of IRC Section 409A. Other nonqualified options are outside the scope of IRC Section 409A if certain criteria are met. It is important for an entity to consult with tax advisers regarding the tax effects of both existing and planned share-based compensation plans to determine whether the requirements in IRC Section 409A or other IRC sections may apply.

For detailed guidance on additional tax implications of share-based compensation, see Chapter 10 of Deloitte's A Roadmap to Accounting for Income Taxes.

5.9.5 Additional Disclosure Requirements

An entity that becomes a public registrant may be required to provide additional disclosures that were not included in prior financial statements. Below is a discussion of income-tax-related disclosure requirements for public entities; note that other tax-related disclosure requirements may apply to particular transactions.

In addition to providing the disclosures described below, public entities must present, under Regulation S-X, Rule 12-09, a “[l]ist, by major classes, [of] all valuation and qualifying accounts and reserves not included in specific schedules,” including valuation allowances related to DTAs. This list must be included as a supplemental schedule in an entity's annual filings, and the schedule must contain a rollforward of such accounts, showing additions and deductions throughout the year.

Changing Lanes

Potential Changes to the Disclosure Requirements for Income Taxes

As part of its project on improving the effectiveness of income tax disclosures in notes to financial statements, the FASB issued a proposed ASU in March 2019 that would add, remove, and modify certain disclosure requirements in ASC 740. (Comments on the proposed ASU were due by May 31, 2019.) Some of these proposed disclosure requirements already exist in Regulation S-X, while others are new requirements that the FASB staff believes would improve the effectiveness of financial reporting. Many of the proposed disclosure requirements apply only to public entities. Accordingly, preparers anticipating an IPO in the near future should monitor the status of this project as well as its impact on the disclosure requirements for public entities. Stay tuned for future Deloitte Heads Up and Financial Reporting Alert newsletters on this project and others.
5.9.5.1 Change in Status

In the event of a change in tax status, an entity is required to present pro forma tax and EPS data on the face of the financial statements for at least the latest fiscal year and interim period (though presentation for all periods presented is encouraged). The financial statements presented in the registration statement on Form S-1 for the periods in which the entity was a nontaxable entity are not restated for the effect of income taxes. Rather, the entity must provide pro forma disclosures to illustrate the effect of income taxes on those years. Paragraph 3410.1 of the FRM states:

If the issuer was formerly a Sub-Chapter S corporation (“Sub-S”), partnership or similar tax exempt enterprise, pro forma tax and EPS data should be presented on the face of historical statements for the periods identified below:

a. If necessary adjustments include more than adjustments for taxes, limit pro forma presentation to latest fiscal year and interim period
b. If necessary adjustments include only taxes, pro forma presentation for all periods presented is encouraged, but not required.

The pro forma information should be prepared in accordance with Regulation S-X, Rule 11-02. The tax rate used for the pro forma calculations should normally equal the “statutory rate in effect during the periods for which the pro forma income statements are presented,” as stated in Section 3270 of the FRM. However, Section 3270 also indicates that “[c]ompanies are allowed to use different rates if they are factually supportable and disclosed.”

Connecting the Dots

The SEC staff has discussed the appropriateness of reflecting the impact of the Tax Act on historical periods (i.e., pre-enactment periods) as a material event in pro forma information presented in accordance with Regulation S-X, Rule 11-01(a)(8). In a panel discussion at the 2018 Baruch College Financial Reporting Conference in May 2018, the SEC staff indicated that such pro forma adjustments may not be appropriate because, for example, they may not reflect alternative judgments, tax strategies, or other actions that a registrant may have taken if the lower tax rate had applied to historical periods. For additional details, see Appendix B of Deloitte’s A Roadmap to Accounting for Income Taxes, which contains frequently asked questions about the Tax Act.

If an entity chooses to provide pro forma information for all periods presented under option (b) above, the entity should continue to present this information in periods after it becomes taxable to the extent that the earlier comparable periods are presented.

5.9.5.2 Unrecognized Tax Benefits

While the accounting for unrecognized tax benefits for private entities is the same as that for public entities, there are incremental disclosure requirements for public entities. Under ASC 740-10-50-15A, public entities must provide “[a] tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period” and “the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.” The tabular reconciliation is essentially a rollforward of unrecognized tax benefits and includes the effects of items such as claims, accrual-to-return changes, settlements, statute expirations, current-year acquisitions or divestures, and currency fluctuations. At a minimum, an entity must present specified types of increases and decreases in the rollforward; however, an entity may separately report individual items within the required categories. If the items are reported separately, the descriptions should be appropriately titled so that financial statement users will understand the nature of the reconciling item being reported.
5.9.5.3 **Deferred Taxes**

ASC 740-10-50-6 requires public entities to disclose "the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of [DTAs and DTLs] (before allocation of valuation allowances)." Although "significant" has not been defined in this context, the SEC staff has indicated that to meet this requirement, public entities should disclose all components that equal or exceed 5 percent of the gross DTA or DTL. This requirement differs from that for nonpublic entities, which are permitted to “omit disclosure of the tax effects of each type” of significant temporary difference and disclose only the nature of those differences.

5.9.5.4 **Rate Reconciliation**

ASC 740-10-50-12 requires that public entities present “a reconciliation using percentages or dollar amounts of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations.” Regulation S-X, Rule 4-08(h), states that as part of this reconciliation, entities should disclose all reconciling items that individually make up 5 percent or more of the computed amount (i.e., income before tax multiplied by the applicable domestic federal statutory tax rate). Nonpublic entities only need to disclose the nature of the significant items that cause the effective tax rate to differ from the applicable statutory tax rate.

5.9.5.5 **Income Tax Expense**

In addition to the rate reconciliation, Regulation S-X, Rule 4-08(h), requires that public entities disclose “the components of income (loss) before income tax expense (benefit) as either domestic or foreign” and “the components of income tax expense, including (A) taxes currently payable and (B) the net tax effects, as applicable, of timing differences.” The components of income tax expense (e.g., current tax expense and deferred tax expense) should be stated separately for federal, foreign, and other income taxes.

5.9.5.6 **Management’s Discussion and Analysis**

As described in more detail in Section 4.3, public entities are also required to include MD&A in their public filings. Discussion and analysis of income taxes is an important part of an entity’s MD&A since income taxes can be a significant factor in the entity’s operating results. Such discussion should address the following (if material):

- **Critical accounting estimates** — The determination of income tax expense, DTAs and DTLs, and unrecognized tax benefits inherently involves several critical accounting estimates of current and future taxes to be paid. Management should provide information about the nature of these estimates in MD&A.

- **Liquidity and capital resources** — The SEC staff expects registrants to disclose (1) the amount of cash and short-term investments held by foreign subsidiaries that would not be available to fund domestic operations unless the funds were repatriated and (2) whether additional tax expense would need to be recognized if the funds are repatriated.

- **Contractual obligations** — The tabular disclosure of contractual obligations required by Regulation S-K should include the entity’s unrecognized tax benefits if it can make reasonably reliable estimates about the period of cash settlement of the liabilities. Entities may disclose, in either a footnote to the table or an “other” column added to the table, a liability for unrecognized tax benefits for which reasonable estimates about the timing of payment cannot be made.
In addition to discussion concerning the current-year operations, Regulation S-K, Item 303(a), requires entities to provide certain forward-looking information related to “material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.”

Many tax-related events and uncertainties may need to be elaborated in MD&A. For instance, before the enactment of tax law proposals or changes to existing tax rules, an SEC registrant should consider whether the potential changes represent an uncertainty that management reasonably expects could have a material effect on the registrant’s results of operations, financial position, liquidity, or capital resources. If so, the registrant should consider disclosing information about the scope and nature of any potential material effects of the changes.

After the enactment of a new tax law, registrants should consider disclosing, when material, the anticipated current and future impact of the law on their results of operations, financial position, liquidity, and capital resources. In addition, registrants should consider providing disclosures in the critical accounting estimates section of MD&A to the extent that the changes could materially affect existing assumptions used in estimating tax-related balances.

The SEC staff also expects registrants to provide early-warning disclosures to help users understand various risks and how these risks potentially affect the financial statements. Examples of such risks include situations in which (1) the registrant may have to repatriate foreign earnings to meet current liquidity demands, resulting in a tax payment (e.g., withholding taxes) that may not be accrued for; (2) the historical effective tax rate is not sustainable and may change materially; (3) the valuation allowance on net DTAs may change materially; and (4) tax positions taken during the preparation of returns may ultimately not be sustained. Early-warning disclosures give investors insight into management’s underlying assumptions as well as the conditions and risks an entity faces before a material change or decline in performance is reported.

Appendix E of Deloitte’s *A Roadmap to Accounting for Income Taxes* contains sample disclosures provided in accordance with the accounting and disclosure requirements of Regulation S-K, Regulation S-X, and ASC 740.

**Connecting the Dots**

In addition to the income tax accounting consequences and reporting requirements described above, entities may need to consider numerous other scenarios, transactions, and requirements as part of the IPO process, including the following:

- Implications of certain IRC elections (e.g., IRC Section 754 elections, which require an adjustment to the basis of partnership property upon distribution or transfer, and IRC Section 336(e) elections, which may provide relief from additional taxation by an adjustment to the basis of an entity’s assets).
- Consequences related to the tax status of the entity going public (e.g., real estate investment trust, master limited partnership, publicly held LLC).
- Tax receivable agreements, which are often entered into by a newly formed public company and its previous owners to compensate the previous owners for any tax basis received by the newly formed public company in connection with the formation transaction(s).
• The tax treatment of transaction costs associated with the IPO, which may differ from the related financial reporting treatment.
• The Tax Act, which might have had significant impacts on the carve-out tax provision, pro forma financial statements, or both, even though it did not specifically include any provisions related to the IPO registration statement process.

The income tax accounting consequences and reporting requirements described above, among others, can be complex for an entity preparing its initial registration statement. Entities that encounter these or similar transactions should consult with their tax advisers to determine the appropriate accounting treatment. For additional details and considerations, see Deloitte’s *A Roadmap to Accounting for Income Taxes*.

### 5.9.6 Resource Considerations

The many considerations highlighted above illustrate that an IPO can cause substantial changes to an entity’s income tax provision and that the entity’s tax department must be significantly involved in planning for such a transaction. To appropriately address the tax implications of going public, it is critical for an entity to obtain sufficient resources and establish appropriate accounting processes and internal controls well in advance of the IPO.

Specifically, entities should consider the resources they need to address the following:

- Tax department participation in initial SEC filings.
- Accumulation of tax information for required historical audited financial statements.
- Quarterly filing requirements.
- Enhancing the quality of financial reporting processes to comply with increased requirements, including more robust financial statement disclosure requirements.
- Augmenting or revisiting current internal controls and preparation for certification related to the effectiveness of tax internal controls. See Sections 6.11 and 7.5 for considerations and requirements related to ICFR.
- Regulatory compliance requirements (e.g., IRS and SEC tax-related filing requirements).
- International tax-planning strategies and their effects on SEC reporting.

In addition to obtaining the appropriate resources, management should consult and work closely with tax advisers in determining the income tax implications of proceeding with an IPO. Tax advisers can add value to IPO planning by highlighting material income or transaction tax issues (such as those described above) that could affect the success of the IPO. For example, tax advisers can help entities:

- Determine the direct and indirect tax consequences of the planned use of IPO proceeds.
- Compare and assess possible reorganization options for effective tax rate planning.
- Benchmark the entity’s tax efficiency compared with that of similar public companies.
- Determine the availability, accuracy, and timeliness of tax information used for financial reporting.
5.10 Earnings per Share

Public entities must comply with ASC 260, which provides guidance on computing and presenting EPS for common stock and potential common stock. Under ASC 260, entities are required to present, for each period presented, basic EPS (i.e., income available to common stockholders divided by weighted-average number of common shares outstanding) and diluted EPS, which includes potential common stock that, if actually issued, would dilute basic EPS.

ASC 260 also provides additional guidance specific to share-based compensation. An entity should carefully analyze share-based compensation arrangements to determine the EPS impact on the basis of the substance of the arrangements. For example, shares may be legally outstanding; however, for EPS purposes, unvested shares are not treated as being issued but are instead viewed as potentially dilutive.

For more information about the presentation and disclosure of EPS, see Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*, especially Section 8.6.2.1, which provides an overview of common ways in which ASC 260 is misapplied in an IPO.

[Sections 5.10.1 through 5.10.4 have been deleted.]

5.11 Segments

Public entities are required to disclose certain financial information for reportable segments under ASC 280. The segment determinations made by a public entity that files with the SEC are the basis for certain other disclosures within the periodic filing, including the business section and MD&A. Accordingly, it is important for an entity that is going public to thoroughly consider the identification of its operating and reportable segments.

To identify operating segments, an entity must use the management approach, which is, as stated in ASC 280-10-05-03, “based on the way that management organizes the segments within the public entity for making operating decisions and assessing performance.” An entity may need to use judgment in evaluating whether a component has all the characteristics of an operating segment. Various information sources may help an entity identify operating segments, including the entity’s organizational structure (i.e., those who directly report to the CODM), the CODM’s periodic reporting package, the level at which budgets are reviewed and approved by the CODM, and an understanding of the incentive compensation structure.

Once an entity has identified its operating segments, it must determine which subset of those operating segments to report in the financial statements (i.e., its reportable segments). An entity uses a modified management approach to identify reportable segments, which is based on aggregation criteria and quantitative requirements. An entity must use reasonable judgment when aggregating two or more operating segments into a single operating segment, and all the aggregation criteria need to be met, including the requirement that aggregation be consistent with the objectives and principles of ASC 280. If a single or aggregated operating segment represents 10 percent or more of revenue, profitability, or total assets, that operating segment represents a reportable segment and separate disclosure is required. Additional segments may need to be disclosed separately to ensure that reportable segments constitute at least 75 percent of reported revenue.

ASC 280 also requires certain entity-wide disclosures, which are intended to ensure some level of comparability among entities. Accordingly, an entity should carefully consider the objectives and principles of ASC 280 when evaluating the disclosure requirements.
5.12 **Subsequent Events**

When evaluating potential disclosures in the financial statements for inclusion in a company's initial registration statement, management should consider subsequent events through the date on which the financial statements are issued or are available to be issued. Such an evaluation should include consideration of whether events are recognized (i.e., “Type 1”) or nonrecognized (i.e., “Type 2”) subsequent events, as described in ASC 855.

An initial registration statement may be amended several times before ultimately becoming effective. Each time the registration statement is amended, financial statements included in the registration statement are reissued. Questions often arise regarding the date through which subsequent events should be evaluated when financial statements are revised or reissued as a result of a registration statement amendment.

If new events are identified after the original registration statement has been filed, but before the subsequent amendment of a registration statement, financial statements included in the amendment may need to include disclosure of additional subsequent events but would not contain recognition of the impact of such events unless a material error was identified. This approach is based on a reissuance framework — the premise that financial statements included in the amendment represent a reissuance of financial statements for subsequent-event purposes. The reissuance guidance in ASC 855-10-25-4 states:

> An entity may need to reissue financial statements, for example, in reports filed with the SEC or other regulatory agencies. After the original issuance of the financial statements, events or transactions may have occurred that require disclosure in the reissued financial statements to keep them from being misleading. An entity shall not recognize events occurring between the time the financial statements were issued or were available to be issued and the time the financial statements were reissued unless the adjustment is required by GAAP or regulatory requirements. Similarly, an entity shall not recognize events or transactions occurring after the financial statements were issued or were available to be issued in financial statements that are later reissued in comparative form along with financial statements of subsequent periods unless the adjustment meets the criteria stated in this paragraph.

To the extent that new information is discovered after the financial statements were originally available to be issued, management should determine whether such currently available information represents (1) information that management was aware of and misapplied or (2) information that management should have been aware of. Errors identified during the preparation of a registration statement amendment that meet the criteria for the correction of an error or for a prior-period adjustment should be evaluated and accounted for in accordance with ASC 250. Management should use judgment in performing such an evaluation.

Unless a material subsequent event was accounted for or disclosed in a subsequent interim period, the annual financial statements would need to be updated to disclose such an event. In addition, the entity's financial statements included within the registration statement are required to include disclosure of the date through which subsequent events were evaluated. When financial statements are revised, ASC 855 requires an entity to disclose the dates through which subsequent events have been evaluated in both the originally issued financial statements and the revised financial statements.
Chapter 6 — Audit Considerations

6.1 Introduction

After the financial statement requirements have been identified for a registration statement, the next step for the registrant's audit committee\(^1\) is to engage auditors to complete the necessary audits and reviews of the financial statements, as applicable (see Section 2.3). The SEC indicates on its Web site that the 1933 Act, which governs registration statements, has two fundamental goals: (1) to "require that investors receive financial and other significant information concerning securities being offered for public sale" and (2) to "prohibit deceit, misrepresentations, and other fraud in the sale of securities." In accordance with these objectives, the Securities Act requires that an independent registered public accounting firm audit annual financial statements and read certain other financial information included in the registration statement. In addition, interim financial statements included in the registration statement are subject to a review under PCAOB auditing standards. In some instances, stub-period financial statements may also need to be audited.

Audited financial statements to be included in the IPO registration statement often will be subject to additional audit procedures because the standards governing audits of public companies are different from those for private companies. Specifically, the audits obtained for a private company and its independent auditor are subject to the auditing standards issued by the AICPA's Auditing Standards Board; however, for a registration statement, the audit of the issuer would need to be performed in accordance with PCAOB auditing standards. Although the auditor may have previously expressed an opinion on the financial statements in accordance with AICPA auditing standards, the auditor will need to issue a new audit report on those financial statements in accordance with PCAOB auditing standards to include the report in the registration statement. To issue this new audit report, the auditor must comply with all relevant PCAOB requirements.

6.2 Independence Considerations

Because the SEC's and PCAOB's independence rules are generally more restrictive than the AICPA's, both the auditor and management, with oversight from the audit committee, need to determine (1) whether there is possible noncompliance with the SEC's and PCAOB's independence rules, (2) whether there are conflicts of interest before the entity undertakes an IPO, or (3) both. For example, because certain nonattest services that the auditor is permitted to provide under AICPA rules may be prohibited under SEC independence rules, the auditor and management need to evaluate whether nonattest services provided during the financial statement periods to be included in the registration statement (or services approved by the audit committee but not yet provided) are permitted under the SEC's and PCAOB's independence rules. In addition, the auditor may need to be independent of other entities that meet the definition of an affiliate of the reporting entity under the SEC's independence rules but not under the AICPA's independence rules. For instance, while controlling entities are within the scope of both the SEC and AICPA definitions of an affiliate, the SEC definition does not stipulate materiality considerations.

\(^1\) If the entity has not yet formed an audit committee, those the entity has charged with governance, such as a board of directors or owners, may fulfill this role before the entity becomes a public company.
with respect to the controlling entity while the AICPA definition does. Therefore, an entity not previously considered an affiliate under AICPA requirements may meet the definition of an affiliate under SEC requirements.

**Connecting the Dots**

Both the auditor and management should compile a list of all of the auditor’s nonattest services and the corresponding fee arrangements that (1) are currently being provided to the entity and its affiliates (as defined by the SEC’s rules), (2) were previously provided during the financial statement periods to be included in the registration statement, and (3) have been approved but not yet provided. In addition, the auditor and the entity should identify and evaluate any business relationships between the parties.

While some ongoing or future services may be permissible, other services or fee arrangements may need to be modified or terminated before the auditor is engaged or begins audit procedures in accordance with PCAOB standards. If prohibited nonattest services, including prohibited fee arrangements, were provided during the financial periods to be included in the registration statement, the auditor may not be independent and therefore may not be able to issue (or reissue) audit reports covering those periods. This conflict and independence review should begin as early as possible (as soon as the IPO is initially considered) so that there is sufficient time to gather, understand, and appropriately address any services or relationships for which there are potential conflicts of interest or independence implications before the IPO.

In addition, audit committee approval is required for any service provided by the auditor; however, approval is not required if those services have been completed. This approval must be obtained before the auditor is engaged to conduct the audit in accordance with PCAOB standards.

Independence concerns may also arise as a result of business relationships (both indirect and direct) between the auditor, including “covered persons” at the auditor, and the entity commencing the IPO process, its affiliates, or persons associated with the entity in a decision-making capacity, such as officers, directors, or substantial stockholders. Therefore, these relationships should be reviewed for compliance with the SEC’s independence rules. See Table 6.2.2 below for a list of potentially independence-impairing business relationships.

The auditor typically will evaluate whether previous or present relationships with any of the following could potentially impair its independence or otherwise pose professional, legal, or business conflicts:

- The entity itself.
- Any of the entity’s affiliates under SEC affiliate rules.
- Individuals serving in a financial reporting oversight role, including officers and directors.
- Record or beneficial owners of more than 10 percent of the entity’s equity securities (both individuals and entities that are not otherwise affiliates).

Further, the auditor should determine whether any officers, directors, and record or beneficial owners of 10 percent or more of the entity’s or its affiliates’ equity securities have a lending relationship with the auditor, any covered person at the auditor, or an immediate family member of any covered person.
Connecting the Dots

A complete corporate entity tree, including a detailed organizational structure consisting of all legal corporate entities considered to be affiliates of the entity (as defined by the SEC), is critical to performing a thorough review of independence and potential conflicts. In conjunction with gathering corporate tree information, the entity should compile a list of services provided by the auditor to the entities within the tree to evaluate any independence/conflict-related considerations. It is advisable for management to work closely with the entity's auditor to ensure that the requisite information is available to complete this process in a timely fashion.

Below are examples of services (Table 6.2.1) and business relationships (Table 6.2.2) for entities to consider when evaluating auditors' independence. As previously mentioned, there are certain differences between the SEC's and AICPA's rules. Such differences may be particularly relevant to nonattest services currently being performed at the entity's affiliates, since an entity deemed an affiliate under SEC rules may not have previously been deemed an affiliate under AICPA rules.

Table 6.2.1 — Examples of Potentially Independence-Impairing Services

- Bookkeeping services
- Financial information systems (both design and implementation)
- Valuation, appraisal, or fairness opinions
- Forecasts and projections
- Actuarial services
- Managed services, including those that might not affect financial systems or financial reporting
- Client project management
- Loaned staff
- Cash handling
- Client agent or representative responsibilities
- Internal audit or other outsourcing services (in whole or in part)
- Internal control services that the entity uses as part of its system of quality control
- Ongoing monitoring
- Control assessment or support
- Legal services, including dispute consulting
- Expert services
- Corporate finance or broker-dealer services
- Investment banking services
- Search firm or recruiting services
- Psychological testing services
- Background or reference checks
- Tax planning services that are not, at inception, at least more likely than not to be allowable under applicable laws
- Tax compliance services for which the auditor may be (1) appointed the agent or (2) handling cash or making payments on behalf of the entity
- Tax services for an individual serving in a financial reporting oversight role
- Contingent or value-added fee arrangements
In accordance with PCAOB Rule 3526, before accepting an initial engagement to audit an entity under PCAOB standards, the auditor must (1) communicate, in writing, to the audit committee all relationships between the auditor and the audit client and its affiliates (or persons in financial reporting oversight roles at the audit client), that may reasonably be thought to bear on the auditor’s independence; (2) discuss, with those charged with governance, the potential effects of such relationships on the auditor’s independence; and (3) document the substance of the discussion with the audit committee. Acceptance of the audit engagement occurs after the auditor completes its engagement acceptance activities and before it obtains the engagement letter establishing the terms of the new engagement to perform PCAOB audits in connection with the IPO (referred to as the “IPO engagement letter”). Rule 3526 also includes the auditor’s responsibilities with respect to annual communications to those charged with governance.

### 6.3 Rotation of Audit Partners

The SEC’s independence rules require that the audit partner and the engagement quality control reviewer (generally another partner in the independent registered public accounting firm) serve in those roles for a maximum of five consecutive years. Certain other partners on the audit engagement or those in equivalent roles are limited to seven consecutive years of service. Before a registration statement is filed and the audit report under PCAOB standards is issued, the audit engagement team needs to reassess the time that partners have served on the audit engagement before being engaged to perform the PCAOB audit. Certain periods during which partners subject to rotation served on AICPA audits may be factored into the determination of compliance with the rotation requirements under SEC rules.

Under SEC rules, the audit partner rotation measurement period generally begins with the earliest audit period included in the initial registration statement or a JOBS Act confidential filing. If a partner on the audit engagement was involved in the prior-year AICPA audits and is continuing in that role for the reissuance of those audit reports for inclusion in the registration statement, each financial statement period included in the initial and amended registration statements counts as one year of service toward the SEC rotation period. Any years of service by those individuals before the financial statement periods included in the registration statement do not count toward the SEC rotation period. Potential delays in the effectiveness of the registration statement and performing initial financial statement audits of multiple periods at the same time could affect the measurement period of required audit partner rotation.
Example 6-1

The partner who served as the audit engagement partner for AICPA audits of 20X0, 20X1, 20X2, and 20X3 financial statements will continue serving in that role for the reissuance of the auditor's report on the 20X1, 20X2, and 20X3 financial statements to be included in the initial registration statement (public or confidential filing). After many amendments to the registration statement, the SEC declared the company's registration statement effective in March 20X5 (the registration statement declared effective included the audited financial statements for the years ended December 31, 20X2, 20X3, and 20X4). For SEC partner rotation purposes, the partner (1) would be viewed as having served as the audit engagement partner for four years (20X1, 20X2, 20X3, and 20X4), counting all the years included in the registration statements filed with the SEC, and (2) has one year (20X5) remaining before starting a five-year time-out period.

6.4 Restriction on Company's Employment of Former Audit Personnel

The SEC's independence rules also mandate a “cooling-off” period before a member or former member of the audit engagement team can begin working for the registrant in an accounting or financial reporting oversight role. Accordingly, management and the audit committee need to consider these requirements when determining whether to offer employment to a current or former partner, principal, shareholder, or employee of the entity’s auditors.

6.5 Legal Protective Clauses in Engagement Letters

Generally, legal protective clauses to mitigate the auditor’s potential liability are permitted in AICPA audit engagement letters. The most common legal protective clause that is included in such letters is a release and indemnification for management misrepresentations. In certain circumstances, such as certain financial statement audits performed in connection with a transfer of ownership interests, other legal protective clauses (e.g., a limitation of liability) may also be included in AICPA audit engagement letters.

However, the SEC’s independence rules do not permit inclusion of legal protective clauses in audit engagement letters. When an entity is an issuer or the auditor is engaged to perform an audit in accordance with PCAOB standards, auditors are subject to, and must comply with, the SEC’s independence rules; accordingly, auditors do not include such legal protective clauses in PCAOB audit engagement letters.

6.6 Changes in Auditors

When planning for an IPO, an entity often considers whether its independent auditors have the requisite qualifications and experience to assist the entity with the IPO process. In addition to seeking an independent registered public accounting firm that has extensive experience with IPOs and public companies, an entity that has (or is interested in developing) international operations often wishes to engage an independent registered public accounting firm with a network of affiliated international firms around the globe.

In certain cases, the entity may be required to change its independent auditor to move forward with its IPO process because the prior auditor may be unable to be associated with the IPO. This could be the case because, for example, the audit firm is not registered with the PCAOB or is not in compliance with the SEC’s independence rules for its audits of the years for which financial statements will be included in the registration statement. A successor auditor will need to gain an understanding of the business, perform audits of one or more years, and coordinate with the predecessor auditor.
Chapter 6 — Audit Considerations

Connecting the Dots

If an entity changes to a new audit firm shortly before it commences an IPO process, the previous audit firm would be required to consent to the use of its previously issued audit report(s) on prior-year financial statements that are included in the SEC filing. If the prior auditor is not able to or willing to consent to the use of its audit reports, the new auditor may need to reaudit previously issued financial statements.

Both AICPA and PCAOB standards allow an audit firm to divide responsibility for an audit with another auditor, although it is not common for audit firms to do so. Under SEC rules, if an independent public accounting firm divides responsibility with another audit firm because another independent auditor audits a component of the entity (e.g., a discrete business), the other auditor’s report must be filed with the SEC and this report must refer to PCAOB standards. The other independent auditor would also need to consent to the use of its audit report in the registration statement. (See Section 6.8 for more information about consents.)

Even if an auditor previously divided responsibility with another auditor in its AICPA audit report, it may not be appropriate to divide responsibility in the PCAOB audit report if the other auditor is not in a position to reissue its audit report on the component it audited and refer to PCAOB standards. In addition, paragraph 4140.1 of the FRM states that “[g]enerally, the principal auditor is expected to have audited or assumed responsibility for reporting on at least 50% of the assets and revenues of the consolidated entity.” As a result, if an auditor previously divided responsibility with another auditor in a prior AICPA audit, the auditor would be required to reevaluate the appropriateness of that conclusion given the SEC’s position on this matter.

6.7 Completing Audits and Reviews

There are currently many differences between AICPA and PCAOB standards, the vast majority of which are nuanced and minor. However, some of the differences are more significant, as a result of which the auditor will be required to perform more procedures under PCAOB standards than under AICPA standards.²

Connecting the Dots

Management should evaluate whether it has sufficient resources to respond to additional auditor information requests.

These differences between the two sets of auditing standards can broadly affect the audit beyond just the testing procedures performed by the audit engagement personnel. For example, because auditors that perform audits and issue a report in accordance with PCAOB standards must be registered with the PCAOB, it is necessary to understand whether the auditor is qualified to issue an audit report in accordance with PCAOB standards. In addition, auditors in foreign jurisdictions that participate as a component audit firm in the audit may also need to be registered with the PCAOB. The need for a component auditor to also be registered is based on the size of the component to the consolidated entity. Under PCAOB Rule 2100, if a component auditor plays a substantial role, defined as performing audit procedures with respect to a subsidiary or component that constitutes 20 percent or more of the consolidated assets or revenue, that firm must also be registered with the PCAOB. For example, the U.S. audit firm may be appropriately registered with the PCAOB, but one of its component audit firms in another jurisdiction that plays a substantial role may not. Also, it may be necessary for the audit firm to change or augment the personnel assigned to the PCAOB audit to achieve the right blend of experience and knowledge for the audit.

² For example, under PCAOB standards, the auditor is always required to perform a test of details in response to a significant risk. In contrast, under AICPA standards, the auditor is not required to perform such a test provided that its response addresses both substantive analytical procedures and tests of controls.
Connecting the Dots
An audit performed in accordance with PCAOB standards versus a previous audit performed in accordance with AICPA standards will be a “new audit” and result in a new report date. In addition to auditing any required incremental public-company disclosures, the auditor will need to inquire about and evaluate subsequent events through the new report date.

An IPO often takes many months or years to complete. In an effort to accelerate that process, some entities request that their auditor perform incremental procedures in accordance with PCAOB auditing standards before they launch the IPO. In making such a request, an entity needs to consider the cost of performing such procedures versus the benefit of accelerating the IPO process.

Connecting the Dots
If the entity’s current owners believe that an IPO may be possible in the foreseeable future, management should discuss such plans and the timing with the auditor as well as the costs and benefits of requesting the auditor to perform accelerated, incremental PCAOB audit procedures.

6.7.1 Audit Readiness and Completion
Once management has identified the appropriate reporting entity or entities for which financial statements are required, as well as the periods covered by those financial statements (see Chapter 2), management must determine, for each set of financial statements to be included in the registration statement, whether audits need to be performed in accordance with AICPA standards (i.e., auditing standards generally accepted in the United States, or “GAAS”), PCAOB standards, or both.

In some cases, the audit required for the IPO will be the first time those financial statements have been audited. While the registrant’s financial statements and those of any predecessors must generally be audited in accordance with PCAOB standards, certain other audited financial statements that must be included in a registration statement (e.g., financial statements of a significant acquisition required by Rule 3-05) may need to be audited in accordance with AICPA standards.

Changing Lanes
The “Compliance With Standards Rule” of the AICPA Code of Professional Conduct indicates that the PCAOB is designated to establish standards related to the preparation and issuance of audit reports for issuers, brokers, and dealers. In contrast, the Auditing Standards Board is designated to establish standards related to the preparation and issuance of audit reports for nonissuers.

The SEC considers entities filing public registration statements to be issuers and requires entities to include with the registration statement an auditor’s report that references performance of audit procedures in accordance with PCAOB standards. This requirement applies to periods during which the registration statement is not yet effective.

Entities filing nonpublic registration statements, typically EGCs or other entities electing the accommodations provided under the JOBS Act, are not technically considered issuers; nonetheless, the SEC requires that audits of nonpublic filers be performed in accordance with PCAOB standards.

To clarify this nuance, the AICPA amended its auditing standards to explain that auditors must still conduct audits in accordance with GAAS for audits of nonissuers even when a regulator (e.g., the SEC) requires that such audits be conducted in accordance with PCAOB standards. In this instance, audits for such entities should be performed in accordance with both GAAS and PCAOB standards and the related auditor’s report must refer to both sets of standards.

3 SAS 131 (codified in AICPA AU-C Section 700).
Connecting the Dots
Early in the process, management should identify all the financial statements to be included in the registration statement and discuss with the auditor whether an audit under AICPA standards, PCAOB standards, or both is required. It may be prudent to consult with outside advisers and, if complex issues are identified, to consider preclearance with the SEC.

6.7.2 Audit Planning and Risk Assessment Process

6.7.2.1 Audit Materiality and Scope
In all audits, the auditor establishes a materiality level for the planning and execution of the audit, which affects many of the auditor's decisions about the audit strategy and scope, including determining which accounts will be tested at which locations as well as the extent of testing to be performed. Materiality is based on quantitative as well as qualitative factors, including the needs of the expected users of the financial statements. The determination of audit materiality is not a mathematical exercise and involves consideration of the entity's specific facts and circumstances. Because users of the financial statements to be included in a registration statement differ from users of a private company's financial statements (e.g., lenders, limited partners, suppliers), auditors' materiality determinations in a PCAOB audit may also differ from those in an AICPA audit.

Accordingly, the auditor would need to revisit its judgments about materiality in prior AICPA audits and determine whether those judgments are significantly different with respect to the needs of the expected users of the financial statements to be included in the registration statement. If so, the auditor may need to revise the scope of its prior audits on the basis of the revised materiality, which could result in the need to perform additional audit procedures for the prior years.

Connecting the Dots
Management and those charged with governance should perform a similar exercise in assessing materiality to potential new financial statement users. In determining financial statement materiality, an entity should consider SAB Topic 1.M (SAB 99).

As discussed in other sections of this Roadmap as well as in Deloitte's A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions, the financial statements included in the registration statement vary and may involve carved-out portions (see Section 2.2.1) or put-together pieces of other entities (see Section 2.2.2). When the reporting entity or its composition changes, the auditor will be conducting a "new" audit of a different entity. While the auditor typically will attempt to leverage audit work performed in prior audits of parts of the new reporting entity, the scope of the previous audit work performed must be reconsidered with respect to the components of the new reporting entity to determine, in the auditor's judgment, whether that audit scope and the related procedures performed are sufficient to issue an audit report on the financial statements of the new reporting entity, particularly if certain components have not been previously audited.

Connecting the Dots
As soon as preparations for the IPO transaction begin, management should consider informing the auditor of its intention to take the entity public. An auditor that has advance notice will be able to take the potential public filing into account in establishing the scope of audit procedures to be performed for the current AICPA audits; accordingly, the auditor may be able to avoid the need to perform expanded audit procedures when the IPO filing is imminent.
6.7.2.2 Auditor Inquiries

Both PCAOB and AICPA standards require auditors to make certain inquiries on various topics as part of their risk assessment and planning process. Because PCAOB standards prescribe certain inquiries not required by AICPA standards, auditors may need to conduct additional inquiries regarding prior AICPA audits. In making these incremental inquiries, auditors may be required to conduct further discussions with the following:

- Management, the internal audit department (when it exists), those charged with governance, and others.
- Legal and regulatory departments.
- Component auditors.\(^4\)
- Service auditors.\(^5\)

The above inquiries are related to the risk assessment process; since the auditor’s risk assessment is an ongoing activity, management should be prepared to respond to the inquiries throughout the audit.

[Sections 6.7.3 and 6.7.4 have been deleted.]

6.7.5 Related-Party Transactions

PCAOB AS 2410 establishes requirements related to the auditor’s evaluation of a company’s identification of, accounting for, and disclosure of relationships and transactions between the company and related parties.

PCAOB AS 2410 states that the auditor is required to perform the following procedures when assessing related parties:

- Perform specific procedures to obtain an understanding of the company’s relationships and transactions with its related parties, including obtaining an understanding of the nature of the relationships . . . and of the terms and business purposes (or the lack thereof) of transactions involving related parties . . . .
- Evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties. [Footnote omitted.] In making that evaluation, the auditor performs procedures to test the accuracy and completeness of management’s identification, taking into account information gathered during the audit. If the auditor identifies information that indicates that undisclosed relationships and transactions with a related party might exist, the auditor performs procedures necessary to determine whether undisclosed relationships or transactions with related parties in fact exist.
- Perform specific procedures if the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists.
- Perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.
- Communicate to the audit committee the auditor’s evaluation of the company’s identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit.

Further, PCAOB AS 2110 indicates that the auditor is required to “perform procedures to obtain an understanding of the company’s financial relationships and transactions with its executive officers.”

\(^4\) Paragraph 11 of AICPA AU-C Section 600 defines a component auditor as “[a]n auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit. A component auditor may be part of the group engagement partner’s firm, a network firm of the group engagement partner’s firm, or another firm.”

\(^5\) A service auditor is an auditor that reports on the effectiveness of controls at an outside service provider (e.g., a transaction processor or investment custodian).
However, the auditor is not required to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

**Connecting the Dots**

If it has not done so previously, management should design a process for (1) identifying related parties and transactions, (2) authorizing and approving transactions with related parties, and (3) accounting for and disclosing relationships and transactions with related parties in financial statements. Entities should be prepared to respond to additional inquiries from auditors and should ensure that executive management and those charged with governance are available for such inquiries.

### 6.7.6 Audit Confirmations

Auditors may consider whether confirmations should be requested from additional external parties, including new legal counsel. While such confirmations are not necessarily related to incremental requirements of a PCAOB audit, they may ultimately be necessary as a response to new risks in an IPO. Confirmations from third parties generally yield reliable audit evidence and can result in higher-quality evidence than relying on inquiries with management alone.

### 6.7.7 Concluding Procedures

#### 6.7.7.1 Subsequent Events

Although management is required to evaluate subsequent events through the date of the registration statement, for previously issued financial statements (e.g., amending a registration statement when the financial statements would be reincorporated), management would generally not update its financial statement disclosure of subsequent events unless the financial statements included in the registration statement have been revised or disclosure would be required to prevent the reissued financial statements from being misleading. See Section 5.12 for additional considerations related to subsequent-event disclosures.

#### 6.7.7.2 Evaluating Uncorrected Misstatements

In both AICPA and PCAOB audits, the entity and the auditor need to accumulate uncorrected misstatements identified during the audit and determine whether those misstatements are material individually or in the aggregate to the financial statements as a whole. In AICPA audits, this accumulation is based on *either* the iron-curtain method or the rollover method, depending on the entity's policy. For audits of issuers, however, entities and auditors need to use *both* the iron-curtain method and the rollover methods to accumulate uncorrected misstatements as of and for each period under audit. Further, the evaluation of the materiality of such errors must principally consider the method that yields the greater value of uncorrected misstatements. The two methods can be described as follows:

- **Iron-curtain method** — Under this approach, the entity and the auditor focus on misstatements existing in the balance sheet at the end of the current period, regardless of the period(s) in which the misstatement originated. This approach does not take into account the income statement effects of the reversal of the carryover of a prior-period misstatement to be evaluated as an error.

- **Rollover method** — Under this approach, misstatements are quantified on the basis of the amount of error originating in the current-period income statement. Therefore, this approach could allow misstatements in the balance sheet to increase each period by immaterial amounts until the cumulative amount becomes material, which could then result in a material misstatement under the iron-curtain method.
**Example 6-2**

Assume that in 20X2, Company A begins over-accruing a liability each year by $20. Therefore, at the end of 20X6, liabilities are overstated by $100. The $20 annual over-accrual is not considered material to any of the individual prior-period financial statements. At issue is whether A should evaluate the uncorrected misstatement as a $100 overstatement of liabilities (iron-curtain method) or a $20 overstatement of expenses (rollover method).

The following table shows adjustments that A would make under each method to correct the 20X6 financial statements:

<table>
<thead>
<tr>
<th></th>
<th>20X6 Iron Curtain*</th>
<th>20X6 Rollover**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overstatement of expenses</td>
<td>$ 20</td>
<td>$ 20</td>
</tr>
<tr>
<td>Entry to adjust</td>
<td>(100)</td>
<td>(20)</td>
</tr>
<tr>
<td>Understatement of expenses (as adjusted)</td>
<td>(80)</td>
<td></td>
</tr>
<tr>
<td>Overstatement of liabilities</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Entry to adjust</td>
<td>(100)</td>
<td>(20)</td>
</tr>
<tr>
<td>Overstatement of liabilities (as adjusted)</td>
<td>$ —</td>
<td>$ 80</td>
</tr>
</tbody>
</table>

* Under the iron-curtain approach, after the adjustment, liabilities will be correct but expenses will be understated by $80.
** Under the rollover approach, after the adjustment, expenses will be correct but liabilities will be overstated by $80.

Under SAB Topic 1.N (SAB 108), registrants are required to use both approaches when evaluating the uncorrected misstatement and to adjust the financial statements if either approach results in quantification of a material misstatement. While typically this materiality analysis would be performed by public entities, management of an entity undergoing an IPO must also consider its application while preparing the entity’s financial statements for the IPO registration statement.

Assume that the $100 uncorrected misstatement under the iron-curtain approach is material to 20X6 and that the financial statements need to be adjusted, as a result of which expenses are understated by $80 and the 20X6 income statement is therefore misstated. The $80 understatement should be evaluated for materiality with respect to the 20X6 financial statements; if this understatement is considered material, the prior-period financial statements should be corrected. In this example, the $20 accrual each year should be reversed as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X6*</th>
<th>20X5</th>
<th>20X4</th>
<th>20X3</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overstatement of expenses (as reported)</td>
<td>$ —</td>
<td>$ 20</td>
<td>$ 20</td>
<td>$ 20</td>
<td>$ 20</td>
</tr>
<tr>
<td>Adjustment</td>
<td>—</td>
<td>(20)</td>
<td>(20)</td>
<td>(20)</td>
<td>(20)</td>
</tr>
<tr>
<td>Overstatement of expenses (as adjusted)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Overstatement of liabilities (as reported)</td>
<td>—</td>
<td>80</td>
<td>60</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>Accumulated adjustment</td>
<td>—</td>
<td>(80)</td>
<td>(60)</td>
<td>(40)</td>
<td>(20)</td>
</tr>
<tr>
<td>Overstatement of liabilities (as adjusted)</td>
<td>$ —</td>
<td>$ —</td>
<td>$ —</td>
<td>$ —</td>
<td>$ —</td>
</tr>
</tbody>
</table>

* No additional adjustment would be necessary in 20X6 since the error was adjusted before the financial statements were filed, as shown above.
Auditors will need to reevaluate whether uncorrected misstatements identified in the prior audits are material to the prior-period financial statements on the basis of (1) the greater of the amount determined under the iron-curtain approach or that under the rollover approach and (2) their judgment about materiality for the PCAOB audit. Further, as a result of this reevaluation, if an auditor determines that the total amount of accumulated uncorrected misstatements approaches materiality, the auditor may either (1) request that management adjust the financial statements or (2) perform additional audit procedures to reduce the risk that the combination of possible undetected misstatements and misstatements identified during the audit results in materiality.

**Connecting the Dots**

Management should consider quantitative and qualitative measures of materiality when reviewing uncorrected misstatements and should determine whether the financial statements need to be revised as a result of prior-year uncorrected misstatements. Management should share its analysis with their auditor and be prepared to support its judgments.

### 6.7.8 Communications With Management and Audit Committees

#### 6.7.8.1 Requirements of PCAOB Auditing Standards

**Communications With Audit Committees**

PCAOB standards encourage auditors and the audit committee to effectively communicate throughout the audit, since such communication can lead to a better understanding of audit-related matters. In preparing to file an initial registration statement, an entity typically will change its governance structure, including the formation and composition of an audit committee, to meet the governance requirements the entity will be subject to after it becomes public. As a result, the individuals auditors communicate with when reissuing audit reports on prior years are often different from the individuals auditors communicated with in prior AICPA audits. In such cases, auditors may consider recommunicating matters related to prior audits for the benefit of new audit committee members.

The PCAOB's auditing standards require auditors to include, among other things, the following in their communications with the audit committee:

- An “evaluation of the company's identification of, accounting for, and disclosure of its relationships . . . with related parties” (PCAOB AS 2410).
- Inquiries of “the audit committee about whether it is aware of matters relevant to the audit, including . . . violations or possible violations of laws or regulations” (footnote omitted) (PCAOB AS 1301).
- The nature and extent of “specialized skill or knowledge . . . needed to perform” the planned audit procedures or “evaluate audit results” related to significant risks (PCAOB AS 2101).
- “[M]atters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process” (PCAOB AS 1301).

#### 6.7.8.2 Management Representation Letters

In connection with each amendment to a registration statement, auditors obtain updates to the management representation letter obtained upon the initial filing of the registration statement, generally on the dates on which each amendment is filed and on the effective date (or as close thereto as is practicable in the circumstances).
6.7.8.3 Form of Auditor's Report

The form and content of the auditor's reports for PCAOB audits differ from those for AICPA audits as a result of differences in the auditing standards. These differences include:

- **The applicable auditing standards** — PCAOB auditors' reports include a statement that the audits were performed in accordance with PCAOB standards, while AICPA auditors' reports include a statement that the audit was performed in accordance with U.S. GAAS. As noted in Section 6.7.1, it is also possible for the auditor's report to refer to both sets of standards, if applicable.

- **Format** — AICPA auditors' reports must include the following section headings: “Management’s Responsibility for the Financial Statements,” “Auditors’ Responsibility,” and “Opinion”; PCAOB auditors' reports must include “Opinion on the Financial Statements” and “Basis for Opinion.”

- **Audit firm tenure** — PCAOB auditors' reports include a statement containing the year the auditor began serving consecutively as the company's auditor.

- **Critical audit matters (CAMs)** — PCAOB auditors' reports include communication of CAMs related to the audit of the current-period financial statements or state that the auditor determined that there are no CAMs. Communication of CAMs is first effective for audits of large accelerated filers for fiscal years ending on or after June 30, 2019, and it is effective for audits of all other companies to which the requirements apply for fiscal years ending on or after December 15, 2020. A CAM is any matter arising from the audit of the financial statements that was communicated, or was required to be communicated, to the audit committee and that (1) was related to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

As noted in Section 1.6.2, communication of CAMs does not need to be included in the audit report of an EGC, since EGCs are exempt from this PCAOB requirement.

In May 2019, the AICPA's Auditing Standards Board issued SAS 134, which addresses the auditor's responsibility to form an opinion on the financial statements and the form and content of the auditor's report issued as a result of an audit of financial statements. SAS 134 is effective for audits of financial statements for periods ending on or after December 15, 2020; early implementation is not permitted.

6.7.9 Interim Reviews

Entities are often required to include interim financial information in the registration statement (see Section 2.6.3). Because the auditor is associated with such information, review procedures are performed in accordance with PCAOB standards. Specifically, paragraph 7 of PCAOB AS 4105 states, in part:

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The objective of a review of interim financial information . . . is to provide the [auditor] with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles. The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with the standards of the PCAOB. A review of interim financial information does not provide a basis for expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles. A review consists principally of performing analytical procedures and
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making inquiries of persons responsible for financial and accounting matters, and does not contemplate (a) tests of accounting records through inspection, observation, or confirmation; (b) tests of controls to evaluate their effectiveness; (c) obtaining corroborating evidence in response to inquiries; or (d) performing certain other procedures ordinarily performed in an audit. A review may bring to the [auditor’s] attention significant matters affecting the interim financial information, but it does not provide assurance that the [auditor] will become aware of all significant matters that would be identified in an audit.

Further, paragraph 16 of PCAOB AS 4105 indicates that the auditor “should apply analytical procedures to the interim financial information to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement.” The analytical procedures that the auditor performs generally include:

- “Comparing the quarterly interim financial information with comparable information for the immediately preceding interim period and the quarterly and year-to-date interim financial information with the corresponding period(s) in the previous year, giving consideration to knowledge about changes in the entity’s business and specific transactions.”
- “Considering plausible relationships among both financial and, where relevant, nonfinancial information.” The auditor also may consider “information developed and used by the entity, for example, information in a director’s information package or in a senior committee’s briefing materials.”
- “Comparing recorded amounts, or ratios developed from recorded amounts, to expectations developed by the [auditor]. The [auditor] develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the [auditor’s] understanding of the entity and the industry in which the entity operates.”
- “Comparing disaggregated revenue data, for example, comparing revenue reported by month and by product line or operating segment during the current interim period with that of comparable prior periods.”

**Connecting the Dots**

Management may perform the same review procedures that auditors do and may use such procedures both as a risk assessment tool and to be responsive to auditor inquiries. Providing the auditor with a description of these procedures and documentation regarding period-to-period fluctuations in account balances (or the absence of expected fluctuations) is likely to reduce the time the auditor spends in completing its review.

### 6.8 Consents

As noted in Chapter 1, the registration statement may be amended a number of times before it is declared effective. In some cases, the financial statements may be revised during this process. Auditors may not need to issue a new audit report but will most likely need to issue a written consent agreeing to the inclusion of their audit report in each filed registration statement amendment.

When providing its consent, an auditor must extend its subsequent-event procedures and inquiries (e.g., management inquiries, legal counsel inquiries). Further, management must provide updated representation letters to the auditor through the date of the auditor’s consent. Updated legal representations may also be needed.

The written consent provided by the auditor will be filed as an exhibit to the registration statement and will include the auditor’s signature and a statement indicating that it consents to have its audit report on the financial statements included in the filing.
Connecting the Dots
Issuers that submit draft IPO registration statements to the SEC staff for nonpublic, confidential review under the accommodations identified in Section 1.4.2 will not need to include a written consent by the auditor in the registration statement amendment; however, requirements to update the financial statements (as necessary), perform additional subsequent-event procedures, and obtain an updated management representation letter still apply.

6.9 Other Financial and Nonfinancial Information
Section 4.1 discusses the preparation of pro forma financial statements in accordance with Regulation S-X, Article 11. While auditors do not report on pro forma financial statements, these financial statements, as well as other information such as MD&A, are included in the registration statement along with the audited financial statements and the auditor’s report. The auditor is required to read MD&A, pro forma financial statements, and other information for material consistency with the audited financial statements.

6.10 Comfort Letters
In conjunction with an IPO, underwriters will request a “comfort letter” from the company’s auditor. The purpose of such a letter is to assist underwriters in performing a reasonable investigation of financial and accounting information in the prospectus that is not covered by the auditor’s report.

The comfort letter lists procedures performed by the auditor on the basis of (1) PCAOB standards and (2) specific requests by underwriters. These procedures typically include:

- Assertion of the auditor’s independence.
- Affirmation of the annual periods audited under PCAOB standards and compliance of the financial statements with the accounting requirements of the 1933 Act.
- Affirmation of the interim periods reviewed under PCAOB standards.
- A description of procedures performed with respect to periods after the latest balance sheet included in the prospectus; the purpose of such procedures is to determine whether there have been any significant financial changes, such as a decline in sales or income since the last balance sheet date, that are not adequately disclosed in the document.
- “Circle-up” or “tickmark” comfort, in which the auditor compares financial data in the prospectus with accounting records or financial statements or proves the arithmetical accuracy of such data.

Under PCAOB standards, the auditor may only provide comfort with respect to information that (1) is expressed in dollars (or percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity’s controls over financial reporting or (2) has been derived directly from such accounting records by analysis or computation. The auditor may also comment on quantitative information that has been obtained from an accounting record if the information is subject to the same controls over financial reporting as the dollar amounts. It is important for the company to be involved in the procedures requested by the underwriters early in the process, since management may need to provide support for amounts in the registration statement.

Two comfort letters are generally issued — one on the effective date of the registration statement and one on the closing date, the latter of which is often referred to as the “bring-down” letter. However, a draft of the comfort letter may be requested as of each filing date so that the underwriters may decide whether the procedures described in the letter are consistent with what they requested.
If more than one auditor is involved in the IPO, either as a predecessor auditor to the registrant or as the auditor of other financial statements included in the IPO document, the other auditors may also be requested to provide a comfort letter related to financial information with which they are associated.

**Connecting the Dots**
Providing supporting documentation for amounts included in MD&A, pro forma financial statements, and elsewhere in the registration statement is critical to expediting the procedures auditors perform upon the request of underwriters. Including both management and the auditor in discussions with the underwriter regarding comfort-letter timelines and the expected nature of the auditor’s “comfort” procedures may prevent surprises.

### 6.11 Internal Control Over Financial Reporting

#### 6.11.1 Management and Auditor Attestations

While a newly public entity does not need to provide management’s report on ICFR in a registration statement or in the entity’s first Form 10-K after the registration statement is declared effective, the entity should nonetheless be prepared to evaluate its ICFR on a quarterly basis, and key executives should be comfortable with certifying that disclosure controls and procedures are effective, in accordance with Section 302 of Sarbanes-Oxley. Auditors are not required to issue an audit report on the effectiveness of ICFR in connection with the entity’s registration statement or its first Form 10-K but may be required to do so in the entity’s second Form 10-K.

**Connecting the Dots**
Under the JOBS Act, an entity that qualifies as an EGC is exempt from the requirement to obtain an attestation report on the entity’s ICFR from its registered public accounting firm. However, as noted in Section 1.6.2, an EGC only qualifies as such during the period in which it meets certain quantitative requirements or up to five years after its initial registration statement. In contrast, EGCs are not exempt from the requirement to perform management’s assessment of ICFR (Section 404(a) of Sarbanes-Oxley and the disclosure requirement in Regulation S-K, Item 308(a)).

In addition to establishing and evaluating the effectiveness of its disclosure controls and procedures as an entity prepares to go public, management will need to assess whether any changes or improvements have been made to its ICFR.

For additional considerations related to control-related public-company disclosure requirements, see Chapter 7.

#### 6.11.2 Auditors’ Testing of Controls in a PCAOB Audit

In both AICPA and PCAOB audits, auditors are required to obtain a sufficient understanding of the entity’s internal controls to plan the financial statement audit. However, the auditor’s evaluation of the design effectiveness of relevant controls and the related documentation may be more extensive in a PCAOB audit than in an AICPA audit.
Connecting the Dots

Management should inform the auditor early of its plans to go public. Because of the increased focus on internal controls for public companies, auditors will often increase their audit procedures related to the entity’s internal control as they perform AICPA audits of an entity that plans to go public in the near future. Auditors can often make helpful suggestions on how management can strengthen internal control and related documentation in preparing to meet the SEC’s requirements.

To this end, management should consider developing plans for implementing any needed internal control enhancements when preparing for an IPO. A leading practice is to prepare process flow diagrams and identify risks of material misstatement associated with each process. Once the risks of material misstatement have been identified, identifying the controls needed to address those risks is more straightforward. Furthermore, auditors will request such documentation from management or the entity’s internal auditors.

In addition to the communication matters described in Section 6.7.8, there are incremental requirements for PCAOB audits related to communicating control-related matters to those charged with governance and management, which include the following:

- If auditors become aware that the oversight of the entity’s external financial reporting and ICFR by the entity’s audit committee is ineffective, auditors communicate that information in writing to the board of directors.
- The auditor needs to communicate in writing information about significant deficiencies and material weaknesses before the audit report release date, instead of just on a timely basis as required by AICPA standards. For more detail on evaluating control deficiencies, see Section 3.7.4.

If members of management or those charged with governance have changed since the previous AICPA audits, auditors may decide to include the matters communicated in previous audits in the current communication. All matters must be communicated before the release of the audit report to be included in the registration statement.
Chapter 7 — What to Expect After the Registration Statement Is Declared Effective

7.1 Introduction

When preparing for an IPO, it would be prudent for management to plan for the SEC compliance and reporting requirements that will affect the company after the registration statement is declared effective. Management should analyze — and should consider engaging specialists to evaluate — whether the processes and controls the company has established to meet these requirements are appropriately designed and implemented. The company may need to develop new processes and controls to ensure that it complies with ongoing regulations fully and in a timely fashion (e.g., periodic reporting requirements, current reporting requirements, and SEC Regulation Fair Disclosure (FD)).

7.2 Periodic Reporting Requirements

After a registration statement is declared effective, a company is required to file quarterly reports on Form 10-Q and annual reports on Form 10-K. The first Form 10-Q, for the quarter after the most recent period included in the registration statement, is due the later of 45 days after the effective date or the date the Form 10-Q would otherwise be due if the company had been a public filer. For example, if a registrant with a December 31 year-end has a Form S-1 that is declared effective on July 15 and for which March 31 interim information is included in the registration statement, the registrant's first Form 10-Q would be for the second quarter ending on June 30 and would be due on August 29, 45 days after July 15. The third-quarter Form 10-Q would be due 45 days after September 30, the end of the third quarter.

A registrant's first annual report on Form 10-K would generally be due 90 days after its fiscal year-end. If the effective date of an initial registration statement was within 45 days after the fiscal year-end but the registration statement did not include the audited statements for the recently completed year, the registrant would need to file, within 90 days of effectiveness, either a full annual report on Form 10-K or a special report on Form 10-K that contains audited statements for that year.1 If a special report on Form 10-K is filed, the registrant would not be required to file a complete annual report on Form 10-K until the following fiscal year. See paragraph 1330.5 of the FRM for further details.

The filing deadlines that apply to quarterly and annual reports after the first Form 10-K are summarized in the table below. These due dates vary depending on whether the company's filing status2 is large accelerated, accelerated, or nonaccelerated. A company's filing status is determined, in part, on the basis of its public float, which is the aggregate worldwide market value of the company's voting and nonvoting common equity held by nonaffiliates. To be considered a large accelerated or accelerated filer, the

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1 If the initial registration statement was filed on Form 8-A or Form 10 to register securities under Section 12(b) or 12(g) of the 1934 Act, an annual report on Form 10-K would be due within 90 days after the registrant's fiscal year-end.

2 As defined in Section 240.12b-2 of Title 17, Code of Federal Regulations; See Section 1340 of the FRM for a summary of the accelerated filer rule.
registrant must have filed at least one annual report and must have been subject to the requirements of Sections 13(a) and 15(d) of the 1934 Act for at least 12 months. Accordingly, the registrant generally cannot be considered a large accelerated or accelerated filer for its first Form 10-K filing as a public company. However, companies that become public through a reverse merger with a public company may be required to take on the filing status of the legal acquirer and should consider carefully evaluating their filing status with their SEC counsel.

<table>
<thead>
<tr>
<th>Filer</th>
<th>Public Float</th>
<th>SEC Form 10-K</th>
<th>SEC Form 10-Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large accelerated filer</td>
<td>≥ $700 million</td>
<td>60 days after end of fiscal year</td>
<td>40 days after end of fiscal quarter</td>
</tr>
<tr>
<td>Accelerated filer</td>
<td>≥ $75 million but &lt; $700 million</td>
<td>75 days after end of fiscal year</td>
<td>40 days after end of fiscal quarter</td>
</tr>
<tr>
<td>Nonaccelerated filer</td>
<td>&lt; $75 million</td>
<td>90 days after end of fiscal year</td>
<td>45 days after end of fiscal quarter</td>
</tr>
</tbody>
</table>

7.3 Current Reporting Requirements

As a public company, a registrant is also required to file a current report on Form 8-K that discloses various material events that occur between its periodic reports, including, but not limited to:

- A public announcement or press release containing material nonpublic information about a registrant’s results of operations or financial condition for a completed quarterly or annual period.
- Entering into or terminating a material agreement not in the ordinary course of business.
- Completion of an acquisition or disposition of assets.
- Creation of a direct financial obligation or obligation under an off-balance-sheet arrangement.
- Exit or disposal activities.
- Material impairment charges under U.S. GAAP.
- Securities and trading information such as a notice of delisting, unregistered sales of equity securities, and material modifications to the rights of security holders.
- A change in its independent registered public accounting firm.
- Corporate governance matters, such as a change in control of the registrant, the appointment or departure of a principal officer, compensation agreements of certain officers, an amendment to the code of ethics, and a submission of matters for a vote by security holders.

Unless otherwise specified in the Form 8-K instructions, such events must generally be disclosed within four business days after they occur. (For additional information about many of the required Form 8-K disclosures, see the SEC’s Investor Bulletin, “How to Read an 8-K.”) Management should consider the controls and procedures in place to identify these events and report them in a timely manner. It is recommended that an entity consult with SEC counsel regarding the Form 8-K reporting requirements.

3 Paragraph 1340.2 of the FRM defines public float as “[t]he aggregate worldwide market value of its voting and non-voting common equity held by non-affiliates.” Therefore, debt-only registrants are nonaccelerated filers.
7.4 SEC Regulation FD
SEC Regulation FD requires that material nonpublic information be fully and fairly disclosed to all investors. For example, if a registrant selectively discloses material information to persons or entities such as securities analysts, money managers, activist investors, or other investors, the company must also disclose the information publicly. If the company intentionally discloses the material nonpublic information, it should make such information public at the same time as it provides the selective disclosure. If the company unintentionally discloses the information, it should provide such disclosure as soon as reasonably possible (i.e., within 24 hours or the start of the next day's trading on the New York Stock Exchange, whichever comes later). Such disclosures should be provided broadly to the public (e.g., in a Form 8-K or, in certain circumstances, on the registrant’s Web site\textsuperscript{4}). To foster compliance with Regulation FD and to prevent unintentional disclosures of material nonpublic information, registrants should consider educating management on Regulation FD and should establish strong investor relations and social media policies.

7.5 Internal Controls and Procedures
There are two types of controls and procedures that a public company will need to address in its filings with the SEC. ICFR refers to procedures within a company that are designed to reasonably ensure compliance with the company’s policies related to the preparation of financial statements that are compliant with U.S. GAAP and Regulation S-X. Disclosure controls and procedures are a broader set of controls that largely encompass ICFR and are designed to provide assurance that information that the registrant must disclose in the reports that it files or submits under the 1934 Act is recorded, processed, summarized, and reported within the periods specified.

When preparing their annual and quarterly reports, registrants need to consider the requirements related to ICFR. Management must annually file a report containing its assessment of the effectiveness of ICFR. Moreover, an auditor's attestation report on the effectiveness of ICFR must be included in annual reports of non-EGC\textsuperscript{5} accelerated and large accelerated filers. However, all newly public companies can take advantage of a phase-in exception in Regulation S-K, Item 308, under which management's report and the auditor's attestation are not required before the second annual report (i.e., until a registrant had been required to file or had filed a Form 10-K for the prior fiscal year).

Changing Lanes
On May 9, 2019, the SEC issued a proposed rule that would amend the definitions of “accelerated filer” and “large accelerated filer” to exclude any issuer with both annual revenues of less than $100 million and public float of less than $700 million. If finalized, this proposed rule would expand the number of issuers that qualify as nonaccelerated filers and are thus eligible to take advantage of certain reporting accommodations offered to such issuers, including the absence of the requirement for auditor attestation on the effectiveness of ICFR.

Also, on a quarterly basis, the company must:

- Disclose any change in its ICFR that occurred during that quarter and that materially affected, or is reasonably likely to materially affect, its ICFR.
- Evaluate and reach a conclusion about the effectiveness of the company’s disclosure controls and procedures as of the end of the quarter.

In addition to the requirements described above, as part of a company’s quarterly and annual reports, the registrant’s principal executive and principal financial officer (typically the CEO and CFO) must file certifications prescribed by Sections 302 and 906 of Sarbanes-Oxley.

\textsuperscript{5} For special relief provisions available to EGCs, see Section 1.6.
The Section 302 certifications signify that the CEO and CFO (1) have reviewed the respective quarterly or annual report; (2) do not know of any material facts that were omitted from, or untrue or misleading statements that were included in, the report; (3) believe that the financial information in the report presents fairly, in all material respects, the company's financial conditions and results of operations; (4) are responsible for establishing and maintaining disclosure controls and procedures and ICFR; and (5) have communicated all detected significant deficiencies and material weaknesses, as well as any fraud involving the company’s management, to the audit committee and the external auditors.

In the Section 906 certifications, the CEO and CFO must certify that (1) the company's quarterly or annual report complies fully with the requirements of the 1934 Act and (2) information contained in this report presents fairly, in all material respects, the company's financial condition and results of operations.

The corporate governance at many registrants includes an internal subcertification process in which other members of management help the CEO and CFO assess disclosure controls and procedures. These subcertifications cover matters consistent with those discussed in the paragraph above and are provided to the CEO and CFO before each periodic report is issued. A company may wish to consider who will be part of the subcertification process during its IPO readiness procedures.

The following table summarizes the control-related reporting requirements for various types of filers:

<table>
<thead>
<tr>
<th>Description</th>
<th>Applicable Regulation</th>
<th>Annual Reporting Requirement?</th>
<th>Interim Reporting Requirement?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s assertion on the effectiveness of disclosure controls and procedures</td>
<td>Rule 13a-15 or 15d-15 of the 1934 Act</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Management’s assertion on the effectiveness of ICFR</td>
<td>Section 404(a) of Sarbanes-Oxley, Regulation S-K, Item 308(a)</td>
<td>Newly public company filing first Form 10-K</td>
<td>No</td>
</tr>
<tr>
<td>Auditor’s report on the effectiveness of ICFR</td>
<td>Section 404(b) of Sarbanes-Oxley, Regulation S-K, Item 308(b)</td>
<td>Newly public company filing first Form 10-K</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>EGCs</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Nonaccelerated filers</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Non-EGC accelerated filer</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Large accelerated filer</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Disclosure of material changes in ICFR</td>
<td>Regulation S-K, Item 308(c)</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>CEO and CFO certifications</td>
<td>Sections 302 and 906 of Sarbanes-Oxley</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

6 Before the initial requirement to file management's assertion on the effectiveness of ICFR, the certifications may omit the specific references to ICFR.

7 For additional information about EGCs, see Section 1.6.
7.6 Other Post-IPO Considerations

In addition to current and periodic filing responsibilities, a company needs to carefully consider other topics as it moves forward as a public registrant. The company will need to establish controls and procedures to support investor relations, XBRL requirements, cybersecurity, proxy statements, compliance with the Foreign Corrupt Practices Act, tender offers, stock repurchase programs, beneficial ownership reporting, trading activities by insiders, compliance with safe harbor provision requirements related to the disclosure of forward-looking information (e.g., the Private Securities Litigation Reform Act of 1995), and disposition of restricted securities and securities held by affiliates. Because these responsibilities and requirements are far-reaching and will take time to implement, it will be important for a company to prepare to comply with them during the planning stages of its IPO. See Deloitte's Strategies for Going Public: The Changing Landscape for IPOs for more information about these requirements.

XBRL is an extensible market language (XML) standard for tagging financial reports. With XBRL, a uniform taxonomy or format is used to facilitate the transparency and comparability of information. For example, the U.S. GAAP financial reporting taxonomy consists of a list of computer-readable tags in XBRL that allows companies to label financial data presented in financial statements and footnote disclosures. On June 28, 2018, the SEC adopted amendments that require the use of inline XBRL on a phased-in basis. Inline XBRL allows filers to embed XBRL data directly into an HTML document. Domestic registrants are subject to a three-year phase-in timeline for implementation of inline XBRL, beginning with fiscal years ending on or after:

- June 15, 2019, for large accelerated filers.
- June 15, 2020, for accelerated filers.
- June 15, 2021, for all other filers.

Domestic form filers will not become subject to the requirement until their first Form 10-Q filed for a fiscal period ending on or after the applicable compliance date. As noted in Section 7.2, a registrant will generally not be considered a large accelerated or accelerated filer for its first Form 10-K filing as a public company.

7.7 Registration Statements After the IPO

After its initial registration, a domestic registrant may need to register additional securities. The SEC offers various forms to facilitate registration; the form used will depend on the type of offering undertaken by the registrant. The sections below briefly summarize the most commonly used forms. When registering securities, registrants should consider consulting their legal counsel to determine the appropriate form to file.

7.7.1 Form S-1

The Form S-1 registration statement is used (1) when no other form is prescribed by SEC rules and (2) by all issuers that have not previously filed under either the Securities Act or the Exchange Act or that have been in the Exchange Act reporting system for less than 12 months. A newly public company may use Form S-1 for a follow-on offering in which the company offers additional registered shares to the public or registers privately held shares of the company's founders, board of directors, or other large shareholders so that those shares may be sold in the public market.
Connecting the Dots

An issuer may voluntarily submit for nonpublic review a draft registration statement within one year of the effective date of either its initial Securities Act registration statement or its Exchange Act Section 12(b) registration statement. This accommodation is available only for the initial submission. A registrant that files a draft registration statement in these circumstances must subsequently respond to Division staff comments on the draft registration statement by means of a public filing rather than a revised draft registration statement. At the time of the public filing, the previously submitted draft registration statement should also be filed. The public filing must be available on EDGAR for at least 48 hours before the issuer’s requested effective date for the registration statement.

7.7.2 Form S-3

Form S-3 is a more simplified form of registration statement than a Form S-1. Eligible public companies can use Form S-3 to sell securities provided that they satisfy certain reporting status requirements. For example, a registrant:

- Must be organized under the laws of, and have its principal business operations in, the United States.
- Must be currently reporting under the 1934 Act and have filed, in a timely manner, all the information required by the 1934 Act for at least 12 calendar months immediately preceding the filing of the form.
- Must not have defaulted on any preferred stock dividend or sinking fund payment, installment on indebtedness for borrowed money, or rental under any long-term lease since the date of the last annual financial statements (unless the effects of such defaults, in the aggregate, were not material to the registrant’s consolidated financial position).

There may also be restrictions on the types or amounts of securities and offerings that may be registered by using Form S-3. A registrant should consult with legal counsel to determine a desired offering of securities that may be S-3 eligible. If a company is not eligible to use Form S-3, the offering may be made by using another appropriate securities offering form, often Form S-1. A Form S-3 can be used as a “shelf offering” in which the company does not intend to immediately sell all the securities being registered but is able to sell the registered shares in future transactions, often referred to as “takedowns” from the shelf.

7.7.3 Form S-4

Form S-4 is used for registration of securities to be issued in specified types of mergers, acquisitions, and exchange offers. For example, if a registrant’s shares are being registered and exchanged as consideration in a proposed acquisition or merger, they may be registered on Form S-4. Form S-4 may also be used to register private debt securities, previously issued under Securities Act Rule 144A, which contained registration rights requiring a future exchange of such debt for debt that is registered.

7.7.4 Form S-8

Form S-8 is used to register securities to be offered to employees as part of certain employee benefit plans. Because many newly public companies have stock compensation plans, it is common for the related shares to be registered by using Form S-8, shortly after the completion of a company’s public offering.
7.7.5  **Form S-11**
Form S-11 is used to register securities to be issued by real estate investment trusts or “other issuers whose business is primarily that of acquiring and holding for investment real estate or interests in real estate or interests in other issuers whose business is primarily that of acquiring and holding real estate or interest in real estate for investment.”

7.7.6  **Other**
There are various other forms that may also be used register securities, including forms that may be used by foreign private issuers. A more complete list of the various forms can be found on the SEC’s [Forms List](http://www.sec.gov/formslist) Web page. The individual forms and related instructions should be consulted for specific eligibility and content requirements.
Appendix A — Common Disclosures on Form S-1

A.1 Typical Sections in an IPO Registration Statement

The table below summarizes the information entities either are required to provide or often include in an IPO registration statement.

<table>
<thead>
<tr>
<th>Section</th>
<th>Section Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospectus summary (often referred to as the “box”)</td>
<td>Highlights in one consolidated location the key information related to the IPO, such as a summary of the company and its business, the nature of the securities being offered, primary risk factors, and summarized financial information.</td>
</tr>
<tr>
<td>Risk factors</td>
<td>Highlights the company's most significant risk factors. Risk factors should be specific to the company.</td>
</tr>
<tr>
<td>Use of proceeds</td>
<td>Describes the primary intended use of the net proceeds. Examples of typical uses may include acquisitions, capital expenditures, debt reduction, and general corporate purposes.</td>
</tr>
<tr>
<td>Dividend policy</td>
<td>Discusses current dividend policy and any anticipated changes to the policy.</td>
</tr>
<tr>
<td>Capitalization</td>
<td>A table presenting the capital structure of the company before and after the offering is often presented.</td>
</tr>
<tr>
<td>Dilution</td>
<td>Disclosure, often in a tabular format, of any material difference between the IPO price of the securities and the net tangible book value per share.</td>
</tr>
<tr>
<td>Selected financial data</td>
<td>Comparative selected financial data, typically for the last five fiscal years and any interim periods.</td>
</tr>
<tr>
<td>Management's Discussion and Analysis (MD&amp;A)</td>
<td>Discusses the company's financial condition and results of operations for the periods presented, including forward-looking information.</td>
</tr>
<tr>
<td>Business</td>
<td>Contains extensive disclosure and discussion about a company's business, including, but not limited to, its industry, customers, products and services, properties, operating segments, and significant litigation and contingencies.</td>
</tr>
<tr>
<td>Executive officers, directors, and principal and selling stockholders</td>
<td>A company's executive officers and directors must be identified. A brief summary of the relevant business experience for each must also be disclosed. In addition, a company must disclose the name and beneficial stock ownership of each director/selling stockholder, executive officer, all directors and executive officers as a group, and each known 5 percent stockholder.</td>
</tr>
<tr>
<td>Executive compensation</td>
<td>Highlights the key provisions of the compensation arrangements of executive officers and directors.</td>
</tr>
<tr>
<td>Description of capital stock</td>
<td>Summarizes the terms of capital stock outstanding after the IPO, including the number of stockholders and shares, rights to acquire capital stock, and any anti-takeover provisions.</td>
</tr>
</tbody>
</table>
## Appendix A — Common Disclosures on Form S-1

(Table continued)

<table>
<thead>
<tr>
<th>Section</th>
<th>Section Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underwriting/plan of distribution</td>
<td>Discloses the price of the securities being offered, the names of the managing underwriters and other members of the underwriting syndicate, and underwriting discounts and any other compensation arrangements with the underwriters.</td>
</tr>
<tr>
<td>Experts</td>
<td>Identifies any parties or persons who have prepared or certified any part of the prospectus (e.g., an independent registered public accounting firm that audits the financial statements included therein).</td>
</tr>
<tr>
<td>Financial statements</td>
<td>Any required annual or interim financial statements of the registrant or other entities. (See Chapter 2 for further details.)</td>
</tr>
<tr>
<td>Other disclosures</td>
<td>Certain relationships and related-party transactions, material income tax consequences, and legal matters.</td>
</tr>
</tbody>
</table>
Appendix B — Summary of Scaled Disclosure Requirements Available to SRCs

The tables below compare certain requirements under Regulations S-K and S-X for SEC registrants\(^1\) and the related SRC scaled disclosures.

**Disclosure Requirements Under Regulation S-K**

<table>
<thead>
<tr>
<th>Regulation S-K Item</th>
<th>Summary of Disclosure</th>
<th>SRC Scaled Disclosure</th>
<th>Registrants Other Than SRCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item 101, “Description of Business”</td>
<td>Description of business developments, including principal products and services rendered</td>
<td>Last three years, and certain description requirements may be less detailed</td>
<td>Last five years</td>
</tr>
<tr>
<td>Item 201, “Market Price of and Dividends on the Registrant’s Common Equity and Related Stockholder Matters”</td>
<td>A graph depicting share performance over the past five years against market indexes</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td>Item 301, “Selected Financial Data”</td>
<td>A table disclosing key financial results for the past five years</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td>Item 302, “Supplementary Financial Information”</td>
<td>Unaudited quarterly information for the most recent eight fiscal quarters</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td>Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”</td>
<td>Discussion of results of operations</td>
<td>Discuss prior two years</td>
<td>Discuss prior three years</td>
</tr>
<tr>
<td></td>
<td>Tabular disclosure of contractual obligations</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td>Item 305, “Quantitative and Qualitative Disclosures About Market Risk”</td>
<td>Disclosure of information about market sensitive instruments and related exposure, including sensitivity analysis</td>
<td>Not required</td>
<td>Required</td>
</tr>
</tbody>
</table>

\(^1\) The disclosures identified in the “Registrants Other Than SRCs” column do not contemplate certain scaled disclosure requirements available to EGCs.
### (Table continued)

<table>
<thead>
<tr>
<th>Regulation S-K Item</th>
<th>Summary of Disclosure</th>
<th>SRC Scaled Disclosure</th>
<th>Registrants Other Than SRCs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Item 402, “Executive Compensation”</strong></td>
<td>Number of named executive officers</td>
<td>Three</td>
<td>Five</td>
</tr>
<tr>
<td><strong>Item 404, “Transactions With Related Persons, Promoters and Certain Control Persons”</strong></td>
<td>Scope of summary compensation table</td>
<td>Two years</td>
<td>Three years</td>
</tr>
<tr>
<td><strong>Item 407, “Corporate Governance”</strong></td>
<td>Compensation discussion and analysis, grants of plan-based awards table, option exercises and stock vested table, pension benefits table, nonqualified deferred compensation table, disclosure of compensation policies and practices related to risk management, pay ratio disclosure</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 503, “Prospectus Summary”</strong></td>
<td>Description of policies/procedures for the review, approval, or ratification of related-party transactions</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 601, “Exhibits”</strong></td>
<td>Disclosure of audit committee financial expert</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 601, “Exhibits”</strong></td>
<td>Disclosure of compensation committee interlocks and insider participation</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 503, “Prospectus Summary”</strong></td>
<td>Compensation committee report</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 503, “Prospectus Summary”</strong></td>
<td>Discussion of the most significant risk factors facing the company</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 503, “Prospectus Summary”</strong></td>
<td>Statement of ratio of earnings to fixed charges</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Item 601, “Exhibits”</strong></td>
<td>Statement regarding computation of ratios</td>
<td>Not required</td>
<td>Required</td>
</tr>
</tbody>
</table>
## Financial Statement Requirements Under Regulation S-X

<table>
<thead>
<tr>
<th>Financial Statement Requirements²</th>
<th>Summary of Disclosure</th>
<th>SRC Scaled Disclosure</th>
<th>Registrants Other Than SRCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual financial statements</td>
<td>Annual audited financial statements</td>
<td>Two years balance sheet, income statement, cash flow, and shareholders' equity</td>
<td>Three years income statement, cash flow, and shareholders' equity, two years balance sheet</td>
</tr>
</tbody>
</table>

Footnote and other disclosures

| Disclosure of accounting policy related to certain derivative instruments (Rule 4-08(n)) | Required | Required |
| Disclosure of certain information related to guaranteed or collateralized securities (Rule 3-10 and Rule 3-16) | Required | Required |
| Compliance with auditor independence requirements (Article 2) | Required | Required |
| Supplemental financial statement schedules | Not required | Required |

² SRCs apply the requirements in Regulation S-X, Article 8, when preparing their financial statements. SRCs typically are not required to apply the disclosure provisions of Regulation S-X in their entirety unless Article 8 indicates otherwise. Registrants other than SRCs should apply Regulation S-X in its entirety, as applicable.
## Appendix B — Summary of Scaled Disclosure Requirements Available to SRCs

### (Table continued)

<table>
<thead>
<tr>
<th>Financial Statement Requirements</th>
<th>Summary of Disclosure</th>
<th>SRC Scaled Disclosure</th>
<th>Registrants Other Than SRCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statements of businesses acquired or to be acquired</td>
<td>Audited historical financial statements for acquired or to be acquired businesses</td>
<td>No more than two years are required&lt;sup&gt;3&lt;/sup&gt;</td>
<td>Up to three years may be required depending on significance</td>
</tr>
<tr>
<td><strong>Pro forma financial information</strong></td>
<td><strong>Pro forma financial information should be provided in certain filings (Article 11&lt;sup&gt;4&lt;/sup&gt;)</strong></td>
<td><strong>Required in fewer circumstances</strong></td>
<td><strong>Required</strong></td>
</tr>
<tr>
<td>Real estate operations acquired or to be acquired</td>
<td>Audited historical financial statements for acquired or to be acquired real estate operations</td>
<td>No more than two years are required</td>
<td>Up to three years may be required depending on significance</td>
</tr>
<tr>
<td>Financial information of equity method investees (EMIs)</td>
<td>Summarized financial data of the EMI disclosed in the registrant’s financial statements</td>
<td>Required if the EMI exceeds 20 percent significance in both interim and annual periods</td>
<td>Required if the EMI exceeds 20 percent significance at interim periods, or 10 percent significance for the annual period&lt;sup&gt;5&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Audited historical financial statements of the EMI</td>
<td>Only required if EMI financial statements would be “material to investors”&lt;sup&gt;6&lt;/sup&gt;</td>
<td>Required if the EMI exceeds 20 percent significance&lt;sup&gt;7&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

---

<sup>3</sup> Sales, gross profit, net income (loss) from continuing operations, net income, and net income attributable to the investee must be disclosed for equity investees that constitute 20 percent or more of a registrant’s consolidated assets, equity, or income from continuing operations attributable to the registrant.

<sup>4</sup> If an SRC acquires a non-SRC company that reports under the Exchange Act, the SEC may require three years of audited financial statements for the acquired entity.

<sup>5</sup> Regulation S-X, Rule 4-08(g) and Rule 10-01(b)(1), prescribe the annual requirements for summarized financial information and the interim requirements for summarized income statement information, respectively.

<sup>6</sup> See paragraph 5330.2 of the FRM.

<sup>7</sup> Regulation S-X, Rule 3-09, prescribes the annual requirements for financial statements of an EMI. See Deloitte’s *A Roadmap to SEC Reporting Considerations for Equity Method Investees* for further guidance on evaluating the significance of EMIs.
Appendix C — Key Benefits Available to EGCs and Non-EGCs

The table below compares certain benefits available to EGCs and non-EGCs.

<table>
<thead>
<tr>
<th>Description of Benefit</th>
<th>EGCs¹,²</th>
<th>Non-EGCs³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Submit draft registration statements for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities Act IPOs and initial registration statements</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Exchange Act Section 12(b) registration statement (e.g., Form 10)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Securities Act offerings within one year of an IPO or Exchange Act Section 12(b) registration statement</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Omit financial information⁴ from a draft registration statement if the company reasonably believes that it will not be required:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>At the time of the offering⁵</td>
<td>X⁶</td>
<td></td>
</tr>
<tr>
<td>At the time of the public filing</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Include only two years of audited annual financial statements in:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>An IPO of common equity securities</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>An IPO of debt securities or Exchange Act registration statements (e.g., Form 10)</td>
<td>(7)</td>
<td></td>
</tr>
<tr>
<td>May limit the annual financial statements of significant acquisitions under Rule 3-05 or equity method investments under Rule 3-09 to a maximum of two years in:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>An IPO of common equity securities</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>An IPO of debt securities or Exchange Act registration statements (e.g., Form 10)</td>
<td>(7)</td>
<td></td>
</tr>
<tr>
<td>Not required to present selected financial data⁸ for periods before the earliest year of financial statements presented in the IPO</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>May elect to defer the adoption of new or revised accounting standards until they become effective for private companies (i.e., nonissuers)⁹</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

¹ See Topic 10 of the FRM for additional information about the eligibility requirements for, and accommodations available to, EGCs.
² See Topic 5 of the FRM for information about the eligibility requirements for, and additional relief available to, smaller reporting companies.
³ See footnote 2.
⁴ We believe this may also include financial information of entities other than the registrant (i.e., under Regulation S-X, Rule 3-05 or 3-09).
⁵ The general instructions to Form S-1 and Form F-1 indicate that before the registrant distributes a preliminary prospectus to investors, the registration statement must be amended to include all financial information required under Regulation S-X.
⁶ This applies only to IPOs of debt or equity securities on Form S-1 or Form F-1. For example, it would not apply to draft registration statements on Form S-11 or Form 10.
⁷ An EGC would generally be required to present three years of financial statements for an IPO of debt securities or a registration statement on Form 10. See paragraph 10220.1 of the FRM for more information.
⁸ In accordance with Regulation S-K, Item 301.
⁹ EGCs should refer to Section 10230 of the FRM for more information.
### Description of Benefit

<table>
<thead>
<tr>
<th>Description of Benefit</th>
<th>EGCs</th>
<th>Non-EGCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible for reduced executive compensation disclosures</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>May omit management's assessment of ICFR under Sarbanes-Oxley Act (SOX) Section 404(a)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>in the first Form 10-K after an IPO</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May omit the auditor's assessment under SOX Section 404(b):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In the first Form 10-K after an IPO</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>In the next four annual periods if the registrant continues to qualify as an EGC</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

The table above is not intended to be all-inclusive. We recommend that an issuer refer to SEC regulations, read the guidance in the FRM, and consult with its external auditors and SEC counsel on the application of SEC reporting requirements before submitting any registration statement or current report on Form 10-K.
Appendix D — Changes Made in the 2019 Edition of This Publication

The tables below summarize the substantive changes made in the 2019 edition of this Roadmap.

**New Content**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.7</td>
<td>Special-Purpose Acquisition Companies</td>
<td>New section that provides an overview of SPACs and filing requirements for when a SPAC acquires a private operating company to facilitate an IPO.</td>
</tr>
<tr>
<td>1.8</td>
<td>Offerings Made in Accordance with Regulation A</td>
<td>New section that provides guidance on public offerings made in accordance with Regulation A and related filing requirements.</td>
</tr>
<tr>
<td><strong>Introduction to Chapter 2</strong></td>
<td>Identifying the Required Financial Statements for the Registration Statement</td>
<td>Added “Changing Lanes” section to discuss the SEC proposed rule that was issued on May 3, 2019, which would amend the financial statement requirements for (1) acquired or to be acquired businesses in Rule 3-05, (2) real estate operations in Rule 3-14, and (3) pro forma financial information in Article 11. The proposal would also make certain modifications to the significance tests in Rule 1-02(w).</td>
</tr>
<tr>
<td>3.6.2</td>
<td>Article 8 — Financial Statements of Smaller Reporting Companies</td>
<td>New section that provides guidance on financial statement requirements for SRCs under Regulation S-X, Article 8.</td>
</tr>
<tr>
<td>4.4</td>
<td>Pro Forma Financial Information</td>
<td>Added “Changing Lanes” section to discuss the SEC proposed rule that was issued on May 3, 2019, which would, among other changes, amend the financial statement requirements for pro forma financial information in Article 11.</td>
</tr>
<tr>
<td>5.9.5</td>
<td>Additional Disclosure Requirements</td>
<td>Added “Changing Lanes” section to discuss the FASB's March 2019 proposed ASU that would add, remove, and modify certain disclosure requirements in ASC 740 and is aimed at improving the effectiveness of income tax disclosures in notes to financial statements.</td>
</tr>
</tbody>
</table>
### Appendix D — Changes Made in the 2019 Edition of This Publication

#### (Table continued)

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.7.8.3</td>
<td>Form of Auditor's Report</td>
<td>Added discussion of SAS 134, which was issued by the AICPA’s Auditing Standards Board in May 2019. SAS 134 addresses the auditor’s responsibility to form an opinion on the financial statements and the form and content of the auditor’s report issued as a result of an audit of the financial statements.</td>
</tr>
<tr>
<td>7.5</td>
<td>Internal Controls and Procedures</td>
<td>Added “Changing Lanes” section to discuss the SEC proposed rule that was issued on May 9, 2019, which would amend the definitions of “accelerated filer” and “large accelerated filer” to exclude any issuer with both annual revenues of less than $100 million and public float of less than $700 million.</td>
</tr>
<tr>
<td>7.6</td>
<td>Other Post-IPO Considerations</td>
<td>Added discussion of amendments adopted by the SEC on June 28, 2018, which require the use of inline XBRL on a phased-in basis. Included discussion of the three-year phase-in timeline for implementation of inline XBRL.</td>
</tr>
<tr>
<td>7.7</td>
<td>Registration Statements After the IPO</td>
<td>New section that discusses the registration of additional securities by an entity after its IPO. The section discusses registration via the following most commonly used forms: Form S-1, Form S-3, Form S-4, Form S-8, and Form S-11.</td>
</tr>
</tbody>
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#### Renumbered Sections

<table>
<thead>
<tr>
<th>2019</th>
<th>2018</th>
<th>Title</th>
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<tr>
<td>2.3.5</td>
<td>2.4.5</td>
<td>Rule 3-13 Waivers and Other Requests</td>
</tr>
<tr>
<td>5.8.2.4</td>
<td>5.6.8</td>
<td>Escrowed Stock Arrangements</td>
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</table>

#### Amended or Deleted Content

The following table summarizes the content that was amended or deleted as part of the 2019 refresh of this Roadmap:

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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<tbody>
<tr>
<td>2.6.3</td>
<td>Summarized Interim Financial Information (Rule 10-01(b))</td>
<td>Renamed from “Interim Financial Information.&quot;</td>
</tr>
<tr>
<td>3.7.4</td>
<td>Impact on Internal Control</td>
<td>Deleted “Connecting the Dots” section discussing proactive disclosures about any material weaknesses identified by management during the IPO process.</td>
</tr>
<tr>
<td>Section</td>
<td>Title</td>
<td>Description</td>
</tr>
<tr>
<td>---------</td>
<td>---------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>5.2.3</td>
<td>Reorganization in Anticipation of a Transaction</td>
<td>Renamed from “Pushdown Accounting.” Amended guidance to discuss an entity’s reorganization of its business in anticipation of a spin-off or IPO and resulting accounting implications.</td>
</tr>
<tr>
<td>5.5.2</td>
<td>Derivatives</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to the Issuer’s Accounting for Convertible Debt</em> and <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.6.1</td>
<td>Sequence of Decision Making</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to Distinguishing Liabilities From Equity</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.6.2</td>
<td>Redeemable Equity Securities (EITF Topic D-98)</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to Distinguishing Liabilities From Equity</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.6.3</td>
<td>Preferred Stock That Is Nonredeemable or Redeemable Solely at the Option of the Issuer</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to Distinguishing Liabilities From Equity</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.6.4</td>
<td>Conversion Features of Preferred Stock and Debt</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to the Issuer’s Accounting for Convertible Debt</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.8.1.1.6</td>
<td>Purchase of Stock From Employees</td>
<td>Renamed from “Share-Based Transactions With Employees.”</td>
</tr>
<tr>
<td>5.8.2.2</td>
<td>Substantive Classes of Equity</td>
<td>Added discussion of what happens to a vested residual interest after termination of employment and how this affects the evaluation of whether profits interests represent a substantive class of equity.</td>
</tr>
<tr>
<td>5.9.1.1</td>
<td>Separate-Return Method</td>
<td>Organized guidance related to the “separate-return” approach, which was included in the 2018 version of the Roadmap, into a new subsection, 5.9.1.1.</td>
</tr>
<tr>
<td>5.9.2</td>
<td>Change in Tax Status</td>
<td>Amended discussion of the recognition tax effects arising in connection with a change in tax status, noting that an entity may (1) recognize deferred tax effects within continuing operations and recognize the step-up in tax basis within equity or (2) recognize all tax effects within continuing operations.</td>
</tr>
<tr>
<td>5.10.1</td>
<td>Changes in Capitalization</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to the Presentation and Disclosure of Earnings per Share</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.10.2</td>
<td>Treasury Stock Method</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to the Presentation and Disclosure of Earnings per Share</em> for further guidance related to this topic.</td>
</tr>
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</table>
### Appendix D — Changes Made in the 2019 Edition of This Publication

(Table continued)

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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<tbody>
<tr>
<td>5.10.3</td>
<td>Contingently Issuable Shares</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to the Presentation and Disclosure of Earnings per Share</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>5.10.4</td>
<td>Participating Securities</td>
<td>Deleted. See Deloitte’s <em>A Roadmap to the Presentation and Disclosure of Earnings per Share</em> for further guidance related to this topic.</td>
</tr>
<tr>
<td>6.7.3</td>
<td>Auditor Responses to Significant Risks</td>
<td>Deleted.</td>
</tr>
<tr>
<td>6.7.4</td>
<td>Substantive Analytical Procedures</td>
<td>Deleted.</td>
</tr>
<tr>
<td>6.7.7.1</td>
<td>Subsequent Events</td>
<td>Amended discussion of subsequent events to focus on considerations that are most relevant for an entity contemplating an IPO.</td>
</tr>
<tr>
<td>Appendix A</td>
<td>Common Disclosures on Form S-1</td>
<td>Renamed from “Other Resources.”</td>
</tr>
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</table>
Appendix E — Titles of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

**AICPA Literature**

**Accounting and Valuation Guide**
*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*

**Professional Standard**
*AU-C Section 600, “Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)”*

**Statements on Auditing Standards**
*No. 131, Amendment to Statement on Auditing Standards No. 122 Section 700, Forming an Opinion and Reporting on Financial Statements*
*No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*

**FASB Literature**

**ASC Topics**
*ASC 250, Accounting Changes and Error Corrections*
*ASC 260, Earnings per Share*
*ASC 270, Interim Reporting*
*ASC 280, Segment Reporting*
*ASC 310, Receivables*
*ASC 340, Other Assets and Deferred Costs*
*ASC 470, Debt*
*ASC 480, Distinguishing Liabilities From Equity*
*ASC 505, Equity*
*ASC 606, Revenue From Contracts With Customers*
*ASC 710, Compensation — General*
Appendix E — Titles of Standards and Other Literature

ASC 718, Compensation — Stock Compensation
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 842, Leases
ASC 845, Nonmonetary Transactions
ASC 850, Related Party Disclosures
ASC 855, Subsequent Events

ASUs
ASU 2013-12, Definition of a Public Business Entity: An Addition to the Master Glossary
ASU 2016-09, Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting
ASU 2017-09, Compensation — Stock Compensation (Topic 718): Scope of Modification Accounting
ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

Proposed ASU

IRC
Section 162, “Trade or Business Expenses”
Section 336, “Gain or Loss Recognized on Property Distributed in Complete Liquidation”
Section 382, “Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change”
Section 422, “Incentive Stock Options”
Section 423, “Employee Stock Purchase Plans”
Section 754, “Manner of Electing Optional Adjustment to Basis of Partnership Property”

PCAOB Literature

Auditing Standards
No. 1301, Communications With Audit Committees
No. 2101, Audit Planning
No. 2110, Identifying and Assessing Risks of Material Misstatement

No. 2410, *Related Parties*

No. 4105, *Reviews of Interim Financial Information*

**Rules**

Rule 2100, “Registration Requirements for Public Accounting Firms”

Rule 3526, “Communication With Audit Committees Concerning Independence”

**SEC Literature**

**ASR**

No. 268, *Presentation in Financial Statements of “Redeemable Preferred Stocks”* (Rule 5-02.28 of SEC Regulation S-X)

**Final Rule**

No. 33-10532, *Disclosure Update and Simplification*

**FRM**

Topic 1, “Registrant’s Financial Statements”

Topic 2, “Other Financial Statements Required”

Topic 3, “Pro Forma Financial Information”

Topic 4, “Independent Accountants’ Involvement”

Topic 5, “Smaller Reporting Companies”

Topic 6, “Foreign Private Issuers & Foreign Businesses”

Topic 7, “Related Party Matters”

Topic 9, “Management’s Discussion and Analysis of Financial Position and Results of Operations (MD&A)”

Topic 10, “Emerging Growth Companies”

Topic 12, “Reverse Acquisitions and Reverse Recapitalizations”

**Industry Guide**

Industry Guide 5, “Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships”

**Interpretive Release**

No. 34-58288, *Commission Guidance on the Use of Company Web Sites*

**Proposed Rules**

No. 33-10526, *Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities*

No. 33-10607, *Solicitations of Interest Prior to a Registered Public Offering*
Appendix E — Titles of Standards and Other Literature

No. 33-10635, *Amendments to Financial Disclosures About Acquired and Disposed Businesses*

No. 34-85814, *Amendments to the Accelerated Filer and Large Accelerated Filer Definitions*

**Regulation S-K**

Item 10(e), “Use of Non-GAAP Financial Measures in Commission Filings”

Item 101, “Description of Business”

Item 201, “Market Price of and Dividends on the Registrant’s Common Equity and Related Stockholder Matters”

Item 301, “Selected Financial Data”

Item 302, “Supplementary Financial Information”

Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”
  - Item 303(a), “Full Fiscal Years”
  - Item 303(b), “Interim Periods”

Item 305, “Quantitative and Qualitative Disclosures About Market Risk”

Item 308, “Internal Control Over Financial Reporting”
  - Item 308(c), “Changes in Internal Control Over Financial Reporting”

Item 402, “Executive Compensation”

Item 404, “Transactions With Related Persons, Promoters and Certain Control Persons”
  - Item 404(a), “Transactions With Related Persons”
  - Item 404(b), “Review, Approval or Ratification of Transactions With Related Persons”

Item 407, “Corporate Governance”

Item 503, “Prospectus Summary”

Item 601, “Exhibits”

Item 901(c), “Definitions” (roll-up transaction)

**Regulation S-X**

Rule 1-02(w), “Significant Subsidiary”

Rule 1-02(bb), “Summarized Financial Information”

Article 2, “Qualifications and Reports of Accountants”

Rule 3-02, “Consolidated Statements of Comprehensive Income and Cash Flows”

Rule 3-03, “Instructions to Statement of Comprehensive Income Requirements”

Rule 3-04, “Changes in Stockholders’ Equity and Noncontrolling Interests”

Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”
  - Rule 3-05(a), “Financial Statements Required”
Rule 3-06, “Financial Statements Covering a Period of Nine to Twelve Months”

Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”

Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”
  - Rule 3-10(g), “Recently Acquired Subsidiary Issuers or Subsidiary Guarantors”
  - Rule 3-10(i), “Instructions for Preparation of Condensed Consolidating Financial Information Required by Paragraphs (c), (d), (e) and (f) of This Section”

Rule 3-12, “Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement”

Rule 3-13, “Filing of Other Financial Statements in Certain Cases”

Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired”

Rule 3-16, “Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered”

Article 4, “Rules of General Application”
  - Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
  - Rule 4-08(h), “Income Tax Expense”
  - Rule 4-08(k), “Related Party Transactions Which Affect the Financial Statements”
  - Rule 4-08(n), “Accounting Policies for Certain Derivative Instruments”

Article 5, “Commercial and Industrial Companies”
  - Rule 5-02, “Balance Sheets”
  - Rule 5-03, “Income Statements”

Article 6, “Registered Investment Companies and Business Development Companies”

Article 7, “Insurance Companies”

Article 9, “Bank Holding Companies”

Rule 10-01, “Interim Financial Statements”
  - Rule 10-01(b), “Other Instructions as to Content”

Article 11, “Pro Forma Financial Information”
  - Rule 11-01, “Presentation Requirements”
  - Rule 11-02, “Preparation Requirements”

Rule 12-09, “Valuation and Qualifying Accounts”

Rule 12-28, “Real Estate and Accumulated Depreciation”

**SAB Topics**

Appendix E — Titles of Standards and Other Literature

- No. 1.B.1, “Costs Reflected in Historical Financial Statements”
- No. 1.B.3, “Other Matters”

No. 1.J, “Application of Rule 3-05 in Initial Public Offerings”

No. 1.M, “Materiality” (SAB 99)

No. 1.N, “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements” (SAB 108)

No. 4.C, “Change in Capital Structure”

No. 4.E, “Receivables From Sale of Stock”

No. 5.A, “Miscellaneous Accounting; Expenses of Offering”

No. 14, “Share-Based Payment”

**Securities Act of 1933**

Section 7, “Information Required in Registration Statement”

Rule 144A, “Private Resales of Securities to Institutions”

**Securities Exchange Act of 1934**

Rule 13a-15, “Controls and Procedures”

Rule 15d-15, “Controls and Procedures”

Section 3, “Definitions and Application of Title”

Section 12, “Registration Requirements for Securities”

Section 13, “Periodical and Other Reports”

Section 15(d), “Registration and Regulation of Brokers and Dealers; Supplementary and Periodic Information”

**Superseded Literature**

**Accounting Interpretation of APB Opinion of Opinion No. 25**

A1N-APB Opinion No. 25, Accounting for Stock Issued to Employees: Accounting Interpretations of APB Opinion No. 25

**Accounting Principles Board Opinion (APB)**

No. 25, Accounting for Stock Issued to Employees
**EITF Issues**

89-11, “Sponsor’s Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan”


00-23, “Issues Related to the Accounting for Stock Compensation Under APB Opinion No. 25 and FASB Interpretation No. 44”

**FASB Statement**

No. 123(R), *Share-Based Payment*
# Appendix F — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AETR</td>
<td>annual effective tax rate</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASR</td>
<td>SEC Accounting Series Release</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>BCF</td>
<td>beneficial conversion feature</td>
</tr>
<tr>
<td>CAM</td>
<td>critical audit matter</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CEO</td>
<td>chief executive officer</td>
</tr>
<tr>
<td>CF-OCA</td>
<td>SEC Division of Corporation Finance, Office of the Chief Accountant</td>
</tr>
<tr>
<td>CFO</td>
<td>chief financial officer</td>
</tr>
<tr>
<td>CODM</td>
<td>chief operating decision maker</td>
</tr>
<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
</tr>
<tr>
<td>DTA</td>
<td>deferred tax asset</td>
</tr>
<tr>
<td>DTL</td>
<td>deferred tax liability</td>
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<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
</tr>
<tr>
<td>EDGAR</td>
<td>SEC’s Electronic Data Gathering, Analysis, and Retrieval system</td>
</tr>
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<td>EGC</td>
<td>emerging growth company</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
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<tr>
<td>EMI</td>
<td>equity method investee</td>
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<td>EPS</td>
<td>earnings per share</td>
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<td>ESPP</td>
<td>employee stock purchase plan</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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</table>

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>FRM</td>
<td>SEC Division of Corporation Finance’s Financial Reporting Manual</td>
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<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<tr>
<td>GAAS</td>
<td>generally accepted auditing standards</td>
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<td>ICFR</td>
<td>internal control over financial reporting</td>
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<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
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<td>IRC</td>
<td>Internal Revenue Code</td>
</tr>
<tr>
<td>IRR</td>
<td>internal rate of return</td>
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<tr>
<td>IRS</td>
<td>Internal Revenue Service</td>
</tr>
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<td>ISO</td>
<td>incentive stock option</td>
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<tr>
<td>KPI</td>
<td>key performance indicator</td>
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<td>LLC</td>
<td>limited liability company</td>
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<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
</tr>
<tr>
<td>NSO or NQSO</td>
<td>nonstatutory option</td>
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<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>PBE</td>
<td>public business entity</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PCC</td>
<td>Private Company Council</td>
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<tr>
<td>REIT</td>
<td>real estate investment trust</td>
</tr>
<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SAS</td>
<td>AICPA Statement on Auditing Standard</td>
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<tr>
<td>S&amp;P</td>
<td>Standard &amp; Poor’s</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td>SFD</td>
<td>selected financial data</td>
</tr>
<tr>
<td>SPAC</td>
<td>special-purpose acquisition company</td>
</tr>
<tr>
<td>SRC</td>
<td>smaller reporting company</td>
</tr>
<tr>
<td>XBRL</td>
<td>eXtensible Business Reporting Language</td>
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The following is a list of short references for the Acts mentioned in this publication:

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Act</th>
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<tbody>
<tr>
<td>Dodd-Frank Act or Dodd-Frank</td>
<td>Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
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<tr>
<td>Exchange Act or 1934 Act</td>
<td>Securities Exchange Act of 1934</td>
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<tr>
<td>FAST Act</td>
<td>Fixing America’s Surface Transportation Act</td>
</tr>
<tr>
<td>JOBS Act</td>
<td>Jumpstart Our Business Startups Act</td>
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<tr>
<td>Sarbanes-Oxley Act or Sarbanes-Oxley</td>
<td>Sarbanes-Oxley Act of 2002</td>
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<tr>
<td>Securities Act or 1933 Act</td>
<td>Securities Act of 1933</td>
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<tr>
<td>Tax Act</td>
<td>Tax Cuts and Jobs Act of 2017</td>
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