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Other Deloitte publications, such as our Roadmap series, are available on the Deloitte Accounting Research Tool (DART), a comprehensive online library of accounting and financial disclosure literature. The Roadmap series includes titles on the following topics:

- Business Combinations
- Business Combinations — SEC Reporting Considerations
- Carve-Out Transactions
- Comparison of IFRS Standards and U.S. GAAP
- Consolidation — Identifying a Controlling Financial Interest
- Contingencies and Loss Recoveries
- Contracts on an Entity’s Own Equity
-Convertible Debt
- Current Expected Credit Losses
- Disposals of Long-Lived Assets and Discontinued Operations
- Distinguishing Liabilities From Equity
- Earnings per Share
- Environmental Obligations and Asset Retirement Obligations
- Equity Method Investments and Joint Ventures
- Equity Method Investees — SEC Reporting Considerations
- Fair Value Measurements and Disclosures
- Foreign Currency Transactions and Translations
- Income Taxes
- Initial Public Offerings
- Leases
- Noncontrolling Interests
- Non-GAAP Financial Measures
- Revenue Recognition
- SEC Comment Letter Considerations, Including Industry Insights
- Segment Reporting
- Share-Based Payment Awards
- Statement of Cash Flows
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About Deloitte’s Life Sciences and Health Care Practice

Deloitte and its subsidiaries have approximately 312,000 professionals with a single focus: serving our clients and helping them solve their toughest problems. Deloitte’s Life Sciences and Health Care practice is among the largest in the world, leveraging the extensive knowledge, skills, and experience of over 24,000 professionals in 90 countries. Our practice offers a distinctive menu of professional services delivered in an integrated approach that address all segments of the life sciences and health care industry. We work in four key business areas — audit, advisory, tax, and consulting — but our real strength comes from combining the talents of those groups to address clients’ needs. Bloomberg Businessweek and Fortune consistently rank our organization among the best places in which to work, which is good news for our talent and our clients alike. When the best people tackle the most compelling challenges, everyone wins.

If you have any questions about this publication or ways in which we can help your organization, please contact the following Deloitte industry specialists.

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- Chapter 2 — Revenue Recognition
- Chapter 3 — Research and Development
- Chapter 4 — Acquisitions and Divestitures
- Chapter 5 — Consolidation
- Chapter 6 — Contingencies and Loss Recoveries
- Chapter 7 — Statement of Cash Flows
- Chapter 8 — Income Taxes
- Chapter 9 — Compensation
- Chapter 10 — Financial Instruments
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Preface

March 2020

To our clients, colleagues, and other friends:

The life sciences ecosystem encompasses a vast array of entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and medical equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the industry face complex issues and must exercise significant judgment in applying existing rules to matters such as research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The 2020 edition of Deloitte's Life Sciences Industry Accounting Guide (the “Guide”) addresses these and other relevant topics affecting the industry this year. It includes interpretive guidance, illustrative examples, recent standard-setting developments (through February 28, 2020), and key differences between U.S. GAAP and IFRS® Standards. In addition, this Guide discusses the outlook for the life sciences industry in 2020. Further, while many of the key accounting and financial reporting considerations stemming from the coronavirus disease 2019 (COVID-19) outbreak are related to topics addressed in this Guide, we encourage you to review Deloitte’s March 25, 2020, Financial Reporting Alert, which discusses accounting and financial reporting considerations associated with COVID-19 that are broadly applicable as well as those that apply specifically to the life sciences industry.

Appendix B lists the titles of standards and other literature we cited, and Appendix C defines the abbreviations we used.

This Guide is available on the Deloitte Accounting Research Tool (DART).

We hope this Guide helps you navigate the various accounting and reporting challenges you face. We encourage you to contact your Deloitte team for additional information and assistance.

Sincerely,

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Chapter 12 — Initial Public Offerings

12.1 Introduction
In recent years, there have been an increasing number of life sciences initial public offerings (IPOs). Nearly 40 percent of all IPOs from 2015 through mid-2019 were in the life sciences industry, as compared with only 19 percent during the preceding 10-year period. The majority of those life sciences IPOs were in the biotechnology subsector, with many qualifying for emerging growth company (EGC) and smaller reporting company (SRC) filing status.

12.1.1 Emerging Growth Companies
12.1.1.1 What Are EGCs?
An EGC is a category of issuer that was established in 2012 under the Jumpstart Our Business Startups Act (commonly referred to as the JOBS Act). EGCs were granted additional accommodations in 2015 under the Fixing America’s Surface Transportation Act (commonly referred to as 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.

12.1.1.2 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.
- 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.

---

1 Statistics compiled from publicly available historical IPO information furnished by Nasdaq and Yahoo.
2 This accommodation is limited to an IPO of common equity. As the SEC clarifies in paragraph 10220.1 of the SEC Financial Reporting Manual (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.
3 This accommodation is available to non-EGCs as well.
4 See footnote 3.
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 SEC Regulation S-X, Rules 3-05 and 3-09.

In addition, an entity 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, at which time all drafts that were previously submitted to the SEC staff for confidential review will become public as well. In addition, any related comment letters and responses that the EGC submitted to the SEC staff will be publicly released on EDGAR by the staff after the IPO registration statement becomes effective.

After the SEC registrant’s IPO, provided that the 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 internal control over financial reporting. 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 were required for certain other issuers beginning in 2019.

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 SEC’s Division of Corporation Finance has issued frequently asked questions on numerous aspects of the JOBS Act, many of which address matters related to qualifying for EGC status and the filing requirements for EGCs.
12.1.2 Smaller Reporting Companies

12.1.2.1 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>
<thead>
<tr>
<th>Criteria</th>
<th>Definition</th>
</tr>
</thead>
<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>
<tr>
<td>Revenue</td>
<td>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:</td>
</tr>
<tr>
<td></td>
<td>• No public float.</td>
</tr>
<tr>
<td></td>
<td>• Public float less than $700 million as of the last business day of the registrant's second fiscal quarter.</td>
</tr>
</tbody>
</table>

For initial Securities Act or Exchange 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 12.1.1.1); 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.

12.1.2.2 Accommodations Applicable to SRCs

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

SRCs may be eligible to apply the scaled disclosure requirements as part of their IPO; those requirements are summarized in the tables below. Topic 5 of the FRM also discusses the SEC staff’s views on many SRC-related issues.

Disclosure Requirements Under SEC 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>
</tbody>
</table>

5 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>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>
<tr>
<td>Item 402, “Executive Compensation”</td>
<td>Number of named executive officers</td>
<td>Three</td>
<td>Five</td>
</tr>
<tr>
<td></td>
<td>Scope of summary compensation table</td>
<td>Two years</td>
<td>Three years</td>
</tr>
<tr>
<td></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>Item 404, “Transactions With Related Persons, Promoters and Certain Control Persons”</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>Item 407, “Corporate Governance”</td>
<td>Disclosure of audit committee financial expert</td>
<td>Not required in first annual report</td>
<td>Required</td>
</tr>
<tr>
<td></td>
<td>Disclosure of compensation committee interlocks and insider participation</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td></td>
<td>Compensation committee report</td>
<td>Not required</td>
<td>Required</td>
</tr>
</tbody>
</table>
(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>Item 503, “Prospectus Summary”</td>
<td>Discussion of the most significant risk factors facing the company</td>
<td>Not required in Exchange Act filings (e.g., annual or interim reports), required in a registration statement</td>
<td>Required</td>
</tr>
<tr>
<td>Statement of ratio of earnings to fixed charges</td>
<td>Not required</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Item 601, “Exhibits”</td>
<td>Statement regarding computation of ratios</td>
<td>Not required</td>
<td>Required</td>
</tr>
</tbody>
</table>

Financial Statement Requirements Under SEC Regulation S-X

<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>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>
<tr>
<td>Compliance with presentation and disclosure requirements of SEC Regulation S-X, including, but not limited to, separate disclosure of revenue and costs from products and services and separate presentation of related-party transactions</td>
<td>Generally not required</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Disclosure of accounting policy related to certain derivative instruments (Rule 4-08(n))</td>
<td>Required</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Disclosure of certain information related to guaranteed or collateralized securities (Rule 3-10 and Rule 3-16)</td>
<td>Required</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Compliance with auditor independence requirements (Article 2)</td>
<td>Required</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Supplemental financial statement schedules</td>
<td>Not required</td>
<td>Required</td>
<td></td>
</tr>
</tbody>
</table>

---

6 SRCs apply the requirements in SEC Regulation S-X, Article 8, when preparing their financial statements. SRCs typically are not required to apply the disclosure provisions of SEC Regulation S-X in their entirety unless Article 8 indicates otherwise. Registrants other than SRCs should apply SEC Regulation S-X in its entirety, as applicable.

7 See footnote 5.
Companies that qualify as SRCs may choose to apply the scaled disclosure requirements on an item-by-item (or an “à 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.

Section 12.2 highlights accounting and disclosure issues commonly encountered by life sciences entities that are associated with IPOs. For more information as well as insights into topics not addressed below, see Deloitte’s *A Roadmap to Initial Public Offerings* and SEC Comment Letter Roadmap.

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8 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.

9 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.

10 SEC 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.

11 See paragraph 5330.2 of the FRM.

12 SEC Regulation S-X, Rule 3-09, prescribes the annual requirements for financial statements of an equity method investee. See Deloitte’s *A Roadmap to SEC Reporting Considerations for Equity Method Investees* for further guidance on evaluating the significance of equity method investees.
12.2 Industry Issues

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

<table>
<thead>
<tr>
<th>Example of an SEC Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>We note that you consummated the [Company A] acquisition . . . but to date you have not filed audited financial statements of the acquired business or pro forma information relating to the acquisition. Please provide us with your calculations of the significance tests outlined in Rule 1-02(w) of Regulation S-X that you used in applying the requirements of Rule 3-05 and Article 11 of Regulation S-X.</td>
</tr>
</tbody>
</table>

As discussed in Chapter 4, it is common for life sciences entities to engage in significant M&A activity. 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,13 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.

The following factors govern whether, and 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.14 Under SEC guidelines, the legal form of an acquisition (i.e., acquisition of assets vs. acquisition of a legal entity) has no impact on 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 operations15 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 SEC Regulation S-X, Rule 1-02(w), can be quite complex. For more information, see Deloitte's *A Roadmap to SEC Reporting Considerations for Business Combinations*.

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13 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.

14 SEC 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."

15 SEC Regulation S-X, 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.”
12.2.1.1 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 acquiree financial statement requirements at various significance thresholds:

<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.</td>
</tr>
<tr>
<td>Exceeds 20 percent but not 40 percent</td>
<td>• Audited balance sheet as of the end of the most recent fiscal year.</td>
</tr>
<tr>
<td></td>
<td>• Audited statements of operations, comprehensive income, cash flows, and changes in stockholders' equity for the most recent fiscal year.</td>
</tr>
<tr>
<td></td>
<td>• Unaudited financial statements as of and for the appropriate interim period preceding the acquisition and the corresponding interim period in the prior year.</td>
</tr>
<tr>
<td>Exceeds 40 percent but not 50 percent</td>
<td>• Audited balance sheets as of the end of the two most recent fiscal years.</td>
</tr>
<tr>
<td></td>
<td>• Audited statements of operations, comprehensive income, cash flows, and changes in stockholders' equity for the two most recent fiscal years.</td>
</tr>
<tr>
<td></td>
<td>• Unaudited financial statements as of and for the appropriate interim period preceding the acquisition and the corresponding interim period in the prior year.</td>
</tr>
<tr>
<td>Exceeds 50 percent</td>
<td>• Audited balance sheets as of the end of the two most recent fiscal years.</td>
</tr>
<tr>
<td></td>
<td>• Audited statements of operations, comprehensive income, cash flows, and changes in stockholders' equity for the three most recent fiscal years.</td>
</tr>
<tr>
<td></td>
<td>• Unaudited financial statements as of and for the appropriate interim period preceding the acquisition and the corresponding interim period in the prior year.</td>
</tr>
<tr>
<td></td>
<td>• Exceptions:</td>
</tr>
<tr>
<td></td>
<td>o If revenues of the acquired business are less than $100 million in the most recent fiscal year, the earliest year can be omitted.</td>
</tr>
<tr>
<td></td>
<td>o If the acquiring company qualifies as an EGC, no more than two years of financial statements are required in an IPO for common equity or in a Form 10.</td>
</tr>
</tbody>
</table>

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.

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 period in the prior fiscal year.

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.

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.

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16 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.

17 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 period in the prior fiscal year.

18 See footnote 17.

19 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.”
12.2.2 Pro Forma Disclosures

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 presentation and preparation of pro forma financial information are addressed in SEC 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. 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 12.2.2.5.

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.

12.2.2.1 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.
12.2.2.2 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.

12.2.2.3 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.

12.2.2.4 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.

**12.2.2.5 ASC 805 Requirements**

In addition to the pro forma financial information that must be disclosed for a business combination or probable business combination, 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.

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.”
- The “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 business combinations, see Chapter 4 of this Guide and Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations.*
12.2.3 Predecessor Financial Information

<table>
<thead>
<tr>
<th>Example of an SEC Comment</th>
</tr>
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<tbody>
<tr>
<td>We note that your historical results of operations for [the fiscal year] do not include the results of [Entity A] prior to [its] acquisition . . . . Based on the significance of [A] prior to the acquisition, it appears that [A] is a predecessor to the registrant. Please expand the disclosure in Selected Financial Data to provide predecessor financial information, pro forma financial information using the guidance in Article 11 of Regulation S-X and expand the notes to the Selected Consolidated Financial Data to include sufficient detail of [A's] historical results of operations to facilitate comparison of the periods presented. Also revise the presentation in MD&amp;A and elsewhere in the document.</td>
</tr>
</tbody>
</table>

In addition to pro forma information, entities should consider whether predecessor financial information is required after a material acquisition. 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).”
- The “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 SEC 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.

12.2.4 Share-Based Compensation Valuation

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, IP, 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.

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 discussion below summarizes some of the more significant considerations related to share-based compensation for an entity contemplating an IPO.
ASC 718 identifies three ways for nonpublic entities to measure share-based compensation 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.

### 12.2.4.1 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.

### 12.2.4.2 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. For example, the use of the New York Stock Exchange Arca Pharmaceutical Index is not an appropriate industry sector index for a small nonpublic biotechnology 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 biotechnology companies would be a more appropriate substitute for the expected volatility of the 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.

12.2.4.3 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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21 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.

22 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.
### 12.2.4.4 Cheap Stock

#### Examples of SEC Comments

- Please tell us the estimated IPO price range. To the extent there is a significant difference between the estimated grant-date fair value of your common stock during the past twelve months and the estimated IPO price, please discuss for us each significant factor contributing to the difference.
- Please disclose the dates and fair values for the third-party valuations of your common stock during the periods presented. Clarify the estimated common stock price at the time of the ... options issuance and explain to us how it relates to the share price in the ... convertible preferred stock financing. Once you have an estimated offering price or range, please explain to us the reasons for any differences between the recent valuations of your common stock leading up to the IPO and the estimated offering price. This information will help facilitate our review of your accounting for equity issuances including stock compensation and beneficial conversion features.

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*. 

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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.

In its disclosures, a registrant undergoing an IPO typically identifies share-based compensation as a critical accounting estimate because the lack of an active market for the pre-IPO shares makes the estimation process complex and subjective.

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. While Section 9520 of the FRM indicates that registrants should significantly reduce disclosures about share-based compensation and the valuation of pre-IPO common stock in the critical accounting estimates section of MD&A, paragraph 9520.2 of the FRM indicates that the SEC staff may continue to request that companies “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 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.23

23 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.
12.2.4.5 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.

12.2.4.6 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. 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.

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.

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.
• 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.

### 12.2.4.7 Valuation Assumptions — Expected Term

**Example of an SEC Comment**

Please more fully explain to us why you believe it is appropriate to use the simplified method to estimate the expected life of your stock options. Please also tell us when you expect sufficient historical information to be available to you to determine expected life assumptions and address the impact that your current approach has had on your financial statements. Refer to SAB Topic 14.D.2.

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 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.
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.

### 12.2.4.8 Valuation Assumptions — Expected Volatility

#### Example of an SEC Comment

We note that the expected volatility of your Class A common stock is based on a peer group in the industry in which the Company does business. Please tell us what consideration you gave to using the Company’s historical pricing data in arriving at a volatility assumption. In addition, tell us what consideration you gave to disclosing the reason for the continued reliance on a peer group in the industry in arriving at this assumption. We refer you to ASC 718-10-55-37 and SAB Topic 14.D.1.

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.

Considerations related to estimating expected volatility may be summarized as follows:

- **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.

For more information on share-based compensation, see Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards*.

### 12.2.5 Liabilities, Equity, and Temporary Equity

**Example of an SEC Comment**

<table>
<thead>
<tr>
<th>Example of an SEC Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>You disclose that . . . you will be required to repurchase each share of [convertible preferred stock] that have not been converted into shares of common stock or automatically redeemed. Please tell us how you determined that your [convertible preferred stock] should be classified as mezzanine equity on your balance sheet and your consideration of the guidance in ASC 480-10-25-4.</td>
</tr>
</tbody>
</table>

Life sciences entities pursuing an IPO often have complex financial instruments. 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 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 financial instruments, see Chapter 10 of this Guide and Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

### 12.2.6 Accounting for Offering Costs

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.

**Connecting the Dots**

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.

#### 12.2.6.1 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 SEC Regulation S-X, Rule 3-05; significant equity method investments under SEC 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.
Appendix B — Titles of Standards and Other Literature

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

**AICPA Literature**

**Accounting and Valuation Guides**
- Assets Acquired to Be Used in Research and Development Activities
- Valuation of Privately-Held-Company Equity Securities Issued as Compensation

**Audit and Accounting Guide**
- Revenue Recognition

**Issues Papers**
- Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories
- 86-2, Accounting for Options

**Other**
- AICPA Technical Q&A Section 2260.03, “Other Assets; Legal Expenses Incurred to Defend Patent Infringement Suit”

**FASB Literature**

**ASC Topics**
- ASC 205, Presentation of Financial Statements
- ASC 210, Balance Sheet
- ASC 220, Income Statement — Reporting Comprehensive Income
- ASC 230, Statement of Cash Flows
- ASC 235, Notes to Financial Statements
- ASC 250, Accounting Changes and Error Corrections
- ASC 260, Earnings per Share
- ASC 270, Interim Reporting
- ASC 275, Risks and Uncertainties
- ASC 280, Segment Reporting
Appendix B — Titles of Standards and Other Literature

ASC 310, Receivables
ASC 320, Investments — Debt and Equity Securities
ASC 321, Investments — Equity Securities
ASC 323, Investments — Equity Method and Joint Ventures
ASC 326, Financial Instruments — Credit Losses
ASC 330, Inventory
ASC 340, Other Assets and Deferred Costs
ASC 350, Intangibles — Goodwill and Other
ASC 360, Property, Plant, and Equipment
ASC 405, Liabilities
ASC 410, Asset Retirement and Environmental Obligations
ASC 420, Exit or Disposal Cost Obligations
ASC 450, Contingencies
ASC 460, Guarantees
ASC 470, Debt
ASC 480, Distinguishing Liabilities From Equity
ASC 505, Equity
ASC 605, Revenue Recognition
ASC 606, Revenue From Contracts With Customers
ASC 610, Other Income
ASC 705, Cost of Sales and Services
ASC 710, Compensation — General
ASC 712, Compensation — Nonretirement Postemployment Benefits
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 720, Other Expenses
ASC 730, Research and Development
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 808, Collaborative Arrangements
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 835, Financial Instruments
ASC 840, Leases
ASC 842, Leases
ASC 845, Nonmonetary Transactions
ASC 860, Transfers and Servicing
ASC 915, Development Stage Entities
ASC 930, Extractive Activities — Mining
ASC 942, Financial Services — Depository and Lending
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies
ASC 948, Financial Services — Mortgage Banking
ASC 954, Health Care Entities
ASC 958, Not-for-Profit Entities
ASC 960, Plan Accounting — Defined Benefit Pension Plans
ASC 985, Software

**ASUs**

ASU 2010-27, Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers — a consensus of the FASB Emerging Issues Task Force

ASU 2011-06, Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers — a consensus of the FASB Emerging Issues Task Force

ASU 2014-02, Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill — a consensus of the Private Company Council

ASU 2014-09, Revenue From Contracts With Customers (Topic 606)

ASU 2014-10, Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation

ASU 2014-15, Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern

ASU 2014-16, Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity — a consensus of the FASB Emerging Issues Task Force

ASU 2015-14, Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date

ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments


ASU 2016-02, Leases (Topic 842)
ASU 2016-08, Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)

ASU 2016-09, Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

ASU 2016-10, Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing

ASU 2016-11, Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting

ASU 2016-12, Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients

ASU 2016-13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments


ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory

ASU 2016-17, Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control


ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers

ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business

ASU 2017-04, Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment

ASU 2017-05, Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets

ASU 2017-11, Earnings per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception

ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

ASU 2017-13, Revenue Recognition (Topic 605), Revenue From Contracts With Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Recission of Prior SEC Staff Announcements and Observer Comments (SEC Update)

ASU 2017-14, Income Statement — Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue From Contracts With Customers (Topic 606) (SEC Update)

ASU 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842

ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

ASU 2018-08, Not-For-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made

ASU 2018-10, Codification Improvements to Topic 842, Leases

ASU 2018-11, Leases (Topic 842): Targeted Improvements


ASU 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities

ASU 2018-18, Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606

ASU 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors

ASU 2019-01, Leases (Topic 842): Codification Improvements

ASU 2019-04, Codification Improvements to Topic 326, Financial Instruments — Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

ASU 2019-05, Financial Instruments — Credit Losses (Topic 326): Targeted Transition Relief

ASU 2019-08, Compensation — Stock Compensation (Topic 718) and Revenue From Contracts With Customers (Topic 606): Codification Improvements — Share-Based Consideration Payable to a Customer

ASU 2019-10, Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates

ASU 2019-11, Codification Improvements to Topic 326, Financial Instruments — Credit Losses

ASU 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes

ASU 2020-01, Investments — Equity Securities (Topic 321), Investments — Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815): Clarifying the Interactions Between Topic 321, Topic 323, and Topic 815 — a consensus of the FASB Emerging Issues Task Force

**Concepts Statements**

No. 5, Recognition and Measurement in Financial Statements of Business Enterprises

No. 6, Elements of Financial Statements

No. 8, Conceptual Framework for Financial Reporting — Chapter 8, Notes to Financial Statements
Proposed ASUs
No. 2015-310, Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material
No. 2015-340, Government Assistance (Topic 832): Disclosures by Business Entities About Government Assistance
No. 2017-200, Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current Versus Noncurrent)
No. 2017-210, Inventory (Topic 330): Disclosure Framework — Changes to the Disclosure Requirements for Inventory
No. 2017-280, Consolidation (Topic 812): Reorganization
No. 2019-730, Debt — Debt With Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity’s Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity
No. 2019-770, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting
No. 2019-790, Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting

Other FASB Proposal

International Standards
IFRS 2, Share-Based Payment
IFRS 3, Business Combinations
IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations
IFRS 9, Financial Statements
IFRS 10, Consolidated Financial Statements
IFRS 11, Joint Arrangements
IFRS 12, Disclosure of Interests in Other Entities
IFRS 15, Revenue From Contracts With Customers
IFRS 16, Leases
IAS 1 (Revised 2007), Presentation of Financial Statements
IAS 7, Statement of Cash Flows
IAS 10, Events After the Reporting Period
IAS 12, Income Taxes
IAS 17, Leases
IAS 20, Accounting for Government Grants and Disclosure of Government Assistance
IAS 27 (Revised 2011), Separate Financial Statements
IAS 32, Financial Instruments: Presentation
IAS 37, Provisions, Contingent Liabilities and Contingent Assets
IAS 38, Intangible Assets
IAS 40, Investment Property

IRC
Section 78, “Gross Up for Deemed Paid Foreign Tax Credit”
Section 163(j), “Interest; Limitation on Business Interest”
Section 199, “Income Attributable to Domestic Production Activities”
Section 382, “Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change”
Section 383, “Special Limitations on Certain Excess Credits, etc.”
Section 409A “Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans”
Section 422, “Incentive Stock Options”
Section 423, “Employee Stock Purchase Plans”

PCAOB Literature

SEC Literature

FRM
Topic 1, “Registrant’s Financial Information”
Topic 2, “Other Financial Statements Required”
Topic 3, “Pro Forma Financial Information”
Topic 5, “Smaller Reporting Companies”
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”

Interpretive Release
33-10403, Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement Into the Pediatric Vaccine Stockpile or the Strategic National Stockpile
Appendix B — Titles of Standards and Other Literature

Proposed Rule Release
No. 33-10635, Amendments to Financial Disclosures About Acquired and Disposed Businesses

Regulation S-K
Item 101, “Description of Business”
Item 103, “Business; Legal Proceedings”
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 305, “Quantitative and Qualitative Disclosures About Market Risk”
Item 402, “Executive Compensation”
Item 404, “Transactions With Related Persons, Promoters and Certain Control Persons”
Item 407, “Corporate Governance”
Item 503, “Prospectus Summary”
Item 601, “Exhibits”

Regulation S-X
Rule 1-02(w), “Definitions of Terms Used in Regulation S-X (17 CFR part 210); Significant Subsidiary”
Article 2, “Qualifications and Reports of Accountants”
Rule 3-02, “Consolidated Statements of Comprehensive Income and Cash Flows”
Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”
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 3-14, “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”
Rule 4-08(g), “General Notes to Financial Statements: Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 4-08(h), “General Notes to Financial Statements: Income Tax Expense”
Rule 4-08(n), “Accounting Policies for Certain Derivative Instruments”
Article 8, “Financial Statements of Smaller Reporting Companies”
Rule 10-01(b), “Interim Financial Statements: Other Instructions as to Content”
Article 11, “Pro Forma Financial Information”
Rule 11-01 “Presentation Requirements”

**SAB Topics**
No. 1.M, “Financial Statements; Materiality”
No. 5.A, “Expenses of Offering”
No. 5.Y, “Miscellaneous Accounting; Accounting and Disclosures Relating to Loss Contingencies”
No. 11.A, “Miscellaneous Disclosure; Operating-Differential Subsidies”
No. 13, “Revenue Recognition”
No. 14.B, “Share-Based Payment; Transition From Nonpublic to Public Entity Status”
No. 14.D.1, “Certain Assumptions Used in Valuation Methods; Expected Volatility”
SAB 116, “Staff Accounting Bulletin No. 116”

**SEC Securities Act of 1933 General Rules and Regulations**
Rule 144, “Persons Deemed Not to be Engaged in a Distribution and Therefore Not Underwriters — General Guidance”

**Superseded Literature**

**EITF Issues**
Issue 00-21, “Revenue Arrangements With Multiple Deliverables”
Issue 01-10, “Accounting for the Impact of the Terrorist Attacks of September 11, 2001”
Issue 02-16, “Accounting by a Customer (Including a Reseller) for Certain Consideration Received From a Vendor”
Issue 01-8, “Determining Whether an Arrangement Contains a Lease”
Issue 08-6, “Equity Method Investment Accounting Considerations”
Issue 09-2, “Research and Development Assets Acquired in an Asset Acquisition”
Issue 09-4, “Seller Accounting for Contingent Consideration”

**FASB Interpretations**
No. 47, *Accounting for Conditional Asset Retirement Obligations* — an interpretation of FASB Statement No. 143
No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109
**FASB Statements**

No. 5, *Accounting for Contingencies*

No. 95, *Statement of Cash Flows*

No. 114, *Accounting by Creditors for Impairment of a Loan* — an amendment of FASB Statements No. 5 and 15

No. 123(R), *Share-Based Payment*

No. 133, *Accounting for Derivative Instruments and Hedging Activities*

No. 141, *Business Combinations*

No. 141(R), *Business Combinations*

No. 160, *Noncontrolling Interests in Consolidated Financial Statements* — an amendment of ARB No. 51
# Appendix C — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABO</td>
<td>accumulated benefit obligation</td>
</tr>
<tr>
<td>AFS</td>
<td>available for sale</td>
</tr>
<tr>
<td>AI</td>
<td>artificial intelligence</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AMT</td>
<td>alternative minimum tax</td>
</tr>
<tr>
<td>API</td>
<td>active pharmaceutical ingredient</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASR</td>
<td>accelerated share repurchase</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>BCF</td>
<td>beneficial conversion feature</td>
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<tr>
<td>BEAT</td>
<td>base erosion anti-abuse tax</td>
</tr>
<tr>
<td>BEMTA</td>
<td>base erosion minimum tax amount</td>
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<tr>
<td>BPD</td>
<td>branded prescription drug</td>
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<tr>
<td>CAGR</td>
<td>compound annual growth rate</td>
</tr>
<tr>
<td>CAM</td>
<td>critical audit matter</td>
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<tr>
<td>CCF</td>
<td>cash conversion feature</td>
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<tr>
<td>CECL</td>
<td>current expected credit loss</td>
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<tr>
<td>CFC</td>
<td>controlled foreign corporation</td>
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<td>CFR</td>
<td>Code of Federal Regulations</td>
</tr>
<tr>
<td>CMO</td>
<td>contract manufacturing organization</td>
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<tr>
<td>CODM</td>
<td>chief operating decision maker</td>
</tr>
<tr>
<td>CRO</td>
<td>contract research organization</td>
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<td>CSR</td>
<td>corporate social responsibility</td>
</tr>
<tr>
<td>DTA</td>
<td>deferred tax asset</td>
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<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>ED</td>
<td>exposure draft</td>
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<tr>
<td>EDGAR</td>
<td>SEC electronic data gathering, analysis, and retrieval system</td>
</tr>
<tr>
<td>EGC</td>
<td>emerging growth company</td>
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<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>ESPP</td>
<td>employee stock purchase plan</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<tr>
<td>FDA</td>
<td>Food and Drug Administration</td>
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<tr>
<td>FDII</td>
<td>foreign derived intangible income</td>
</tr>
<tr>
<td>FIFO</td>
<td>first in, first out</td>
</tr>
<tr>
<td>FIN</td>
<td>FASB Interpretation</td>
</tr>
<tr>
<td>FOB</td>
<td>free on board</td>
</tr>
<tr>
<td>FRM</td>
<td>SEC Division of Corporation Finance Financial Reporting Manual</td>
</tr>
<tr>
<td>FVTOCI</td>
<td>fair value through other comprehensive income</td>
</tr>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
</tr>
<tr>
<td>GILTI</td>
<td>global intangible low-taxed income</td>
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<tr>
<td>GPO</td>
<td>group purchasing organization</td>
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<td>HFI</td>
<td>held for investment</td>
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<tr>
<td>HFS</td>
<td>held for sale</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
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<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>IFRIC</td>
<td>IFRS Interpretations Committee</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<tr>
<td>IIR</td>
<td>investigator-initiated research</td>
</tr>
<tr>
<td>IP</td>
<td>intellectual property</td>
</tr>
<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>in-process research and development</td>
</tr>
<tr>
<td>IRC</td>
<td>Internal Revenue Code</td>
</tr>
<tr>
<td>IRS</td>
<td>Internal Revenue Service</td>
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<tr>
<td>ISO</td>
<td>incentive stock option</td>
</tr>
<tr>
<td>IT</td>
<td>information technology</td>
</tr>
<tr>
<td>LCD</td>
<td>liquid-crystal display</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>LIFO</td>
<td>last in, first out</td>
</tr>
<tr>
<td>LLC</td>
<td>limited liability company</td>
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<tr>
<td>M&amp;A</td>
<td>merger and acquisition</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion &amp; Analysis</td>
</tr>
<tr>
<td>MSL</td>
<td>medical science liaison</td>
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<tr>
<td>NFP</td>
<td>not-for-profit entity</td>
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<tr>
<td>NOL</td>
<td>net operating loss</td>
</tr>
<tr>
<td>NQSO</td>
<td>non-qualified stock option</td>
</tr>
<tr>
<td>NSO</td>
<td>nonstatutory option</td>
</tr>
<tr>
<td>OCI</td>
<td>other comprehensive income</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OEM</td>
<td>original equipment manufacturer</td>
</tr>
<tr>
<td>PBE</td>
<td>public business entity</td>
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</table>

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>PBO</td>
<td>projected benefit obligation</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PCC</td>
<td>Private Company Council</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>property, plant, and equipment</td>
</tr>
<tr>
<td>PRV</td>
<td>priority review voucher</td>
</tr>
<tr>
<td>PTRS</td>
<td>probability of technical and regulatory success</td>
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<tr>
<td>Q&amp;A</td>
<td>question and answer</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
</tr>
<tr>
<td>R&amp;E</td>
<td>research and experimentation</td>
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<tr>
<td>REMS</td>
<td>risk evaluation and mitigation strategy</td>
</tr>
<tr>
<td>ROC</td>
<td>return on capital</td>
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<tr>
<td>ROU</td>
<td>right of use</td>
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<tr>
<td>SaaS</td>
<td>software as a service</td>
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<tr>
<td>SAB</td>
<td>Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SME</td>
<td>small to medium-sized entity</td>
</tr>
<tr>
<td>SPPI</td>
<td>solely payments of principal and interest</td>
</tr>
<tr>
<td>SRC</td>
<td>smaller reporting entity</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>Standard &amp; Poor’s 500 Index</td>
</tr>
<tr>
<td>TD</td>
<td>Treasury Decision</td>
</tr>
<tr>
<td>TRG</td>
<td>transition resource group</td>
</tr>
<tr>
<td>UTB</td>
<td>unrecognized tax benefit</td>
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<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
<tr>
<td>VWAP</td>
<td>volume-weighted average daily market price</td>
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</table>
The following is a list of short references for the Acts mentioned in this Guide:

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Act</th>
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<tbody>
<tr>
<td>FAST Act</td>
<td>Fixing America’s Surface Transportation Act</td>
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<tr>
<td>JOBS Act</td>
<td>Jumpstart Our Business Startups Act</td>
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<tr>
<td>Securities Act</td>
<td>Securities Act of 1933</td>
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<td>TCJA</td>
<td>Tax Cuts and Jobs Act of 2017</td>
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