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IPO in your future?

Preflight your company's finances now to be sure you can hit your runway

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By Kathy Ryan and Kelley Wall

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IPOs are exciting—the mere prospect puts a spring in a company's step. But in the rush to the road show, many hot companies neglect crucial finance work and end up stumbling into a quagmire of complex accounting issues and previously unforeseen problems. Stuck there, they miss their runway by miles. This guide, part one of our series on executing a flawless IPO, outlines common issues affecting S-1 filings and steps you can take to resolve them well in advance.

Start your IPO finance prep in advance—far in advance

If your company is planning an IPO within the next year—or even in two years—start getting your finance house in order now.

Seriously. We've seen record numbers of companies pull their IPOs in the past year, incurring significant costs in the process. These companies made it all the way to filing their S-1s and maybe even responded to a few rounds of SEC comments—then withdrew their registration statements. Reasons varied, but the two primary causes were general business unreadiness or finance unreadiness: they either weren't good IPO candidates (the business wasn't sound enough or developed enough to solicit investors), or they missed their window of opportunity because they jumped into the IPO process with messy finances and unrealistic ideas about timing.

Top executives spend plenty of time thinking about how to enhance valuations and listen attentively to investment bankers' advice on timing their IPO road shows, but often don't realize that the supporting finance work involves more than just generating a few reports. Failing to tackle that work can be a beast that turns around and bites you.

In RoseRyan's work since 1993 with Silicon Valley companies preparing for IPOs, the biggest mistakes we've seen—over and over—are a lack of preparation and not leaving enough time for the crucial financial half of the initial S-1 filing. If your first pass at the S-1 reveals sticky problems that take time to resolve—frequently the case with emerging technology companies—you can miss your runway by miles. One company we know ended up filing its S-1 more than four months late because it had no ERP system in place, it wasn't used to closing the books so quickly, and it had to do an audit in short order. Look at your company in the mirror and be honest: could this be you?

You can avoid a similar fate with proper planning and by addressing common S-1 issues well in advance.

Equity issues: the lurking time bomb in your S-1 work

Of all the snafus that can happen in preparing an S-1, equity issues are the most common. These include problems with administration (how your shares have been documented and recorded), valuation of the underlying common stock, stock-based compensation expense, stock splits, and intentional or unintentional stock award modifications.

These issues typically rear their ugly heads near the tail end of the process—when the document is at or almost at the printer—and can stall an S-1 filing for days or weeks, depending on the company's age, number of employees, and stock complexities. One company we know was delayed for months because it lacked equity documentation and missed its IPO window entirely. We've also seen companies have to re-create board minutes to deal with equity issues.

You can avoid similar messes by taking these steps:

- Create a strict stock administration policy (never give stock away as a trade for office furniture, don't make exceptions for anyone's family members, and so on).
- Perform a self-audit of your stock records as least quarterly by matching the details in your records to board minutes, exercise documentation, and employee termination information. You should do this even if your attorneys have been maintaining this information for you.
- Reconcile, reconcile, reconcile. Make sure your stock records agree with your attorney's records and with information you have provided to your auditors. In our experience, differences crop up regularly in these three sets of records, and they can take time to resolve.
- Get third-party valuations for your common stock at least once a year (more frequently if significant changes occur during the year). Discuss with your auditors the best approach to valuing the stock between valuation dates.
- Vet with your auditors the assumptions you make in determining the fair value of stock-based compensation, including the expected term of the awards, volatility, and forfeiture rate.
- Keep robust records. Stock administration records (grants, exercises, and cancellations) should be complete and include technical accounting memos documenting the accounting and assumptions used in the valuing of stock-based awards.

All public and private companies must track equity in a timely way and keep historical records in an orderly manner. The more you delay this work, the more expensive it gets. Put a stock administration policy and procedure in place as early as possible, and implement a low-cost database software solution to avoid the pitfalls of manual record keeping.

It's also useful to consult an expert in accounting for stock-based compensation to assure you that you are on the right track.

The curse of the new: novelty can mean delays

Your IPO may present accounting issues that are specific to your industry or that involve new funding mechanisms. For example, biotech companies generally go public based on future possibilities that are hard to define, and cleantech companies may have financing arrangements through the Department of Energy involving unusual terms and accounting.

Any unproven or leading-edge technology may require added disclosures, such as risk factors related to the technology, in the nonfinancial sections of the S-1 document. And if your company has an accounting transaction that's complex or out of the ordinary, your auditors may have to kick it up to their national office for review.

For us accounting gurus, this is interesting new terrain. For everyone else involved with your IPO, it can be a huge headache if you're not prepared. This is one more reason to build extra time into your IPO preparation schedule.

Annual audits: your ticket to finding problems early

As cash flow allows, start-ups should complete audits annually. First off, running a multiyear audit while kicking off an IPO is not something you want to do—trying to find the people or documentation needed to address issues in three-year-old financials can be an epic hassle. Second, audits will raise issues that could slow an IPO, such as improper timing or recording of material transactions and other technical accounting issues.

If you're on the verge of going public and an unusual accounting transaction crops up during your yearly audit, *do not wait* to see what the auditor says about the sticky situation—reach out and resolve it. Then record what happened. If the SEC flags the transaction, this documentation will help explain it.

Rev rec: do it right now, or pay later

Gaining sales traction is a great story, but not all revenue goes directly to your P&L. Young companies often run afoul of accounting rules for revenue recognition and have to spend precious time and resources reviewing prior-period sales transactions. Delays like this are unnecessary. If you have revenue, have your sales and finance teams work together early on to address compliance issues.

An added complication: the Financial Accounting Standards Board (FASB) rev rec rules are in transition. Stay tuned for new rules and consider whether it makes sense to adopt them early (if allowed), so that you prepare every year in your S-1 document on a consistent basis. You don't want to spend precious time on your road show explaining weird fluxes in your revenue that result from accounting rule changes.

Accounting systems: QuickBooks won't cut it

Most companies start off with an accounting system anchored in simple and inexpensive software, then move to something more sophisticated over time. If you're eyeing an IPO, now is the time to make that move.

You simply can't go public with QuickBooks or similarly unsophisticated programs—they lack the required internal controls—and depending on the size, stage, and complexity of your company, it can take six months or more to select and implement a new accounting system.

Your reward: touchdown on your runway

The more transparent and well documented the accounting in your S-1 is, the shorter your SEC review and comment period will be. That's because accounting-related disclosures in the S-1 are always an area of focus during this back-and-forth process, which typically takes three to four months. And the SEC will exercise due diligence, regardless of your preferred timing.

If you have a strong accounting and finance team in place, plan your S-1 document's timing realistically, do your homework on making your accounting materials supportable, and use a collaborative process (which we'll cover in part two), you'll be well positioned to file your initial S-1 on time and hit your IPO runway on schedule.

A final note: for a small private company with a skeleton accounting staff, taking on all these activities at once can be overwhelming. Wondering how you can do all this on your own? You don't have to. RoseRyan can assist with all aspects of IPO preparation. Contact Maureen Ryan mryan@roseryan.com to find out how.

About Kathy Ryan: Kathy Ryan is CEO and CFO of RoseRyan, the firm she co-founded in 1993. She has served as interim CFO at more than 50 emerging companies, mostly in the high-tech sector, and is a former Big Four CPA.

About Kelley Wall: Kelley Wall, a CPA with more than 15 years' experience in finance and accounting, regularly advises clients on preparing for IPOs. She joined RoseRyan in 2005 and helps lead the firm's growing technical accounting group.