

From Private to Public: The IPO Readiness Series

Six technical accounting issues every company must address for a successful IPO



The IPO process brings heightened scrutiny from regulators, investors, and auditors.

Proactive management of accounting complexities and technical details is crucial. Failure to address these areas effectively can lead to delays, increased costs, reputational damage, or even the need to withdraw the IPO.

Here are six areas where it is essential to conduct thorough and robust technical analyses to mitigate risk:

1 Revenue Accounting

The Financial Accounting Standards Board (FASB) has added disclosure requirements to ASC 606 for public companies to increase transparency for financial statement users. The following disclosure topics are required for public companies but may not be mandatory for private entities. It is wise to plan ahead, particularly if the underlying data is not easily reportable in a manner consistent with disclosure requirements.

Disaggregated Revenue

Provide a granular view of your revenue, broken down by key economic factors. For example, product lines, geographic markets, and customer segments – the more detailed, the better. This allows investors to understand the underlying drivers of your revenue growth and assess the sustainability of your business model.

Contract Balances

Deferred revenue and contract assets tell a story. Investors want to understand the nuances of your contract balances and how those translate into recognized revenue. How much of your revenue is deferred? How does fulfilling performance obligations impact your bottom line? These are questions investors will ask.

Performance Obligations

Performance obligations are central to revenue recognition. They are an essential indicator of your company's future revenue potential. Carefully consider the required disclosures. They allow financial statement users to know how much revenue recognized during the period is related to satisfied (or partially satisfied) performance obligations.



2 Equity and Debt Arrangements

As companies prepare to go public, they often juggle an array of financial instruments. Preferred stock, convertible debt, SAFEs, etc., are the building blocks of a pre-IPO company's capital structure. They have intricate terms that can be presented incorrectly within financial statements if not carefully analyzed. This will cause delays in financial reporting or even restatements of financial statements.

Below are some main considerations that require a significant amount of time, effort, and judgment to ensure the accounting for debt and equity instruments is accurate:

Understanding all the terms of your debt or equity instruments, including conversion, redemption, or other contingent and non-contingent features.

These can significantly impact the accounting for, and presentation of, financial statements of debt and equity instruments. A comprehensive understanding of the terms is critical. Misapplying the guidance can cause errors such as misclassifying mezzanine and permanent equity or failing to properly account for embedded derivatives. These errors can lead to restatements and delays.

Upon the effectiveness of an IPO, many instruments convert, are redeemed, or otherwise impacted.

Thoroughly evaluate what happens to these instruments upon IPO and how to reflect those impacts quantitatively and qualitatively within the financial statements and related disclosures.

Pre-IPO companies may engage in secondary transactions to provide liquidity to shareholders before the IPO.

Companies should understand the accounting implications of these transactions, which may include material elements of compensation expense they didn't anticipate.

Debt refinancings or restructurings may occur to optimize financing structures.

Careful analysis is required. It can be difficult and involve significant judgments that result in either extinguishments or modifications of debt. Depending on those decisions, it can yield materially different accounting results.

3 Segment Reporting

The goal of ASC 280 is not only compliance, but also the provision of decision-making information to financial statement users. By reflecting a company's internal view of operations, segment reporting equips stakeholders with necessary information to evaluate the company's financial performance, capital allocation, and potential risks. Yet in today's data-heavy environment, segment reporting can be particularly challenging, requiring significant management judgment to properly present the required segment information within the financial statements.

The following are two common questions companies encounter in applying segment guidance that often require considerable judgment and can introduce complications:

- **What are your operating segments?**

An operating segment is a component of a public entity that has the following characteristics:

- **It engages in business activities** from which it may recognize revenues and incur expenses.
- Operating results are regularly reviewed by the public entity's **chief operating decision maker (CODM)** to allocate resources to the segments and assess performance.
- **The CODM can be an individual or group** responsible for allocating resources and assessing segment performance. The challenge is determining who or what entity qualifies as the CODM in practice, which is not always the CEO. In organizations with multiple layers of management, it may be unclear whether the CODM is a single executive, a group (like the board of directors), or divisional heads.
- **Its discrete financial information is available.** Determining what characterizes a business activity can become unclear in early-stage or pre-revenue operations, shared service centers, internal-facing divisions, or R&D-focused entities. This requires careful evaluation of the specific facts and circumstances.
- **Evaluating the availability of discrete information** can be particularly judgmental. Given the large amount of available data, companies need to think critically about what discrete financial data the CODM uses, not just theoretically available.



- **What are your reportable segments?**

Companies can combine multiple operating segments into one reportable segment if they share similar characteristics. These similarities may include economic factors (margins, profitability trends, etc.), products and services, production processes, customer types, and distribution methods.

Determining whether operating segments meet the criteria for aggregation involves significant judgment and interpretation of similarity. For example, segments serving different markets with different profit margins or profitability trends may challenge aggregation decisions. Public companies face heightened SEC scrutiny when aggregating segments, as overly broad aggregation can obscure key financial trends and risks. You should maintain clear documentation for such aggregation of decisions and judgments.

Proper allocation of shared costs and resources, including corporate overhead or material cross-segment transactions, can significantly impact whether reportable segments are correctly identified and can materially impact the financial statements.



4 Earnings Per Share

Calculating earnings per share (EPS) under ASC 260 is a critical aspect of financial reporting for public companies. It is often time-consuming to make sure the relevant historical periods are presented properly and the requisite technical expertise is available for accurate reporting in the future. The process can be complex due to technical requirements, areas requiring judgment, and the need to account for various equity and derivative instruments that impact EPS.

The following are some important factors that require careful consideration:

Share Completeness

Identifying all securities that can impact either basic or diluted EPS requires a detailed understanding of each outstanding financial instrument.

Weighted Average Shares

Calculating the time-weighted average of common shares, adjusting for issuances, repurchases, stock splits, and other changes during the reporting period can involve a significant volume of transactions. Ensure you have a model for accurate calculations, especially after restructuring events like IPO-related stock conversions, stock splits, or reverse splits.

Allocation of Earnings

Allocating earnings between common shareholders and other participating securities, such as preferred stock with dividend rights, may be required. If so, understanding the dividend entitlements, liquidation preferences, and undistributed earnings is critical and may require significant legal input.

Applying the if-converted and treasury stock methods

Estimating the impact of potential conversions or exercises on the numerator (earnings) and denominator (shares outstanding) requires a robust and accurate model, which can be challenging to apply.



5 Cheap Stock

The term cheap stock refers to equity awards, such as stock options, restricted stock units (RSU), or other equity instruments granted to employees, directors, or advisors before an IPO at a price that may be significantly lower than the IPO offering price. The valuation and timing of these equity grants often attract heightened scrutiny from auditors, investors, and regulators such as the SEC.

Here are core considerations when dealing with cheap stock in preparation for an IPO:

Determining Fair Value at Grant Date

The fair value of equity awards should reflect the stock's market value (or intrinsic value) at the date of issuance. If a stock or a share-based payment is granted at an undervalued price, it can result in substantial non-cash compensation expense after the fact.

Don't rely on stale 409A valuations to price options grants within a short timeframe before the IPO, especially during periods where the company is experiencing significant revenue growth has encountered events that could impact a company's valuation, for example, signing a considerable customer contract, launching a major new product, deciding to enter new markets or regions, etc.

Anticipating Scrutiny on Pre-IPO Equity Awards

The SEC and other stakeholders closely examine equity awards issued within the 12-18 months before an IPO to assess whether the pricing aligns with fair market value at the grant date. Maintain detailed records justifying each stock grant, including board approvals, contemporaneous valuations, and supporting business developments that define the grant's timing.

Be prepared to reconcile and disclose differences between pre-IPO valuation assumptions and the expected IPO price. Differences may result from:

- Anticipated growth or performance improvement
- Market conditions
- The nature of the company transitioning to being a public entity

Considering the timing of new and repricing or modifications of existing equity grants

High-volume stock grants issued shortly before an IPO (or close to a significant increase in FMV) can appear opportunistic and attract heightened scrutiny. If the valuation of stock options changes significantly after grants, companies may be tempted to reprice or modify options to reflect the anticipated IPO price. This can raise questions and create financial reporting complications.

Evaluate the timing and purpose of any large or unusual pre-IPO stock grants, repricing, or modifications. Those completed within 6-12 months before an IPO should have strong business justifications (e.g., tying top executives to long-term incentives or hiring critical talent) as they can highlight underlying valuation issues and raise concerns.

Avoid granting equity awards during periods of valuation uncertainty, such as late-stage funding rounds or just before IPO roadshows. Consider the optics of back-to-back large grants, as regulators might view these as attempts to provide recipients with a windfall.



6 Pro Forma Financial Statements

Pro forma financial statements, required for certain SEC filings, simulate the impact of IPO-related transactions or significant events like acquisitions or recapitalizations. These help investors and analysts understand a company's adjusted operations. Preparing pro forma financial statements can be difficult because they illustrate the financial impact of significant past or expected transactions upon the completion of the offering.

Here are some challenges that you might face preparing pro forma financial statements:

- IPOs often involve significant changes to a company's capital structure. Understand the accounting impact of converting preferred stock, warrants, or convertible debt into common equity at the offering date, determining the dilution impact of newly issued shares on EPS, including the retrospective impact on historical periods, and reflecting the settlement of debt or extinguishment costs in the pro forma balance sheet and income statement.
- If your company has recently completed a large acquisition or anticipates completing one in connection with the IPO, pro forma statements must reflect these transactions under ASC 805 (Business Combinations) and Regulation S-X, which can introduce complexity into the pro forma model.
- SEC guidelines require pro forma adjustments to reflect only those transactions directly attributable to and factually supportable within the scope of the IPO transaction. It is critical to exclude hypothetical or speculative transactions that lack sufficient support (e.g., anticipated cost synergies from a planned restructuring) and avoid adjustments that reflect forward-looking estimates or management discretion outside the scope of SEC requirements.
- In periods or industries where valuations have decreased, companies may trigger anti-dilution clauses concerning the IPO. Ensure you fully understand and are aligned with legal counsel and shareholders on how anti-dilution clauses function. Also, you need a robust model that allows you to quickly alter assumptions that flow through to the pro forma financial statements.

Successfully navigating the composite landscape of an IPO requires meticulous attention to detail, robust technical expertise, and proactive management of potential pitfalls. The areas above all demand thorough analysis and careful preparation. Companies investing the time and resources to address these challenges head-on will be better positioned to withstand regulatory scrutiny, meet investor expectations, and ultimately achieve a successful public offering. By maintaining a comprehensive understanding of these critical accounting and reporting issues, companies can mitigate risks and build a solid foundation for their future as public entities, ensuring transparency, compliance, and credibility in the eyes of regulators, investors, and the broader market.



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Founded in 2006, Connor Group quickly became the leading IPO advisory firm. Helping over 250 companies go public built our pragmatic, delivery-oriented approach and \$3.3 trillion in client valuation. It also created elite-level pattern recognition and listening skills to identify problems quickly and solve them efficiently.

The majority of Connor Group has industry experience. We know how to get things done. Our expert teams are fluent in function, technology, and world-class communication. Unlike others, we're independently owned and fully in control of how we deliver. We never compromise on quality.

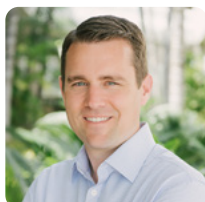
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