Initial Public Offerings and the Role of the Management Accountant

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Taking a company public is not an easy decision to make. Going through the initial public offering (IPO) process involves significant costs and benefits. Management accountants play critical roles throughout by helping management to prepare GAAP-based financial statements, to select an outside accounting firm, to select the underwriter for the IPO and to draft the prospectus, to meet SEC reporting requirements, to determine the initial offering price and prepare for the road show, and to assist the company's CFO.

When a privately owned company decides to list its stock on an exchange for sale—"go public"—it undergoes an initial public offering (IPO).[1] Going public is a monumental decision that forever changes how a company does business. The actual process of going public can be time-consuming and presents certain unique challenges for which a company should be prepared.

The decision to take a company public is not an easy one. While going public can provide greater access to sources of capital, it also comes with significant responsibilities, including sharing corporate control with shareholders, increased corporate governance, and Sarbanes-Oxley (SOX) requirements. There also are significant direct and indirect costs associated with the IPO process and ongoing (future) reporting requirements.

Management accountants are uniquely qualified to facilitate the IPO process. They have the skills and knowledge to gather the information that company owners need to make the decision to go public, and then they can provide the financial and nonfinancial information needed to register the company's securi-

ties (i.e., its offering) with the Securities & Exchange Commission (SEC).

While there is anecdotal evidence of the importance of accountants in the IPO process, there has been little or no research on the strategic role of the management accountant in the IPO process. This process can perhaps best be examined in reference to the definition of management accounting from IMA®:

> Management accounting is a profession that involves partnering in management decision-making, devising planning and performance-management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization's strategy.[2]

In short, management accountants participate actively in the entire IPO process: the initial strategic decision to go public or not, the compilation of information that must be filed as part of the IPO registration process, the discussion regarding the initial offering price of the company's stock, planning the road show, and oversight of the company's internal control process. After a successful public offering, management accountants help the CFO meet ongoing reporting requirements of the SEC.

Because of the infrequency with which IPOs occur, many accountants may not have direct exposure to the IPO process. This article should be of interest to accounting practitioners as well as accounting students interested in learning about the expanded breadth and scope of responsibilities associated with the practice of management accounting today.[3] It should also be of interest to individuals seeking certification as management accountants.[4]

The Decision to Go Public

The first step in the process involves careful consideration of the advantages and disadvantages of becoming a public company and then making the decision whether or not to go public. The most obvious advantage is greater access to capital. An infusion of capital can help a company retire debt, invest in plant and equipment, support future growth, expand research and development programs, and more.

There also are value-related benefits. A public company generally has greater value than its private equivalent. The increased liquidity of its stock, more readily available information about the market, and observable market prices translate into a greater value for a public company compared to a private one.

Further, a public company may offer employees stock purchase plans or stock options, restricted stock, or regular stock as part of their compensation—a significant competitive advantage in some cases. Because of significant upside potential, the existence of stock option plans may be critical to the company's ability to attract and keep talented officers and key personnel.

In some cases, a private company will go public in order to merge with or acquire another company (via the issuance of stock as payment). The primary advantage of this strategy is the conservation of cash by the company.

Finally, a public company usually has an improved debt-to-equity ratio because of the increased level of equity capital relative to debt. This can make it easier to borrow more funds and/or lower the cost of borrowing.

Costs of Going Public

Going public involves difficult-to-quantify (or nonfinancial) disadvantages as well as financial costs.

Difficult-to-Quantify Disadvantages

One major disadvantage (or cost) of going public is the need to share corporate control with stockholders. Related to this is the realization that selling equity in the company represents a permanent forfeiture of a portion of future returns generated by the company. There is also a loss of privacy for a public company—information related to sales, profit margins, the compensation of officers and directors (including cash compensation, stock option plans, and deferred compensation plans), and the security holdings of insiders (i.e., officers, directors, and major shareholders) must be disclosed to the public.[5]

Going public also increases a company's risk exposure. Having shares publicly traded reduces the company's ability to control its ownership and exposes the company to the risk of a hostile takeover. In addition,

there is the risk of shareholder lawsuits, particularly since the Sarbanes-Oxley Act was passed.

Financial Costs

The initial financial costs (also called flotation costs) of going public can be very high and include both indirect and direct costs.

For secondary offerings—in which securities held (all or in part) by the company's owners are sold, and from which the owners receive the proceeds—the major indirect cost is selling the stock at an offering price less than the true value of the stock, or underpricing. Typically, the company going public would like a higher offering price, while the firm selling the stock (the underwriter) prefers a lower price in order to ensure that the entire offering is sold.[6] If the stock is underpriced, it represents a financial cost to the existing owners because the new investors in the company are allowed to buy shares in the firm at a favorable price.

Direct financial costs include costs associated with preparing the registration statement and prospectus (management, legal, and accounting fees), underwriting spread (i.e., difference between what the underwriter pays for the shares and the amount at which the shares are sold), the cost of developing a public image for the company, and ongoing reporting costs. The largest initial cost in an IPO is the underwriter's cost or commission (i.e., spread), which generally is stated as a percentage of the offering price.[7] Initial fees associated with an IPO also include the SEC filing fee, the exchange listing fee (NASDAQ or NYSE), and any "Blue Sky" filing fees.[8]

Often overlooked in planning an IPO is the cost associated with developing a public image for the company. A positive image (with stockbrokers, the financial press, financial analysts, etc.) can enhance the initial sales effort and maintain investor interest in the stock after the IPO. Developing an image can take months or even years to accomplish and may require hiring a public relations firm well in advance of the public offering. Other ways a company can enhance its public image include adding analysts and business press editors to its mailing lists, participating in trade shows and conferences that are attended by analysts, and publicizing key employee appointments. Obviously, all of these tactics involve a cost.

Ongoing reporting costs associated with a public company also can be high. Public companies need to file financial statements with the SEC on a quarterly (10-Q) and annual (10-K) basis, as well as special reports (8-K) when needed.[9] These reports are due shortly after the end of the period, so there is increased time pressure on reporting.

Most companies also choose to employ a transfer agent as part of the IPO and afterward. Basically, transfer agents are hired by companies as "caretakers" for their shareholders. Transfer agents issue and cancel stock certificates to reflect changes in ownership; serve as the company's paying agent to pay out interest, cash, and stock dividends or other distributions to stock and bond holders; and handle lost, destroyed, or stolen certificates.[10] Sometimes a company acts as its own transfer agent, but most transfer agents are banks or trust companies.

Under SOX, initial and ongoing regulatory reporting requirements are numerous and costly.[11] The management of newly public companies is required to deliver a report that assesses the effectiveness of the company's internal control over financial reporting (pursuant to SOX Section 302) in the second annual report filed subsequent to the IPO. SOX Section 404 requires a company's independent public accounting firm to annually deliver an opinion on the company's audited financial statements and an attestation report on the operating effectiveness of the company's internal controls over financial reporting.

Many companies find that they require significant process changes to effectively implement a strong internal control framework to meet SOX requirements. Accordingly, private companies contemplating going public should consider the following SOX-related items well in advance of preparing their initial filing:

- *Management certifications.* SOX Sections 302 and 906 require that the CEO and the CFO of a public company certify that they have evaluated the company's internal controls, that the company's financial statements are accurate and comply with the requirements of the exchange acts, and that the information reported is fairly presented.

These are required with the initial filing.

- *Audit committee.* SOX requires public companies to have an independent audit committee with at least one member qualified as a financial expert. Accordingly, companies should understand the necessary requirements and skills and evaluate the composition of the audit committee to allow sufficient time to seek qualified individuals.
- *Board of directors.* A majority of the members of the board of directors are required by SOX to be from outside the company. At least one board member must have a financial background either as a CPA or CFO. One member must chair the audit committee, and outside directors must meet in executive session. (A company that qualifies as a "controlled company" is exempt from the requirements of having an independent board of directors.) Attracting and retaining board members has become more difficult and more expensive because of the perceived higher level of risk and shift from equity to cash compensation.
- *Auditor relationship.* SOX prohibits a company's external auditor from providing certain nonaudit services, including but not limited to internal audit, legal, and valuation services. There are a number of nonaudit services that an auditor can provide, such as tax services and general advisory services. These permissible services must be preapproved by the audit committee. Accordingly, companies should evaluate their existing relationship with their outside audit firm to clarify permissible and impermissible services and to establish clear independence related to existing or future services.
- *Code of ethics.* SOX requires that a company either has a code of ethics for senior financial officers or explains why one has not been implemented. The corporate governance listing requirements of many exchanges also require a code of ethics. It is important to understand the overlapping nature of these requirements so appropriate processes can be developed and put in place.
- *Loans to company executives.* Public companies are prohibited from extending or maintaining credit in the form of a personal loan to or for any director or executive officer. Appropriate actions should be taken to ensure these types of arrangements can be extinguished prior to the initial public offering.[12]

To conform to SOX requirements, a company planning to go public must perform substantial work (and incur substantial expense) to implement the appropriate processes, document the system of internal control over key processes, assess their design, remediate any deficiencies identified, and test their operation. Management accountants can assist by helping to document both the requirements and their estimated costs.

A company's registration statement and all future financial statement filings with the SEC require a Management's Discussion and Analysis (MD&A). In essence, the MD&A is a quantitative and qualitative discussion of the company's performance. The company must provide in-depth descriptions of items such as changes in cost structures and sales volumes, sources and uses of cash flows, liquidity and capital resources, employee compensation, vendor relationships, unusual nonrecurring charges, significant environmental exposures, and other risks and uncertainties. There is a cost of monitoring company performance and the major drivers of that performance in order to meet MD&A reporting requirements.

Finally, there is a class of costs that we will refer to as board-related costs. The costs associated with the need to hold board and shareholder meetings (as well as for the company to communicate with each of these two groups of individuals) can be significant. Because of their responsibilities to the public shareholders, the board of directors and the audit committee are significantly more important in a public company. If the board were previously composed entirely of insiders, a number of outside directors would need to be added (likely incurring additional costs) to satisfy the NYSE or the NASDAQ National Market listing requirements.

Management accountants can help inform those involved with the IPO decision by properly estimating the one-time costs associated with the registration process as well as ongoing reporting and disclosure costs, including those associated with the company's internal control process.

Input from Management Accountants

In addition to considering the advantages and disadvantages, the decision to go public depends on an objective assessment of the growth prospects of the company (i.e., the attractiveness of the company as an investment). In general, a company with above-average growth prospects will be more attractive to investors. Additional factors associated with the predicted success of a public offering include: an experienced management team; a positive track record of financial results; a product or service with some distinguishing characteristic; a relatively large market for the company's output (service or product); a well-defined business plan; and strong financial, operational, and compliance controls.[13] The management accountant can assist management with making these assessments—all of which relate to the growth prospects of the company (and therefore the predicted success of a public offering).

To facilitate the owners' decision to go public, management accountants should look at other public companies in the same line of business, paying special attention to the price/earnings (P/E) multiple of these benchmark companies. To gain access to more underwriters, companies going public should make legitimate attempts to maximize earnings. The reason for this is that the initial offering price (value of the company) is partly a function of the capitalization of reported accounting earnings. Thus, prior to an IPO the company may consider expanding product lines, entering into a related business, or merging with another company. The management accountant can help weigh these options as part of the company's overall strategy.

Potential investors will focus on one- and two-year multiples such as P/E ratio, price-to-book (P/B) ratio, FV/EBITDA (Firm Value/Earnings Before Interest, Tax, Depreciation, and Amortization), etc. The company's historical and projected revenue growth will be compared to that of its peers. As part of the decision-making process, management accountants should prepare this data and benchmark it to peer institutions or best-in-class performers.

Before considering an IPO, the private company may have been trying to minimize taxes in order to maximize after-tax returns to the owners of the company. But underwriters and investors will be interested in accounting earnings, using earnings growth before the IPO as an indicator of earnings growth after the IPO. Management accountants will have to work with others for several years before the planned IPO to show earnings growth using U.S. Generally Accepted Accounting Principles (GAAP). One strategy to increase accounting earnings is to reduce shareholder-officer salaries, perhaps paying a dividend to make up for the shortfall. Different tax effects must be considered, and consideration may be given to becoming a Subchapter S corporation.[14]

Notice this discussion is couched within the context of legitimately maximizing reported accounting income. The *IMA Statement of Ethical Professional Practice* states that management accountants have a responsibility to perform professional duties in accordance with relevant laws, regulations, and technical standards and to provide decision-support information and recommendations that are accurate, clear, concise, and timely. Further, practitioners have a responsibility to communicate information fairly and objectively and to disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.[15]

Pressures to manage (or manipulate) earnings, often using methods that may border on fraud, may be more acute for IPO companies because their directors must convince stakeholders to invest in the soon-to-be-public firm. Further, the pressures to manage earnings may also be heightened by compensation packages that involve stock options, which typically increase in value with positive financial and operational results.

In "Predicting Management Fraud in IPO Companies," Todd A. Shawver and Tara J. Shawver found evidence suggesting that having company insiders on the board of directors who own higher percentages of company stock will protect the interests of shareholders and reduce the likelihood of financial statement fraud.[16] The standards listed in the *IMA Statement* demand vigilance on the part of management accountants as they participate in the process of producing credible and objective financial reports for which potential investors can use to help make investment decisions.

Once the decision is made to go public, the next step is for the company to prepare a formal proposal for con-

sideration by the company's board of directors. After the board gives its approval, attention turns to preparing the registration statement. This requires knowledge of the Securities Act of 1933 (often referred to as the "Truth in Securities" law) and related SEC regulations that govern the registration process.

The Securities Act of 1933

The Securities Act of 1933 (as amended through P.L. 111-72, approved October 13, 2009) was passed after the stock market crash of 1929 in part to restore confidence in the U.S. securities market. Section 6 (Registration of Securities) and Section 7 (Information Required in Registration Statement) of the Act deal specifically with the issuance of securities and have two primary purposes:

1. Ensure transparency in published financial statements so that investors in the market can make more informed decisions. In other words, the Act requires that the market receive appropriate financial and other significant information concerning securities being offered for public sale.
2. Provide penalties for deceit, fraudulent reporting, or misrepresentation of information offered by companies in conjunction with the listing of stock on an open (i.e., public) exchange.

The Act addresses the need for better disclosure of information by requiring would-be issuers of securities to register with the SEC. Implementation details regarding the registration process are contained in Regulation C of the SEC, Rules 400 through 498.[17] Registration is designed to ensure that companies provide the SEC and potential investors with all relevant information—both financial and nonfinancial—in the form of a registration statement, which includes a description of the company's properties and businesses, a description of the security to be offered for sale by the company, information about the management of the company, and a set of audited financial statements.

Overview of the Registration Process

In general, Form S-1 is the registration statement that companies must complete to register securities with the SEC.[18] This form consists of two parts: a prospectus and other information. The prospectus contains all pertinent facts about the business, including financial statements and information regarding the management team.[19] Other information includes items such as expenses associated with the issuance and distribution of the securities, indemnity of officers and directors of the company, and recent sales of unregistered securities.

Information requirements for Form S-1 are contained in SEC Regulation S-X and Regulation S-K. Regulation S-X of the Code of Federal Regulations specifies the form, content of, and requirements for financial statements submitted to the SEC's Division of Corporation Finance, while Regulation S-K specifies the disclosure requirements of nonfinancial information in conjunction with the registration process.

Availability of Information

Shortly after the registration statement is filed with the SEC, the prospectus must be made public. Public posting of the other information is at the discretion of the company. Both components of the registration statement are subject to examination by the SEC for compliance with disclosure requirements. For U.S. registrants, registration statements are available on the EDGAR database maintained by the SEC (www.sec.gov/edgar.shtml).

All SEC registrants are or will soon be required to provide their financial statements and financial statement schedules to the SEC and to post them on their corporate websites in an interactive data format using XBRL (eXtensible Business Reporting Language). The requirement is being phased in, with all domestic and foreign large accelerated filers required to report their financial information in XBRL for fiscal periods ending after June 15, 2010, and all other remaining registrants reporting their information by June 15, 2011.[20]

Exemptions

There are some cases where, as a matter of law, a stock offering does not have to be registered with the SEC. The goal of exempting many small stock offerings from the normal registration process is to facilitate the free flow of capital by lowering the cost of offering securities from such companies to the public. Exempt offerings

include intrastate offerings and those covered by SEC Regulations A and D. This includes:

- Private offerings to a limited number of persons or institutions (covered under SEC Regulation D),
- Offerings of a limited size (covered by SEC Regulation A, this exemption allows for simplified registration for companies with offerings of $1.5 million or less),
- Intrastate offerings, and
- Securities of municipal, state, and federal governments.

The Management Accountant and the IPO Process

Management accountants can be substantively involved in the IPO process, including assisting in the following areas:

- Preparing GAAP-based financial statements,
- Selecting the outside accounting firm,
- Selecting an underwriter and drafting the prospectus,
- Meeting SEC Form S-1 reporting requirements,
- Determining the initial offering price of the company's stock, and
- Assisting the company's CFO before and after going public.[21]

Preparing GAAP-based Financial Statements

After the board agrees with the proposal to go public, the next step is for the accountants to review the company's books for the last two to three years in search of any items that were not recorded or disclosed according to GAAP. Based on this careful review, restatements of financial statements may be necessary. The accountant will also be on the lookout for intracompany transactions and related-party transactions.

The SEC requires audited financial statements for three years as part of the registration process. The most common reason IPOs are delayed is because the financial statements are not audited or auditable. Revenue recognition is the area that most often causes problems for companies that want to go public.[22] Management accountants can help examine the company's terms of sale for products/services. Terms may need to be changed in order to satisfy the SEC. A notable example of an IPO that was delayed because of questionable revenue-recognition practices is Medco (Merck's pharmacy benefits unit).[23]

In the case of a merchandizing company or a manufacturer, it may be a good idea to have an independent accountant observe the counting of inventory at year-end so that it is auditable.

A strong system of internal control over financial reporting will be essential before an IPO. Many companies are moving toward building internal control assessment into their ongoing management functions, so the role of the management accountant is becoming even more important.

Management accountants should be on the lookout for any illegal or potentially illegal practices years ahead of the planned IPO. These practices may create contingent liabilities that will have to be disclosed in the registration statement. Some examples of contingent liabilities that have caused IPOs to be canceled are environmental and tax liabilities, insider transactions not at arm's length, and violations of international laws.

Prior to the IPO, it is a good idea to have any loans from shareholders paid back or replaced with bank debt. Similarly, any receivables due from shareholders or officers should be collected prior to the IPO.

It is widely believed that publicly traded companies will, at some point in the future, be required to use International Financial Reporting Standards (IFRS). The switch from U.S. GAAP to IFRS will likely require significant time and effort from the company's accountants.

Under Staff Accounting Bulletin (SAB) No. 99, accountants must consider qualitative materiality as well as quantitative materiality. SAB No. 99 also requires accountants to consider market reaction as another factor in determining materiality, which substantially increases the cost of accounting determinations.[24]

Management accountants should make sure that the financial reporting system in place can provide the information required by the SEC, including industry segment data. Compensation strategies should also be reviewed before going public.

Tax and estate planning is also extremely important before going public. It may be advantageous to determine if the company can be taxed as a Subchapter S corporation. Some restructuring may be necessary in

order to take advantage of tax considerations.

Selection of the Outside Accounting Firm

A big consideration for the company going public—and an area where the management accountant can help—is the selection of its outside accounting firm. Many management accountants have experience in public accounting and may be well-suited to help select a public accounting firm. One factor in this decision is the reputation of the accounting firm, which can lend increased credibility to the company's audited financial statements and the so-called "comfort letter" (which serves to assure that the unaudited financial information in the initial documents appears to follow GAAP). Other considerations in the selection of the accounting firm include the firm's experience in securities offerings and in dealing with the SEC, its industry experience, and its ability to offer advice on corporate and personal tax implications. Smaller private companies are rejected more frequently than large private companies by the Big Four accounting firms for IPOs.

Selecting an Underwriter and Drafting the Prospectus

Selecting the underwriter is also part of the IPO process. The role of the underwriter is to act as intermediary—to buy the stock from the company and then sell it to the public.[25] The underwriters also have an important role as advisors to the company going public. Underwriters are more apt to pair with a company with a strong management team. Therefore, a company planning to go public should start to assemble a strong team at least a year in advance of the planned IPO. The management accountant can help with the selection of qualified individuals. The company may have to upgrade its internal accounting staff, often hiring accountants with prior experience with public company accounting. Existing accounting staff may also undergo more training on SEC accounting requirements.

One way to learn more about a company's potential for an IPO is to interview several underwriters years before the target IPO date. These early meetings are typically free and can help the company develop a successful plan.[26]

After an underwriter is selected and a letter of intent has been executed, it is time to draft the prospectus, a process that usually takes about three to five weeks. The prospectus provides detailed information about the company and the offering and is written by the management team, including management accountants, bankers, lawyers, and outside auditors. The management accountants assist with the first draft of the prospectus, which is described in detail in the next section.

Form S-1 Reporting Requirements

The preliminary prospectus is filed with the SEC as part of Form S-1 (also referred to as the registration statement). Form S-1 must be filed with the SEC at least 20 days before the IPO. Typically 50 to 100 pages long, it provides financial, legal, and technical information about the company. Within the SEC, the Division of Corporation Finance reviews the registration statement for accuracy and adequacy of all material facts. The SEC responds to the registration statement with a comment letter noting any deficiencies. It is common for the SEC to object to or require further explanation as to revenue recognition, so this is an area where accountants need to make certain there are no errors. The SEC review period typically lasts six to eight weeks. After the SEC's comments on the preliminary prospectus are received, revisions and supplemental explanations are prepared, and the final prospectus is drafted and then filed with the SEC.

The parts of a typical Form S-1 are:

1. The *Front Section* contains general information regarding the company.
2. The *Cover/Inside Cover* contains general terms of the proposed stock offering.
3. The *Prospectus Summary* summarizes the company's business and history with financial information for the last five years, if available.
4. *Risk Factors* include risks related to the business as well as risks related to the stock and the offering.
5. *Use of Proceeds* discusses what the company plans to do with the money raised.
6. *Dividend Policy* discusses the company's current dividend policy and any anticipated changes.

7. *Capitalization* includes actual and pro forma data for long-term debt and stockholders' equity.
8. *Dilution* covers how to calculate the effect of the IPO on current shareholders.
9. *Selected Financial Data* includes income statement and balance sheet data for up to five years.
10. *Management's Discussion and Analysis* (MD&A) summarizes the basic business model of the company to be read in conjunction with the Selected Financial Data.
11. *Business* provides an outline of the business, industry, company strengths and strategy, products and customers, competition, regulation, employees, legal proceedings, properties, etc.
12. *Management* includes brief information about the executive officers and directors, the Board of Directors, the Board Committees, and executive compensation.
13. *Certain Transactions* contains information about financing transactions between the company, its backers, and management.
14. *Principals and Selling Stockholders* discloses who the owners are and who is selling stock.
15. *Description of Capital Stock* discusses types of stock (common, preferred), registration rights, etc.
16. *Underwriting* addresses the underwriting agreement.
17. *Legal Matters/Experts/Where You Can Find More Information* are sections with typically standard legal information.
18. *Financial Information* includes the Report of Independent Registered Public Accounting Firm, the audited balance sheets, statements of operations, statements of stockholders' equity and of cash flows, and the notes to the financial statements.
19. *Other Documents* include the articles of incorporation, stock option agreements, etc.

Management accountants can help prepare many of the above parts of the S-1, especially the selected financial data and MD&A. The MD&A will include information about operations and financial condition, information on use of proceeds, effect of dilution on existing shares, dividend policy, and capitalization. This section is usually drafted by the management team, including management accountants, along with the outside auditors. The bankers and lawyers may revise it as needed.

The management accountant also must help make sure the company is in compliance with SOX requirements, including Section 404. Under Section 404, the CEO and the CFO are required to certify the adequacy of internal controls and the accuracy of the financial statements. If the accountant does not do a good job in these two key areas, the IPO process can be compromised.

Numerous IPOs have been delayed because of accounting questions. One notable case is software maker Salesforce.com, which had its IPO delayed because the SEC had concerns over a change in accounting method. The company changed the way it accounted for sales commissions, which (in the opinion of some) had improperly bolstered the company's net income. This delayed the approval process by four months.[27]

The management accountant can also help with disclosures after the S-1 is filed. The SEC's Form 8-K requirements have been expanded recently. Entry into any material agreements must be disclosed. This imposes an additional burden on the management accountant, especially in smaller companies where an agreement is more likely to be material.

Further, in December 2006 the SEC increased the disclosure requirements for public companies' executive compensation. When Visa Inc. went public in 2008, its IPO documents contained 28 pages of disclosures relating to executive compensation. Management accountants can help with these types of disclosure requirements.

After the prospectus is drafted, the underwriter assembles the syndicate, which is the group of investment bankers who will place portions of the offering. This is followed by formal presentations to prospective investors, often called the "road show."

The Price, the Road Show, and Initial Trading

A major part of the IPO process is determining the price at which to sell the stock. Pricing errors can occur

Additional IPO Sources

www.hoovers.com/global/ipoc
In-depth information about IPO filings, recent offering performance, and the upcoming IPO calendar

www.123Jump.com/ipo/index
Alternative site providing IPO-related information for individual filings, including IPO withdrawals

http://ipoportal.edgar-online.com/ipo/home.asp
Detailed information regarding individual IPOs, some available only on a subscription basis

Executing a Successful IPO, PricewaterhouseCoopers, Transaction Services Practice, October 2010. This publication provides detailed guidance and tips regarding IPO readiness. It is available at www.pwc.com/us/en/transaction-services/publications/executing-a-successful-ipo.jhtml

The New York Stock Exchange IPO Guide, Caxton Business & Legal, Inc., Chicago, Ill., 2010
As noted in the introduction, "The goal of this guide is to demystify the initial public offering (IPO) process... [and] to help you understand and navigate a complex process that will ultimately lead to a positive and successful IPO experience." It is available at www.kpmginstitutes.com/global-enterprise-institute/insights/2010/pdf/ipo-guide-july-2010.pdf.

Ernst & Young's Guide to Going Public: Lessons from the Leaders, 2010
The introduction to this comprehensive guide states that "Ernst & Young is the undisputed U.S. leader in the number of companies taken public" and that the firm has "guided more companies through the SEC filing process than any other firm." The Guide is available at www.ey.com/Publication/vwLUAssets/EYs_guide_to_going_public_Lessons_from_the_leaders/$FILE/Ernst%20and%20Young's%20guide%20to%20going%20public%20Lessons%20from%20the%20leaders.pdf.

in both directions. Obviously, the company going public does not want to price the stock too low because that would result in an opportunity loss, i.e., a less-than-optimal amount of capital generated. At the same time, the company does not want to overprice its stock because the company might not be able to sell the issue or because of the potential price decline during the initial trading of the stock.[28] Accountants can play a vital role in the initial pricing decision, looking at price/earnings multiples or EBITDA multiples of comparable companies and comparable market conditions as well as taking into consideration projected future financial performance and any new products or services.

Once Form S-1 has been filed, the company's senior management, investment bankers, and lawyers go on what is referred to as the road show. Over the span of 10 to 14 days, the team makes several presentations each day to potential institutional investors. After the presentation, the investment bankers ask the potential investors for an indication of interest in purchasing the shares. This process of "book-building" is very important. If demand is high enough, the offering price may be increased. If the demand is not high enough, the offering price may be reduced or, in extreme cases, the IPO may be canceled.

After the road show, the offering price will be finalized on the night before the actual offering date. The first day of actual trading can be very exciting. For the 2009 IPO of Rosetta Stone, the IPO price was $18 per share, and the stock closed the first day of trading at $25.12, a rise of nearly 40% in one day.[29] For the IPO of Verisk, the IPO price was $22, and the stock closed the first day of trading at $27.22, a rise of almost 24%.[30] With some IPOs, however, the share price actually declines on the first day of trading. For the IPO of Omeros, the IPO price was $10, and the stock closed the first day of trading at $8.73, a drop of almost 13%.[31]

At the completion of the IPO, a tombstone ad (which gets its name from its black border and heavy black print) is placed by investment bankers in the print media. This ad is the official notice that a securities placement has occurred. It lists basic information about the issue, such as the security being sold and its price, as well as the underwriting groups involved in the deal,

which are listed in order of importance. The tombstone ad provides investors with bare-bones information, usually directing prospective investors to where they can find a red herring/prospectus.

Assisting the CFO

Management accountants can help the company's CFO in the following areas:

- Implementation of newly issued or newly applicable FASB Statements;
- Assistance with accounting for partnership "roll-ups" and/or business acquisitions completed in conjunction with the IPO;
- Accounting for compensation and valuation issues associated with stock, stock options, and warrants; and
- Assistance with the dual presentation of earnings per share when common stock equivalents are present.

After a successful IPO, the role of the management accountant is far from over. Audited financial statements must be filed annually with the SEC. Regulatory requirements, including SOX, still have to be met. Finally, management accountants will work closely with the CEO and COO to help ensure that the company remains profitable.

Adding Value to the IPO

Since 2005, there have been more than 4,300 IPOs in the United States. While the IPO market in the United States has slowed recently, there still have been a number of large and otherwise noteworthy IPOs, including the successful IPO of Visa, Inc. in 2008, Rosetta Stone in 2009, and the completed IPO of GM in 2010.[32] Rosetta's stock price increase of almost 40% on the first day of trading leads some analysts to believe that this is a sign of more successful IPOs to come.

In light of the definition of management accounting promulgated by IMA, management accountants in general need greater insight into the IPO process and how they can both facilitate and add value to it. For those who want to obtain additional information regarding the IPO process, please refer to the sidebar, "Additional IPO Sources." ■

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Endnotes

1 An IPO in which a company sells its unissued securities and receives all the proceeds is called a *primary offering*. A securities sale in which securities (all or in part) held by the owners (and/or venture capitalists) of the company are sold, and from which the owners receive the proceeds, is called a *secondary offering*. Some of the biggest secondary offerings have involved governments (non-U.S.) selling off stock in nationalized industries. IPOs are commonly both primary and secondary: In such a case, the company raises new cash at the same time that some of the existing shares in the company are sold to the public.

2 IMA, *Definition of Management Accounting*, Montvale, N.J., 2008. Available at www.imanet.org/resources_and_publications/research_studies_and_statements/statements_on_management_accounting.aspx (member login required).

3 This article was motivated by a speech given by the guest speaker at the Beta Alpha Psi (BAP) banquet hosted at the institution of one of the authors. The speaker, who was both a CMA® and CPA, was the CFO of a privately owned company that eventually went public. The speaker recounted for those in attendance how little he know of the IPO process in terms of his professional training and how much he was forced to learn. This article is largely the result of that presentation and the speaker's suggestion that we share with a wider accounting audience insights about the IPO process and the role of the management accountant in that process.

4 Current Learning Outcomes for the CMA exam pertaining to IPOs are specified in Part 2—Section B.6, Raising Capital (see www.imanet.org/PDFs/Public/CMA/CMA_2010_LOS_Final_10_10.pdf), accessed March 8, 2011. The following specific learning outcomes apply: demonstrate an understanding of the roles of investment banks, including underwriting, advice, and trading; define offering price and calculate spread; identify and define the terms "best-efforts distribution," "syndicate," and "tombstone ad"; identify the information that must be supplied when registering with the SEC; distinguish between a public offering and a private placement; define Initial public offerings (IPOs).

5 Further, there are typically restrictions on insider sales during the IPO process. Specifically, most underwriters require that a company's existing shareholders enter into contractual agree-

ments to refrain from selling their stock during a specified time following the IPO, typically 180 days. This is called the "lock-up" period.

6 An underwriter is a firm that buys the securities issue from a company and then resells these shares to the public. Underwriters are investment banking firms and can be considered the "middle man" between the public and the company issuing securities. The investment banker usually buys a new issue of a stock (or bond) directly from the issuing corporation and sells it to individuals and institutions. A small IPO may have only a single underwriter, but larger issues usually require a syndicate of underwriters. For example, the IPO by Microsoft involved more than 100 underwriters.

7 Aaron Lucchetti, Dennis K. Berman, and Robin Sidel, "GM Will Pay a Cut-Rate Price to Do Its New IPO," *The Wall Street Journal*, Saturday/Sunday, June 12-13, 2010, pp. B1, B3. The article reports that JPMorgan Chase and Morgan Stanley won the role of underwriting General Motors Co.'s IPO. These underwriters earned 0.75% of the overall deal. According to data cited from Dealogic (www.dealogic.com), this fee was the lowest it has seen in tracking more than 4,300 IPOs since 2005. The GM IPO, however, was one of the biggest on record. Its IPO gave the two lead underwriters the biggest portion of a $112.5 million fee pool. When Visa, Inc. sold $19.7 billion in shares to the public in 2008, banks led by JPMorgan and Goldman Sachs Group collected a fee of 2.8%, according to Dealogic. The next-largest IPOs had fees of 2.7% to 4%, Dealogic said.

8 "Blue Sky" law refers to the securities laws of various states enacted to protect investors from companies that promise the sky to investors. While the SEC regulations are national in application, various states have securities laws that affect public offerings. Note that expenses directly related to the offering in a completed IPO are reflected as an offset to the proceeds received and a reduction of additional paid-in-capital. If the IPO is not completed, however, such costs are generally expensed on the company's income statement for the period in question.

9 Form 10-K is the annual report to shareholders (conforming to SEC specifications) that discloses in detail information about the company's activities, risks, financial condition, and results of operations. It also contains the company's audited annual financial statement, which includes the external auditor's opinion of financial statements and SOX Section 404 attestation (only required from the second Form 10-K filed after going public). Form 10-Q is the quarterly report required for each of the first three quarters of the fiscal year. It includes condensed financial data and information on significant events. In addition, SEC rules require that the interim financial information included in the quarterly report be subject to a review by an independent accountant prior to filing. Finally, Form 8-Q is used to report significant events (such as an acquisition or disposal of assets, a change in control, bankruptcy, a change in independent accountants, resignation of directors because of disagreement with the registrant, the entry into a material definitive agreement, creation of direct obligations or obligations under off-balance-sheet arrangements, a commitment to a plan involving exit or disposal activities, asset impairments, and when a company concludes or is advised by its independent accountants that previously issued financial statements should no longer be relied upon).

10 See www.sec.gov/answers/transferagent.htm for more details of the functions a transfer agent performs.

11 One way to raise capital but avoid SOX requirements and the need to register with the SEC is to issue a private placement. In a private placement, securities are sold to a small number of select investors (usually banks, mutual funds, pension funds, etc.).

12 This summary is based on PricewaterhouseCoopers, LLP, *Roadmap for an IPO: A Guide to Going Public*, 5th ed., 2010, pp. 27-28. (Available at www.pwc.com/us/en/transaction-services/publications/roadmap-for-an-ipo-a-guide-to-going-public.jhtml; accessed March 8, 2011).

13 *Ibid.*

14 F. D. Lipman, *International and U.S. IPO Planning: A Business Strategy Guide*, Wiley, Hoboken, N.J., 2009.

15 IMA, *IMA Statement of Ethical Professional Practice*, Montvale, N.J., 2005, www.imanet.org/PDFs/Secure/Member/SMA/SMA%201C%20FINAL-EthicalProfPractice.pdf (member login required).

16 Todd A. Shawver and Tara J. Shawver, "Predicting Management Fraud in IPO Companies," *Management Accounting Quarterly*, Vol. 11, No. 1, Fall 2009, pp. 22-26.

17 See www.law.uc.edu/CCL/33ActRls/regC.html for more information.

18 Form S-1 can be found online at www.sec.gov/about/forms/forms-1.pdf. In contrast to Form S-1, the form used by foreign issuers is Form F-1.

19 Guidance for the preparation of financial information as part of the registration process is provided by the *Financial Reporting Manual* prepared by the SEC's Division of Corporation Finance, available online at www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf. Guidance for "smaller companies" is available at www.sec.gov/divisions/corpfin/guidance/cfsmallcompanyregistration.htm.

20 The SEC defines a "large accelerated filer" as a company with a market value of publicly floated equity equal to or exceeding $700 million as of the last business day of the company's most recently completed second fiscal quarter. *Federal Register*, Vol. 74, No. 26, Tuesday, February 10, 2009, Rules and Regulations, p. 6785 (available at www.sec.gov/rules/final/2009/33-9002fr.pdf).

21 A typical IPO execution process can take about 6-12 months. For a timeline for the period leading up to and after an offering broken down by key participants in an IPO, see PricewaterhouseCoopers, *Roadmap for an IPO*, pp. 39-40.

22 Lipman, 2009.

23 L. Krauskopf, "Merck's Medco IPO Hits New Snag: Spinoff Is Delayed by Revenue Scrutiny," *Knight Ridder Tribune Business News*, July 9, 2002, p. 1.

24 Lipman, 2009.

25 Most IPOs are *firm commitment* deals, which means that the lead underwriter buys all of the shares and is responsible for selling them. In a small number of cases, the IPO is effected on a *best efforts* case, which means that the underwriters are only obligated to do their best to sell the shares. There are variations on these two basic agreements. They include an *all-or-none* commitment, which is a modification of the best-efforts agreement. In this commitment, all of the stock must be sold by the underwriter or the entire issue is canceled (at considerable cost to the company). In a *partial all-or-none* agreement, the underwriter requires sale of a specified portion of the issue (typically two-thirds) for the best efforts to remain in effect on the remainder of the issue. Many IPOs involve a group of underwriters, called a *syndicate*, which buys the shares to sell to the public.

26 Lipman, 2009.
27 J. Shinal, "Cautionary Notes from Salesforce Saga," *San Francisco Chronicle*, April 10, 2004, p. C-1.
28 T. Loughran and J.R. Ritter, "Why Has IPO Underpricing Changed Over Time?" *Financial Management*, Vol. 33, No. 3, 2004, pp. 5-37.
29 L. Cowan, "Rosetta Stone's IPO Jumps Nearly 40%," *The Wall Street Journal*, April 17, 2009, p. C2.
30 L. Cowan and R. Jelmayer, "Year's Biggest IPOs Make Debuts," *The Wall Street Journal*, October 8, 2009, p. C3.
31 L. Cowan, "Mistras Up, Omeros Not on IPO Day," *The Wall Street Journal*, October 9, 2009, p. C5.
32 L. Cowan, "Rosetta Opens Door for Select Stocks," *The Wall Street Journal*, April 20, 2009, p. C5.