

Hot accounting issues and SEC topics in recent US IPOs

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March 2005

SEC Comments – Recurring Themes

- Revenue recognition
- Stock based compensation – “Cheap Stock”
- Preferred stock – “BCF”
- Business combinations
- Segments
- Contingencies and reserves
- MD&A
- Non-GAAP measures

SEC Comments – Recurring Themes

Revenue recognition

- **Criteria:**
 - **Evidence of arrangement**
 - **Delivery**
 - **Collectibility**
 - **Price is fixed and determinable**
- **Extended payment terms**
- **Acceptance**
- **Revenue arrangement with multiple deliverables**
- **Sales to resellers**

SEC Comments – Recurring Themes

Cheap stock – stock based compensation

- Cheap stock exists when the exercise price of stock option is below the market value of the stock at the time of grant
- SEC would challenge companies for options granted at exercise prices below IPO price
- The presumption is that options granted 1 year prior to the IPO should be at the IPO price, unless can be proved differently
- P&L presentation

SEC Comments – Recurring Themes

Cheap stock – stock based compensation VPES a/k/a Cheap Stock

- Recent AICPA paper on VPES completed, but CorpFin holds some views that indicate the standards have not been liberalized from prior practices
- Three approaches in the Paper: Market Approach; Income Approach; Asset-Based Approach
- Theme #1: Approach used to determine enterprise value must be appropriate to the stage of development
- Theme #2: Approach used to allocate enterprise value must be appropriate to the stage of development
- Theme #3: Any discounts require objective and reliable support

SEC Comments – Recurring Themes

Preferred Stock - “BCF”

- **BCF - Beneficial Conversion Feature exists when the conversion price is below the fair value of the common stock on the commitment date**
- **Similar to cheap stock issues, SEC focuses on the conversion price embedded in convertible preferred stock and debt securities issued within 1 year of an IPO**
- **Effect on financial statements**

SEC Comments – Recurring Themes

Business combinations

- Purchase price allocation
 - In process research & development (IPR&D)
 - Goodwill
- Amortization method

SEC Comments – Recurring Themes

Segments

- Segments continue to be a “hot topic” for the SEC:
 - FAS 131 disclosure
 - Business overview (S-K 101)
 - MD&A
- SEC staff will look for inconsistencies between MD&A/press release/website disclosures and financial statement disclosures
- In the comment letter process, SEC staff has requested to review the full monthly and/or quarterly reporting packages provided to “Chief Operating Decision Maker” and to BOD
- SEC will challenge large companies with 1-2 segments or no change from FAS 14 segments

SEC Comments – Recurring Themes

Contingencies and reserves

- **Disclosures should be in compliance with FAS 5**
 - **No general disclosures**
 - **Disclosure should include estimated loss, or range of loss, that is “reasonably possible”, or disclosure that such estimate cannot be made**
- **SEC may question tax reserves and other types of reserves**

SEC Comments – Recurring Themes

Contingencies and reserves

“Please supplementally provide us with an analysis of all tax reserves recorded in your financial statements. As part of your response, please include the following:

- The amount of each specific tax reserve recorded and the date it was recorded;**
- A description and analysis of the tax issue and the alternative viewpoints underlying each specific reserve;**
- A complete and full analysis supporting your accounting treatment under SFAS 5;**
- The amount and dates of any subsequent payments or adjustments to the reserve;**
- The current status of the issue surrounding the reserve.”**

SEC Comments – Recurring Themes

MD&A

Common deficiencies found in MD&A:

- Lack of transparency
- Lack of related party disclosures
- Disclosure of non-GAAP measures
- Omission of forward looking information

SEC Comments – Recurring Themes

MD&A

FR 72 - SEC guidance on improving MD&A:

- Executive summary
- Give greatest prominence to most important information
- Avoid unnecessary duplication
- Focus on material information
- Identify and discuss key performance indicators
- Disclose known, trends, events, demands, commitments, and uncertainties
- For liquidity and capital resources – discuss company's ability to meet cash requirements over both short and long term
- For critical accounting estimates – supplement, don't duplicate, descriptions of accounting policies

SEC Comments – Recurring Themes

MD&A

Critical Accounting Policies- “Please expand your disclosure of the Company’s critical accounting policies to include:

- **An analysis of the uncertainties involved in applying the principle and variability that is reasonably likely to result from its application**
- **An analysis of how you arrived at the measure and how accurate the estimate or underlying assumptions have been in the past**
- **An analysis of your specific sensitivity to change based on outcomes that are reasonably likely to occur and have a meaningful effect”**

SEC Comments – Recurring Themes

Non-GAAP Measures

A non-GAAP financial measure includes:

- **Measures of performance that are different from that presented in the financial statements in accordance with GAAP**
- **Measures of liquidity that are different from cash flow or cash flow from operations determined in accordance with GAAP**

Examples of Non GAAP financial measures:

- **Performance vs. liquidity measures – especially EBIT and EBITDA**
- **Definition of EBITDA and EBIT**
- **Describing items by “excluding”**
- **Non-recurring items**
- **Total measure of segment profitability**
- **Profitability excluding depreciation and amortization**

SEC Comments – Recurring Themes

Non-GAAP Measures

Recurring SEC comments:

- reconciliation of the non-GAAP measure to the most comparable GAAP measure
- Adjusting a non-GAAP performance measure to eliminate “non-recurring, infrequent or unusual” items, when such items are likely to recur within two years or there was a similar item within the prior two years
- Presenting a non-GAAP financial measure on the face of the financial statements or in the footnotes
- Using titles or descriptions of non-GAAP financial measures that are the same as or similar to titles or descriptions of GAAP financial measures

Summary

- **Increased scrutiny on corporate and financial reporting resulting from the corporate scandals of 2001 and 2002 means greater regulatory diligence for companies preparing for an IPO**
- **SEC expects its rules to be regarded as the floor not the ceiling**

However, the US financial market remains the largest and the most appealing...