GIORDANO, HALLERAN & CIESLA
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
PLEASE RESPOND TO:
U.S. POSTAL SERVICE ADDRESS:
POST OFFICE BOX 190
MIDDLETOWN, NEW JERSEY 07748
OR:
HAND DELIVERY AND OVERNIGHT SERVICE ADDRESS:
125 HALF MILE ROAD
RED BANK, NEW JERSEY 07701
(732) 741-3900
FAX: (732) 224-6599
www.ghclaw.com

April 2007

Preparation for the Initial Public Offering

By John A. Aiello, Esq., Philip D. Forlenza, Esq.,
Paul T. Colella, Esq. and Gerald P. Lally, Esq.

The initial public offering ("IPO") is an attractive vehicle for a company to raise capital and to secure, at the same time, many of the other advantages of public company status. In recent periods, the high valuations ascribed by investment bankers to certain private companies, particularly those in the technology sector, have allowed those companies to sell stock in initial public offerings to raise significant amounts of capital for a variety of purposes, including product development, marketing and financing growth that public offering candidates typically experience. In addition, having publicly traded stock allows companies to grow by acquisition, utilizing their stock as currency to acquire other companies. In short, the rewards of going public are numerous, but there are many risks and uncertainties involved in the public offering process.

Certain of the IPO risks such as market conditions are beyond the control of management of the public offering candidate; however, there are a variety of matters within the control of management that can be addressed to enhance the prospects of successfully completing the IPO. This article highlights several issues that a corporate lawyer can address with the management of a corporate client contemplating a public offering of its securities so that the company is prepared to successfully achieve the objective of going public.

We will outline several planning matters in the balance of this article that should be carefully considered by the public offering candidate and its counsel, including the following:

- ✓ Organizational structure
- ✓ Charter documents and corporate housekeeping
- ✓ Sales of unregistered securities
- ✓ Issues to address in negotiations with private investors
- ✓ Stock based incentive programs

- ✓ Financial and accounting issues

Organizational Structure

One of the initial steps in counseling a client contemplating a public offering of securities is to determine the form of legal entity that will be offering its securities to the public. Most of the commonly used forms of legal entities for start-up businesses, such as limited liability companies and S-corporations, are generally not suitable to take public. Although limited liability companies and S-corporations provide certain tax advantages to their owners, the pass-through treatment of tax items arising from the operation of these entities and the limitations in the capital structure and ownership of an S-corporation make such forms ineffective for public offerings.

The preferred form of legal entity for a public offering is a C-corporation. Counsel representing a limited liability company, S-corporation or partnership that is contemplating a public offering of securities must consider the conversion or merger of the entity into a C-corporation. Prior to any conversion or merger into a suitable public vehicle, the client will need to consult with its tax advisors with respect to the tax consequences (including the treatment of the legal entity's net operating losses, if any) of any such conversion or merger. Further, if the client expects to go public within a few years, it may make sense for the legal entity to be in a form suitable for a public offering from inception in order to avoid the conversion/merger issue.

When forming a legal entity with the expectation that it will be utilized as a vehicle for a public offering, or converting or merging an existing legal entity into another form of business organization, such as a C-corporation, in anticipation of a public offering of that entity's securities, the jurisdiction of organization for the legal entity should be considered. For example, if the public vehicle is a C-corporation, counsel should be aware that the laws of certain jurisdictions are more favorable to corporations, either because the tax laws present certain advantages or the corporate laws have been designed to provide flexibility in the organization and operation of a corporation. Moreover, the corporate laws of certain states are easier to understand and apply because they have been interpreted and developed through case law and other commentary.

In reviewing whether the corporate law of a jurisdiction is favorable for a public company, counsel should focus on whether such jurisdiction has adopted "anti-takeover" statutes. Generally, "anti-takeover" statutes, such as the New Jersey Shareholders Protection Act, are purportedly enacted to protect a publicly traded corporation's shareholders, employees and customers and the communities whose residents may be dependent on the corporation from undesirable takeovers. However, "anti-takeover" provisions may not always be in the best interests of the shareholders of a corporation and may present certain obstacles to mergers and acquisitions which management may want to undertake in the future.

Charter Documents and Corporate Housekeeping

If the client is an existing C-corporation that was incorporated in a jurisdiction with laws favorable to a public vehicle, a conversion or merger into a newly formed legal entity will not be necessary. However, the certificate or articles of incorporation and bylaws of the corporation must be reviewed to determine whether they contain any provisions which could have an adverse effect on the offering of the corporation's securities to the public. Counsel to the underwriter engaged in connection with the offering will also review such documents to determine whether any of the provisions need to be removed or modified prior to the public offering so that the corporation is more attractive to the investing community. Provisions providing for non-voting common stock, preemptive rights, cumulative voting with respect to the election of directors and super majority voting rights may have to be deleted from such documents.

When conducting a pre-public offering review of a corporation, counsel must also examine whether it is appropriate or necessary for the corporation to enter into an employment agreement with its key officers and other personnel or whether any existing employment agreement needs to be modified so that the corporation is more attractive to investors. For example, if the corporation's chief executive officer is the primary developer of the products being offered by the corporation, an employment agreement that prohibits the officer from competing with the business or provides the officer with financial incentives to remain employed by the corporation for a substantial period would be more attractive to the investment community than a short term agreement or one that provides significant severance compensation in the event the chief executive officer elects to leave the corporation.

It is very important for counsel to determine whether any corporate housekeeping needs to be performed prior to the public offering. The corporation's books and records must be examined to ensure that directors and officers were properly elected and appointed, that there were regular meetings of the board of directors and shareholders and that the corporation has otherwise complied with its certificate or articles of incorporation, bylaws and the corporate and other laws of the corporation's state of incorporation. In some instances, it may be necessary to have the present board of directors and shareholders adopt resolutions ratifying prior actions of the corporation. In addition, counsel will need to review whether the corporation is qualified to do business and in good standing in each jurisdiction where it conducts business and has all licenses and other permits necessary to conduct its business.

In reviewing a company's bylaws, particular attention should be paid to provisions related to the conduct of shareholder meetings. Provisions which require that shareholder proposals be submitted no later than a specified number of days prior to the meeting and which limit the business which can be conducted at a shareholder meeting should be considered. Also, the bylaws should give the company's board of directors or chairman of the board the right to establish rules or regulations related to the conduct of the meeting.

In order to provide flexibility for future capital raising transactions, the inclusion of a provision in the company's certificate or articles of incorporation providing for a class of "blank check" preferred stock should be considered. These types of provisions permit the board of directors to establish the rights and preferences of a class or series of preferred stock without receiving shareholder approval. The ability to avoid a shareholder vote on the creation of a class or series of the preferred stock can result in significant time and costs savings to a public company that is raising capital in a private transaction.

In addition, most states allow for the certificate or articles of incorporation to include a provision limiting the liability of officers and/or directors to the corporation and its shareholders. The inclusion of a limitation of liability provision in the certificate or articles of incorporation, together with broad mandatory indemnification provisions and director and officer liability insurance, may help a corporation attract qualified officers and directors. Generally, underwriters find these methods of insulating directors and officers of the corporation from liability to be very important.

Selling Unregistered Securities; Avoiding Rescission Offers.

Whenever a company issues securities, it must register the securities under Federal and/or state securities laws unless an exemption from registration can be identified. In most cases, a private offering exemption, such as those provided by Section 4(2) of the Securities Act of 1933 ("1933 Act") or Regulation D, will be available. These exemptions may, however, require filings to be made with the Securities and Exchange Commission and state blue sky commissions. In addition, an applicable exemption may require certain information, including audited financial statements, to be provided to prospective investors before the sale is made. The exemption may also preclude the participation of investors lacking sophistication in financial matters. As explained below, the failure to comply with federal and state securities prior to conducting an IPO can have a serious impact on the going public process.

The due diligence investigation of an IPO candidate is an essential component of the going public process. One of the primary focus areas of the due diligence investigation is an analysis of all issuances of securities by the company to confirm that all of the company's outstanding securities were issued in transactions exempt from state and Federal registration. The identification of any failures to comply with Federal and state registration requirements frequently causes delays in the public offering process due to the need to cure the prior violations before the offering commences.

Curing securities law violations which arise from a failure to issue unregistered securities under an appropriate private offering exemption requires the issuer to make a "rescission offer" to all or some of its securityholders. In a rescission offer, the securityholders are given the opportunity to rescind their investment transaction and receive a return of their investment plus interest. Rescission offer requirements vary on a state by state basis. Rescission offer documents must often be filed with state blue sky commissions, and some states, including New Jersey, require preclearance of rescission documents before the rescission offer can be made. Most states require the rescission offer to be kept open for 30 days. Because rescission offers are treated as both an offer to buy and an offer to sell the securities which are the subject of the rescission offer, an appropriate exemption from state and Federal registration must be identified for the rescission offer. If an exemption is not available, state and/or Federal registration will be required.

In some cases, a company, in consultation with its underwriter, may choose to proceed with the public offering without conducting a rescission offer based upon a belief that due to economic or other factors, the prior violations are unlikely to result in claims by securityholders. If this approach is taken, the potential exposure to securityholders, if material, must generally be disclosed as a contingent liability and a potential risk factor in the public offering prospectus and may cause an adjustment of the equity section of the company's balance sheet. This type of disclosure may make the public offering less attractive to investors. In addition, some blue sky administrators may require the rescission offer to be made before granting clearance of the public offering registration statement.

In light of the potential delays and adverse disclosures that may arise from securities law violations, it is important that companies that wish to go public pay close attention to Federal and state securities laws when they issue securities privately, including options granted to employees at no cost. All issuances should be reviewed with competent counsel so that an appropriate exemption from registration is identified and any requisite state and Federal filings made before the securities are offered and sold.

Negotiating With Private Investors.

Before going public, candidates for IPO's often raise capital through a series of private transactions. In negotiating with potential investors, companies should be mindful that some protections requested by investors may adversely impact the company's ability to raise capital in the future and its ability to conduct a public offering. For instance, investors sometimes demand antidilution protection so that their percentage interest in the company is not reduced by subsequent issuances of stock. Although certain forms of antidilution protection are appropriate when issuing convertible securities or rights to acquire common stock, agreements to issue "free" shares to holders of common stock in the event of future securities issuances should be avoided.

Often, investors will request a preemptive right to acquire securities if the company issues securities in the future. Generally, these types of rights are less offensive than the type of antidilution protection described above; however, companies granting these rights should try to provide for the termination of the preemptive rights after the company raises a specified amount of capital or, at a minimum, when the company commences a public offering.

Venture capital and other investors typically request that the company grant to them demand and "piggyback" registration rights for their securities. Demand registration rights provide the investor with the ability to compel the company to register the investor's shares for public sale. Piggyback rights provide to the investors the right to have their shares registered if the company is registering shares on its own behalf or on behalf of other investors. In negotiating registration rights agreements with investors, it is important to prohibit the investors from being able to exercise demand rights before the company completes its initial public offering. If the rights can be exercised before the company has completed its public offering, an investor could theoretically exercise its registration rights and force the company to become a public reporting company before there is any trading market in the company's stock.

Companies should endeavor to structure piggyback registration rights so that the investors cannot "piggyback" on to the initial public offering. Although registration rights agreements typically give the company's underwriter the ability to exclude investors' shares from an offering if the inclusion of the investors' shares would adversely impact the underwriter's ability to market the offering, precluding the exercise of piggyback rights in connection with the IPO can avoid a potential dispute with investors as to whether the underwriter has proper justification for excluding the shares.

Underwriters are often concerned that sales in the public market by pre-IPO shareholders will have an adverse impact on the trading price of the company's stock. As a result, it is useful to include in a registration rights agreement "market stand-off" provisions which preclude the investors from selling shares within a specified period of time (usually 90 to 180 days) after the effective date of a public offering registration statement. If these types of provisions are not in place, the underwriter will often condition the IPO upon the execution of "lock-up" agreements containing similar restrictions by all or certain pre-IPO shareholders. The inclusion of market stand-off provisions in a registration rights agreement may enable the company to avoid the burden and delays associated with obtaining lock-up agreements at a later date.

Stock Based Incentive Programs

Providing stock based incentives to employees of an IPO candidate is critical in attracting, retaining and motivating employees. Today, employees at all levels view ownership of their employer as an important means to increasing their personal net worth. The creation of wealth at all employee levels through stock based incentive programs can be successfully achieved; however, not without compliance with a complex regime of securities, tax and accounting rules affecting both the corporation and the employee.

There are a wide variety of stock based incentive programs that a company can institute, including incentive stock options, non-qualified stock options and restricted stock purchase plans. The design of a stock based incentive plan involves a number of factors and a complete discussion of plan design is beyond the scope of this article.[1] Instead, our objective in this article is to discuss certain significant securities, tax and accounting issues that should be considered as the potential IPO candidate develops a stock based incentive plan.

Employee Plan Design

There are several issues to examine in connection with the preparation of a stock based employee incentive program including, among others, eligibility for participation in the plan, vesting and rights and obligations arising upon termination of employment with the company. An in depth discussion of many plan design issues is not possible in an article of this length; however, there are certain plan provisions that should be mentioned inasmuch as they are particularly relevant to the private company planning a public offering.

- Stock Option Exercise Methods. It is not uncommon for options that are granted while a company is private to be exercised after the company becomes a public company. With that in mind, the plan should include provisions that allow different methods of option exercise. Of course, exercises for cash would be included; however, the issuer may want to include other option exercise methods that do not require a cash outlay. Two such methods are the so called "stock swap", where the amount due on exercise is paid with other shares of stock held by the employee[2] and the "net exercise" or "cashless exercise", where the exercise price is effectively paid through a forfeiture of certain of the options, or shares underlying the options are sold contemporaneous with the exercise of the options and a portion of the proceeds of the sale is used to pay the exercise price.[3] These additional methods of exercise are normally important to employees participating in the plan, and the absence of these provisions may render the plan less attractive to the key employees that the company is endeavoring to incent. Counsel should be aware, however, that certain exercise methods are not available for options intended to qualify for incentive stock option treatment under Section 422 of the Internal Revenue Code (the "Code").

- Acceleration of Vesting or Lapse of Restrictions. In this age of fast moving corporate events, the time between a public offering and a follow-on sale of the company may not be great. Entrepreneurs, including those who have elected to effect an initial public offering rather than pursue a merger or acquisition as an exit strategy, remain focused on the M&A marketplace and sales or mergers of public companies soon after their initial public offering is not uncommon.

  Against this backdrop, employees who have been granted options that vest over a period of time or who have purchased restricted stock where the restrictions lapse over a period of time are generally interested in how the plan deals with vesting and/or lapse of restrictions when there has been a change in control of the company. A change in control is normally defined to include a change in ownership of a substantial number of the company's outstanding shares, sale of all or substantially all of the company's assets and a merger or consolidation where, in effect, the company is not the surviving corporation.

Because of concerns over their relationship with the acquirer, employees participating in a stock based employee plan are generally interested in seeing that the plan provides for an acceleration of vesting of options or the lapse of restrictions, as the case may be, if an event constituting a change in control occurs. Automatic acceleration provisions have been particularly important to companies seeking to have the accounting rules known as the "pooling" rules apply to a merger transaction, because a decision to accelerate made immediately prior to the merger would disqualify it for "pooling" treatment. It would appear that the American Institute of Certified Public Accountants and the Financial Accounting Standards Board will eliminate the pooling rules by the end of 2000, which will, in turn, eliminate the concern about accelerating vesting immediately prior to the merger transaction. If the pooling rules are not repealed, this issue of acceleration remains to be considered in a stock based incentive plan for a private company that is about to go public. The rules governing pooling are complex; however, it is important to note the significance of acceleration provisions in a merger and acquisition context.[4] If the pooling rules are not a significant concern, companies whose value rests in the intellectual capital of its employees are sometimes reluctant to accelerate vesting and/or lapse of restrictions upon the occurrence of a change of control event inasmuch as this may adversely affect the acquiring company's ability to retain employees and give rise to a discounting of the purchase price to account for this uncertainty.

Impact of Securities Laws on Stock Based Compensation

As discussed above, it is very important that a corporation seeking to go public issue securities in compliance with the Federal and state securities laws. Since the sale or issuance of shares to employees of a corporation fits within the ambit of the sale of a security, it is essential that a public offering candidate take measures to comply with the Federal and state securities laws. Fortunately, there are a variety of exemptions from registration that are available to the closely held company to facilitate compliance in the sale of stock to employees.

One exemption that deals specifically with sales of securities to employees is Rule 701, promulgated under the Securities Act of 1933. Rule 701:

- is only available to private companies, i.e. companies that are not subject to the reporting requirements of the Securities Exchange Act of 1934 ("1934 Act");[5]

- exempts the offer and sale of securities pursuant to written employee benefit plans such as stock option or restricted stock purchase plans;

- limits the amount of securities that can be sold by the issuer pursuant to this exemption in any twelve month period to the greater of (i) securities having a value of $1,000,000; (ii) securities having a value of up to 15% of the issuer's total assets; or (iii) an amount of securities that does not exceed 15% of the outstanding amount of the class of securities being sold under Rule 701;[6]

- provides that sales of securities under this rule are not integrated with sales by the issuer pursuant to other exemptions.[7]

Except for the requirement for the issuer to provide the employee with a copy of the benefit plan, there are no disclosure requirements under Rule 701 unless sales in any twelve month period exceed $5,000,000, in which case additional disclosure is required. Even though the Rule 701 disclosure requirements are not onerous, it is worthwhile to note that the anti-fraud rules of the Federal and state securities laws apply to the sale of securities to employees. Accordingly, the disclosure of material information about the Company to offeree/employees in a written format is strongly recommended.

In addition to the Federal securities laws, it is necessary for the privately held company to comply with applicable state securities laws. Under the New Jersey blue sky law, such compliance requires no additional action if the issuer has complied with Federal Rule 701 since the regulations promulgated under the New Jersey Uniform Securities Laws exempts from registration sales of securities under employee benefit plans pursuant to Rule 701.[8] Other jurisdictions have enacted laws exempting securities issued in connection with employee benefit plans.[9]

Tax Aspects of Stock Based Incentives

If shares are sold to employees of a corporation for less than their fair market value, either intentionally or because the Internal Revenue Service ("IRS") disagrees with the company's determination of fair market value, then the employee has received taxable ordinary income and the company is obliged to withhold income tax from the employee's salary or collect amounts to be withheld from the employee. Failure to comply with the withholding requirements gives rise to a violation by the company of Section 3402(a) of the Code and an obligation to disclose the violation in the prospectus prepared in connection with the initial public offering[10]. It is important to avoid negative disclosure of this nature, and, accordingly, paying close attention to the income tax withholding requirements that may arise in connection with the sale of stock to employees of the company is very important.

Another tax issue that is sometimes overlooked arises when a company has embraced either a non-qualified stock option plan or restricted stock purchase program, as a stock based incentive program. In either case, ordinary income (as opposed to capital gain) will be recognized by the employee either upon the exercise of the non-qualified option[11] or when restrictions lapse in the case of a sale of restricted stock[12], assuming in either case that the stock has appreciated in value. An employee who either cannot exercise an option because of vesting requirements or who elects not to exercise an option until immediately prior to its expiration or an employee who has purchased stock that is restricted for a period of time, will be seriously disadvantaged because the appreciation in value of the shares will be taxed at ordinary income rates, which are significantly higher than current capital gains rates. The incentive that the company sought to provide, albeit still present, is diminished in value and less effective than originally anticipated.

The dampening effect of ordinary income treatment described in the preceding paragraph can be avoided without the company sacrificing one of its primary objectives, retention of the employee over a period of time through vesting provisions in options or risks of forfeiture of stock in the case of a restricted stock purchase plan. Specifically, the vesting provision can be eliminated from the non-qualified option so that it is immediately exercisable, and at the same time the stock acquired upon exercise of the option can be subject to a risk of forfeiture back to the company if the employee does not remain in the employee of the company for a specified period of time. Under these circumstances, the person exercising a non-qualified option would have the same treatment as the person who made an outright purchase of shares under a restricted stock purchase plan. The question remains as to how one goes about avoiding ordinary income treatment when restrictions on the stock lapse and locking in future appreciated value in the stock for more favorable capital gain treatment. The answer lies in Section 83(b) of the Code. If the employee makes a proper election under this section of the Code, ordinary income tax is paid on the difference between the option exercise price and the fair market value of the stock on the date of exercise or, in the case of a restricted stock purchase, on the difference, if any, between the amount paid for the stock and the fair market value on the date of purchase.[13] When the restrictions on the stock lapse, there is no further income tax consequence, and any future appreciation in the value of the stock from and after the date of purchase receives capital gain treatment upon the sale of the shares assuming that the requisite capital gain holding period requirements have been satisfied.[14] Without question, the employee who has the good fortune of participating in a stock based incentive program where the value of the stock is increasing significantly will benefit substantially by the use of a Section 83(b) election.

Accounting Rules

A future public company will be required to present financial statements prepared in accordance with generally accepted accounting principles, commonly referred to as GAAP. In the competitive environment to attract employees, if there is an intention to sell stock or grant options that are exercisable at a purchase price which is less than the fair market value of the stock on the date of sale or option grant, the company must be aware that GAAP rules require a charge to earnings for the amount of the discount from fair market value. If the stock or option vests over a period of time, the charge is accounted for over the vesting period. This issue of reducing earnings to account for the compensation element of the stock sale or option grant may not be significant in the early stages of a company when losses are expected; however, this accounting treatment should be reviewed to assure that charges to earnings are not taken during periods when earnings are important in the sale of securities to the public. There is an increasing trend to have the stock of a privately held company appraised before being sold to employees to assure that the stock is sold at fair market value, or, alternatively to ascertain the amount of the discount from fair market value. If the corporation cannot demonstrate that sales to employees were at fair market value in connection with the filing of a registration statement for an initial public offering and no charge to earnings was taken for the applicable accounting period, the Securities and Exchange Commission ("SEC" or "Commission") may require a restatement of the company's financial statements, which, among other things, may have the effect of delaying the review and ultimate effectiveness of the registration statement. The way in which stock sales to employees are treated may, in fact, impact a company's bottom line and should be carefully reviewed with the company's independent public accountants and other advisors.

Financial Statement Requirements

In connection with a company's IPO, the company will most likely file a registration statement on Form S-1 with the SEC. As discussed below, "small business issuers" may also file a registration statement on Form SB-1 or Form SB-2 in connection with a public offering. The purpose of the registration statement and the prospectus contained therein is to disclose to potential investors comprehensive information with respect to the company, and its business, operations and prospects, that a reasonable investor would deem important in making an investment decision. The critical component of the basic information package required by the Commission to be presented to the investing public is the company's financial information, principally in the form of the financial statements and related notes included with the registration statement. A future public company will be required to present financial statements to the public which are prepared in accordance with GAAP, and which have been audited by independent certified public accountants. The form and content of and requirements for financial statements included in the registration statement are determined by the uniform instructions contained in Regulation S-X, which is one-half (Regulation S-K being the other half) of the integrated disclosure system adopted by the Commission for filings under the 1933 Act and the 1934 Act.[15]

Typically, a company will be required to include in a registration statement audited balance sheets as of the end of each of the two most recent fiscal years and audited statements of income and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet being filed.[16] In the fast-paced high technology world where there has been a surge of IPO activity over the last several years, it is not uncommon for the period between start-up and going public to be much shorter than has been customary for more traditional businesses. If a company has been in existence for less than one fiscal year at the time of its IPO, the company is required to include in its registration statement an audited balance sheet as of a date within one hundred thirty-five days of the date of filing the registration statement.[17] Similarly, if the company cannot provide audited statements of income and cash flows for three fiscal years, the company is required to include in its registration statement, audited statements of income and cash flows for the period the company has been in existence.

The financial statement requirements of Regulation S-X do not apply to a company which qualifies as a small business issuer, which means the company is a U.S. or Canadian issuer, is not an investment company, has revenues of less than $25 million, and has a public float of less than $25 million.[18] Regulation S-B, adopted by the Commission as the integrated disclosure system for small business issuers, governs the financial statement requirements for qualifying small business issuers and requires such a company to include with its registration statement, an audited balance sheet as of the end of the most recent fiscal year, or as of a date within one hundred thirty-five days of the filing of the registration statement if the company has been in existence for less than one fiscal year, and audited statements of income, cash flows and changes in stockholder's equity for each of the two fiscal years preceding the date of such audited balance sheet or such shorter period that the company has been in existence.[19]

As a company enters into and continues with the registration process, it will be important for the company and the other parties involved in the process (underwriters, accountants, attorneys, etc.) to keep track of the age requirements of the financial statements to be included in the registration statement. The aging requirements must be met at the time of the initial filing of the registration statement with the SEC and at the time of filing each amendment to the registration, including the final amendment when the registration statement is scheduled to become effective. Registration statements filed by non S-B filers between the 90th and 134th day following the end of a company's fiscal year must include audited balance sheets for the two most recent fiscal years and audited statements of income and cash flows for the three fiscal years preceding the date of the most recent balance sheet filed. If a registration statement is filed more than one hundred thirty-four days after the end of a company's fiscal year, the company will be required also to file an unaudited interim balance sheet as of a date within one hundred thirty-five days of the filing of the registration statement together with unaudited statements of income and cash flows for both the interim period between the latest audited balance sheet and the date of the interim balance sheet and for the corresponding interim period of the preceding fiscal year.[20]

If a registration statement is filed within forty-five days after the end of the company's fiscal year and audited financial statements for the last fiscal year are not available, the company can satisfy the financial statement requirements by filing audited balance sheets as of the end of the two fiscal years preceding the last fiscal year and audited statements of income and cash flows for the three fiscal years preceding the last fiscal year.[21] Where financial statements for the last fiscal year are not available, the company must include also an unaudited balance sheet as of a date at least as current as the end of the third fiscal quarter of the last fiscal year and unaudited statements of income and cash flows for such interim period as well as for the corresponding period of the preceding fiscal year.[22] If audited financial statements for the last fiscal year become available before the registration statement becomes effective, then the audited statements must be included in the registration statement.

In view of the requirements that audited financial statements be included in registration statements filed with the SEC, it is extremely important for the private company contemplating a public offering to obtain audited financial statements in advance of its targeted date for filing the registration statement for an IPO.

Management's Discussion and Analysis of Financial Condition and Results of Operations.

In addition to the company's financial statements, the section of the registration statement containing management's discussion and analysis ("MD&A") of the company's financial condition and results of operations is a significant part of the basic information package required by the SEC to be presented to potential investors. The MD&A requires a company's management to review, analyze and discuss the company's liquidity, capital resources and results of operations as well as any known material trends, uncertainties and other circumstances that may have a material impact in the future on the company's financial condition and results of operations. The MD&A provides potential investors with a short and long-term analysis by management of the business of the company as well as with the ability to assess the financial condition and results of operations of the company and whether certain events, risks and uncertainties could cause reported financial information to not be indicative of the company's future operating results or future financial condition.[23]

Involving the Accountant.

It is important for the company to bring the independent, certified public accountant into the registration process as early as possible. Many companies which desire to undertake an IPO have not maintained their accounting books and records nor prepared financial statements in conformity with GAAP. Further, unless a company has been required to provide audited financial statements in connection with previous debt or private equity financings, it is not all that common for a company to have the required audited financial statements before it commences the IPO process. The transition from a private company to a company ready to go public and comply with the public company financial reporting and disclosure requirements can be a time consuming process. The company's accountant will play a critical role in this transition. It is important, particularly if the accountant has not been previously engaged by the company, for the accountant to review the company's accounting books, records, systems and internal controls. The accountant should discuss with the company whether it is necessary for the company to institute any modified or new procedures and controls to comply with the requirements of the Foreign Corrupt Practices Act and to produce reports required under the periodic reporting system of the 1934 Act when the company is a public company. In selecting an accountant the company should confirm that the accountant is qualified to practice before the SEC and should consider the accountant's experience in dealing with the SEC in public offerings. In order to practice before the SEC, an auditor must be duly registered, in good standing and entitled to practice as such under the laws of the jurisdiction of the accountant's residence or principal office.[24] The experienced accountant can play an invaluable role in identifying those issues to which the SEC staff is sensitive and those areas which are frequently the subject of SEC comment during the registration review process. Some of the accounting issues to which the SEC is sensitive and which have received SEC scrutiny in recent periods include the issuance of "cheap stock" to employees prior to an IPO, purchased in-process R&D, revenue recognition, deferred costs, reserves, segment disclosure, related party transactions, environmental liabilities and audit committees. To the extent the accountant determines that there are accounting issues which could affect the timing of the IPO, the company and accountant may want to consider a pre-filing conference with the SEC to discuss the issues. The accountant will also be involved in evaluating and responding to the SEC's accounting related comments. The availability of the required financial statements and other financial information and the resolution of the accounting issues will have an impact on the timing of the IPO. The failure to actively involve the accountant in the early stages of the registration process could lead to costly delays in the company's IPO. In selecting the auditor a company and its advisors should be aware of the Commission's current proposed rule amendments regarding auditor independence.[25] Among the items covered by the proposed rules are the scope of non-audit services provided by an auditor to an audit client and when such services can impair and compromise the auditor's independence. If the accountant which the company plans to use as its independent auditor has provided certain non-audit services to the company, such as valuation or appraisal services, the independence of the accountant as it relates to the company could be impaired, requiring the company to look elsewhere for its independent auditor.

<u>Establishing an Audit Committee.</u>

Another related item that the private company should consider early on in the IPO process is the creation and appointment of an audit committee of the company's board of directors. Audit committees are a condition to listing on the New York Stock Exchange ("NYSE") and American Stock Exchange ("AMEX") and a condition to quotation on the Nasdaq Stock Market. The principal purpose of the audit committee is oversight of the company's audit process. Typical audit committee practices include (i) reviewing the company's accounting systems and internal accounting controls, (ii) reviewing the company's interim and annual financial statements, (iii) recommending to the company's board of directors, an independent certified public accountant as the company's outside auditor, (iv) reviewing the audit plan with the outside auditor and the subsequent compliance with and adherence to such plan, and (v) reviewing the results of the company's audit by the auditor as well as the results of internal audits conducted by the company.

Based on recommendations made by a Blue Ribbon committee on Improving the Effectiveness of Corporate Audit Committees sponsored by the NYSE and the National Association of Securities Dealers ("NASD"), a series of new requirements for audit committees were adopted by the SEC, the NYSE and the NASD during the past year. Included in these changes were new stock exchange rules governing the composition of audit committees and the qualifications of audit committee members. Under the new stock exchange rules, audit committees are to be comprised of at least three directors, each of whom is to be independent of the company and its management and each of whom is financially literate or shall become so within a reasonable period of time. At least one member of the audit committee shall have financial expertise. The rules of each of the stock exchanges establishes the parameters for the independent director, financial literacy and financial expertise requirements. While the rules of the stock exchanges regarding audit committee membership and qualifications are similar, they are not identical. Further, AMEX and the Nasdaq Stock Market require companies which qualify as small business issuers under Regulation S-B only to have an audit committee of at least two members, a majority of whom shall be independent. If the committee is comprised of only two members, both must be independent. Small business issuers are also exempt from the financial literacy and financial expertise requirements for committee members.

---

[1] An informative source which sets forth a thorough analysis with respect to the design of a stock based incentive plan is Herbert Kraus, Executive Stock Options & Stock Appreciation Rights, Chapter 7 (Law Journal Press, 10th Rel. 2000).
[2] See Kraus, supra, §8.08[2] which outlines several issues that should be addressed when utilizing a "stock swap" in exercising an option.
[3] See Kraus, supra, §8.08[5] for a brief discussion of "cashless exercise", also known as "immaculate exercise."
[4] See Arthur Anderson, *Accounting for Business Combinations: Interpretations of APB Opinion No. 16,* Paragraph 47c-18 (1999).
[5] See Rule 701(b)(1), 17 C.F.R. § 230.701(b)(1).
[6] See Rule 701(d)(2), 17 C.F.R. § 230.701(d)(2).
[7] See Rule 701(f), 17 C.F.R. § 230.701(f).
[8] See N.J.S.A. 49:3-50(a)(11); see also N.J.A.C. 13:47A-12.2.
[9] See 1A Blue Sky L. Rep. (CCH) ¶ 14,121, Conn. § 36b-21(a)(11); 1A Blue Sky L. Rep. (CCH) ¶ 15,109, Del. § 7309(a)(11); 1A Blue Sky L. Rep. (CCH) ¶ 20,104 Haw., § 485-4(11); 1 Blue Sky L. Rep. (CCH) ¶ 9,136, Ariz. § 44-1844A.14; 1A Blue Sky L. Rep. (CCH) ¶ 10,163, Ark. § 23-42-503(a)(10); 2 Blue Sky L. Rep. (CCH) ¶ 30,171, Md. § 11-601(11); 2 Blue Sky L. Rep. (CCH) ¶ 32,132, Mich. § 451.802(a)(10); 2A Blue Sky L. Rep. (CCH) ¶ 34,145, Miss. § 75-71-201(11); 2A Blue Sky L. Rep. (CCH) ¶ 35,114, Mo. § 409.402(a)(11); 2A Blue Sky L. Rep. (CCH) ¶ 39,177 N.H., § 421-B:17(I)(j); 1 Blue Sky L. Rep. (CCH) ¶ 7,110, Ala. § 8-6-10(10); 1 Blue Sky L. Rep. (CCH) ¶ 8,134, Alaska § 45.55.900(a)(5); 3A Blue Sky L. Rep. (CCH) ¶ 64,112, Wis. § 551.22(10); 3A Blue Sky L. Rep. (CCH) ¶ 63,132, W. Va. § 32-4-402(a)(11); 3A Blue Sky L. Rep. (CCH) ¶ 57 144, Utah § 61-1-14(1)(j); 3A Blue Sky L. Rep. (CCH) ¶ 66,114, Wyo. § 17-4-114(a)(x); 2A Blue Sky L. Rep. (CCH) ¶ 38,178, Nev. § 90.520(1)(l); 1A Blue Sky L. Rep. (CCH) ¶ 21, 137, Idaho § 30-1434(1)(k).
[10] Under Section 3402(a) of the Internal Revenue Code, and except as otherwise provided, an employer making payment of "wages" must deduct and withhold tax upon such wages in accordance with prescribed tables or computational procedures. Under Section 3401 of the Internal Revenue Code, the term "wages" generally means

all remuneration for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash.

[11] See IRC §83(a); Treas. Regs. 1.83-7(a).

[12] See IRC §83(a).

[13] IRC §83(b)(1); Treas. Regs. §1.83-2(a).

[14] Treas. Regs. §1.83-2(a).

[15] 17 C.F.R. § 210.1-210.12.

[16] 17 C.F.R. § 210.3-01(a); § 210.3-02(a).

[17] 17 C.F.R. § 210.3-01(a).

[18] 17 C.F.R. § 228.10-228.702.

[19] 17 C.F.R. § 228.310(a).

[20] 17 C.F.R. § 210.3-01(e), § 210.3-02(b).

[21] 17 C.F.R. § 210.3-01(b).

[22] 17 C.F.R. § 210.3-01(b); § 210.3-01(c); § 210.3-12(b).

[23] 17 C.F.R. § 229.303.

[24] 17 C.F.R. § 210.2-01(a).

[25] Proposed rule on Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7870, Exchange Act Release No. 42994, Public Utility Holding Company Act Release No. 27193, Investment Company Act Release No. 24549, Investment Advisers Act Release No. 1884 [2000 Current Binder] Fed. Sec. L. Rep. (CCH) ¶86,315 (June 30, 2000).