TBH Consulting LLC

IPO Readiness: A Guide to Becoming a Public Company

Executive Summary

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I. Deciding to go Public

Definition of IPO

An initial public offering ("IPO") refers to the process of offering shares of a private company's common stock to the public in a new stock issuance as a viable method of raising capital from public investors. IPOs almost always involve the offering of primary shares but may also include the sale of shares held by the present owners.

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In an IPO, a company transitions from private to public status and raises capital for the business. Over time, previous owner shares become more liquid, and the shareholders may keep their shares in the public market or sell for gains.

Is a public offering right for your organization?

Companies requiring additional capital to finance growth may automatically consider transferring from private to public status. However, this necessity does not always mean that going public is the proper solution. There are several questions and factors to consider before determining whether your organization is an ideal candidate for an IPO.

Do I have an attractive performance record?

Can I forecast future finances?

Are my prospects good for maintaining strong sales, earnings growth, and profitability?

Is my company highly visible and of interest to the public?

Can I simultaneously manage business operations and shareholder expectations?

Will I be able to meet all filing requirements in a timely manner? Am I willing to allow much greater transparency?

Are business processes and systems in place to support expected growth and life as a public company?

Have I analyzed the areas of cost, risk, benefits, and opportunity?

What are the current and expected market conditions? Is this the right time to go public given the market and industry outlook?

Which securities exchange will I use?

Is leadership experienced, capable, and committed?

Has a system of internal controls been established to meet the obligations of a public company?

Becoming a public company can be an arduous undertaking, which is why it is imperative to understand the obstacles that could arise along the journey and focus on the areas that can be controlled. Once you have obtained public company status, it is extremely difficult to reverse the process. Therefore, it is important to discern whether becoming a public company is right for your organization before moving forward. In planning for the next stage of growth, be attentive to these IPO candidate considerations to ensure your organization is well-equipped.

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IPOs are undertaken by companies of all sizes. Whether you are a pre-revenue company or an established company looking to go public, thorough evaluation and readiness are important for a successful IPO.

Advantages of being a public company

By going public, a company can raise money by accessing investment from the public capital markets to expand operations. Capital can be raised on an equity or debt basis and continual market access can be granted to companies who perform at or above expectations. Additional funds can be raised in the future through secondary offerings because the company already has access to the public markets as a public company.

A company can use its publicly traded stock as currency to facilitate more seamless business acquisitions. An IPO can also lead to increased cash, long-term capital, and market value. The funds from an IPO are often used to increase working capital, pay off debt, fund acquisitions, and invest in fixed assets and research and development. The value of public companies will likely rise due to increased access to investors, greater liquidity, transparency, and available information. The increased transparency from required filings, disclosures, and improved equity from the sale of common stock can attribute to more favorable credit borrowing terms.

Public companies can also attract and retain more skilled management and employees. Many companies will compensate their employees and executives through stock-based compensation at the time of the IPO or shortly thereafter. A stock-based compensation program can provide tax advantages to executives and additional capital for the company, contributing to long-term prospects for greater wealth and value for shareholders.

Lastly, going public can enhance a company's reputation by increasing exposure, prestige, and public image, which can boost sales and profits.

Critical issues and factors to consider

An IPO brings about a new set of challenges, regarding requirements for reporting, controls, business processes, and governance. Companies may confront several issues and disadvantages to going public and potentially choose alternative strategies. Some of the major factors to consider when evaluating whether to go public include:

<u>IPO expenses</u> - The costs of becoming a public company include significant legal, accounting, underwriting, marketing, and advisory costs, which are generally independent of the other costs of doing business. IPO transaction costs can be up to 10-15% of gross proceeds from the offering.

<u>Loss of privacy</u> – A public company is required to disclose business and financial information in its filings on a timely and accurate basis. Sensitive disclosure areas may reveal trade secrets, compensation, and business methods that could now be made known to employees, customers, suppliers, and competitors.

<u>Public company expenses</u> – The costs of maintaining a public company are significant and continuous. New roles and responsibilities will require internal controls, investor relations, directors' and officers' liability insurance, and compliance costs. Increased time, effort, and attention is required for reporting.

<u>Performance pressure</u> – Shareholders expect steady growth, and management is under constant pressure to balance short-term demands and long-term goals. Fluctuations in share price can be a distraction for management which may be compensated and evaluated based on stock performance.

<u>Loss of control</u> – The shares offered in an IPO are widely distributed to new shareholders who obtain voting rights and are represented by the Board of Directors to whom management reports. This often provides less autonomy than existed prior to the IPO.

<u>Litigation risk</u> – Public companies are more vulnerable to litigation due to having a higher risk of legal and regulatory issues. Exposure to private securities class action lawsuits and

shareholder actions is increased when expectations of the company are not met.

Keep in mind that focus on the initial offering can be a distraction from daily business activities, so it is important to have strong management already in place during this time.

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To avoid the significant expenses and risks associated with going public, a company can explore alternatives such as exempt offerings, reverse merger/ special purpose acquisition (SPAC), or private sale.

II. Determining Filer Status

Assessed throughout the process of becoming a public company and at Q2-end for public companies, filer status sets the foundation for reporting requirements. Whether your company is classified as a foreign private issuer, emerging growth company, or non-qualifying EGC, each status comes with its own accommodations and will serve as the basis for your accounting and financial reporting.

Emerging growth company

The Jumpstart Our Business Startups ("JOBS") Act of 2012 created a new issuer category called an "emerging growth company" ("EGC"). An EGC is an issuer whose IPO was or will be completed after December 8, 2011. EGCs can be domestic issuers or FPIs that meet 3 main criteria:

- Have < $1.07 billion in gross revenue during the most recently completed fiscal year
- Have < $1.0 billion in issues of non-convertible debt in a 3-year period
- Generally, have < $700M in worldwide public float

The EGC category, designed to ease the process of going public for companies that did not meet the 3 criteria, permits qualifying companies to abide by less stringent reporting rules and reduced registration process time compared to non-EGC filers.

Advantages and impact of EGC status

Electing EGC status is accompanied by several advantages including submitting confidential draft registrations statements to the SEC, confidential SEC review, only needing to disclose their intention to list their shares 21 days before they start their investor road show, only releasing 2 years (instead of 3) for the income and cash flow statements of audited financial statements and being required to only disclose the compensation for the top three 3 executives (rather than 5).

In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act gives public company shareholders the opportunity to vote on whether they approve of the company compensation practices ("say-on-pay") and include a separate resolution stating how often the vote will occur ("say-when"). EGCs are exempt from this provision as well as "golden-parachute" executive compensation disclosures. An audit of internal controls over financial reporting is not required of EGCs until 5 years after the company's IPO when EGC status is lost.

EGCs may omit annual and interim financial statements that it reasonably believes will not be required at the time of the IPO, although they must include applicable interim financial information when filing the registration statement. The SEC prefers that EGCs disclose provisions to potential investors because they apply to all EGCs and can affect investment discussions.

Non-qualifying

Companies that do not qualify as an EGC are still allowed their own form of relief. Non-EGCs can submit registration statements to the SEC for confidential review, while deciding whether to follow through with the transaction, followed by a resubmission of response letters at the time of the IPO. Companies may keep confidentiality of submission-related financial information 15 calendar days before conducting a roadshow.

III. Preparing to Transition from Private to Public Company Status

Transitioning from private to public company status requires extensive time, planning, and preparation. Achieving readiness through proper care and preparation will ensure a strong introduction to the capital markets. The best way a company can prepare to go public is by internally and externally operating and functioning like a public company months before its first public offering. The most successful companies generally begin to prepare 12-36 months prior to the IPO. Adequate preparation is important to maintain minimum IPO costs, avoid surprises, take on the due diligence process, and increase chances of good timing in the market. During the preparation stage, be prepared to implement change throughout business processes and operations, corporate structure, and company culture.

Accounting and finance

As a company prepares to become public, it must first address the changes required to establish a proper public company accounting and finance function. The company will need to have its financial statements audited by an independent firm registered with the Public Company Accounting Oversight Board (PCAOB) and resolve any accounting and disclosure issues found. It will also need to assess the adequacy of its current financial resources for reporting and establish a reporting close cycle. Systems and IT should be put in place for improved accuracy in maintaining records, internal controls, recording transactions, and reporting.

Internal controls must also be evaluated to comply with the Sarbanes-Oxley Act of 2002 (SOX), where applicable, and a formal internal audit function may be required for certain registrants. The company must also assess its current tax structure and may want to complete some tax planning in advance of becoming a public company. Developing a budget and measuring performance is also crucial during the preparation period as underwriters ask for financial projections for performance comparisons.

> Historical financial statements are essential to the registration process. Specific audit requirements of these statements by the SEC must be met before the registration statement can be reviewed and to provide an independent validation of financial reporting standards.

Governance and leadership

Establishing an effective management team and understanding the governance requirements for public companies is imperative in the preparation process. Attracting and retaining members to be on the Board of Directors is an important, yet challenging task. An audit committee must also be formed to ensure integrity and transparency of financial reporting. A code of conduct and company ethics should be implemented as well as a whistleblower hotline to demonstrate strong corporate leadership and responsibility.

Executive compensation and HR

Extensive compensation program disclosures for executives and directors are required when filing for an IPO in the registration statements and in annual proxy disclosures. Insight into governance, risk profile, management, and corporate strategy provide investors with the information they need to understand and analyze a company. Compensation programs should be designed around competitive compensation levels and are part of corporate strategy to attract, retain, and motivate employees.

> Executive compensation practices must be proven reasonable when compared to the industry and necessary for corporate strategy and overall performance.

To oversee executive compensation decisions, public companies should designate an independent compensation committee since the Board of Directors has a fiduciary responsibility for executive compensation and related programs.

Treasury and legal

Creating a strong, future-focused capital structure, managing risks, securing insurance protection, and upgrading operational infrastructure can improve the increased treasury operations of collecting, disbursing, and investing of cash and liquid assets. In addition, having a well-established legal counsel is crucial to functioning as a public company and meeting specialist requirements. A company preparing to go public can also benefit from establishing a legal and compliance program designed to consider all regulatory risks impacting operations, strategies, and growth.

Media and investor relations

A positive reputation and public image generate interest in a company, crucial in the marketing effort to enhance sales. Achieving a strong company image takes time, so starting the development process early can keep you get ahead of the game. Hiring a public relations firm, attending trade shows and conferences, creating publications, and reaching out to analysts and business editors can attract potential buyers and decision influencers.

ERM and technology

The Board of Directors is responsible for overseeing risk and it is recommended that companies disclose information as to how the Board plans to address all material risks faced by the company. Enterprise risk management (ERM) involves implementing company-wide risk management procedures on a daily basis, and it is important to clearly establish the process of reporting risks between those responsible including management, the board committees, and the full Board. An ERM program can enable companies to determine their risk appetite in achieving their strategic goals. Developing response and recovery strategies to risk-related events can provide for improved decision-making so that a company can be better prepared for uncertainty.

Becoming a public company holds additional requirements for company systems and processes. Integrating the management of business processes using software and technology greatly impacts the accuracy and efficiency of reporting. Successful public companies have adopted the automation of technology, services, HR, production, accounting, and other business functions. Extensive resource planning is required to ensure that systems are updated, accurate, and properly managed.

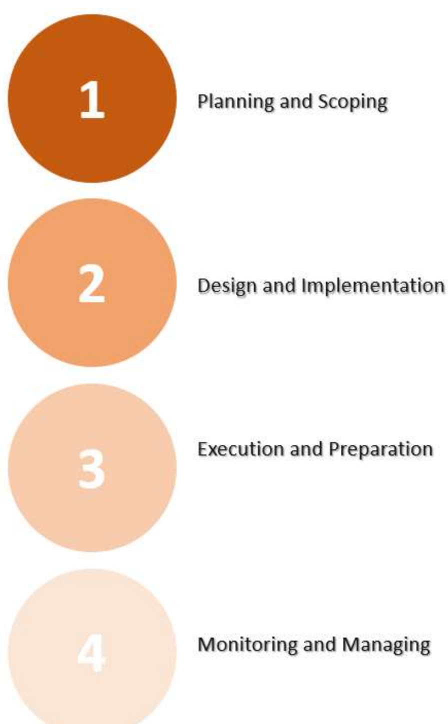
Management and communication

Coordinating internal and external business activities and making informed decisions are crucial to a successful IPO. Strong, effective, and efficient project management is necessary along with seamless communication across all levels of the company.

IV. Navigating the Process of going Public

Becoming a public company: timeline

The IPO filing and marketing process may last only 3 - 4 months, but it is only one step in a much longer journey when evolving from a private to a public company. The public company transformation process occurs in 4 phases. The first 2 phases fall under the pre-marketing process of the offering while the last 2 phases encompass the initial public offering, itself, and functioning as a public company:



A successful transition to being a public company requires initial planning and readiness assessment, kick-off, IPO process execution, IPO pricing, and operating as a public company.

Planning and scoping

During the first 12-36 months before the expected IPO date, companies make an IPO readiness assessment and begin initial planning and preparation. The readiness assessment covers all major business areas including strategy, structure, taxes, timing, finance and accounting, governance, functions, and systems. The company assesses its readiness in conjunction with core public company requirements. It also analyzes costs vs. benefits and develops a high-level work plan, timeline, and listing of resource requirements. Completing a business plan with financial projections and a due diligence checklist is crucial before selecting an underwriter.

During the planning phase, companies must select an underwriter, which is involved in every aspect of the IPO due diligence, document preparation, filing, marketing, and issuance. Underwriters present proposals and valuations, the best type of security to issue, and estimated timing for the market offering. Typically, the underwriter purchases the securities from the company and sells them to the public through a syndicate. The company must demonstrate to the underwriter that it is qualified to go public. The company's business plan, financing needs, attractiveness to the market, and projected issues in the due diligence process will be factors in generating underwriter interest.

IPO teams are formed comprising underwriters, lawyers, CPAs, and SEC experts. Management, select employees, customers, and suppliers make up these teams as well. Information regarding the company is compiled for required IPO documentation.

Design and implementation

After several months of planning, the 2-3 month long due diligence process and preparation of the registration statement can begin. These areas serve as the most time-consuming areas in the process of attaining public company status. As part of the due diligence process, the company designs required solutions for initial assessment findings and needs and develops a baseline of policies and procedures. Review of the revenue recognition process and development of a financial close process takes place. The company proceeds to perform the risk assessment and initial scoping for SOX readiness and compliance, assesses the IT environment, and selects the appropriate ERP system, if required. Market research and strategy are discussed by the IPO team.

Throughout the due diligence process, an intense investigation occurs, probing anyone who might be held liable if the registration statement contains any material misstatement or failure to disclose material facts.

Execution and filing preparation

In this phase, the company can begin executing the IPO process and transformation, enabling it to act as a public entity. During this time, the Form S-1 is prepared and filed with the SEC in electronic format using the SEC's Electronic Data Gathering and Retrieval (EDGAR) system., and the company begins to implement solutions and remediate urgent needs.

Monitoring and managing

Within approximately 30 days, the SEC reviews the registration statement and responds with comments about accounting and disclosures that need enhancement, clarification, or modification. During this time, negotiations regarding share price and number of shares to be offered are completed with the underwriter. After several rounds of comments, responses, and revisions by the SEC, the registration statement is deemed effective. The final step in the registration process is the closing, about 3 days after the effective date in which you give the underwriter the shares and receive the net offering proceeds.

Through the second 10-K filing, the company produces SOX 302 certification and achieves SOX 404 compliance. Management proceeds to draw attention to short and long-term goals and ensures the Section 906 hotline is in place.

SOX compliance

Public companies are required to comply with Sections 302 and 404 of the Sarbanes-Oxley Act of 2002 which requires public companies to annually file the Form 10-K to report on the effectiveness of their internal controls over financial reporting (ICOFR). SOX is intended to protect company stakeholders and provide assurance on the adequacy of the internal controls put in place to prevent material financial misstatement and fraud.

The process of becoming a public company is strenuous and SOX compliance is often overlooked or underestimated. The process of introducing SOX should begin 18-24 months prior to going public, and some of the most successful IPO companies operated under public company rules for 12 months prior to going public. Demonstrating SOX compliance prior to going public shows management's commitment to protecting future stakeholders by identifying risks and weaknesses, remediating them, and implementing industry best practices for all business processes. This reaffirms the adequacy of management and the company's awareness to areas of risk.

Key SOX provisions when considering an IPO:

Section 302 – Requires public companies to certify that they have established and maintained ICOFR.

Section 404 – Requires management and external auditors to report on the adequacy of ICOFR.

Section 802 – Outlines rules for record keeping including a) destruction and falsification of records, b) retention periods for storing records, and c) types of records to be stored.

Benefits for a SOX-compliant company include:

- Prioritizing risks
- Strengthening internal control
- Improving performance audits
- Establishing centralized, automated financial reporting

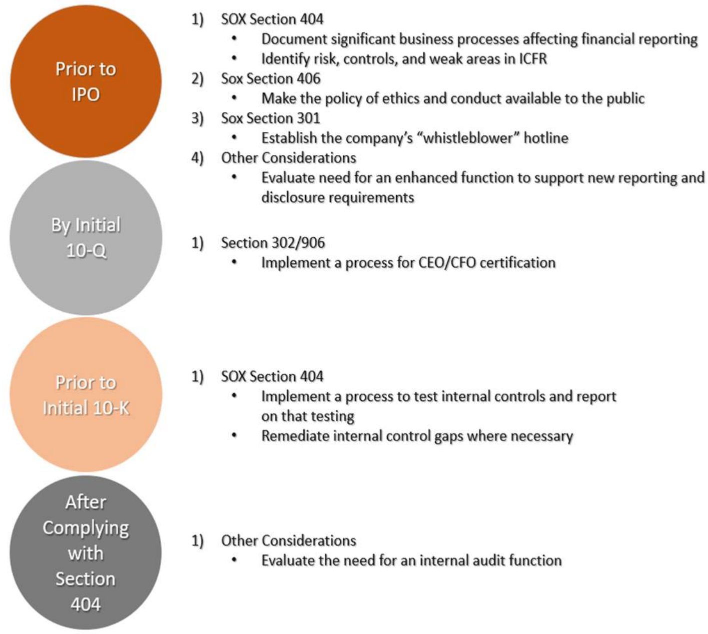
SOX compliance is a significant undertaking and a long, expensive endeavor for any business. Companies should consider the available resources they have for the design, implementation, and maintaining of compliance.

Timing and deadlines

Public companies must submit their annual (Form 10-K) and quarterly (Form 10-Q) financial statements by deadlines according to the size of the organization. However, all IPO registrants are considered a non-accelerated filer until they have met the requirements of the Securities Exchange Act of 1934 for 12 months. The deadlines for non-accelerated filers are as follows:

Form 10-K	Form 10-Q
90 days after fiscal year-end	45 days after fiscal quarter-e

SOX requires several components that must be completed within the given time frame for a public company to be compliant. To become SOX ready, a company must comply with Section 404 which requires the greatest volume of work and lists the requirements related to ICOFR where internal controls must be documented, evaluated, and tested.



Complying with SOX for the first time requires about 4-6 quarters depending on the size and complexity of the company. It is suggested that companies preparing for an IPO begin their Section 404 compliance agenda as soon as the initial readiness assessment has been completed.

Newly public companies can elect to delay SOX compliance until after they become public. However, this increases exposure to serious risks, non-compliance, and a compressed compliance effort while undergoing numerous other challenges of being newly public.

Roles, responsibilities, and participants

The period leading up to and proceeding an initial offering includes several key participants, each of whom plays a critical role in a company's journey to becoming public.

The Company: Company officers and employees are responsible for the items required during the registration process, including drafting and reviewing the registration statement. The company is also responsible for all reporting requirements and obligations that come with public status.

Independent auditor: The effectiveness of ICOFR must be attested to by an external independent auditor registered with the PCAOB and discussed in financial reporting. Companies that are newly public must generally include the ICOFR report and the auditor's attestation in their second annual report after becoming a public company. SOX also requires quarterly disclosures related to ICOFR.

Advisors and legal counsel: Those with significant knowledge and experience in the IPO process execution, registration statement preparation, statement printing, and securities law are often consulted during the process of becoming public.

Underwriter: The managing underwriter or investment banker is responsible for selling the stock and determining the share price. An underwriter purchases your company's securities and sells them to other syndicate members or the investing public. An underwriter is also responsible for providing market support for the shares following the IPO and providing research and market advice. Therefore, your relationship with the underwriter should be long-term and not end upon IPO completion. The underwriter is generally compensated based on a commission (typically 5-7%) of the gross IPO proceeds.

SEC: The Securities and Exchange Commission has the authority to review, approve, and deem effective the registration statement. It has the authority to prosecute those who breach procedure and disclosure requirements intended to protect investors from deception.

V. Accounting and Financial Reporting

Making changes to accounting and financial reporting is part of the process of becoming a public company. Disclosure issues relating to technical accounting topics and financial statements arise when proper adjustments for public company requirements are not made. In addition to areas like income taxes that require significant judgement, there are several common issues faced during SEC reviews and throughout the IPO process.

Segment Reporting is required for all public companies, so private companies looking to go public must begin reporting segment information. This area is a common pitfall for companies during SEC reviews as they often misidentify operating segments or do not properly follow aggregation criteria.

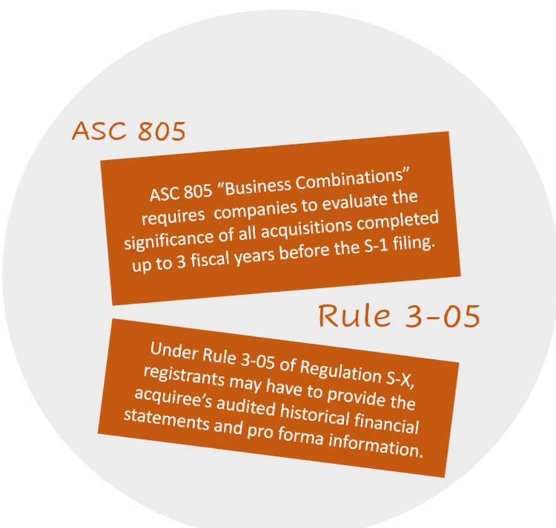
Stock-based compensation expense arises when equity instruments are issued at a price below the expected IPO price 1-2 years before the IPO. The SEC requires accounting estimate disclosures within the registration statement MD&A regarding methods used to determine the fair value of company shares, material assumptions, valuation approaches, and estimates involved. Companies must carefully review their option pricing history. Unusual valuations appearing close to the grant or IPO date are subject to intense review.

Earnings per share is not required to be presented by private companies and those with multiple types of equity, potential common shares, and classes of common stock can have very complicated calculations. In transitioning to public company status, it is important to consider all EPS reporting requirements as this is an area for many SEC comments.

Non-GAAP measures can provide investors with insight on company value and performance when used properly. Companies can choose how to use these measures in their IPO filing. Commonly used measures include EBIT, EBITDA, adjusted revenues, free cash flows, earnings, and funds from operations. Investors will expect consistency in the usage of non-GAAP measures and the SEC will closely review the calculation, level of disclosure, and reasoning for use.

Management Discussion and Analysis (MD&A) is tailored to each company and relays the quality of earnings and cash flow to indicate future performance. In-depth descriptions of certain items as well as objectives and disclosures are required to provide relevant, company-specific information. The MD&A must be included in the financial statements and the practice of writing a thorough MD&A can contribute to a smooth registration process.

Accounting for business combinations under US GAAP requires that the purchase price allocation proceed with an analysis to identify all assets acquired and liabilities assumed, measured at their fair values to which the purchase cost is allocated. Underlying assumptions and data to support valuations should be tested.



Revenue recognition over-time vs. upfront is often an area that receives attention from the SEC. In addition, new guidance under ASC 606 "Revenue from Contracts with Customers" provides a single, comprehensive model to be applied in all industries, effective for all public entities for annual and interim reporting periods. The impact of this new standard should be accounted for by all companies considering an IPO.

Compensation discussion and analysis focuses on the objectives and implementation of executive compensation program policies and decisions. Changes to proxy requirements aim to increase disclosures relating to the relationship between compensation policies and company risk, only if the impact is material.

Regulation S-K requires companies to disclose all known significant risk factors that affect the offering in the non-financial section of the registration statement. Common categories of risk include industry risks, company risks and investment risks.

Liability and equity classification is a primary area of scrutiny by the SEC. A company looking to go public should pay close attention to the area of mandatorily redeemable shares, which are required to be reported as liabilities under FASB or as a separate classification and accounting under the SEC.

The conversion of debt or equity issued within a year of an IPO draws attention from the SEC. Valuation issues can arise (similar to stock-based compensation) regarding issuance at a conversion price below the expected IPO price.

Goodwill and intangibles must be assessed for impairment at least once per year by public companies. The reporting unit forms the basis for impairment tests and their determination is often challenged by the SEC.

Pro forma financial information provides investors with an idea of the supposed financial statement impact of a large transaction (i.e. business combination). If applicable, this information is required in the S-1 filing.

VI. Preparing the Registration Statement

All IPO candidates must file a registration statement with the SEC in compliance with the Securities Act of 1933. You may also be required to submit state securities filings (Blue Sky filings) in each state stock or securities are intended to be sold. The SEC is primarily concerned with disclosure adequacy while the states evaluate the quality and fairness of the offering.

The most common registration statement is the Form S-1. In preparing the S-1, a company must consider several required disclosures including a prospectus summary and business risks, uses for the IPO proceeds, selected financial data, business information, related-party transactions, stock ownership, dividend policy, capitalization and dilution, underwriting, security distribution, and MD&A.

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Regulation S-X is the principal accounting and financial reporting regulation, specifying the financial information (including guidance on form and content) to be included in filings with the SEC. Regulation S-X lists all disclosure requirements for the non-financial statement portion of SEC filings.

In addition, financial statements and pro forma financial information are required in the S-1. Executive compensation, executive and shareholder information, and board member information must also be included in the filing.

The SEC requires the filing of all material documents or agreements to which the company is involved in (i.e. articles of incorporation, bylaws, lease agreements, compensation agreements, purchase, sales, or marketing agreements, etc.) along with the S-1.

VII. Operating as a New Public Company

As a newly public company, intense pressure to perform will immediately set in. Your company will need to balance short-term demands and long-term goals.

Business decisions become more complicated as major transactions require approval from the Board of Directors or company shareholders. As a newly public company, you may decide to release current news articles to provide further transparency and build a strong public image. Developing and maintaining this image is especially important as a public company to reaffirm trust and broaden market support for your company.

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As a public company, you have the obligation to be transparent with shareholders, comply with reporting requirements, maintain strong performance, and act with integrity – all of which contribute to forming a positive company image.

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