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IPO Readiness: Preparation Makes Going Public Less Taxing

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Introduction

We've lived through both the highest highs and lowest lows of the IPO market since we first began working in Silicon Valley in the late 1990s. We've experienced both the manic days of the dot-com boom's seemingly daily S-1 filings (remember Pets.com and Webvan?) and the darkest days of the Great Recession (and everything in between).

More recently, due to a variety of economic and political factors, we've seen somewhat of a pause in the IPO market. According to a recent Harvard Law School 2017 IPO report, the IPO market produced 98 IPOs in 2016, the second down year in a row, coming in 36 percent below the tally of 152 IPOs in 2015. In the 12 years preceding 2015, which saw an annual average of 138 IPOs, there were only three years in which IPO totals failed to reach the 100-IPO threshold.

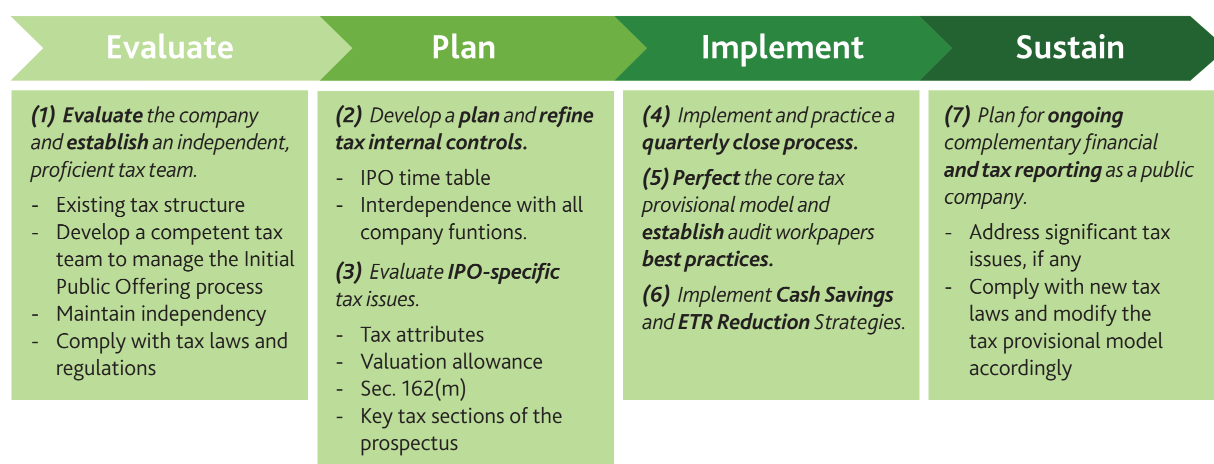
Nonetheless, the US capital markets maintain sustained strength. Public markets hover around record highs, and the pool of venture-capital-backed IPO candidates remains large and opportunistic, including about 150 private tech companies valued at USD1bn or more. Private equity firms are also sitting on record levels of committed capital after four consecutive years of increased fundraising. Combined with solid 2016 performance of VC-backed IPOs and the need of private equity firms to utilize their reserves, all the pieces are in place for increased future IPO demand. As of August 2017, there had already been over 100 IPOs priced in 2017.

Given these favorable IPO conditions, companies in the IPO pipeline should be well prepared for the numerous demands that accompany going public, such as audit and tax assistance in preparation of financial statements. In doing so, companies will be looking to their tax departments and advisors to manage and lead the pre- and post-IPO transformation process, as navigating the labyrinth of IPO complexities extends beyond normal compliance areas and into structural considerations, compensation and benefits planning, and financial statement presentation.

As taxes continue to be a high-risk area resulting in a disproportionate percentage of reported public company internal-control weaknesses, perhaps the most important advice that a company should follow in preparing its tax function for an IPO is to "act public before going public." From perfecting the tax teams and refining internal controls to establishing a quarterly close process and preparing interim tax provisions, it is important that the pre-IPO company operate for a year or more as if it is public with respect to all key facets of its tax functions to best ensure a smooth and successful transition to public status.

In working closely with company management and auditors through numerous public transitions, we've established the seven-step process illustrated below for private companies on how to approach "acting public" with respect to their tax functions before starting and executing the IPO process.

Exhibit 1: "Acting Public" Approach Guide



The Seven-Step Process

Step 1: Establish an Independent, Proficient Tax Team

According to a recent benchmarking analysis of newly public and pre-IPO technology companies, over 40 percent of companies do not maintain dedicated in-house tax personnel. Those that do will typically continue to rely on outside service providers to prepare the ASC 740 tax provision and advise on other tax matters.

While the enactment of the Sarbanes-Oxley Act of 2002 (SOX) significantly increased the complexity of going public, more recent Public Company Accounting Oversight Board (PCAOB) requirements have placed further pressure on tax resource expertise. Accordingly, pre-IPO companies may find that their current tax resources are no longer adequate for a public company. Therefore, a private company should review internal resources and external advisors to ensure they employ the necessary technical and public company expertise before initiating the IPO process. Most companies will experience some level of increased costs associated with their tax accounting and should prepare for that outlay.

Pre-IPO companies that previously relied on their external audit firm to provide many tax services for the company, including the tax provision preparation, should take measures to ensure continued auditor independence in the years leading up to the IPO. Certain of these services may be permissible services under the private company AICPA independence rules; however, they may be considered an impermissible managerial service under PCAOB/SEC requirements.

Step 2: Develop and Refine Tax Internal Controls

Based on a study by Audit Analytics for 2015, 15 percent of all financial reporting restatements related to tax control issues. This seems to indicate an abnormal proportion of tax control issues escalating to financial restatements. Some of the challenges and significant risks in tax provision processes that need to be addressed are:

- Tight close cycle;
- Legal-entity-level data;
- Rework of financial data;
- Accounting, tax law update and business transactions;
- Embedded evidence of review and sign-off.

Although SOX is not expressly applied to private companies, many private companies have adopted its best practices in some form. Because of the Jumpstart Our Business Startups (JOBS) Act, certain emerging growth companies (EGCs) may be exempt from Section 404(b) of SOX for the first five years after going public. However, EGCs still need to follow 404(a) and document and assess internal controls annually. Therefore, we recommend developing and refining tax internal controls more than 12 months prior to the IPO to facilitate the transition from private to public status.

Step 3: Address IPO-Related Tax Issues

For many private companies, going public triggers tax issues that could significantly affect the company. Such issues should be evaluated prior to beginning the IPO process to allow sufficient time to fully understand and account for them. Common issues include:

Issue	*Potential Impacts*
Tax attribute limitations	An IPO may result in an ownership change under tax law, triggering limitations on pre-IPO tax losses and credits.
Valuation allowance	A private company may anticipate using a portion of IPO proceeds to pay off debt, thereby reducing future interest deductions. This increase in future taxable income may result in the release of valuation allowance against the company's deferred tax assets.
Stock-based compensation	Due to lack of marketability, stock award deductions may not be significant prior to an IPO. However, under recent changes to tax accounting for stock-based compensation (ASU 2016-09), these deductions can created significant volatility in the post-IPO effective tax rate.
Compensation limitations	The tax code limits the corporate tax deductions for non-"performance-based" compensation paid to top executives of publicly held corporations to no more than $1 million per executive per year. This issue has become more prevalent in recent years with a greater use of restricted stock awards.

Step 4: Implement and Practice a Quarterly Close Process

For numerous reasons, companies are expected to close the financial statement in fewer days post-IPO, with about two-thirds of public companies closing within 15 days relative to one-third

of companies doing so pre-IPO. Further complicating this expedited close are additional expectations regarding a high level of accuracy in public company provision computations.

To successfully meet these requirements, as much of the work as possible should be frontloaded into the month prior to the close of the quarter. During this period, a kickoff meeting should occur between the company and its advisors to identify and discuss any complex or non-recurring issues during the quarter. The provision computation should also be completed to the extent possible using estimated financial data and annual projections.

Ongoing communication should be occurring between all parties (*i.e.*, management, preparers, auditors) throughout the process, and key issues should be raised as they arise to provide management and the external audit firm with adequate time to research and obtain technical guidance early in the process.

Once the tax provision has been completed, a "close meeting" is recommended to ensure the company's internal controls have been satisfied. A similar technical meeting with the external audit team can also greatly facilitate the timeliness of its review.

Step 5: Establish Tax Provision Workpaper Best Practices

It is difficult to establish an efficient quarterly tax provision process without workpapers that follow established best practices. The primary challenge in standardizing workpapers relates to scalability and efficiency. Companies must be able to consistently replicate their provision workpapers on a timely basis and maintain integrity constraints, yet avoid inflexibility and rigidity that would disallow effective handling of different fact patterns and growth scenarios.

The supporting workpapers should incorporate all elements necessary to facilitate company and auditor review, thereby decreasing review time and fostering a smooth audit. At a minimum, the tax provision workpapers should follow audit workpaper best practices:

Best Practices	*Goals*
Completeness and accuracy	Workpapers should clearly document observations, testing, conclusions and recommendations.
Clarity and understanding	A reviewer should be able to readily determine each workpaper's purpose, the nature and scope of the work done and the preparer's conclusions.
Pertinence	Information contained in workpapers should be limited to matters that are important and necessary to support the established objectives and scope.
Legibility and neatness	Workpapers' presentation should facilitate an efficient review (e.g., consistency in fonts, column/row width, spacing and minimization fo color varieties).
Logical arrangement	Workpapers should be organized from the reviewer's perspective (logical flow, concise, etc.) and from most summarized to most detailed.

Step 6: Review Tax Planning Strategies

While private companies typically focus on cash saving opportunities, pre-IPO entities should review effective tax rate (ETR) reduction strategies as well due to the benefits to earnings per share (EPS) as a public company. This is particularly true for strategies that may result in short-term tax rate volatility. For example, optimizing a company's global structure via transfers of intellectual property can reduce a company's structural long-term ETR, but may cause a short-term rate spike. A private company that implements such a structure pre-IPO will be better positioned to enjoy a reduced ETR (and higher EPS) once it goes public.

Step 7: Plan for Public Company Reporting Requirements

In connection with their interim tax provision preparation, private companies anticipating an IPO should align their footnote disclosures with those required by public companies. For example, ASC Subtopic 740-10 disclosures are broader for public companies, requiring a quarterly tabular reconciliation of unrecognized tax benefits, as well as disclosure of whether those unrecognized tax benefits, if recognized, would affect the company's ETR. Public companies are required to disclose in their footnotes an ETR reconciliation. Such additional disclosures should be incorporated into a private company's footnotes on a quarterly basis prior to seeking an IPO.

A pre-IPO company should also consider how it will report non-GAAP tax expense in its public quarterly press release. The SEC has recently begun more greatly scrutinizing methodologies employed by companies for non-GAAP purposes.

Alvarez & Marsal Taxand Says:

With a return of normalized IPO market conditions, more private companies will likely seek public status as we move into 2018. Given the complexities, time constraints and significantly heightened public and regulatory scrutiny facing public companies, it is important that a private company begin acting public with respect to its tax accounting management well in advance of an IPO.

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