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Life Sciences Industry Accounting Guide
Initial Public Offerings

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Preface

The life sciences ecosystem encompasses a wide array of entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the life sciences industry face complex issues and must exercise significant judgment in applying existing rules to matters such as research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The 2025 edition of Deloitte's *Life Sciences Industry Accounting Guide* (the "Guide") addresses these and other relevant topics affecting the industry this year. It includes interpretive guidance, illustrative examples, recent standard-setting and rulemaking developments (through March 7, 2025), and key differences between U.S. GAAP and IFRS® Accounting Standards. Appendix B lists the titles of standards and other literature we cited, and Appendix C defines the abbreviations we used. Key changes made to this Guide since publication of the 2024 edition are summarized in Appendix D.

We hope the Guide is helpful in navigating the various accounting and reporting challenges that life sciences entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

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Chapter 11 — Initial Public Offerings

11.1 Introduction

In recent years, life sciences companies have represented a significant portion of IPOs in the marketplace. Approximately 43 percent of all IPOs from 2019 through 2024 were in the life sciences industry.[1] The majority of those life sciences IPOs were in the biotechnology subsector, with many qualifying for EGC and SRC filing status.

11.1.1 Emerging Growth Companies

11.1.1.1 Definition of EGCs

An EGC is a category of issuer that was established in 2012 under the Jumpstart Our Business Startups Act (commonly referred to as the JOBS Act) and was granted additional accommodations in 2015 under the Fixing America's Surface Transportation Act (commonly referred to as the FAST Act). The less stringent regulatory and reporting requirements for EGCs are intended to encourage such companies to undertake public offerings. A private company undertaking an IPO will generally qualify as an EGC if it (1) has total annual gross revenues of less than $1.235 billion during its most recently completed fiscal year and (2) has not issued more than $1 billion of nonconvertible debt over the past three years. Once a company completes its IPO, it must meet additional criteria to retain EGC status.

11.1.1.2 Accommodations Applicable to EGCs

There are many potential benefits for registrants that file an IPO as an EGC. For example, EGCs:

- Need only two years of audited financial statements in an IPO of common equity.[2]
- May omit financial information (including audited financial statements) from an IPO registration statement if that financial information is related to periods that are not reasonably expected to be required at the time the registration statement becomes effective (see Section 11.1.4.1)
- May elect not to adopt new or revised accounting standards until they become effective for private companies.
- Are eligible for reduced executive compensation disclosures.

[1] Statistics compiled from publicly available historical IPO information furnished by Nasdaq and Yahoo.

[2] This accommodation is limited to an IPO of common equity. As the SEC clarifies in paragraph 10220.1 of the SEC Financial Reporting Manual (FRM), an entity that does not qualify as an SRC will generally need to include three years of audited financial statements when entering into an IPO of debt securities or filing an Exchange Act registration statement, such as a Form 10, to register securities.

EGCs are not *required* to apply the above accommodations and may choose to provide some scaled disclosures but not others. However, if an EGC has elected to opt out of the extended transition period for complying with new or revised accounting standards, this election is irrevocable. Therefore, the registrant, its advisers, and the underwriters should consider which EGC accommodations to use early in the IPO process. The SEC expects EGCs to disclose, in their IPO registration statements, their EGC status and to address related topics, such as the exemptions available to them, risks related to the use of those exemptions, and how and when they may lose EGC status.

Certain scaled disclosure provisions that apply to EGCs may also be available for other entities' financial statements. For example, financial statements required under SEC Regulation S-X, Rule 3-05 or Rule 3-09, may be omitted from an IPO registration statement if that financial information is related to periods that are not reasonably expected to be required at the time the registration statement becomes effective.

In addition, an entity that was an EGC at the time it initially submitted its IPO registration statement for SEC review but that subsequently ceased to be an EGC before it completed its IPO is allowed to continue to use the accommodations provided to EGCs until the earlier of either the date it completes its IPO under that registration statement or one year after it ceased to be an EGC.

After the entity's IPO, provided that the entity retains its EGC status, additional accommodations are available for its ongoing reporting obligations. One of the most significant of these accommodations exempts EGCs from the requirement to obtain, from the entity's independent registered public accounting firm, an auditor's report on the entity's internal control over financial reporting (ICFR). EGCs are also exempt, unless the SEC deems it is necessary, from any future PCAOB rules that may require (1) rotation of independent registered public accounting firms or (2) supplements to the auditor's report, such as communications regarding critical audit matters (CAMs), which have been required for certain other issuers since 2019.

After going public, a registrant will retain its EGC status until the earliest of:

- The last day of the fiscal year in which its total annual gross revenues exceed $1.235 billion.
- The date on which it has issued more than $1 billion in nonconvertible debt securities during the previous three years.
- The date on which it becomes a large accelerated filer (which is an annual assessment performed on the last day of the fiscal year on the basis of public float as of the end of the second fiscal quarter). To be considered a large accelerated filer, the registrant must have (1) $700 million or more in public float, (2) filed at least one annual report, and (3) been subject to the requirements of Sections 13(a) and 15(d) of the Exchange Act for at least 12 months. Accordingly, the registrant generally cannot be considered a large accelerated filer for its first Form 10-K filing as a public company.
- The last day of the fiscal year after the fifth anniversary of the date of the first sale of common equity securities under an effective Securities Act registration statement for an EGC.

Topic 10 of the FRM summarizes many of the SEC staff's views on EGC-related issues. To further assist registrants, the Division has issued FAQs on numerous aspects of the JOBS Act, many of which address matters related to qualifying for EGC status and the filing requirements for EGCs.

11.1.1.3 Loss of EGC Status and Impact on Adoption Dates for New Accounting Standards

An EGC may elect to adopt new accounting standards on the basis of effective dates that apply to non-PBEs (e.g., the option to first adopt a new standard in annual financial statements). However, such an election is available only for as long as the entity qualifies as an EGC. An entity may lose EGC status after the effective date for PBEs but before the effective date for non-PBEs. As discussed in paragraph 10230.1 of the FRM, the SEC staff generally expects an EGC that loses its EGC status to comply with the PBE requirements in the first filing after loss of EGC status. Accordingly, a registrant that loses EGC status before adopting a new standard should reflect such adoption as of the beginning of the current fiscal year. Previously issued financial statements do not need to be amended unless the standard requires full retrospective application. Entities that lose EGC status during the IPO process but are permitted to retain the accommodations during the IPO process (i.e., the company completes its IPO within one year after it ceased to be an EGC) would reflect adoption of any deferred standards in their first periodic report (i.e., on Form 10-Q or Form 10-K) after the IPO. Entities that lose EGC status after their IPO would reflect adoption of any deferred standards in their next periodic report (i.e., on Form 10-Q or Form 10-K) after loss of EGC status.

The SEC staff encourages EGCs to (1) review their plans to adopt accounting standards upon the loss of EGC status and (2) consult with the Division if they do not believe that they will be able to comply with the requirement to reflect new accounting standards on a timely basis.

11.1.2 Smaller Reporting Companies

11.1.2.1 Qualifications of SRCs

A registrant may qualify as an SRC on the basis of either a public float test or a revenue test. The thresholds for qualification as an SRC are as follows:

Criteria	Definition
Public float test	Less than $250 million of public float as of the last business day of the registrant's second fiscal quarter.
Revenue test	Less than $100 million of revenue as of the most recently completed fiscal year for which audited financial statements are available and public float less than $700 million as of the last business day of the registrant's second fiscal quarter.

For initial Securities Act or Exchange Act registration statements, public float is measured as of a date within 30 days of the filing and is computed by multiplying the estimated public offering price of shares by the sum of (1) the aggregate worldwide number of all shares outstanding held by nonaffiliates before the filing of the registration statement and, in the case of a Securities Act registration statement, (2) the number of such shares included in the registration statement.

A company may qualify as both an SRC and an EGC (see Section 11.1.1.1); however, unlike the five-year limit for qualifying as an EGC, there is no time limit for qualifying as an SRC. Investment companies, asset-backed issuers, and subsidiaries that are majority-owned by non-SRC registrants cannot qualify as SRCs. An issuer that becomes an investment company or qualifies as an asset-backed issuer is disqualified from being considered an SRC for its next filing. Registrants should consider consulting with their legal counsel when determining whether they qualify as SRCs.

11.1.2.2 Accommodations Applicable to SRCs

A key feature of reducing the reporting burden on SRCs is the scaling back of the requirements in both SEC Regulation S-K and SEC Regulation S-X.

SRCs may be eligible to apply the scaled disclosure requirements as part of their IPO; those requirements are summarized in the tables below. Under those requirements, SRCs do not have to disclose as many years of audited financial statements and MD&A as non-SRCs. SRCs are also exempt from the requirements for unaudited quarterly financial information after a retrospective accounting change as well as qualitative and quantitative information about market risk. Topic 5 of the FRM also discusses the SEC staff's views on many SRC-related issues. Other than within this section, this Guide generally does not specifically address SRC requirements.

Disclosure Requirements Under SEC Regulation S-K

Regulation S-K Item	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs[3]
Item 101, "Description of Business"	Description of business developments, including principal products and services rendered	SRCs may elect to provide the alternative business disclosure (which may be less detailed) under Item 101(h)	Required
Item 201, "Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters"	A graph depicting share performance over the past five years against market indexes	Not required	Required
Item 302, "Supplementary Financial Information"	Under Item 302(a), if a registrant reports a material retrospective change (or changes) for any of the quarters within the two most recent fiscal years, the registrant must disclose (1) an explanation for the material change(s) and (2) select financial information reflecting such change(s) for the affected quarterly periods, including the fourth quarter	Not required	Required after an IPO
Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"	Discussion of results of operations	Discuss prior two years	Discuss prior three years, but may refer to discussion of earliest period in prior filing
Item 305, "Quantitative and Qualitative Disclosures About Market Risk"	Disclosure of information about market-sensitive instruments and related exposure, including sensitivity analysis	Not required	Required

3 The disclosures identified in the "Registrants Other Than SRCs" column do not take into account certain scaled disclosure accommodations that may be available to EGCs..

(Table continued)

Regulation S-K Item	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs
Item 402, "Executive Compensation"	Number of named executive officers	Three	Five
	Scope of summary compensation table	Two years	Three years
	Compensation discussion and analysis, grants of plan-based awards table, option exercises and stock vested table, pension benefits table, nonqualified deferred compensation table, disclosure of compensation policies and practices related to risk management, pay ratio disclosure	Not required	Required
Item 404, "Transactions With Related Persons, Promoters and Certain Control Persons"	Description of policies/procedures for the review, approval, or ratification of related-party transactions	Not required	Required
Item 407, "Corporate Governance"	Disclosure of audit committee financial expert	Not required in first annual report	Required
	Disclosure of compensation committee interlocks and insider participation	Not required	Required
	Compensation committee report	Not required	Required
Item 503, "Prospectus Summary"	Discussion of the most significant risk factors facing the company	Not required in Exchange Act filings (e.g., annual or interim reports); required in a registration statement	Required

Financial Statement Requirements Under SEC Regulation S-X

Financial Statement Requirements[4]	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs
Annual financial statements	Annual audited financial statements	Two years balance sheet, income statement, cash flow, and shareholders' equity	Three years income statement, cash flow, and shareholders' equity, two years balance sheet
Footnote and other disclosures	Compliance with presentation and disclosure requirements of SEC Regulation S-X, including, but not limited to, separate disclosure of revenue and costs from products and services and separate presentation of related-party transactions	Generally not required	Required
	Disclosure of accounting policy related to certain derivative instruments (Rule 4-08(n))	Required	Required
	Adoption date for new or revised accounting standards[5]	Use "Bucket 2" adoption dates (i.e., those applicable to nonpublic entities, generally two years after "Bucket 1" adoption dates)	Use "Bucket 1" adoption dates (unless the registrant is an EGC that has elected to defer adoption dates for new standards)
	Disclosure of certain information related to guaranteed or collateralized securities (Rule 3-10/13-01 and Rule 3-16/13-02)	Required	Required
	Compliance with auditor independence requirements (Article 2)	Required	Required
	Supplemental financial statement schedules	Not required	Required

[4] SRCs apply the requirements in SEC Regulation S-X, Article 8, when preparing their financial statements. SRCs typically are not required to apply the disclosure provisions of SEC Regulation S-X in their entirety unless Article 8 indicates otherwise. Registrants other than SRCs should apply SEC Regulation S-X in its entirety, as applicable.

[5] As a result of ASU 2019-10, SRCs can adopt ASU 2016-13 (as amended) and ASU 2017-04 in a manner consistent with private-company adoption dates. In addition, the FASB intends to use the two-bucket framework to stagger effective dates for future major accounting standards.

(Table continued)

Financial Statement Requirements	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs
Financial information of equity method investees	Summarized financial data of the equity method investee disclosed in the registrant's financial statements	Required if the equity method investee exceeds 20 percent significance in both interim and annual periods	Required if the equity method investee exceeds 20 percent significance at interim periods or 10 percent significance for the annual period[6]
	Audited historical financial statements of the equity method investee	Only required if equity method investee financial statements would be "material to investors"[7]	Required if the equity method investee exceeds 20 percent significance[8]

Companies that qualify as SRCs may choose to apply the scaled disclosure requirements on an item-by-item (or an "à la carte") basis. However, their disclosures should be consistent from year to year and must comply with federal securities laws, including those that require disclosures not to be misleading.

Connecting the Dots

In determining which scaled disclosure requirements to apply, eligible companies may wish to conduct outreach and consider the information needs of their investors and other financial statement users. Thus, eligible companies may consider weighing any potential cost savings associated with the scaled disclosure requirements against not disclosing information that investors may consider valuable.

If an SRC is a nonaccelerated filer, not only is it eligible to apply the scaled disclosure requirements available to all SRCs, but it is also exempt from the requirement under Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX) to obtain an audit report on ICFR from its independent auditor. The following table summarizes the criteria on the basis of public float and revenue levels in the context of the SOX Section 404(b) requirements:

	Definition		Requirement
Status	Public Float	Annual Revenues	SOX Section 404(b)
SRC and nonaccelerated filer	Less than $75 million	No limit	No
	$75 million to less than $700 million	Less than $100 million	No
SRC and accelerated filer	$75 million to less than $250 million	$100 million or more	Yes for non-EGCs; no for EGCs

6 SEC Regulation S-X, Rule 4-08(g) and Rule 10-01(b)(1), prescribe the annual requirements for summarized financial information and the interim requirements for summarized income statement information, respectively.
7 See paragraph 5330.2 of the FRM.
8 SEC Regulation S-X, Rule 3-09, prescribes the annual requirements for financial statements of an equity method investee. See Deloitte's Roadmap *SEC Reporting Considerations for Equity Method Investees* for further guidance on evaluating the significance of equity method investees.

11.1.3 Mergers With Special-Purpose Acquisition Companies and Shell Companies

Many private operating companies have merged with special-purpose acquisition companies (SPACs) or other shell companies to raise capital rather than using traditional IPOs or other financing activities. After a SPAC or shell company merges with a private operating company (the "target"), the target's financial statements generally become those of the combined public company (the "combined company"). Therefore, a target will need to devote a considerable amount of time and resources to technical accounting and reporting matters. The discussion herein primarily addresses mergers with SPACs; however, similar considerations apply if a private operating company merges with a public shell company other than a SPAC, such as a company that has abandoned all research or other operational activities. A reverse merger between two operating companies also requires careful consideration of SEC reporting requirements; for more information, see Section 1.7.2 of Deloitte's Roadmap *Initial Public Offerings*.

A SPAC is a newly formed company that raises cash in an IPO and uses it to fund the acquisition of one or more private operating companies. After the IPO, the SPAC's management looks to complete an acquisition of a target company within the period specified in its governing documents (e.g., 24 months). If an acquisition cannot be completed within this time frame, the cash raised in the IPO must generally be returned to investors. Because SPACs hold no assets other than cash before completing an acquisition, they are nonoperating public "shell companies" as defined by the SEC (see paragraph 1160.2 of the FRM). If a target is identified and the SPAC is able to successfully complete the acquisition transaction, the private operating company target will succeed to the SPAC's filing status as a result of the merger. On the closing date of the acquisition, the former private operating company, as the predecessor to the SPAC registrant, becomes a public company and must be able to meet all the public-company reporting requirements applicable to the combined company.

A SPAC's shareholders are often required to vote on the merger transaction, so the SPAC may file a combined proxy and registration statement on Form S-4 to effect the transaction. These documents must include audited financial statements of the private operating target. The target's financial statements must comply with SEC rules and regulations, including SEC Regulation S-X and SEC Staff Accounting Bulletins, both of which govern presentation and disclosures in the financial statements. Further, because the private operating company is considered the predecessor to the registrant, financial statements included in Form S-4 or the merger proxy must be audited in accordance with PCAOB standards. In addition, the target's financial statements cannot reflect Private Company Council (PCC) accounting alternatives or practical expedients applicable to non-PBEs and generally must reflect the adoption of new accounting standards on the basis of the dates required for public companies. However, we understand that the SEC staff will not object if a target uses private-company (non-PBE) adoption dates if (1) the SPAC is an EGC that has elected to defer the adoption of accounting standards by applying private-company adoption dates, (2) the target would qualify as an EGC if it were conducting its own IPO of common equity securities, and (3) the combined company will qualify as an EGC after the transaction (see paragraph 10120.2 of the FRM for a discussion of assessing EGC eligibility after the transaction).

Audited financial statements should generally be presented for both the SPAC and the target entity (or entities) for the three most recent fiscal years. However, there are two scenarios in which the SEC staff would not object when a registrant presents two years of annual financial statements, rather than the otherwise required three years:

- *SRCs* — In a manner consistent with the requirements described in paragraph 1140.3 of the FRM, a target may provide **two** years of audited financial statements rather than three years if the target would meet the definition of an SRC if filing a registration statement on its own.(e.g., it had less than $100 million in annual revenues in its most recent fiscal year for which audited financial statements are available).
- *EGCs* — A target may provide **two** years of audited financial statements rather than three years if the target would qualify as an EGC if it were conducting its own IPO of common equity securities.

The SPAC and its target must also comply with the requirements related to the age of financial statements in SEC filings. (See Section 11.1.5 for further guidance on the age of financial statements.) Within four days of the closing of the acquisition, the combined company must file a Form 8-K (referred to as a "Super Form 8-K") that includes all the information that would be required if the former private operating company had registered securities on Form 10. There is no 71-day grace period for providing audited financial statements of the formerly private operating company in the Super Form 8-K, as there may have been if the acquisition had been between two operating companies.[9] Accordingly, the SPAC and the private operating target should take care to ensure that the acquisition is not closed until all the financial information required for the Super Form 8-K is available, including financial statements that comply with the SEC's age requirements and are audited in accordance with PCAOB standards. Paragraph 12220.1 of the FRM provides more information about the requirements related to the Super Form 8-K.

In addition, to avoid a gap or lapse in the target's financial statement periods after a transaction, the combined company may need to amend its Super Form 8-K to provide updated financial statements of the target. For example, if the transaction closes soon after the target's fiscal quarter or year-end, the Super 8-K generally will not include the target's financial statements for the most recently completed period. In such a case, the combined company will need to amend its Super 8-K to provide the recently completed annual or interim period on or before the registrant's due date for its Form 10-K or Form 10-Q for that same period.

It can be complex to determine the ICFR attestation requirements that apply to management and the auditor after the close of a SPAC transaction. The phase-in exception in SEC Regulation S-K, Item 308, for an IPO, under which management's report and the auditor's attestation on ICFR are not required before the second annual report, typically does not apply in a transaction with a SPAC. Further, if the SPAC is an EGC, the EGC status of the combined entity would also have to be assessed after the close of the transaction to determine whether the combined company could continue to qualify for the scaled disclosure requirements applicable to EGCs, including relief from the auditor's attestation report. These transactions often involve a change in auditors, and if the SPAC's year-end differs from that of the target, they may also involve a change in fiscal year-end. Given the complex reporting requirements associated with SPAC acquisitions, private operating companies contemplating such transactions should consider consulting with legal and financial reporting advisers as early as possible.

[9] Under Form 8-K, Item 2.01, a registrant is required to file a Form 8-K to announce a significant business acquisition within four business days of consummation and to include the required financial statements within 71 calendar days.

Changing Lanes

On January 24, 2024, the SEC issued a final rule related to the financial reporting and disclosure requirements for SPACs. The final rule aims to (1) "enhance investor protections in [IPOs] by [SPACs] and in subsequent business combination transactions between SPACs and private operating companies (commonly known as de-SPAC transactions)" and (2) "more closely align the treatment of private operating companies [target companies] entering the public markets through de-SPAC transactions with that of companies conducting traditional IPOs." In summary, the final rule:

- Provides new requirements related to a SPAC's IPO registration statement and its subsequent de-SPAC registration/proxy statement, such as additional disclosure requirements related to the SPAC sponsor and financial projections.
- Addresses certain liability matters by requiring the target company in a de-SPAC transaction to be a co-registrant with the SPAC in the de-SPAC registration/proxy statement.
- Codifies, through new Article 15 of Regulation S-X, various requirements related to the financial statements included in SPAC IPO registration statements and de-SPAC registration/proxy statements as well as filings made after the de-SPAC transaction.

When planning for SPAC transactions, entities should be mindful of the unique considerations noted above as well as other specific accounting and SEC reporting considerations. For more information about the final rule related to SPAC transactions, see Deloitte's February 6, 2024, *Heads Up*.

11.1.3.1 Transactions Entered Into in Connection With a SPAC Merger

Entities going public via a SPAC often raise additional capital through a structure known as a private investment in public equity (PIPE). We have observed several transactions in which an unrelated third-party vendor enters into a stock subscription agreement with the SPAC to purchase a fixed number of shares for $10.00 per share as part of the PIPE. Concurrently, the SPAC's target enters into a vendor contract with the same unrelated third-party vendor to receive the vendor's services. Often the customer begins to receive the vendor's services before the PIPE closes, and the termination and payment provisions in the vendor contract are adjusted on the basis of whether the PIPE closes.

When evaluating these arrangements, an entity should consider whether the stock subscription agreement and vendor contract are accounted for as a combined arrangement and whether the consideration in the stock subscription agreement and vendor contract should be allocated in a manner that differs from what is contractually specified. An entity should also consider the nature of the vendor contract and carefully consider the appropriate expense recognition. Given the complexities of these arrangements, entities should consult with their accounting advisers on the appropriate accounting treatment.

11.1.3.2 Accounting for Shares and Warrants Issued by a SPAC

The guidance in this section is based on the typical terms and conditions that have been observed in practice. Since the specific terms can affect the accounting, consultation with an entity's accounting advisers is recommended.

In its IPO, a SPAC typically issues units to third-party investors at $10 per unit. Each unit generally contains both of the following:

- One Class A ordinary share (a "Class A Share").
- A fraction of a warrant to purchase one Class A Share at an exercise price of $11.50 (a "public warrant").

The sponsor and its affiliates generally receive Class B ordinary shares ("Class B shares") in return for forming the SPAC. They may also purchase warrants ("private placement warrants") to acquire Class A shares at an exercise price of $11.50 per share. Alternatively, in lieu of the sponsor, a so-called "anchor investor" may purchase private placement warrants. The private placement warrants are generally purchased at $1 or $1.50 per warrant, and the proceeds received by the SPAC are used to pay the underwriting fees incurred in conjunction with the SPAC's IPO.

In addition, entities may enter into other arrangements upon the formation of a SPAC or at a later date before the SPAC completes a merger. Such arrangements may include the following:

- Forward contracts that (1) obligate the SPAC to issue additional Class A shares to a counterparty at a fixed price and (2) are settled immediately before the SPAC completes a merger with a target.
- Warrants on Class A shares or on Class B shares that are issued to the sponsor, its affiliates, or third parties in return for providing financing to the SPAC.
- Classes of preferred stock issued to third-party investors, the sponsor, or the sponsor's affiliates.
- Class A shares or Class B shares (or warrants on such shares) that are issued to the SPAC's employees or third-party service providers as compensation for services provided.

The accounting analysis for some of these arrangements (e.g., the forward contracts and warrants described in the first two bullet points) may be similar to that for public warrants or private placement warrants. SPACs that issue preferred shares or enter into share-based payment arrangements should consider other applicable GAAP to determine the appropriate accounting, including the potential effect of those instruments on reported EPS. Any shares or warrants issued as a share-based payment arrangement must be accounted for in accordance with ASC 718.

Although initially issued as a unit, the Class A shares and public warrants become separately tradable shortly after the IPO. In addition, upon exercise, the public warrants do not alter the terms of the Class A shares previously issued. Therefore, the public warrants (1) are legally detachable and separately exercisable from the Class A shares issued as part of the units and (2) meet the definition of a freestanding financial instrument in ASC 480-10-20.

Since the Class A shares and public warrants constitute separate units of account, the proceeds from the issuance of these units (net of any direct and incremental offering costs paid to the investors) must be allocated between the two components. The appropriate allocation method depends on how the public warrants are classified:

- *Public warrants classified as liabilities* — The SPAC must use the with-and-without method to allocate the net proceeds among the Class A shares and public warrants. Under that method, a portion of the net proceeds from the issuance of the units that equals the issuance-date fair value of the public warrants must first be allocated to such warrants. The entity then allocates the remaining net proceeds to the Class A shares. The with-and-without allocation approach avoids the recognition of a "day 1" gain or loss in earnings on the public warrants that is not associated with a change in their fair value (i.e., an entity does not recognize a day 1 gain or loss for the public warrants, which are subsequently measured at fair value, with changes in fair value recognized in earnings).
- *Public warrants classified as equity instruments* — The SPAC must use the relative fair value method to allocate the net proceeds among the Class A shares and public warrants. Under that method, the SPAC separately estimates the fair values of the Class A shares and public warrants and then allocates the net proceeds in proportion to those fair value amounts. Because SPACs that apply the relative fair value method are required to independently measure each instrument, entities must make more fair value estimates under this method than under the with-and-without method. The Class B shares and any private placement warrants issued by the SPAC also generally represent separate units of account. If the private placement warrants were purchased by the sponsor in contemplation of the formation of the SPAC, the entity should consider (1) the need to allocate the amount it paid for these warrants between the Class B shares and private placement warrants and (2) whether such warrants represent share-based payment awards to the sponsor. In a manner consistent with the above discussion of Class A shares and public warrants, if the private placement warrants are classified as liabilities, the initial amount allocated to those warrants must equal their initial fair value.

To perform the allocations discussed above, entities must measure the fair value of the instruments in accordance with ASC 820. Although public warrants and private placement warrants are generally not "in-the-money" on the issuance date and are often contingently exercisable, their fair value is nevertheless greater than zero. When measuring fair value, the entity must take into account the relatively high probability that the SPAC will successfully merge with a target and the warrants will subsequently become exercisable and contain intrinsic value. The issuance-date fair value of a public warrant or private placement warrant is not zero because there is no intrinsic value on that date. All warrants on equity shares have time value, which equals the fair value of the warrant when it is not in-the-money.

For more information about allocating proceeds to multiple freestanding financial instruments, see Section 3.4 of Deloitte's Roadmap *Issuer's Accounting for Debt*. For more information about fair value measurements, see Deloitte's Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)*.

After the required allocations are performed, SPACs must determine (1) the appropriate classification of Class A shares, Class B shares, public warrants, and private placement warrants as equity, temporary equity, or liabilities and (2) the accounting for issuance costs.

11.1.3.2.1 SEC Comment Letter Themes Related to the Classification of Warrants

Example of an SEC Comment

We note you have classified the . . . private placement warrants as equity. Please provide us with your analysis under ASC 815-40 to support your accounting treatment for these warrants. As part of your analysis, please address whether there are any terms or provisions in the warrant agreement that provide for potential changes to the settlement amounts that are dependent upon the characteristics of the holder of the warrant, and if so, how you analyzed those provisions in accordance with the guidance in ASC 815-40.

Entities should evaluate financial instruments that have both debt- and equity-like characteristics to determine whether the instruments should be classified as liabilities or equities in the financial statements. An entity should first determine whether a financial instrument should be classified as a liability in accordance with ASC 480. If the financial instrument is not classified as a liability under ASC 480, the entity should analyze the financial instrument under other accounting guidance, such as ASC 815. The SEC staff has asked registrants to explain the basis for their determination of how financial instruments should be classified, including the application of relevant accounting literature. Such comments are especially common for SPACs or companies that have merged with SPACs since complex financial instruments are often issued to raise capital for SPACs and SPAC transactions.

11.1.3.3 Differences in SEC Reporting Requirements — IPOs Versus SPACs

In addition to the matters discussed above, entities considering a SPAC transaction should take into account key differences between the SEC reporting requirements related to traditional IPOs (sale of newly issued common shares to the public) and those for SPAC transactions, some of which are summarized in the table below.

Topic	Traditional IPOs (Sale of Newly Issued Common Shares)	SPAC Transactions[10]
Adoption dates of accounting standards	EGCs can irrevocably elect to defer adoption of new accounting standards on the basis of adoption dates used for private companies (non-PBEs).	The target company may defer adoption of new accounting standards only if (1) the SPAC is an EGC that has elected to defer the adoption of accounting standards by applying private-company adoption dates, (2) the target would qualify as an EGC if it were conducting its own IPO of common equity securities, and (3) the combined company will qualify as an EGC after the transaction.

[10] The discussion herein applies to SPAC transactions in which (1) a domestic SPAC merges with a domestic target and (2) the SPAC has identified only one target for the transaction. SPAC transactions result in additional complexity when foreign entities or multiple targets are involved. In addition, we have recently observed new structures in which either the target or a newly formed company acquires the SPAC (e.g., a structure frequently referred to as a "double dummy" transaction). Such transactions may be viewed as the IPO of the target and, thus, different considerations may apply (e.g., two years of financial statements may be appropriate if the target qualifies as an EGC, and the confidential filing process may be available for a longer period).

(Table continued)

Topic	Traditional IPOs (Sale of Newly Issued Common Shares)	SPAC Transactions
Confidential or nonpublic submissions of the IPO document	Confidential or nonpublic submissions to the SEC staff are allowed for all companies undertaking an IPO (i.e., EGCs and non-EGCs). Such submissions, and any associated SEC comment letter responses, may continue to be submitted confidentially until they must be filed publicly as described in Section 11.1.4.	The SEC staff may agree to review the initial nonpublic draft Form S-4 if it is submitted within 12 months of the SPAC's IPO. However, SEC comment letter responses and all subsequent amendments must be filed publicly.
Pro forma information included in the IPO document	Pro forma information is not required unless the registrant has other transactions for which pro forma information is required in accordance with SEC Regulation S-X, Article 11.	An entity must provide pro forma information for the accounting impact of (1) the SPAC transaction and (2) any other transactions for which pro forma information is required in accordance with SEC Regulation S-X, Article 11.
Prospective financial information included in the IPO document	Prospective financial information (i.e., forecasted information) is generally not presented.	Prospective financial information generally must be presented if the boards of directors of the company and SPAC used such forecasted information in evaluating the transaction.
Initial quarterly periodic reporting obligation	The registrant becomes subject to the SEC's periodic reporting requirements beginning with the first quarterly or annual period after consummation of the IPO. The first Form 10-Q, for the quarter after the most recent period included in the registration statement, is due on the later of 45 days after the effective date or the date the Form 10-Q would otherwise be due if the company had been a public filer. For example, if an IPO becomes effective on April 15, 20X1, and includes financial statements through December 31, 20X0, the first Form 10-Q required will be for the quarter ended March 31, 20X1, and must be filed 45 days after April 15, 20X1.	The combined company retains the previous SEC reporting obligations of the SPAC and must file financial statements for quarterly or annual periods that end before the close of the transaction on the basis of the SPAC's filing deadlines, without reference to the closing date of the transaction, even if not included in the Super Form 8-K. For example, if the SPAC transaction closes on April 15, 20X1, the Super 8-K due within four days must only include annual financial statements through December 31, 20X0. The combined company retains the SPAC's requirement to file a Form 10-Q for March 31, 20X1, for the SPAC and an amended Super Form 8-K with the financial statements of the target company for March 31 20X1, by the relevant Form 10-Q due date (i.e., 45 days for nonaccelerated filers).

(Table continued)

Topic	Traditional IPOs (Sale of Newly Issued Common Shares)	SPAC Transactions
Ongoing reporting requirements related to ICFR	Management's report and the auditor's attestation on ICFR are not required before the second annual report. The auditor's report may also not be required afterward to the extent that the registrant is an EGC or nonaccelerated filer.	If the SPAC filed its first annual report before the close of the transaction, management's report on ICFR is required in the next annual report after the close of the transaction. However, as noted in Section 215.02 of the C&DIs on Regulation S-K, the SEC may not object to the exclusion of management's report (and the auditor's report) on ICFR depending on the closing date of the transaction and other conditions. We recommend that management consult with its legal counsel and auditors before excluding reports on ICFR.

11.1.4 Nonpublic Review Process for Draft Registration Statements

Historically, registration statements filed with the SEC were immediately accessible to the public via EDGAR, the SEC's online public database. However, EGCs may confidentially submit certain IPO registration statements to the SEC. In 2017, the SEC extended a similar confidential benefit to non-EGCs, allowing them to also voluntarily submit draft IPO registration statements to the SEC staff for nonpublic review. The ability to file nonpublicly is a significant benefit because it allows companies to keep potentially sensitive information from customers or competitors until later in the IPO process. It also lets companies, on a nonpublic basis, respond to SEC comments, update the draft registration statement, and continue to assess market conditions throughout the IPO process. Companies that use this benefit can also delay or withdraw the IPO, if desired, without public scrutiny.

While draft registration statements may be initially submitted nonpublicly, a company will eventually be required to publicly file all previously submitted drafts unless it elects to withdraw the IPO. Specifically, all comments and the related responses, even if they were previously submitted nonpublicly, will be posted to the SEC's Web site no earlier than 20 days after the registration statement is declared effective. All nonpublic submissions of Securities Act registration statements must be filed publicly[11] no later than 15 days before (1) a road show or (2) the requested effective date of the registration statement if no road show is planned.

Connecting the Dots

In the answer to Question 1 of its FAQs on the voluntary submission of draft registration statements, the SEC staff states, in part:

> The confidentiality provisions of Securities Act Section 6(e)(2) are limited to certain draft registration statements of Emerging Growth Companies. An issuer relying on the Division's policy should consider requesting confidential treatment under Rule 83 (17 CFR 200.83) for its draft registration statement and associated correspondence when seeking a nonpublic review.

As a result, "confidential" draft registration statements are reserved for EGCs. Other issuers may submit draft registration statements "nonpublicly" and request that they be given confidential treatment.

[11] For Exchange Act statements, the registration statement must be filed no later than 15 days before the expected effective date of the registration statement.

When submitting a draft registration statement for nonpublic review, companies should consider the following:

- The draft registration statement must be "substantially complete." It must contain a signed audit report from the company's independent registered public accounting firm and meet all line item requirements applicable to the registration statement, unless a company is using certain permitted accommodations for omitting otherwise required information.[12] Also, we understand that the SEC staff expects the lead underwriter to be named in the draft registration statement for a traditional IPO and may defer its review until a lead underwriter is identified.
- For a draft registration statement, companies do not need to include items such as the required signatures of executives and directors, the auditor's consent, and the filing fee.

At the time of a company's initial public filing, the registration statement should be:

- Devoid of any indications that the document is nonpublic.
- Complete (e.g., it should include signatures, signed audit reports, consents, exhibits, and any required filing fees).
- Accompanied by the contemporaneous filing of any previously submitted nonpublic draft registration statements.

11.1.4.1 Omission of Certain Financial Information From Draft Registration Statements

While each draft of a registration statement is generally expected to contain all information required by SEC regulations, there is an accommodation available to companies that allows them to omit financial statement periods in certain circumstances. This accommodation was initially granted to EGCs as part of the JOBS Act but was subsequently expanded by the SEC to include non-EGCs as well. Specifically, under the accommodation, a non-EGC may omit financial information from a nonpublic draft registration statement (see Section 11.1.4) for historical periods currently required if the company reasonably believes that it will not be required to include these historical periods at the time of the public filing. EGCs may omit financial information that they reasonably believe they will not be required to include in the registration statement "at the time of the **contemplated offering**"[13] (emphasis added). These provisions are likely to apply when the SEC's review process extends through a financial statement stale date (see Section 11.1.5). When a non-EGC files publicly for the first time, it must include all financial information required as of the public filing date.

Example 11-1

A non-EGC calendar-year-end company submits a draft registration statement in December 20X7 and reasonably expects to file publicly for the first time in April 20X8 when annual financial statements for 20X7, 20X6, and 20X5 will be required. In such a case, the company may omit its 20X4 annual financial statements from its nonpublic draft registration statement because the 20X4 annual financial statements will not be required at the time of the first public filing. However, for either a confidential submission or public filing more than 45 days after the 20X7 year-end, audited 20X7 financial statements must be included because those financial statements will be required at the time of the first public filing and the company must comply with the staleness requirements discussed in Section 11.1.5.

[12] See Question 101.05 of the SEC's C&DIs on Securities Act Forms.
[13] Quoted from Section 71003 of the FAST Act.

For non-EGCs, Question 101.05 of the SEC's C&DIs on Securities Act Forms clarifies that when evaluating which interim periods to include in a draft registration statement, companies may omit interim financial information if they reasonably believe that they will not be required to separately present such information at the time they publicly file their registration statement. As a result, many initial draft registration statements may not need to include interim financial statements when they are submitted nonpublicly.

11.1.5 Age of Financial Statements

In accordance with SEC Regulation S-X, Rule 3-12, the financial statements in an IPO must meet certain age requirements as of each registration-statement filing date as well as when the registration is declared effective; otherwise, the financial statements will be considered "stale." In general, the financial statements in an IPO filing must not be more than 134 days old (i.e., the gap between the date of filing or effectiveness and the date of the latest balance sheet cannot be more than 134 days). However, third-quarter financial statements are considered timely through the 45th day after the most recent fiscal year-end, after which the audited financial statements for the most recent fiscal year are required. See Section 1220 of the FRM for additional details.

The table below provides the dates on which financial statements become stale for a calendar-year-end company undertaking an IPO during 2024 or 2025. That is, financial statements for the respective financial statement period can be included in an IPO registration statement up to the dates listed below. When filing an IPO registration statement after these dates, an entity must update financial statements and other financial information to comply with the SEC's age requirements (i.e., an additional unaudited interim period or audited fiscal year would be required).

	First Quarter Ended March 31 (Unaudited)	Second Quarter Ended June 30 (Unaudited)	Third Quarter Ended September 30 (Unaudited)	Fiscal Year Ended December 31 (Audited)
Fiscal/calendar year 2024	August 12, 2024	November 12, 2024	February 14, 2025	May 14, 2025
Fiscal/calendar year 2025	August 12, 2025	November 12, 2025	February 16, 2026	May 14, 2026

11.2 Industry Issues

The sections below highlight accounting and disclosure issues commonly encountered by life sciences entities that are associated with IPOs. For more information as well as insights into topics not addressed below, see Deloitte's Roadmaps *Initial Public Offerings* and *SEC Comment Letter Considerations, Including Industry Insights*.

11.2.1 Financial Statements of Businesses Acquired or to Be Acquired (Rule 3-05)

Example of an SEC Comment

We note that you consummated the [Company A] acquisition . . . but to date you have not filed audited financial statements of the acquired business or pro forma information relating to the acquisition. Please provide us with your calculations of the significance tests outlined in Rule 1-02(w) of Regulation S-X that you used in applying the requirements of Rule 3-05 and Article 11 of Regulation S-X.

As discussed in Chapter 3, it is common for life sciences entities to engage in significant M&A activity. Therefore, registrants in the life sciences industry should be mindful of the SEC reporting requirements when they acquire, or it is probable that they will acquire, a business. This section provides a high-level summary of the SEC reporting requirements under SEC Regulation S-X, Rule 3-05 and Article 11. For more information about the application of these requirements, see Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions* (including Section 2.12 of that Roadmap, which discusses how to apply these requirements in an IPO).

When a significant business acquisition is consummated, or it is probable that the acquisition will be consummated, the registrant may be required to file certain financial statements of the acquired business or to be acquired business (acquiree) in accordance with Rule 3-05. While existing registrants are subject to periodic reporting requirements for significant acquisitions,[14] a company is not subject to such requirements before an IPO. Therefore, in the context of an initial registration statement, a company must evaluate recent consummated and probable acquisitions, as further described below.

The following factors govern whether and, if so, for what period the acquiree's financial statements are required for a consummated or probable acquisition:

- *Definition of a business* — Rule 3-05 applies to an acquisition of a business. The definition of a "business" for SEC reporting purposes differs from the definition under ASC 805 for U.S. GAAP purposes and focuses primarily on the continuity of operations.[15] Note that an acquisition can take many forms (i.e., acquisition of assets vs. acquisition of a legal entity) and that such forms typically will not affect the determination of whether the acquiree is a business. For additional discussion of SEC considerations related to the definition of a business, including whether licenses of drug compounds in early-stage development that have yet to generate revenue could meet the definition of a business for SEC reporting purposes, see Section 3.2.1.3.
- *When the acquisition was completed* — The acquiree's financial statements are not required once the registrant's audited financial statements reflect the operating results of the acquiree for at least:
  - Nine months if any of the results of the significance tests are greater than 20 percent but none are greater than 40 percent.
  - A complete fiscal year if the results of any of the significance tests are greater than 40 percent.

  As a result, acquisitions that occurred in the second or third back year of annual financial statements presented by the registrant will not need to be presented in separate preacquisition financial statements unless the omission of such financial statements would be misleading.

[14] Under Form 8-K, Item 2.01, a registrant is required to file a Form 8-K to announce a significant business acquisition within four business days of consummation and to include the required financial statements and related pro forma financial information within 71 calendar days.

[15] SEC Regulation S-X, Rule 11-01(d), states, in part, "[T]he term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business."

- *Significance* — The highest level of significance based on the following three tests is used to determine the financial statements, if any, that an entity is required to provide in the registration statement:
    - *Investment test* — The GAAP purchase price is compared with the total assets of the registrant on the basis of its most recent preacquisition annual financial statements. While the investment test stipulates the use of aggregate worldwide market value (AWMV) of the registrant's common equity (i.e., market capitalization) when available rather than total assets, companies undertaking an IPO would not yet have an observable AWMV and thus must use total assets. Once an entity completes its IPO, it should use its AWMV when performing the investment test. For example, if a registrant consummates an acquisition on March 15, 2024; completes its IPO on June 15, 2024; and consummates an acquisition on November 15, 2024, it should use total assets and AWMV to perform the investment test for the March and November acquisitions, respectively.
    - *Asset test* — The registrant's share of the acquiree's total assets is compared with the registrant's total assets on the basis of the most recent preacquisition annual financial statements of each company.
    - *Income test* — The income test consists of an income component and a revenue component:
        - *Income component* — The registrant's share of the acquiree's pretax income from continuing operations[16] is compared with the registrant's pretax income from continuing operations on the basis of the most recent preacquisition annual financial statements of each company.
        - *Revenue component* — If both the registrant and the acquiree have material revenue in each of the two most recently completed fiscal years, the revenue component is calculated by comparing the registrant's share of the acquiree's revenue with the registrant's revenue on the basis of the most recent preacquisition annual financial statements of each company. If either the registrant or the acquiree does not have material revenue for each of the two most recently completed fiscal years, only the income component should be used and the registrant should use income averaging if applicable.

      An acquiree will only be considered significant if **both** the income component and the revenue component (if applicable) exceed the significance threshold (i.e., 20 percent). When both components exceed the significance threshold, the lower of the two components is used to determine the number of periods for which the acquiree's financial statements are required.

Pro forma financial information is generally required under SEC rules if the acquiree is deemed to be significant. The significance tests in SEC Regulation S-X, Rule 1-02(w), can be quite complex. Entities are advised to consult with their independent auditors and legal counsel when applying the tests in special circumstances.

[16] SEC Regulation S-X, Rule 1-02(w), indicates that pretax income from continuing operations is "consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests."

11.2.1.1 Preacquisition Financial Statements Required

The table below summarizes whether preacquisition financial statements are required for an acquiree within a registration statement on the basis of the timing of the acquisition and the significance threshold.

Significance	Acquisition Closed *Before* the Most Recent Full Fiscal Year Presented	Acquisition Closed *During* the Most Recent Full Fiscal Year Presented	Acquisition Closed *After* the Most Recent Full Fiscal Year Presented	Probable Acquisition (Not Yet Consummated)
20 percent or less	No	No	No	No
Exceeds 20 percent but not 40 percent	No	If the acquisition closed during the first quarter, no; otherwise yes. See Section 11.2.1.2 below for further details.	Yes. See Section 11.2.1.2 below for further details.	No. See Section 11.2.1.3 below for further details.
Exceeds 40 percent but not 50 percent	No	Yes. See Section 11.2.1.2 below for further details.	Yes. See Section 11.2.1.2 below for further details.	No. See Section 11.2.1.3 below for further details.
Exceeds 50 percent	No	Yes	Yes	Yes

11.2.1.2 Grace Period

Financial statements of a significant acquired business that are not more than 50 percent significant (on the basis of any of the three significance tests) are not required in a registration statement that is filed or declared effective before the 75th day after the consummation of the acquisition. (See paragraph 2040.1 of the FRM and the discussion of Company D in Example 11-2.) However, any amendment to the initial registration statement filed 75 or more days after the consummation must include the required financial statements and pro forma financial information. Further, if the registration statement is declared effective during the grace period, the registrant must file on Form 8-K the required financial statements and pro forma financial information within 75 days of the closing of the transaction. These requirements may be accelerated if certain acquisitions are significant in the aggregate, as noted below.

11.2.1.3 Aggregate

Separate financial statements are generally not required in a registration statement for a significant probable acquisition whose significance does not exceed 50 percent or for a significant consummated acquisition whose significance does not exceed 50 percent within the grace period discussed above. However, an entity must perform an additional test to calculate the aggregate significance of the following categories:

1. Probable acquisitions whose significance does not exceed 50 percent.
2. Consummated acquisitions within the grace period whose significance is greater than 20 percent but not greater than 50 percent.
3. Any individually insignificant (i.e., the significance does not exceed 20 percent) businesses acquired since the end of the registrant's most recently completed fiscal year presented.

The acquirees in all three of these categories are commonly referred to as individually insignificant acquirees, and if their aggregate significance exceeds 50 percent, the registration or proxy statement must include:

- The audited preacquisition financial statements for the most recent fiscal year and interim period for any acquirees in categories 1 and 2 above whose significance exceeds 20 percent and that have not yet been filed.
- Pro forma financial information to reflect the aggregate effects of all individually insignificant acquisitions (i.e., all three categories).

See Section 2.9 of Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions* for more information. In addition, companies should consult with their independent auditors and legal counsel in such circumstances.

11.2.1.4 Periods of Preacquisition Financial Statements Required

If preacquisition financial statements are required, the significance level is used to determine the periods as follows:

- Significance exceeds 20 percent but not 40 percent:
  - One year of audited preacquisition financial statements.
  - Interim unaudited financial statements (1) as of the acquiree's last fiscal quarter-end completed before the closing of the acquisition and (2) for the year-to-date interim period ending on that date.
- Significance exceeds 40 percent:
  - Two years of audited preacquisition financial statements.
  - Interim unaudited financial statements (1) as of the acquiree's last fiscal quarter-end completed before the closing of the acquisition, (2) for the year-to-date interim period ending on that date, and (3) for the corresponding year-to-date interim period in the prior year.

Example 11-2

Assume the following:

- Registrant A, a calendar-year-end company, is planning to file its initial registration statement on or around September 15, 20X6.
- Registrant A does not qualify as an EGC.
- Registrant A will include its historical financial statements for the following periods in its initial registration statement:
  - Audited balance sheets as of December 31, 20X5, and December 31, 20X4.
  - Audited statements of operations, comprehensive income, cash flows, and changes in stockholders' equity for each of the three years in the period ended December 31, 20X5.
  - Unaudited financial statements as of and for the periods ended June 30, 20X6, and June 30, 20X5.

Example 11-2 (continued)

Registrant A made the following acquisitions:

Company	Acquisition Date	Highest Level of Significance	Years Required	Financial Statements Required[17]
B	December 15, 20X4	60%	N/A	Because the acquisition of Company B occurred before the most recent full fiscal year presented by Registrant A, B's preacquisition financial statements are not required.
C	January 15, 20X5	55%	2	Because Company C has not been included in A's audited results for a complete fiscal year, A must provide two years of preacquisition financial statements: C's financial statements as of and for the years ending December 31, 20X4, and December 31, 20X3.
D	July 15, 20X6	25%	1	While one year of audited financial statements will eventually be needed, as of the initial filing date, no financial statements of Company D are required on the basis of the accommodation for recently consummated business acquisitions, commonly referred to as the grace period, discussed in Section 11.2.1.2. In any amendment to the IPO registration statement filed 75 or more days after the acquisition date of July 15, 20X6, audited financial statements as of and for the years ended December 31, 20X5, as well as unaudited interim information as of and for the six-month period ended June 30, 20X6, would be required. In addition, if Company A completes its IPO during the grace period, the required financial statements and pro forma financial information must be filed on Form 8-K within 75 days of the closing of the acquisition.

11.2.1.5 Omitting a Balance Sheet for a Significant Business Acquisition

In accordance with SEC Regulation S-X, Rule 3-05(b)(4)(iv), when the registrant's audited balance sheet is for a date after the consummation of the acquisition, the separate balance sheet(s) of the acquiree may be omitted, since the acquiree's balances are included in the acquiring company's balance sheet. The registrant is still required to provide the acquiree's statements of operations, comprehensive income, and cash flows for the appropriate periods.

[17] Assumes that all acquired companies are calendar-year-end companies and that the registrant is not using the accommodation to omit the acquiree's balance sheet, when applicable.

Example 11-3

Registrant A acquires Company B on December 15, 20X7. Both A and B have a December 31 fiscal year-end. The highest level of significance for the acquisition of B is 35 percent. Registrant A plans to file an initial registration statement in March 20X8 that will include A's audited financial statements as of December 31, 20X6 and 20X7, and for the three years ended December 31, 20X7. Registrant A is required to include B's audited financial statements for **one** year in the initial registration statement.

Because A's audited balance sheet as of December 31, 20X7, is for a date after the acquisition was consummated, B's balance sheet may be omitted. Registrant A is still required to provide B's statements of operations, comprehensive income, and cash flows for the appropriate periods.

11.2.2 Pro Forma Financial Information

A registrant in an IPO may have consummated, or may be contemplating, a transaction in which presentation of pro forma financial information is required. The objective of providing pro forma financial information is to enable investors to understand and evaluate the continuing impact of a transaction (or a group of transactions) by showing how the transaction might have affected the historical financial position and results of operations of the registrant if it had been consummated at an earlier date.

The requirements related to the presentation and preparation of pro forma financial information are addressed in SEC Regulation S-X, Article 11. Article 11 prohibits presentation of pro forma information in the historical financial statements unless such disclosure is required by GAAP or IFRS Accounting Standards. Therefore, the pro forma presentation is often presented in a separate section in the registration statement. Note that the requirements for pro forma financial information under Article 11 are separate and distinct from the requirements to present supplementary pro forma information for a business combination under ASC 805. For more information about the pro forma information disclosures that ASC 805 requires for a completed business combination, see Section 5.4 of Deloitte's Roadmap *Initial Public Offerings*.

11.2.2.1 Circumstances in Which Presentation of Pro Forma Information Is Required

Article 11 lists several circumstances in which a registrant may need to provide pro forma financial information. Such information is most commonly required when a significant business combination or a disposition of a significant portion of a business has occurred or is probable. As part of an IPO, corporate reorganizations, changes in capitalization, and the use of proceeds may be reflected in pro forma financial information; however, a registrant needs to consider whether any other significant events or transactions that have occurred or are probable would also be meaningful to investors on a pro forma basis. Factors that may affect whether a registrant needs to provide pro forma financial information in a registration statement include (1) whether the event or transaction is significant; (2) whether it is already reflected in the historical financial statements; (3) if the event has not yet occurred, whether it is probable; and (4) in the case of the acquisition of a business, whether the separate financial statements of the acquiree are included in the registration statement (see Section 11.2.1 for more information).

11.2.2.2 Basic Presentation Requirements

Pro forma financial information, which is unaudited, typically includes an introductory paragraph, a pro forma balance sheet, pro forma income statement(s), and accompanying explanatory notes. The introductory paragraph briefly describes the transaction(s), the entities involved, the periods for which the pro forma financial information is presented, and any other information that may help readers understand the content of the pro forma information. The pro forma balance sheet and income statement are presented in a columnar format with separate columns for the registrant, the acquiree (in the case of a business combination), transaction accounting adjustments, autonomous entity adjustments, and pro forma totals. See below for more information about the types of pro forma adjustments. Further, each adjustment should include a reference to an explanatory note that clearly discusses the assumptions involved and how the adjustments are derived or calculated. In the limited cases in which only a few adjustments are required and those adjustments are easily understood, a registrant may include a narrative presentation of the pro forma effects of a transaction in lieu of full pro forma financial information.

11.2.2.3 Pro Forma Periods Presented

A pro forma balance sheet is required as of the same date as the registrant's most recent balance sheet included in the IPO registration statement (i.e., one pro forma balance sheet as of the end of the fiscal year or the subsequent interim period, whichever is later). In the computation of pro forma balance sheet adjustments, it is assumed that the transaction was consummated on the balance sheet date. A pro forma balance sheet is not required if the transaction is already reflected in the historical balance sheet.

Pro forma income statements are required for both the registrant's most recent fiscal year and any subsequent year-to-date interim period included in the IPO registration statement. In the computation of pro forma income statement adjustments, it is assumed that the transaction was consummated at the beginning of the most recently completed fiscal year (and carried forward to the interim period, if presented). The SEC normally does not permit registrants to prepare pro forma information for more than one complete fiscal year. However, a registrant must provide pro forma information for all periods presented in its historical financial statements if the pro forma information reflects the impact of a transaction that must be revised retrospectively in the historical financial statements, such as a discontinued operation or a reorganization of entities under common control. A pro forma income statement is not required if the transaction is included in the historical financial statements for the full period covered by the pro forma income statement.

11.2.2.4 Pro Forma Adjustments

There are two categories of required pro forma adjustments:

- *Transaction accounting adjustments* — These adjustments are limited to those that reflect the accounting for the transaction in accordance with U.S. GAAP or IFRS Accounting Standards, as applicable. For an acquisition, such adjustments may include, among other items, the recognition of goodwill and intangible assets and adjustments of assets and liabilities to fair value on the balance sheet, as well as the related impacts on the income statement, under the assumption that the balance sheet adjustments were made as of the beginning of the fiscal year presented. For dispositions, the adjustments may reflect the disposal of assets and related impacts. The SEC staff has also indicated that transaction accounting adjustments should generally be shown gross rather than net so that the reader can understand the nature and amount of each adjustment. Alternatively, a more detailed explanation of the components of the adjustments may be presented in the notes to the pro forma financial information. The

transaction accounting adjustments should contain references to notes that clearly explain the assumptions involved and other relevant information for each adjustment.

- *Autonomous entity adjustments* — These adjustments, which are only required if the registrant was previously part of another entity, reflect incremental expense or other changes necessary to reflect the registrant's financial condition and results of operations as if it were a separate stand-alone entity. For example, if a public entity plans to distribute a portion of its business to shareholders as a separate public company (e.g., spin-off), the spinnee's pro forma financial statements must include autonomous entity adjustments to reflect the incremental costs expected to be incurred as if it were a separate stand-alone entity.

  At the 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff addressed considerations related to distinguishing between autonomous entity adjustments and management's adjustments (see following paragraph). The staff noted that changes to a spinnee's cost structure that are supported by a contractual arrangement may be considered autonomous entity adjustments (e.g., a new lease agreement, a TSA with the former parent). By contrast, changes in spinnee costs that are not supported by contractual arrangements generally do not represent autonomous entity adjustments. However, such changes may represent synergies or dis-synergies that may be presented as management's adjustments if they meet the conditions in SEC Regulation S-X, Rule 11-02(a)(7).

In addition to requiring the adjustments noted above, the pro forma rules give registrants the flexibility to present, in the explanatory notes to the pro forma financial information, management's adjustments that reflect synergies and dis-synergies related to acquisitions and dispositions. Management's adjustments also may provide insight into the potential effects of an acquisition or disposition and the plans that management expects to take after a transaction (which may include forward-looking information).

Registrants must provide separate columns in their pro forma financial information for (1) historical financial information, (2) transaction accounting adjustments, and (3) autonomous entity adjustments, as well as a pro forma total, which would include pro forma EPS. In the notes to the pro forma financial information, a registrant must (1) clearly explain each adjustment and (2) detail any revenues, expenses, gains and losses, and related tax effects that will not recur in the registrant's income statement beyond a year from the transaction date.

Adjustments made to the pro forma income statement are not required to have a continuing (recurring) impact. Accordingly, a pro forma income statement must reflect both the recurring and nonrecurring effects of the transaction (e.g., transaction expenses, one-time compensation charges, and adjustments to inventory). In addition, it is not appropriate to include a transaction accounting adjustment to eliminate or omit the effects of nonrecurring items reflected in the historical financial statements. Rather, a registrant should separately disclose in a note to the pro forma financial statements the amounts associated with revenues, expenses, gains and losses, and related tax effects that will not recur in the income of the registrant more than 12 months after the transaction.

For additional discussion of pro forma financial statement requirements, see Chapter 4 of Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions*.

11.2.2.5 Other Common IPO Considerations Related to Pro Forma Information

In addition to the information discussed above, certain pro forma information may need to be included in specific situations, as discussed in Section 3400 of the FRM. Such situations include distributions to owners under SAB Topic 1.B.3, changes in capitalization at or before the closing of an IPO, and changes in corporate structure that result in a change in tax status. For more information about distributions to owners, changes in capitalization, and changes in corporate structure, see Sections 5.6.1, 5.6.2, and 5.9.2, respectively, of Deloitte's Roadmap *Initial Public Offerings*. Changes in capitalization are further discussed in Section 11.2.2.6 below.

Changing Lanes

Section 3400 of the FRM required a registrant to include certain pro forma disclosures in or alongside the historical financial statements in an IPO registration statement. SEC Regulation S-X, Rule 11-02(a)(12)(i) — as amended — states that a registrant must not "[p]resent pro forma financial information on the face of the registrant's historical financial statements or in the accompanying notes, except where such presentation is required by U.S. GAAP or IFRS-IASB, as applicable." The guidance in FRM Section 3400 on presenting such pro forma financial information has not yet been updated to reflect the amendments to Article 11. However, we understand that the SEC staff expects that disclosure giving pro forma effect to the transactions described in Section 3400 of the FRM would be provided elsewhere (i.e., outside of the financial statements) in the IPO registration statement.

11.2.2.6 Changes in Capitalization

The registration statement may need to include pro forma financial information related to changes in capitalization that occur around the same time as an IPO.

The SEC staff often asks registrants to present pro forma information when changes in capitalization will occur after the date of the latest balance sheet. Paragraph 3430.2 of the FRM indicates that when such changes (1) will "result in a material **reduction** of permanent equity" or (2) result from "redemption of a material amount of equity securities . . . in conjunction with the offering," a pro forma balance sheet should be included in the filing that takes into account the change in capitalization but not the effects of the offering proceeds. As previously noted, Rule 11-02(a)(12) states that a registrant must not "[p]resent pro forma financial information on the face of the registrant's historical financial statements or in the accompanying notes, except where such presentation is required by U.S. GAAP or IFRS-IASB, as applicable." Accordingly, registrants should determine the appropriate location of the pro forma information, which might include summary financial information, the capitalization table, or separate unaudited pro forma financial information.

The conversion of preferred stock to common stock in conjunction with an IPO is not a **reduction** of permanent equity and therefore does not need to be included in the pro forma balance sheet (see paragraph 3430.2 of the FRM). However, many entities choose to reflect such a conversion in pro forma balance sheet information.

A prospective registrant should also present pro forma EPS when outstanding securities are or will be converted after the latest balance sheet date and this conversion will cause a material reduction in EPS (excluding the effects of the offering). The pro forma EPS should reflect the securities conversion but not the effects of the offering. Such pro forma EPS should be presented for the latest fiscal year and interim period presented in the registration statement.

11.2.3 Predecessor Financial Information

Example of an SEC Comment

We note that you completed the acquisition of the assets of [Entity A] on [date X]. It appears that you succeeded to substantially all of the business of [A] and your operations prior to the succession appear insignificant relative to the operations acquired. As a result, it appears that [A] is the Company's Predecessor for financial statement purposes as such term is defined in Rule 405 of Regulation C. Given this factor, please revise your registration statement as follows:

- Please revise to include [predecessor financial statements for the required periods].
- Revise the pro forma statements of operations on . . . the draft registration statement to identify [A] as your predecessor.
- Revise management's discussion and analysis to discuss the results of operations cash flows and liquidity of [A] for all periods presented in the financial statements included in the filing.

If you do not believe this entity represents your predecessor as such term is defined in Rule 405 of Regulation C, please explain your basis for this conclusion. In the event that you conclude that this entity is your predecessor, please confirm your understanding that you will be required to continue presenting predecessor financial statements and the applicable management's discussion and analysis in your periodic reports subsequent to the effective date of your registration statement, to the extent necessary to cover all periods prescribed by the form.

If a registrant has not had substantive operations for all periods presented in an IPO registration statement, it is important to consider whether the registrant has a "predecessor" company or business, especially in light of the definition of a business for SEC reporting purposes (see Section 3.2.1.3). For example, life sciences entities frequently acquire licenses for drug candidates. A license may meet the definition of a business for SEC reporting purposes if there is sufficient continuity of the acquired license's operations (which could be primarily related to R&D activity) before and after the transaction. If the license is determined to be a business for SEC reporting purposes, the acquirer should also evaluate whether (1) the acquirer's operations have substantially succeeded to the operations of the target's business and (2) the acquirer's operations before the succession appear insignificant relative to the operations acquired and therefore may require predecessor financial statements for the target/predecessor business. Given the level of judgment and inherent complexity in these circumstances, discussion with accounting advisers is encouraged.

Section 1170 of the FRM indicates that the designation of an acquired business as a predecessor is based on both of the following criteria:

- The registrant "succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities)."
- The "registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired."

A predecessor's historical financial information is considered important to an investing decision. As a result, the registrant's financial statements and those of its predecessor must be presented in the IPO registration statement and together should typically cover all periods required by SEC Regulation S-X, with no lapse in audited periods. Further, the predecessor financial statements must be audited in accordance with PCAOB, not solely AICPA, standards and will be required not only in the IPO but also in subsequent periodic reports.

The SEC staff believes that when a newly formed company (i.e., a "newco") is formed to acquire multiple entities in conjunction with an IPO, instances in which there is no predecessor would generally be rare (unless the registrant is a start-up business), even if the newco is substantive and was deemed the accounting acquirer. The staff highlighted a number of factors for registrants to consider in determining the predecessor, including, but not limited to, (1) the order in which the entities are acquired, (2) the size of the entities, (3) the fair value of the entities, and (4) the historical and ongoing management structure. No one item is determinative on its own. In addition, the staff has encouraged registrants to evaluate their determination of predecessors in light of how management intends to discuss its business in the IPO registration statement as well as whether financial information in its subsequent Forms 10-K would provide sufficient information to investors.[18] The staff noted that while there may be situations in which more than one predecessor exists, it would be rare for no predecessor to be identified unless the registrant is a start-up business. Carve-out entities and entities in roll-up transactions frequently meet the criteria to be identified as predecessors. For more information about carve-out financial statements, see Section 12.4.

There may be circumstances in which full financial statements or carve-out financial statements may not be practicable to prepare, such as when the acquiree is a small portion or a product line of a much larger business and separate financial records were not maintained. In such cases, the SEC staff allows registrants to file abbreviated financial statements to comply with Rule 3-05 provided that certain qualifying conditions and presentation and disclosure requirements are met (see Sections 2.6.4.1 and 2.6.4.2 of Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions*).

However, there may be circumstances in which it is challenging for a registrant to make the relevant allocations needed to provide carve-out financial statements. If the qualifying conditions for abbreviated financial statements have not been met but a registrant nevertheless believes that such statements would provide sufficient disclosure for investors, the registrant may request a waiver from the SEC staff under SEC Regulation S-X, Rule 3-13. Note also that while a registrant generally may not use abbreviated financial statements for an acquiree that has been identified as its predecessor, the SEC staff may consider requests under Rule 3-13 to provide such statements (e.g., when full successor financial statements have been presented in the initial registration statement for some periods).

For additional guidance on Rule 3-13 waivers and other requests, see Section B.2 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

11.2.4 Share-Based Compensation Valuation

An entity that is preparing for an IPO may have a share-based compensation strategy designed to retain and attract employees and nonemployees. Share-based compensation often is in the form of stock options, stock appreciation rights, restricted stock, restricted stock units, or an employee stock purchase plan (ESPP). In addition, an entity may use share-based compensation to purchase goods, IP, or services from third-party vendors or service providers. Management should consider the financial reporting implications associated with each of the various types of share-based compensation arrangements that an entity may enter into with employees and nonemployees. Additional topics that an entity undergoing an IPO often must consider include the valuation of share-based compensation, repurchase features, certain profit-sharing arrangements, performance conditions associated with liquidity events, modifications, employee loans, escrowed stock arrangements, EPS, and disclosures.

[18] If a business is not identified as a predecessor, it would generally be evaluated under SEC Regulation S-X, Rule 3-05. Therefore, in an IPO registration statement, the financial statements of nonpredecessor entities may be provided under Rule 3-05. However, for subsequent Forms 10-K, only the financial statements of the registrant and its predecessor(s) would be required.

This section focuses on share-based compensation granted to grantees under ASC 718. There are certain differences under ASC 718 between the accounting for employee share-based payment awards and the accounting for nonemployee awards. Because of these differences, it is important for an entity to consider whether the counterparty in an arrangement is an employee or a nonemployee when accounting for share-based payment awards. See Chapter 9 of Deloitte's Roadmap *Share-Based Payment Awards* for additional considerations specific to nonemployee awards.

As a reminder, share-based payment awards accounted for under ASC 718 must be either (1) settled by issuing the entity's equity shares or other equity instruments or (2) indexed, at least in part, to the value of the entity's equity shares or other equity instruments. Generally, equity-classified share-based payment awards are measured by using a fair-value-based measure on their grant date. Liability-classified share-based payment awards are also generally measured by using a fair-value-based measure; however, they are remeasured in each subsequent reporting period until settlement. The fair-value-based measure for share-based payment awards is recognized over the requisite service period, which often is the vesting period.

One of the most significant inputs related to measuring share-based compensation is the underlying valuation of the entity's shares. A pre-IPO entity should become familiar with the U.S. GAAP and SEC valuation requirements, including differences between valuation methods for public entities and those for nonpublic entities. The discussions below summarize some of the more significant considerations related to share-based compensation for an entity contemplating an IPO.

ASC 718 identifies three ways for a nonpublic entity to measure share-based compensation awards (the terms below are defined in ASC master glossary):

- By using fair value, which is the "amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."
- By using a calculated value, which is a "measure of the value of a [stock] option or similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity's share price in an option-pricing model." For more information, see Section 4.13.2 of Deloitte's Roadmap *Share-Based Payment Awards*.
- By using intrinsic value, which is the "amount by which the fair value of the underlying stock exceeds the exercise price of an option" or similar instrument. For more information, see Section 4.13.3 of Deloitte's Roadmap *Share-Based Payment Awards*.

Nonpublic entities may elect to use a practical expedient to determine the current price input of equity-classified share-based payment awards issued to both employees and nonemployees on a measurement-date-by-measurement-date basis. ASC 718-10-30-20G notes that a valuation performed in accordance with specified U.S. Treasury regulations related to Section 409A of the Internal Revenue Code (IRC) is an example of a reasonable valuation method under the practical expedient. In addition, ASC 718-10-30-20G explicitly refers to other valuation approaches under IRC Section 409A that are presumed to be reasonable.

Although the SEC has provided transition guidance for entities that elect the practical expedients related to intrinsic value or calculated value when changing their status from nonpublic entity to public entity (see Section 11.2.4.7), there is no similar transition guidance related to the practical expedient for the current price input. Therefore, an entity that no longer meets the criteria to be a nonpublic entity would have to reverse the practical expedient's effect in its historical financial statements. Consequently, before electing the practical expedient, nonpublic entities that could become public entities should carefully consider the potential future costs of having to perform such a reversal.

11.2.4.1 Fair-Value-Based Measurement

Nonpublic entities should try to use a fair-value-based measure to value their equity-classified awards. A nonpublic entity may look to recent sales of its common stock directly to investors or common-stock transactions in secondary markets. However, observable market prices for a nonpublic entity's equity shares may not exist. In such an instance, a nonpublic entity could apply many of the principles of ASC 820 to determine the fair value of its common stock, often by using either a market approach or an income approach (or both). A "top-down method" may be applied, which involves first valuing the entity, then subtracting the fair value of debt, and then using the resulting equity valuation as a basis for allocating the equity value among the entity's equity securities. While not authoritative, the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the "AICPA Valuation Guide") emphasizes the importance of using contemporaneous valuations from independent valuation specialists to determine the fair value of equity securities.

Changing Lanes

On June 23, 2024, FinREC announced the release of a working draft of two revised chapters that are ultimately expected to be included in the next edition of the AICPA Valuation Guide. For more information, see Section 8.1.1.2 and Deloitte's June 27, 2024, *Heads Up*.

11.2.4.2 Calculated Value

When stock options or similar instruments are granted by a nonpublic entity, the entity should try to use a fair-value-based measure to value those equity-classified awards. However, a nonpublic entity sometimes may not be able to reasonably estimate the fair-value-based measure of its options and similar instruments because it is not practicable for the entity to estimate the expected volatility of its share price. In these cases, the nonpublic entity should substitute the historical volatility of an appropriate industry sector index for the expected volatility of its own share price. In assessing whether it is practicable to estimate the expected volatility of its own share price, the entity should consider the following factors:

- Whether the entity has an internal market for its shares (e.g., investors or grantees can purchase and sell shares).
- Previous issuances of equity in a private transaction or convertible debt provide indications of the historical or implied volatility of the entity's share price.
- Whether there are similarly sized public entities (including those within an index) in the same industry whose historical or implied volatilities could be used as a substitute for the nonpublic entity's expected volatility.

If, after considering the relevant factors, the nonpublic entity determines that estimating the expected volatility of its own share price is not practicable, it should use the historical volatility of an appropriate industry sector index as a substitute in estimating the fair-value-based measure of its awards.

An appropriate industry sector index would be one that is narrow enough to reflect the nonpublic entity's nature and size (if possible). For example, the use of the New York Stock Exchange Arca Pharmaceutical Index is not an appropriate industry sector index for a small nonpublic biotechnology development entity because it represents neither the industry in which the nonpublic entity operates

nor the size of the entity. The volatility of an index of smaller biotechnology companies would be a more appropriate substitute for the expected volatility of the entity's own share price.

Under ASC 718-10-55-58, an entity that uses an industry sector index to determine the expected volatility of its own share price must use the index's historical volatility (rather than its implied volatility). However, ASC 718-10-55-56 states, in part, that "in **no** circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000, or Dow Jones Wilshire 5000" (emphasis added).

A nonpublic entity's conclusion that estimating the expected volatility of its own share price is not practicable may be subject to scrutiny. We would typically expect a nonpublic entity that can identify an appropriate industry sector index would be able to identify similar entities from the selected index to estimate the expected volatility of its own share price and would therefore be required to use the fair-value-based measurement method.

In measuring awards, a nonpublic entity should switch from using a calculated value to using a fair-value-based measure when it (1) can subsequently estimate the expected volatility of its own share price or (2) becomes a public entity. ASC 718-10-55-27 states, in part, that the "valuation technique an entity selects [should] be used consistently and [should] not be changed unless a different valuation technique is expected to produce a better estimate" of a fair-value-based measure (or, in this case, a change to a fair-value-based measure). The guidance goes on to state that a change in valuation technique should be accounted for as a change in accounting estimate under ASC 250 and should be applied prospectively to new awards.[19] Therefore, for existing equity-classified awards (i.e., unvested equity awards that were granted before an entity switched from the calculated value method to a fair-value-based measure), an entity would continue to recognize compensation cost on the basis of the calculated value determined as of the grant date unless the award is subsequently modified. An entity should use the fair-value-based method to measure all awards granted after it switches from the calculated value method.

ASC 718-20-55-76 through 55-83 provide an example of when it may be appropriate for a nonpublic entity to use the calculated value method.

11.2.4.3 Intrinsic Value

Nonpublic entities can make a policy election to measure all liability-classified awards (not including awards determined to be consideration payable to a customer under ASC 606) at intrinsic value (instead of at their fair-value-based measure or calculated value) as of the end of each reporting period until the award is settled. However, it is preferable for an entity to use the fair-value-based method to justify a change in accounting principle under ASC 250. Therefore, a nonpublic entity that has elected to measure its liability-classified awards at a fair-value-based measure (or calculated value) would not be permitted to subsequently change to the intrinsic-value method.

ASC 718-30-55-12 through 55-20 illustrate the application of the intrinsic value method for liability-classified awards granted by a nonpublic entity.

[19] A nonpublic entity's use of calculated value does not represent an accounting policy election, since a nonpublic entity must use calculated value to measure its awards if it is not practicable for the entity to estimate the expected volatility of its share price. Thus, once an entity is able to estimate the expected volatility of its own share price or it becomes a public entity, the entity should switch from using a calculated value to using a fair-value-based measure and should account for the change as a change in accounting estimate under ASC 250.

11.2.4.4 Cheap Stock

Examples of SEC Comments

- Once you have an estimated offering price or range, please explain to us how you determined the fair value of the common stock underlying your equity issuances and the reasons for any differences between the recent valuations of your common stock leading up to the initial public offering and the estimated offering price. This information will help facilitate our review of your accounting for equity issuances including stock compensation. Please discuss with the staff how to submit your response.
- Please tell us the estimated IPO price range. To the extent there is a significant difference between the estimated grant-date fair value of your common stock during the past twelve months and the estimated IPO price, please discuss for us each significant factor contributing to the difference.
- Please provide a summary of stock options granted since [the beginning of the most recent completed fiscal year]. Provide the date and amount of each stock option granted along with estimated fair value of the underlying shares of common stock. Reconcile and explain the differences between the fair values determined on each grant date including the difference between the most recent grant date fair value and the midpoint of your offering range. This reconciliation should describe significant intervening events within the company and changes in assumptions with the valuation methodologies employed that explain the changes in fair value of your common stock up to the filing of the registration statement. Continue to provide us with updates to the above analysis for all equity related transactions through the effectiveness date of the registration statement.

The SEC often focuses on "cheap stock"[20] issues in connection with a nonpublic entity's preparation for an IPO. The SEC staff is interested in the rationale for any difference between the fair value measurements of the underlying common stock of share-based payment awards and the anticipated IPO price. In addition, the SEC staff will challenge valuations that are significantly lower than prices paid by investors to acquire similar stock. If the differences cannot be reconciled, a nonpublic entity may be required to record a cheap-stock charge. Since share-based payments are often a compensation tool to attract and retain employees or nonemployees, a cheap-stock charge could be material and, in some cases, lead to a restatement of the financial statements.

An entity preparing for an IPO should refer to paragraph 7520.1 of the FRM, which outlines considerations that registrants should take into account when the "estimated fair value of the stock is substantially below the IPO price." In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

The SEC staff has frequently inquired about a registrant's pre-IPO valuations. Specifically, during the registration statement process, the SEC staff may ask an entity to (1) reconcile its recent fair values with the anticipated IPO price (including significant intervening events), (2) describe its valuation methods, (3) justify its significant valuation assumptions, and (4) discuss the weight it gives to stock sale transactions. We encourage entities planning an IPO in the foreseeable future to use the AICPA Valuation Guide and to consult with their valuation specialists. Further, they should ensure that their pre-IPO valuations are appropriate and that they are prepared to respond to questions the SEC may have during the registration statement process.

The AICPA Valuation Guide highlights differences between pre-IPO and post-IPO valuations. One significant difference is that the valuation of nonpublic-entity securities often includes a discount for lack of marketability (DLOM). The DLOM can be determined by using several valuation techniques and is significantly affected by the underlying volatility of the stock and the period in which the stock is illiquid.

[20] Cheap stock refers to issuances of equity securities before an IPO in which the value of the shares is below the IPO price.

In addition to considerations related to cheap stock, entities commonly face issues caused by obtaining independent valuations infrequently, because the dates of those valuations do not always coincide with the grant dates, or other relevant measurement dates, for share-based payment awards. As a result, management must assess the current fair value of the underlying shares as of the measurement date. Further, an entity could evaluate the use of an interpolation or extrapolation framework to estimate the fair value of the underlying shares when equity is granted (1) on dates between two independent valuations or (2) after the date of an independent valuation. For details on interpolation and extrapolation methods, including examples, see Section 4.12.4 of Deloitte's Roadmap *Share-Based Payment Awards*.

11.2.4.5 Internal Revenue Code Section 409A

When granting share-based payment awards, a nonpublic entity should be mindful of the tax treatment of such awards and the related implications. IRC Section 409A contains requirements related to nonqualified deferred compensation plans that can affect the taxability of holders of share-based payment awards. If a nonqualified deferred compensation plan (e.g., one issued in the form of share-based payments) fails to comply with certain IRC rules, the tax implications and penalties at the federal level (and potentially the state level) can be significant for holders.

Under U.S. tax law, stock option awards can generally be categorized into two groups:

- Statutory options, including incentive stock options (ISOs) and ESPPs that are qualified under IRC Sections 422 and 423, respectively. The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the issuing entity unless the employee or former employee makes a disqualifying disposition. While an ISO may result in favorable tax treatment for the recipient, certain eligibility conditions must be met.
- Nonstatutory options, also known as nonqualified stock options (NQSOs or NSOs). The exercise of an NQSO results in a tax deduction for the issuing entity that is equal to the intrinsic value of the option when exercised.

The ISOs and ESPPs described in IRC Sections 422 and 423, respectively, are specifically exempt from the requirements of IRC Section 409A. Other NQSOs are outside the scope of IRC Section 409A if certain requirements are met. One significant requirement is that the exercise price must not be below the fair market value of the underlying stock as of the grant date. Accordingly, it is imperative to establish a supportable fair market value of the stock to avoid unintended tax consequences for the issuer and holder. While IRC Section 409A also applies to public entities, the valuation of share-based payment awards for such entities is subject to less scrutiny because the market prices of their shares are generally observable. Among other details, entities should understand (1) which of their compensation plans and awards are subject to the provisions of IRC Section 409A and (2) how they can ensure that those plans and awards remain compliant with IRC Section 409A and thereby avoid unintended tax consequences of noncompliance.

A company's failure to comply with the requirements in IRC Section 409A related to nonqualified deferred compensation plans may affect how the fair value of existing and future share-based compensation is determined and how those awards are taxed. Specifically, if the form and operation of compensation arrangements do not comply with the requirements in IRC Section 409A, service providers will be required to include the compensation in their taxable income sooner than they would need to under general tax rules (e.g., vesting as opposed to exercise of an option) and service providers will be subject to an additional 20 percent federal income tax plus interest on the amount included in their taxable income. Although the tax is imposed on the individuals receiving the compensation, in certain instances, an entity may decide to pay the additional tax liabilities on behalf of its employees.

Among IRC Section 409A's many requirements, valuation of the stock on the grant date is critical, and grantees should establish the fair market value of their shares to ensure compliance. Both nonqualified and statutory options are subject to IRC Section 409A unless they otherwise meet its criteria for treatment as exempt stock rights. It is important for an entity to consult with tax advisers regarding the tax effects of both existing and planned share-based compensation plans to determine whether it is subject to the requirements in IRC Section 409A or other IRC sections.

In addition, when recognizing compensation cost, many nonpublic entities use IRC Section 409A assessments to value share-based payments. Because those assessments are used for tax purposes, nonpublic entities should carefully consider whether they are also appropriate for measuring share-based payment awards under ASC 718.

See Chapter 10 of Deloitte's Roadmap *Income Taxes* for a discussion of the income tax effects of share-based payments.

11.2.4.6 SAB Topic 14, "Share-Based Payment"

The SEC issued SAB Topic 14 (codified in ASC 718-10-S99-1) to "assist issuers in their application of FASB ASC Topic 718 and enhance the information received by investors and other users of financial statements." SAB Topic 14 contains interpretive guidance related to share-based payment transactions (e.g., guidance on the transition from nonpublic-entity to public-entity status and valuation methods, including assumptions such as expected volatility and expected term).

In November 2021, the SEC staff issued SAB 120, which includes amendments to SAB Topic 14 and provides the SEC staff's views on the measurement and disclosure of certain share-based payment awards granted when entities possess material nonpublic information (i.e., "spring-loaded" awards). In SAB 120, the SEC staff describes a spring-loaded award as follows:

> A share-based payment award granted when a company is in possession of material nonpublic information to which the market is likely to react positively when the information is announced is sometimes referred to as being "spring-loaded."

Under the SAB, an entity that grants or modifies a share-based payment award while in possession of positive material nonpublic information should consider whether adjustments to the following are appropriate when determining the fair-value-based measure of the award: (1) the current price of the underlying share or (2) the expected volatility of the price of the underlying share for the expected term of the share-based payment award.

11.2.4.7 Transition From Nonpublic-Entity to Public-Entity Status

The measurement alternatives available to a nonpublic entity (calculated value and intrinsic value) are no longer appropriate once the entity is considered a public entity.[21] In addition, the practical expedient related to determining the expected term of certain options and similar instruments is used differently by public entities than it is by nonpublic entities. To estimate the expected term as a midpoint between the requisite service period and the contractual term of an award, entities will need to comply with the requirements of the SEC's simplified method (see Section 4.9.2.2.2 of Deloitte's Roadmap *Share-Based Payment Awards*).

[21] The definition of a "public entity" in ASC 718 encompasses entities that make "a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market." The definition therefore includes entities that have filed an initial registration statement with the SEC before the effective date of an IPO.

In SAB Topic 14.B, the SEC discusses various transition issues associated with valuing share-based payment awards related to an entity's becoming public (e.g., when the entity files its initial registration statement with the SEC), including the following:

- If a nonpublic entity historically measured equity-classified share-based payment awards at their calculated value, the new public entity should continue to use that approach for share-based payment awards granted before the date it becomes a public entity unless those awards are subsequently modified, repurchased, or canceled.
- If a nonpublic entity historically measured liability-classified share-based payment awards on the basis of their intrinsic value and the awards are still outstanding, the new public entity should measure those liability awards at a fair-value-based measurement upon becoming a public entity.
- Upon becoming a public entity, the entity is prohibited from retrospectively applying the fair-value-based measurement to its awards if it used calculated value or intrinsic value before the date it became a public entity.
- Upon becoming a public entity, the entity should clearly describe in its MD&A the change in accounting policy that will be required by ASC 718 in subsequent periods and any reasonably likely material future effects of the change.

The SEC's guidance does not address how an entity should account for a change from the intrinsic value method for measuring liability-classified awards to the fair-value-based method. In informal discussions, the SEC staff indicated that it would be acceptable to record the effect of such a change as compensation cost in the current period or to record it as the cumulative effect of a change in accounting principle in accordance with ASC 250. While the preferred approach is to treat the effect of the change as a change in accounting principle under ASC 250, with the cumulative effect of the change recorded accordingly, recording it as compensation cost is not objectionable given the SEC's position. Under either approach, entities' financial statements should include the appropriate disclosures.

ASC 250-10-45-5 states, in part, that an "entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so." Retrospective application of the effects of a change from intrinsic value to fair value would be impracticable because objectively determining the assumptions an entity would have used for the prior periods would be difficult without the use of hindsight. Therefore, the change would be recorded as a cumulative-effect adjustment to retained earnings and applied prospectively, as discussed in ASC 250-10-45-6 and 45-7. This conclusion is consistent with the guidance in SAB Topic 14.B that states that entities changing from nonpublic to public status are not permitted to apply the fair-value-based method retrospectively.

11.2.4.8 Valuation Assumptions — Expected Term

Example of an SEC Comment

Please more fully explain to us why you believe it is appropriate to use the simplified method to estimate the expected life of your stock options. Please also tell us when you expect sufficient historical information to be available to you to determine expected life assumptions and address the impact that your current approach has had on your financial statements. Refer to SAB Topic 14.D.2.

ASC 718-10-55-30 states, in part:

> The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement).

Although ASC 718 does not specify a method for estimating the expected term of an award, such a method must be objectively supportable. Similarly, historical observations should be accompanied by information about why future observations are not expected to change, and any adjustments to these observations should be supported by objective data. ASC 718-10-55-31 provides the following factors that an entity may consider in estimating the expected term of an award:

- *The vesting period of the award* — Options generally cannot be exercised before vesting; thus, an option's expected term cannot be less than its vesting period.
- *Historical exercise and postvesting employment termination behavior for similar grants* — Historical experience should be an entity's starting point for determining expectations of future exercise and postvesting termination behavior. Historical exercise patterns should be modified when current information suggests that future behavior will differ from past behavior. For example, rapid increases in an entity's stock price after the release of a new product in the past could have caused more grantees to exercise their options as soon as the options vested. If a similar increase in the entity's stock price is not expected, the entity should consider whether adjusting the historical exercise patterns is appropriate.
- *Expected volatility of the underlying share price* — An increase in the volatility of the underlying share price tends to result in an increase in exercise activity because more grantees take advantage of increases in an entity's share price to realize potential gains on the exercise of the option and subsequent sale of the underlying shares. ASC 718-10-55-31(c) states, "An entity also might consider whether the evolution of the share price affects [a grantee's] exercise behavior (for example, [a grantee] may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time)." The exercise behavior based on the evolution of an entity's share price can be more easily incorporated into a lattice model than into a closed-form model.
- *Blackout periods* — A blackout period is a period during which exercise of an option is contractually or legally prohibited. Blackout periods and other arrangements that affect the exercise behavior associated with options can be included in a lattice model. Unlike a closed-form model, a lattice model can be used to calculate the expected term of an option by taking into account restrictions on exercises and other postvesting exercise behavior.
- *Employees' ages, lengths of service, and home jurisdictions* — Historical exercise information could have been affected by the profile of the employee group. For example, during a bull market, some entities are more likely to have greater turnover of employees since more opportunities are available. Many such employees will exercise their options as early as possible. These historical exercise patterns should be adjusted if similar turnover rates are not expected to recur in the future.

If historical exercise and postvesting employment termination behavior are not readily available or do not provide a reasonable basis on which to estimate the expected term, alternative sources of information may be used. For example, an entity may use a lattice model to estimate the expected term (the expected term is not an input in the lattice model but is inferred on the basis of the output of the lattice model). In addition, an entity may consider using other relevant and supportable information such as industry averages or published academic research. When an entity takes external peer group information into account, there should be evidence that such information has been sourced from entities with comparable facts and circumstances. Further, entities may use practical expedients to estimate the expected term for certain awards. Questions 5 and 6 of SAB Topic 14.D.2 note that if a public entity concludes that "its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term," the entity may use what the SEC staff describes as a "simplified method" to develop the expected-term estimate. Under the simplified method, the public entity uses an average of the vesting term and the original contractual term of an award. The method applies only to awards that qualify as "plain-vanilla" options.

As discussed above, an entity measures stock options under ASC 718 by using an expected term that takes into account the effects of grantees' expected exercise and postvesting behavior. However, determining an expected term for nonemployee awards could be challenging because entities may not have sufficient historical data related to the early exercise behavior of nonemployees, particularly if nonemployee awards are not frequently granted. In addition, nonemployee stock option awards may not be exercised before the end of the contractual term if they do not contain certain features typically found in employee stock option awards (e.g., nontransferability, nonhedgeability, and truncation of the contractual term because of postvesting service termination). Accordingly, ASC 718 allows an entity to elect on an award-by-award basis to use the contractual term as the expected term for nonemployee awards. If an entity elects not to use the contractual term for a particular award, the entity must estimate the expected term. However, a nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for awards that meet the conditions in ASC 718-10-30-20B (see discussion in Section 9.4.2.1 of Deloitte's Roadmap *Share-Based Payment Awards*). In accordance with ASC 718-10-55-29A, if an entity does not elect to use the contractual term as the expected term for a particular award and, for a nonpublic entity, does not apply the practical expedient to estimate the expected term, the entity should consider factors similar to those in ASC 718-10-55-29 when estimating the expected term for nonemployee awards.

As stated in SAB Topic 14.D.2, the simplified method applies only to awards that qualify as plain-vanilla options. A share-based payment award must possess all of the following characteristics to qualify as a plain-vanilla option:

- "The share options are granted at-the-money."
- "Exercisability is conditional only on performing service through the vesting date" (i.e., the requisite service period equals the vesting period).
- "If an employee terminates service prior to vesting, the employee would forfeit the share options."
- "If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days)."
- "The share options are nontransferable and nonhedgeable."

If an award has a performance or market condition, it would not be considered a plain-vanilla option. Entities should evaluate all awards to determine whether they qualify as plain-vanilla options.

The SEC staff believes that public entities should stop using the simplified method for stock option grants if more detailed external information about exercise behavior becomes available. In addition, the staff issues comments related to the use of the simplified method and, in certain instances, registrants have been asked to explain why they believe that they were unable to reasonably estimate the expected term on the basis of their historical stock option exercise information.

In accordance with the SEC staff's guidance in Question 6 of SAB Topic 14.D.2, a registrant that uses the simplified method should disclose in the notes to its financial statements (1) that the simplified method was used, (2) the reason the method was used, (3) the types of stock option grants for which the simplified method was used if it was not used for all stock option grants, and (4) the period(s) for which the simplified method was used if it was not used in all periods presented.

11.2.4.9 Valuation Assumptions — Expected Volatility

Example of an SEC Comment

We note that the expected volatility of your Class A common stock is based on a peer group in the industry in which the Company does business. Please tell us what consideration you gave to using the Company's historical pricing data in arriving at a volatility assumption. In addition, tell us what consideration you gave to disclosing the reason for the continued reliance on a peer group in the industry in arriving at this assumption. We refer you to ASC 718-10-55-37 and SAB Topic 14.D.1.

ASC 718-10-55-36 states, in part:

> Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the shares can be expected to vary — up or down.

ASC 718 does not require entities to use a single method for estimating the expected volatility of the underlying share price; rather, ASC 718-10-55-35 states that the objective of estimating such volatility is "to determine the assumption about expected volatility that marketplace participants would be likely to use in determining an exchange price for an option." ASC 718-10-55-37 lists factors that entities would consider in estimating the expected volatility of the underlying share price. The method selected to perform the estimation should be applied consistently from period to period, and entities should adjust the factors or assign more weight to an individual factor only on the basis of objective information that supports such adjustments. The interpretive response to Question 1 of SAB Topic 14.D.1 notes that entities should incorporate into the estimate any relevant new or different information that would be useful. Further, they should "make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility" of the underlying share price.

Entities would consider the following factors in estimating expected volatility:

- *Historical volatility of the underlying share price* — Entities typically value stock options by using the historical volatility of the underlying share price. Under a closed-form model, such volatility is based on the most recent volatility of the share price over the expected term of the option; under a lattice model, it is based on the contractual term. ASC 718-10-55-37(a) states that an entity may disregard the volatility of the share price for an identifiable period if the volatility resulted from a condition (e.g., a failed takeover bid) specific to the entity and the condition "is not expected to recur during the expected or contractual term." If the condition is not specific to the entity (e.g., general market declines), the entity generally would not be allowed to disregard or place less weight on the volatility of its share price during that period unless objectively verifiable evidence supports the expectation that market volatility will revert to a mean that will differ materially from the volatility during the specified period. The SEC staff believes that an entity's decision to disregard a period of historical volatility should be based on one or more discrete and specific historical events that are not expected to occur again during the term of the option. In addition, the entity should not give recent periods more weight than earlier periods.

  In certain circumstances, an entity may rely exclusively on historical volatility. However, because the objective of estimating expected volatility is to ascertain the assumptions that marketplace participants are likely to use, exclusive reliance may not be appropriate if there are future events that could reasonably affect expected volatility (e.g., a future merger that was recently announced). In addition, an entity that is valuing a spring-loaded award would consider whether it should factor material nonpublic information into its determination of historical volatility.

- *Implied volatility of the underlying share price* — The implied volatility of the underlying share price is not the same as the historical volatility of the underlying share price because it is derived from the market prices of an entity's traded options or other traded financial instruments with option-like features and not from the entity's own shares. Entities can use the Black-Scholes-Merton formula to calculate implied volatility by including the fair value of the option (i.e., the market price of the traded option) and other inputs (stock price, exercise price, expected term, dividend rate, and risk-free interest rate) in the calculation and solving for volatility. When valuing employee or nonemployee stock options, entities should carefully consider whether the implied volatility of a traded option is an appropriate basis for the expected volatility of the underlying share price. For example, traded options usually have much shorter terms than employee or nonemployee stock options, and the calculated implied volatility may not take into account the possibility of mean reversion. To compensate for mean reversion, entities use statistical tools for calculating a long-term implied volatility. For example, entities with traded options whose terms range from 2 to 12 months can plot the volatility of these options on a curve and use statistical tools to plot a long-term implied volatility for a traded option with an expected or a contractual term equal to an employee or nonemployee stock option.

  Generally, entities that can observe sufficiently extensive trading of options and can therefore plot an accurate long-term implied volatility curve should place greater weight on implied volatility than on the historical volatility of their own share price (particularly if they do not meet the SEC's conditions for relying exclusively on historical volatility). That is, a traded option's volatility is more informative in the determination of expected volatility of an entity's stock price than historical stock price volatility, since option prices take into account the option trader's forecasts of future stock price volatility. In determining the extent of reliance on implied volatility, an entity should consider the volume of trading in its traded options and its underlying shares, the ability to synchronize the variables used to derive implied volatility (as close to the grant date of employee or nonemployee stock options as reasonably practicable), the similarity of

the exercise prices of its traded options to its employee and nonemployee stock options, and the length of the terms of its traded options and employee or nonemployee stock options. In addition, an entity that is valuing a spring-loaded award would consider whether material nonpublic information affects the extent of reliance on implied volatility when estimating the expected volatility.

- *Limitations on availability of historical data* — Public entities should compare the length of time an entity's shares have been publicly traded with the expected or contractual term of the option. A newly public entity may also consider the expected volatility of the share prices of similar public entities. In determining comparable public entities, the newly public entity would consider factors such as industry, stage of life cycle, size, and financial leverage.

  Nonpublic entities may also base the expected volatility of their share prices on the expected volatility of similar public entities' share prices, and they may consider the same factors as those described above for a newly public entity. When a nonpublic entity is unable to reasonably estimate its entity-specific volatility or that of similar public entities, it may use a calculated value.

- *Data intervals* — An entity that considers the historical volatility of its share price when estimating the expected volatility of its share price should use intervals for price observations that (1) are appropriate on the basis of its facts and circumstances (e.g., given the frequency of its trades and the length of its trading history) and (2) provide a basis for a reasonable estimate of a fair-value-based measure. Daily, weekly, or monthly price observations may be sufficient; however, if an entity's shares are thinly traded, weekly or monthly price observations may be more appropriate than daily price observations.

- *Changes in corporate and capital structure* — An entity's corporate and capital structure could affect the expected volatility of its share price (e.g., share price volatility tends to be higher for highly leveraged entities). In estimating expected volatility, an entity should take into account significant changes to its corporate and capital structure, since the historical volatility of a share price for a period in which the entity was, for example, highly leveraged may not represent future periods in which the entity is not expected to be highly leveraged (or vice versa).

As stated in the interpretive response to Question 1 of SAB Topic 14.D.1, the SEC staff "believes [entities] that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure." Further, depending on the extent to which these financial instruments are actively traded, more reliance or exclusive reliance on implied volatility may be appropriate because implied volatility reflects market expectations of future volatility.

SAB Topic 14.D.1 also addresses circumstances in which it is acceptable to rely exclusively on either historical volatility or implied volatility. To rely exclusively on historical volatility, an entity must:

- Have "no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past."
- Perform the computation by using a "simple average calculation method."
- Use a "sequential period of historical data at least equal to the expected or contractual term . . . , as applicable."
- Apply "[a] reasonably sufficient number of price observations . . . , measured at a consistent point throughout the applicable historical period."
- Consistently apply this approach.

To rely exclusively on implied volatility, an entity must:

- Use a valuation model for employee stock options "that is based upon a constant volatility assumption."
- Derive the implied volatility from "options that are actively traded."
- Measure the "market prices (trades or quotes) of both the traded options and underlying shares . . . at a similar point in time to each other and on a date reasonably close to the fair value measurement date of the share options."
- Use traded options whose (1) exercise prices "are both . . . near-the-money and . . . close to the exercise price of the share options" and (2) "remaining maturities . . . are at least one year."
- Ensure "[m]aterial nonpublic information that would be considered in a marketplace participant's expectation of future volatility does not exist."
- Consistently apply this approach.

If an entity is newly public or nonpublic, it may have limited historical data and no other traded financial instruments from which to estimate expected volatility. In such cases, as discussed in the SEC staff's guidance in SAB Topic 14.D.1, it may be appropriate for the entity to base its estimate of expected volatility on the historical, expected, or implied volatility of comparable entities.

Further, when valuing spring-loaded awards, an entity needs to determine whether a marketplace participant would consider the material nonpublic information when estimating expected volatility. As SAB Topic 14.D.1 indicates, material nonpublic information may affect the extent of reliance on implied volatility and may need to be factored into the determination of implied and historical volatility.

For more information on share-based compensation, see Deloitte's Roadmap *Share-Based Payment Awards*.

11.2.5 Liabilities, Equity, and Temporary Equity

Example of an SEC Comment

You disclose that . . . you will be required to repurchase each share of [convertible preferred stock] that have not been converted into shares of common stock or automatically redeemed. Please tell us how you determined that your [convertible preferred stock] should be classified as mezzanine equity on your balance sheet and your consideration of the guidance in ASC 480-10-25-4.

Life sciences entities pursuing an IPO often have complex financial instruments. The SEC historically has focused on the classification of financial instruments as liabilities or equity in the balance sheet when those financial instruments have redemption provisions or possess characteristics of both liabilities and equity. For example, the classification of embedded features within convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.[22]

[22] For more information about the classification of warrants issued in SPAC transactions, see Section D.6 of Deloitte's Roadmap *Initial Public Offerings*.

At the time they are approaching a potential IPO, prospective registrants may have outstanding financial instruments with characteristics of both liabilities and equity, or in connection with a potential IPO, an entity may issue new financial instruments. Even if certain instruments are already outstanding before an IPO, when public financial statements are initially issued, it may be appropriate for a financial instrument to be classified as temporary equity (e.g., outside of permanent equity) in accordance with SEC rules even if it was acceptable for the financial instrument to be classified as permanent equity before the IPO. In accordance with ASC 480-10-S99-3A(2), which contains interpretations of the requirements of SEC Regulation S-X, Rule 5-02.27(a) (as amended by ASR 268), an equity-classified instrument is presented outside of permanent equity if it is redeemable for cash or other assets in any of the following circumstances: at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer. The SEC's guidance on temporary equity applies to SEC registrants' financial statements that are prepared in accordance with SEC Regulation S-X. Nonpublic entities are not required to apply this guidance but may elect to do so. Accordingly, an entity undertaking an IPO that has not previously elected to apply the SEC's guidance on temporary equity would need to reassess its classification conclusion for equity-classified instruments. For equity-classified instruments (e.g., preferred stock) that must be treated as temporary equity, specific balance sheet presentation and disclosure would be required. In subsequently measuring an instrument classified in temporary equity, an entity must also assess whether (1) the instrument is currently redeemable or (2) it is probable that the instrument will become redeemable in the future.

The SEC staff closely scrutinizes whether registrants' balance sheet classification of capital securities is appropriate, as demonstrated in recent comment letters on registrants' filings and the number of restatements associated with inappropriate classification. Given the extent of the SEC's scrutiny on proper classification of capital securities as liabilities, temporary equity, or permanent equity, entities are encouraged to consult with their accounting advisers on the appropriate application of GAAP.

For more information about financial instruments, see Chapter 9 of this Guide and Deloitte's Roadmap *Distinguishing Liabilities From Equity*.

11.2.6 Accounting for Offering Costs

Expenses incurred during an IPO can be divided into those that occur as a direct result of an IPO and those that occur as part of an entity's ordinary operations. SAB Topic 5.A (codified in ASC 340-10-S99-1) indicates that "[s]pecific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering." Therefore, entities undertaking an IPO should ensure that all costs earmarked for deferral are incremental costs directly resulting from the IPO as opposed to costs that are part of an entity's ongoing operations before or after the IPO.

Connecting the Dots

Costs incurred during an IPO may be significant. Therefore, the appropriate identification of costs that qualify for deferral is particularly important given the potential impact on reported profit or loss if such costs are incorrectly allocated. Similarly, entities should be cognizant of the risk of deferring costs that do not qualify for such treatment. In certain cases, management may need to exercise judgment to appropriately allocate costs and should consider consulting with professional advisers and auditors before making a final determination.

Costs that may qualify for deferral include registration fees, filing fees, listing fees, specific legal and accounting costs, and transfer agent and registrar fees. However, in accordance with SAB Topic 5.A, costs such as management salaries or other general and administrative expenses generally are not considered incremental or directly attributable to the IPO, even though they may increase as a result of the IPO. Such costs should be accounted for under other accounting standards.

In rare instances, an IPO could consist solely of selling shareholders, with no new shares being issued by the entity. In such cases, offering costs should be expensed because there are no proceeds against which to offset the costs.

Changing Lanes

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, SEC Associate Chief Accountant Carlton Tartar highlighted a scenario addressed by the SEC staff in which a registrant proposed treating costs related to the initial preparation and auditing of its financial statements as deferred offering costs because the financial statements were prepared for the sole purpose of pursuing an IPO. The staff objected to the registrant's proposed accounting because, while the registrant needed to obtain audited financial statements to pursue an IPO, audited financial statements may be obtained for various other reasons. As a result, the staff did not view these costs as being directly attributable to the planned offering.

For more information about issuance costs within the scope of SAB Topic 5.A, see Deloitte's Roadmaps *Distinguishing Liabilities From Equity* and *Issuer's Accounting for Debt*.

11.2.6.1 Aborting or Postponing an Offering

An entity that aborts an IPO can no longer defer offering costs that otherwise qualified for deferral; rather, such deferred costs should be immediately expensed. However, as indicated in SAB Topic 5.A, a "short postponement (up to 90 days) does not represent an aborted offering." In practice, postponements regularly occur in response to market fluctuations or entity-specific circumstances (e.g., delays in the finalization of a contract that is intended to form the foundation of an entity's IPO). Judgment should be used in the determination of whether a postponement of more than 90 days represents an aborted offering.

When a delay or postponement occurs, the determination of whether costs should continue to be deferred as a result of a delay or postponement depends on whether the costs are associated with a probable, successful future offering of securities. To the extent that a cost will be incurred a second time or will not provide a future benefit, it should be charged to expense.

In determining the actual postponement date, an entity may be required to use significant judgment and consider the facts and circumstances. For example, if an offering is delayed beyond 90 days because market conditions would not yield an acceptable return, the delay would generally be considered an aborted offering and previously deferred offering costs would be charged to expense. Conversely, a delay of more than 90 days could be considered a short postponement, rather than an aborted offering, in certain circumstances. Sufficient and appropriate evidence should exist to support the assertion that

the delay of an offering of securities does not constitute an aborted offering. Factors that may indicate that an offering has not been aborted include, but are not limited to, the following:

- The resolution of the items causing the delay (e.g., accounting, legal, or operational matters) is necessary for the completion of the offering. Such resolution may include:
  - Completing new (or revising existing) contractual arrangements with shareholders or other parties.
  - Obtaining audited financial statements for other required entities (e.g., significant acquisitions under SEC Regulation S-X, Rule 3-05; significant equity method investments under SEC Regulation S-X, Rule 3-09).
- A plan for resolving the delay, including a revised timetable detailing the necessary steps to achieve a registration; such a plan should be approved by the board of directors or management.
- Continuing to undertake substantive activities in accordance with the plan, demonstrating an intent to proceed with the offering.
- Continuing to prepare financial information or updating the registration statement either to respond to SEC staff review comments or because information may become stale.

Management will need to use significant judgment in determining whether a delay is a short postponement or an aborted offering and may need to consult with accounting and legal advisers.

Appendix B — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guides

Assets Acquired to Be Used in Research and Development Activities

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

Clarified Statements on Auditing Standards

AU-C Section 501, “Audit Evidence — Specific Considerations for Selected Items”

AU-C Section 620, “Using the Work of an Auditor’s Specialist”

FASB Literature

ASC Topics

ASC 105, *Generally Accepted Accounting Principles*

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Income Statement — Reporting Comprehensive Income*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 320, *Investments — Debt Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 410, *Asset Retirement and Environmental Obligations*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 440, *Commitments*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 830, *Foreign Currency Matters*

ASC 832, *Government Assistance*

ASC 835, *Interest*

ASC 840, *Leases*

ASC 842, *Leases*

ASC 845, *Nonmonetary Transactions*

ASC 848, *Reference Rate Reform*

ASC 852, *Reorganizations*

ASC 855, *Subsequent Events*

ASC 860, *Transfers and Servicing*

ASC 905, *Agriculture*

ASC 915, *Development Stage Entities*

ASC 930, *Extractive Activities — Mining*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 954, *Health Care Entities*

ASC 958, *Not-for-Profit Entities*

ASC 960, *Plan Accounting — Defined Benefit Pension Plans*

ASC 970, *Real Estate — General*

ASC 985, *Software*

ASUs

ASU 2010-27, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers* — a consensus of the FASB Emerging Issues Task Force

ASU 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

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Appendix C — Abbreviations

Abbreviation	Description
AETR	annual effective tax rate
AFS	available for sale
AFSI	adjusted financial statement income
AI	artificial intelligence
AICPA	American Institute of Certified Public Accountants
AIN	AICPA Accounting Interpretation of an APB Opinion
AMT	alternative minimum tax
ANDA	abbreviated new drug application
APB	Accounting Principles Board
API	active pharmaceutical ingredient
ARO	asset retirement obligation
ASC	FASB Accounting Standards Codification
ASR	accelerated share repurchase
ASU	FASB Accounting Standards Update
AUD	Australian dollar(s)
BC	Basis for Conclusions
BEAT	base erosion anti-abuse tax
BEMTA	base erosion minimum tax amount
BPD	branded prescription drug
C&DI	Compliance and Disclosure Interpretation
CAM	critical audit matter
CAQ	Center for Audit Quality
CARB	California Air Resources Board
CARES Act	Coronavirus Aid, Relief, and Economic Security Act

Abbreviation	Description
CECL	current expected credit loss
CFC	controlled foreign corporation
CIMA	Chartered Institute of Management Accountants
CMO	contract manufacturing organization
CODM	chief operating decision maker
CPU	central processing unit
CRO	contract research organization
CSRD	Corporate Sustainability Reporting Directive
DTA	deferred tax asset
DTL	deferred tax liability
EBITDA	earnings before interest, taxes, depreciation, and amortization
EC	European Commission
ED	exposure draft
EDGAR	SEC electronic data gathering, analysis, and retrieval system
EFRAG	European Financial Reporting Advisory Group
EGC	emerging growth company
EITF	Emerging Issues Task Force
ELOC	equity line of credit
EPS	earnings per share
ESA	energy service agreement
ESG	environmental, social, and governance
ESPP	employee stock purchase plan
ESRS	European Sustainability Reporting Standards

Abbreviation	Description
E.U.	European Union
EUR	euros
Exchange Act	Securities Exchange Act of 1934
FAQ	frequently asked question
FASB	Financial Accounting Standards Board
FAST Act	Fixing America's Surface Transportation Act
FDA	U.S. Food and Drug Administration
FDII	foreign-derived intangible income
FOB	free on board
FPI	foreign private issuer
FRM	SEC Division of Corporation Finance Financial Reporting Manual
FVO	fair value option
FVTOCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
GDP	gross domestic product
GHG	greenhouse gas
GILTI	global intangible low-taxed income
GloBE	Global anti-Base Erosion
GPO	group purchasing organization
GPU	graphics processing unit
HAFWP	how and for what purpose
HFI	held for investment
HFS	held for sale
HVAC	heating, ventilation, and air conditioning
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IIR	investigator-initiated research

Abbreviation	Description
IOSCO	International Organization of Securities Commissions
IP	intellectual property
IPO	initial public offering
IPR&D	in-process research and development
IRA	Inflation Reduction Act of 2022
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ISO	incentive stock option
ISSB	International Sustainability Standards Board
IT	information technology
ITC	invitation to comment
JOBS Act	Jumpstart Our Business Startups Act
LCD	liquid-crystal display
LIBOR	London Interbank Offered Rate
LIFO	last in, first out
LLM	large language model
M&A	merger and acquisition
MD&A	Management's Discussion & Analysis
MNE	multinational enterprise
MSL	medical science liaison
NDA	new drug application
NFP	not-for-profit (entity)
NFRD	Non-Financial Reporting Directive
NIH	National Institutes of Health
NLP	natural language processing
NOL	net operating loss
NOPA	notice of proposed adjustment
NQSO or **NSO**	nonqualified stock option
OCA	SEC Office of the Chief Accountant
OCI	other comprehensive income

Abbreviation	Description
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PIPE	private investment in public equity
PP&E	property, plant, and equipment
PRV	priority review voucher
PTRS	probability of technical and regulatory success
Q&A	question and answer
QIP	qualified improvement property
R&D	research and development
R&E	research and experimental
RAM	random-access memory
REMS	risk evaluation and mitigation strategy
RIM	retail inventory method
ROU	right-of-use
SaaS	software as a service
SAB	SEC Staff Accounting Bulletin
SAFE	simple agreement for future equity
SEC	U.S. Securities and Exchange Commission

Abbreviation	Description
Securities Act	Securities Act of 1933
SEPA	standby equity purchase agreement
SG&A	selling, general, and administrative
SOX	Sarbanes-Oxley Act of 2002
SPAC	special-purpose acquisition company
SPPI	solely payments of principal and interest
SRC	smaller reporting company
S&P 500	Standard & Poor's 500 Index
TCFD	Task Force on Climate-related Financial Disclosures
TD	Treasury Decision
TDR	troubled debt restructuring
TRG	transition resource group
TSA	transition services agreement
USD	U.S. dollar(s)
UTB	unrecognized tax benefit
VCO	voluntary carbon offset
VIE	variable interest entity
VWAP	volume-weighted average daily market price
XBRL	eXtensible Business Reporting Language

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