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Becoming a Publicly Held Corporation

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BALTIMORE'S population is exploding along with that of the rest of the nation, and its business is expanding. To what extent, though, is the subject of my talk with you here tonight—*Becoming a Publicly Held Corporation*—applicable in your city? I would like to show you.

How many United States businesses in private hands do you think will become publicly owned corporations in the next fifteen years? 5,000? 10,000? 15,000? A well-regarded speaker gave his opinion recently in a talk before a group of the American Management Association—*30,000* privately held companies, he predicted, will *go public* in the next fifteen years.

Since Baltimore's metropolitan population of 1.7 million represents in excess of 1½ per cent of the country's metropolitan population, the prediction I just quoted when applied to Baltimore indicates that in the next fifteen years approximately five hundred companies in your area will obtain capital from the public for the first time. In the manner of Madison Avenue in some of its TV commercials, I could well point to any section of this room and say, *This could be you!*

All of this seems to me to indicate the timeliness of a discussion on those companies whose position renders it desirable for them to consider *going public.*

In the short time we have available I should like to touch on four areas:

- What leads to the public offering of privately held shares?
- What are the various mediums through which capital can be raised?
- What are some accounting matters encountered in an SEC registration statement?
- What are some problems after the public enters into the ownership?

REASONS FOR PUBLIC OFFERING

First—what are some of the forces that lead to a decision to make an initial public offering?

The active and imaginative purpose that the public offering usually serves is that of a spearhead for expansion—plant consolidation, additional modern equipment, development of new products or revision of existing ones, increase in working capital. In these situations the majority stockholders are usually financially unable to furnish the needed additional capital, and conventional borrowing limits have been reached.

More passive factors, but nevertheless powerful ones—death and taxes—are basic reasons that seem to be behind practically every new issue of stock. There may be more immediate reasons, such as the expansion forces I have just touched upon, but creating a ready market for the company's stock has been a factor in every case with which I have had personal contact. In many situations the majority holders are getting along in years and desire to establish the value of their shares for estate purposes. Serious problems of valuation frequently result with taxing authorities when there is no ready market for the shares. If a ready market exists, however, the area for possible controversy is held to rather narrow limits. And from the standpoint of payment of the estate taxes themselves, the matter of raising the cash is simplified.

In other instances, the primary reason for public offering was simply a desire on the part of the sellers to diversify, to put their eggs in a number of baskets.

A family situation I recall was one in which the principal holder and founder of the company in nearby Washington, D. C. felt it wise to change the ownership from a purely family affair. Apparently he was not confident that his three sons could run the company successfully after his death.

Another interesting situation we were confronted with several years ago in Cleveland, Ohio, was one in which two stockholders who had been so-called partners all of their working lives, owned the majority of the common stock of their company; several hundred individuals, mostly employees, owned the remaining minority. The minority holders became dissatisfied with conditions within the company, and were sufficiently strong and vociferous to force a public offering by the two majority holders.

A final example is the case of the president of a company in California who held 80 per cent of the shares. He needed cash personally and therefore sold half his holdings. By using an underwriter the stock was sold to over five hundred individuals located in widespread

geographical areas, primarily in the East and Midwest. As a result, his remaining 40 per cent holding enabled him to retain adequate working control of the company.

CAPITAL-RAISING MEDIUMS

Next let us consider what are some of the different mediums through which capital can be raised.

First, it should be recognized that a reasonable amount of regular bank borrowing is usually in order, since it brings flexibility to the company's short-term financing picture. Equity financing works well together with short-term borrowing: The two facets of this combination unite to strengthen the ability of the company to pursue its goals, the additional equity capital providing needed permanent funds for the long run and at the same time operating to expand the credit base for additional short-term borrowing.

Once it is decided to sell the equity securities publicly rather than to place them privately, the next decision—whether to sell them yourself or through an investment banking house, more commonly called an underwriter—usually makes itself for you. Most companies that have tried the *do it yourself* method have been disappointed. The rosy $10,000 promise becomes only $500 when converted to hard cash. Whether the underwriting agreement be a firm commitment or only a *best efforts* arrangement the need for reasonable certainty of the success of a financing that an underwriter can provide becomes apparent. Along with the company's banker, lawyer, and independent public accountant, management must then make a very important decision—the choice of the *right* underwriter—the one best qualified, considering all circumstances, to handle the particular issue. For example, some underwriters may specialize in the chemical industry, or the oil industry, or the electronic industry. Others handle many *first time* issues. All initial public offerings with which I have been personally associated, incidentally, used underwriters. It is the underwriters who then advise the company regarding the type of security it should sell—common stock, preferred stock, debentures, warrants, or a combination of them. The cost of a public offering, as you might imagine, is not insignificant. Thinking in the terms of smaller companies, recent issues under $500,000 cost on the average between 20 and 25 per cent of the offering total. Because of the elements of fixed expenses, percentagewise this cost is reduced on issues of a higher

total, averaging just over 10 per cent on issues of between one and two million dollars.

SEC REGISTRATION

When thinking of *going public* one thinks of the SEC—the Securities and Exchange Commission. This group administers a number of laws, including the Securities Act of 1933, which provides that securities must be registered with the Commission before they can be sold to the public. Offerings under $300,000 are usually exempted from this registration requirement, and are known as Regulation A offerings.

It should be emphasized that the 1933 Act is a disclosure statute. The disclosure is provided by means of a registration statement and a prospectus, each of which contains specified financial and other information. Offerings under Regulation A frequently require an *offering circular,* which is not so elaborate as a regular prospectus.

Another general matter I should like to emphasize is that the SEC does not pass on the merits of securities. The Commission is only concerned to see that all the material facts with respect to a security are truthfully told and that no material information is withheld. It is up to the investor to make up his mind whether or not to buy the security.

As you might expect, there are a number of accounting problems that must be considered in connection with registering an issue with the SEC. I should like to discuss some of those particularly pertinent to, or perhaps I should say bothersome to, companies making initial public offerings.

The prospectus must include a certified balance sheet, certified profit and loss and surplus statements for three fiscal years, and a summary of earnings for the last five fiscal years. Depending on the timing, unaudited financial statements may also be required for a portion of the current year and of the prior year.

After the registration statement is filed with the SEC, the Commission reviews it to see that the information is presented in proper form and that it meets the standards of disclosure required by the Securities Act. This review period is set by statute at twenty days, but is now extended in nearly all cases; in new filings it is currently running about two months, and that time lapse may well increase as time goes on.

Following the Commission's review the Commission prepares a

letter of comment, often called a *deficiency letter,* in which it raises questions and describes amendments it considers necessary for adequate disclosure. Following amendment of the registration statement satisfactory to the SEC, the registration becomes effective and sale of the securities to the public may begin.

Incidentally, under the Regulation A ($300,000 or less) rules, the offering circular referred to before must be filed with the regional office of the SEC, a principal distinction being that financial statements need cover operations for only two years and need not be certified.

ACCOUNTING MATTERS

FINANCIAL STATEMENTS

It must be remembered that with respect to the large body of accounting principles underlying the preparation of financial statements, the SEC has for the most part relied on generally accepted principles of accounting as they existed at the time and as they have developed with the passage of time. In this connection, the SEC has stated that if the financial statements are based on unsupported accounting principles, disclosure will not correct the statements. Further, since the law calls for certified statements, the SEC will not accept an accountant's certificate if it is qualified in any important respect, except in the case of an unresolved contingency, clearly disclosed. In our subsequent discussion, let me repeat for emphasis, we should bear in mind:

the financial statements must be prepared in accordance with generally accepted accounting principles;
disclosure does not "heal" the lack of these principles;
the independent accountant's certificate must be unqualified in all important respects.

INVENTORIES

Perhaps the most common problem that the company and the independent public accountant face revolves around the matter of inventories: valuation by the company and verification by the CPA.

Let us look at the company that has for a number of years let tax considerations dominate its thinking in the valuation of its inventories. It has excluded all overhead, and perhaps even direct labor, too, in its inventory dollar totals. Now the need for a public offering becomes ap-

parent, and an audit is arranged for. In many of these situations there has not been a prior audit, or, if there was one, it has been limited in scope because the company asked the CPA not to observe the taking of physical inventories, thus inviting in the accountant's report on those prior examinations, important qualifications covering inventory quantities and probably prices as well.

The closing inventories become correctly stated, and now include the cost of material, labor, and overhead, because, as was mentioned earlier, the financial statements must be *certified,* for the accountant's opinion will not be acceptable to the SEC if it contains important qualifications. Now that the closing inventory is correct, what about the prior inventories at the beginning of the current year and the two prior years—which are known to be seriously understated from the standpoint of generally accepted accounting principles, although perhaps accepted for federal taxes because the valuation has been consistently applied? There is no choice. The prior financial statements have to be revised so that the inventories and the net income are correctly stated, even though this may give rise to a provision for taxes greater than the taxes payable as shown by the returns. The company is thus faced with reporting in the registration statement to the SEC, inventories that differ in amount from those previously reported in tax returns to the Treasury Department. Is it any wonder that when faced with this choice, many companies have felt it prudent to defer a public offering until they have had an opportunity to conform their tax reporting to that required by generally accepted accounting principles?

Let us stay on this important subject for just a few minutes longer and look at the problems faced by the CPA who is called in to perform an audit for the entire three-year period, or who has been making examinations limited in scope as to the observation of inventories. These limited-scope examinations should be better known as *penny-wise, pound-foolish* audits. Even aside from public offerings, it is impossible to predict what event or transaction may arise in connection with which the company would want to be able to furnish conventional certified statements. How much better to be able to furnish a clean certificate when asked to do so than to be forced to explain why a qualified certificate is all that is available. The additional cost is usually not significant. To get back however to the matter of verifying inventories that one has not observed: Sometimes it can be done and sometimes it cannot. Some of the methods used by accountants

to satisfy themselves about the reasonableness of inventories they have not seen include examining and testing not only the available records on inventory-taking and pricing, but also on purchasing, usage, and production. Sales records and gross-profit ratios must be scrutinized and considered. Even when a judgment can be reached, as you can well imagine, considerable time and effort is expended by both the accountants and the company's employees. But what of cases where no physical inventories were taken, or if taken, where the detailed lists have been discarded or lost? The accountant's opinion concerning the inventories in these situations usually cannot be conclusive, and as a result sometimes no opinion can be given. What happens then? The answer might be that a company can not be registered at that time; the best advice might be to wait a year or so, and in the meantime to take physical inventories and have the financial statements audited.

Sometimes seemingly minor requirements can be of sufficient importance in a specific situation to block a registration effort. As an example, the fact that Regulation S-X stipulates that income statements must show sales and cost of sales caused one prospective registrant I know of to change its mind about filing with the SEC, because the company was unwilling to disclose its percentage of gross profit.

APPRAISAL WRITE-UP

When fixed assets of a corporation have been written up as the result of an appraisal, the financial statements including such assets at appraised value are not acceptable to the SEC. This position has been called their *no write-up* policy. In one registration statement of which I learned, a company reported it was able to borrow $15 million on a building that cost $4 million; even in this case the building was required to be carried at $4 million.

CONTRACTUAL COMMITMENTS

Another area possible to overlook in planning ahead is that of contractual commitments. Certain conditions could interfere with the sale of stock or payment of dividends—for instance, limitations imposed by existing preferred stock could cause a problem. Obviously, these roadblocks must be removed or modified, and early advice from competent legal counsel is a *must.* At the same time it may be found that some important agreements had been entered into quite

informally, often orally. These should probably be incorporated by the attorney into formal contracts. At the same time other corporate records such as minutes and stock certificate books should be updated and corrected if necessary.

PRINCIPLES AND METHODS

As we saw just a few minutes ago in discussing inventories, *tax accounting* is not necessarily good accounting. Just because certain life insurance premiums are not deductible for tax purposes does not mean the cost should be charged to surplus; nevertheless I have seen situations where this was done. Or, of much more significance, companies sometimes will insist that cash-basis accounting is generally acceptable when inventories of goods for sale are not a factor. This line of argument will get nowhere with the SEC; while they will not insist that the books be changed, the financial statements will have to be presented on the accrual basis. Where the company has an agreement with the Treasury Department that its tax returns are to be filed on a cash basis, it may feel that the issuance of financial statements on a basis other than cash would be prejudicial to its income tax position. In this situation, I am afraid the company has to make a choice either not to register or to register filing its financial statements on the accrual basis and assume whatever risk this action may entail.

There is an increasing tendency among electronic companies in particular to defer research, development, and engineering costs incurred in developing new products or in training production and engineering staffs to handle potential contracts. Sometimes these costs are being amortized over excessively long periods. Many times it is extremely difficult to evaluate such deferred assets. When the amounts are material this puts the CPA in the position of having to qualify his opinion, or in extreme cases, of having even to disclaim an opinion, since he just cannot form a judgment as to whether or not the value of the assets will be recovered.

AUDITOR'S INDEPENDENCE

The independence of the auditor is extremely important. If the SEC decides that an accountant is not independent, not only would the company have the expense of engaging new auditors, but what may be more important to the financing, the timing of the public offering would have to be delayed until the auditor had completed his

examination. Let us take a look at situations in which an accountant has been held to be not independent.

He may not be a stockholder or have any financial interest in the client at the date of making his report or during the period that his report covers. Nor may any of his close relatives or partners stand in such relationship. Neither the accountant nor any of his partners may be an officer or director of the company. But the most common cause of all of lack of independence is this: In the SEC's viewpoint an accountant may not hold himself out as independent if the financial statements have been prepared from accounting records that he has kept. Thus, many accountants unwittingly lose their independence just by performing the bookkeeping work. The reasoning behind this view is that continuous bookkeeping services may cause an accountant to become too closely identified with the management, even if only in his own thinking.

* * *

Time will not permit me to continue further with examples of the problems of an accounting nature that can arise in connection with an initial registration statement. There are many, and we have touched on only a few of the more common. Before closing, I should like to mention a few problems of another nature—those facing a company after the public enters into the ownership.

It is safe to say, I think, that after *going public* a company faces a new set of facts of life. The new state of mind for members of management to cultivate must be to become aware that although in the past they were responsible only to themselves in running the company, they now have to consider the results of their actions in terms of the effect on the interests of the new shareholders—which might not always be identical with their own. I recall one president's telling me that he was not going to change his method of operating and reporting, in the words, "I'm not going to do business in a goldfish bowl." Unknowingly, however, he had put his finger on the central criterion, and eventually he had to comply. In nearly all instances this means that extremely conservative operating and reporting practices had to be loosened up.

It can be expected, too, that the underwriters will require the right to designate a member of the board of directors, at least for a time, and will ask for the right to handle future financing of the company for three to five years.

Inevitably there are more reports to make—interim reports to stockholders to keep them informed of the operations of the company in general, even though the company may not be obligated to do so. If the stock is listed on a securities exchange or if the aggregate value of all outstanding shares of the class issued to the public exceeds $2 million, the company must comply with certain reporting requirements of the SEC, including submission of annual audited financial statements—on Form 10K—as prescribed by regulations of the Commission pursuant to the Securities Exchange Act of 1934. Also, if the company's stock is listed, its major stockholders and officers will have to submit information to the SEC relating to their personal transactions in the company's stock.

SUMMARY

To summarize:

Why do companies *go public?* The main reasons are to provide for expansion on the one hand, death and taxes on the other; very often it is the result of both forces combined.

What medium do companies use? Nearly always they choose the guidance of an underwriter.

How can companies best minimize their accounting problems? Though I can assure you that I did not visit you to make a sales pitch for the CPA, it is a fact that a company early in its life will benefit greatly from annual audits, unqualified in scope, carried out by auditors who are independent of management.

After the public offering, corporate life does change, but I think in most cases for the better.

Going public can certainly be regarded as one of the truly outstanding events in the life of any business enterprise.