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Going Public?

American Institute of Certified Public Accountants. Special Committee to Study Displacement of CPA Firms

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ACKNOWLEDGEMENT:

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Going Public?

. . . Then here is some information you may find helpful about an important step in your corporate development.

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FOREWORD

This booklet covers a number of significant points about an initial public offering. It is not intended to be a complete guide, but describes how your CPA firm and other professional and technical advisors may help you through the complex process of registering a public offering.

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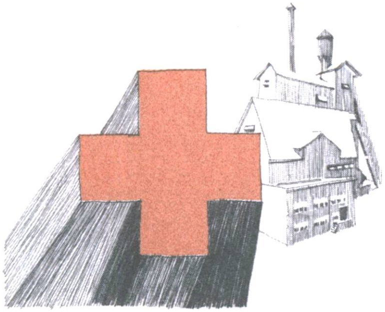
Should Your Company Go Public?

Healthy, growing companies frequently need additional funds to reach immediate goals. Going public is a popular, usually effective but sometimes burdensome way to obtain them.

It is not a decision to be reached lightly. It can be ideal for your company but it can also be costly, even critical, to your company's future.

Before taking such a step, seek expert advice. Talk to your attorney, your commercial and investment bankers and your CPAs. Because your accountants know a great deal about your company, they can be particularly helpful to you in reaching your decision on offering stock to the public.

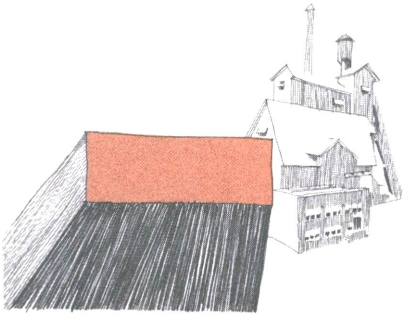
Here are some possible advantages and disadvantages of going public, not only to your company but to its stockholders. Read them carefully and discuss them with your advisors before making a move.



POSSIBLE BENEFITS TO THE COMPANY

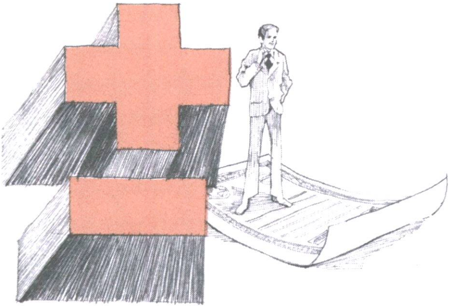
- Additional working capital is provided.
- Funds can be obtained for acquisitions, for retirement of short-term or long-term debts, for retirement of outstanding senior capital stock, for research and development, for expansion and diversification, for new equipment, and for plant modernization.
- Sale of stock or bonds on the public market establishes an effective method of valuing these securities.
- Stocks or bonds of a publicly-held company can be used for acquisitions and mergers while securities of a privately-held company are usually unacceptable.
- Sale of stock improves the debt to equity ratio, enhancing the ability to borrow.
- Favorable performance of your stock will improve your ability to sell future public issues of stock or bonds on favorable terms.
- Stock options may be used to recruit or retain exceptionally well-qualified executives.
- A public market for your company's stock can enhance your corporate image, and improve your public relations.

- Ownership of stock in your company can generate more interest in it by customers, suppliers, employees and business associates.



POSSIBLE DISADVANTAGES TO THE COMPANY

- Financial and other information not ordinarily disclosed by privately-held companies will now be available to competitors, customers, employees and others.
- Paper work will increase because SEC regulations require detailed reporting. Formal board and stockholder meetings must be held and periodic financial reports issued.
- Pressure from stockholders to maintain or steadily increase earnings and dividends may lead to short-term decisions that are harmful to the long-term welfare of the company.
- Selling securities to the public can be expensive.



POSSIBLE BENEFITS TO STOCKHOLDERS

- With a public market, present stockholders will find it easier to dispose of a portion of their interest in the company to diversify their investment portfolio or for other reasons.
- A public offering of stock in a previously closely-held company usually enhances its value.
- A public market provides a basis for valuation of the company's stock. This valuation is necessary in establishing individual net worth and in connection with gift and inheritance taxes.
- Executors of a stockholder's estate are able to liquidate the company's stock more readily to pay taxes, other debts, and bequests.
- A public market usually offers protection to minority stockholders. It enables them to sell the company's stock more easily.
- In many cases, stock in a publicly-held company provides a more secure investment for retirement.

POSSIBLE DISADVANTAGES TO STOCKHOLDERS

- Present stockholders may lose control of the company.
- Major stockholders, officers and directors become subject to detailed SEC reporting requirements.
- The freedom of the present stockholders to deal with the firm may be severely curtailed—for example, with respect to borrowing from the company by insiders.
- The company's management can be sued by dissident stockholders who may claim insider transactions or conflicts of interest.
- The freedom to utilize partnerships, multiple corporate arrangements or family trusts to reduce income taxes is lost.

Alternative sources of capital, not involving the public sale and public ownership of your company's securities, may also be available. Before you arrive at a final decision regarding a public offering, ask your CPA firm to assist you by exploring with your commercial and investment bankers how best to finance your needs.

Among the many sources of funds are:

- Short-term and long-term unsecured loans from banks, insurance companies, or other private lenders.
- Loans secured by real estate mortgages, chattel mortgages on equipment, or warehouse receipts.
- Factoring or sale of accounts receivable.
- Loans against the cash value of life insurance.

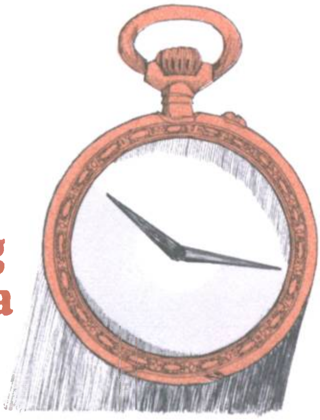
- Loans from the Small Business Administration or from Small Business Investment Companies.

- Sale and lease-back arrangements involving plant and equipment.

- Private sale of securities under conditions exempt from regulation by the SEC.

Each of these methods has its advantages and its drawbacks. Your CPA firm can help you analyze each possibility in relation to your company's specific requirements.

Timing of a Public Offering



The timing of a public offering is of crucial importance and you will do well to heed the advice of your underwriters on the subject. Success of an offering requires that the company, the market and the investing public be ready.

Investigating the answers to the following questions may help you to determine the state of readiness of your company and the investment market.

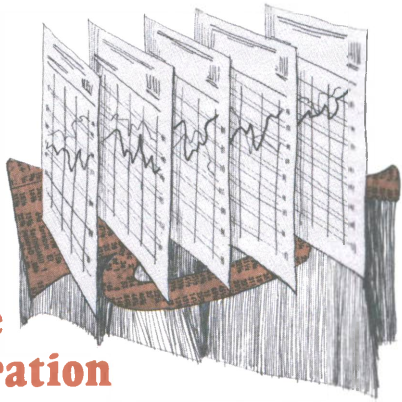
- Has the company shown long and consistent record of sales and earnings?

- Do sales and earnings show a healthy growth pattern?

- Are the prospects for growth of sales and earnings good?
- Do earnings and sales growth compare favorably with other companies in the industry?
- Will investors be satisfied that the company has effective management?
- Is the state of the economy favorable?
- Is the stock market strong and rising?
- Are new issues currently being fully subscribed?

Of course, if your offering is especially attractive, your underwriter may suggest that you proceed even though stock market conditions are not entirely favorable.

In any case, following the underwriters advice on the timing of your offering is essential to success.



Advance Preparation For a Public Offering

If you are thinking about making a public offering within the next few years, now is the time to start assembling the team to help you—underwriters, CPAs and attorneys. They can give you professional guidance on the essential preliminary steps to registration.

The SEC requires that each registration statement and prospectus include a five year summary of earnings if your company has been in business that long. The Commission requires that the last three years be audited but many underwriters prefer to have all five years audited.

At this time, therefore, you may wish to consider making certain accounting changes that are acceptable to the SEC in first offerings because they make your company's financial statements more comparable to those of other publicly-held companies.

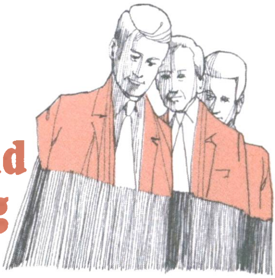
Your CPA firm can help you identify desirable changes in items such as reporting results of discontinued activities and others.

PRELIMINARY SUMMARY OF EARNINGS

When you approach underwriters regarding a prospective public offering by your company it is helpful if there is an impressive record of consistent earnings growth. However, a dip in earnings during the last five years need not be fatal. Your CPA firm can assist you in the preparation of such a preliminary five-year earnings summary and in its presentation to the underwriters.

OTHER IMPORTANT CONSIDERATIONS

The actual application for registration of your offering will be prepared by your legal counsel who, working with your CPA firm and staff, will see that all SEC requirements concerning corporate records, both legal and financial, are properly presented. This team, together with the underwriters, can also help you to determine the proper form of capitalization for your company and its conformance with SEC regulations.



Selecting and Working With the Managing Underwriter

The selection of the right managing underwriter is a critical decision. It can mean the difference between success or failure of your offering. A properly selected underwriter can ensure adequate distribution of your public offering and will endeavor to maintain a strong market for your company's securities after they are in public hands.

The qualities that should be considered in choosing the managing underwriter are:

- Does the underwriting firm have a reputation for integrity and high standards of performance?
- How effective has it been in other first public offerings?
- Will it take a strong interest in your firm?

A good choice of underwriter can be the beginning of a mutually advantageous and enduring relationship. A poor choice can be laden with serious consequences.

Frequently, an initial offering is followed by other public offerings by the company or original stockholders. A managing underwriter who has become familiar with your company's operations and management by handling one public offering, often can expedite subsequent issues.

Your commercial bank, your attorneys, and your CPA firm can supply information about underwriting firms. Your CPA firm can even make preliminary inquiries to ascertain which underwriters may be interested in handling your public offering.

It is not wise to "shop around" too much when selecting an underwriter because many underwriting firms will lose interest even though the underwriting field is quite competitive. Consequently, some companies negotiate with only one underwriter. However, others find it beneficial to approach a second underwriting firm to obtain another point of view regarding alternate financing methods, marketability of the company's stock, offering-price ranges, and the form and amount of underwriter compensation.

The underwriting firm you select may be national, regional, or local, partly depending on the nature, scope, and contemplated distribution of your offering. If nationwide distribution of your public offering is not contemplated, you may wish to consider local or regional underwriters. They may be more familiar with your company and more interested in its operations. Even if national distribution is desired, many local and regional underwriters can arrange a nationwide underwriting syndicate.

COMPENSATING THE UNDERWRITER

The underwriter is compensated for his efforts in a number of ways, the basic one being a discount or commission. The underwriter undertakes to sell your company's stock at an agreed price and he obtains the stock from your company at a discount. The difference between the price paid by the underwriter and the offering price to the public represents the underwriter's commission.

Sometimes, an underwriter will ask for warrants or options to buy additional shares of stock at a specified price. The underwriter may also ask for "bargain" stock or a specified amount for expenses of the underwriting. However, many underwriters confine their compensation to the underwriter's discount or commission, believing that unfavorable connotations may flow from other forms of compensation.

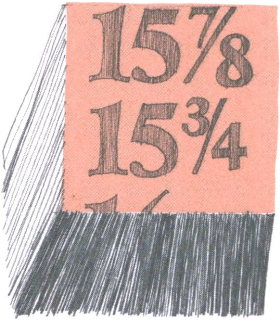
Your CPA firm can compile comparative data on underwriter's commissions and other income from recent public offerings that will assist you in evaluating the total compensation requested by the underwriter.

The underwriter may make a "fixed commitment" to purchase a specific number of shares of the proposed offering at an agreed price. On the other hand, the underwriter may make no firm commitment and merely undertake to exercise his "best efforts" to sell your company's shares, or to market the offering on an "all or none" basis. Obviously, without a firm commitment, you have no assurance that adequate financing, or any financing at all, will result.

All terms of the agreement with the underwriter are open for negotiation. If your company is well-established, financially sound, and has a consistent earning record; if the public is interested in the kind of business conducted by your company, and if stock market conditions are strong, you are in a better position to hold out for favorable terms. On the other hand, if your company is untried and its stock is rated as highly speculative, your bargaining position is weakened.

In any event, it is prudent to have your attorneys and your CPA firm present during discussions with the underwriter. They can be invaluable in working out equitable terms and avoiding unfavorable commitments such as too low a price range, too high an underwriter's commission, undue restrictions or concessions, or undesirable forms of underwriter compensation.

Pricing Your First Public Offering



The proposed price range and the final price of your public offering is the result of negotiation between the managing underwriter and the company. The underwriter has had a great deal of experience in pricing first issues and his opinion should be given considerable weight.

Obviously, a high price appeals to the selling company. However, overpricing should be avoided as it can have both immediate and long-term bad effects. If overpriced, the issue may be difficult to sell. After issue, the market price may decline and it may take a long time to revive the interest of the investing public in your company's stock. The ideal situation is a public offering so priced that the stock will show a modest increase in price after distribution has been completed.

Occasionally, the price realized on the sale of the public offering is higher than the price initially proposed by the underwriter.

Since it is impractical to agree on a firm price until just before the security is publicly offered, preliminary proposals by the underwriter usually take the form of a price range. Immediately after the registration is declared effective by the SEC, the final offering price is negotiated by the underwriter and the company and the stock is offered for sale to the public.

The most significant factor in arriving at the price of your first public offering is the earnings per share of your company as compared with similar companies publicly held. Other important factors are the growth rate of your company's sales and earnings, the prevailing stock market conditions, and the interest of the investing public in new issues.

A realistic proposed price range is best arrived at by the use of a comparative pricing schedule. Your CPA firm can prepare this for you. It compares your company with similar companies already on the market in such vital areas as:

- Market on which traded.
- Number of shares of common which will be outstanding if all securities convertible into common shares are converted.
- Capitalization: long-term debt, minority interests, preferred stock, and common stock.
- Current ratio and debt-to-equity ratio.
- Gross revenues for the five most recent years, estimated revenues for the year in progress and the rate of gross revenue growth for the same period.
- Net income and earnings per share (before and after dilution by convertible securities) for the five-year period, and rates of growth.
- Ratios of net income for the most recent full year to gross revenues, total assets, equity of common stock, and total capitalization including long-term debt.

- Most recent market price of common stock, equity per share of common stock, and ratio of market price to equity.
- Price to earnings ratio on common stock (before and after dilution by convertible securities) for the most recent fiscal year and estimated for the year in progress.
- Dividend yield on common stock for the most recent fiscal year and estimated for the year in progress.

Other factors which affect the price of your first public offering are:

- Dilution of future earnings per share which will result from the sale of the new shares.
- Effect on future earnings of the proposed uses of the new funds.
- Investors' assessment of management, standing of the company, labor supply, labor relations (strike proneness), plant and equipment in comparison with competition, vulnerability to competition, acquisition and expansion policies, and size of the public issue.

Cost of Going Public

The main cost of a public offering is the underwriter's total compensation. One element of this compensation, the underwriter's discount or commission, has ranged around 7% to 10% on recent stock offerings of from one to five million dollars. On some larger issues of over ten million dollars it has been as low as 5% on stock offerings and 1¼% on debentures. In addition, there may be special forms of underwriter compensation such as "bargain" stock, options, warrants, or a contribution to the expenses of sale. These special forms of compensation must be evaluated to ascertain the underwriter's total compensation.

The underwriter's discount and special forms of compensation will vary depending on whether the issue is common stock or debentures, its size, and his assessment of the difficulty of selling your public offering.

In addition to the underwriter's compensation, other expenses will range from about 1½% to 5% on a public stock offering of between one and five million dollars. These other expenses include:

- Cost of printing the registration statement, prospectus, underwriting agreement, and other documents.
- SEC and Blue Sky registration or filing fees.
- Stock or bond certificates.
- Registrar and transfer agent fees.
- Federal issue tax.
- Insurance to protect underwriters and selling stockholders against suits under the Federal Securities Act. (This insurance is not always available.)
- Legal and accounting fees.

Legal and accounting fees will depend on the complexity of the company's operation. If this is your first public offering they will be substantial, particularly if your company's financial statements have not been audited for at least the last three years.

Role of Your Accounting Firm

Your CPA knows your company, your industry, and the financial data which must be presented effectively to carry your offering through to a successful sale. He can provide you with valuable assistance throughout the entire process of going public by:

- Evaluating the benefits and disadvantages of going public.
- Helping you with your planning and your initial preparation (see section on Advance Preparation For a Public Offering).
- Approaching underwriters to ascertain their interest in your public offering.
- Compiling data to evaluate the compensation proposed by the underwriter.

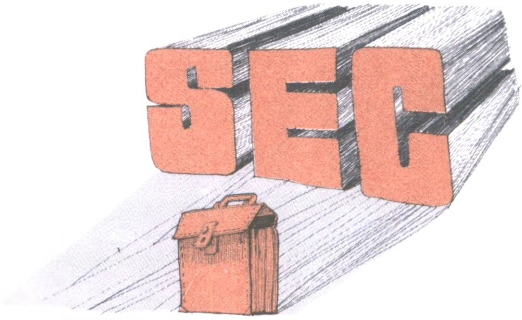
- Providing consultation and advice in your negotiations with the underwriter concerning financial matters to be included in a letter of intent and in the final underwriting agreement.
- Arranging for a pre-filing conference with the SEC if considered necessary.
- Helping you prepare the required financial data and auditing your financial statements.
- Participating with you, your attorney and the underwriter in the preparation of the registration statement and the prospectus.
- Reviewing proofs of the registration statement and prospectus.
- Revising the financial information in the registration statement and prospectus if required by the SEC.
- Furnishing a "comfort letter" to assure the underwriters that there were no material adverse changes in the financial information included in the registration statement after it was filed with the SEC.

If your present outside auditors are independent, adequately staffed, and capable of complying with the requirements of the SEC, they should handle the presentation of your financial statements and other supporting schedules in the registration statement filed with the Commission. Their knowledge of your operations can be very valuable in speeding the preparation of the registration statement and in helping you "put your best foot forward" in connection with your public offering.

Underwriters sometimes request that

your present outside auditors be displaced by a nationally-known accounting firm. However, a great many underwriters will not propose displacement of the company's present accounting firm if it is independent, adequately staffed, and capable of complying with SEC requirements. These underwriters are satisfied that neither the formation of the underwriting syndicate nor the offering price is affected by the choice of auditors.

The SEC encourages all firms meeting its requirements to engage in registration work and has indicated concern over the unjustified displacement of accounting firms at the suggestion of some underwriters. Over 500 accounting firms, other than nationals, served as the principal accountants on registration statements filed and becoming effective in a recent year. More are being added each year to the list of firms that are qualified by experience to do SEC work and many underwriters are beginning to recognize this fact.



AN UNDERWRITER'S VIEW

One underwriting firm of national reputation sends each new first-offering client a statement about the selection of independent CPAs which has this to say about going public and the expertise, manpower and independence required of accountants in this work:

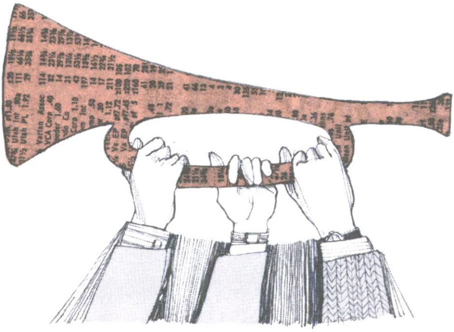
In the course of bringing forth public offerings we are often asked if there are special requirements in selecting independent certified public accountants for this purpose. Our answer in brief is this.

"Going public introduces new accounting responsibilties to the conduct of business. Annual and periodic reports will have to be filed with the SEC in forms prescribed by that Commission and in accordance with their rules and regulations. Further, in presenting a proposed offering to the SEC, sound guidance by independent certified public accountants experienced in such work is most important. Competence in SEC matters, then, is a primary requisite. Underwriters and investment bankers have found that national accounting firms and many local or regional accounting firms have this competence. It is not necessary that the firm be national, but it is necessary that it be competent in SEC work.

"A public offering can also be very demanding of accounting manpower. An offering may involve many accounting complexities and usually requires the assemblage of a great amount of accounting data within short periods of time to meet tight schedules for submission of reports. The accounting firm, therefore, should have sufficient manpower to meet these needs. Your present CPA firm, whether national or local, may have the necessary manpower as well as the competence described earlier. Further, you should consider the familiarity your present firm has with your business, its history and background. This can be a very valuable additional factor in speeding the progress of the work and facilitating the functions of the underwriter.

"Whether the accounting firm selected is national, regional or local, the underwriter will charge the same discount or commission for his services and will price the stock in the same way—in accordance with the market value of the business.

"P.S. It goes without saying that the accounting firm must meet the SEC requirements of 'independence'. "



YOUR GOING PUBLIC TEAM

In view of this statement, now is the time for you to discuss going public with both your CPAs and your attorneys. Find out whether they have the competence, manpower, independence and financial responsibility to take you through a public offering or whether they can retain the assistance necessary from firms that are qualified. If they have the needed characteristics or can acquire them, with the assistance of other firms, then plan to keep them as members of your going public team.

If when going public a company going public makes a strong stand for retention of its present CPA firm for the registration, the underwriter will in most instances go along with the choice.

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