

# FINANCIAL STATEMENTS & NON-GAAP MEASURES

## REQUIRED FINANCIAL STATEMENTS

Registration statements require Regulation S-X compliant audited financial statements, as well as AS 4105 reviewed interim financial statements where applicable.

As a general rule, an IPO registration statement must include three years of audited financial statements (an EGC may present only two years), plus financial statements for the most recent interim period and the same period in the prior fiscal year. Companies preparing for an IPO should confirm availability of required PCAOB audited and interim financial statements for IPO issuer entity (parent or operating subsidiary financials are generally not sufficient).

The following table summarizes the general financial statement requirements for an IPO.

Basic Financial Statement Requirements	
<b>Audited Financial Information</b>	<ul style="list-style-type: none"> <li>Audited balance sheets as of the end of the two most recent fiscal years; if the issuer has been in existence less than one year, an audited balance sheet as of a date within 135 days of the date of the filing of the registration statement</li> <li>Audited income statements, statements of comprehensive income, statements of cash flows and stockholders' equity covering each of the <b>three</b> most recent fiscal years (or <b>two</b> most recent fiscal years for EGCs), or for the life of the issuer (and its predecessors), if shorter</li> </ul>
<b>Unaudited Financial Information</b>	<ul style="list-style-type: none"> <li>Interim unaudited balance sheet as of the most recent three-, six- or nine-month period following the most recent audited balance sheet.</li> <li>Interim unaudited statements of income, comprehensive income, cash flows and stockholders' equity for any stub period covered by any interim balance sheet, together with statements of income and cash flows for the corresponding three-, six- or nine-month stub period of the prior year.</li> </ul>
<b>Acquired Company Financial Information and Pro Forma Financial Information</b>	Audited financial statements for a significant acquisition of a business that has taken place 75 days or more before the offering or becomes "probable" and pro forma financial information complying with Article 11 of Regulation S-X

## Staleness of Financial Statements for IPOs

SEC rules require registrants to include up-to-date financial statements in their registration statements. Except as noted above, registration statements may not be filed with financial statements that have become “stale”. Under the financial staleness rules, audited annual financial statements must be provided for an issuer’s prior fiscal year beginning on the 46th day of the issuer’s current fiscal year, while unaudited interim period financial statements must be updated beginning on the 135th day following the end of the most recent interim period for which financial statements are provided.

The below chart sets out the general financial statement staleness rules for initial public offerings, with financial statements becoming stale at close of business on the dates shown below for calendar year companies. **Note that financial statement staleness is calculated differently for already-public companies. See the SEC Filing & Staleness Calendar on page D-1 for a complete list of financial statement deadlines.**



Executive compensation disclosure for the prior fiscal year goes stale on the **first day of the following fiscal year**. This means that any registration statement filing or amendment filed on or after the first day of the fiscal year must contain executive compensation information for the prior fiscal year, whether or not the prior fiscal year’s audited financial statements are required to be included.

In addition, PCAOB rules only permit accountants to provide traditional negative assurance until the end of the 134th day after the date of the most recent financials the auditors have either audited or reviewed under AS 4105. For first quarter offerings, auditors will not give full negative assurance after February 11<sup>th</sup> (the 134<sup>th</sup> day after the end of the issuer’s third fiscal quarter). Thus, contemplated offerings after February 11<sup>th</sup> but before first quarter financial information is available should be discussed with the deal team.

## Omitting Certain Financial Statements from Initial Submission

Typically, the SEC requires all financial statements outlined above to be included in a draft registration statement prior to initial submission. However, companies conducting an initial public offering are permitted to omit from their **confidentially submitted draft registration statements** annual and interim financial information for historical periods if they reasonably believe such omitted periods will not be required to be included at the time of the first public filing (for non-EGCs) or the offering (for EGCs).

In addition, financial statements of acquired companies and related pro forma financial information may be omitted from a registrant's initial confidential submission if such financial statements are not expected to be required at the time of the first public filing of the registration statement.

### Quarterly Financial Information

While not required by SEC rules, underwriters will typically suggest including quarterly financial information on a quarterly basis for the previous eight quarters. This information helps prospective investors to build their valuation models. Discuss the inclusion of quarterly financial information early on with your lead underwriters, including the level of auditor comfort to be provided.

### Flash Financial Information

In the event the road show marketing occurs after quarter-end, but before the prior financial statements go stale, the underwriters will often recommend including in the prospectus preliminary, unaudited financial information related to the most recently completed quarter. Typically, these "flash" results are presented as narrow ranges of key financial and operating metrics. Because auditors will not provide comfort on these estimates or preliminary results, the CFO will need to certify as to their accuracy through the provision of a CFO Certificate.

### PCAOB Auditor Independence

Your audit firm must be registered with the PCAOB and satisfy the "independence" requirements under SEC and PCAOB rules. If you are currently using an audit firm that would not qualify (or that is otherwise not suitable for a public company), you should consider making a change as soon as possible to allow the new firm sufficient time to prepare and audit the required financial statements. Auditor independence can take time to verify and to address any issues. Companies planning for an IPO should ask their auditor to confirm independence well in advance of kicking off the formal IPO process and should ensure their auditor continuously monitors for any new engagements that would implicate independence.

### Acquired Company Financial Statements

#### Significance Tests.

SEC rules require the inclusion of separate audited annual and unaudited interim pre-acquisition financial statements of acquired businesses in registration statements in certain circumstances. If a significant acquisition of a business has taken place 75 days or more before the offering or becomes "probable", audited financial statements and pro forma financial information complying with Article 11 of Regulation S-X is required. A "significant acquisition" is any acquisition that exceeds 20% ***in any of the three tests*** outlined below:

	Numerator	Denominator
<b>Investment Test</b>	Registrant's and its other subsidiaries' investments in, and advances to the acquired company.	Total consolidated assets of the registrant and its subsidiaries
<b>Asset Test</b>	Total assets of the acquired company (after intercompany eliminations) as of end of the most recently completed fiscal year.	Registrant's and its subsidiaries' consolidated total assets (after intercompany eliminations) as of the end of the most recently completed fiscal year.
<b>Income Test (the lower of the two components below determines the outcome of the income test)</b>		
<b>Net Income Component</b>	Absolute value of the acquired company's consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) for the most recently completed fiscal year.	Absolute value of the registrant's and its subsidiaries' consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) for the most recently completed fiscal year.
<b>Revenue Component</b>	Acquired company's consolidated total revenues (after intercompany eliminations) for the most recently completed fiscal year.	Registrant's and its subsidiaries' consolidated total revenues (after intercompany eliminations) for the most recently completed fiscal year.

### Financial Statement Requirements.

Depending on the results of the above-listed significance tests, financial statements of the acquired business and pro forma financial information may be required. The below chart sets forth the requirements for inclusion of acquired company financials:

Significance	Financial Statement Requirements	Pro Forma Financial Information Requirement
<b>20% or Less</b>	None.	None.
<b>Greater than 20% &lt; 40%</b>	Most recent fiscal year audited, as well as unaudited for the subsequent interim period. No comparative interim period needed.	Pro forma financial information prepared in accordance with Article 11 for the registrant's most recently completed fiscal year and subsequent interim period.
<b>Greater than 40%</b>	Audited financial statements for the two most recent fiscal years, as well as most recent unaudited interim period and the comparative interim period of the prior year.	Pro forma financial information prepared in accordance with Article 11 for the registrant's most recently completed fiscal year and subsequent interim period.

Note as well that **multiple insignificant acquisitions** of unrelated businesses that collectively aggregate more than **50% significance** will require one year of audited financial statements and unaudited financial statements for the subsequent interim period,

as well as pro forma financial information for the registrant's most recently completed fiscal year and subsequent interim period.

In addition, pro forma financial information is also required when a material subsidiary that exceeds 20% significance is *disposed of*.

### NON-GAAP FINANCIAL MEASURES

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Non-GAAP financial measures are numerical measures of a registrant's historical or future financial performance, financial position or cash flows that (i) exclude amounts, or are subject to adjustments that have the effect of excluding amounts, or (ii) include amounts, or are subject to adjustments that have the effect of including amounts, that are included in or excluded from, as the case may be, the most directly comparable GAAP measure in the registrant's statement of income, balance sheet or statement of cash flows (or equivalent statements).

Non-GAAP financial measures do not include operating and other statistical measures (for example, unit sales, numbers of employees, etc.) or ratios or statistical measures calculated using exclusively GAAP financial measures (for example, operating margin).

Commonly used non-GAAP financial measures include EBIT, EBITDA, Adjusted EBITDA, adjusted net income and constant currency metrics.

Non-GAAP performance measures cannot exclude "normal, recurring, cash operating expenses necessary to conduct the Company's business. In addition, non-GAAP liquidity measures cannot exclude cash settled items and cannot be presented on a per share basis regardless of how the metric is characterized by the issuer (for example, per-share Adjusted EBITDA may not be presented). As a result, non-GAAP measures presented to shareholders may differ from those in debt documents.

### Presentation of Non-GAAP Financial Measures in Registration Statements

#### Required Disclosure.

Whenever a registrant presents a non-GAAP financial measure in a filing, it must:

- Present, with equal or greater prominence, the most directly comparable financial measure calculated and presented in accordance with GAAP;
- Reconcile the differences between the non-GAAP financial measure and the comparable GAAP financial measure;
- Disclose the reasons why the registrant's management believes the presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial conditions and results of operations; and
- To the extent material, disclose the additional purposes, if any, for which the registrant's management uses such non-GAAP financial measure.

**Certain Prohibitions.**

The use and presentation of non-GAAP financial measures are a common focus of the SEC when reviewing registration statements and issuing comment letters. In particular, the SEC will frequently comment on any of the following, which are prohibited in registration statements under Regulation S-K:

- Excluding charges or liabilities that required, or will require, cash settlement from non-GAAP liquidity measures, other than EBIT and EBITDA;
- Adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual if such item is reasonably likely to recur within two years or there was a similar item within the prior two years;
- Presenting non-GAAP financial measures in its financial statements or accompanying notes;
- Presenting non-GAAP financial measures in any pro forma financial information required by SEC rules; and
- Using titles of non-GAAP financial measures that are the same as, or confusingly similar to, titles used for GAAP measures.

**SEC GUIDANCE SPOTLIGHT:**

**Question: Are there examples of disclosures that would cause a non-GAAP measure to be more prominent?**

Answer: Yes. This requirement applies to the presentation of, and any related discussion and analysis of a non-GAAP measure. Whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made. The staff would consider the following to be examples of non-GAAP measures that are more prominent than the comparable GAAP measures:

- Presenting an income statement of non-GAAP measures.
- Presenting a non-GAAP measure before the most directly comparable GAAP measure or omitting the comparable GAAP measure altogether, including in an earnings release headline or caption that includes a non-GAAP measure.
- Presenting a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence.
- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font, etc.) that emphasizes the non-GAAP measure over the comparable GAAP measure.
- Describing a non-GAAP measure as, for example, “record performance” or “exceptional” without at least an equally prominent descriptive characterization of the comparable GAAP measure.
- Presenting charts, tables or graphs of non-GAAP financial measures without presenting charts, tables or graphs of the comparable GAAP measures with equal or greater prominence or omitting the comparable GAAP measures altogether.
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

## Key Takeaways

The SEC deploys a prescriptive approach with regards to non-GAAP financial measures and regularly comment on the use and presentation of such items. When drafting your registration statement, it is important to remember that order matters. Present the GAAP measure before the related non-GAAP measure. Merely presenting the GAAP measure once, followed by pages of only non-GAAP measures, discussion and analysis is inconsistent with the guidance and would likely draw SEC scrutiny.

When preparing non-GAAP financials, companies should not exclude normal, recurring, cash operating expenses that are necessary to operate their business in their non-GAAP performance measures. Note that an expense could be regarded as recurring even where it occurs occasionally, including at irregular intervals. For example, the SEC staff may object to the exclusion of “restructuring expenses” if they have historically occurred occasionally.

Companies should carefully review the applicable rules relating to the use of non-GAAP financial measures (Regulation G and Item 10(e) of Regulation S-K), the SEC staff’s compliance and disclosure interpretations guidance on non-GAAP financial measures, as well as recent SEC comment letter trends on the topic when preparing their disclosures.

*For more information, please contact your usual Ropes & Gray attorney or reach out to a member of our capital markets team below.*

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