US GAAP Workshop Series

Common IPO Issues & SEC Highlights

7 January 2010

Agenda

Overview

Commonly Encountered Accounting Issues during IPO

SEC Conference Highlights

Q&A

What financials do you need?

- Typically companies need to present the following historical financial statements
  - 2 years of balance sheets
  - 3 years of income statements, cash flow statements and shareholders equity statements
  - Detailed footnotes
- Interim financial statements may be required depending on:
  - time of filing
  - your year end; and
  - duration of the review process
  - commonly included on a voluntary basis if new high growth company to show quarter on quarter growth
- 5 year summary financial information required in forepart

What financials do you need?

- You may also need other company's financial statements
  - Rule 3-05 – Significant acquisitions and subsidiaries
  - Rule 3-09 – Significant equity investees
  - Rule 3-10 - Guarantors
  - Rule 4-08 Parent company stand alone financial statements
- You may also need proforma financial statements
  - Article 11 proforma financial statements
- Quarterly data for marketing purposes (may be required by merchant bankers)

Commonly encountered accounting issues

- Reorganisation / Basis of presentation
- Consolidation
- Business Combinations
- Revenue Recognition
- Preferred Shares
- Stock-based Compensation

Commonly encountered accounting issues

Reorganisation / Basis of presentation

- Common control transactions
  - Carryover basis
  - Predecessor accounting or step-up accounting
  - Non-concurrent change in shareholding of Listco
- Carve out considerations
  - Allocating common costs

Determines the financial statements composition for the track record period.

Example of presentation

Listco is an investment holding company incorporated in British Virgin Islands on February 16, 2008.

Opco is a domestic outdoor media company established in China by 3 PRC citizens on March 13, 2007. These PRC citizens are not the investors of Listco.

On July 15, 2008, Listco entered into an agreement with the 3 PRC citizens to acquire 100% equity interests in Opco, and became the sole shareholder of Opco.

Listco had no other business prior to July 2008. Listco is planning an US IPO in 2009.

How should the historical financial statements of Listco, for the years ended December 31, 2007 and 2008, be presented in the prospectus of Listco in anticipation of its US IPO?

Example of presentation (Continued)

A black line between the financial statements of predecessor and successor

	March 13 - December 31	January 1 - July 15	July 16 - December 31
	2007	2008	2008
	Rmb	Rmb	Rmb
	(Predecessor)	(Predecessor)	(Successor)
Revenue	XXXX	XXXX	XXXX
Cost of Revenue	XXXX	XXXX	XXXX
Gross Profit	XXXX	XXXX	XXXX
Expenses	XXXX	XXXX	XXXX
Operating profit	XXXX	XXXX	XXXX
Income tax	XXXX	XXXX	XXXX

Example of presentation (Continued)

If Listco is established by the same 3 PRC citizens, how should the historical financial statements of Opco, for the years ended December 31, 2007 and 2008, be presented in the prospectus of Listco in anticipation of its US IPO?

Example of presentation (Continued)

	March 13 - December 31	January 1 - December 31
	2007	2008
	Rmb	Rmb
Revenue	XXXX	XXXX
Cost of Revenue	XXXX	XXXX
Gross Profit	XXXX	XXXX
Expenses	XXXX	XXXX
Operating profit	XXXX	XXXX
Income tax	XXXX	XXXX

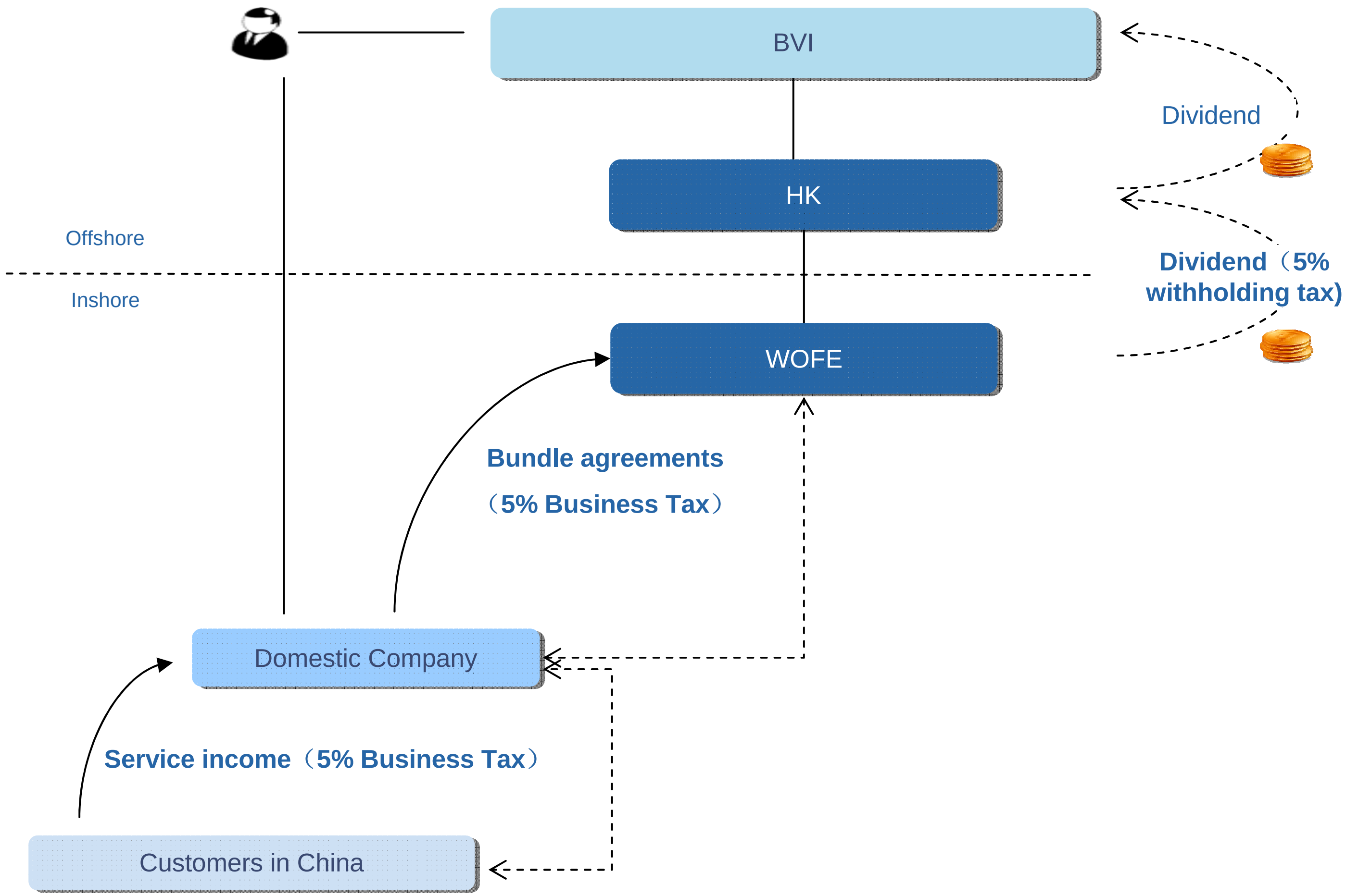
Commonly encountered accounting issues

Consolidation

- Wider than traditional voting interest model
- Power to direct activities, economic risks and rewards
- Requires detailed assessment
- Impact of foreign investment restrictions in China
- Judgmental
- Direct impact on top-line, bottom-line and net assets
- Minor variation in fact pattern can lead to equity accounting vs. full consolidation

Determines the entities whose financial statements will be included in your consolidated financial statements.

Example – a typical VIE model



Commonly encountered accounting issues

Business combinations

- Purchase price allocation
- Push down accounting required >95% interest
- Date of acquisition
- Acquisition costs
- Purchase consideration
- Contingent consideration
- Determination of Goodwill and intangible assets
- Impairment considerations
- Proforma disclosures

Significant changes in the new rules require consideration

Example Business Combination

Company A purchased Company B. How should Company A account for the following from Company B in applying the purchase price allocation as of the acquisition date?

A. **In-process research and development**
B. **Brand names that Company A does not plan to use**
C. **Assembled workforce**
D. **Favorable contract with Customer**
E. **Anticipated restructuring costs**
F. **Company B's pending legal matter**
G. **Contingent consideration based on revenue for next 2 years**
H. **Transaction costs**

Example Business Combination

Continue with prior example. Assume Company A paid $1000 along with contingent consideration, and the fair value of Company B's other net assets was $900? How much goodwill should Company A record?

	Fair value	
Cash consideration	1,000	
Contingent consideration	500	
In-process R&D	200	
Brand names	75	
Assembled workforce	300	
Favorable contract	50	
Restructuring costs	(100)	
Pending legal matter	(100)	
Transaction costs	(50)	
Other net assets	900	
Goodwill	**?**	

Example Business Combination

Continue with prior example. Assume Company A paid $1000 along with contingent consideration, and the fair value of Company B's other net assets was $900? How much goodwill should Company A record?

	Fair value	
Cash consideration	1000	**$1500**
Contingent consideration	500	
In-process R&D	200	+200
Brand names	75	+75
Assembled workforce	300	N/A
Favorable contract	50	+50
Restructuring costs	(100)	N/A
Pending legal matter	(100)	-100
Transaction costs	(50)	N/A
Other net assets	900	+900
Subtotal		**+1125**
Goodwill		**$375**

Commonly encountered accounting issues

Revenue Recognition

- Multiple element arrangements
- Timing of revenue recognition
- Presentation of revenues (net vs. gross)
- Guidance is very industry specific

Direct impact on valuation and marketing

Example – Multiple element arrangements

CellularCo runs a promotion in which new customers who sign a two-year contract receive a "free" phone. The contract requires the customer to pay a cancellation fee of $300 if the customer cancels the contract. There is a one-time "activation fee" of $50 and a monthly fee of $40 for the ongoing service. The same monthly fee is charged by CellularCo regardless of whether a "free" phone is provided. The phone costs CellularCo $100. Further, assume that CellularCo frequently sells the phone separately for $120. CellularCo is not required to refund any portion of the fees paid for any reason. CellularCo is a sufficiently capitalized, experienced, and profitable business and has no reason to believe that the two-year service requirement will not be met.

CellularCo is considering whether(a) the phone and (b) the phone service (that is, the airtime) are separable deliverables in the arrangement. The activation fee is simply considered additional arrangement consideration to be allocated. The phone and activation are delivered first, followed by the phone service (which is provided over the two-year period of the arrangement).

Example – Gross vs. Net presentation

Media Company sells television air time (i.e., advertising) to advertisers. The Company sells the air time either through its own internal sales team or through an independent national sales agency. For example, if a $100 air time slot is sold by its own sales team, the Company recognizes revenue of $100 and commission expense of $15 pursuant to a gross reporting conclusion after evaluating the ASC 605-45 indicators.

When air time is sold through the independent national sales agency, the Company is willing to sell the air time at a discount equal to the commission that would have been paid had the air time been sold by the Company's sales team. For example, the Company is now willing to sell a $100 air time slot for $85 to the national sales agency. The independent national sales agency then approaches the advertiser and sells the air time slot for $100.

How much revenue should the Company recognize from the sale of air time sold through the independent national sales agency?

Consideration to determine gross or net:

Primary obligor, Product, Pricing, Inventory Risk, Credit Risk, etc.

Commonly encountered accounting issues

Preferred shares or convertible bonds

- Classification as debt/equity/mezzanine
- Beneficial conversion features
- Embedded options / put and call rights
- Dual currency issues
- Redemption, conversion features

Consider accounting implications prior to issuance of any such instruments to avoid unforeseen accounting implications

Redemption features

	Perpetual	Fixed Redemption Date	Event Triggered Mandatory Redemption	Non-Contingent Put	Contingent Put
Balance Sheet Classification	Permanent Equity	Debt	If event is certain to occur future: debt* If event is not certain to occur in future: mezzanine	Mezzanine	If event is within control of company: permanent equity If event is outside control of company: mezzanine

Example Redemption Features

A private company wishes to raise funds via selling preferred shares. The Company is considering various redemption features. Consider the following potential terms:

A. **Investor may redeem in 5 years**
B. **Redeem if no IPO within 3 years**
C. **Investor may redeem upon change in control transaction**
D. **Redeems in 3 years (no conversion rights)**
E. **Redeems in 3 years (if conversion right not exercised)**
F. **Not redeemable**

Liability?

Equity?

Mezzanine?

Commonly encountered accounting issues

Share-based compensation

- Cheap stock
- Includes transactions with founder(s) / employees
- Can be extremely complex
- Fair value and assumptions
- Performance and market conditions
- Valuation issues

Minor changes in the terms can result in very significant accounting charges

Example – Typical stock based compensation

Grant Date：	Jan. 1 2006
Quantity of Options：	100
Share price at the grant date：	$25
Exercise Price：	$25
Exercise date：	Jan.1 2010
Option fair value at the grant date：	$5 (Black-Scholes Model)

Assume there is only service condition, and all options vest at the end of year 4.

How to account for the compensation charge every year ?

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Conference Themes

- Overall focus on investors
    - Transparency and robust financial information
    - Disclosure of key judgments
    - Communication (vs. compliance)
    - Needs of investors (vs. regulators)

- International
    - Status of convergence projects
    - IFRS roadmap

SEC Conference, December 7-9, 2009

Other accounting topics

- Goodwill
- Segments
- Income Taxes
- Non-GAAP measures
- Consolidation of VIEs
- New basis accounting
- Fair value and valuation

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International / IASB update

- Continued support of a single set of high quality global accounting standards
- Convergence must be accompanied by improvement over current standards
- Additional communication by SEC regarding the roadmap is expected in early 2010
- IFRS impact on domestic investors will be a key consideration by SEC
- PCAOB considers International Standards on Auditing in developing new auditing standards

SEC Conference, December 7-9, 2009

The FASB provided an update on the following projects:

- Financial instruments
- Financial instruments with characteristics of equity
- Fair value measurement
- Revenue recognition
- Leases
- Financial statement presentation
- Insurance
- Fair value disclosures
- Disclosure of loss contingencies

Thank you!

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