Special Report

NAVIGATING THE FINANCIAL REPORTING CHALLENGES
NAVIGATING THE NEW FINANCIAL REPORTING CHALLENGES

New challenges in financial reporting can sometimes make it seem that a company is in a maze. Seemingly clear paths can lead to dead ends and force companies to alter their course in unexpected ways. When navigating between swift-moving market and regulatory changes, it takes a sharp eye to plot the best passage.

When it comes to cross-border reporting, for example, potential hazards include how best to report on currency risks and hedging activity. Sometimes making the proper – and logical – accounting decision can confuse markets, prove counterproductive and hurt a company’s stock price. In the U.S. home market, meanwhile, sweeping new accounting standards are poised to recast how companies recognize revenues, and many executives do not yet fathom just how deep into the organizations the new rules will force change. For many companies, contingent fee revenues will be recorded earlier than in the past and the time-value of money could alter recorded revenue for longer-term contracts. Changes in the top line, of course, can have a far-reaching impact on taxes, bonuses and other areas.

Another key domestic challenge: determining when an initial public offering makes sense, given the many opaque costs and the mounting popularity of mergers and acquisitions, and other exit vehicles.

In this special report, Wharton and PwC have teamed up to highlight the hidden risks and opportunities that can arise from these key accounting challenges, and to suggest ways for companies to manage them — and prosper. The articles collected here originally were published separately over the course of 2013 and 2014.

How Should Global Companies Communicate Currency Risk? 1

Large currency valuation swings can play havoc with financial reports. A company may have performed well in the latest quarter in a local currency, but if it lost value against the home currency, performance can quickly move from good to lackluster — or worse. Poor performances can be similarly masked. It is a thorny problem that companies continue to grapple with, especially with new volatility in emerging markets, the Eurozone and China.

Currency Hedging: The Risks and Benefits Aren’t Limited to Financial Issues 6

The rise in cross-border activity, plus increasing currency volatility, is forcing multinationals to reconsider exchange rate exposure and the way investors react to using currency hedges. “It may seem counter-intuitive at first, but if analysts and investors don’t understand what the firm’s doing, a company’s stock price may suffer even if the hedging actually helps the firm,” says Chris Rhodes, director of transactional services at PwC.

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A comprehensive new accounting standard is set to change the way many companies recognize revenue in their financial statements, and that could reverberate through many systems and processes in deeply significant ways. Many companies do not yet realize the degree of change the new standard will usher in, nor how it could affect many industries in unexpected ways.

Can Companies Adapt to Changes in the IPO Environment? 16

Developing an exit strategy — whether an initial public offering or some other approach — is critical in today’s globally interconnected and highly regulated environment. The Sarbanes-Oxley Act, for example, raised the costs of going public, helping to curtail IPOs while spurring more interest in alternative capital sources. The options have evolved quickly, market demands are higher and evaluating the best path has become more complex.
Navigating the Financial Reporting Challenges

While many companies do a good job managing currency volatility, reporting it in a meaningful and transparent way that keeps investors and other stakeholders informed, a sizable number appear still to be grappling with the issue. So, how should companies present bottom-line results when currency volatility distorts the bigger picture? When is it appropriate to explain that a “loss” is not a loss, but simply the result of a — perhaps very temporary — currency movement?

It is a thorny problem that takes on new immediacy with the greater currency volatility brought on by events like the eurozone turmoil and concern over the slowdown in China's economy, says Catherine Schrand, a Wharton accounting professor. The fluctuations flow right to the bottom line, “and management may be concerned about shareholder reaction.”

More generally, “many investors tend to focus on short-term results, so income declines due to currency fluctuations may disturb them,” Schrand says. “This is so even though currency fluctuations may in fact reverse themselves to the advantage of the company in the next reporting period, minimizing the overall impact to earnings.”

It’s not enough that companies understand the currency dynamic internally and make balanced decisions. Publicly held companies must communicate financial results to analysts and investors through a variety of methods, including 10-Qs and periodic earnings reports filed with the Securities and Exchange Commission (SEC). This information helps guide investors in making buy-sell decisions and in judging how well management is performing.

Net profit or loss, naturally, is usually the first metric to catch investors’ eyes. But that number packs in many variables, including currency impact, that can leave management looking for ways to explain which variables are “central to a company’s operations and which variables may be slightly less vital,” says Chris Rhodes, accounting advisory partner at PricewaterhouseCoopers (PwC).

Companies that have not been focused on currency reporting policies have been thinking, “Well, it’s never really affected budget; it’s never really moved out of a 2% band. It’s never affected...
earnings by more than 3%,” Rhodes says. But in today’s environment, all of a sudden something can pop and “they will have to talk about it, and they’re not ready. Other companies that have historically focused on this are ready and may be at an advantage.”

**DOES CURRENCY VOLATILITY MATTER?**

One of management’s challenges in carefully explaining reporting profit or loss involves the basic issue of reporting sales, for example. In order to give shareholders a more complete picture about revenues reported in financial statements, the SEC sometimes prefers companies to address the distinction between price and quantity, explains Rhodes.

The SEC wants investors to know if “you are moving more units through your company or if you are just raising prices.” Similarly, retail chains may differentiate between sales from stores open a year or more (same-store sales), and newly opened stores, so investors can make an apples-to-apples comparison of sales progress by factoring out data from the new stores.

Currency fluctuations offer a comparable test for transparency. For example, retail price and volume of units sold in a certain country may explain local currency sales better than fluctuations in the U.S. dollar-equivalent of those sales, which adds the variability of exchange rates. Or, take a global company with a Brazilian subsidiary during a period when the U.S. dollar-translated performance was going up or down wildly, but its local currency performance was steadily increasing over three years. “A question may arise whether management should be concerned about that — especially if there are no short-term plans to liquidate that business or to get out of the Brazil market,” says Rhodes.

“There’s no easy answer because stakeholders sometimes find explanations about currency movements too subtle for what is often a very quick, targeted analysis, says Rhodes. And it does not encourage investors to take a more balanced view when some executives want to blame a falling currency for poor results but are quick to claim success when a local currency values rises and pumps up dollar results. What is clear, however, is that since the financial crisis of 2008, rising currency volatility has moved the whole issue to the forefront and intensified the debate over how currency risk should be managed and reported, says Rhodes.

Says Schrand: “Is this something management should be held accountable to?”

Currency volatility has been consistently higher since the financial crisis and continuing through to uncertainty in the Eurozone, Rhodes explains. Given the many uncertainties at the global economic level, “no one’s sure what the ‘new normal’ is going to be,” Uncertainty about individual economies adds to the unpredictability, and “now the Street is trying to parse currency risk out of the financials a little more than before” Rhodes says.
All this presents a thorny communications challenge for investor relations: How should a company speak to investors when separating the effects of currency from overall performance? Currency fluctuations can certainly distort results. Yet, giving the issue too high a profile — when explaining away a nominally poor performance in quarterly analyst calls, for example — can sometimes backfire. While many analysts place fluctuations under careful consideration, others sometimes overlook the nuance involved in such explanations and simply react negatively to any “complexity,” Rhodes points out.

**CONSTANT CURRENCY REPORTING**

Multinational companies (MNCs) experience a variety of risks while operating in foreign territories, including political and regulatory risk, and risks from local competitors and customs.

Currency risk is one of the most direct risks. Under Financial Accounting Statement (FAS) No. 52, now Accounting Standards Codification (ASC) section 830, companies that consolidate the results of foreign operations denominated in local currencies must translate the foreign financial statements into the parent company’s currency, which for U.S. companies is U.S. dollars. This one-size-fits-all, single currency reporting requirement can mask critical details — strong foreign subsidiary performances can look misleadingly weak in dollar terms and vice versa.

MNCs can turn to a couple of different strategies to deal with this anomaly, notably constant currency treatment and hedging. Neither solution works for all companies and choices depend on many variables, including currency and economic growth trends in different countries, and, of course, individual company circumstances. But constant currency reporting offers one simple and inexpensive way to talk to Wall Street if, say, a U.S.-based company’s Brazilian operation had a great year operationally, but a rising exchange rate makes the translated financial results look weak, say Schrand and Rhodes.

**RISKS, EXPOSURES AND MANAGEMENT RESPONSIBILITIES**

Chad Kokenge, a PwC accounting advisory partner, says that from an analyst’s viewpoint, the issue is “figuring out management’s motivations and what they can control or not control…. It’s important to determine what should be reported or not. It begins with the financial instruments world, but then it permeates the rest of accounting.” The real economic issue is the time horizon, he says. From an economic point of view, whether or not currency fluctuations matter is affected by a company’s plans to take money out of the business in the near term vs. reinvesting it locally longer term.

When it comes to internal reporting, however, some firms informally strip out currency fluctuation when they measure business-unit performance, says Schrand. Others take a more active role, either hedging currency at the corporate level, or letting regional or country managers engage in hedging. But these kinds of details are not likely to be disclosed to public stakeholders or analysts. “From the viewpoint of external reporting, most companies don’t disclose (MD&A) section of the financial statements. This “as if” reporting method adjusts for the effects of exchange rate fluctuations, and reports core profit and loss operations more directly by excluding currency rate fluctuations.

In addition to currency translation, some firms also experience a different kind of risk — cash flow fluctuations due to foreign-currency-denominated transactions. To address these cash flow fluctuations, firms use currency hedging strategies, but that can be a time-consuming, labor-intensive operation with costs that can outweigh the benefits, notes Schrand. Hedging often requires setting up a “dedicated department and powerful computer programs to crunch a great deal of information.” The complexity can be particularly burdensome if an MNC operates in many nations. Adding to the complications: the basic nature of MNC operations, which involve labor, plants, equipment and investments — all requiring consideration. Still, many companies enter into derivatives to hedge currency risk, which adds one more layer for investors to consider.
this granular kind of information,” Schrand notes. “Issues like centralized or decentralized currency management, or the role that currency movements play in evaluation of divisional or other personnel are rarely disclosed in segment reporting.”

In addition to currency risks that the market presents, there is also the risk of government action — say a devaluation or capital flow restrictions. These issues can be critical in deciding whether a firm should continue investing in a given country or instead move to a substitute. And such decisions are often aimed at a moving target because they must consider how competitors might game out the alternatives. Each of these risk layers also creates exposure for the firm and presents challenges for investor relations.

“There are some companies that are not as concerned about their exposure to currency swings,” says Kokenge. “They ask why they should go through a convoluted hedging profile when they can, basically, self-insure, and take their risks and deal with the spot market next year.” Schrand concurs. Currencies may go up one year and down the next, but “do you care if it flip flops? How will it affect your value if it does? Maybe fluctuations don’t matter to you.” She cites one firm that did not hedge currency risk, though all of its competitors did. The reason: it was a highly rated, well capitalized company able to borrow cheaply to maintain cash flows if the currency took a turn for the worse.

**MAKING THE CALL**

In the end, public companies must decide how investor relations will handle the currency issues in financial reports. Schrand says that those kinds of questions go to the heart of the purpose of the income statement: the ability to use historical data to attempt to predict future results.

“One argument for making the effects of currency transactions transparent is that such variations themselves are unpredictable. And since management has no control over them, variations in one time period really aren’t a good indicator of future results,” she explains. “In contrast, events like labor relations and the probability of a strike may be reasonably ascertained by considering the company’s historical experiences, and thus the effects of a strike would be properly reflected in the income statement.”

Another issue is the fact that many currency impacts that appear in the financial reports are “unrealized” and are not likely to affect future cash flows, Schrand adds. “One could say that any movement is simply a ‘display’ issue, especially since those operating cash flows are likely to be reinvested in the local business.”

Theoretically, management could report hedging activity in the profit and loss statement, and also increase disclosures about the activity. But Schrand says that could quickly become cumbersome and could confuse investors instead of helping them.

Further, don’t expect a constant currency strategy necessarily to satisfy the many investors who simply go straight to the bottom-line results on traditional financial statements, and who don’t pay attention to MD&A, footnote and other supplementary disclosure, Schrand says. What’s more, “an increasing volume of trading is being done by computerized ‘quant’ or quantitative programs that may not even recognize supplementary disclosures.”

At the same time, addressing currency issues through constant currency methods is increasingly important in other contexts. In due diligence reports that value acquisitions, for example, “constant currency analysis has moved from the back of a 50-page report to the front.… The first thing you’re trying to do is take that complex topic of currency off the agenda because people want to get at, ‘what are the core earnings or what is the quality of earnings?’”

—Catherine Schrand
Also worth noting: From a strictly best-practices standpoint, “if something is disclosed and measured, there’s a greater chance that it will be managed,” says Schrand, who points to a *Journal of Applied Corporate Finance* article by Nigel Topping, chief innovation officer at the Global Carbon Disclosure Project as an example. Topping cites a giant retailer that credited a Carbon Disclosure Project questionnaire with spurring its realization that the refrigerants used in its grocery stores accounted for a larger percentage of the firm’s greenhouse gas footprint than its entire truck fleet. Starting to measure output suggested the potential for reducing the firm’s “refrigerant footprint.” Measuring led to insight.

Paying more attention to currency issues could also provide something of a first-mover advantage, says Schrand. “If your firm is one of the early ones to get investors to understand the issues involved in currency valuations, you’re more likely to gain an edge on your competitors.”

PwC’s Rhodes agrees. “If currency risk has a significant effect on a multinational’s strategic decision making process, it’s important to communicate this to stakeholders in a meaningful way. You can use the MD&A to put many issues into context, but currency fluctuation in particular can be treated in a way that’s very focused and clearly explained to stakeholders. But it’s not a slam-dunk decision.”

Management should carefully review its operations and strategies regarding currencies, and recognize that the market appears to be trending towards more disclosure, Rhodes points out. So even if management is not currently worried about investor reaction, companies may wish to consider reviewing their currency-fluctuation management and reporting policies with these disclosure trends in mind.

“Companies and investors will only benefit from improved communication about how currency risk impacts financial statements, and that leads to more efficient allocation of capital,” Rhodes says. And as Schrand suggests, by thinking through how to communicate better around the issue, companies may also find that they may uncover better ways to manage. ◆
CURRENCY HEDGING: THE RISKS AND BENEFITS AREN’T LIMITED TO FINANCIAL ISSUES
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When a publicly held company engaged in a multi-billion dollar investment in an overseas location recently, the firm considered using a hedge — or swap — contract to reduce the risk that a big currency swing would impact costs and financial results. The plan was sound financially. Yet, management had concerns about the reaction of investors to this approach and decided to drop the hedging plan, says Chris Rhodes, accounting advisory services partner at PricewaterhouseCoopers (PwC).

Why? Because the CFO determined that, although the hedge would protect all the cash spent in the foreign jurisdiction against currency exposure, the cost of capital — in this case borrowing in external markets — “would be negatively impacted by the inability of some analysts to understand the reporting issues involved,” Rhodes explains. “The concern is that, although many analysts would immediately grasp the sophisticated currency-hedging procedures that were key to the plan, others might not.”

“In this case, at least, the CFO decided she would accept variability in cash costs rather than risk misunderstanding or instability in reported results that could potentially disrupt access to cheap debt financing.

If management makes the right move but doesn’t communicate it properly, the wrong signal may be sent to the marketplace, Rhodes adds. “It may seem counter-intuitive at first, but if analysts and investors don’t understand what the firm’s doing, a company’s stock price may suffer even if the hedging actually helps the firm.” So, even though hedging itself is a tool — neither intrinsically good nor bad — “the direct costs and benefits of the strategy have to be weighed against the impact on investor relations.”

Put another way, answering the question “to hedge or not to hedge” is more than a straightforward mathematical decision. “There is no simple answer,” notes Catherine M. Schrand, a Wharton accounting professor. The idea behind currency hedging involves reducing or eliminating risk, but the cost involved and the ability to achieve the aims needs ongoing consideration. “The risks, from political uncertainty, to global funding flows,
to the timing of revenue collections and other transactional activity, may be difficult to predict.”

An increasing volume of cross-border activity, coupled with rising currency volatility, is forcing many multinational companies (MNCs) to think harder about exchange rate exposure and the way that investors react to the use of currency hedges and other derivatives. For example, a recent press release from the CFA Institute, which oversees the Chartered Financial Analyst designation, notes that derivatives “are prone to leaving investors with a lack of understanding of associated risks and unable to anticipate potential losses if they are not disclosed properly.”

Of course, savvy analysts and investors don’t have a problem understanding sophisticated hedging and other strategies, but as hedge-use grows — more than 100 MNCs ranked the risks brought on by currency hedging as their biggest concern, ahead, even, of liquidity risk and counter-party risk, according to a July 2012 Barclays Bank Plc Global Risk Survey — efforts are being made to ensure that more people have a good grounding in these issues.

STACKING THE COSTS

Costs can add up quickly, too. “A company will have to hire staff to collect information from subsidiaries and to crunch data, and to maintain relations with a variety of brokers and broker-dealers,” Schrand says. “The outlays can quickly become a large fixed cost, so bigger firms are generally more likely to hedge since they can amortize the costs over a larger base.”

And not all of the many issues requiring consideration relate directly to the economics of hedging. Another perceived risk, particularly for investors, is incentive asymmetry, or at the least the appearance of it, says Rhodes. “Say you represent a pension fund that’s invested in a stock. You want management to have a 20-, 30- or 40-year time horizon, but what if they appear to have a shorter horizon?”

The challenge is that some investors may view the short-term nature of hedge programs as one more example of management’s preoccupation with short term results, similar to investors’ complaints about managers who obsess over quarterly earnings. But the issue is deeper than that, Rhodes adds, since the short-term nature of budget cycle hedges should be considered in light of how they fit into a company’s long-term plan.

Budget-cycle hedging, for example, is useful for managing issues like short-term swings and liquidity that are commonly associated with near-term planning purposes. But what happens when the business design encompasses structural long-term exposures, such as a revenue base that’s tied to the euro but also has funding sources that are in U.S. dollars?

In a case like that, the short-term benefits of the hedge are indeed limited to the maturity of the hedge, but by rolling the hedges, or updating them periodically, management also addresses the long-term exposure issues. That may not be immediately apparent to outsiders, however, so investors will need to understand both the long- and short-term profiles, and how management approaches each.

In fact, Wharton finance professor Wayne Guay thinks that the potential for a misalignment of managerial vs. shareholder incentives is not as likely now as it once was. In many cases today, most components of management compensation are “stocks and options that vest over a period of years…. Because their portfolio is tied to the long-term stock price of the company, management is more likely to think long-term, aligning their interests with those of investors.”

WALKING AND TALKING THE TALK

For many companies, the key operational considerations for hedging include why the company is hedging in the first place and how the transactions relate to the core business, Rhodes says. Other prominent issues include the profit margin and credit profile. “Some or all of these issues should be part of the decision-making process. But it really boils down to two elements: How good are you at hedging, and how good are you at explaining it?”

Hedging can be the "hinge" that connects historical cost accounting with fair value concepts, Rhodes says. This idea comes out of accounting regulation ASC 815 (formerly FAS 133), wherein a change in the market value of any
derivative — a hedging instrument being but one example — is offset against the change in market value of the underlying asset or liability. Typically, those items are carried on the balance sheet at historical — or acquisition — cost. Changes in the value of the derivative and underlying instrument then get reported in another section of the financial statements — in the earnings statement. So, while hedging offers economic benefits, it can also complicate score-keeping — or financial reporting — particularly for publicly held companies that must make extensive disclosures.

There’s “incredible complexity” when it comes to hedging, says Guay. “Often, there’s a tradeoff between a company’s efficiency in hedging and the understanding that’s communicated to investors. If the hedging tools are so opaque that investors don’t understand how the firm works, then it may be better in some cases to back off on the use of complex hedging.”

That “introduces another layer to the discussion, expanding it from a numbers-crunching exercise to an investor relations issue,” notes Henri Leveque, leader of PwC’s U.S. capital markets and accounting advisory services. “It adds a unique dimension, where a company has to determine if it can overcome the complexity inherent in the hedging instruments as well as the accounting presentation, and if the firm can explain it in a way that outsiders will understand. You have to know your analysts and how they follow certain elements of your company.”

Some analysts, for example, tend to make judgments and issue reports based on a narrow selection of metrics that they’re comfortable with. He notes, though, that even if the long-term economics and return on equity for a hedge make great sense, the strait-jacket of financial reporting may jumble the perceptions among some analysts.

“Many of them are able to penetrate the noise and will understand the underlying economics,” says Leveque. “But the ones who don’t will find it difficult to understand the long-term alignment of the executive suite. So your investor relations professionals must be able to tell a story that lays out the really good analysis that the company did as it navigated a complex financial pathway.”

What’s more, it is not simply a matter of getting the analyst community to understand long-term, net-positive results. A company may execute “a perfectly good trade with a clear explanation to support it,” says Rhodes. But when investors raise questions about the transaction, management may be forced to spend “a significant amount of time” figuring out how to correctly display the activity in the financial statements and how to explain it. Although some companies do this very well, others often “miss the angle” in management’s analysis of hedging transactions.

**POTENTIAL DRAG ON THE STOCK PRICE**

How should a company make an overall assessment of a potential hedging transaction? One approach, Rhodes suggests, is to adopt a “four box” decision set — similar to a decision tree — to weigh the pluses and minuses. Imagine a kind of flow chart, where the first “box” poses a “yes” or “no” question that must be answered before moving on to the next box. Each subsequent box also poses a question that must be answered before moving to the subsequent box. The entire process — in this case the decision whether or not to make a hedge — would end if the answer to any question is “no.”

“In box one, a company could determine, based on the specific circumstances, whether a hedge makes economic sense,” he says. If it does, the company can move to box two, where management should “look at whether, on the face of it, hedging may drive negative investor reaction.” If decision-makers decide that hedging may make sense after the initial consideration of analyst reaction, then the process moves on to box three, where they may decide that hedging not only can make sense but also the company...
could either: (1) disregard the level of negative analyst and investor reaction; or, (2) disclose the hedging activity with simplified reporting.

Finally, in box four, the analysis may conclude that hedging may make sense and management may decide to disclose the activity using sophisticated hedge accounting, and that the company will invest the time needed to explain its actions in a way that brings clarity to analysts and investors.

“A best-practice approach will generally call for management to gain a thorough understanding of the underlying issues before making the decision to hedge or not to hedge,” says Leveque. “The four-box decision tree can assist in making that decision, and once management has arrived at a conclusion, it’s a matter of communicating the activity to the investment community. The reason: If analysts or investors don’t understand something, their very human reaction is generally to go negative on it. And going negative is likely to have other real economic impacts on this enterprise that frankly may not have been there.”

To illustrate the practical effect on a company, consider two companies involved solely in gold mining that have taken fundamentally different approaches to earning profits and communicating their business model to the public. One company forgoes hedging gold and the other hedges the commodity.

The first company fundamentally offers a gold price pure-play, says Rhodes. “In effect, management is saying, ‘I control a block of mineral rights for extracting gold. The value of the gold in the ground will either go up or down and I accept that risk. I focus only on getting it out of the ground efficiently with the right equipment and the right people.’ If gold goes up, the company’s stock will likely go up, and vice versa.

The second mining company chooses to hedge. The message here, says Rhodes, “is basically that when you buy my stock, you are not buying the near-term risk of gold. I hedge against the gold that’s in the ground and the price at which I sell it. The only thing you’re buying is how efficiently I can get it out of the ground.” Investors in the first company buy mostly gold risk “with a little bit of operational risk.” Investors in the second company are “buying mostly operational risk.”

It’s a personal choice. Some investors want a company to retain risk, instead of hedging it out, often because of the potential for a higher return. Others may generally favor the industry’s prospects, but prefer to try to lower the risk of large swings in value. All of this used to be left entirely for investors to sort out. But explaining things in a way that analysts and shareholders will understand is increasingly important because accounting regulations now call for more transparency, notes Schrand.

“Early on, accounting rules regarding the reporting of derivatives actually increased volatility among firms’ reported financial results,” she notes. “That was the exact opposite of what companies hoped to achieve with hedging. But developments like the comprehensive income statement have helped to bring more order to hedge accounting reporting. There is some evidence, however, that the term ‘derivatives’ may cause some concern among investors who associate it with undue risk; so companies should be very careful when they describe their hedging activities.”

In fact improved disclosure is “crucial in allowing investors to make more informed decisions and to ensure that company financial reports communicate key information regarding risk exposures and risk management more clearly,” notes a recent CFA report, User Perspectives of Financial Instrument Risk Disclosures Under IFRS Volume II - Derivatives and Hedging Activities Disclosures.

BEST PRACTICES

When the rewards from hedging appear to be too high to pass up, management could invest the time needed to improve on its explanations of its trades. One potential avenue is through meetings or conference calls with analysts and investors, suggests Wharton accounting professor Brian Bushee.
“It would be best to do it at a time separate from regular earnings announcements or other disclosures, so that everyone can focus on the issue and not have it be confounded with performance numbers or forecasts.” The only downside would be “potential proprietary costs if this is an open meeting, such as a freely available conference call or webcast” where “competitors could potentially listen in and gain competitive information. So perhaps a better venue would be an investor conference, or even a private meeting.”

Private meetings are not necessarily forbidden by Regulation FD (Regulation Fair Disclosure). “As long as the managers of a publicly held company do not give out earnings or sales guidance, and just stick to the details of the hedging strategy, then there would be no problem with a private meeting,” Bushee says. “This is because the managers are not disclosing privileged information, but are simply filling in the ‘mosaic’ of analyst and investor information.”

Some clear lessons in all of this are that decisions about currency hedging are highly case-specific and will vary depending on a company’s individual circumstances. But on balance, hedging is very complex. “Decision makers must talk to the CFO, the CEO and the board, and explain the economics,” Rhodes says. It also takes a material amount of time to know how to “correctly display and explain their strategy” to analysts. An integral part of that: “You must know your analysts, and how are they following” complex derivative transactions. ◆
The new standard’s rules are now set to take effect for periods beginning after December 15, 2016, offering companies extra time to adjust beyond the original 2015 deadline in the Exposure Draft. The effects can reach so deep into a company in many complex ways that prudent firms are beginning to plan now for the big shift. “They will also drive a variety of significant internal changes at many firms, from a redesign of the information gathering systems to potential adjustments in the ways that some companies do business,” says Chris Smith, an accounting advisory partner with PwC.

The new principles were designed to help harmonize U.S. generally accepted accounting principles (GAAP) with global international financial reporting standards (IFRS). It is the sweeping nature of the changes to systems and processes that will follow the new rules that led officials to postpone the application date and provide more time to prepare. (It is FASB, or the Financial Accounting Standards Board in the U.S., and IASB, the International Accounting Standards Board in Europe and other continents, that collaborate to create unified global accounting and reporting standards.) The Boards have been clear all long that they wanted “to make sure financial statement preparers had enough time to implement the changes — the deferral of the effective date will take a little bit of the pressure off,” Smith points out.

“They will also drive a variety of significant internal changes at many firms, from a redesign of the information gathering systems to potential adjustments in the ways that some companies do business.”

—Chris Smith

A BOLD STEP

The IASB is now planning on allowing early adoption of the new standard, note PwC experts. It’s quite possible that they did so as a way to give companies more flexibility, particularly for companies that are adopting IFRS for the first
time in the next few years, so they don’t have to go through significant change twice — once to adopt IFRS, and then again to adopt the new standard.

The new “rev-rec” rules reflect the principles-based approach that characterizes IFRS, PwC experts say. A key feature of the new approach suggests, for example, that companies might be able to make a reasonable estimate of revenue and book that estimate when the goods or services are delivered, even where there is some uncertainty regarding the final amount to be received due to issues such as collectability or contingent payments. Companies operating under traditional U.S. GAAP often wait to record revenue until such uncertainties related to an arrangement are resolved.

THE END OF TRADITIONAL GUIDANCE

Many companies do not yet realize just how extensive the changes driven by the new rules will be. Once they take effect, all of the old rules in the U.S. “regarding revenue recognition will be replaced,” Smith explains. And those changes affect industries that had industry-specific guidance, for example, far more than others.

Telecom companies, for example, regularly provide a “free” handset to customers upon signing up for a service contract. Under today’s rules, no revenue is recognized upon delivery of the handset because it is all considered contingent upon delivery of service under the service contract. But under the new rules, telecom companies will be required to allocate some of the estimated total contract value to the handset, recognize a portion of the revenue upon delivery of the handset, and then ratably recognize a smaller amount each month as service is delivered.

The software industry also could see significant change. It “has very tough rules focusing on revenue recognition that were written back in the 1990s in the wake of some perceived abuses,” notes Smith. Software companies sometimes sell product licenses that include access to future products over a given period. Under existing rules, they usually recognize that revenue ratably over the contract-delivery period since the products also are delivered gradually.

Software companies are also held to a high accounting standard when it comes to proving a breakdown between the current and future revenues for a given reporting period. If they are unable to prove the fair value of future deliverables under the software rules, they might be required to defer revenues until actual delivery of those future deliverables.

This can cause companies to play it safe. Under existing GAAP, when there is a judgment required regarding the accrual of estimated revenues, the overriding tendency is often to defer recognition until the amount is known with certainty. That often is not until the end of the transaction period, Smith says. “That’s mainly because practitioners are very nervous about getting ahead of themselves.” But that has also led at times to “profit and loss statements that don’t reflect the economics of the underlying transactions. So in some ways the new standard represents a very positive development.”

In the “big picture,” this ability to estimate will offer companies more latitude in judgment, notes Chad Kokenge, PwC accounting advisory partner.

But there may be a downside.

Over the years, some companies have conformed to accounting rules in a way that led to a “ratable attribution model,” under current GAAP. That made “forecasting and predictability a lot easier,” Kokenge points out. “But the new standards may mean that they’ll have to change their models.”

Many companies also will need to rethink the way they process transactions through their information technology systems, adds Smith. The challenge arises because the estimates required under the new rules may be complicated for some industries — such as the semi-conductor industry — that often operate via a distributor sales channel.

In sell-through transactions, a distributor buys and stocks products from a manufacturer or another distributor, but may have rights to price protection, returns, or other rebates or credits. Given that those rights create uncertainty about the amount that the manufacturer will ultimately receive from a transaction, many semiconductor companies defer recognizing revenue until the
distributor sells the product through to the final customer and the amount the manufacturer will receive is known with certainty.

Under the new rules, the sellers will likely have to make their best estimate of sales through this arrangement and recognize that amount when products are sold to the distributor. “It may be a more accurate view of the economics to book the revenue net of my estimated rebate — say 80% of the order when I sell to the reseller,” Smith points out. Then later, “when they sell through and I know the actual amount of the rebates,” they can book the appropriate adjustments.

A NEW BUSINESS MODEL?

This all presents challenges for companies: Estimates entered on the books may not be as simple to automate on a transaction-by-transaction basis. Instead, a company will likely develop a process to capture data necessary for estimates and periodically update them and then, to the extent possible, automate that process. “So trying to embed that into a system that usually processes a high volume of transactions for your financial statements could be a challenge,” Smith says. “Companies will want a good system of internal controls to process and monitor those judgments.”

As part of that approach, companies may want to stratify transactions, essentially segregating them based on similar characteristics or perhaps key elements. That way, the IT system could have a better chance of processing them on more of a volume basis.

But that’s not the only significant change that firms should consider.

Right now, some businesses may pass up a deal, or defer reporting of revenue until cash is collected, because of issues such as poor customer credit ratings, Smith says. But he questions that approach, noting that, when a firm signs a contract, the obvious expectation is that it will be paid at some point. As a practical matter, companies would not sign the contract otherwise. Under the new rules, companies will have more flexibility in “deciding how much revenue they should recognize at a given point in time.” Here again, they generally will book revenue sooner than in the past.

Still, while that increased freedom to estimate collectability under the new regime may have some effect on firm behavior, don’t expect companies to start taking on an inordinate amount of risk, says Karthik Balakrishnan, a Wharton accounting professor. The rules may alter their choice of projects to some degree, given that companies will have more latitude regarding timing and revenue stream recognition. “So, you may see changes in the timing of performance objectives that have to be achieved in order to recognize revenue, and that may drive changes to contract design. But I do not see a direct link to changes in an organization’s risk appetite.”

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—Karthik Balakrishnan

Investor relations, however, will almost certainly be shaped by the change, notes Kokenge. Expect at least some stakeholders to want a better understanding of the revenue recognition judgments. They will want to know “how those estimates were made so they can make an informed decision as to how the judgments are actually operating.”

MARKET REACTION

Upon adoption, companies may be required to record a “catch-up” entry on the adoption date to account for the effect of moving to the new standard. For some companies, that means a significant amount of deferred revenue will be released directly to opening retained earnings – effectively recognizing it as a prior period adjustment on the balance sheet instead of reflecting it as revenue on the P&L statement.

But will the one-time changes, which could be sizable, cause turmoil in capital markets as investors assess and assimilate them?

That is not likely, according to Wharton accounting professor Paul Fischer. Markets often
respond to significant events, but the question is whether they will see the effect of these rule changes as a "one-time event or as something that's likely to persist. I expect firms will educate investors about the revenue recognition changes, so we're not likely to see a major upheaval in the markets, at least not from this event."

Firms can help with that education process through early disclosure, he adds. Market reaction tends to be most dramatic when investors are unprepared. But if they have been forewarned and understand what the likely effects will be, “then there’s less likely to be market disruption when the accounting entry for the event is actually reflected on a company’s books.”

“Evidence suggests that when a firm takes a restructuring charge one time, it’s likely to do so again in the future, clouding the very meaning of a ‘one-time’ event.”
—Paul Fischer

Companies must be careful when describing the one-time effect, however. “Just because management says that an event is a ‘one-off’ occurrence doesn’t always mean that it actually is,” Fischer points out. A restructuring charge offers a good example of that. Take a company that gets into trouble, takes some write-downs, and then incurs other expenses and tries to report it as being related to a “one-time” restructuring charge. The challenge: “Evidence suggests that when a firm takes a restructuring charge one time, it’s likely to do so again in the future, clouding the very meaning of a ‘one-time’ event.”

Firms also must balance investor disclosure against maintaining the confidentiality of information that could benefit competitors, Fischer says. Companies often can overstate the scope of competitive effect and “use it as an excuse to limit disclosure. But under the new regime, companies will generally be expected to disclose more information than they do today.

How much should a company disclose about the contracts themselves? There’s no blanket answer given the complexity involved, including “the degree of disclosure that’s already taken place and, of course, whether or not the current disclosure can be made in a way that doesn’t reveal too many specific details while still providing meaningful information to investors,” Fischer points out.

Even with proper disclosures, however, investors may suffer some initial confusion once companies begin reporting under the new revenue recognition rules, Fischer says. There are no “broad industry benchmarks for the new reporting regime, at least among U.S. companies.”

He adds that the new rules differ from other areas of accounting guidance, such as those for defined benefit pension plan return assumptions, which have a history, and can be audited and compared relatively easily. For revenue recognition, “companies will be reporting numbers in a new way, and it may not be clear how valuable a comparison will be among companies and across industries, at least initially.”

Adequate disclosure, such as information about models and assumptions, may give some comfort to investors, Fischer adds. But in dealing with management projections, there is always some risk of unintentional or intentional errors. “Once more data have been generated and the models are standardized, investors will be a lot more comfortable with the numbers.”

Inevitably, under an accounting regime that allows for greater judgments and estimates, there will be times when a company’s actual results turn out to be different from initial estimates. That will require revisions to those estimates, and also potentially will result in greater volatility in their results than they had previously experienced, say PwC experts.

**WHAT SHOULD COMPANIES DO NOW?**

The delay in the required implementation of the new rules until 2017 means companies can be more strategic and methodical about implementation, notes Smith. “For example, they can consider how they want to present prior-period financial statements for comparative
purposes — to either recast the comparative periods, or to present a reconciliation from the old GAAP to the new GAAP in the year of adoption."

Though meant to increase transparency, the rules are not a precise tool, and companies should examine the best way to explain the potential for earlier recognition of revenue. Some companies initially “could see significant revenue impacts, while others will clearly have less reporting impacts,” says Kokenge.

So, while companies have about three years before they have to implement the new standards, Smith says they shouldn’t delay preparations. He advises beginning impact assessments now, evaluating the differences under the new regulations and determining how significant they will be going forward.

Start by considering what the implementation roadmap for accounting policy, process and system changes should look like for the next two or three years, Smith advises. But don’t implement the new system immediately. “Instead, wait until you’ve seen the final revenue recognition standards on paper, since you won’t know all of the nuances until then.”

Even when the final standards are published, it still takes time to work through them and determine what the guidance — or the accounting Boards — actually intended by their wording “and how other people in your particular industry will deal with specific issues.”

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“It gives companies a chance to re-examine operations, systems and procedures, and reporting and disclosure formats.”

— Chad Kokenge

There undoubtedly will be challenges and disruption, adds Kokenge, but also opportunity. “It gives companies a chance to re-examine operations, systems and procedures, and reporting and disclosure formats.” The result should enhance financial reporting, and may be beneficial for investors and companies alike.

Additionally, many U.S. companies, particularly those with industry-specific guidance, find that today’s accounting rules can restrict how the business operates or result in an accounting answer that doesn’t really reflect the economics of the arrangement. “The new rules should allow companies more flexibility in their business models, with the ability to make estimates to better reflect the economics of the arrangement appropriately.”

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CAN COMPANIES ADAPT TO CHANGES IN THE IPO ENVIRONMENT?

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At one time, an initial public offering (IPO) was considered de rigueur for growing companies — a seemingly endless availability of capital plus the panache conferred by a public listing helped to spur an avalanche of filings that swelled to more than 600 in 1996. But a spate of regulatory burdens — like the Sarbanes-Oxley Act (SOX) — raised the costs of going public, helping to curtail IPOs while spurring more interest in alternative capital sources, say experts from Wharton and PricewaterhouseCoopers (PwC).

“Companies and private venture sponsors now have multiple options when it comes to considering liquidity and sources of capital,” including venture capital, private equity and debt, says Mike Gould, partner at PwC. Wharton finance professor Luke Taylor adds that “by volume, there’s been a pretty big shift toward M&A as a means of exit, at least among venture-backed companies…. But the IPOs tend to be bigger exits....”

The strong showing continued into the second quarter of 2014, as 89 public companies debuted, representing $21.5 billion in proceeds, notes PwC’s Q2 2014 IPO Watch. For the first half of the year, there were a total of 160 IPOs, generating $32.4 billion in proceeds compared to 97 IPOs totaling $21 billion in the same period the previous year. “The improving domestic economy, rising confidence among CEOs and continued record low interest rates all combined to fuel very strong activity in the U.S. capital markets during the first six months of the year,” says Henri Leveque, partner at PwC.

While some sophisticated companies are thinking of alternative exits, the IPO market is not exactly drying up. The U.S. IPO market in 2013 was the most robust since 2007, as 238 public companies raised $56.9 billion, eclipsing the 146 IPOs that raised $42.9 billion in 2012, according to PwC’s Annual Capital Markets Watch.

Beyond access to capital, the incentives for launching an IPO include the ability to use publicly traded stock as a currency to acquire other companies, to attract talented employees, to diversify and reduce investor holdings and...
to provide liquidity for shareholders. A public listing may also enhance a company’s brand and reputation in a new market.

While many firms still see public offerings as the way to go, says Gould, the first question that companies need to ask is: “What do we hope to gain from going public?” A public company must “meet shareholder and market expectations from day one. Companies will need to address ongoing compliance and regulatory requirements, operational effectiveness, risk management, periodic reporting and investor relations.”

**DOWNSIDE CONCERNS**

In the late 1990s and early 2000s, companies had a sense of having arrived when they did an IPO. But today, an IPO can also give rise to mixed feelings, notes Neil Dhar, a PwC partner. A CFO recently quipped to Dhar that the good news is the board wants to go forward with an IPO, and the bad news is that the board wants to go forward with an IPO. Going public can mean a lot of liability and stress. “He was glad about the capital infusion, but was concerned about possibly being pressured to manage for quarterly results instead of for long-term results.”

Other issues that can dog a publicly held company include legal concerns: 94% of the U.S. merger and acquisition deals announced in 2013 valued at more than $100 million were challenged in shareholder lawsuits, notes a survey by Boston-based Cornerstone Research, Inc.

And a PwC survey of newly public companies found that 48% of respondents said the cost of doing an IPO exceeded their expectations. Added to direct costs are ongoing tangible and intangible costs associated with transparency and disclosure requirements, as well as other issues.

SOX, for example, requires CEOs and CFOs to report the effectiveness of internal control over financial reporting. The company’s external auditor is required to annually attest to the effectiveness of the company’s internal control over financial reporting. Further, as the economy becomes more global, public companies considering overseas or dual listings will need to evaluate the impact of International Financial Reporting Standards on the offering process.

There may even be some evidence to suggest that IPOs are not as efficient as issuers would hope, Taylor adds. “There’s a big misunderstanding about IPO underpricing,” he says. “When new offerings like Twitter [which soared some 73% above its offering price during the first day of trading, jumping from $26 a share to more than $45] pop up, I see it as money that was left on the table by the company.”

“**The improving domestic economy, rising confidence among CEOs and continued record low interest rates all combined to fuel very strong activity in the U.S. capital markets during the first three months of the year.**”

—Henri Leveque

Underwriters and early investors make out well, Taylor explains, but “extreme underpricing may indicate that the investment banks erred on the low side in their pricing advice,” essentially resulting in a shortfall for the company.

Historically, a significant number of IPO investors have not made out too well either, according to David Musto, a Wharton finance professor. Even in the booming 1990s, evidence indicates that investors who bought and sold newly public companies on the first day of trading tended to profit nicely, but those who purchased IPO stock in the secondary markets and held on to it tended to see constrained gains or, in some cases, a loss on their initial investment.

“The results indicate that many IPOs were indeed underpriced initially,” he explains. “The market valuation may quickly rise, but then tends to stall or even fall back.”

There are exceptions, such as social media companies, where the current consumer demand translates into hefty market valuations. “But overall, the takeaway for investors is that if you can buy into an IPO early before it lists, and then sell the stock
the first day of trading, you’re likely to make money. But if you hold it longer, your gains may be less — although as a group IPOs continue to be up on their IPO price.” Musto notes.

**INTANGIBLE BENEFITS**

For some issuers, the benefits of an IPO go beyond tapping a new capital source — a new stock market listing can enhance brand recognition. A public company’s stock may also function as a kind of currency for attracting and retaining employees, or for a merger or acquisition.

But companies have other options, including exempt offerings and private equity (PE) transactions.

Exempt offerings (144A offerings) are transactions where securities are sold on a restrictive basis to sophisticated investors with very limited SEC filing and reporting requirements, notes Dhar. “Because there is no requirement for a Securities and Exchange Commission review process, the transaction can be completed faster, generally at a lower cost compared to an IPO.”

Further, in a 144A offering, funds can be raised immediately, but the costly and cumbersome public company reporting obligations are deferred until the securities are later exchanged for registered securities.

PE sales are also gaining steam, with more than 500 PE firms in operation, each with assets of $1 billion or more, according to some reports. In a PE transaction, shares are sold directly to private buyers outside of an exchange, which may enable the issuing firm to initially transfer more equity at a lower cost — and without a mandatory SEC review. Underwriters are generally not required in a private sale, although they may add valuable support, say PwC experts.

One example of a private sale is Facebook’s late-March announcement of a planned $2 billion purchase of Oculus VR, a virtual reality headset company, notes Musto. The $2 billion deal reportedly includes a $400 million cash component and $1.6 billion in Facebook stock, and was to close in the second quarter of 2014.

“The Sarbanes-Oxley Act may have had the unintended consequence of spurring more private placements,” he observes. “Instead of startups seeking to go IPO, they may consider a model that will be a threat to a company like Facebook — or one that complements it — in the hopes that a tech giant will buy the startup.”

“In today’s low-interest rate environment, the cost of PE capital may be higher, but billions of dollars are sitting on corporate balance sheets, and PE investors want to put them to use,” notes Dhar. PE portfolio companies generally have a three- to seven-year exit strategy. “At the end of that timeframe the investors will usually look to either sell the securities to another firm that has synergies, or to another PE investor, or they may go with an IPO, especially in a relatively strong market like this one.”

**WEIGHING IPO COSTS**

Top management knows that going IPO is a transformational experience and requires significant changes to processes, reporting and other structures. Yet many companies embark upon this process without understanding all of the costs.

This was dramatically illustrated in a PwC study “Considering an IPO? The costs of going and being public may surprise you,” which revealed that the one-time costs associated with an IPO had exceeded the expectations of some 48% of participating U.S. CFOs.

—David Musto
The costs associated with going public can vary significantly based upon the size of the offering, size and complexity of the company, and their current level of preparations. However, there are four basic buckets of costs, notes Gould. First are expenses directly attributable to the IPO, “which are netted against the proceeds.” These include underwriter discount fees equal to about 5%-7% of gross proceeds, and “another $3.7 million, on average, for road show expenses and for legal, accounting and printing fees associated with drafting the registration statement and comfort letter.”

The second bucket of costs, which can easily total another $1 million or more, are typically incurred for: tax and legal restructuring in anticipation of the IPO; additional audit, interim and quarterly reviews; and advisory accounting and other costs to make the financial statements SOX compliant. Also included in that estimate are valuation reports, new articles of incorporation, the audit committee charter and by-laws, and other agreements.

The third bucket can also run to $1 million or more and consists of one-time costs for converting to a public company. These are also expensed as incurred, and include costs or charges: to implement new financial reporting systems and processes; to document internal controls and comply with SOX; to identify and recruit a new board of directors; and to implement new executive and employee compensation plans.

Even after completing an IPO, a company typically incurs ongoing, incremental costs associated with being a public entity. This fourth bucket may run $1.5 million or more each year, and can include internal staffing costs for accounting, tax, legal, human resources, technology, internal audit and investor relations services, as well as outside professional fees for legal and accounting advice.

Given the number of variables, any particular IPO can be considerably more expensive, cautions Gould. “In some cases a company may spend $10 million in order to raise $30 million in an IPO. So it’s important to bring management and outside advisors together early on to thoroughly investigate the costs and benefits of an IPO, and of the alternatives to an IPO.”

THE RIGHT TEAM

“That’s one of the reasons that an increasing number of companies are using independent capital markets advisors to help them navigate the process,” Gould explains.

Independent capital markets advisory firms, also known as IPO advisors, are often staffed with former investment bankers and other experts. Among other services, they can help management build the IPO plan, keep task lists, monitor progress and forecast delivery dates. They may get involved at the start, gathering information for the registration statement, and then help throughout the process, from assisting during the SEC comment period to helping the firm prepare as it makes the transition to a public company.

“The planning process for an IPO can start the day a company is incorporated or as late as three months before a public offering.”

—Derek Thomson

Initial considerations about going public are often limited to a company’s owners and its CEO (who may also be an owner). If they decide to move ahead, the CFO is usually brought in at this time and will become the focal point of the IPO execution.

“The planning process for an IPO can start the day a company is incorporated or as late as three months before a public offering,” says Derek Thomson, a director at PwC. PwC recommends an orderly plan over one to two years. “This window gives a private company time to think, act and perform as a public company.”

Early on, however, a company may wish to add staff in marketing, operations, development and finance with public company experience. It may also want a CFO who has previously been through the IPO process.
The company should also consider a search for qualified outside board members, and may wish to build relationships with an investment banking firm, law firm, accounting advisors and an independent auditor, since these help establish credibility.

In the pre-IPO period, an issuing company typically considers questions like how much money to raise, what type of security to issue and what the preliminary valuation should be, observes Taylor. “During this time — known as a beauty pageant or bake-off — a lead underwriter and other underwriters in the syndicate will be selected, the underwriting contract will be negotiated, and board approval will be sought.”

“It’s also important to have the right team before beginning the road show — the issuer’s presentation of securities to potential buyers. The road show is when you’ll be gathering important information related to the pricing of the securities,” Taylor says. “During the road show, top management will travel around the country, or internationally, to give presentations to analysts, fund managers and potential investors — the issuer will gather ‘soft’ information about the demand for its securities.”

During these presentations the rule of thumb is to lay out the proposed deal and highlight the key investment selling points, typically with five or six bullet points, explains Dhar.

Information, such as data analysis and the executive summary, should be short and to the point, he says. “But you also have to be prepared to go one-on-one with individual investors, and ensure that you’re able to drill down to the main points of your story and explain why your management team is the right one for the company. Investors will be on the lookout for weaknesses in your argument.”

There is also a need to describe your company in a “crisp and concise way,” says Thomson. “If you go into too much detail about your company’s supply chain and value proposition, the investors’ eyes may glaze over. Instead, you’ve got to be able to communicate in a short and concise way just how your company will make money.”

Determining where to list is another critical decision.

“Many elements must be considered,” says Dhar. “Let’s say you’re a software company based in Europe — should you list in your home market or in another venue? Key consideration points will include who you anticipate will buy your stock, and where you plan to grow.”

Listing in multiple markets may be an option, he adds, “but then you also have to consider how you’ll meet the reporting requirements in each market, how you’ll communicate with investors, and what peers your company will be compared with. These kinds of decisions usually require a great deal of forethought and analysis.”

The next stage is the “book building” process, when underwriters accept orders for shares from investors, who indicate the number of shares they want and the price they are willing to pay. The goal: Discover the right offer price and find investors to buy shares, says Taylor. “At this point, the prospectus may be amended as needed.”

The day before or morning of the IPO, the underwriters will set the final offer price and the number of shares to be issued.

Developing an exit strategy — whether an IPO or another approach — is critical in today’s globally interconnected and highly regulated environment. But the options have evolved fast, market demands are higher and evaluating the best path has become more complex. Regardless of the final approach, a growing company that takes the right steps at the start can save a significant amount of time and resources.◆
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