

Overview and History of Initial Public Offering:

An interesting Historical fact is that the first company that got listed was in the year 1602, “The Dutch East India Company” (Chambers, 2006).

Organizations in the 21 st Century are not only getting bigger, but also extremely complex. The M&A route adopted by many organizations to become even larger by acquiring smaller organizations is also on a roll, albeit in the short term.

Given the Global meltdown and its imperatives on the world economy, companies trying hard to stay afloat, approaching the small investor with a Public offerings is no more as exciting as it used to, yet Companies continue to choose the option of an Initial Public Offering (herein after referred as “IPO”). Being a professional in such demanding market situation, it becomes important to know certain aspects of the IPO.

Requirement for an IPO:

As organizations grow bigger, the requirement for funds increases. Such Organisations have limited options. They will either have to approach a Bank or a lender for money or go in for a “Private Equity Fund” (herein after referred to as “PE Fund”) investment. The funding from the PE Funds are expensive and stressful for a Company and proves counter productive in the long run as compared to public finance. The PE Funds also want to exercise the *Exit Option* at an appropriate price. In such a situation there are two options available for the Company namely:

1. IPO
2. Management Buy Out/ Leveraged Buy Out (herein after referred as “MBO/LBO”)

Generally, the option of MBO/LBO is preferred by the management where the acquiring entity is already listed. The benefit that arises out of such a transaction is that the acquired company becomes a listed entity directly, as the acquirer is a listed entity or it becomes a subsidiary of a listed company. This option to exercise is very cheap for the company as it does not have to incur any cost except the costs incurred at time of acquisition and such capital expenditure incurred by the company becomes allowable to the company for tax purpose under section 35D of the Income Tax Act, 1961. However, the only benefit that the company loses in exercising the option of MBO/LBO is loss of its identity. So far as other Commercial, Strategic or Financial benefits are concerned, they are for the management to decide. There is no debate here regarding which option is better to be exercise.

The IPO – Process

1. IPO process
2. Indian Regulatory and the Frame work
3. QIPs
4. Analysis and Restatement of Financial Statement of 5 years prior to listing
5. Management Discussion & Analysis
6. Auditors Role and Comfort letter issued & Compilation

7. Consent Letter
8. Risk Management

1. IPO Process:

The process can be divided into three stages:

- a. Planning Stage – Phase 1
- b. Executing and Controlling – Phase 2
- c. Closing of the Deal – Phase 3

a. Planning Stage – Phase 1

1. Defining the Business Plan
2. Transaction Development
3. Formation of the Team
4. Assignment of the areas to the team and moderation.

b. Execution & Controlling – Phase 2

1. Capital Structure planning – Debt/ Equity
2. Preparing the Company profile – Due Diligences and Valuation
3. Co-ordination with Underwriters
4. Auditors Role – Analyses, Compilation, Auditors Letter of Comfort and Financial/ Accounting Ratios.
5. Legal – Due Diligences (Legal), Red Hearing Prospectus (Draft), registration with the regulator (Draft), other Civil/Criminal cases/FIRs against the Directors and the Company.

c. Closing the Deal – Phase 3

1. Filing of the Final registration with SEBI
2. Dealing with Merchant Bankers and Price Fixation
3. Agreements with Ad Agencies, Print Media and other PR Firms/Companies.
4. Other Sales Promotion
5. Successful Closure.

Critical factors to be considered for an IPO:

a. Strengthening the Corporate Governance:

As the Company goes for a public listing the compliances required becomes more stringent and transparent in comparison to the private company or an unlisted public company. The company has to expand the Board i.e. the company will have to include Independent Directors on the board, Committees such as Audit Committee, Remuneration Committee, Share Holder Grievance Committee, the related party transactions of the company will have to be disclosed a length and will have to be thoroughly scrutinized, a compliance officer shall be appointed.

b. Financial Statements and Disclosures:

Firstly, the financial statements for the previous 5 financial years will have to be restated as per the requirement of Security and Exchange Board of India (herein after referred as “SEBI”)

guidelines. Secondly, financial statements will have to be reconciled/ prepared/ restated showing the accounts as per U.S GAAP and Indian GAAP as per the requirement, being optional. The historical information of the company will have to be collected from the financial analysts for the analysis purpose. Management Discussion and Analysis will also have to be modified and thoroughly scrutinized. Even details of directors such as his identity proof, number of directorships held, criminal/civil cases against the directors and FIR if any launched against the director will have to be scrutinized.

c. Capital Structure Planning and Policies:

The capital structure of the company will have to be finalized with regards to bonus, convertible shares and shares outstanding as options. There should be no open financial instruments such as share warrants and certificates. The above planning shall not include the Employee Stock Option Plan (herein after referred as “ESOP”).

d. Internal Policies of the Company:

Internal Policies such as Sexual Harassment Policy, Insider Trading Policy, and Other Employee related policies would have to be finalized and implemented.

e. Company Law and Regulatory matters:

The will have to amend its MOA and AOA as per the requirements of a public company. The same shall have to be vetted by the stock exchanges before few days of filing final registration.

2. Indian Regulatory and the Frame work:

- a. Compliance with SEBI (ICDR) Guidelines – Issue of Capital and Disclosure requirement.
- b. Compliance with Part – II of Schedule – II of the Companies Act, 1956.
- c. Compliance with Security Contract (Regulation) Act, 1956 (SCRA)
- d. Compliance with allied laws such as Indian Penal Code, Code of Criminal Procedures and Code of Civil Procedures.
- e. Following the Guidance notes issued by Institute of Chartered Accountants of India (ICAI).
 - Audit Reports / Certificates on Financial Information in Offer Document
 - Reports in Prospectus

1. Eligibility Criteria for listing for Company having Track Record – SEBI Compliance and Requirement.

All the five criteria given below shall be satisfied: (SEBI Guidelines)

- a. The Company should have distributable profits for minimum period of 3 yrs out of 5 relevant previous years#
- b. The tangible assets (Net) should be minimum of Rs. 300 lacs in each of the preceding 3 years out of which not more than 50% should be monetary assets.
- c. The Company should have Net Worth of minimum Rs. 100 lacs for preceding 3 full years.
- d. Where the company has changed the name in last year, then 50% of the revenue earned in last full 1 year shall be attributable to the new name.

- e. The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size, does not exceed five (5) times its pre-issue net worth as per the last annual audited balance sheet.

Distributable profits shall have same meaning as it is has as per section 205 of the Companies Act, 1956.

2. Eligibility Criteria when the Company does not have any Track Record – SEBI Compliances and Requirements.

Where any unlisted company does not meet any of the criteria given above in point 1, can make the IPO of Equity Shares only if it meets **BOTH** the conditions a and b, as below:

- a. The issue shall be made through a Book Building process, with at least 50% of the Net public Offering is made to Qualified Institutional Buyers (QIBs) OR the “Project” has at least 15% participation from Financial Institutions/ Schedule Banks out which the 10% comes from the appraisers, and over above this 10% should be allotted to QIBs.
- b. The minimum post – issue face value of share capital of the shall be Rs. 10 crores OR there should be a compulsory market making for the period of 2 years from the date of listing of the share, as per norms.

3. Prospectus :

The key Disclosures in the Prospectus are as follows:

- a. Particulars of the Company, Management and Project.
- b. Risk Factor and Managements perception about the same. (Risk factor shall be indicated with a font size of not less the 10)
- c. Restated Financial Statements for last 5 years.
- d. Audited Financial Statements of the Ventures, Firms Companies that are promoted by the Promoters of the Company which is being listed.
- e. Management Discussion and Analysis by the directors over the financial results. And performance of the company.
- f. Capital Structure of the Company.
- g. Basis of Issue price and the objectives of the issue.
- h. Any outstanding litigations against the company or its directors
- i. Any complaint/FIR launched against the directors.
- j. Statutorily required information in relation to utilization of the funds rose from public.
- k. Significant/ Major Contracts that are entered or are to be entered by the Company.

4. Management Discussion and Analysis:

The Management with consultation with the Merchant Bankers would need to select the basis of the presentation and write up of MD & A.

The MD & A is made to reflect the financial performance of the last 3-year and can be based on following:

- Unconsolidated financial results, audited
- Unconsolidated financial results, unaudited
- Consolidated financial results, audited

- Consolidated financial results, unaudited

These financial statements are prepared as per the Indian GAAP.

Sometimes the MD&A is also prepared with Consolidated financial Statements for last 3 years in accordance with U.S. GAAP/IFRS. While the Unconsolidated financial statements are prepared in accordance with Indian GAAP.

The company would also have to give the analysis of the reasons for the changes in significant items of the Income and Expenditure, containing following:

- Unusual, non-recurring transactions.
- Economic changes that significantly affected the profit figures.
- The known trends of the uncertainty and how it works
- Relationship between the Costs and Revenue.
- The correlation between the volume on sales and materials.
- Turnover as compared to industry
- Dependence of the company on certain suppliers.
- Competitors.

5. Promoters and Other Conditions:

1. The promoters contribution for the IPO of an unlisted public company shall on be more then extent of 20% of the post issued capital
2. Shares that are issued 1 year prior to IPO to the promoter at a price equivalent which is lower than what is offered to public shall be considered in above 20% of the holdings.
3. The promoter contribution of 20% shall be locked in for the period of 3 years from the date of allotment of shares in IPO or the commencement of commercial production of the company, whichever is later.
4. Any holdings by the promoter in excess of 20% shall be locked for the period of 1 year.

3. Qualified Institutional Placements (herein after referred as “QIPs”):

In order to make Indian markets more competitive and efficient, it has been decided to introduce an additional mode for listed companies to raise funds from domestic market in the form of “Qualified Institutions Placement” (QIP). Key features:

- a. Any domestic company whose shares are listed is eligible.
- b. Issues only QIBs as per the guidelines.
- c. No restrictions as to lock in period
- d. The restriction only to the extent of the amount which is raised through this channel.
- e. No requirement of pre – issue filing of the Offer document with SEBI.
- f. Pricing bases are similar to that of ADRs/GDRs.
- g. No specification for the period/years of which the financial statements are to be filed.

4. Role of the Auditor:

The key deliverables to be issued by the auditor are:

- a. Restated summary Financial Statements for previous 5 years immediately preceding the year in which prospectus is issued.
- b. Last audited financial statements for which audit has been conducted not prior to 6 months from the date of prospectus.

The financial statements are subjected to below given adjustments:

1. Adjustments to wrong accounting practices or errors in estimations.
2. Adjustments to the quantified or unquantified qualification by the auditors.
3. Changes in accounting policy if any.
4. Non-recurring/ extra ordinary items to be separately disclosed.

Critical issues to be dealt with:

- Restated financial statements with period not less than 12 for 5 preceding years.
- Changes in the Statutory Auditor within 5 preceding previous year.
- Whether to present Consolidated Financial Statements or Standalone Financial Statement of the Company.
- Whether to present the financial statements of the overseas subsidiary, if any, in accordance to Indian GAAP or in accordance with the local GAAP.
- Whether to present financial statements as per U.S.GAAP/IFRS in addition to Indian GAAP.
- Timelines for presentation and audit – at discretion between the company, merchant bankers and the auditors
- However, it should be noted that no projected financial information should be included in the offer document in any case.
- Disclosure of the significant account policies.
- Accounting ratios based on the restated Financial Statements such as Earning per Share, Return on Equity, Return on Capital Employed etc.
- Basis of issue price should be justified.
- Statement of tax shelter.
- Rate of dividend to equity share holders.
- Tax benefit availed and available to the company.
- Turnover shall be segmented in accordance with each and every sale line item.
- Unsecured loans from group companies, JVs and associates shall be disclosed in the Offer Document.
- Details of the other Income exceeding 20% of the PAT, its sources and its nature.
- Details of discontinued business or business line and its impact over the Profit/Loss of the Company.
- Where the proceeds of the issue are to be used for acquisition of any other business where the interest is more than 50%, then Profit/Loss of such company for 5 preceding years and

statement of assets and liabilities of that company for the of 120 days preceding the date of issue.

Auditors Responsibility before an IPO:

1. Assistance in preparing the financial statements.
2. Evaluation of internal controls and accounting system.
3. Audited Financial Statements and Significant disclosures.
4. Tax consequences of the IPO.
5. Providing Services to the management as a trusted Business Advisor.

Auditors Responsibility after an IPO:

1. Drafting report for prospectus and filing registration statement.
2. Review the MD & A.
3. Issue Comfort Letters.
4. Co-ordinate with Merchant Bankers, Lead Book Runners, Lawyers and the Management.

5. Issue of the Comfort and Consent Letters:

1. **Clause 5.3.3** of the **SEBI Guidelines** requires that the lead merchant bankers furnish a due diligence certificate as specified in Schedule III along with the draft prospectus.
2. The underwriters and certain other parties involved with the registration of securities may be held liable for false or misleading statements or omissions made in a registration statement. Generally, the underwriters would have little or no liability for statements made on the authority of an expert (e.g., independent auditors)
3. The due diligence certificate (Schedule III to the Guidelines) inter-alia include that the LMBs give comfort that the *“the disclosures made in the draft prospectus / letter of offer are true, fair and adequate to enable the investors to make a well informed decision as to the ssinvestment in the proposed issue”*
4. The due diligence review is generally is performed by the underwriters or their legal counsel and includes an examination of all material information contained in the registration statement or offering document.
5. However, because underwriters and certain other parties are not familiar with the company's accounting systems or personnel, they cannot personally conduct a "reasonable investigation" of financial and accounting data not covered by the auditors' report.
6. Instead, a usual condition of an underwriting agreement is that the independent auditors perform certain procedures and, based on those procedures, issue a letter to the underwriters (commonly referred to as the "**comfort letter**").

Sources of Comfort Letter:

No specific guidelines have been issued by the Indian GAAP.

Consent Letter:

According to Section 58 of the Companies Act, 1956, the expert should give his written consent, to the issue of the prospectus, with his statement or report included in the form and context in which it is included. The prospectus should further state that he has not withdrawn his consent as aforesaid.

Pursuant to section 60 of the Companies Act, 1956, 'No prospectus shall be issued by or on behalf of a company or in relation to an intended company unless, on or before the date of its publication, there has been delivered to the Registrar for registration a copy thereof signed by every person who is named therein (a) Any consent to the issue of the prospectus required by section 58 from any person as an expert'.

The auditor would need to consent for the inclusion of the name of the auditor, the auditors' report on the financial statements, the examination report to the restated financial statements, in the context in which it appears in the offer document proposed to be filed with the SEBI /ROC for the initial public offering and offer for sale of shares.

6. Managing the Firm Risk:

A Chartered Accountant or a firm of Chartered Accountants is always involved in the IPO process from beginning to the end. Hence, it becomes quite risky for a chartered accountant when there is any material misstatement, any undisclosed fatal fact or for that matter any crucial information which has not been disclosed by the management. In such cases in a chartered accountant falls in the loop of gross negligence and faces fatal consequences as per the ICAI Code of Conduct, Code of Criminal Procedures and Code of Civil Procedures. Hence, a chartered accountant to maintain his due diligences over such assignments should hedge the risk by following the policies as listed:

1. The public offering shall be reviewed by the independent partner of the same office and expert should be involved for all the legal matter and for drafting purposes.
2. Pre-clearance letters to the predecessor auditors should be circulated and confirmed.
3. Work program should be prepared in Compliance with the ICAI Guidance Notes on 'Audit Reports/Certificates on Financial Information in Offer Documents' and 'Reports In Company Prospectuses'.
4. Where ever possible the opinion of Expert Advisory Committee of ICAI or any firm of Chartered Accountant with a good reputation and experienced in the said field should be asked for

Sources (Internet):

1. SEBI
2. ICAI
3. SEC
4. Wikipedia
5. Companies Act, 1956.
6. ICAI CA final LAW modules
7. EAC opinions of ICAI

