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5 Warning Signs for IPOs

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Investors looking to jump aboard social-gaming darling Zynga and group-buying biggie Groupon may have been taken aback recently when these pre-IPO companies restated their financial results. Although these companies aren't the first pre-IPO companies to restate their results (and likely won't be the last), what's more important for retail investors is to size up potential IPO lemons that are likely to restate their results again in a *post*-IPO world.

Below, IPO experts offer the top five tips designed to reduce the potential of investing in restatement-repeat offenders.

And believe me, a little caution is a good thing. The number of newly minted U.S. public companies that restate their financial results within the first three years of going public account for a high percentage of all U.S. companies issuing restatements, according to a [report](#) (pdf file) released last year by University of Alabama finance professor Anup Agrawal and Kansas State University assistant finance professor Tommy Cooper.

Over a 10-year period ending in 2005, the report found that 412 companies that went public during that time restated their financial results. Of this group, 248 companies -- or 60% -- issued a restatement within three years of their IPO. A restatement, as the authors note, goes to the heart of a company's ability to issue quality financial reporting, compared to using its ability to manage earnings forecasts as a gauge for its financial reporting prowess.

So, with this in mind, how can investors assess whether a company that restated its financial results during its IPO process may suffer a similar snafu once it's public? Lise Buyer, principal of IPO advisory firm Class V Group, and Paul Bard, research director at Renaissance Capital in Greenwich, Conn., offer these top tips:

1. Beware of pre-IPO companies that cite accounting rule changes as the reason that they have a huge restatement of revenue in excess of 25%.

"When there's changes to accounting rules, it's not all black and white and often subject to interpretation. But most of the changes you see affect the income side and you shouldn't see a number of changes on the [revenue] line," says Buyer. "If you see a huge change in revenue, more than 25%, then you need to understand why."

2. Stay on the alert if a new chief financial officer is brought in after the first or second amendment to the IPO filing, S-1, is filed.

"It's not uncommon for a company to name a new CFO as they start the IPO process and get ready to file the S-1," says Buyer. "But to file a couple amendments then bring in a new CFO begs a lot of questions. For one, a new CFO will need time to understand the business."

3. A change in auditors is also a red flag.

It is extremely rare for a company to change auditors once they file their IPO documents, and auditors serve as the last gatekeepers to ensuring a company's financials are up to snuff. If a change is made, wannabe-IPO investors need to ask questions, Buyer says.

4. By the same token, a last-minute change in lead underwriters is something to be wary of, says Bard. If a lead underwriter suddenly drops off, it could reflect a difference in how the bankers want to value the company and management's view of its business, he noted.

Buyer, a former Wall Street analyst and also later hired by Google to help maneuver through the IPO

process, noted that it's important, overall, to watch for any changes in advisory firms and question some of these maneuvers.

5. A change in law firms is another possible warning sign.

Buyer notes it's easy to track any changes in law firms, since it's plastered on the cover of the S-1 filing and any amendments that companies file with the SEC. Potential investors will see two law firms listed, one for the company and one representing the underwriters. A change in either firm late in the game is a red flag, she says.

Of course, signs of mice fleeing a troubled ship are not always evident prior to the IPO.

MicroStrategy (Nasdaq: [MSTR](#)) is one example of a company that not only overstated its revenues and earnings within two years after going public in 1998, but also for the year before its public market debut, according to the SEC statement announcing its settlement with the company.

Nonetheless, Buyer says investors should take comfort in the SEC's efforts to "scrub, scrub, scrub" a private company's financials before blessing its IPO registration statement. And she notes, above all else, investors should avoid placing an uncapped "buy" order on an IPO darling's first day of trading.

In addition to Groupon and Zynga, other companies have restated their financial results while preparing for an IPO. **Reddy Ice Holdings** (NYSE: [FRZ](#)) restated its consolidated statement of operations, **salesforce.com** (NYSE: [CRM](#)) restated the way it recognized revenue for 2002 and 2003 prior to its 2004 IPO, and **Nexstar Broadcasting Group** (Nasdaq: [NXST](#)) restated its debt financing costs.

Luckily for these companies' investors, they announced restatements prior to becoming public companies. But in the case of MicroStrategy's restatement, and others like **Medicis Pharmaceutical** (NYSE: [MRX](#)) , **Dell** (Nasdaq: [DELL](#)) , and **Royal Caribbean Cruises** (NYSE: [RCL](#)) , the damage to those companies' reputation and stock price occurred after they were already public.

Company	Adjusted Closing Announcement Day	% Drop
MicroStrategy	\$867.50	62.0%
Medicis Pharmaceutical	\$15.11	13.0%
Dell	\$25.93	1.4%
Royal Caribbean Cruises	\$35.62	2.2%*

Source: Yahoo! Finance. *Due to a time difference on release of the news, the stock reacted to a greater degree the following day, falling 12.6%.

As investors can see, a restatement is a far more painful experience post-IPO, and one is wise to size up a company's financial reporting wherewithal before becoming enamored.

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