2023 IPO material weakness study

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Background

The purpose of our research was to understand the challenges related to internal controls over financial reporting companies faced at the time of their initial registration for new securities as well as through their first 10K/10Q filing.

Our scope included traditional initial public offerings (IPOs)—special-purpose acquisition company (SPAC) transactions were excluded—for companies listed on the NYSE or NASDAQ that closed between January 1, 2022 and December 31, 2022.

107 traditional IPOs closed during 2022.

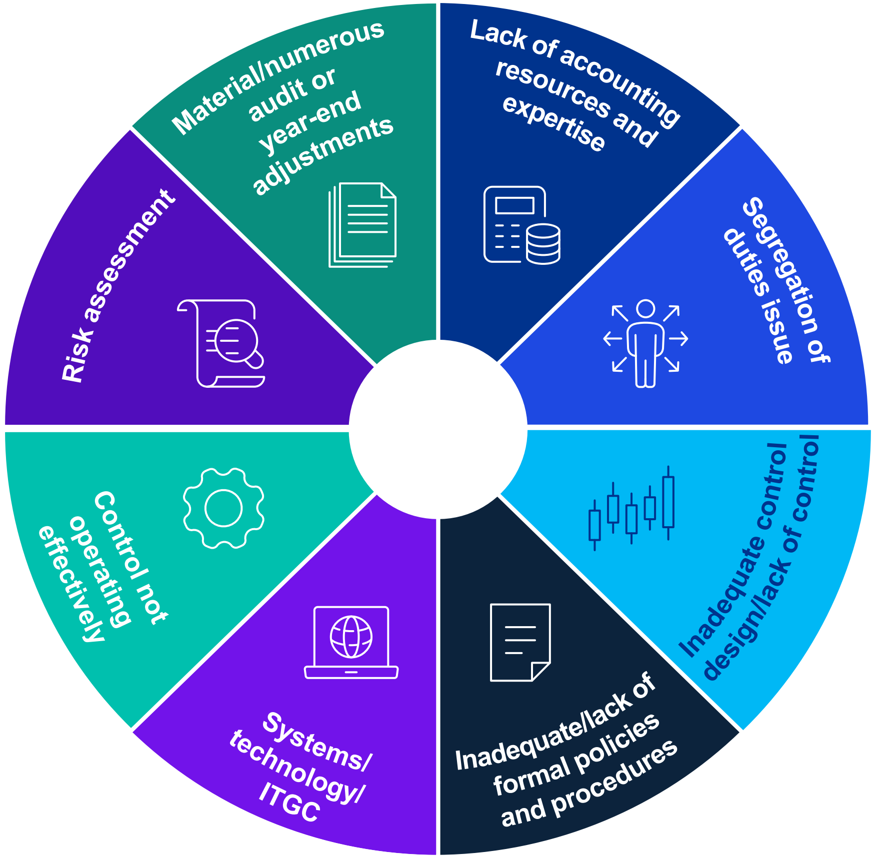
Of 107 traditional IPOs that closed in 2022:

- 62 (58%) noted material weaknesses in their initial S-1/S-1a, S-4/S-4a, or F-1/F-1a:
  - 5 of these 62 companies did not note material weaknesses (MWs) in their first 10K, indicating that they were likely able to remediate their material weaknesses prior to their first 10K.
- 69 (64%) noted MWs in 10K/10Q:
  - 12 of the 69 companies noting MWs in their subsequent 10K/10KA or 10Q/10QA or had not previously reported a material weakness in their S-1/S-1a filings, indicating new material weaknesses that were not known at the time of the S-1.
- The total disclosed MWs for the year 2022 is calculated by combining 62 MWs from S1/S-1a/S-4/S-4a/F1/F-1a and an additional 12 MWs from 10K/10Q, resulting in a total of 74 disclosed MWs.

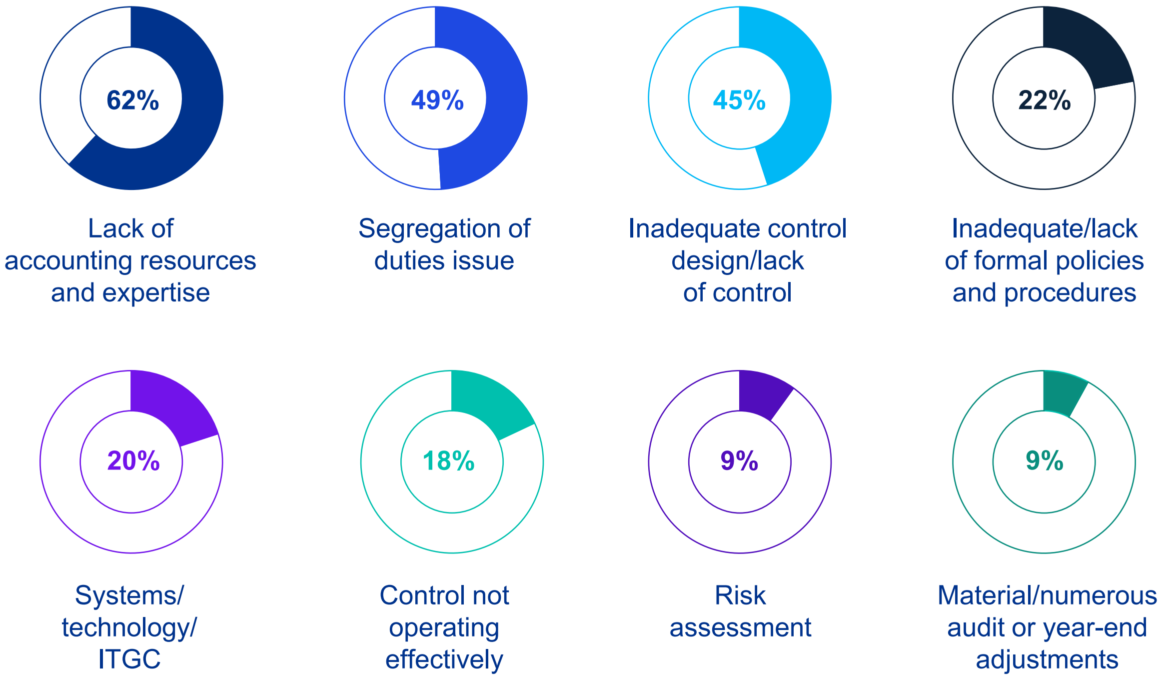
SPACS[1]: On January 24, 2024, the Securities and Exchange Commission (SEC) adopted final rules to enhance disclosures and provide additional investor protections in IPOs by SPACs and in subsequent business combination transactions between SPACs and target companies (de-SPAC transactions) effective July 1, 2024. Approximately 88% of SPACs noted material weaknesses in their 10Ks, which is largely attributed to warrant accounting related to the SEC's *Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")* dated April 12, 2021. Due to the unique nature of material weaknesses in SPACs, they were excluded from further analysis.

Source(s): (1) US SEC website (January 24, 2024)

Summary of material weaknesses reported by recent traditional IPOs

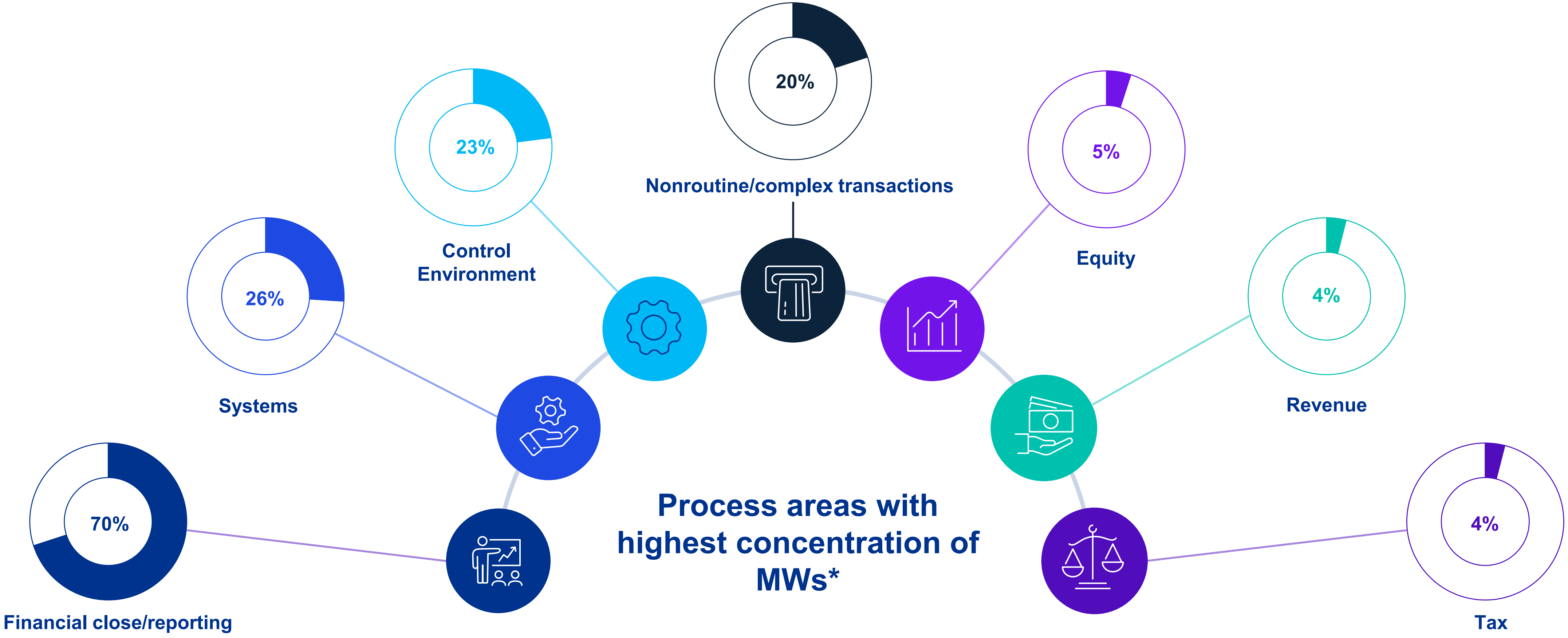


Issues contributing to material weaknesses*



*Material weaknesses reported were often the result of more than one overlapping issue/challenge.
2022 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

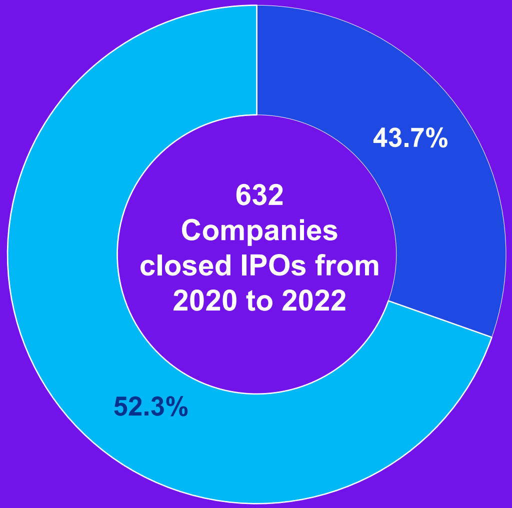
Summary of material weaknesses reported by recent traditional IPOs (continued)



* MWs reported often overlapped multiple process areas.
2022 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

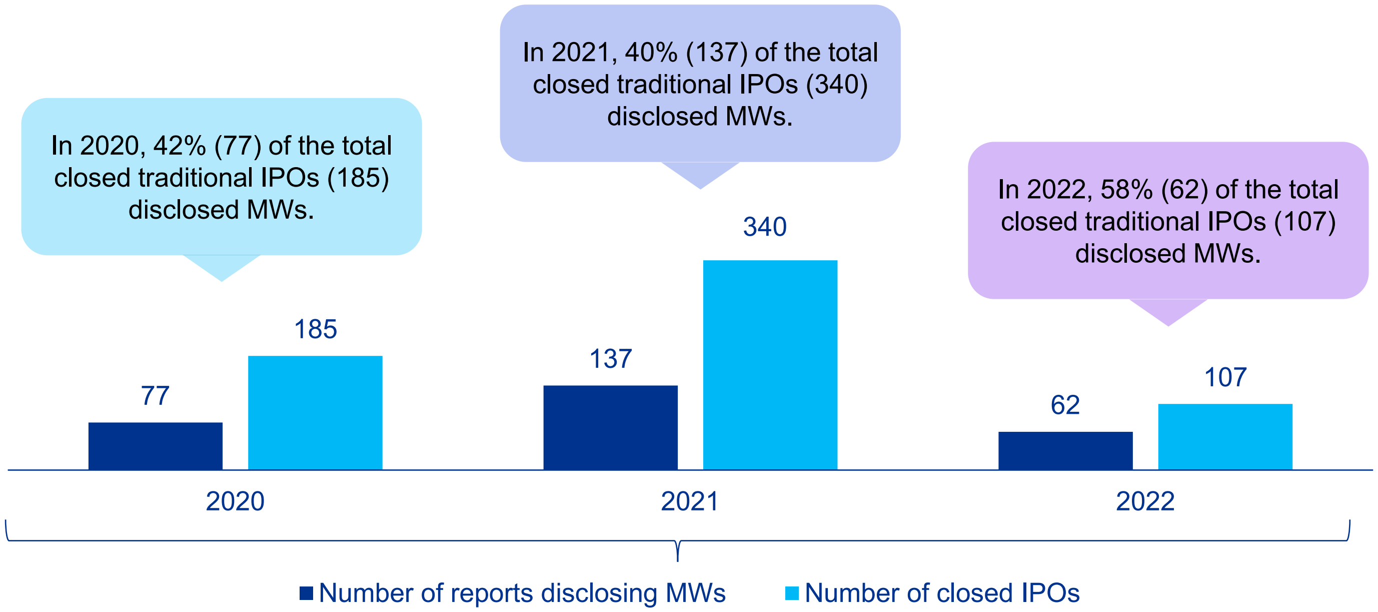
2020–2022 material weaknesses study – Background statistics

Comparison of the total number of closed IPOs (traditional) and total number/percentage of IPOs (traditional) with MWs disclosed in the initial registration statement (including amendments) for the past three years



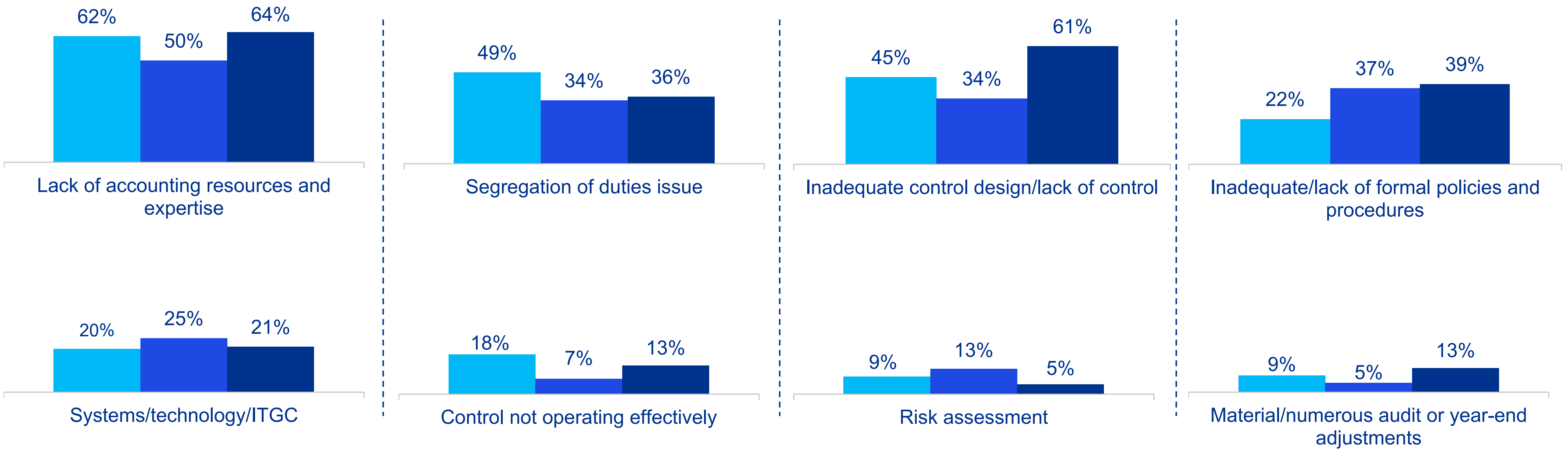
Out of 632 companies that **closed traditional IPOs from 2020 to 2022, 276 companies (43.7%) disclosed** MWs in their initial registration statement, including amendments (S-1/S-1a/F-1/F-1a/S-4/S-4a).

The percentage of MWs ranges between 40% and 58% during the years covered in the study (2020–2022)*



*Number of companies that closed IPOs and disclosed MWs their initial registration statement, including amendments (S-1/S-1a/F-1/F-1a/S-4/S-4a).

Comparison of material weaknesses reported by IPOs from 2020 to 2022 (excludes SPACs)

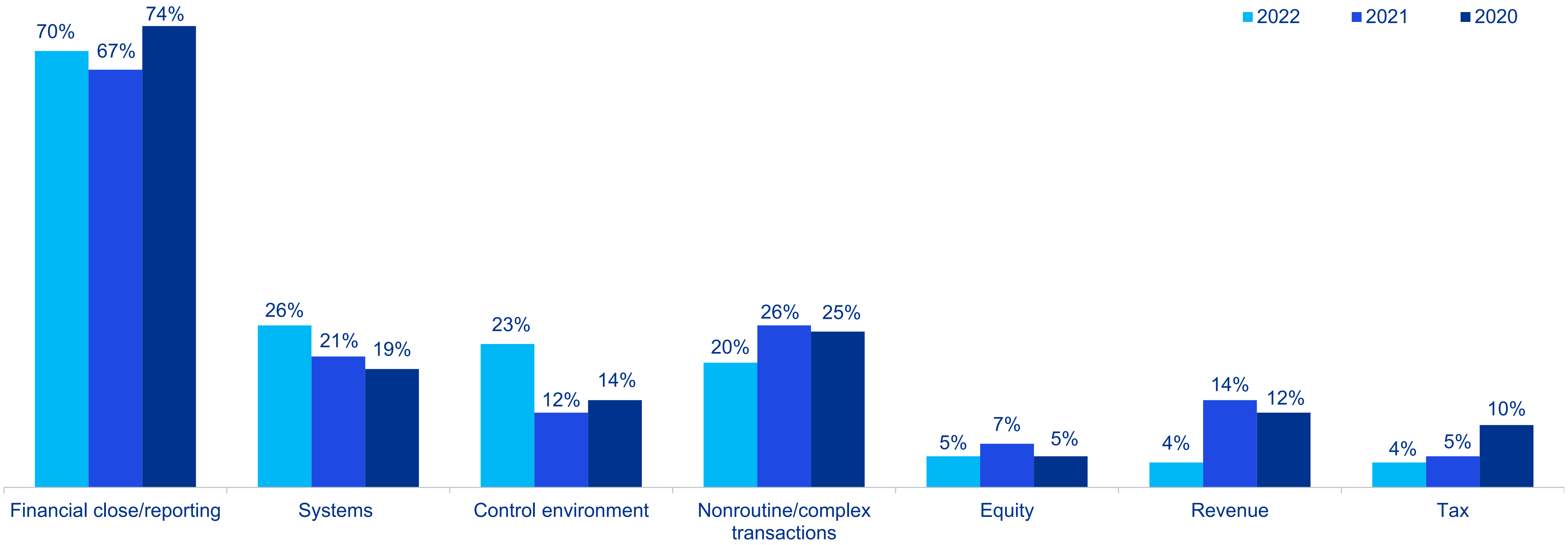


2020–2021 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a filings and 2022 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

2022 2021 2020

Lack of accounting resources and expertise, segregation of duties issue, inadequate control design/lack of control, and inadequate/lack of formal policies and procedures are consistently the top four material weaknesses over the last three years.

Comparison of process areas with the highest concentration of material weaknesses from 2020 to 2022 (excludes SPACs)



2020–2021 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a filings and 2022 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

In 2022, there was an increase in the number of MWs in the financial close/reporting, systems, and control environment processes compared to the prior year.

Examples of material weaknesses

Common themes by issue

Lack of accounting resources and expertise

"The material weaknesses identified to date relate to a lack of accounting staff and resources with appropriate knowledge of generally accepted accounting principles in the United States (US GAAP) and SEC reporting and compliance requirements."

Inadequate control design/lack of control

"We did not design and maintain effective controls over information technology, or IT, general controls for information systems that are relevant to the preparation of our financial statements. Specifically, we did not design and maintain (i) program change management controls to ensure that information technology program and data changes affecting financial…"

Systems/technology/ITGC

"We lack proper procedures developed and implemented for IT risk assessment and vulnerability management; (4) we lack proper procedures developed and implemented for access to systems and data, which include user account management and password management…"

Risk assessment

"The ineffectiveness of our internal control over financial reporting was due to the following material weaknesses which are indicative of many small companies with small number of staff: lack of risk assessment procedures on internal controls to detect financial reporting risks in a timely manner…"

Segregation of duties issue

"The material weakness that has been identified relates to user access controls to ensure appropriate segregation of duties and to adequately restrict user and privileged access to appropriate personnel…"

Inadequate/lack of formal policies and procedures

"The other material weakness that has been identified related to our lack of comprehensive accounting policies and procedures manual in accordance with US GAAP."

Control not operating effectively

"We have identified a material weakness in our internal control over financial reporting. Failure to maintain effective internal controls could cause our investors to lose confidence in us and adversely affect the market price of our common stock. If our internal controls are not effective, we may not be able to accurately report our financial results or prevent fraud."

Material/numerous audit or year-end adjustments

"These material weaknesses resulted in adjustments to selling, general, and administrative expenses; cost of revenue and vessel operating expenses; provision for income taxes; and related account balances and disclosures.

Examples of material weaknesses (continued)

Common themes by issue

Financial close/reporting

"We have identified material weaknesses in our internal control over financial reporting with respect to our periodic and annual financial close processes."

Control environment

"We did not have in place an effective internal control environment with formal processes and procedures, including journal entry processing and review, to allow for a detailed review of accounting transactions that would identify errors in a timely manner."

Equity

"The material weaknesses identified include…(iv) we did not have strong accounting consideration and analysis over equity accounts and inventory valuation."

Tax

"We failed to maintain effective controls over the period-end financial reporting process, including controls with respect to preparation and disclosure of provision for income taxes, valuation, and presentation of asset acquisition, content assets and liabilities, and investments…"

Systems

"The lack of monitoring over the completeness and accuracy of our underlying accounting records and ineffective controls over our period-end financial disclosure and reporting processes and information technology systems…"

Nonroutine/complex transactions

"We did not design and maintain effective controls related to the accounting for certain nonroutine or complex transactions, including the proper application of US GAAP to such transactions."

Revenue

"We did not maintain effective internal controls over financial reporting and the following material weaknesses existed as of June 30, 2023: revenue recognition procedures did not prevent us from recording revenue for which the earnings process was not complete…"

Inventory

"The Company lacks accounting resources and controls to prevent or detect material misstatements. Specifically, the Company continues to have a material weakness in our controls over accounting for inventory due to a lack of controls over ensuring inventory movement was being processed accurately and in a timely manner…"

Key takeaways

1

For each of the past three years, 40% to 58%* of US-based, NYSE, and NASDAQ traditional IPOs have disclosed material weaknesses in their S-1/S-1a, S-4/S-4a, or F-1/F-1a filings.

2

The root cause of most material weaknesses for traditional IPOs disclosed in S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings for 2022, is lack of resources with sufficient knowledge to analyze complex transactions for proper accounting treatment, meeting reporting requirements of US GAAP, ensuring proper segregation of duty and review procedures, or inadequate control design/lack of control.

3

Material weaknesses primarily fall in areas of accounting complexity that require the use of estimates and judgment, such as financial reporting, systems, control environment, nonroutine and complex transactions, equity, revenue, and tax. Private companies often do not have the in-house expertise and/or resources are stretched too thin to appropriately identify, analyze, and account for complex transactions.

4

Material weaknesses are typically the result of control gaps or controls and processes that have not been properly designed, rather than controls that fail to operate. Companies should perform a proper risk assessment including identification of "what could go wrongs" and ensure controls are designed at an appropriate precision level and performed by competent personnel. Additionally, companies should pay special attention to the identification of "what could go wrongs" and associated controls in nonroutine processes/transactions.

5

Companies should not overlook the technology aspect of financial reporting. Often systems used by private companies are not able to scale to the requirements of public companies. Additionally, IT general controls and application controls are not properly implemented to ensure financial information is appropriately safeguarded and accurately processed. Special consideration should be paid to controls around completeness and accuracy of key report and spreadsheets. A strong IT team and well-implemented and controlled systems are critical in ensuring internal controls over financial reporting.

6

Total traditional IPOs dropped 68.5% from the previous year. Overall, it seems that the IPO boom seen over the last year has paused.

* 2020–2022 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a filings.

Lessons learned from prior IPOs

Start early:

A key success factor for getting a pre-IPO company through Sarbanes-Oxley (SOX) compliance is starting early. While timing may vary by company size, structure, number of locations in scope, etc., it takes at least a year or more to get a company through its initial SOX compliance effort. Many pre-IPO companies do not have employees with recent SOX experience and thus tend to discount the effort related to the changing regulatory environment. The burden of leading the SOX compliance effort typically falls on Accounting and Finance along with other IPO responsibilities that include preparing the S-1 and getting the company through its financial audit.

Tone at the top:

Getting buy-in from the executive management team, including the CEO, CFO, and CIO, is essential. Communication that comes directly from upper management supporting the SOX effort and reemphasizing this message during strategic meetings/discussions throughout the course of the project helps ensure success.

Key employees:

Employees who need to provide support or who may be impacted by SOX 404 should be notified prior to kicking off the project and should receive SOX awareness training. A kick-off meeting with key executives is highly recommended. It is important to explain that SOX is an ongoing process rather than a one-time project. A successful SOX program requires that employees performing controls take ownership of their role in SOX and understand the value in the controls they perform
(i.e., not just a compliance exercise).

Dedicate resources:

Most companies underestimate the number of resources required to successfully navigate through a company's first year of compliance. If the company does not have an established Internal Audit Department (which most small pre-IPO companies do not), then resource needs should be addressed early by hiring or collaborating with outside consultants. It's also important to dedicate at least one internal resource to lead the project effort and assist with remediation.

Cost:

Although companies are aware that the initial cost of compliance is high, most companies still underestimate this cost. While it's difficult to provide exact estimates, drivers such as number and complexity of revenue streams, number of geographical locations, level of automation, etc., can be used to develop an estimate.

Risk and reward:

Companies should strive to take a risk-based approach to SOX and consider this exercise to add value and improve processes while achieving an important compliance requirement.

Lessons learned from prior IPOs (continued)

Transition from private to public:

The transition from being a privately held company to a public company can be significant. The additional hurdle of navigating SOX 404 compliance makes this process even more challenging.

New processes:

While existing processes may change, the company will also need to establish new processes as part of being a public company. The external financial reporting process is a good example of a new process that will need to be established and fine-tuned prior to going public such as implementing disclosure committees.

External auditor:

It is important to get external auditors involved early during the process to understand their expectations and to get buy-in on scope, design and implementation, timing of the project, and communication protocols. The experience of KPMG as an auditor of public companies and in working with other Big Four firms can assist in navigating your discussions with the external auditors.

Expect change:

Depending on how well the company and its finance and accounting functions are structured, the company may experience slight to significant change after the completion of its initial documentation and identification of design gaps. Processes with significant design flaws may need to change completely and could take over a year to remediate, especially if the solution requires implementation of new technology/systems. Some level of change should be expected throughout the organization.

Technology considerations:

Companies that have not adequately invested in technology and tools for financial reporting and business operations may struggle with technology and system limitations. This may require additional resources to implement new technology/systems or customize existing systems and reports. The IT effort required for SOX compliance should not be underestimated. IT plays a large role within the internal control structure and will be an integral part of SOX compliance. Additionally, to the extent possible, companies should consider implementing necessary new systems prior to the IPO. KPMG uses multidisciplinary teams that typically include Internal Audit, IT, and Tax. In addition, subject matter professionals are also incorporated as part of the project team.

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