2024 IPO material weakness study

May 2025

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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 10-K/10-Q filing.

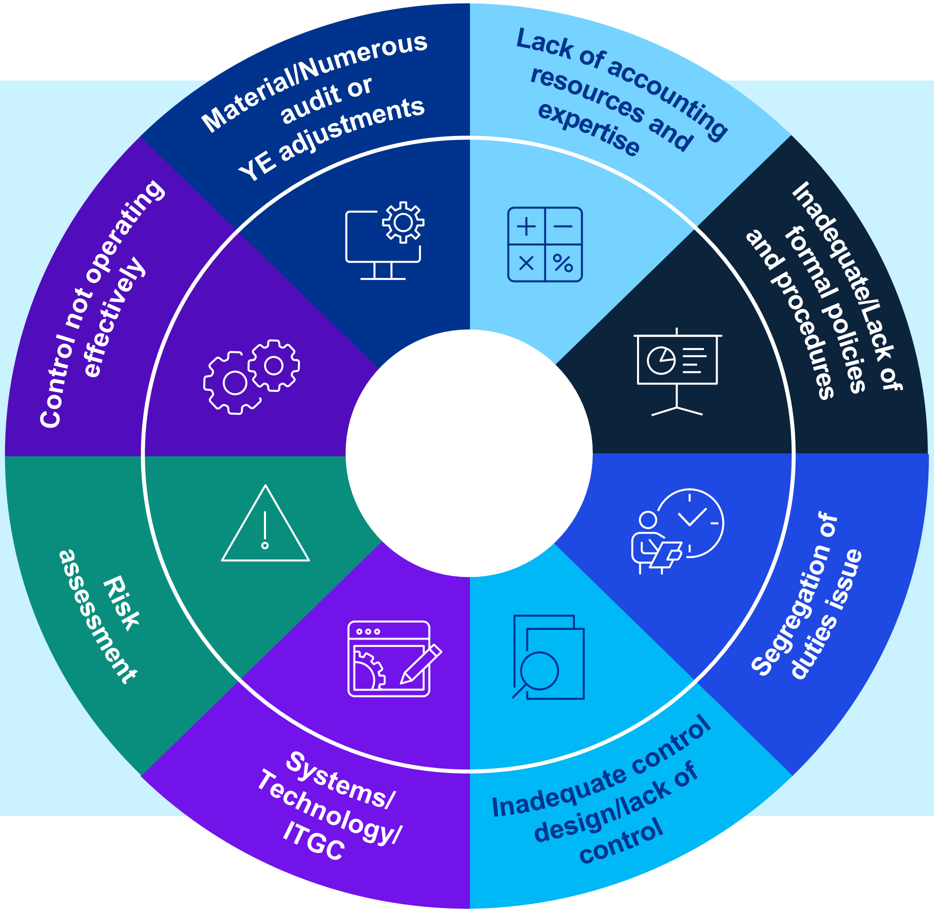
Our scope included traditional IPOs (SPAC transactions, direct listings, uplistings, etc. were excluded) for companies listed on the NYSE or NASDAQ that closed between January 1, 2023 and December 31, 2023.

One hundred twenty-two (122) traditional IPOs closed during 2023.

Of 122 traditional IPOs that closed in 2023:

- 54 (44 percent) noted material weaknesses (MWs) in their initial S-1/S-1a or S-4/S-4a or F-1/F-1a.
  - 14 of these 55 companies did not note MWs in their first 10-K, indicating that they were likely able to remediate their MWs prior to their first 10-K.
- 51 (42 percent) noted MWs in 10-K/10-Q.
  - 11 of the 51 companies noting MWs in their subsequent 10-K/10-KA, 10-Q/10-QA or had not previously reported an MW in their S-1/S-1a filings, indicating new MWs that were not known at the time of the S-1.
- The total disclosed MWs for the year 2023 is calculated by combining 54 MWs from S1/S-1a/S-4/S-4a/F-1/F-1a and an additional 11 MWs from 10-Q/10-K, resulting in a total of 65 disclosed MWs.

Summary of MWs reported by recent traditional IPOs



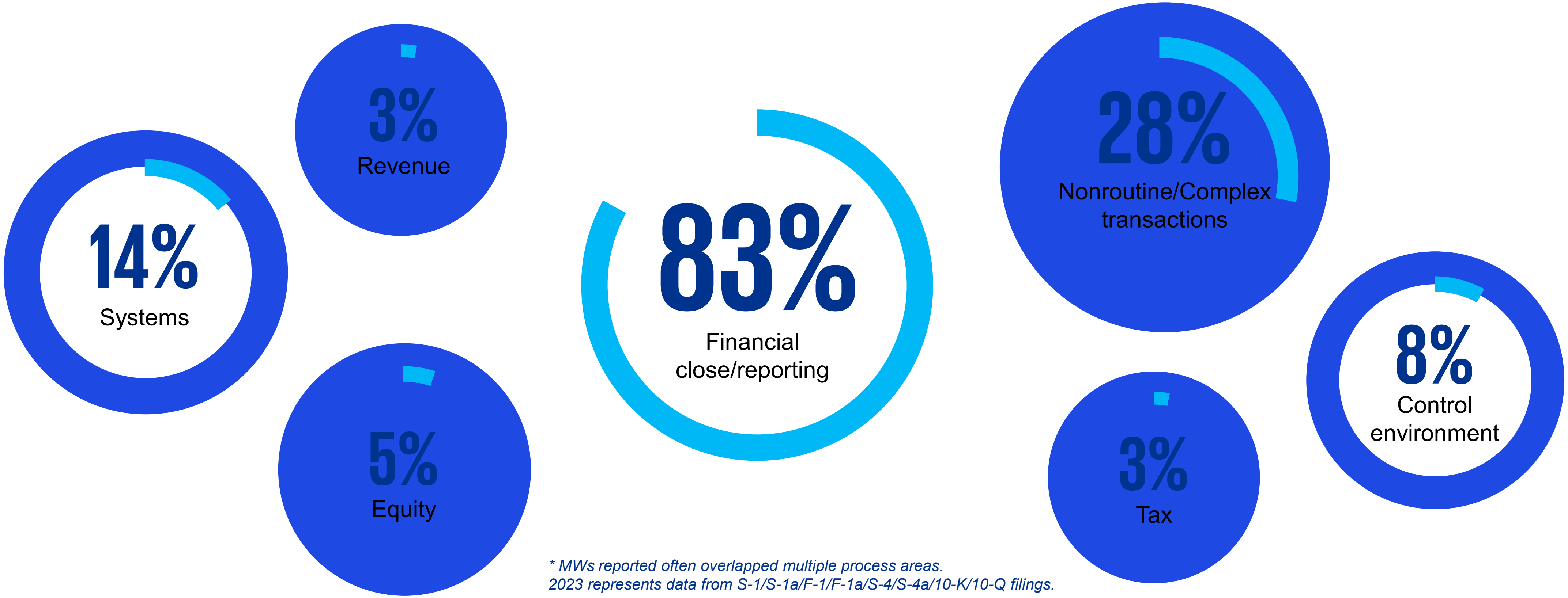
Issues contributing to MWs*

- 68% Lack of accounting resources and expertise
- 42% Inadequate control design/Lack of control
- 34% Inadequate/Lack of formal policies and procedures
- 32% Segregation of duties issue
- 20% Systems/ Technology/ ITGC
- 20% Risk assessment
- 12% Control not operating effectively
- 6% Material/Numerous audit or YE adjustments

** MWs reported were often the result of more than one overlapping issue/challenge.*
2023 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

Summary of MWs reported by recent traditional IPOs (continued)

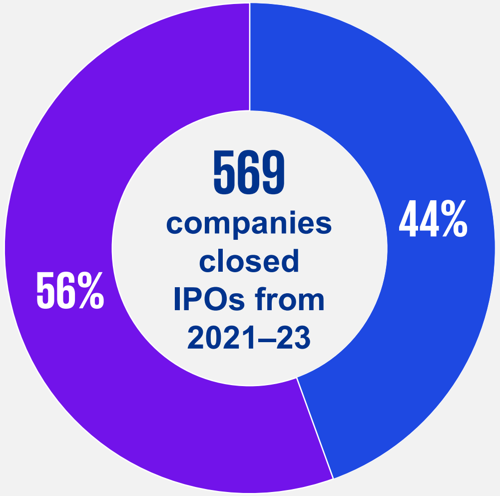
Process areas with the highest concentration of MWs*



** MWs reported often overlapped multiple process areas.*
2023 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

2021–2023 MW 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



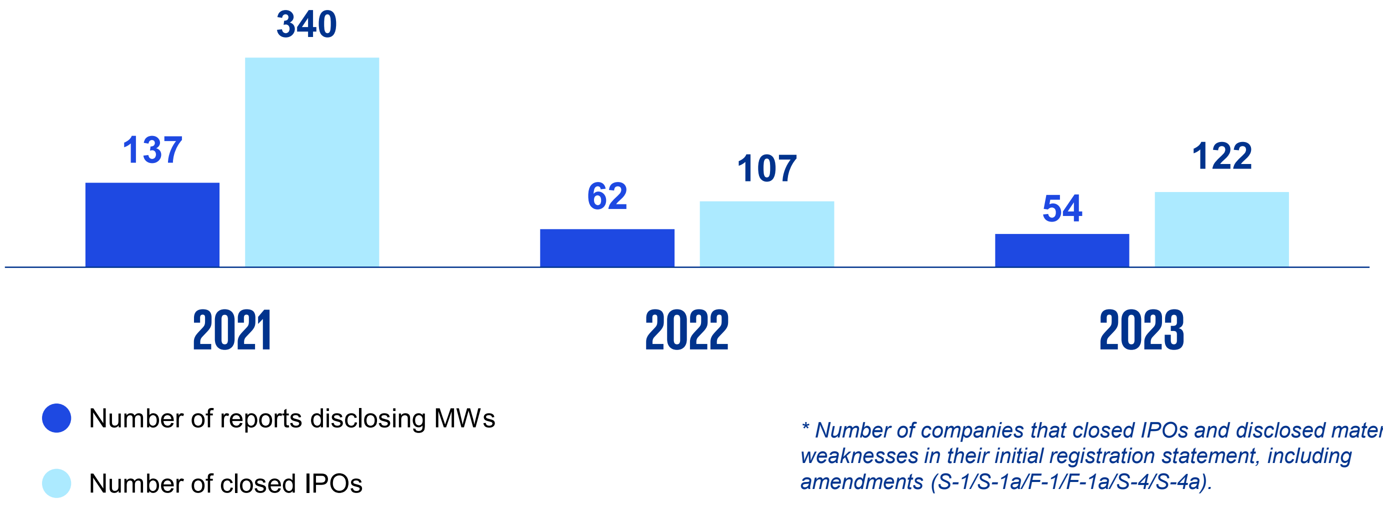
Out of 569 companies that **closed traditional IPOs from 2021–2023, 253 companies (46.4 percent) disclosed MWs** (MWs) in their initial registration statement, including amendments (S-1/S-1a/F-1/F-1a/S-4/S-4a)

The percentage of MWs ranges between 40 percent and 58 percent during the years covered in the study (2021–23)*

In 2021, 40 percent (137) of the total closed traditional IPOs (340) disclosed MWs.

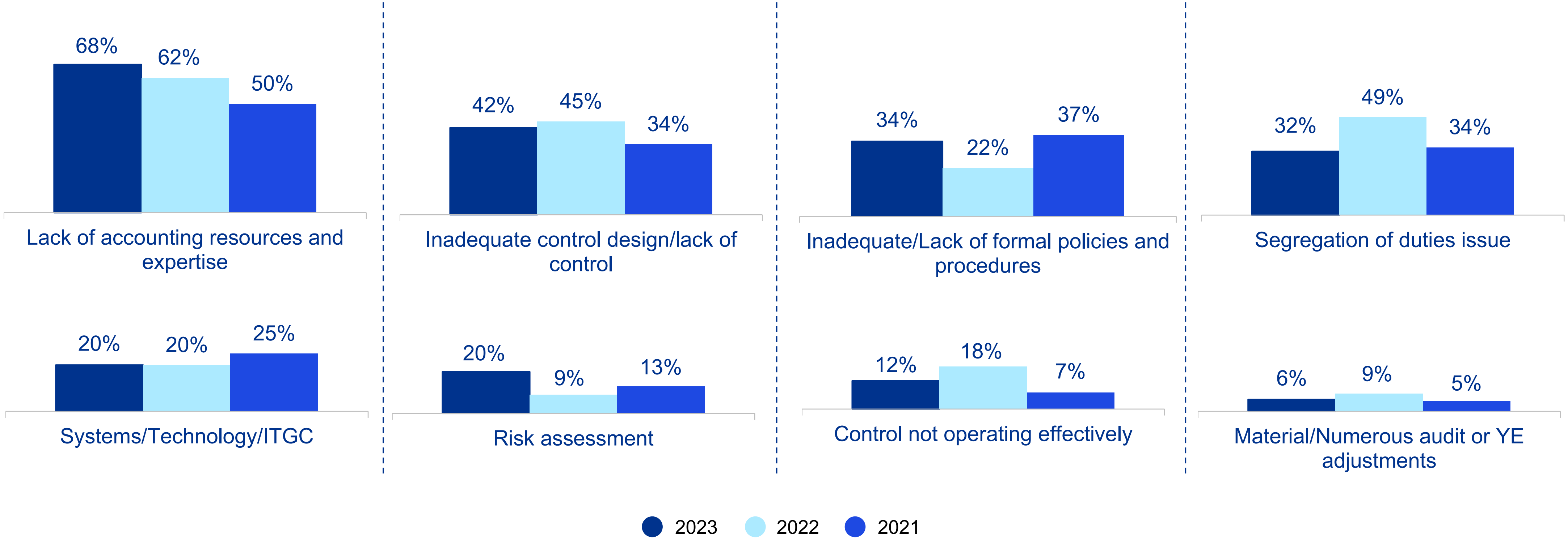
In 2022, 58 percent (62) of the total closed traditional IPOs (107) disclosed MWs.

In 2023, 44 percent (54) of the total closed traditional IPOs (122) disclosed MWs.



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

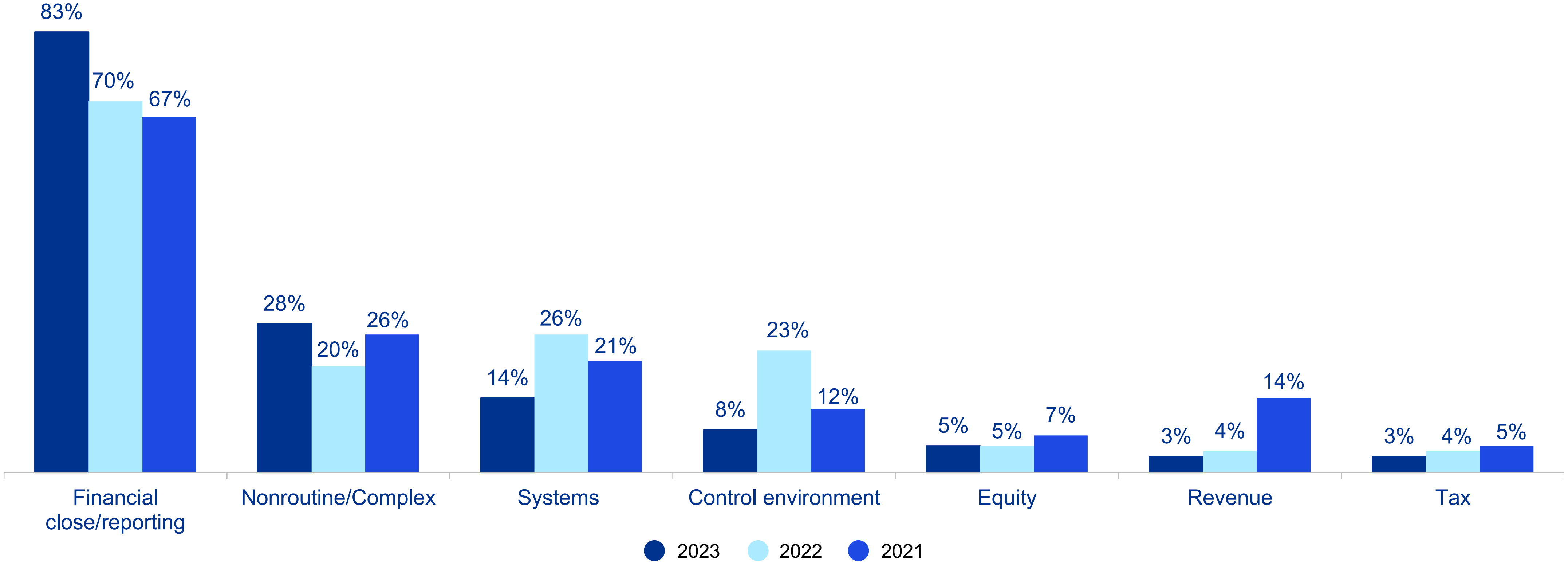
Comparison of MWs reported by IPOs from 2021 to 2023 (excludes SPACs)



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

2021 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a filings, and 2022–23 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

Comparison of process areas with highest the concentration of MWs from 2021 to 2023 (excludes SPACs)



In 2023, there was an increase in the number of MWs in the financial close/reporting process and nonroutine/complex transactions compared to the prior year.

2021 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a filings, and 2022–23 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.

Examples of material weaknesses

Common themes by issue

Lack of accounting resources and expertise

“The material weaknesses identified related to our lack of sufficient full-time personnel with appropriate levels of accounting knowledge and experience to monitor the daily recording of transactions, address complex U.S. GAAP accounting issues."

Inadequate/Lack of formal policies and procedures

“We identified the following material weaknesses in our internal control over financial reporting: lack of formal policies and procedures."

Segregation of duties issue

“We did not design and maintain an effective risk assessment process at a precise enough level to identify new and evolving risks of material misstatement in the financial statements. Additionally, we did not design and maintain effective controls over the segregation of duties related to journal entries and account reconciliations."

Inadequate control design/lack of control

“We identified two material weaknesses, related to (i) a lack of sufficient accounting and supervisory personnel with the appropriate level of technical accounting experience and training and (ii) a lack of internal controls and processes."

Systems/Technology/ITGC

“We lack proper IT policies and procedures developed for system change management, user access management, backup management and service organization management."

Risk assessment

“The material weaknesses related to a lack of risk assessment as well as formal, documented and implemented processes, controls and review procedures, specifically due to a lack of a sufficient number of professionals with an appropriate level of internal control knowledge, training and experience.”

Control not operating effectively

“Company lacks segregation of duties in several areas, and its review controls are not considered operating effectively due to historical misstatements."

Material/Numerous audit or YE adjustments

“Material weakness relates to a lack of adequate and timely review of accounts and reconciliations by management, primarily due to a large number of accounting journal entries across operating entities resulting in material audit adjustments and significant post-closing adjustments.”

Examples of material weaknesses (continued)

Common themes by issue

Financial close/reporting

"Material weaknesses that have been identified are summarized as the followings: (1) our lack of financial reporting and accounting personnel with understanding of U.S. GAAP to address complex U.S. GAAP technical issues [and] related disclosures in accordance with U.S. GAAP."

Nonroutine/Complex transactions

"We do not employ full time in-house personnel with the technical knowledge to identify and address some of the reporting issues surrounding certain complex or non-routine transactions."

Systems

"Furthermore, we lack robust accounting systems as well as sufficient resources to hire such staff and implement these accounting systems."

Control environment

"Our management identified a material weakness in our internal control over financial reporting as we had not designed or maintained an effective control environment and associated control activities to meet our accounting and reporting."

Equity

"The material weaknesses identified include the lack of controls around the issuance of shares of the Company's common stock that should have been issued and presented as outstanding [prior period]."

Revenue

"Several material weaknesses in our internal control over financial reporting were identified: ... (ii) Revenue recognition – customer contracts: In connection with our former auditor's testing of revenue, several test selections did not have documentation such as a corresponding contract or third party written documentation of the customer's order."

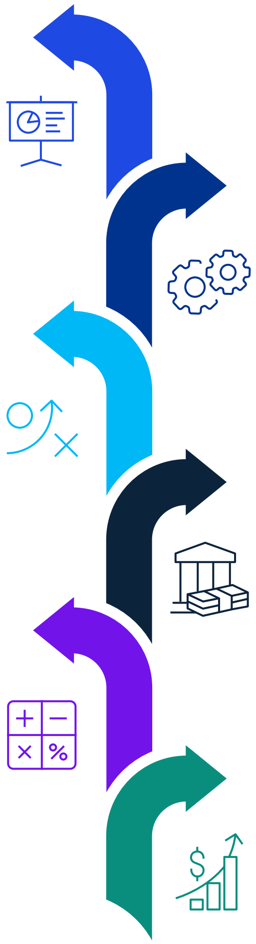
Tax

"Lack of resources to evaluate and review appropriate accounting treatment for certain complex areas, such as the treatment of deferred tax assets, unique transactions, and share based compensation."

Inventory

"Material weakness identified by management, as related to... (iii) the failure to keep an up-to-date perpetual inventory control system or timely perform company-wide inventory count at or near its fiscal year-end date. Specifically, maintaining records for inbound warehouse purchases or have specialized personnel to scan goods into the warehouse on a timely basis."

Key takeaways



1. For each of the past three years, 40 percent–58 percent* of US-based, NYSE, and NASDAQ traditional IPOs have disclosed MWs in their S-1/S-1a or S-4/S-4a or F-1/F-1a filings in 2021 and S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings in 2022–2023.

2. The root cause of most MWs for traditional IPOs disclosed in S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings for 2023 is lack of resources with sufficient knowledge to analyze complex transactions for proper accounting treatment, meeting reporting requirements of US GAAP, Inadequate control design/lack of control, or Inadequate/lack of formal policies and procedures
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3. MWs primarily fall in areas of accounting complexity that require the use of estimates and judgment, such as financial reporting, nonroutine and complex transactions, systems, control environment, equity, revenue, and tax. Private companies often do not have the in-house expertise, and/or their resources are stretched too thin to appropriately identify, analyze, and account for complex transactions.

4. MWs 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 increased 14 percent from the previous year.

** 2021 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a filings, and 2022–23 represents data from S-1/S-1a/F-1/F-1a/S-4/S-4a/10-K/10-Q filings.*

Lessons learned from prior IPOs

Start early

A key success factor for getting a pre-IPO company through 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 that need to provide support or that may be impacted by SOX 404 should be notified prior to kicking off the project and should receive SOX awareness training. A kickoff 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), 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. Our experience 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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