IPO Governance Playbook

Deciding to pursue Initial Public Offerings (IPOs) can be the biggest decision a company will make and it does not come without its fair share of obligations and risk.

The public company regulatory requirements and performance expectations are more demanding than staying private. As a result, there is a need to invest in maturing your company's foundation to be successful.

AdviseUp

Here are some common challenges your company could face while getting ready for an IPO:

- Lack of financial controls and strong processes to protect your cash.
- Immature information technology controls and processes to protect your assets from a data breach.
- Lack of documentation, policies, and procedures.
- Limited accounting resources/expertise.
- Unclear roles and responsibilities.
- Informal governance structure including the Board, management, and auditors.

Compliance Requirements

Companies that decide to enter the public market have to comply with the Sarbanes-Oxley Act of 2002 (SOX) within approximately two years of going public.

The purpose of SOX is to ensure companies report complete and accurate financial data to their stakeholders. To comply with SOX, companies must establish internal controls over financial reporting (ICFR).

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) internal controls framework is used by US companies to assess and report on the design and operating effectiveness of their ICFR.

Even though SOX is often seen as a necessary administrative burden, there is tremendous value in the regulation and its supporting COSO framework. They offer a footprint for how to build and run an effective organization that leads to greater trust with your shareholders.

Risks of Not Having Control Compliance

One of the more likely risks associated with going public is reporting a Material Weakness (MW) over your internal controls.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. PCAOB Formal Definition[1]

The number of MWs increased almost 20% from 499 in 2022, to 593 in 2023[2]. The leading causes for MWs in the 2023 SEC filings include:

- Lack of accounting resources/expertise.
- Lack of documentation, policies and procedures.
- IT, software, security, and access control issues.
- Inadequate disclosure controls.

These leading causes for MWs also happen to be the same challenges organizations face when getting ready for an IPO.

New York Community Bancorp shares tumble 26% after 'material weakness' disclosure rattles investors[3]

Don't let all the requirements and regulations scare you off. Some amazing benefits can only be gained by pursuing an IPO. And the good news is, you can prepare for your IPO process, starting today.

1. Pre-IPO Readiness

The following work should start at least 9 months in advance of the IPO.

1.1 Risk Assessment

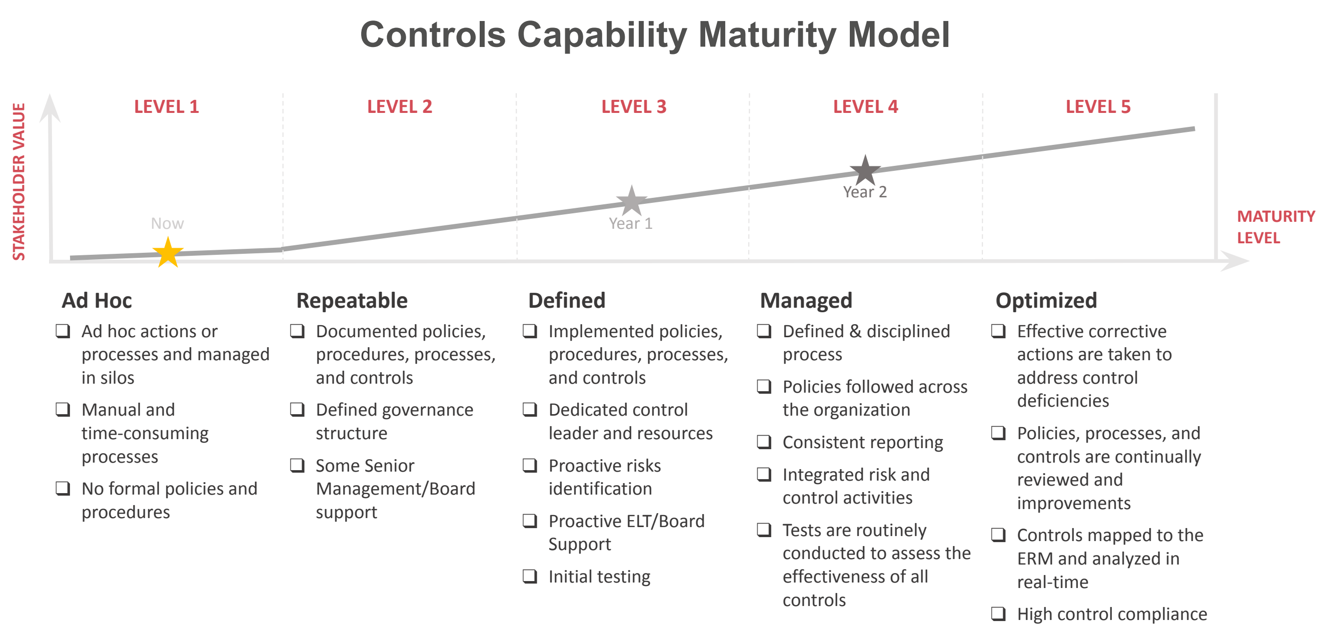
- Document the journey of your dollar from inception (when a customer is acquired) to financial reporting and tax payments.
- Identify the key processes, people, and systems involved in that journey.
- Review the documentation associated with the processes.
- Inventory the policies and procedures.
- Evaluate the Board bylaws.
- Evaluate the company's governance structure including the processes associated with training, fraud prevention, ethics and compliance, budget management, third-party oversight, and strategic goal setting.
- Charter a team of internal and external subject matter experts to help with gap anaylsis and remediations.

1.2 Gap Analysis

- Review and determine the strengths and areas of improvement associated with the artifacts gathered during the risk assessment.
- Identify the key controls (formal or informal) for the processes and systems in scope.
- Reconcile to standard controls required to comply with SOX.
- Identify strengths, gaps, root causes, and implications associated with modifying the processes associated with the gaps.
- Assign a capability maturity rating to the current state and develop a roadmap to achieve greater maturity. See Figure 1.

Note: It is not necessary to become SOX compliant before the IPO.

Figure 1: Example of a Controls Maturity Model



1.3 Remediation Planning

- Utilize the results of the gap analysis to identify remediation steps to improve the processes and controls.
- Perform an impact analysis of the remediation steps to estimate cost, resources, timelines, and associated benefits. This is necessary to determine if the remediations outweigh the cost and efforts or if alternative remediations should be identified.
- Develop an implementation roadmap and start executing remediation steps.

1.4 Reporting and Communication

- Establish a governance committee with representation from key areas including but limited to Finance, HR, Compliance, and IT.
- Schedule recurring meetings to measure progress against metrics.
- Identify key metrics to measure progress toward the designed maturity state. Report on the performance of these metrics at least every quarter. Some key metrics include:
  - % of approved critical policies.
  - % of compliance and ethics training completed on time.
  - % of designed controls by the domain (E.g., accounts payable, payroll, access controls, etc).

1.5 External Auditor Selection

Select an external auditor that fits the company's culture and growth aspirations. This is one of the most challenging tasks because the external audit firm can become a great partner, a great challenge, or another vendor who adds no value.

- Interview the partners and leading directors or managers. Ensure that their audit style is such that they audit to prove you are compliant, not otherwise.
- Check references.
- Enquire about their audit team's experience with newly-established SOX programs.

Replacing an external audit firm is time-consuming and expensive. This is why you need to make sure that you either have subject matter experts to lead the selection or engage consultants like AdviseUp who can assist you in the process.

2. Post-IPO Readiness

2.1 Remediation Execution

Year 1: Implement policies and procedures and perform initial design testing. During the testing, you will identify if the remediation plans were effective and if you need to perform additional remediations.

Year 2: Perform the controls as designed and conduct frequent implementation testing to avoid a material weakness or significant deficiency.

2.2 Financial Reporting & Control Establishment

- Quarterly, annual, and disclosure reporting.
- Internal controls over financial reports.
- Disclosure controls and procedures.

2.3 Internal Audit Formation

Establish an Internal Audit (IA) function, operating model, governance structure, and scope. It is common for IA to manage the SOX program and assist with the establishment of risk programs which are all necessary when going public.

Summary of the operating models

Model	Overview
In-house	Internal team develops and executes on all SOX, risk, and audit activities.
Co-sourced	The internal team is supported by external subject matter experts to manage the scope of work.
Outsourced	External team executes on all efforts. This team is different from your external auditors who are required to perform an independent audit of your financial data.

Reference **https://www.adviseupconsulting.com/internal-audit-outsourcing** for guidance on choosing the best resourcing model for your needs.

We recommend a co-sourcing model until you operationalize the Internal Audit and SOX programs.

On your IPO journey, make sure you have the right partner

Another key to keeping your IPO process on track and ready for its stock market debut is working with the right partner. An IPO filing is a complex undertaking, but the right partner should be able to do the heavy lifting when it comes to navigating this highly regulated environment.

Endnotes

[1] PCAOB Audit Standard No. 5; https://pcaobus.org/oversight/standards/archived-standards/pre-reorganized-auditing-standards-interpretations/details/Auditing_Standard_5_Appendix_A
[2] KPMG; 2023 Trends in Material Weaknesses; https://kpmg.com/us/en/articles/2024/trends-material-weaknesses.html
[3] Niket Nishant and Nupur Anand; NYCB shares tumble 26% after 'material weakness' disclosure rattles investors; https://www.reuters.com/business/nycb-shares-plunge-loan-review-disclosure-adds-cre-exposure-woes-2 024-03-01/

Work with the experts at AdviseUp. We will partner with you to plan for the nuances ahead as well as remain flexible in any unforeseen circumstances. Ultimately, we will steer you away from any pitfalls for a successful IPO.

Start preparing your business for the future. Request a consultation today.

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