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Assessing IPO readiness and optimizing launch timing

Given the volatility and uncertainty of the current capital markets environment, launching in a favorable IPO window can prove challenging. Scrutiny of the background of proposed board members and key management is a necessary part of the underwriters' pre-IPO due diligence process, but the issuer can take ownership of this and incorporate it earlier into their own IPO readiness process. This self-due diligence can help identify previously unknown problematic issues which can ideally be cured sooner, preventing revisions to an S-1 filing and avoiding derailment of the IPO timeline. When an issuer is unaware of the red flags that the underwriters may uncover in their diligence process, under certain circumstances, remediating these issues can be time consuming and a distraction if not handled with adequate time.

The background investigation process

As part of their due diligence process, the underwriting syndicate (typically the lead underwriter or underwriters' counsel) will task a third-party firm with conducting investigative due diligence (i.e. "background checks") on the issuer along with key officers and directors to be included in the S-1. The background investigations are a requirement for the underwriters' internal committees. Biographical information concerning the officers and directors is part of the S-1 disclosure and the listing exchanges have strict rules regarding previous bad acts. Regardless of the tasking party, the scope of research is analogous across all major investment banks, consisting of comprehensive public-records research that seeks to develop an in-depth understanding of the track record and reputation of each relevant executive or board member. This includes corroborating key biographic information to be included in the S-1, along with noting any potential disclosures required around related-party transactions, conflicts of interest or salient risk issues pertaining to past leadership roles and associations.

The findings arising out of the diligence process allow the underwriters to identify the "low-hanging fruit" that could represent potential headline risk and leave underwriters exposed to, among other things, litigation, reputational damage or regulatory inquiry. It also allows the

underwriters to fine tune items such as other risk factors, disclosures and board composition. Failure to adequately identify or disclose problematic issues can leave the door open to shareholder litigation or allow activist investors looking for governance weaknesses to gain a toehold.

Timing, consequences and best practices

Early identification of potential risk issues makes resolving them more manageable for the issuer. The investigations commissioned by the underwriters can often happen late in the IPO process, even sometimes after a draft S-1 has been filed with the SEC. As a result, any material findings can have an outsized impact given the steps necessary to remediate. At the most benign, findings related to personal issues can yield awkward conversations to clarify certain items. At the other extreme, material findings can lead to significant disclosures, amendments to already drafted documents and/or changes of executive or board composition. Almost always, the subsequent remediation steps are all manageable, if they're identified at the right point in the process.

For the issuer, there should be no surprises when the underwriters conduct their background investigations on the parties to be included in the S-1. Including the self-due diligence earlier in the IPO readiness process affords the issuer greater control of the narrative to the issuer. It allows the issuer to remediate and/or proactively address red flags with the bankers.

Types of issues typically found that can adversely impact timing

CRA's Risk, Investigations & Analytics team, comprised of former prosecutors, investigators and forensic accountants has a unique understanding of the types of red flag issues that underwriters will identify and how they will be perceived.

The following matters illustrate the types of findings CRA has identified in the past. While certain findings may be deemed more material than others, it is also the timing of the findings as they relate to the anticipated timing of the IPO launch which may make certain issues more significant than others.

Sins of omission

- A CEO claimed to have graduated with a bachelor's degree: Research with a third-party verification service uncovered that the CEO had attended the school but had not graduated. In follow-up conversations with underwriters' counsel he insisted he received the degree- even after the university provided the underlying transcript showing that the CEO needed more than a year's academic credits to graduate. The company's auditor refused to certify the company's financials, citing a lack of forthrightness by the CEO. This led to the removal of the CEO from his role, and the company's Chairman was placed in the CEO position just before the IPO launched.
- Research identified a brief directorship for an independent director nominee that was not disclosed in his biography or the Directors' and Officers' (D&O) questionnaire. A review of

the corporate filings for the entity showed that it was linked to a disqualified director in the UK described as a “serial fraudster.” The nominee was interviewed by counsel to find out how he was connected to the disqualified director and the reasons for his resignation. Further public record research demonstrated that the nominee was not entirely forthright in his explanation and was eventually removed from the board prior to the IPO.

- Research of a senior executive identified a previous employer through a FINRA filing which was not disclosed in the executive’s professional biography or his LinkedIn profile. Research into the entity found that it was an early-stage Fintech company operating out of Miami. The company only operated for approximately one year, and the executive held a senior role. Media reports stated that one of its “officers” was in fact a janitor working in the office building. Further research revealed that another officer of the entity was linked to numerous shell companies reportedly created for members of a drug cartel.

Issues related to prior leadership roles

- Diligence research on one company’s CFO noted that he had resigned from his prior firm after he was informed that his previous company had received a Wells Notice in connection with certain disclosure matters requiring a restatement of financials. Further, the notice said that the SEC was recommending a civil enforcement action against the CFO, who had also been denied his multimillion-dollar termination package when he left his prior company.
- CRA conducted extensive research into the background of a COO of a Silicon Valley tech company. The officer had served as COO and CFO at a previous publicly traded company where he was named in a cease-and-desist order issued by the SEC in connection with an alleged revenue recognition scheme. He was accused of a number of conduct violations, including the directing of fund transfers to shell companies and assisting in the creation of false purchase orders.

Personal litigation

- Investigative research on the company’s Chairman and CEO identified an arrest for “alleged fraud” according to a press release issued by a government law enforcement agency though local criminal records had been purged. The arrest appeared to be related to gambling debts with several lawsuits filed around the same time which showed that the CEO had accumulated over \$1 million in gambling debts and attempted to pass bad checks while trying to settle the debt and failed to adhere to a payment plan.
- Investigative research conducted by CRA identified background information on an independent director nominee, who was found to have complicated family matters including a claim that he had fathered a child with another woman while still married. During a paternity lawsuit over this child, various accusations were made against the director regarding his alleged use of alcohol and prescription drugs and that he had physically and mentally abused his wife.

Disclosure concerning independent directors

- A proposed independent board member of one company was identified as previously sitting on the Board of Trustees at a religious university founded by the company's CEO. CRA's investigation into the proposed board member's history found that the individual failed to note the prior relationship with the CEO through the university board seat and also had not disclosed that the company had entered into several real estate loans with entities associated with the proposed board member.

It is not uncommon for senior executives and board members to have had prior professional or personal issues. In some instances, those issues (e.g. litigation, a controversial social media post, non-disclosure of a corporate affiliation) can be explained, or at least addressed; however, the goal is to identify the issues early on in the IPO readiness process so that the issuer can control the narrative, make any necessary changes, and sail through a desirable IPO launch window.

About CRA's Risk, Investigations & Analytics Practice

The Risk, Investigations & Analytics (RIA) Practice is unique in its approach to executing large, multijurisdictional and multidisciplinary investigative, compliance and disputes assignments for clients. These complex matters often require sophisticated data analytics tools combined with unique investigative capabilities and deep subject matter expertise integrated into a single team for efficient delivery of services. By analyzing data collected from disparate sources and utilizing advanced analytics techniques, we can uncover instances and patterns of fraud and previously unknown issues or other problematic activity.

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