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Preparing for the first-time audit

Seven considerations for emerging growth companies

For an emerging growth company (EGC), an independent financial statement audit may be the farthest thing from management's mind. All eyes are on raising capital, generating revenue, and getting the business to scale.

Eventually, however, many companies will reach an inflection point when an audit is called for. Often that happens when they take on outside investment—be it a bank loan, venture capital equity, or some other private investment vehicle—and an audit is part of the terms. Other times, the inflection point happens when the company reaches "critical mass," prompting founders and their advisers to think about laying the groundwork for the next stage of development, even a potential initial public offering or other exit strategy.

Either way, an accurate and transparent first-time audit of the company's financial statements, which represents the company's official adoption of US Generally Accepted Accounting Principles (GAAP), is imperative. There are steps any company can take to help their first audit go as smoothly as possible. Among them:

1 **Secure the commitment of senior management.** As a compliance exercise, an audit might not invoke the same sense of urgency as tasks that are more closely tied to building the business. But it is important, particularly when lenders or investors are counting on it Thus, make sure the audit is high on the agenda of key stakeholders in management.

2 **Get accounting records in order.** Not every early-stage company has a full-fledged finance and/or accounting department. In fact, it is not unusual for emerging growth companies to operate on a cash basis for a period of time before hiring their first finance chief. That means it may be necessary to collect the relevant records and prepare them for the audit. It also means it is time to begin maintaining financial records in a way that eases the audit process going forward.

3 **Engage an employee or professional who understands the process.** At its most basic level, an audit examines that financial statements are prepared in accordance with GAAP and free of material misstatement. As simple as that may seem, GAAP accounting rules can be highly nuanced, requiring significant technical knowledge and judgment. They are also continually updated, so current audit preparation and reporting experience is essential. In short, before starting an audit, see to it that at least one person on staff or working on the audit knows GAAP and how it applies to the company.

4 Be mindful of potential accounting complexities. That includes several that are common among emerging growth companies. One is revenue recognition, which can be highly industry specific. Another is equity transactions, from stock-based compensation to securities such as warrants and convertible notes. Another layer of complexity often identified is accounting for software development costs. And, finally, the presentation of gross margin (revenue minus cost of sales) is unique to each company and must be thoughtfully considered in creating a financial reporting framework. Anticipating these complexities and delegating the appropriate resources for managing them are important to keeping them in check.

Common deficiencies identified during a first-time audit

A first-time audit often reveals two types of deficiencies:

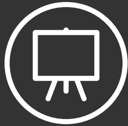
1. **Record retention.** Emerging growth companies often lack all the records needed to fully support the transactions that underlie their financial statements.
2. **Segregation of responsibilities.** In a growing company, it is not uncommon for one person to handle multiple accounting responsibilities, giving rise to a control deficiency from a financial reporting perspective.

If either of these turns up in the initial audit, boards and investors should put them in perspective. Typically, they can be ironed out as the company's internal processes evolve and the accounting function is expanded.

5 Make time to see the process through. A growing organization tends to be consumed with product development, sales, and customer support. Internal infrastructure may be important, but less of a priority. At the same time, employees can wear many hats. In finance, this might mean responsibility not only for financial reporting but diverse other areas as well (think facilities, human resources, and office IT systems). Since an audit can take a nontrivial amount of time and effort, it is especially imperative in this environment to free the bandwidth to support it from beginning to end.

6 Determine who will own the results. An audit process does not end with producing the report. Stakeholders may need guidance on the report's key findings, the areas presenting the greatest risk, and other insights of significance emerging from the findings. They also may have questions that someone intimately familiar with the business, GAAP, and the audit itself will need to address. And if the audit reveals opportunities for improvement, the company should have the ability to carry them out. For all these reasons, someone within the company should take charge of the audit's conclusions.

7 Know the indicators of an effective first audit. Three outcomes are desirable: First is a common upfront understanding of what the audit will entail, which can be achieved through a "whiteboarding," or pre-audit planning, process involving the audit team (internal) and the auditors (external). A second important outcome is meeting all deadlines and commitments as the audit process unfolds. The third outcome is a good working relationship between the audit team and auditors at the end of the process.



Whiteboarding: Measure twice, cut once

In whiteboarding, the audit team and auditor dive deep into the financial accounting practices of the company—transaction cycle by transaction cycle, area by area. Objectives of the process include:

- Gaining an understanding of how the company operates
- Identifying potential differences between the company's existing financial reporting practices and what is required under US GAAP (a great educational opportunity for the company's audit team)
- Understanding the auditor's approach, types of questions likely to be asked, and specific types of information likely to be requested as part of the audit

Bottom line: An emerging company that's approaching its first financial statement audit should not overemphasize the importance of effective planning.

Let the journey begin

An independent financial statement audit represents a significant advancement in the maturity level of an emerging growth company. At the same time, it also creates an expectation among the company's senior management, advisers, lenders, and investors that the audit process will repeat year after year. The upshot is that financial statement audits are seldom "one and done." Instead, they are a commitment that requires an ongoing investment of time, resources, and labor. By following these tips, growth companies may position themselves for a successful first audit and the ability to take on the demands of an effective ongoing audit process.

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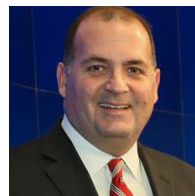

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