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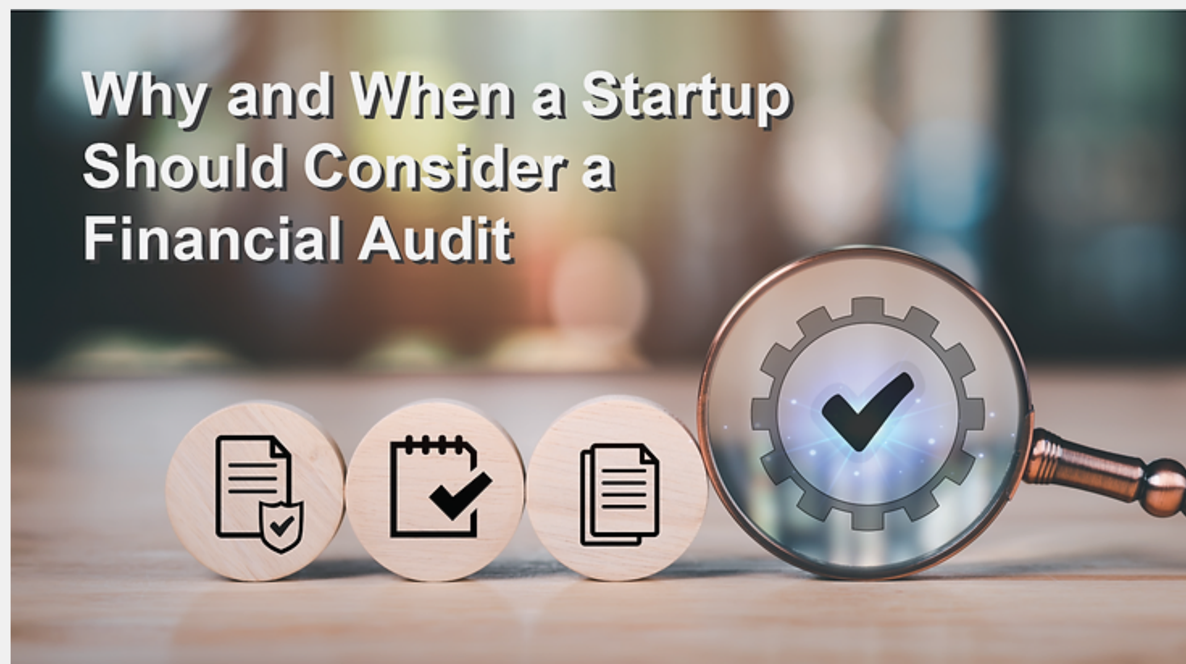
Why and When a Startup Should Consider a Financial Audit

An independent financial audit is helpful for startups, especially as they mature and expand their operations. While there isn't a hard and fast rule about when a company should conduct its first audit, certain milestones and factors can indicate the appropriate time to initiate the process. In this discussion, we'll delve into the significance of independent financial audits for private companies, the ideal stage for their implementation, the revenue thresholds that might trigger the need for an audit, and related considerations.



Importance of Independent Financial Audits
An independent financial audit entails thoroughly examining a company's financial records, transactions, and internal controls by a certified public accountant (CPA) or an independent auditing firm. The primary objective of such audits is to provide assurance to stakeholders, including investors, creditors, regulatory bodies, and sometimes potential customers, regarding the accuracy, reliability, and transparency of the company's financial statements. Why private companies should opt for a financial audit:

1. Enhancing Credibility and Transparency:
- An audit enhances the credibility of a company's financial statements by providing an unbiased assessment of its financial position and performance.
- Transparency is crucial for building trust among stakeholders. Audited financial statements demonstrate the company's commitment to openness and integrity.

2. Facilitating Access to Capital:
- For private companies seeking external financing, audited financial statements may improve their credibility and attractiveness to potential investors or lenders.

3. Identifying Internal Control Weaknesses:
- Auditors evaluate a company's internal controls to identify weaknesses or deficiencies that could increase the risk of fraud, errors, or misstatements.
- Remedying internal control weaknesses can help prevent financial losses and safeguard the company's assets.

4. Supporting Decision-Making:
- Reliable financial information is essential for informed decision-making. In the past few years, a topic of much interest has been the proper recognition of when revenue is earned—it is probably the most significant reason that companies have to restate their financial information.

When to Implement a Financial Audit
Determining when to initiate audits depends on various factors, including company size, complexity, industry, growth trajectory, and regulatory environment. While there's no universal threshold, certain milestones or triggers may indicate the appropriateness of conducting an audit:

1. Revenue Growth and Size:
- As a company grows and its revenue increases, its financial transactions and reporting complexity typically rise. Higher revenue levels may necessitate more robust financial controls and scrutiny, making it advisable to consider an independent audit. In my previous blog post on when to hire a full-time CFO, these same factors are mentioned, and hence, it is no surprise that there is a strong correlation between companies having a full-time CFO and having an annual audit.

2. Preparation for External Financing or Exit:
- Private companies planning to raise capital through equity or debt financing or contemplating an initial public offering (IPO) or merger/acquisition often undergo independent audits to prepare for due diligence by potential investors or buyers. The IPO route requires 2-3 years of audited financial statements; so need to plan well in advance of an anticipated IPO date.

3. Investor Expectations:
- Often, a new large VC investor in an A round financing will require an annual audit if the process is not already in place.
- If investors express concerns about the accuracy or reliability of financial information, conducting an independent audit can address their apprehensions and demonstrate the company's commitment to transparency and accountability.

4. Competitive Advantage:
- Companies might undertake an audit to position themselves better to win contracts. We see a growing occurrence in RFPs requiring or saying it is advantageous for bidders to have audited financial statements.

Revenue Thresholds and Other Considerations
1. Revenue Thresholds:
- Using the same data set of Blu Ventures portfolio companies noted in the previous blog post, most companies with at least $5 million in revenues have a financial audit. This decision does not come lightly, as the cost of using a regional auditing firm could be in the $40K range annually.

2. Other Considerations:
- Does the company's finance team (maybe just one) have the bandwidth to prepare the information and schedules required by the auditors?

- In startup companies with small finance teams, having the desired separation of duties that enhances financial controls is often challenging. If the finance team engages the auditors, they are auditing themselves. To provide transparency, the board often forms an audit/finance committee, or a board member will formally engage the audit firm and receive its report/finding. The finance team will be the primary interface with the auditors.

3. Growing into a Full Financial Audit
- **Start with a Compilation:**
1. **Cost-Effective Option:** Compilation engagements are typically the most cost-effective option among financial statement services. They involve assembling financial data into a structured format without providing any assurance of the accuracy or completeness of the information.
2. **Basic Financial Reporting:** Compilations are suitable for small or early-stage companies with straightforward financial transactions and minimal external reporting requirements. They enable businesses to fulfill basic financial reporting needs without incurring the expenses associated with more comprehensive services.

- **Progressing to Review:**
1. **Moderate Assurance:** Review engagements offer a higher level of assurance than compilations but are less extensive than full audits. Review procedures include analytical procedures, inquiries, and limited testing aimed at providing limited assurance that the financial statements are free from material misstatement.
2. **Interim Step:** Review engagements serve as an interim step between compilations and complete audits, allowing companies to gradually increase the level of assurance provided to stakeholders as they grow and expand their operations.

- **Transitioning to Audit:**
1. **Enhanced Assurance:** Once the company reaches a certain size, complexity, or regulatory threshold, transitioning to a full audit provides enhanced assurance to stakeholders, including investors, lenders, and regulatory authorities.
2. **Strategic Timing:** Building up to a full audit through compilation and review processes allows companies to strategically time their transition based on revenue growth, industry dynamics, regulatory requirements, and investor expectations.

Conclusion
While the literature focuses on the value of independent financial audits for enhanced financial controls, integrity, and transparency, startup companies usually need some external push to justify the expense, staff time required, and potential disruption to operations. These pushes are most likely:
- A new investor requires it
- The Company feels it would be a competitive advantage
- The Company is planning for an exit (IPO required), (M&A desirable)
- The Company is planning for a significant new financing (desirable)

Blu Ventures portfolio companies have found the sweet spot for having an audit starting at about $5 million in revenues, and most begin with a full audit as compilations and reviews do not provide the same value and are thought of as just spinning one's wheels. Make no mistake, though; the first year's audit is rough, from learning the process and receiving the auditor's comments on where financial controls may need improvement and then needing to do so.

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