

Part 12 of 32

GAAP Compliance and the Audit Relationship at the Growth Stage

The first audit process, common audit adjustments in growth companies, ASC 805 for acquisitions, ASC 718 for equity compensation, the audit committee relationship, and financial statement presentation

WHAT YOU WILL LEARN AND WHY IT MATTERS

GAAP compliance and the external audit relationship are the foundational financial governance requirements that distinguish the growth-stage company from the early-stage startup. The shift from informal accounting to GAAP-compliant, audited financial statements is more than a technical accounting transition — it is an organizational discipline upgrade that touches every aspect of the finance function and creates the financial credibility that investors, acquirers, and public market participants require.

Most growth-stage companies face their first formal audit with an accounting environment that is not fully prepared: revenue recognition practices that have never been formally assessed against ASC 606, equity compensation expense that has not been calculated using the required Black-Scholes methodology, lease obligations that have not been evaluated against ASC 842, and internal controls that have never been systematically documented. The audit process surfaces these issues, and the CFO who prepares in advance — who conducts the accounting review before the auditors arrive — converts the audit from a discovery process into a confirmation process.

This part covers the key technical accounting areas that most frequently require adjustment in the first audit of a growth-stage company, the relationship management disciplines that make the audit process efficient and productive, and the financial statement presentation standards that the institutional investor audience expects.

THE FIRST AUDIT: PREPARATION AND PROCESS

The first formal audit of a growth-stage company is a significant organizational event that requires months of preparation to execute efficiently. The CFO who treats the first audit as a normal business activity that the accounting team can manage alongside its regular responsibilities will typically find that the audit takes much longer than expected, surfaces more accounting issues than anticipated, and consumes a disproportionate amount of management time.

THE PRE-AUDIT ACCOUNTING REVIEW: Three to six months before the first audit begins, the CFO should conduct a comprehensive pre-audit accounting review — a self-assessment of the company's accounting policies and practices against GAAP requirements in every significant accounting area. The review should cover: revenue recognition (are all customer contracts accounted for in accordance with ASC 606?), equity compensation (is option expense calculated using the appropriate fair value methodology?), lease accounting (are all lease obligations recognized in accordance with ASC 842?), deferred revenue (is the deferred revenue schedule accurate and reconciled to the balance sheet?), accounts receivable (is the allowance for doubtful accounts adequately reserved?), and fixed assets (are all capital expenditures properly capitalized and depreciated?).

The pre-audit review typically surfaces three to five accounting issues that need to be corrected before or during the audit. Correcting these issues before the auditors arrive is significantly less expensive and less disruptive than correcting them during the audit process, when the audit timeline is compressed and the auditors' discovery of the issues raises questions about the quality of the company's financial

management.

AUDITOR SELECTION: The selection of the external auditor is one of the most consequential decisions a growth-stage CFO makes. The auditor must have the technical capability to audit the company's specific accounting complexities (revenue recognition for the company's business model, equity compensation, international operations if applicable) and the institutional credibility that the company's current and prospective investors require. For a company approaching a growth equity financing or a potential exit, the auditor selection should be made with the exit in mind: a company with a small regional accounting firm as its auditor will be required to change auditors as it approaches a PE sale or an IPO, adding cost and disruption at an already demanding time. Engaging a national or large regional accounting firm early — even if it is slightly more expensive than the alternatives — avoids this disruption.

KEY TECHNICAL ACCOUNTING AREAS: ASC 718 AND EQUITY COMPENSATION

Equity compensation accounting under ASC 718 is one of the most complex and most frequently mishandled accounting areas in growth-stage companies. The combination of a large option pool, rapid hiring, frequent grant activity, and multiple classes of equity creates a compensation expense calculation that requires sustained analytical rigor to maintain accurately.

THE ASC 718 EXPENSE CALCULATION: Under ASC 718, stock options must be measured at their fair value on the grant date using an option pricing model — typically the Black-Scholes model for standard employee options. The inputs required for the Black-Scholes calculation are: the fair value of the underlying stock (the common stock price established by the most recent 409A valuation), the exercise price (the strike price of the option grant, which must equal or exceed the fair market value), the expected life of the option (typically calculated using the simplified method for companies without sufficient historical exercise data), the expected volatility of the underlying stock (calculated from the volatility of comparable public companies), and the risk-free interest rate (the U.S. Treasury rate with a maturity corresponding to the expected life).

THE GRANT DATE DETERMINATION: A common accounting error in growth-stage companies is the incorrect determination of the grant date for option awards. Under ASC 718, the grant date is the date on which the employer and the employee reach a mutual understanding of the key terms of the award — typically the date the board approves the specific grant rather than the date the option agreement is signed by the employee. Companies that grant options with a delay between the board approval date and the employee communication date may have the wrong grant date in their option accounting records, resulting in an incorrect fair value measurement.

THE FORFEITURE ASSUMPTION: When options are forfeited before vesting — typically when an employee leaves the company — the associated compensation expense that was recognized while the employee was employed is reversed. The ASC 718 accounting can be handled on either an actual forfeiture basis (recognizing expense for all options and reversing when forfeitures occur) or an estimated forfeiture basis (reducing the expense recognition to reflect the expected rate of forfeiture). Most growth-stage companies use the actual forfeiture method for simplicity, but the CFO must ensure that

forfeitures are tracked accurately and that the accounting system is updated promptly when employees terminate.

ASC 805: BUSINESS COMBINATIONS

For growth-stage companies that have made acquisitions — a common strategy for growth equity-backed companies pursuing the buy-and-build thesis — the business combination accounting under ASC 805 is a significant accounting complexity that requires careful management.

THE PURCHASE PRICE ALLOCATION: When a company acquires another business, ASC 805 requires the acquirer to allocate the total purchase price to the fair value of the identifiable assets acquired and liabilities assumed. This purchase price allocation requires the acquirer to identify and value all of the acquired company's identifiable intangible assets — customer relationships, developed technology, trade names, and non-compete agreements — even if these assets were not recognized on the acquired company's balance sheet. The excess of the total purchase price over the fair value of the net identifiable assets is recognized as goodwill.

The purchase price allocation typically requires the engagement of a valuation specialist and must be completed within the measurement period (generally up to one year from the acquisition date). The CFO must manage the purchase price allocation timeline carefully: completing the allocation before the first annual audit that follows the acquisition is required for the audit to be completed on schedule.

GOODWILL IMPAIRMENT: The goodwill recognized in a business combination must be tested for impairment annually (and more frequently if there are indicators of potential impairment). For a growth-stage company that has made acquisitions at premium valuations, a deterioration in the acquired business's financial performance can trigger goodwill impairment — a non-cash charge that reduces earnings and book value without affecting cash flow but that can significantly affect investor perception of the quality of the acquisition. The CFO must monitor the financial performance of acquired businesses against the acquisition model regularly and should consult with the external auditors if there are indicators of potential impairment.

THE AUDIT COMMITTEE AND THE AUDITOR RELATIONSHIP

The audit committee of the board — typically composed of two to three independent directors with financial expertise — is the governance body responsible for overseeing the financial reporting process, the internal control environment, and the external audit relationship. The CFO's relationship with the audit committee is one of the most important governance relationships in the company, and managing it effectively requires both the technical credibility to address the committee's substantive financial questions and the communication discipline to maintain the committee's confidence through the year-round reporting cycle.

THE AUDIT COMMITTEE CALENDAR: The audit committee's governance activities follow a calendar that the CFO must actively manage: the pre-audit planning meeting (where the auditors present the audit plan and the committee approves the scope), the mid-audit status update (where any significant audit findings are disclosed to the committee before they are finalized), the final audit presentation (where the auditors present the audit results and the committee approves the financial statements), and the quarterly review meetings (where the unaudited quarterly financial statements are reviewed and the auditors' review findings are discussed).

THE MANAGEMENT REPRESENTATION LETTER: At the conclusion of each audit, management provides the auditors with a representation letter that confirms the accuracy and completeness of the information provided during the audit, the adequacy of the internal controls, and the disclosure of all significant subsequent events. The CFO signs the management representation letter, and the statements made in the letter create legal obligations — a misrepresentation in the management letter can expose the CFO to personal liability. The CFO must review the management representation letter carefully before signing and must ensure that the specific representations are accurate and supportable by evidence.

ACTIONS TO TAKE BEFORE PART THIRTEEN

Conduct the pre-audit accounting review described in this part at least six months before the first formal audit. Prioritize the review of revenue recognition (the ASC 606 assessment), equity compensation (the ASC 718 fair value calculation), and deferred revenue (the contract-level schedule) as the three areas most likely to require adjustment in a growth-stage company that has not previously been audited.

Select the external auditor using the criteria described in this part: technical capability for the company's specific accounting complexities, and institutional credibility appropriate for the company's expected financing and exit path. Engage the auditor with sufficient lead time to complete the pre-audit planning and to conduct the year-one audit on the timeline required by the investors' information rights provisions.

CLOSING PERSPECTIVE

GAAP compliance and the external audit are the financial credibility infrastructure that institutional investors, future acquirers, and public market participants require. The CFO who manages this infrastructure proactively — who prepares for the audit rather than reacting to it, who maintains technically rigorous accounting across all the complex areas, and who cultivates a productive relationship with the audit committee and the external auditors — is building the financial credibility that makes every subsequent financing, acquisition, and exit transaction more efficient and more favorable.

COMING NEXT IN THE SERIES

Part 13 — Equity Compensation at Scale: ISO, NSO, RSUs, and 409A Management

Part Thirteen covers the equity compensation framework for growth-stage companies — the tax treatment and governance requirements for ISOs, NSOs, and RSUs, 409A valuation management and the timing discipline that protects employees and the company, the equity compensation expense accounting under ASC 718, and the cap table impact of equity compensation at scale.