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Meeting the Needs of Private Equity in the Finance Organization

When there is a change in a company's ownership, significant changes are generally required in its finance organization. This is especially true when the new owner is a private equity ("PE") firm. The "heavy lifting" required up front to satisfy a PE firm's appetite for data, particularly financial data used to capture the total picture of what drives a business, is worth the effort in the long run of the company. PE firms often change the strategic direction of their investments to create value for shareholders. In such situations, a company's finance organization, as well as other functional areas, must align to support the new direction. In order to create value, companies must combine financial expertise with key operating facts to make business decisions.

Traditional Finance Role

It is not uncommon for a company's finance organization to become consumed by its monthly close process. The close is a process during which significant efforts are directed towards recording of large volumes of accounting transactions and the management of ERP systems. This is followed by preliminary and final closings of the general ledger before consolidated financial statements are prepared and the rush to complete high level analysis for senior management, owners and creditors takes place. Quarterly reporting adds further burden to this process, and at the same time, all compliance issues must be addressed. The entire process can be extremely challenging for a company due to business complexity, the continually expanding compliance environment and the speed at which financial results are expected.

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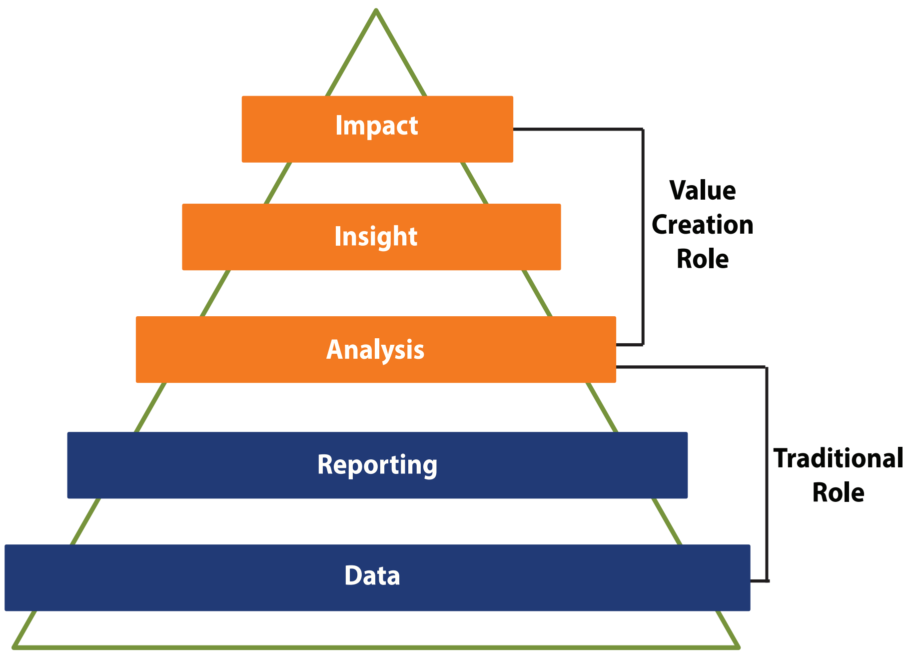
PE firms certainly recognize the importance of the monthly close process and the need for historical financial statements. However, they may also see these statements as chronological reports that do not provide enough detail to support business decisions.

The monthly close often prevents the finance organization from dedicating resources to company-wide initiatives. Furthermore, due to the high level nature of reports produced by a finance organization, they generally offer little value to business decision makers, particularly those in operations and sales. These decision makers often have their "own set of numbers" produced independently from the finance organization. Consequently, a company's finance organization can become detached from the business decision making process, and even worse, other members of management may discount the value finance can add to the organization.

The Value Creation Role

All financial organizations believe they provide value to the business. However, many finance organizations do not create additional enterprise value. In fact, only the best performing companies have finance organizations with value creation responsibilities across operational activities.

PE firms have a heightened awareness of the need to create value. Their ability to raise and invest funds is dependent upon high targeted returns in a relatively short period of time. Furthermore, their business model is no longer based solely on financial engineering and leverage; driving performance improvement has taken on an equally important role.



In order to create value, finance needs to provide insight and impact the decision making process. Creating value requires getting the right information to the right people at the right time. Knowledge and good communication provide forward looking insight, which can be achieved through improved financial reporting and performance management.

Improved Financial Reporting

In the context of improved financial reporting, the focus is on internal and operational reporting. The most obvious change is the preparation of Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") operating statements. While EBITDA statements have become common with many businesses and investors, most finance organizations still refer to them as non-GAAP financial statements, in deference to the fact that EBITDA is not a prescribed performance measure from a US GAAP compliance standpoint.

Incorporating the EBITDA concept into cost structures at a detailed level can become very challenging. Finance can create value by ensuring growth is profitable on an EBITDA basis. This requires financial reporting one or two levels below that of the consolidated financial statements. EBITDA based reports need to be prepared for Profit Centers, Cost Centers, Shared Service Centers and Overhead Centers. This requires detail reporting for every line of service, product or project and should include pricing, volumes, unit cost and margin information. Although this sounds simple, the determinations of what actually drives revenues, costs and EBITDA is often not well understood. Furthermore, traditional allocations, chargebacks and intercompany fees need critical review in the EBITDA world. In partnership with all functional areas, finance can report detailed operating results, identify trends and convert that information into valuable insight. This process will lead to gross margin improvement and the identification and management of cost reduction opportunities.

What actually drives Revenues, Costs and EBITDA is often not well understood.

Capital expenditure ("Capex") reporting is another area that can typically be improved to create value. Although PE firms are willing to invest in Capex to meet growth targets, such expenditures are highly scrutinized. Prior to an acquisition by a PE firm, many companies make Capex decisions based on operating needs and available cash. However, in the value creation process, the entire company has a responsibility to plan current and future Capex requirements. The role of finance is to assist in the preparation of costs estimates, revenue benefits, impact on operating costs and resulting internal rates of return, as well as assessing actual versus expected benefits.

Performance Management

Perhaps the biggest challenge in the value creation process is for the finance organization to partner with operations to develop and implement performance metrics. Performance metrics are dynamic facts from operations and sales that have an economic impact and are derived from customer, vendor or employee activity. Performance metrics tie company-wide activities and performance into a common set of measures. With performance metrics in place, the company can measure its activities and performance against specific and manageable goals.

Perhaps the biggest challenge to the finance organization is to partner with operations to develop and implement performance metrics.

Performance metrics need to be focused and credible. The most valuable metrics are aligned throughout the organization and all stakeholders can understand how their role impacts performance. In order to achieve this, a company must establish a common base of data and processes that combines both financial and non-financial information and provides clear and consistent insights. This often requires realigning people, functions and processes from their traditional roles.

The "Heavy Lifting"

Due to the PE firm's investment horizon, transforming the finance organization from the traditional role to the value creation role needs to take place quickly. PE firms often express frustration with the time it takes a portfolio company to generate requested data. However, many portfolio companies, being consumed by the monthly close process, find it difficult to allocate resources to accommodate the new reporting requirements of the PE firm. Furthermore, the finance organization may not fully grasp how critical the new reporting requirements are to the company's operating strategy.

In most cases, it is highly desirable to develop, implement and integrate the expanded reporting and performance management requirements into the existing organization and systems. Increasingly, PE firms are calling on outside advisors to perform the "heavy lifting" to meet this task. Following the "heavy lifting," the new reporting requirements should be a seamless addition to the company's monthly close process. Companies should strive to initiate and complete the "heavy lifting" process as quickly as possible after the change in ownership.

Mandate From Owners And Management Team

A mandate to transform financial reporting can be an easy sell to the finance organization immediately after the change in ownership. However, due to the importance and impact on all functional areas, a clear mandate must be made by both the new owners and senior management. An initial briefing on the mandate, followed by training sessions and effective organizing and planning, can greatly benefit the development and implementation of this transformation. Also, introducing the finance organization as a business partner to all other functional areas can have a significant impact.

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As part of the mandate, it is important to meet with the business leaders to define their critical information needs. The business leaders must play a major role in defining the objectives of financial reporting and performance management that help create value. It is also an important time to identify other key stakeholders in the transformation process, including knowledge workers and IT.

Improving Finance Efficiencies

It is generally not desirable to add finance staff to meet new reporting requirements. With the change in ownership and new reporting mandate, reviews of the finance organization and its processes should be conducted. It is reasonable to expect that with appropriate process reviews and revisions, efficiencies can be found to expand capacity and free finance resources.

During this process, it is also common to identify and eliminate legacy reports that no longer add value and redundant activities. A good example of this is sales reporting performed by both the sales and finance organizations. The rationalization of reporting and processes should take place, and any unnecessary or low value activities should be eliminated. This process will free up numerous resources and allow for a critical review of existing data and reporting.

Finally, this is an appropriate time to review the effectiveness of reporting systems, use of spreadsheets and the various finance functions. There may be further opportunities for automated processes, streamlined procedures or outsourced activities.

Revise Financial Reporting

As discussed earlier, EBITDA statements have become the new normal for internal reporting. However, merely revising statements on a prospective basis is not sufficient. PE firms need to understand trends and performance against plan. Accordingly, prior months EBITDA results need to be constructed for both the current and prior fiscal years and a current EBITDA budget must be created. Working capital and cash management reporting will take on a higher level of importance in a value creation focused entity. As most PE acquisitions are funded in part by debt, monthly debt covenant compliance reporting will also be required. Additionally, monthly Capex reporting will become the new normal due to the high level of scrutiny.

The monthly reporting package will be the first taste of the PE firm’s insatiable appetite for information in the mission to create value. It also becomes the first document that expands monthly reporting well beyond historical financial reporting and the traditional monthly close process. Much of the information that will eventually be required for the monthly reporting package may not be readily available upon the change in control. Consequently, it is important to commence reporting with well documented information and expand the reporting requirements as processes are realigned and the necessary data and information becomes reliable.

The monthly reporting package is the first document that is used to provide the insights necessary to support the value creation process. Important consideration should be paid to key issues, target exceptions, trends and other forward looking items.

When developing the monthly reporting package, one must identify and include information critical to business leaders in the value creation process. This information will originate in operations, sales, HR and other functional areas of the company. Even sensitive information, such as customer or quality issues, should be included due to their associated risk and cost exposure.

Initiate Fact Based Performance Reporting

"If you can't measure it, you can't improve on it" is a well-accepted business principle. To successfully meet company-wide strategies and create value, it is important to develop fact based measurements that include economic impacts. It is critical that the entire company focuses on a common set of measurements and targets. These measurements are often referred to as Key Performance Indicators (KPIs). It can be difficult to identify what a company's KPIs should be and then find and assimilate the related data. Prior to the change of ownership, business leaders often rely on their experience and knowledge of the company and the industry to make business decisions. With a change in strategic direction, key facts, not intuition, need to be communicated to owners to support business decisions.

Key operating facts exist throughout a company and all lead to an impact on the financial statements. Key operating facts in sales and marketing activity can include pricing, sales pipeline facts, closure rates and lead times. Key operating facts in operations can include costs, production or delivery facts, quality issues and scheduling. Employee headcounts and classifications exist in both the functional areas and in HR. It is a very common that key operating facts are not available to the finance organization and that data inconsistencies exist between functional areas of the company. In addition to key operating facts, available data has expanded significantly and exists in many formats. The massive amount of available data has become known as "Big Data." Big Data can be financial or non-financial, internal or external, and it can also come from customers, vendors, operations, sales, employees or advisors. A company can develop a competitive advantage if it carefully selects key data. The data must be timely, relevant and reliable. It also must be comparable and provide the sought after insight. With such a plentiful supply of Big Data, its use needs to be well managed and not abused. There should be single data sets within a company and the most reliable and timely sources identified. Careful consideration needs to be paid to collecting, migrating, cleansing, transforming, and integrating Big Data into a company's performance metrics. This process invariably leads to the realignment of company employees, processes and systems.

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> Effective performance metrics find their way into the planning and budgeting process.

Effective performance metrics find their way into the planning and budgeting process. Because they are fact based and have an economic impact, performance metrics easily fit into strategic plans, budgets, goals and incentive plans. They also become the principle metrics used in daily, weekly and monthly dashboards prepared for business leaders. All of these tools lead to better insights and decisions that ultimately add value to the enterprise.

Transformation Process

To meet new reporting requirements, companies often make the mistake of investing in an Information Technology ("IT") solution too soon. IT solutions have an important role in the value creation process, but the decision to select and implement a system should be made after the requirements to support the company's new strategy are determined. The first step in transforming the financial reporting and performance management processes is to identify the data and information required to provide insight and impact decision making. It is critical to survey the business leaders and prepare an inventory of the data, data sources, systems, processes and reporting required, as better use of IT systems, particularly Enterprise Resource Planning ("ERP") and Customer Relationship Management ("CRM"), can dramatically improve the company's performance.

> Often times, to meet new reporting requirements, companies make the mistake of investing in an IT solution too soon.

The company should take a balanced approach to transformation, looking at both information needs and business processes. There is no shame in using spreadsheets to manually transform financial information and performance management data, to allow for quick delivery of key operating facts with reliability and integrity. In fact, after two to three months of working to realign the company, business leaders may be in a better position to evaluate the requirements necessary to support the valuation process.

Once data and data sources are known, IT solutions can be considered to automate the process. Additionally, a company may reconfigure or add modules to existing systems. The company may also consider the use of Business Intelligence ("BI") tools, which can be highly effective. Some of the most common BI tools are Oracle, Hyperion, SAP Business Planning and Consolidation, Host Analytics and Adaptive Planning.

Through the initial "heavy lifting" process, particularly efforts provided by financial executives with significant operational experience, PE firms can quickly and effectively commence the value creation process. The finance organization's new partnership with operations will result in a strong bond between financial and operational metrics, provide greater insight for the business decision making and will ultimately lead to greater value creation.

To learn more about improving the value creation process to meet the unique financial reporting requirements of private equity-owned portfolio companies, contact your local SolomonEdwards office.

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