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INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
FALL 2021

PE Reporting Requirements: Burden or Benefit?

Extra work for a CFO but increased knowledge can improve decision making.

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Many expected changes are top-of-mind when a founder or family-owned business is considering a partial sale to a sophisticated financial investor such as a private equity firm or family office. Sellers are typically concerned with major impacts such as losing their decision-making authority, disrupting employee or customer relationships, or saddling the business with too much debt.

One often-overlooked change is the increased breadth, depth, and frequency of financial and operating reporting. Owners of closely-held businesses often require limited financing reporting, partially because they don't make decisions based on reports and partially because they feel they are close to all the business decisions and don't need reports to tell them what they already know. Private equity-owned companies, on the other hand, typically produce a broad range of recurring financial and operational reports. This can be a difficult change for a company's owner and finance staff.

Implementation of stringent reporting requirements is a time-consuming effort and requires ongoing attention from the Chief Financial Officer (CFO) and his or her team on a monthly and even weekly basis. It can be easy to view these extra reports as useless, cumbersome, and even annoying at first. However, many of our clients who have remained invested in their businesses alongside private equity firms have eventually come around to see the value in this extra reporting.

REPORTING IN A PRIVATE EQUITY ENVIRONMENT

Given how involved they are in the day-to-day management of the business, owners of closely-held businesses often view financial reporting as extraneous. Reports may consist only of monthly or quarterly income statements and balance sheets supplemented by year-end financial reports compiled or reviewed by a Certified Public Accountant. Several sizeable businesses we know have limited their financial reports to annual tax returns.

The characteristics of private equity ownership require a much different approach to financial reporting. As we discussed in our Summer 2016 article "Professionalizing the Family Business", private equity owners have a desire to institutionalize management systems so they are repeatable, data-driven, and not reliant upon a single person. Because they are removed from everyday management, private equity firms rely on institutionalized financial reports and key performance indicators (KPIs) to understand how the business is performing.

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Private equity firms are also working against the clock to maximize financial returns. Detailed, timely reports allow them to make quick decisions and remain proactive with any necessary changes to business strategy or management in order to achieve key initiatives. To the extent that debt is involved in the new capital structure, lenders will have their own reporting requirements and will rely on the supplemental reporting that the private equity owners receive.

The exhibit BELOW illustrates the dramatic difference in what a private equity owner of the business might expect relative to the Company's historical processes.

BENEFITS OF ENHANCED REPORTING

Extra reporting requirements are not enacted simply to make the CFO's job more difficult. Rather, investors are looking for root causes and drivers of business performance with the philosophy that "you cannot make successful changes unless you understand what is actually happening."

Many businesses do not operate as efficiently as possible, and business models are often based on rules of thumb developed over a long period of time. As conditions change, the model does not necessarily adjust. Understanding the business at a more granular level allows ownership and management to make better-informed and more timely decisions which drive improved outcomes for the entire organization.

There are numerous examples of when performance improved after measurements were put in place, and the affected employees could see the impact of their daily actions. In one recent project, a business began tracking a new

Exhibit: Sample Reporting Requirements Before and After a Transaction

Before (Closely-Held)	After (Private Equity Owned)
▪ Annual financial statement, compiled or reviewed by CPA ▪ Monthly or quarterly Income Statement and Balance Sheet ▪ Annual shareholder meeting to discuss how the business performed over the past year	▪ Annual financial statement, audited by a CPA ▪ Monthly financial statement with Income Statement, Balance Sheet, and Cash Flow Statement, with comparison of each statement to the budget for such month, year-to-date, and trailing twelve-month (TTM) period ▪ Monthly financial and operating metric reports measuring critical KPIs ▪ Monthly or quarterly covenant reporting to lenders and investors ▪ Weekly 13-week cash projection ▪ Monthly budget for the current and upcoming fiscal year, with different budgets for internal and lender purposes ▪ Updated budget on a monthly basis to reflect current expectations ▪ Rolling long-term (~5 years) forecast of financial performance and cash flows ▪ Quarterly Board Reports including financial, operational, and strategic updates ▪ Participation in annual meetings(s) of private equity firm ▪ Recurring weekly or monthly strategy/management meetings with investors ▪ Annual third-party valuations to update the estimated market value of the investment

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KPI which measured the rate of automation in its processes relative to the industry average. The company quickly concluded that it was automating at about half the rate of its typical competitor. By establishing an organization-wide focus on automation, the company was gradually able to reduce the manual labor associated with each client account, thereby allowing the company to take on new accounts without increasing headcount. This new operating leverage allowed each employee to serve a wider client base, with no negative impact on the level of service the existing clients received.

Another former client was "forced" to implement a system to measure profitability by customer and product. Management found that there were marginal or even negative contributing products that were the creators of capacity constraints that were leading to a capital infusion to fund capacity expansion. Management was able to transition away from unprofitable products and fill the resulting capacity with more profitable business without adding additional physical capacity.

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WHY WAIT?

There is no reason a closely-held business can't implement more insightful and impactful reporting and gain the associated benefits in advance of a transaction. By understanding how an institutional investor will look at their businesses, managers can implement changes and best practices that improve both the near-term and long-term prospects of their businesses regardless of whether a new partner is in the mix.

Developing a history of institutional-level reporting has the added benefit of making the business better prepared for new ownership during a sale process and giving prospective buyers added confidence in the management team and the business's underlying economics. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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