

GOVERNANCE AND PRIVATE EQUITY: Best Practices for Attracting Capital and Avoiding Litigation



By: Harry Cendrowski, CPA, CFE, CVA, CFD, Briehe Guevara, CFD of CCA, and co-authored with Dr. David J. Brophy, MBA, Ph.D., Director of the Center for Venture Capital and Private Equity Finance at the University of Michigan Business School

To be Published in *Journal of Private Equity*

Overview

Private equity firms, including venture capital, buy-out, and mezzanine, must reevaluate their model of governance as it extends in two directions: 1.) from private equity firm to the portfolio companies, and 2.) from private equity firm to the limited partners. The ability to attract capital and to successfully steer portfolio companies where that capital is placed - without overly exposing the private equity firm to stakeholder-related litigation - depend on updating corporate governance practices.

New private company rules and regulations (see below, "*Private and Public Regulations Align*") are putting general partners on the hook to increase disclosures to investors, eliminate conflicts of interest in deals, and formalize overhaul efforts to their governance. This regulation and a coinciding increase in investor demands are changing the power balance in general partner-limited partner relationships.

Consider the critical process of attracting capital. This ability is influenced in large part by broad economic conditions. For instance, downturn economies spur investors to reduce the overall supply of available investment funds; stronger economies, of course, open the wallets back up. The implications of this point, historically, have shifted terms and conditions advantage from general partner to limited partner in the downturns, and from limited partner to general partner as the economy strengthens. Such shifts in advantage should become less eccentric because of new and impending regulations affecting private companies. These regulations fix a great deal of advantage with the limited partners, namely, a greater ease with which to sue and penalize general partners if they do not uphold their fiduciary responsibilities (see below, "*Pereira v. Cogan*").

Such are the compliance aspects of governance reform: companies will first consider it to avoid being litigated and fined

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

out of business. However, with more and more firms competing for the same pool of investment dollars, sound governance will not only protect general partners from legal liabilities, but can also serve as a distinct advantage when running the portfolio companies.

For private equity firms, steering a portfolio company often involves taking board seats and imposing strong-arm tactics over how that company operates. This method is obsolete. All boards, whether private or public, are now responsible for ensuring that company financial reports are accurate, and that management has a basis for claiming operations will produce consistent results into the future. This means the board must have mechanisms in place to control the process of financial reporting, safeguard assets, and reduce opportunities for fraud. Mechanisms that meet these objectives will provide greater operational insight to senior management and the board, prepare the company for acquisition by a public company (or for going public itself), and ensure that major initiatives are not forced at the expense of quality and accurate financial reporting.

Governance, defined as the process by which persons exercise authority and administer business, has been covered by the press in stories that too often draw parallels to "the Enron disaster" and the Sarbanes-Oxley legislation. Such references can be difficult to relate to in the private company world at first blush. However, private equity firms can use tenets of sound corporate governance to aid in attracting capital and to reduce the risk of litigation for business failures attributable (even loosely) to board-level missteps.

Governance - By the Numbers

Sound corporate governance creates value because it leads to higher levels of information integrity. And as information integrity increases so does the certainty that company reports are accurate, and that operations will produce consistent results into the future. This makes the investments of a general partner more desirable to potential limited partners, attracting capital and even commanding premiums - or better investment terms - for the general partners. For example, according to McKinsey & Company, "...investors will pay as much as 28% more for the shares of well-governed compa-

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

nies..."². And other research confirms "that better corporate governance is highly correlated with better operating performance and market valuation"¹. Similar conclusions have been drawn from research conducted by The World Bank, Credit Lyonnais Securities Asia, Asian Corporate Governance Association, and members of the academic community.

Attention to corporate governance preserves value. According to a study of 1,600 firms conducted by GovernanceMetrics International, Inc., companies with the worst governance ratings over the past three years lost an average of 13% market value per year compared with a loss of 1.8% for all companies³. The challenge for general partners is twofold: 1.) to ensure the portfolio companies have one standard for efficiency, financial reporting, and regulatory controls that are summarized and reported to senior management and the board, and 2.) to aptly communicate those summaries in the form of disclosures to investors. Such practice will decrease the likelihood of unintended process outcomes caused by fraud, operational failure, or lack of key-personnel depth.

Private and Public Regulations Align

Investor confidence is down while the appetite to invest is not. Private equity overhang hovers around \$100 billion⁴, while venture capital investments are only now beginning to rebound after several consecutive years of 30% declines⁵ - two conditions made worse by a rising floor of investor demands. Similar shareholder sentiment in the public company arena was addressed with reform legislation such as the Sarbanes Oxley Act (the "Act"). Private equity players need only worry about the complete legislation in a limited, and important, number of cases (see sidebar "*Private to Public Considerations*").

However, reform applicable to private equity firms directing private companies has materialized and will likely proliferate until the standards are in line with public company requirements. Recent initiatives in this area include:

July, 2004 - the American Institute of CPAs (AICPA) launches a web-based survey to poll private company stakeholders to determine if financial statements prepared for investors are sufficient.

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

July, 2004 - the United Nations Environment Program (UNEP) is working with major institutional investors to develop globally recognized principles for protecting the planet and long-term shareholder value by integrating governance, environmental, and social concerns into investor and financial market considerations.

March, 2004 - the AICPA Private Company Financial Reporting Task Force is established (www.aicpa.org). This body is expected to recommend financial reporting requirements that include robust evaluation of governance at private companies.

June, 2003 - the GAO calls on auditors to do additional work in connection with testing and reporting on internal controls - an area critical in sustaining successful models of governance (www.gao.gov/govaud/pryb2003.pdf).

May, 2003 - in *Pereira v. Cogan, et al.* (No. 00 Civ. 619 RWS SDNY, May 27, 2003; U.S. Dist. LEXIS 7818), Judge Robert W. Street's ruling may significantly expand the responsibilities and

liabilities of private companies. The judge rules that directors at the bankrupt Trace International Holdings failed in their responsibilities by allowing Trace's chairman and controlling shareholder to drain company funds by drawing excessive compensation, loans, and dividends.

January, 2002 - Certain Sarbanes Oxley sections apply directly to private companies:

- o § 802 - Criminal liability for document destruction
- o § 904 - Increased liability for white-collar crimes
- o § 803 - Increased penalties for securities fraud
- o § 806 - Liability for retaliation against whistleblowers

January, 2002 - the GAO announces significant changes to the auditor independence requirements that cover federal entities and those organizations receiving federal funds (www.gao.gov).

In public companies, the new audited internal control report will soon be on par with the income statement, balance sheet, statement of cash flows, and

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

statements of shareholder's equity as a primary source of information about a company. There will be no reason to buy public company shares without formal regard to that company's governance and underlying business processes.

Likewise, there is no reason to disregard this information in the private company world. General partners and executive management in private companies that assess and report on key features of governance will be in a better position to allay investor concerns, to drive efficient and controlled business processes, and to enhance the accuracy and transparency of accounting and financial reporting. By acting now, private companies can avoid the magnitude-shock of satisfying the requirements, all at once, as currently felt in public companies.

Governance Framework - Background

Investors must be able to trust that four primary objectives are met at a target investment:

- o Financial reporting is accurate and transparent
- o Assets are safeguarded
- o Business processes are efficient and controlled

- o Policies articulate a sound model of governance and procedures execute according to policy

In implementing practices to meet the objectives above, firms should not start from scratch. Ongoing public company efforts to comply with the Act are producing extensive governance-related methodologies. Remember, the Act shifts focus to the events and environment leading up to financial statement generation. Aspects of the Act require certain COSO⁶ considerations, a model providing a unified definition of control over 19 years ago.

To establish a framework suitable for private equity use, begin with a proven model that has been used extensively to assess governance in both public and private companies:

1. Identify financial, operational, and compliance related objectives
2. Deconstruct business processes into discrete tasks prioritized by significance and risk
3. Assess system-based and manual activities designed to satisfy entity and process-level objectives

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

4. Compare actual activities to documented activities to optimum activities and rate gaps by impact to the organization
5. Analyze historical transactions to identify and quantify non-conforming transactions

Once these steps have been executed, practitioners should identify individually significant deficiencies and thematic deficiencies in the governance architecture. This is the framework applicable to private companies - for achieving sound governance and information integrity - writ large.

By distilling the five steps above into three phases, an industry-neutral, private company assessment approach is established. This can then be used on an as-needed basis at portfolio companies. Regularly executing this assessment will keep your thumb on the pulse of operations, and best of all, demonstrates that the board has taken the necessary measures to fulfill its responsibility, i.e. a wider range of business outcomes are more defensible from litigation in the event that unforeseen problems arise that negatively impact financial reporting.

The Framework - Three Phases

Phase 1 - Risk Assessment

First, assess organizational risk. This involves meeting with senior management, reviewing existing policy, process and procedural information, and analyzing current oversight mechanisms at a high-level. On the governance side, this means looking at the extent to which oversight activities are integrated and kept free of conflicts of interest. Regarding business operations and infrastructure, this means assessing the COSO elements of control against four organizational characteristics: business and system complexity, existence and custody of assets, control structure performance, historical results of incurred risks and action plans. Recommendations in this phase identify areas for further detailed analysis.

Phase 2 - Operational Assessment

Second, analyze the reliability and adequacy of the operations. The goals in this phase are to address noted risks and improve the operating environment. Here, processes are deconstructed into discrete tasks where objectives must be met through coordination of manual, system, preventive, and detective control-

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

ling activities. Inspection of major asset categories (e.g. cash receipts, disbursements), accounting, and financial reporting yields a prioritized gap analysis for decision makers. This way, where assets are not protected or key processes are not well-governed, the costs of not taking action can be weighed against the costs of gap remediation.

Phase 3 - Transaction Review

Third, where key business activities are weak, conduct detailed analytical procedures on historical transactions to identify and quantify errors. Root-cause analysis is performed to determine whether non-conforming transactions are attributable to process design, control failure, fraud, or system integrity.

With cost-efficient and tactical application of the governance methods being proven in public companies, private investment evaluations and monitoring practices can create and preserve value.

Link to Private Equity

Traditional due diligence limits organizational understanding to the financial outputs of a company. Little is revealed in terms of how those outputs came to be.

Were the financial results a stroke of luck? Are they repeatable? Or were the financial statements manufactured in corrupt and fraudulent schemes?

By knowing more about the business behind the numbers, private equity general partners can make better funding, acquisition, and investor attraction decisions. More importantly, those partners will have a basis for monitoring and reporting on their investments as they grow.

A) ABC Holding Company - Case One

1. The Client

ABC Holding Company is a private equity firm based in the Midwest. Executing a portfolio company acquisition strategy focused on the automotive tier-two supply base, ABC Holding has completed 6 transactions in less than 3 years. As the general partner, ABC Holding owns 51% in its portfolio companies with a mix of the same limited partners per company.

2. The Challenge

The portfolio companies operate with varying levels of sophistication in key elements of governance and operations. For example, financial reporting, information technology, and tax regulations are

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

handled differently at each portfolio company. However, ABC Holding and its limited partners do not have varying levels of expectations when it comes to oversight, standardization, and financial reporting. They need financial reporting to be equally reliable across the portfolio companies.

3. Sound Governance

ABC Holding made the decision to rationalize its governance and operational practices by setting one standard for oversight and monitoring. In the first assessment phase, variations in the sales and marketing process at each company were identified as a high risk and was prioritized for further review. In phase two, practices in forecasting were identified that threatened to impair certain private equity objectives (see Figure 1). In the third phase, complete populations of disbursement data and related general ledger accounts were analyzed for non-conforming transactions indicating fraud or process failure.

4. Results

Costs to integrate sales operations with conflicting policies, system controls, and sales-force incentives were identified as a

quantifiable impediment to realizing immediate synergies. Subsequently, this information prompted ABC Holding to view a foreign-based target more attractively and abandon its acquisition plans for the first target.

One Step Further

According to another McKinsey & Company study, "... the most critical requirement in corporate governance is raising the quality of the strategic dialogue between the board and management. To do so, both sides must see timely information that shows a company's progress in implementing its strategy"⁷ At the board, executive management, or partner level, there is no shortage of information to be digested. Given the number of sources this information comes from, data must be valid, timely, customized, and disseminated.

As the next case illustrates, there is no greater danger for a relatively small firm than to be compromised by specific - preventable! - governance weaknesses. And although this case references a Nigerian letter scam - a fraud that is hard to imagine still taking place - the story is true. In fact, the average fraud in a small

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

company results in a loss of \$127,500 and the average financial statement scheme is \$4.25 million.

B) LegalCo., A Law Firm - Case Two

1. The Client

LegalCo. is a trusted advisor to its clients; it often assists on matters related to compliance and asset protection. Also, the firm serves as custodian for various client settlement payments.

2. The Challenge

In January, 2002, LegalCo.'s Bookkeeper received a fax from a person claiming to be Dr. Mbuso Nelson, an official with the ministry of Mining in South Africa. Dr. Nelson offered to pay her a \$4.5 million fee to help him transfer \$18 million from South Africa to the United States. This instance of The Nigerian Letter scam convinced the Bookkeeper to fraudulently wire \$2.2 million from her law firm's bank accounts to unauthorized accounts in South Africa and Taiwan.

3. Sound Governance

A well-functioning model of governance could have prevented this large loss to the relatively small law firm. The Certified Fraud Examiners 2002 Report to the

Nation on Occupational Fraud and Abuse estimates fraud related losses at approximately 6% of GDP - \$600 billion annually. And as it turns out, it is the smaller firms that suffer the highest median fraud losses. Small staffs often lack basic internal controls, e.g. a single person is responsible for payment of invoices, check production, counting cash, and reconciliation of the bank statements.

4. Results

"Strong internal controls", as identified in the Report, are the single most powerful deterrent to occupational fraud. In 46% of the cases examined, fraud occurred because insufficient controls were in place within the organization. Remediation efforts to ensure those controls are incorporated into LegalCo's overall governance structure are ongoing.

No company - whether due to small staffs, rapid periods of growth, competing priorities, complex operating environments, or ignorance - should have to find out the importance of safeguarding assets only after a severe loss has taken place.

Time to Plan

Business as usual is not an option for

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

public companies; the Sarbanes Oxley Act ensured as much. But reform is never easy, especially when public companies are trying to fight the two-front war of education and implementation. Education is a challenge because honest assessments of governance involve the organization, from the top down. The tight, albeit moving, deadlines set forth in the Act meant companies had to begin their compliance initiatives before everyone knew what exactly the obligations entailed, let alone what the plan was for coordinating such daunting tasks.

The bureaucratic window of opportunity is open for private companies. But it will not be long before the red tape is cut and another round of legislation is passed. For that matter, the drivers for increased attention on governance within private companies might come from investor demands, boards, and industry - in chorus. With the press continuing to run headlines of business failure and executive convictions, there is enough momentum to leave the status quo behind. What's ahead is a stasis in which assessments of and reporting on governance is not only common, but expected.

Sound governance and a resultant boost to information integrity are a must in attracting capital and avoiding litigation. While the requirements in this area are in flux, private equity firms should use this time to learn more about COSO, process and control models, related information systems, and additional benefits that can be derived from such broad and in-depth business understanding.

Sidebar: 'Private to Public Considerations' *Sarbanes Oxley Compliance Triggers*

- o Filing a registration statement under the Securities Act of 1933
- o Private companies with registered debt securities
- o Initial Public Offering with a market capitalization greater than \$75 million (IPOs under that cap have a one year reprieve and are not subject to the entire legislation of the Act until 15 July, 2005)
- o Acquisition by a public company

Challenges

- o Identifying and recruiting independent directors

GOVERNANCE AND PRIVATE EQUITY:

Best Practices for Attracting Capital and Avoiding Litigation

- o Establishing independent audit committees and designating a financial expert
- o Designing and documenting financial and disclosure controls
- o Adopting and implementing policies to avoid conflicts of interest
- o Providing a functioning whistleblower process to all employees
- o Establishing processes to identify control deficiencies, evaluate those deficiencies, and follow-through with timely corrective action plans
- o Ensuring the independent accountants are not providing any impermissible non-audit services
- o Implementing anonymous reporting facilities and procedures to appropriately