Mission creep

Last year went down as one of the most difficult audit periods ever for the private fund CFO, and there's no sign of things getting any easier as 2014 draws to a close. But assuming it can be done, what actions can the CFO take in order make the audit process any easier? And have CFOs and auditors finally reached an equilibrium on the amount of disclosures and type of work that should go in the financial statement? We brought together three CFOs, a valuation expert and an industry auditor to ask these questions and more. What they agreed is the status quo may be here to stay, but firms can find ways to adapt to today's tougher audit season.

by NICHOLAS DONATO

photography by MARY BYRON

◂ **Front line, from left to right:** EisnerAmper partner Anthony Minnefor; and EisnerAmper partner Michael Aronow. **Back line, from left to right:** Veritas Capital CFO Jason Donner; WL Ross & Co CFO Michael Gibbons; and KPS Capital Partners CFO Stephen Hoey

If your CFO seems a little more stressed this time of year, it's probably because the year-end audit turned out to be more demanding than anticipated. Some might think the CFO's expectations should adjust; maybe they should plan a little more in advance for what's to come, but be warned: the CFO will sharply tell you they've already been doing that.

"There's been a lot of frustration over the last number of years because each year the goalposts keep moving back," says Michael Gibbons, chief financial officer of turnaround investment firm WL Ross & Co. To his immediate left, nodding in agreement, is Stephen Hoey, the chief financial officer of peer distressed investor KPS Capital Partners.

"Part of it is the documentation required to support the valuations. If you were to measure, each year, how much paper was printed to justify the marks, you would see this incremental jump in inches from five or six years ago to today," says Hoey. He's only half kidding.

Seemingly on cue, a third CFO, seated to Hoey's left, shares his own frustrations about the fact that auditors and GPs can't seem to reach a consensus on how much work and documentation should go into the year-end audit. Jason Donner, the finance chief of mid-market private equity firm Veritas Capital, says this gradual shift towards more work is impacting the full portfolio, not just new investments.

"So what happens is you have the same portfolio company valuation being audited over a five or six year period. During a prior year audit, a question may have come up that we're able to resolve and document; but because the bar keeps being raised, the next year we end up having to revisit the question again and going over something we thought was already discussed and resolved."

This is not to say that auditors and their GP clients are always sitting across the table from each other with clenched teeth. In most cases, their collaboration is a friendly one, and even when differences arise, they can be resolved amicably. Indeed, sitting across from the three CFOs are EisnerAmper partners Michael Aronow, a valuations specialist, and his colleague Anthony Minnefor, an auditor with a focus on the alternative investment industry. The five industry professionals recently sat down with *pfm* in New York City to talk about ways CFOs and auditors can work together to smooth out the year-end audit. The forum provided a chance for all involved to reflect and review what's worked (and what hasn't) when trying to simplify the audit process. Especially now, in December, it's an issue top of mind for the firm's finance team.

Regular talks

"The best way to ensure an efficient private equity year-end audit is to do two things: consistent communications with auditors and good documentation," says Minnefor. He elaborates that, in

Around the table

Michael Aronow is a partner in the corporate finance group of **EisnerAmper**, which provides accounting, consulting and tax services. Aronow has over 25 years of valuation experience which encompasses overseeing the auditing of fair value measurements for clients of the firm, including private equity and hedge funds.

Jason Donner is the chief financial officer of **Veritas Capital**, a New York-based mid-market private equity firm. Prior to joining Veritas in 2006, Donner was a vice president at a major private equity fund administrator where he co-managed the organizations institutional private equity sponsor group. Prior to that, he worked at Swiss Re Group as a controller in its private equity division.

Michael Gibbons is chief financial officer of **WL Ross & Co.**, which invests in and restructures financially distressed companies. He is responsible for the firm's financial and tax related structuring of investments, implementation and monitoring of investment guidelines, as well as all aspects of financial reporting including accounting policies and procedures, accounting and information system design, external reporting, audits, financial and organizational structure.

Stephen Hoey is chief financial officer and chief compliance officer of **KPS Capital Partners**. The New York-based firm manages more than $6.1 billion in assets focused on making controlling equity investments in restructurings, turnarounds, bankruptcies and other special situations. He has over 20 years of experience in private equity.

Anthony Minnefor is an audit partner with **EisnerAmper**, which provides accounting, consulting and tax services. He has more than 20 years of accounting and auditing experience with a focus on the alternative investment industry and leads engagement teams on audits of private equity and venture capital funds and funds of funds. He also provides audit and advisory services to funds' portfolio companies.

his experience, the most successful audits started with a detailed timetable of milestones. He added that it's important for auditors to have a complete understanding as early as possible of what transpired during the year with portfolio companies and what valuation ramifications those events presented, so as to avoid 11th-hour problems.

Aronow said GPs should also make sure to talk with their auditors throughout the year, and not just wait until year-end.

"The best way to look at it is to try and make the audit a non-event," he said. "Have a lot of communication with the auditors, go through the issues all throughout the year as things come up, so when the actual audit comes up many of the issues are resolved and you are really just in a closing process."

November is the ideal time that CFOs are offering auditors every acquisition, disposition, dividend recapitalization and other significant transaction up through September 30th for review, adds Gibbons. "What you don't want to happen is the auditor coming to you in February asking about something that happened in April of the prior year. If everything goes according to plan, the auditor has all the right documents and enough time to ask follow-up questions to feel satisfied. And if there's a transaction or significant valuation change in the interim...that's discussed in advance too."

"We are very similar," adds Donner. "We are issuing our third quarter reports usually on November 15th, and shortly thereafter we send all that information to our audit firm. From there we schedule a time for them to come in and do three quarters of the work before year-end."

Hoey says his firm does things a little bit differently by using November 30 as the cutoff point for year-end valuations. By accelerating the process, he says the

audited financial statement ends up being delivered two weeks earlier than most.

But how to account for valuation movements in December? "Let's face it, these are private equity investments. They're not going to change all that much in one month's time," answers Hoey. "But if the market tanks, or takes off, we can adjust accordingly. And that way we can get the valuations done to the point where I can present them to the LP advisory board by the first week of February and then have the audits out by March 15th every year."

Binders of information

No matter what the timeline, it's important to designate a point person (likely the CFO) and a back-up for the auditor to reach, adds Minnefor. By establishing clear lines of communication, the two sides can then set up a cadence for how and when questions are asked and answers delivered.

"It can be done in person, through email, or increasingly so now via a secure, shared data room where files are easier to track," says Minnefor, who stresses documentation is the other key ingredient in the audit process.

"Documentation really does help facilitate the process," adds Aronow. He says that when GPs are providing answers to auditor questions, they should be mindful of when it should be supported in writing. "It's not that auditors don't believe their answers, but that documentation is a way to create a paper trail for a more efficient process. So certain clients, especially in the mid-market, might just want to get on the phone and fly through these things. But to make sure everyone understands the conversation, we need reference points. We want to say, ok, on question 11, here's the information we need and here's where we can properly document the response afterwards."

Gibbons is quick to agree with these suggested best practices. Beginning in November, Gibbons welcomes external auditors to his offices as part of an arduous six month stay. "What I can't have is one of my staff members being distracted by someone from the audit team asking a question every 18 minutes. The process needs to be much more efficient than that." Instead, he asks that the audit team send his team a list of questions at the end of each day, and to expect a complete response within two business days.

Preparing audit binders for auditors with all the right paperwork is a related strategy that's proven helpful for Donner. "Over the years we've built up this expectation on what information auditors need. So now when the auditors come in, we hand them a binder that contains all the documents that take them through our transactions." Donner adds that when a deal closes, his team coordinates with the deal team responsible for the transaction regarding recordkeeping of the closing documents, "just like the old days."

Hoey offers a way to take the practice even further, pointing out that GPs in fundraising mode typically have to write up a summary of past deals as part of their PPMs. "And we decided, let's just continue updating those even after we're done raising money. We call them portfolio company summaries. If there is a dividend recapitalization or something else that happened, these summaries are updated and part of the quarterly report, with all the historical stuff as an addendum. It's a live document. So when the audit and valuation folks come in, you just hand it to them and say 'this explains the deal from the beginning.'"

Minnefor confirms the usefulness of these binders (or portfolio company summaries) for auditors, saying they

can also include things like investment memoranda and other documents that explain the rationale behind any given transaction.

All hands on deck

The perfect CFO who plans everything in advance, communicates well and meticulously documents all the important conversations between the finance team and auditors can still run into trouble however. That's because, in some ways, the CFO is as only as good as the firm's deal team when it comes to finishing year-end audit work.

"Sometimes there just isn't enough context there that can be a symptom of the deal team not being involved enough in the valuation process," says Aronow.

The roundtable's three CFOs agree that it's part of their job to communicate the importance of the audit at a firm-wide level.

If accomplished, Hoey mentions that it becomes easier to schedule a time for deal team members to answer auditor questions. "What we actually try to do is sit all the principals who led the deal teams at once with auditors to begin knocking out their questions." Minnefor says this has the added advantage of avoiding the hassle in scheduling individual phone calls or meetings with various deal team members, which can also be difficult to track and document.

The roundtable adds another interesting element to the equation: regulation and compliance. Partners and principles will need to understand that if the SEC comes knocking on the firm's door, the CFO and CCO will need to have proper documentation and controls in place to show that they can support the work being performed.

Providing a rare glimpse into how the SEC may be interpreting the audit process, Aronow says the commission's main priority is to see some level of pushback is taking place on marks. "During one of the SEC's routine phone enquiries of one of our long-standing fund clients, we'll walk them through how the fund is audited, and then at the end of the call they'll ask something like: 'Well, have you ever had disagreement on their valuations?' And we'll answer that we have, and hear back 'ok, have a nice day', click."

Gibbons facetiously offers the roundtable another strategy when selling the audit message to colleagues: "The way to get things done is to blame the auditors when the investment guys need to do more work; and to the auditors, blame the investment guys when there isn't enough context."

Finding your disclosure balance

A last topic raised by the roundtable related to the amount of disclosures

CFOs should include in the financial statement. On the one hand, auditors want to see enough disclosures to adequately satisfy their curiosities about an estimate, or as a way of notifying users of the financial statement about a change in valuation practice. On the other hand, CFOs are conscious of how easily financial statements can become bloated with too many disclosures, and potentially result in an information overload for LPs and others.

Minnefor and Aronow provide a few common mistakes they see GPs making on this front. "Most importantly, any change in the valuation approach, for instance a change in the weightings of the valuation methodologies used for an estimate, needs to be properly disclosed," says Aronow. He adds that too much consistency can also be a red flag to auditors: "Using the same public market comparables year in and year out for a valuation without analyzing whether certain comparables should be added or removed isn't necessarily the best valuation approach."

Recognizing that too much disclosure can be its own problem, Minnefor adds that most auditors "are not proponents of quantity but quality."

And what can CFOs expect in 2015? Will the year-end audit process continue to escalate in complexity and work required? Recent comments made by head SEC inspector Drew Bowden on bogus fees may lead one to wonder if his words will impact the audit process.

Happily for CFOs, the roundtable feels that the industry has reached a balance.

"I'm hesitant to say auditors and CFOs have reached an equilibrium, because a new regulation or piece or accounting rule change can change everything, but there seems to be a better understanding between the two parties," says Hoey.

Minnefor agrees, adding that escalated SEC scrutiny on the industry shouldn't result in wholesale changes to the audit process. "With respect to the latest SEC hot-button issues and related party transactions and disclosures, you're likely to get more questions from auditors; however, I wouldn't expect such additional work and focus to be significantly disruptive."

In all, the biggest message coming from the roundtable is that by providing auditors a complete understanding as early as possible of what transpired during the year with portfolio companies, the year-end audit can be a less stressful one. Or at least less stressful than forced conversation with relatives over the holiday season… ■