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Investigating the impact of SEC scrutiny on Form ADV disclosures


COLUMBIA
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Meeting of the minds: (from left to right) NewSpring Capital CFO Jonathan Schwartz; LLR Partners CFO Noah Becker; KPMG partner Tom Angell; EisnerAmper director Craig Ter Boss; Duff & Phelps managing director David Larsen; New Venture Partners CFO Marc Rappoport; and WL Ross & Co CFO Michael Gibbons

Monday morning rigor

Is the industry on the verge of providing investors with monthly reporting? It's a scary question for CFOs, who struggle enough as it is to deliver valuation statements on a semiannual or even quarterly basis. But forces outside of GPs' control may prompt institutional investors to demand timelier, more rigorous reporting. Questions surround whether this is ultimately good for the industry, and if so, how firms' finance teams could possibly cope with a heavier workload. To find out, *pfm* assembled a roundtable of private fund CFOs, auditors and valuation specialists to assess the situation and discuss what other valuation best practices a firm could utilize to save time and expense, and above all, to satisfy information-hungry LPs.

by NICHOLAS DONATO

photography by MARK BYRON

sponsored by Duff & Phelps, EisnerAmper, KPMG

The life of a private fund CFO isn't easy. In one respect, they must play referee between deal partners debating the worth of prized portfolio companies. Getting the right partners together in the same room to discuss valuation is a challenge in its own right. Valuation policies and procedures must be meticulously adhered to; it's never clear what disclosures should be included in the financial statement; and it's invariably a struggle to get portfolio company execs to send their own data on time for reporting purposes. That's why, for the most part, comprehensive financial statements are only delivered once or twice a year, assuming the firm isn't part of the growing minority of GPs who now do it on a quarterly basis.

Here's where things get unnerving then. Investors, whether pushed by regulations or internal portfolio management needs, are beginning to expect full valuation procedures on a regular basis – perhaps every month, in line with what some other alternative asset classes like hedge funds give them. It isn't exactly clear what constitutes a robust valuation process – every firm will negotiate their own interpretation of that with LPs – but the expectation is a more formal, recurring process that GPs fear will be a drain on resources.

That being said, is this even the right approach for private equity or real estate assets, where valuations creep along ten-year holding timescales? The gut reaction from industry practitioners is no (and for good reason) but more nuanced reactions begin forming once a consortium of valuation service providers, auditors and private fund CFOs are brought around the same table to discuss the matter. Last month, in midtown Manhattan, *pfm* did just that.

An emerging regime

"You need to have the same valuation process every time," says Duff & Phelps managing director David Larsen, a former auditor who is now an industry valuation provider. "It doesn't matter if it's the quarterly valuation or year-end audit, the valuation process should be the same, rigorous exercise."

For the CFOs in the room, the thought weighs heavy and doesn't seem all that intuitive.

"I don't think our investors want us spending a huge amount of time and effort on valuation every quarter," responds Jonathan Schwartz, chief financial officer at NewSpring Capital.

Around the table

Noah Becker is chief financial officer at **LLR Partners**, a mid-market firm based in Philadelphia. Joining the firm in 2012, Becker is responsible for financial reporting and oversight of all administrative financial matters at LLR. He has more than 20 years of experience in the corporate financial and public accounting sectors.

Craig Ter Boss is a valuation-focused director at professional services firm **EisnerAmper**. He has nearly 20 years of experience providing valuation services to public and private clients, with a specialty for valuations relating to alternative asset managers including private equity, hedge funds and venture capital. Ter Boss also serves as an instructor for EisnerAmper University and has presented, as well as served as panel member, to industry associations regarding valuation issues for alternative asset investments.

Marc Rappoport is chief financial officer at **New Venture Partners**, a global venture capital firm dedicated to corporate technology spin-outs. Rappoport oversees finance and administration, compliance, human resources, tax and investor relations at the firm. Previously, he was CFO at Lucent Venture Partners, where he established the financial and operational infrastructure for the firm.

"It's an agreement between the fund manager and their LPs. Our approved methodology calls for a robust valuation process semiannually while being mindful of material events on the off-quarters, because there's a cost to it, and quite frankly, very limited benefit in doing anything more."

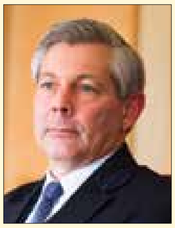
Noah Becker, finance chief at mid-market firm LLR Partners, agrees that increases in valuation frequency do not necessarily increase the benefit: "While we do update each quarter, the simple truth is valuations aren't necessarily moving much quarter to quarter."

Envisioning a future in which private fund managers provide comprehensive monthly reporting, EisnerAmper director Craig Ter Boss, a valuation services provider, adds a quality component to the conversation: "Let's consider the possibility that fund managers, if forced to do it more often, just end up taking the whole valuation process less seriously. I mean to take what's done on a semiannual basis – all the work that goes into that – and say do that 12 times a year now…it's asking a lot. With less time and planning, I'd expect GPs to put less work in their valuation process, which isn't an outcome anybody wants."

Monthly reporting could also mean more standardization, which isn't necessarily a good thing either, adds KPMG audit partner Tom Angell. "What may wind up happening is having the valuation process become more of an exercise in filling out a pro forma spreadsheet instead of spending time doing a qualitative review. The finance group has a limited amount of time. You move towards this model approach instead of a more qualitative one."

Indeed, it wasn't long before the roundtable reached a consensus that monthly reporting shouldn't be the way forward. Larsen too concedes quarterly statements provide investors

Around the table



Tom Angell is an audit-focused partner in the alternative investment practice with professional services firm **KPMG**. Angell, a certified public accountant, advises private equity funds and investment advisers on all aspects of private equity transactions, such as raising financing, deal origination and structuring. He was previously the principal-in-charge of legacy firm Rothstein Kass' national commercial services group and its private equity practice.

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.

enough up to date information to reasonably monitor their illiquid private fund investments. But there's still one problem: investors may feel compelled to demand it.

Good grief GASB

Sparking the entire conversation is new fair value guidance issued last month by the Governmental Accounting Standards Board (GASB). Regular readers of *pfm* will know that the guidance may push public pension plans – the buyout industry's biggest source of capital and pacesetters for best practices in the LP community – to require more regular (and lengthier) reporting from GPs.

In a nutshell, GASB allows users to estimate a fund's fair value using its reported Net Asset Value (NAV) per share. However, the measurement date must sync with the report date – a difficulty in the private funds industry where reports are only provided on a quarterly or semiannual basis. If there is a lag in reporting dates, or if some of the fund's investments are not held at fair value, then the public pension plan "should consider whether an adjustment to the most recent NAV per share (or its equivalent) is necessary," the guidance states. And it's here that LPs (subject to GASB) who haven't given much thought to the trust embedded in GPs' fair value estimates may begin pushing for timelier reporting.

"If I'm an LP, and I'm using NAV as my fair value estimate, I need to be able to demonstrate that the same rigorous valuation process is undertaken every time I use that information in my own report," says Larsen continuing his earlier point. "The GASB guidance makes it clearer that LPs can't rely on stale data."

"Even though some would like to say it's easier if we go back to the old days where everything was held at cost – or cost was an approximation of fair value – that prevents the LP from exercising their fiduciary duty; it stops them from having relevant information to make asset allocation decisions, which LPs all do every month or quarter. And if they're providing disingenuous information to their constituents, it's a problem. The private fund assets need to be on the same fair value basis as all other assets in the rest of the portfolio, every time the LP reports to their management, board and/or constituents."

But what is stale data in the private funds universe? And would quarterly or monthly valuations even provide LPs meaningful information? The latter question prompts Michael Gibbons, chief financial officer of turnaround investor WL Ross & Co., to describe monthly private fund data as "noise" to LPs. "You're not necessarily telling them anything about the long-term trend of those companies."

Any volatility being registered in the

valuation could also be misleading, points out Becker. "The public market comparables are always moving up and down, but that liquidity isn't true for privately held companies."

Angell, the roundtable's auditor, agrees monthly reporting is overkill but takes the opportunity to stress that public market comparables are just one data point. "Just because the market went up 20 percent, you don't expect your portfolio companies to do the same. We know that valuations lag public markets on the way up or down because of less transactions in our market."

Marc Rappoport, chief financial officer at venture capital firm New Venture Partners, adds that alternative assets are often used by managers as a hedge against systematic risk of their overall portfolio. "If we were to regularly update our portfolio company's valuation based on the public market comps and option pricing models, it would increase the volatility of the portfolio without capturing the appropriate underlying risk. What happens internally at the portfolio companies and their progress towards various milestones we think of as unsystematic risk (or unique risk) – and to me that's the risk element worth capturing and that our LP's are interested in understanding. This is not usually priced on a monthly or quarterly basis but over time."

Thinking about the issue further, EisnerAmper's Ter Boss wonders how private fund valuations tracked on a monthly basis could be explained during an audit. "Whenever you have a change in value, there's got to be some supporting rationale and evidence behind it. I have to imagine that's harder to document on a monthly basis, where there's less information to work with in between estimates."

Larsen responds, noting that a robust valuation process doesn't necessarily mean a valuation change after each measure. "On the flip side, if there is real volatility, it ought to be reported. Not reporting it doesn't make the volatility go away."

With that sentiment circling the air, the roundtable was asked to pretend more regular (and consistently robust) reporting was, in fact, the way forward. Should CFOs expect valuations to become a budget buster? Or is there a smarter way to meet investors' potential new expectations?

A possible way forward

Rappoport provides a starting point to the thought experiment by describing some of his firm's current valuation practices.

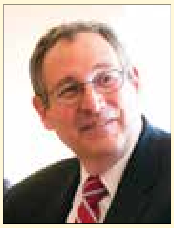
"For our firm, valuation is a continuous process. During our Monday morning partner meetings we touch on all of our portfolio companies that have had board meetings during the prior week. If there is a significant event at one of these companies or we learn of a significant market change we take a deeper dive into the company. If we feel a valuation adjustment is warranted we will work with the valuation committee to make a final determination. We use the same process in analyzing and providing public and private company comps or relevant transactions in the portfolio company's sector."

That Monday morning meeting could prove instrumental in helping GPs cope with a heavier reporting burden, surmises Angell. "It wouldn't be about adding a huge new infrastructure to the back-office but building on what you already have."

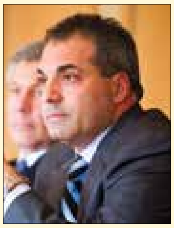
"Right, and if the GP learns during the Monday meeting that the value changed, the idea would be to capture and document it somehow," adds Larsen.

A more regular routine has other efficiency-related advantages. At WL Ross, where valuations are performed on a quarterly basis, Gibbons says deal partners "have learned to expect the types of questions I'll ask around valuation" and that "portfolio companies have gotten into a routine of getting me their numbers by set deadlines. The

Around the table



David Larsen is a managing director and leader of the alternative asset advisory practice in the San Francisco office of **Duff & Phelps**, a financial advisory and investment banking firm. He is a member of a new American Institute of Certified Public Accountants' (AICPA) taskforce on private equity and venture capital; the International Private Equity and Venture Capital Valuation Board (IPEV); and a board member of the Private Equity Industry Guidelines Group (PEIGG).



Jonathan Schwartz is chief financial officer and partner of **NewSpring Capital**. Based in Radnor, Penn., NewSpring is a provider of private equity capital focused in the Mid-Atlantic region with over $1 billion of committed capital across growth equity, control buyout and mezzanine debt funds. Schwartz is responsible for the operations of the firm, including finance and administration, compliance, fund formation and human resources. He has more than 25 years of experience in the investment management industry.

process has become very refined."

Still, the thought of assembling a valuation committee on, say, a weekly basis, or convincing deal partners to carve more time out of their busy schedules to chat valuation is a daunting one for any CFO. But maybe not always. Ter Boss explains that a wide range of valuation committee structures are utilized by firms, with anywhere from one-person to 15-person teams. "Of course, LPs want to know there is more than just one person ultimately responsible for the estimate, which is where third party specialists can come in for those single person committees."

"And that brings us back full circle to the negotiations you have with investors," says Schwartz. "At the onset, you say to your LPs, 'Here's what we'll provide you; is that sufficient for your needs?' and by them voting with their checkbook, it says the answer is yes."

"In fact, if this expectation of CFOs running full valuation procedures on a recurring basis is going to start anywhere, it's during investor due diligence, says Larsen. "The LPA only defines the frequency of reporting, so the actual valuation process needs to be understood during fundraising."

Most partnership agreements do, however, state that financial statements will be written in accordance with GAAP, which sets the expectation that every report (regardless of how often it's delivered) follows a baseline level of rigor. If monthly reporting becomes a reality – or at least an expectation for LPs following GASB – this presents a problem.

Angell suggests the fix may simply be more negotiation, or more disclosures, about how valuation is treated in the partnership agreement, something Larsen agrees with: "If I say on an off-quarter I'm not going to give you GAAP financial statements, that's absolutely fine. And I think there may be situations that LPs have agreed to that. However, if the LP reports fair value information quarterly, which many do, they need the same rigor applied to valuations every quarter to allow the LP to use NAV as the LP's fair value estimate."

It's a practical solution because it removes a level of scrutiny reserved for statements purporting to be GAAP compliant, adds Ter Boss. "You're not going to get auditors to come in every quarter to bless your numbers. It's too expensive. But if you are promising GAAP numbers, auditors are going to be looking back the entire year."

The roundtable carved out other ways in which monthly reporting could work in practice, but kept returning to the conclusion that it was a redundant level of reporting for the industry.

"At some point LPs say, 'Why are

you doing all this work? Nothing has changed.' Valuations in my world might stay the same years at a time," says Schwartz capturing the sentiment neatly.

If investors and regulators force the issue, however, the trick is to not allow reporting to suddenly become a huge exercise, the roundtable collectively agrees, but to instead incorporate weekly meetings and other tweaks into the overall reporting process.

"If deal people are doing their jobs – and we can safely assume that they are – then the information needed to do this extra work is already embedded in their heads or documentation," says Larsen. "They may need some encouragement from the top to understand why regular valuation is important, but the information and resources for getting it done should already be there."

Easier said than done, maybe, but once again the roundtable circled back to the question: do LPs really care?

Keeping up with the Joneses

Strong arguments were already heard that LPs need up-to-date information for portfolio monitoring purposes. A pension plan waiting for its latest private equity or real estate valuations to come in might watch its more liquid investments jump up and down in value, creating a feeling of unease about signing a new commitment to Buyout Fund IX (because it's hard to say if the target allocation for private equity has been met until the reports come in). Not an ideal outcome for risk management purposes.

On the other hand, as argued at the roundtable, private fund valuations don't move all that much on a monthly (or quarterly) basis, making more frequent reporting of limited value (and a drain on resources). The irony of this debate – and it's a debate that's likely to take off in the coming year – is that LPs seem relatively unaware of it at the moment.

"We ask LPs every quarter what we should, if anything, be doing differently," says Schwartz. "They might have a hundred GPs they're invested in, and so [they] have a great vantage point to monitor best practices. We're not hearing anything about monthly reporting."

True, but Larsen asks the roundtable to consider the internal organization of a pension plan: "Depending on the LP, it's probably very splintered." In other words, the pension plan representatives responsible for overall portfolio monitoring and investment aren't necessarily the same folks responsible for gauging the quality of fund managers' financial statements. Alternative assets usually represent a small fraction of a LP's portfolio, meaning it doesn't get much attention from busy investment boards.

What they might notice though, points out Rappoport, is the fact that monthly reporting is being provided at all. "They're going to look at your procedures, the quality and consistency of the information you provide to them, and what types of disclosures you make." Less attention, however, may be given to the nitty gritty contained in the statements; that "noise" which provides limited value.

Angell continues the line of thought: "The LP is going to look more favorably at a fund manager who has all the right pieces in place, who is more robust and transparent on a comparative basis."

In a toss-up between two managers then, providing monthly reporting may swing a capital commitment in one GP's favor. The industry may not be there yet (it may never be), but a few trends bubbling underneath the surface of the valuation landscape may force a little more robustness, organization and documentation during the firm's Monday morning meeting. ■