

# Financial Reporting Challenges for Capital Providers

This decades old problem can be solved.

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Providing transparent and accurate financial performance data to investors, partners and auditors is becoming increasingly important, if not critical for those engaged in the business of private equity and venture capital. In the recent past, this complex environment was tied together with a myriad of Excel® spreadsheets that served to aggregate, consolidate and report portfolio-company performance, making this task extraordinarily inefficient, costly and fraught with error. This paper will frame the problem in some detail and will offer several solutions designed to meet the needs of capital providers that seek to provide more accurate and consistent financial reporting to those that depend on it most.

## Industry Problem – Disparate Data

Unique capital structures and fiscal periods, disparate operating systems and vastly different financial reporting practices describe the condition of a typical portfolio of companies held by private equity, venture or hedge-funds. From a financial reporting perspective, the problem is similar to that of a company growing through acquisition. Monthly portfolio company performance data must be obtained, aggregated, consolidated and reported accurately and in a timely manner. To further confound this already complex process, monthly performance data is typically submitted via Excel®, PDF or word documents where it is normally re-keyed into yet another spreadsheet. Oftentimes this same spreadsheet is shared by multiple users in the habit of changing fields, files and file locations while adding and deleting worksheets and macros along the way. Few could argue that the process is not inaccurate, insecure, and highly inefficient. Worse, the process creates an auditing nightmare when critical historic data must be accessed quickly and reconciled accurately. Indeed, data stored in this environment is likely to be compromised and may or may not reflect the current state of the company let alone tie back to a revision-level that meets with the auditor's approval. Unlike the stand-alone company, capital providers cannot solve the problem by installing a single ERP across a diverse set of portfolio companies.

## Performance vs. Plan

In addition to the obvious need to access monthly balance-sheet and income statement data, investors and capital providers remain keenly interested in knowing how their companies fare each month compared to the original plan. Indeed, most deals are struck with a fair amount of weight on future company performance. Often, management compensation, earn-outs and loan covenants are tied to specific performance metrics that must be met in order for all parties involved to succeed. Typically, this financial plan originates with the portfolio company's forecast or budget that represents the management team's best estimate of the company's future performance. If the estimate is in line with the capital provider's expectations to the extent that performance is likely to result in a desirable economic outcome, the plan is accepted. Unfortunately, even the most skillfully designed plans change and evolve as uncertainty is resolved, resulting in new growth targets and funding requirements as portfolio companies navigate around loan covenants and other important financial obligations. This scenario often wreaks havoc on company managers and their capital providers as they scramble to understand the effect of dilution, return rates and the impact on other important fiduciary responsibilities. Comparing historical performance to plan may also impact fair market value under FAS157 making the need for discipline with respect to financial reporting especially clear.

## Enormous Responsibility

To say that portfolio company financial reporting is a challenging task represents a gross understatement of this enormous responsibility. Mistakes are seldom tolerated in an environment where opportunity for error appears limitless while consequences remain exceedingly high.

## Summary of Inherent Problems

Managers responsible for portfolio company financial reporting are challenged with no less than ten major obstacles.

- ❶ Vastly different account structures.
- ❷ Ever changing account structures.
- ❸ Frequent capitalization table changes.
- ❹ Inconsistent data format.
- ❺ Data stored in various databases.
- ❻ Accessibility to historical data.
- ❼ Confidence in source data.
- ❽ Constant changes to budget and plan.
- ❾ Monitoring events vs. covenants.
- ❿ Diverse reporting needs.

## The Cost of Doing it Right

For many, the solution has been to allocate additional human resources to the problem. While on the surface it protects the interests of each party involved, it fails to address the root problem. Done manually, improving the integrity and accessibility of disparate, dislocated sources of frequently changing data can only be improved marginally at best. Time, effort and opportunity is often diverted away from talented deal-makers, relationship-builders and business people only to focus on data issues that need not exist.

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## What can be done?

One strategy to overcome the ten problems outlined above is to build an in-house data-warehouse with functionality designed to roll-up complex data and account structures up to a common level, facilitating financial analysis, modeling and reporting. While this would appear relatively straightforward on the surface, such an undertaking can be complex and the cost extraordinarily high. For example, a simple data repository designed to house historical balance sheet and income statement data can be designed rather inexpensively, however implementing the functionality needed to provide drill-down analytics and reporting complete with multiple data views including year over year, trailing-twelve months, quarters, etc. can be costly. Combine this with the ability to compare actual performance to plan, capitalization table functionality, multi-currency consolidation and finally the ability to organize data from multiple sources in one dynamic report that can be configured according to each managing partner's personal preference is a monumental task at best.

In addition to the considerable investment in both time and money to develop such a solution, the cost of ongoing design requirements and maintenance necessary to keep the solution relevant may well exceed the initial cost over time. Moreover, a move to an alternative solution at some point in the future may result in sunk costs since it would be unlikely that the design and technology could be leveraged going forward.

Perhaps most important, after investing several hundred thousand dollars to build a minimal solution or millions required to build a best-in-class solution, it still does not solve the portfolio company's problem of reporting to each capital provider or lender in a different format.

## Alternative Solution

A second strategy to overcome the inefficiencies and other problems surrounding portfolio company data management is to take advantage of one of several different software solutions available. For example, ClearMomentum, Inc. offers a version of the CPM solution, ClearFinancials<sup>®</sup> that is specifically tailored to meet the needs of capital providers such as those engaged in private equity, venture capital and hedge-fund management. The solution is delivered via SaaS and sold as a subscription. It requires minimal set-up and is infinitely configurable to meet the most demanding analysis and reporting requirements.

Perhaps most important is the value that ClearFinancials<sup>®</sup> delivers to the portfolio company. In addition to solving each of the ten industry problems outlined above for the capital manager, ClearFinancials<sup>®</sup> can be used by the portfolio company as a corporate performance management application. Powerful analytic, modeling, budgeting and planning capabilities provide the user with one single solution from which to report financial performance to various capital providers, investors, lenders or other user-groups.

In addition to ClearFinancials<sup>®</sup>, other well known solutions including Hyperion<sup>®</sup>, e-prosper<sup>®</sup> and e-front<sup>®</sup> provide a host of robust features and capabilities that benefit those in the private equity, venture and hedge-fund industry.

## Forward Progress

The reporting problems associated with capital providers and their portfolio companies have been around for decades. Until now, the problems have remained unsolved despite numerous attempts by traditional license based software developers. Fortunately, that has changed thanks in part to the SaaS environment that makes it efficient and cost effective to compile, organize, analyze and report data from disparate data sources. And unlike traditional license based models, SaaS inherently provides the customer with the flexibility to unsubscribe, avoiding sunk costs should the application not perform as expected.

## Conclusion

No matter which solution that you choose, whether the in-house strategy, licensed-based software, or a SaaS subscription, the days of stringing together piecemeal spreadsheets and distributing them via email are gone. The best-practice capital provider with instant access to any portfolio company data-point is at a crystal clear advantage over those that do not. Combine that with the transparency of data and the ability to satisfy auditing requirements with immediate access to historical data, and spreadsheets can be seen for what they are in the financial reporting environment, a costly and unnecessary liability.