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Internal controls: A hidden driver of value creation at portfolio companies

Three steps that can improve the speed and quality of financial information for business decisions

As private equity (PE) firms look for ways to increase the value of their portfolio companies, one powerful lever, internal controls, may be hiding in plain sight.

When many hear internal controls, they think Sarbanes-Oxley or other compliance requirements. In fact, internal controls may drive value creation by taking out costs and providing investors and management with more accurate, reliable financial information on demand. Efficient and well-controlled financial reporting processes that can drive greater insights into business performance can make a company more attractive to investors and streamline the sale process. With a well-controlled information technology (IT) infrastructure, covering supporting technology and data, purposefully designed processes can also relieve the business of several tedious, manual tasks that may be susceptible to error.

What does it take to get a portfolio company's critical business processes and controls to a level that can provide reliable and timely information as well as help create additional value? Here are three steps for operating partners, deal professionals, and portfolio company CFOs to consider.

It's never too late to design and implement purposeful business processes that can create substantial value for the business and its investors by enabling better decision-making.

1 Set an effective tone

Companies, especially private companies with limited internal resources, are often stuck with ineffective operational and financial reporting processes that are not suitable for their purposes because "that's the way they have always done it." Spending time reevaluating process and control improvements may be perceived as an unnecessary distraction for their limited resources. However, having a well-thought-out system of internal control is important to address the completeness and accuracy of the information used in the operational and financial decision-making process. It can help manage the company's susceptibility to fraud and risk of misappropriation of assets, and supports a model that ideally prevents material misstatements in the financial statements. This value creation can make the company more attractive to investors and potential buyers.

It means the tone at the top and effectively communicating organizational goals and plans are often integral, and it typically takes the commitment of the entire leadership team—not just the CFO—to convey the impact that efficient, well-controlled processes can have on the company and to encourage employees to challenge the status quo by identifying better ways to do their jobs. A culture of focusing on processes and controls as a business imperative can lay the groundwork for producing more timely, reliable financial information. CFOs will likely have to lead the organization through this shift in mindset. Control owners can join the CFO in educating employees on how a well-managed program of controls can help improve operational excellence and manage the quality of information.

2 Consider an operational assessment

Resources can be a challenge for privately held companies, particularly when specialized skill sets may be required. One way to deal with resource constraints is to perform a strategic operational assessment focusing on people, process, and technology. An operational assessment identifies which critical processes might be susceptible to errors and what could happen if those errors were to occur. The idea is to identify gaps or issues within your programs, governance models, and key processes—think authorization, reconciliations, segregation of duties, and so forth—which would typically require enhanced controls to address the completeness and accuracy of information. This allows management to focus resources, upskilling, and energy on the areas that are important to your business strategy and operations.

An effective operational assessment often involves stakeholders throughout the company, including the controllership, finance, operations, human resources, legal, and compliance functions. Once the relevant risks are identified, the company may consider creating a prioritized plan to address such risks and close identified gaps by formalizing the company's processes. Improvement can mean new technology and automation, but it doesn't have to. It could also mean redesigning a process or overhauling the operating model for greater efficiency and effectiveness. Consider a governance, risk, and controls tool to aggregate your risks and controls to ensure this organizational alignment. They can bring structure to your environment making it more sustainable.

CFOs may periodically consider an operational assessment to identify any gaps and verify efforts are focused on the ability to produce timely, accurate, and reliable financial information. Significant changes within a company—including those in an accounting process, IT role, organizational structure, or financial performance—may be overlooked if an operational assessment isn't performed or isn't treated as an iterative process to factor in those changes throughout the year. CFOs might need to consider a fresh set of eyes in identifying potential short- and long-term solutions on methods to improve the systems of internal controls and processes.

Signs that processes and controls are not built for purpose

There are various factors that may indicate that the current state of a company's processes and controls are ripe for improvement, including but not limited to:

- The company does not have formalized processes and procedures to ensure the completeness and accuracy of financial information.
- The company identifies data quality issues, oftentimes very late in, or even after, the financial close process.
- The financial close process takes too long, or management has the inability to produce financial information on demand without significant manual intervention.
- The company's business processes and controls do not consider current-period activities and are not scalable or iterative in nature.
- Process owners do not understand why control activities matter and what risks are being addressed (e.g., the level of training provided to process owners is inadequate).
- The company does not have a business continuity plan or effective onboarding process to ensure continuity should key personnel leave.
- The company does not have an adequate or effective monitoring program to ensure relevant controls are operating in a manner consistent to mitigate the identified risks.

When reflecting on the current state of business processes and controls, it's important for CFOs to identify and address issues with being able to produce accurate and timely financial information. This is especially important when scaling for the organization's future growth, such as changes in the current business, mergers, acquisitions, and the release of new accounting standards. Improving a company's business processes often takes an actionable plan, experienced professionals to execute the plan, an effective governance structure, and tone at the top to achieve appropriate accountability and collaboration.

3 Understand your IT stack

When CFOs hear automation or optimizing technology stack, they often think of implementing potentially expensive enterprise resource planning (ERP) systems. While some portfolio companies may have outgrown their ERPs, new technology isn't always necessary to get value from your information and improve efficiency in internal controls. Portfolio company CFOs may want to keep the following technology considerations in mind:

- Taking advantage of current technology packages. It is not unusual for companies to have invested in comprehensive software package solutions, but they may not be taking advantage of available functionality. Fully harnessing the existing technology may result in incremental improvement in the control environment and potentially increase the company's ability to leverage automated processes and controls.
- Consider potential cost-effective solutions to automate processes. Replacing manual tasks with current system capabilities or intelligent automation can have an outsized impact on improving the quality of data while adding efficiency and allowing employees to focus on value-added tasks.
- The current technology platform a company operates on may have been appropriate for a smaller, less sophisticated organization. As a company continues to grow, it might need something more robust to be able to meet its business imperatives.

It's critical not to underestimate the importance of a sustainable and reliable IT infrastructure to support operational needs and financial reporting requirements. The benefits may include:

- Fewer costly, labor-intensive manual processes.
- Reliable, timely monthly reporting to course-correct the business or make quicker meaningful business decisions.
- Less risk of basing business decisions on manual errors.

If your technology stack is not fit for purpose, it could have a pervasive impact on the entire environment given potential downstream implications. There's not a one-size-fits-all solution, and companies often struggle with identifying the appropriate corrective course of action. CFOs and other executives who are experiencing challenges due to unreliable IT may consider establishing and executing a tailored remediation plan with the involvement of experienced IT professionals.

Ready for action

A well-designed program of internal controls, informed by periodic operational assessments, can help reduce costs at a portfolio company while providing useful, real-time insights about the business. Although the program may involve new technologies and ways of working, a strong, positive controls culture can encourage employees to adopt the behaviors required of them. When it comes to internal controls, even interim steps and small changes can yield meaningful results for the company and investors.

If any of these thoughts resonate with you, please contact us. We welcome the opportunity to explore ways to help you create value and reduce risks through internal controls in your own organization. At Deloitte, our scalable approach can be suitable for companies of all sizes from startups to midsize and beyond. Access to our global network of resources allows us to bring a wealth of experience and knowledge to our clients.

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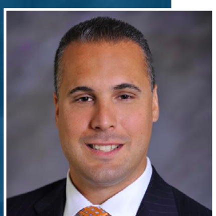

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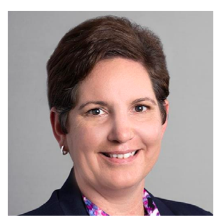

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