



KPMG Internal Audit 2015: Top 10 considerations for private equity firms

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cutting through complexity



Historically, private equity has been less regulated than other parts of the investment world. However, during the last few years, sweeping financial regulation in the U.S. and reform in Europe have brought a new level of regulatory supervision of the industry. After years of operating “under the radar,” the industry is undergoing a transition to being more regulated. As a result compliance processes are evolving, with a wide range in operational maturity among firms.

Furthermore, increasing investor demands are changing the nature of fund operations, revenue models and investor relations. In addition, the competition for portfolio company investments has increased, resulting in the need to refine the investment process and broaden a firm’s geographic reach in search of opportunities. In light of these significant and swift changes to the environment, KPMG wanted to identify how Internal Audit can assist organizations in adapting and evolving. We spoke with chief audit executives at private equity firms, listened to internal audit executives at our share forums, and gained insights from KPMG’s professionals who work with private equity firms.

The result is our “Top 10 in 2015” – key risks that private equity firms should consider as they evaluate their strategies and make their investments and ways Internal Audit can help.¹

The Top 10 in 2015

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¹ Every private equity firm is unique. It is important that Internal Audit rely on company-specific analysis of its risks in developing its Internal Audit plan.

1 Cyber security



Drivers:

- Avoiding costly consequences of data breaches such as investigations, legal fines, coverage of customer losses, remediation efforts, loss of executive and mid-level time and focus, and potential loss of customers and business
- Averting reputational damage to the organization, especially with regard to breaches that could involve investor or portfolio company data
- Preventing loss of strategic, financial and other privileged company information

In today’s world of constant connectivity, cyber security is a key focus point for many private equity firms. Cyber security frequently appears on the top of many board agendas, and data security breaches are now headline news. Several factors have driven the increased attention paid to cyber security issues, including changes in the threat landscape, rapid changes in technology, and increased focus of the SEC’s Office of Compliance Inspections and Examinations (OCIE) on cyber security, social change, and corporate change. Additionally, the capabilities and techniques used by hackers are continuously growing and evolving, especially with regards to targeting specific information or individuals. New methods are constantly being developed by increasingly

sophisticated and well-funded hackers who can target companies not only through networks directly but also through connections with key suppliers and technology partners. Lapses in security can have disastrous impacts on an organization’s reputation and bottom line. It is critical that private equity firms remain vigilant and up to date regarding various recent guidance.

How Internal Audit Can Help:

- Perform a top-down risk assessment around the company’s cyber security process using industry standards as a guide, and provide recommendations for process improvements
- Review existing processes to help ensure they consider the threats posed in the constantly evolving environment
- Assess implementation of revised technology security models, such as multilayered defenses, enhanced detection methods, and encryption of data leaving the network
- Assess third party security providers used by technology companies to evaluate the extent to which they are addressing the most current risks completely and sufficiently

2 Valuation



Drivers:

- Regulatory scrutiny pertaining to valuation policies and procedures
- Increasing investor demands to understand the valuation process
- Achieving greater investor confidence through disclosure of valuation practices
- Increasing consistency of valuations policies and processes internally across geographies, business units and asset classes
- Averting reputational damage to the organization arising from flawed or heavily scrutinized valuations

Valuation is at the heart of the private equity business and is a key focus point for many private equity firms. Private equity funds invest in less liquid assets and hence have specific characteristics that make valuation challenging. Several factors – including subjectivity, lack of definitive rules, inputs subject to varying degrees of reliability, the potential for conflicts of interest in the valuation process, and increasingly complicated investment structures – have focused attention on valuation issues in the industry.

How Internal Audit Can Help:

- Perform a top-down risk assessment around the company’s valuation process using industry leading practices as a guide, and provide recommendations for process improvements
- Conduct valuation audits that focus on compliance with industry standards and effectiveness of internal valuation controls, including reviewing the processes and controls over data that is self-reported by portfolio companies
- Review overall key valuation process areas and control environment and assisting with creating and/or updating existing documentation in these areas
- Review the process by which third party vendors, including external valuation firms, are identified, as well as due diligence, selection, and on-boarding processes and controls for selected vendors



3 Corporate Governance/Compliance Considerations



Drivers:

- Enhancing oversight and visibility into compliance operations, especially with regards to the Alternative Investment Fund Managers Directive (AIFMD) and the Foreign Account Tax Compliance Act (FATCA)
- Insufficient growth in compliance to handle overall business growth
- Achieving greater confidence in the propriety of local business practices and compliance with corporate policies and regulations such as the Foreign Corrupt Practices Act ("FCPA") and Anti-Money Laundering (AML)
- Increasing consistency of business policies and processes across regions
- Reducing risk of noncompliance with laws and regulations

Within the U.S., under recent rules, private equity firms must register with the Securities and Exchange Commission; develop compliance policies for handling

potential conflicts in business relationships and employee stock trades; hire chief compliance officers; disclose more information about investor agreements, prospectuses for raising money, and portfolio company valuations; and submit to regular SEC inspections. More recent regulation, in the form of AIFMD within Europe and FATCA within the U.S., has further increased regulatory and tax compliance standards.

How Internal Audit Can Help:

- Review key process areas and control environment, including compliance with U.S. and local requirements and assist with creating and/or updating existing corporate documentation in these areas
- Review business practices, as well as potential code of ethics, anti-bribery and corruption issues among foreign entities or business partners

4 International Operations



Drivers:

- Enhancing oversight and visibility into international operations, especially with regards to regional geopolitical issues
- Achieving greater confidence in the propriety of local business practices and compliance with corporate policies and any related regulations
- Increasing consistency of business policies and processes across regions
- Reducing risk of noncompliance with laws and regulations

Global operations present some unique challenges and risks for private equity firms. Many private equity firms are exploring global opportunities for revenue generation and deal sourcing. However, international operations raise a multitude of issues ranging from international investment due diligence to compliance with complex local regulatory requirements. Geopolitical issues, such as sanctions and cross-border trade regulations, add another

dimension of complexity to dealing with foreign countries, requiring companies to have detailed knowledge of world events and evolving expectations. Additional risks include inconsistency in business practices, inadequate corporate oversight, and complicated and changing legal and regulatory requirements.

How Internal Audit Can Help:

- Review overall key process areas and control environment, including compliance with U.S. and local requirements and investment due diligence processes, and assist with creating and/or updating existing corporate documentation in these areas
- Review business practices, as well as potential code of ethics, anti-bribery and corruption issues among foreign entities or business partners
- Communicate the company's risks and controls to international employees to support consistency of corporate policies and procedures in each entity



5 Third Party Relationships



Drivers:

- Increased shift toward the use of third-party providers
- Increased risk due to increased reliance on third parties for critical functions
- Enhancing relationships with business partners

In a fundamental shift affecting all industries, more and more companies are turning to third-party providers – such as administrators, compliance specialists, tax specialists, and valuation specialists – to offset rising costs. Though this trend is likely to continue, it is accompanied by increased risks inherent in third-party relationships. Use of third parties does not diminish the responsibility of the board or senior management to ensure that activities are performed in a

safe and sound manner and in compliance with all laws and regulations. It is imperative that third-party relationships be subject to a robust risk assessment and monitoring process, with emphasis on the most critical functions.

How Internal Audit Can Help:

- Review the process by which vendors are identified, as well as due diligence, selection and on-boarding processes and controls for selected vendors
- Conduct vendor audits of contract compliance, vendor internal controls, and vendor self-reporting
- Assist in developing, implementing, and calibrating a continuous monitoring system of vendor self-reporting

6 Expense Allocations



Drivers:

- Continued pressure on margins and profitability
- Potential non-compliance with newly applicable SEC expense allocation rules and view points
- Inadequate framework, policies and procedures for expense allocations
- Prior significant deficiencies or material weaknesses, as defined by the standards of the PCAOB², in the internal control framework
- Loosely constructed legal agreements, such as limited partnership agreements

Historically, private equity firms have pointed to the heavily negotiated and voluminous limited partnership agreement as a source of investor protection. Recently, however, regulators have more closely scrutinized these agreements, including the types of expenses that can be charged to portfolio companies and limited partners. Regulators have

exposed charges to investors by some private equity firms that were not reasonably within the scope of the limited partnership agreement or were inconsistent with the fiduciary standard of the Investment Advisers Act of 1940, resulting in fines and penalties in the search for more transparency.

How Internal Audit Can Help:

- Review the process by which expenses are characterized and allocated among the general partner and limited partners and whether the methodologies are consistent with the legal agreements
- Assist in developing, documenting and implementing a methodology for allocating expenses, while providing sufficient disclosure to limited partners
- Assist the firm's compliance function with performing reviews over the consistent application of the allocation methodology



7 Fee Disclosures



Drivers:

- Continued pressure on margins and profitability
- Potential non-compliance with newly applicable SEC expense allocation rules and viewpoints
- Opaque legal agreements, such as transaction and monitoring agreements
- Increased investor demands to understand the nature and extent of fees borne implicitly and explicitly by investors

Fees borne by investors may be opaque and insufficiently identified and clarified in communications to investors and regulators. Investor understanding of the value of monitoring and transaction fees may be insufficiently developed which can lead to confusion and dissatisfaction.

As many limited partners are aware, monitoring fees are commonly charged to portfolio companies by advisors in exchange for board oversight and other advisory services rendered by the parent to the portfolio company over the holding period. Fees may also be charged when there is a trigger event, such as an IPO, and any remaining monitoring fees become due.

However, other fees subject to regulatory scrutiny include administrative fees to limited partners that are not explicitly disclosed in the limited partnership agreements, transaction fees not clearly outlined in the partnership agreement, and fees for service providers when it is unclear what value was derived from the services. In addition, fees are sometimes charged to portfolio companies for longer than the term of the investment.

How Internal Audit Can Help:

- Review the process by which fees are characterized and allocated amongst the general partner and the limited partners or portfolio companies and whether the methodologies are consistent with the legal agreements
- Assist in documenting more transparent disclosures and disclosure processes surrounding various types of fees and their impacts
- Audit fee disclosures to ensure transparency to outside investors

8 Fund Marketing



Drivers:

- Enhancing performance tracking
- Continued pressure on margins and profitability
- Improving disclosures and underlying processes to derive claims made during private equity fund raising

With the recent ban on private equity fund advertising lifted on September 23, 2014, new risks arise in the marketing of funds to the public. Private equity marketing comes with inherent risks in the disclosure of complex and sophisticated underlying investments, which customers must be able to understand thoroughly. Public marketing campaigns must be equally sophisticated, substantive and innovative. The need to manage this increased reputational risk effectively is leading many private equity firms to design new rigor into their fund marketing programs to help ensure a fact-based and well controlled diligence, valuation and disclosure process. The recent trend in expanding marketing targets and increased competition for investor commitments has led to increased levels of effort managing time consuming marketing projects.

How Internal Audit Can Help:

- Assess adherence to accounting and internal control due diligence checklists that address key deal areas (i.e., quality of earnings and assets, cash flows, unrecorded liabilities) and identify internal control gaps for both the acquired and combined company
- Assess communication processes between marketing, finance and deal teams to determine controls surrounding the gathering of valuation and performance data
- Perform a project risk assessment review of the marketing process, focusing on potential risks, performance metrics, and information systems



9 Initiatives to Increase Value at Portfolio Companies



- Drivers:**
- Continued pressure on margins and profitability
 - Assessing strategic risks of investment and realization activity
 - Implementing a more rigorous and better-controlled investment program to identify and manage these risks and validate transaction risk
 - Enhancing execution planning, delivery, and performance tracking
 - Improving integration (or carve-out) processes across all key functions

Private equity firms are in business to create and return value for their limited partners, a pursuit that occupies countless hours in boardrooms and executive suites globally. For publicly traded private equity firms, these challenges are intensified by quarterly reporting requirements, governance rules meant to drive accountability and transparency, and the demands of a large and vocal group of shareholders. Private equity firms, however, enjoy advantages when it comes to building efficient, high-growth businesses, including a

predetermined exit time frame, tightly aligned ownership and compensation models, and limited institutional loyalties. The need to manage this execution risk more effectively is leading many private equity firms to design added rigor into their investment, portfolio company monitoring, and divestiture programs to help ensure a fact-based and well-controlled diligence, valuation, planning, and execution process.

- How Internal Audit Can Help:**
- Perform “post mortem” reviews on prior realizations to assess effectiveness of procedures and playbooks
 - Understand communication processes between finance, internal audit, and deal teams to assess control implications of executing business process change during active integrations or divestitures
 - Perform a project risk assessment review of the business integration or divestiture process, focusing on potential risks, integration success metrics, and information systems

10 System Implementation and Upgrades: Transitioning to Cloud



- Drivers:**
- Identifying needs for cloud solutions in order to facilitate transition
 - Leveraging recent advances in off-premise technology for operational efficiencies
 - A timely view into the risks and issues that allows management to correct course or implement risk mitigation strategies prior to going live
 - Continuous monitoring of cloud risks and data following implementation
 - Implementing an effective process for managing regulatory and legal requirements post implementation of a cloud platform.

As cloud services can be delivered in a variety of ways (e.g., SaaS, PaaS, and IaaS) and operational models (such as public, private, and hybrid), companies face risks and challenges when moving their IT infrastructure to the cloud. These include risk of cloud systems implementation not being able to deliver the intended value/benefits, budget and schedule overruns, overlooking related process and people issues, and managing individuals who are resistant to change.

The solution architecture should account for the nature of risks in the cloud environment as well as the implementation itself, and determine how the provider implements controls. The greatest opportunity to reduce or remediate risks lies with the proactive involvement of IT teams during the solutions architecture phase.

Any proposed cloud approach should be evaluated for regulatory compliance and data security before it is implemented. Cloud planning cycles should also be monitored continuously throughout the cloud solution’s life cycle. Beyond IT implications, critical business operations such as tax, regulatory compliance, vendor management, and a host of other areas are also affected.

- How Internal Audit Can Help:**
- Review the process by which management establishes a business case for cloud and performing due diligence for services provided, such as assessing internal controls of vendor and cadence for roles and responsibilities for vendor and company.
 - Review the approach to organization change management and business readiness around the implementation
 - Review programs around data breach/unauthorized access as required by legal and regulatory compliance.
 - Assist management in developing security and privacy programs and training
 - Security audits around cloud services.





Internal Audit

KPMG's Internal Audit Regulatory Compliance Services ("IARCS") Practice builds relationships with Private Equity firms through an organized and effective approach combining a global perspective and in-depth industry knowledge. We align our services with clients' needs throughout every aspect of the Private Equity Cycle by helping to mitigate risk, reduce costs and sustain values. KPMG's Internal Audit Practice tailors services for each client to address their specific requirements. KPMG's Internal Audit delivers practical guidance in areas such as fund raising, investments and deals, portfolio management, exit strategies and realization.

Private Equity

KPMG LLP's (KPMG) Private Equity practice is a fully integrated, cross functional team focused on serving private equity firms and their portfolio companies wherever they may be located. Our private equity practice brings a fresh approach to the issues that challenge our clients through the entire private equity life cycle; from fundraising to realizing value. Our PE practice supports the links between PE funds, managers, transactions, investments, and value realization. We provide a single point of contact to bring the services that meet your needs—raising capital and making investments, fund and portfolio management, and exit and value realization.

About KPMG

KPMG LLP (KPMG) is the U.S. member firm of KPMG International, a global network of professional firms providing audit, tax, and advisory services and industry insight to help organizations seize opportunities, overcome complex challenges and negotiate risk to better perform in the dynamic and challenging environments in which they do business. As a leading professional services firm, KPMG has more than 24,000 partners and professional providing services throughout all 50 states.

Our high-performance culture promotes using our experience and insight to simplify complex challenges, seek new opportunities, and deliver informed perspectives and clear methodologies of value to clients and stakeholders. Our client focus, commitment to excellence, global mind set, and consistent delivery build trusted relationships that are at the core of our business and reputation.

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