

# THE FOUR QUESTIONS EVERY CFO SHOULD ASK THEMSELVES

Chief Financial Officers in private equity firms are required to be current and proactive. Their role is continuously evolving as the business cycle of the firm progresses, the core businesses of the organization mature, and new strategies unfold.

**In the face of unending challenges and a high-pressure environment, the great CFO recognizes opportunities during this evolution to provide their firm's general partners and other senior leadership with strategic value in various areas of finance and operations.**

## HOW DO THEY DO IT?

Alter Domus' Sean Reilly explains how the great CFOs attain this success. Through his years working alongside senior management, other CFOs and his own experience serving as a private equity Chief Financial Officer as well as working in the private arms of The Blackstone Group and Credit Suisse, Sean has found that the best performing CFOs provide the greatest strategic value to their firm when they're able to answer four key questions.



1. DO I UNDERSTAND MY FIRM'S KEY STAKEHOLDERS AND THE INFORMATION THEY NEED?
2. DO I UNDERSTAND THE RISK AREAS OF THE FIRM AND THE FINANCE AND OPERATIONS FUNCTION?
3. DO I UNDERSTAND THE RESOURCES AVAILABLE TO ME NOW AND IN THE FUTURE?
4. DO I ALLOCATE SUFFICIENT TIME FOR STRATEGIC THINKING?

Accomplished Chief Financial Officers can be found across the entire universe of private equity firms regardless of firm size and complexity, and there appears to be a common formula used by the CFOs who have set the bar of becoming strategic contributors to their firms (and have a seat at the table) versus the CFO who has not. While this formula has been interpreted in many publications over the years, this series attempts to convey the secret to success through 4 simple questions that can help the CFO focus on strategic value in the dynamic, high pressure PE firm environment.

These questions will help you, as a strategic financial and operational leader, maintain sharp focus and allow you to quickly differentiate between critical tasks and obstructive clutter. The experienced CFO understands that these questions are generally not applied in sequence nor are they a "once and done" exercise, but instead may be applied simultaneously and regularly as part of their routine approach to their role.

# 1. DO I UNDERSTAND MY FIRM'S KEY STAKEHOLDERS AND THE INFORMATION THEY NEED?

A great CFO understands that all stakeholders are not created equal. An accomplished CFO identifies which internal and external relationships are critical to the firm and directs the firm's limited resources to focus on the financial and operational activities related to each priority stakeholders' needs and avoids the pitfalls of ignoring this approach, which inevitably lead to continuous fire-drills and resource drains.

Effectively identifying and managing the information needs of the firm's key relationships such as investors, managing partners (Key Persons), minority interest holders and at times, regulators, are generally top priority for the CFO and provide a path for demonstrating tremendous visible, strategic value to the firm.

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The less-experienced CFO will attempt to satisfy every request regardless of stakeholder status where the accomplished CFO has learned to effectively communicate realistic turnaround times to lower priority stakeholders.

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The opportunities to provide strategic value with respect to meeting stakeholder needs are numerous when the CFO elevates him or herself above a controllership psyche. For example, meeting investor reporting requirements may seem mundane and at times uninspiring, but peeling back the onion uncovers various issues and questions that the seasoned CFO will evaluate and consider strategically. These issues may include those related to accounting, reporting and structural complexity, specific jurisdictions requiring local expertise, technology shortfalls, internal or external resource insufficiencies, incomplete, inaccurate and/or delayed information, volume demands, presentation complications, and compliance considerations.

The veteran CFO also recognizes that addressing key internal stakeholder information requirements presents a unique opportunity to demonstrate strategic value through supporting or influencing the decision-making process of the managing partners.

The managing partner must have confidence in the CFO's understanding of the business, financial operations, the economic and fee arrangements in various documents, and have trust in the CFO's ability to communicate the effects of various business decisions on the income statement, the firm's liabilities, and at all times, cash. The seasoned CFO can ascend above interpreting the numbers in terms of intransigent

accounting rules and lingo and effectively communicate in the nomenclature important to senior management, such as ROI, cash, IRR, distributable economics, growth forecasts, LP relations, governance, and future fundraising.

Success in this area will undoubtedly lead to a seat at the table and can only be achieved by demonstrating a disciplined focus on the goals of the managing partners and senior leadership. One technical tool veteran CFOs may incorporate into their communication is translating and converting their understanding of the business into a concise forecasting/budgeting model. Such a tool allows the CFO to react and respond more quickly to various economic scenarios and provide valuable quantitative facts to senior management.

While other relationships, such as professional service providers, may not take priority in terms of a fundamental impact to the success of the firm, they still require effective relationship management since they ultimately provide an important supporting role to the firm and an integral role in meeting the demands of the key stakeholders. A veteran CFO recognizes and leverages the fact that he or she and their PE firm are key stakeholders for these parties when reversing the lens.

This allows the strategically focused CFO to evaluate these relationships beyond pricing and instead focus on the provider's ability to grow with the private equity firm's certain future complexity, as well as examining their global resource capabilities, their perspective on technology, and most importantly, their experience. If these criteria are not met, great CFOs do not hesitate to make changes; otherwise, weak outside relationships can impact the CFO's ability to meet the increasing demands of the key stakeholders.

## 2. DO I UNDERSTAND THE RISK AREAS OF THE FIRM AND THE FINANCE AND OPERATIONS FUNCTION?

This is one of the more challenging questions for CFOs to answer and the great ones do it by asking themselves “Do I know what I don’t know?”

All successful executives understand the relevance of this self-awareness question and there is no better area for the private equity CFO to ask it than in the realm of risk management. Honestly answering this question assists the wise CFO with quickly identifying where third-party expertise may be needed and where a greater allocation of his or her time may be required, at least initially. That said, as time-intensive as risk management can be, particularly for the CFO who also serves the role of CCO, having a handle on the impact, probability, and vulnerabilities of various risk scenarios help to provide strategic value to their senior management.

This does not mean the CFO must strive to become an expert in all areas of risk or implement a formal unsupportable enterprise risk program, but accomplished CFOs are keenly aware of the higher areas of vulnerability in the firm and the negative consequences related to the accumulation and interaction of risks over the longer term, including areas such as reputation (brand risk), regulation, and overall performance.

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Regulation alone has been the single most important driver to the evolution of the CFO’s role, whether the CFO also serves as the compliance officer or not.

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For the CFOs that serve as CCO, risk management and documentation exercises have required an enormous time commitment from even the best, most organized CFOs. Where firms have a dedicated compliance officer or third-party compliance consultants, the CFO knows they cannot dismiss themselves from regulatory responsibility and recognizes how their role intertwines with the compliance function through partnering to identify regulatory risk watch areas such as conflicts of interest, proper marketing material notations, operating partner structures, origin and allocation of ancillary fee revenue, other fee and economic arrangements, expense allocations, co-investment opportunities, governance procedures, executed and fully complete inventory of firm-wide documentation, financial reports and audits.

While generally not thought of as a formal risk management tool, most CFOs, in areas specific to the finance and operations function, instinctively run through “if/then” scenarios in their mind, but the smart CFO takes this exercise one step further by tailoring this approach in areas where poor execution would lead to risk. These areas may include negotiating leverage facilities, investor communications, investor reporting, internal reporting, fundraising support, allocation and coding of expenses, revenue allocations, valuation, cybersecurity, technology, disaster recovery, privacy, waterfalls, the investment process and deal closings. Using this approach in conjunction with healthy communication with your fund counsel and other deal advisors provides a time efficient vehicle for identifying where vulnerabilities may exist and opportunities to add strategic value over time.



Advising senior management on risk management matters during business planning meetings for the experienced CFO, who already has a seat at the table, is second nature. For the less experienced CFO, it’s risky until he or she has done their “know what you don’t know” homework and has attained credibility with the managing partners. The veteran CFO invests time in this area, utilizes their outside resources, and where possible, incorporates risk management factors into their forecasting and budgeting models.

### 3. DO I UNDERSTAND THE RESOURCES AVAILABLE TO ME NOW AND IN THE FUTURE?

Analyzing these resource-related questions provides immeasurable benefits to the private equity CFO. Dedicating the time and attention necessary while working in a high-pace environment may seem unrealistic, particularly in the face of the many time-sensitive deliverables and fire-drills, not to mention the urgent items taking shape on the horizon. But as experienced financial leaders know, those urgent matters, situations, and itemized to-do lists never cease. As such, they dedicate time to strategically and periodically rationalizing resource strategies and their impact on their ability to execute effectively over the firm's forecasted growth expectations.

Veteran private equity CFOs might begin their assessment by estimating the trajectory of resources required by marrying the key stakeholder and risk results (discussed in question **one** and **two**) over senior management's near, intermediate, and long-term strategic goals. This approach may sound cumbersome and prone to overthinking, but the seasoned CFO understands this exercise is simply projecting out the firm's resource needs as the demands on the finance and operations team expand over the time based on the firm's anticipated growth forecasts. Applying their analysis to each type of resource category constructs a calculated, holistic, time-weighted picture for anticipated resource requirements that can be discussed with senior management. Across the fund complex, GP entities and management company, these categories may cover single or multi-jurisdictional areas and include tax, compliance, technology, accounting systems, valuation and portfolio company monitoring, accounting and reporting, and other operations.

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Discussing the results of their assessment and its implications, including the direct or indirect financial impact to the firm, as well as qualitative considerations, allow the CFO to demonstrate strategic value to the firm's senior leadership in an unambiguous way.

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Maintaining discipline when communicating with senior management in such terms keeps the veteran CFO focused on contributing strategic value to the dialogue and avoids taking a biased approach towards resource expansion. Presenting the direct financial implications in both absolute dollars and as part of a comprehensive financial forecast (possibly with visual charts) often allows for coherent senior management dialogue regarding resource model alternatives, which primarily center on insourcing versus outsourcing solutions.

A good financial model can reasonably compare insourcing to outsourcing and quantify the financial impact of items such as compensation, employer taxes, employee benefits, overhead, cash flow available for hiring alternatives (for example back office versus investment professionals), technology investments, additional cash flow for expansion, fund partnership expenses, Net IRR and PREF. The seasoned CFO also presents important qualitative risk considerations in a measurable fashion.

Some of the most relevant risk considerations include:

- reputational risk,
- key staff turnover or extended absences,
- loss of invaluable institutional knowledge,
- loss of personnel trained in the firm's systems,
- lack of ability to scale quickly,
- operational inefficiencies,
- performance uncertainty of additional hires,
- automation opportunities,
- increased regulation and reporting requirements,
- increased investor reporting demands,
- future outsourcing requirements by institutional investors, and
- market trends

Every private firm is dynamic and evolves differently, thus the veteran CFO revisits and examines the resource model each year. When the strategic decision is made to "right-size" the middle and back office through the addition of or transition to external resources, he or she ensures the selected third-party providers are the right long-term partners for the firm. While colleague recommendations and historical brand recognition are useful tools in narrowing down options for the right service provider partner, the smart CFO avoids biased input by maintaining an active "pre-outsourcing dialogue" with a select network of services providers that the CFO identified by looking beyond the firm's structure today and focusing on providers that can scale and execute quickly on unforeseen operational and reporting challenges, as well as the future anticipated growth of the firm.

Such criteria has become routine when selecting auditors, tax advisors, legal counsel, deal consultants, and valuation experts, but now there is a trend towards applying this same formula to fund administrators due to the CFO's need to have today's fund administrator perform and function as if they were an extension of the CFO's internal resources.

All private equity CFOs generally own the selection process of the fund administrators. Therefore, the pressure to choose the right partner is critical in building or maintaining internal credibility. The wrong decision is time-consuming to unwind and jeopardizes the CFO's ability to meet stakeholder reporting requirements.

Knowing that the fund administration model is evolving rapidly, the smart CFO approaches their due diligence with a strong focus on the fund administrator's business, service, and technology models. For example, when comparing fund administrators' business models, the veteran CFO will examine the firm's:

- history
- product offering
- growth trajectory and forecasts
- expansion strategies
- management and ownership structure
- local and global footprint
- number of employees
- key employee credentials
- policies related to attracting and retaining talent
- track records
- client base
- key differentiators
- cybersecurity and disaster recovery policies

Additionally, common service model comparisons will encompass the administrators' ability to scale as needed locally or globally, the composition and experience levels of the engagement teams, communication intervals and philosophy, deliverable calendars, general and specific turn-around times, progress tracking, work product examples, reporting capabilities including tools and flexibility, data access and availability, escalation procedures, and the administrators' understanding of complex structures and key technical matters such as foreign investment structures and distribution waterfall nuances.

Lastly, technology models have become one of the most important determining factors during the fund administrator selection process as most CFOs now recognize that the administrator's current and future blueprint for technology advancement can have severe consequences as to whether the fund administrators' service model has staying power or will become stale over the long term. Future technological advancements

will allow fund administrators to provide their clients with a service model experience that truly feels as if their engagement teams are sitting in the next room.

The smart CFO understands that advancing technological tools towards this goal requires a heavy commitment to internal and external resources in terms of dollars, talent, and time. In selecting the right fund administrator, the CFO devotes time to critiquing these points and procuring comfort around the fund administrators' attentiveness to its technology model. They also ensure that the members of the technology strategy team are in-touch with the private equity community.



Ultimately, the smart CFO understands that communication and mutual respect are the keys to any successful relationship. Leadership exemplifying these qualities has a trickle-down effect to subordinate levels in the organization who play the key execution roles of the relationship. Without healthy communication and mutual respect at all levels of the relationship, service provider partnerships will deteriorate over time; therefore, it is important for both sides to understand their responsibility in regards to these less-measurable keys to success.



## 4. DO I ALLOCATE SUFFICIENT TIME TO STRATEGIC THINKING?

Allocating time to think, read, research, and network may seem like a luxury to most private equity CFOs, but the best set aside the time because they understand that it's during these moments when the CFO can move past prudent controllership tendencies to focus on more strategic planning and value creation opportunities.

Experienced CFOs think about the company's current performance, where it must be improved, and uncover strategies to influence efforts for improvement. While there are numerous areas to reflect upon, which may vary depending on the CFOs tenure at the firm and the maturation stage of the firm, some areas the experienced CFO may focus on will include:

- Prioritizing the most important areas of focus for senior management, which include those with direct implications on the firm's current strategy, and offering solutions
- Anticipating the next phase of the firm's evolution and identifying the operational changes required to support future growth.
- Communication strategies with senior management; understanding their styles, personalities, and what drives them
- Identifying and developing important relationships that contribute to the success of the firm's strategy
- Maintaining knowledge on current market trends in fundraising, investor due diligence, regulation, compliance, accounting policy, areas of auditor focus, valuation, structuring, tax and technology
- Analyzing the finance function's capabilities for advancing data analytics and new financial models to support senior management's decision-making process
- Devising solutions for obstacles inhibiting efficiency, such as internal resources issues and talent levels, historical complacency, lack of process or discipline, and underperforming third-party provider relationships
- Leading the finance and operations team on a path to provide greater strategic, value-added contributions to the firm
- Recruiting, advancing, mentoring, and retaining top talent
- Understanding the firm's technology platforms and assessing any operational inefficiencies that could be remedied with new technology tools
- Performing strategic hypothetical "what-if" scenarios and processing audits to ensure the CFO stays ahead of unforeseen events or damaging situations around the corner

These are but a few possible areas of concern for the private equity CFO. Dedicating the time to think clearly

about them helps the smart CFO visualize solutions and mold a disciplined, yet flexible approach to decision making. As thoughts and ideas become more perceptible and tangible, the veteran CFO may use some form of financial analysis to support their ideas, hypotheses, recommendations, and strategies with quantitative facts, providing further credibility during discussions with senior management. The experienced CFO knows that demonstrating the financial impact, or return on investing in a strategy shift— even at the operational level— will create sponsorship for moving his or her initiatives forward.

In addition to making time for strategic thinking, committing time to networking provides invaluable opportunities to gain insights and mentorship from other CFOs, who are generally very willing to share their experiences with their peers. Joining industry groups that also hold events, round-table discussions, and seminars is an easy way to further cultivate peer relationships and generally leads to expanding the CFOs connectivity in the private equity community. Given the private equity CFO typically operates on an island, a cordial network of similar professionals provides a convenient option for quick input or simply a resource to bounce ideas around with.

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**The experienced CFO considers networking as part of their responsibility and uses this mindset in apportioning some amount of time to this important avenue for strategic advancement.**

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The bottom line is the veteran CFO is able move beyond a technical controllership mindset and stay ahead by spending time deliberating on matters beyond the numbers.

As discussed, accomplished private equity Chief Financial Officers can be found across the entire universe of private equity firms regardless of firm size and complexity. Each CFO is defined by slightly varying experiences and challenges, but to be successful, the CFO must work at developing disciplined strategies to obtain and maintain a seat at the senior leadership table. Hopefully, these four questions offer a concise suggestion in helping private equity CFOs formulate their strategies for achieving this goal.

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## YOUR KEY CONTACT



SEAN REILLY  
Managing Director  
+1 203 309 6105  
sreilly@cartafundservices.com

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