THE PRIVACY OF PRIVATE EQUITY

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Abstract

In developing his code of practice for private equity reporting, Sir David Walker argued vigorously for the right to privacy, particularly about the rewards of senior managers and the partners in private equity firms. Walker's arguments – about peoples' need for information about business, and about the entitlement to receive it – went largely unchallenged. I challenge his arguments in this paper. I argue that Walker's philosophy is inconsistent with modern notions of accountability and is not grounded in GAAP or company law; if widely accepted it would turn the clock back a generation. I reassert the central role of transparency and disclosure in a shareholder-capitalism economy.

I was greatly helped by discussions with a number of colleagues, in particular: Eli Amir, Yally Avrahampour, Jane Barker, Martin Deboo, Dick Edwards, Julian Franks, Andrew Likierman, Sebastian Nokes, Ken Peasnell, Brian Singleton-Green, Eli Talmor and one or two others whose anonymity I will preserve. These people did not necessarily share my views, of course.

Summary

Background

In 2007 the UK private equity industry was engulfed by virulent media criticism[1] and found itself the subject of a Treasury Committee investigation. One concern was the level of disclosure by private equity, and early in 2007 the private equity industry trade group, the British Venture Capital Association (BVCA), commissioned Sir David Walker to develop a voluntary code of practice on transparency and disclosure. His draft proposals were published in July 2007, and his final code of practice in November 2007[2].

Framing the debate

Walker described his goal as positioning private equity disclosure somewhere between that of public and private companies, while protecting the industry from the 'burdensome' disclosure regime that public companies face. This was an artful piece of argumentation, because the FSA and stock exchange compliance that listed companies claim to find burdensome would not have applied to private equity in any case.

The debate was actually about privacy and, in particular, about maintaining privacy around the rewards of senior managers and of the partners in the private equity firm, and secrecy about ultimate ownership. This information is disclosed by public companies. To understand who ultimately owns the business you work for would seem to be a basic right, and it does not seem unreasonable that private equity general partners should disclose how much money they make. But faced with these suggestions, the industry (with some honourable exceptions) responded with tabloid fury; these requests were 'voyeuristic' and driven by 'curiosity', or 'envy'.

Private equity firms tend to use legal structures that do not oblige them to publish any accounts at all. Perhaps the most striking omission by Walker was the absence of any discussion of these structures. Because his proposals were compared against zero disclosure rather than against public company disclosure, they could thus be depicted as concessions.

The arguments for privacy and transparency

In essence, Walker's argument is as follows. Financial statements are for owners. Because public company financial statements are in the public domain, other constituencies such as creditors, managers and employees can use them. But these people do not need all the information that owners need, and are not entitled to it. Broad narrative disclosures will suffice for them.

On the contrary, both US GAAP and International Accounting Standards emphasize that these other constituencies all have similar information needs since they all make risky investment decisions. Moreover, the entitlement of all to receive a company's financial statements, whether the company is public or private, is clear and long established in UK law.

There is a fundamental confusion by Walker, and more broadly, between the shareholders' right to run the business and other constituencies' right to be informed about it. Disclosure and transparency about economic performance is at the heart of the pact between business and society in a shareholder-capitalism market economy. It is also an essential lubricant of competition.

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[1]There had been several triggers: a campaign of opposition from trades unions; targeting of high street names like Debenhams, Boots, and Sainsbury; and acquisitions such as that by Permira and CVC in Autumn 2004, of the Automobile Association – something of a national treasure – promptly followed by firing a third of the patrolmen. In both the tabloid and the broadsheet press private equity were variously 'barbarians at the gate' of course, 'vultures', and 'locusts', although the Mirror went on to argue that comparing private equity to locusts was unfair on large grasshoppers (Kevin Maguire, The Mirror, 21/02/2007).

[2] Unless otherwise stated, references in this paper are to Walker's draft proposal document.

Protecting disclosure and transparency

We need companies that are acquired by private equity to disclose the same information as would public companies of similar size, and we need the private equity firm itself to report as if it was a public company.

The working assumption in the 20th century was that most businesses of any size and importance would be public companies and would be subject to the disclosure and scrutiny that this brings. However, using ‘public’ as a proxy for ‘large’ or ‘important’ is unreliable in the modern economy. The concerns that private equity raise about privacy apply with equal or greater force to other forms of private acquisition: by sovereign wealth funds, private individuals and families, and other corporate acquirers. Critics talk about companies ‘going dark’ after private equity acquisition. Unless we understand the importance of transparency and disclosure, and unless there is the political will to protect it, more and more business activity will pass into shadow.

Structure of this document

- Part 1 locates the private equity disclosures requested by Walker within the current disclosure requirements for public and private companies.
- Part 2 examines Walker’s beliefs about people’s needs and entitlement to information, and argues that they are not grounded in GAAP or company law.
- Part 3 discusses the roles of transparency and privacy in a competitive market economy.
- Part 4 concludes.
- An appendix to the paper discusses how private equity should fill the ‘knowledge gap’ that currently exists about its economic model.

1 DISCLOSURE REQUIREMENTS ON PUBLIC AND PRIVATE COMPANIES

I start by summarizing some relevant disclosure requirements on public[3] and private companies, and Walker's proposals for disclosure by the 'portfolio' company and by the private equity firm itself.

Existing disclosure rules

The public filing requirement
All UK registered companies must prepare accounts in accordance with accounting standards and company law; the body of rules known as Generally Accepted Accounting Principles, or GAAP. These accounts are filed in the official registry and are available for public inspection. This applies equally to public and private registered companies, though private companies file within nine months of the financial year-end, while public companies have a 4-month filing deadline. The requirement of public filing for all registered companies has a long history in the UK. Around Europe, countries have different histories in this regard, but European law has now consolidated the public filing requirement and requires registered companies to provide the individual documents to anyone who requests them[4]. Americans struggle to comprehend this feature of UK and European law. In the US, private companies are not required to produce their accounts under GAAP, or publicly file them.

So after a UK firm is acquired, its financial statements remain publicly available. Discussions with bankers, who are major users of financial reports following private equity acquisitions, suggest that they continue to find what they need by accessing the financial statements filed in the public registry. Discussions with trades unions suggest that the system can fail when private investors channel an acquisition through holding companies that may be offshore and/or file their accounts late.

Market regulation
It is important to distinguish regulation to maintain the integrity and orderly functioning of securities markets, and regulation on corporate governance, from legislation on the information content of periodic financial reports. The disclosure requirements on public companies by the London Stock Exchange (LSE) and the Financial Services Authority (FSA) are market-oriented; they require event- or news-based filings relating to securities, tighter reporting deadlines for periodic financial statements, and the requirement to produce interim reports. The governance disclosures under the Combined Code on Corporate Governance are also part of the listing rules of the FSA[5].

Walker was keen to protect the private equity industry from the excessive regulatory burden on public companies. There would be widespread sympathy for that. However the argument was rather misleading because the compliance costs that public companies find costly and burdensome mostly relate to governance and to event-based disclosures – which would not apply to private equity – rather than to the content of financial statements.

Partnership accounting
Private equity firms typically invest via a 'limited partnership'. Limited partnerships do not have to publish accounts at all because they are not 'companies', neither public nor private. Since the law views a partnership simply as a group of individuals acting together, for most purposes it looks through the firm to the individual partners. One consequence is tax transparency[6]. Another

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[3] Throughout this paper I use 'public company' as synonymous with 'listed company', US-style.
[4] 4th Company Law Directive of 25 July 1978 (78/660/EEC) as amended by Directive 2003/51/EC of 18 June 2003 and the 7th Company Law Directive of 13 June 1983 based on consolidated accounts (83/349/EEC) as amended by Directive 2003/51/EC of 18 June 2003.
[5] The EU Disclosure and Transparency Rules deal specifically with periodic reporting, including annual and half-yearly financial reports, and quarterly reporting in the form of interim management statements (IMS). The IMS is broadly the same as the 'business review' requirement of the Companies Act.
[6] The partners, rather than the firm, are taxed, and this has enabled general partners in private equity firms to reduce, or even eliminate, taxation on their income, principally by exploiting capital gains tax privileges available to individuals, and sometimes by claiming overseas tax residency. In the UK, this included generous taper relief on capital gains.

consequence is that it acts as a block to accountability. We look through the partnership to the partners, but as individuals they do not have to publish accounts either.

So, in terms of accountability, the transparency of the partnership structure leads to opacity. By contrast in a 'limited liability partnership' (LLP) all partners have limited liability and, in consequence, a LLP is required to publish financial statements that are broadly similar to those of a company.

The reporting model
There remain important differences between the periodic reporting model for a public and private companies, including the following:

- CA2006 requires a 'business review' from all except small companies. Public companies must provide an 'enhanced' business review (from 1 October 2007) which includes trends and factors affecting future development of the business, and also information about the environment, employees, and social and community issues.
- A directors' remuneration report is required for public companies (Directors Remuneration Report Regulations, 2002).
- While private UK companies still report under UK GAAP, public companies report under IFRS.

The Walker code

Disclosure by the portfolio company
Walker proposed a size-based threshold for additional disclosure by private-equity investees, but pitched at the upper end of the public-company size distribution. He requires an enhanced business review from these firms, including a discussion of balance-sheet management. Walker requires a report of the composition of the board and senior management but *not* a directors' remuneration report, and this is the key exclusion under Walker's scheme.

Disclosure by the private equity firm
The most striking omission in the Walker's arguments was the absence of any discussion of the use of legal structures by private equity firms that avoid the accounting requirements on companies. By benchmarking his proposed disclosures against zero disclosure, this permitted them to be depicted as concessions.

The appropriate benchmark for the accountability of a private equity firm would appear to be the information that would be provided if it were a public holding company of similar size. Inter alia:

- If the private equity firm were a public company and the general partners were its directors, their remuneration would be fully disclosed.
- If the limited partners were shareholders, the register of shareholders would be available for public inspection, and the identities and investment of significant holdings would be disclosed.
- If the private equity firm were a company, it would have to produce group accounts, consolidating the results of the underlying investee companies that it controlled.

Walker requires much more limited disclosure than this. He argues that private equity firms should identify the names of the senior members of the general partner team, but *not* their rewards.

2 THE ENTITLEMENT TO INFORMATION

Consider this cameo view about accountability:
'Corporate reporting is essentially aimed at owners of companies. Because the owners of public companies may be numerous and dispersed, financial statements are put in the public domain. As a result, other constituencies can use them, but these people do not need all the information that owners need, nor are they entitled to it. Broad narrative disclosures covering the relationship with employees and suppliers are provided for those stakeholders.'

This is essentially Walker's philosophy and provides the grounds for limiting private equity disclosure; it is a view that also seems to be shared by others [see the exhibit]. I argue that this view misrepresents GAAP and company law.

Exhibit: Some views on accountability

Walker's view:
'Put in other terms, it is important to differentiate between the information needs of investors (in private Equity, the limited partners) who require information on remuneration and other matters to exercise their ownership function and those, who need information for general or some other particular interest – for example, in a values statement or broad indication of the company's future plans. These information thresholds are altogether different.' (para 12)

'But employees and other stakeholders such as suppliers, without access to any other regular information on the business, have a continuing and reasonable interest in the state of the business which would be satisfied by some form of the interim report on the development of the company in which they are engaged. Meeting such reasonable interest would not call for the degree of detail normal in listed company interim statements, but could be a vehicle for reporting on key elements in development of the business in particular in respect of growth, employment and investment. As envisaged here, such interim reports would not need to include detailed financial information could be audited, but might take the form of a basically narrative statement.' (para 14)

Ed Ball's view:
This distinction [between private equity owned companies and listed companies] is logical – it is rooted in the distinction between keeping a small group of private shareholders informed, and reporting to markets as a whole. Nevertheless, large businesses, and particularly those in the public eye, have a wider responsibility to engage with the community in which they operate and to meet the legitimate interests of stakeholders, both employees and the wider public, in how their operations affect them. Speech by Ed Balls, when Economic Secretary to the Treasury, to the London Business School, March 2007

Peter Linthwaite's view:
Peter Linthwaite, then of the BVCA, told us that the main purpose of transparency was to make sure that there is information to investors, or potential investors, from which they can make an informed decision. House of Commons Treasury Committee, 10th Report of Session 2006-07

Need

It is helpful to separate the *need* for information from the *entitlement* to it.

Think about the information needs of customers and suppliers, including employees as an important supplier group[7]. If a supplier is currently a creditor and has an existing financial claim on the company, it requires assurance that the firm is solvent. Insolvency is a fairly unlikely outcome and is

[7] There are other important groups with similar information needs, including lenders, government and regulators, the community and society.

the domain of traditional credit analysis. But consider the information needs of someone expecting to have a continuing and significant relationship with a company, involving an investment in 'institution-specific' capital. For instance, an employee makes a decision to locate their family in a particular place, they invest in building skills and knowledge related to their work, and they expend effort to build their reputation. A supplier of components or services makes similar investments in infrastructure, learning and reputation-building. Customers also make long-term commitments when choosing a supplier[8].

Owners need to forecast the future flows of cash and profit, and the risk of those flows, in order to value their claim on a company. Suppliers and customers whose relationship with the company is completely contracted can assess the value of their claim on the basis of a credit analysis of current solvency. But if they make investments that are based on expectation and trust, where the contracting is 'incomplete', they also need to model the company's future performance and assess its potential as a trading partner. Of course suppliers, employees and customers may not appear to analyze firms financially in any sophisticated way. But, frequently, nor do owners. The costs involved mean they all tend to rely on third-party suppliers of analysis, such as credit-rating agencies or equity analysts. But when a large corporate trading partner or a major trade union is analyzing a company with whom it has a significant relationship, it is likely to build much the same model as an equity analyst would.

The argument is not that everyone needs full disclosure when they transact; you do not need to tell your life story to the person who comes to fix your boiler. It is that anyone who makes a significant investment in a relationship with a company, or indeed is likely to be significantly affected by the actions of the company, has an equity-like need for information about it.

This view is shared by GAAP. An important foundation for the conceptual framework of modern US GAAP, with its emphasis on 'decision usefulness', was the 1973 Trueblood Report. Trueblood argues that although users are a diverse group of people, they have similar information needs since they all make risky investment decisions. '*Economic decisions about commercial enterprises are made principally by present or potential investors in equity securities, by creditors, and by managers or employees who invest time or effort.*' (Trueblood[9], p18) The subsequent conceptual framework of International Accounting Standards, the IASB Framework[10], is similar to the US model in this respect. Indeed, all discussions of the needs of users of financial statements that I am aware of, on both sides of the Atlantic, have taken the same position[11].

Entitlement

Though people other than owners may need equity-like information, or might like to have it, are they *entitled* to it? The group of people who have never required the protection of financial reporting legislation are the controlling owners of closely-held firms. This group, which arguably includes general and limited partners in private equity firms, should be able to get all the information they need.

Rather, financial statements are aimed at those people who *do not* have close and easy access to the business. Quoting Trueblood again (p17), '*An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.*'

In the UK, the right of other constituencies to receive financial statements is clear and long-established, whether the company is public or private. The introduction of limited liability for registered companies in 1844, coincided with the growth of public equity markets. Shareholder protection and

[8] This is easy to see for intermediate goods, for example a manufacturer's choice of a preferred supplier. But it also applies to durable final goods – when we buy a car or a computer, its future support, functionality and residual value all depend critically on the future economic condition of the supplier.
[9] The Report of the Study Group on the Objectives of Financial Statements, chaired by Robert M Trueblood, published as Objectives of Financial Statements by the American Institute of Certified Public Accountants (AICPA, October 1973).
[10] Approved by the International Accounting Standards Committee (IASC) in July 1989, and adopted by the International Accounting Standards Board (IASB), that replaced the IASC, in April 2001.
[11] See Richard Macve, 'A Conceptual Framework for Financial Accounting and Reporting', Garland, New York, 1997 for his own account, and his summary of some others.

creditor protection are joint goods. The separation of ownership and control that arises when shares are traded on public markets requires financial reporting to protect remote shareholders. Equally, limited liability requires public access to financial reports for creditor protection. These arguments were clearly made in the 19th century, by Gladstone amongst others, but they were checked by the countervailing claims of privacy for family firms. It was over a century before the decisive shift was made to basing disclosure on company size. From 1967, public and private companies above a certain size had to publicly file their financial statements.[12]

Partnership accounting provides a nice controlled experiment for anyone needing convincing about the nexus between creditor protection and the legal requirement for accountability. By default, the partners in a partnership have unlimited liability. In a *limited liability partnership* all partners have limited liability and, in consequence, a LLP is required to publish financial statements. In a *limited partnership*, although some partners have limited liability there is at least one general partner with unlimited liability who is deemed to protect creditors, so a limited partnership does not publish accounts. The owners' access to information is the same in either case.

An element of unlimited liability, thus, currently exempts a firm from the need to produce accounts. Such structures include limited partnerships, which are a popular structure with private equity firms, unlimited companies, and 'European Economic Interest Groupings'.

Some sources of confusion

One reason why there may be confusion for whom financial statements are prepared is that GAAP is written in terms of shareholders; the UK 2006 Companies Act (CA2006) is a case in point. The reason for this is that the information model of shareholders is by far the most clearly articulated in economic theory. The logic is explained in the IASB Framework. '*While all of the information needs of these [various] users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.*' (para 10) The 'shareholder value' orientation of GAAP does not therefore imply that financial statements are prepared principally 'for' shareholders; but it easy to see how this can confuse.

Developments in accountability over the last decade or two, now codified in the UK in CA2006, mandate narrative disclosure. This may also foster confusion between 'disclosure to' and 'disclosure about'. Amongst other things, the narrative must discuss the impact of business activity on the environment and provide information about employees. This disclosure, as I understand it, has the aim of tempering the single-minded pursuit of the shareholder value goal[13]. However, the fact that a particular narrative disclosure is *about*, say, employees does not mean that it is disclosure aimed *to* employees or even provided *for* them. It certainly does not mean that it is the main or only disclosure that employees would be interested in.

[12] For a more detailed account of this history, see Chris Higson, 'A brief history of the public filing of financial statements', mimeo, 2007.
[13] Section 172 of CA2006, in the same spirit, requires directors to promote the success of the company for the benefit of its members while having regard to other stakeholders.

3 PRIVACY AND TRANSPARENCY

Transparency and shareholder capitalism

One debating ploy, when defending privacy, to link an owners' right to privacy with the robust 'Anglo-Saxon' shareholder model of capitalism, while associating the idea that other constituencies have rights to information with the 'European' stakeholder model. In the eye of many private equity practitioners disclosure thus becomes deeply suspect; even 'socialist'! This argument exploits a widespread confusion between two distinct issues: the shareholders' right to run the business, and other constituencies' right to be informed about the business.

The shareholder/stakeholder distinction is about the governance and goals of the company. For example, if a business is going to be acquired, should the interests of shareholders be paramount, or should the impact on all stakeholders be taken into account? There clearly are deep cultural differences between countries such as the US and the UK, on the one hand, and Continental European countries, in this area.

But the financial reporting implications of shareholder capitalism are, arguably, the opposite of what is implied. Rather than a crude affirmation of the primacy of property rights, shareholder capitalism reflects a pragmatic view about economic efficiency; its advocate is saying '*I am also concerned about welfare, but I believe that the stakeholder model is inevitably ambiguous and inefficient and impedes the efficient allocation of resources. Pursue shareholder value, and let law and morality discipline it.*'[14] Transparency is at the heart of the pact between business and society under this model. It helps to provide ethical discipline and to reduce the risk that managers might do in private things they would be ashamed to do in public. It aids efficient resource allocation and is the lubricant of competition. Disclosure of the economic returns and rewards to different activities, and transparency about the presence of economic rents, provides the signal for competitive entry.

The costs of disclosure

GAAP acknowledges that the benefits of disclosure need to be balanced against the costs of providing the information. This is reflected in the more limited disclosure requirements on smaller firms. If you happen to be the remote shareholder, a supplier, or a customer of a small firm, your personal need for information about it is just as pressing as if it were a large firm. Indeed it may be greater, since small firms are inherently riskier. But GAAP would argue that the costs of providing information bear disproportionately on a small firm.

'Commercial confidentiality' is an argument against disclosure that is frequently used by Walker[15]. From an efficiency perspective the criteria are clear. We want firms to invest in intangible assets such as human capital, organizational competences and know-how, and these are assets that do not have the legal protection that patent or copyright law gives to some intellectual property assets. Confidentiality may be needed to protect proprietary assets such as this, otherwise there will be underinvestment. We do not want firms to use confidentiality to mask the excess returns earned from a comfortable market position.

In practice, because intangibles are typically missing from the balance sheet, it can be hard to distinguish a fair return on an investment in intangible assets, from the presence of economic rents. Existing law can be unhelpful and ambiguous, tending to define the right to confidentiality in terms of

[14] Milton Friedman is a good reference on this. Friedman was often depicted as believing that the sole responsibility of managers is towards their shareholders. What he actually said was *'In a free-enterprise, private property system… [The responsibility of a corporate executive] …generally will be to make as much money as possible* while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom [my emphasis]*. (The New York Times Magazine, September 13, 1970)'*

[15] In Para 11 Walker says: '…private equity firms will be expected to be more accessible to specific enquiries from the media and more widely. Confidentiality concerns will constrain responses that can be given in some situations, but the line between openness and secretiveness should be drawn up with much greater flexibility than hitherto, especially in respect of large transactions which, in the listed sector, would attract very full public presentation.'

protecting the 'self-interest' of the company[16]. Managers naturally interpret this as protecting the company from competition. For this reason, voluntary disclosure is unlikely to bring forth the disclosure that society might want.

Private Equity's case for confidentiality

Walker's initial proposal, which was subsequently dropped, was that private equity should explain its modus operandi by providing a value attribution analysis. At the level proposed, this disclosure would have been unexceptionable. But were it asked to disclose details of its unique and proprietary ways of working, a private equity firm could reasonably claim confidentiality.

Walker invoked confidentiality to prevent the disclosure of the returns to general and limited partners and of the senior management of portfolio companies. '*On remuneration, despite frequently intense media and political interest in remuneration policies and practices, in respect of both general partners and the executive board in portfolio companies, these are substantially matters for the investors, that is, limited partners.'* [para 12] Also, '… *the recurrent public curiosity about these arrangements* [about carry and the compensation of the general partner] *does not appear to warrant or validate disturbance of their confidentiality if the principals involved wish to keep them private*.' [para D5]

The efficiency argument for private equity to disclose this information might go as follows. Private equity has shown itself very effective in transforming acquired companies. But some would argue that it is a costly mode of governance in terms of its impact on other stakeholders, the fees and transaction costs involved, and the transfer of wealth to general partners. Super-normal returns, monopoly rents, to general and limited partners provide an incentive for competitive entry by other private equity investors or by alternative governance mechanisms. We might then see an increased supply of private equity governance, with more acquired firms able to enjoy its benefits. On the other hand, if advisory fees and general partners' carry are seen to provide a fair return to the unique skills of the people involved, disclosure will not affect the status quo.

Disclosure of the contingent rewards, pay, and equity-based remuneration of senior managers in the acquired firm is important to provide information on the agency issues that arise after acquisition. The modus operandi of private equity is, typically, to offer great rewards to a small group of senior people who will actively manage the firm, contingent on meeting the new owners' performance targets. These rewards align incentives and help resolve agency conflicts between senior managers and owners. The corollary is that they may detach the senior team from employees, managers and other groups with whom they had previously formed a community and with whom they had implicit contracts and relationships based on trust.

Finally, Walker argues at some length that private equity firms should categorize the limited partners, but *not* disclose their names and stakes, which again are 'private matters'. On the contrary, the right to know who owns the business you are dealing with would appear to be fundamental. It is a right we have when dealing with public companies, and it is unclear why ownership requires the protection of confidentiality in the present case. Much the same issue is now arising, and on a much larger scale, with 'sovereign wealth funds', and it seems that developed economies will have no qualms in demanding transparency about ownership from them.

[16] For example, the European framework directive on information and consultation (Directive 2002/14/EC, 11 March 2002) lays down that a business need not reveal information to employees if it was provided in confidence *and* if it is deemed to be confidential 'in the legitimate interest of the undertaking or establishment' (Article 6(1)). Article 6(2) talks about 'information…that , according to objective criteria… would seriously harm the functioning of the undertaking or establishment, or would be prejudicial to it.' See Brian Bercusson, 'The European Social Model Comes to Britain, (2002)' 31. Industrial Law Journal, pp 209-244

4 CONCLUSION

What we believe about information needs of people other than the owners of businesses, and about their entitlement to information and the right to confidentiality, is central to the debate on private equity accountability. I have argued that other constituencies need much the same information as owners and their entitlement to that information is firmly-established in law and in GAAP.

It follows that there is no real distinction between the disclosure requirements on public and private companies. We need companies that are acquired by private equity to disclose the same information as would public companies *of similar size*, and the private equity firm itself to report as if it was a public company.

There are two main countervailing arguments to disclosure – the compliance costs of disclosure, and the right to confidentiality. These arguments are easily abused, and the costs, or risks, of disclosure exaggerated. So there has to be a presumption of transparency, and the firm made to argue its confidentiality or cost case.

Transparency is at the core of the pact between business and society in our 'shareholder capitalism' economic system. But disclosure that is in society's interests, for ethical discipline and to facilitate competition, will not always be in the self-interest of managers and owners. So arguments against disclosure on the grounds of compliance cost or commercial confidentiality need to be rigorously tested. There is also a need for a well-resourced process of oversight and scrutiny, if disclosure is not going to regress to tokenism and boilerplate.

The working assumption in the 20th century was that most businesses of any size and importance would be public companies and would be subject to the disclosure and scrutiny that this brings. However, the public market model may be in retreat. Using 'public' as a proxy for large or important is unreliable in the modern economy. The concerns that private equity raise about lack of transparency apply with equal or greater force to other forms of private acquisition, and recommendations on disclosure need to apply to all significant private companies whose size merits it.

APPENDIX: THE PRIVATE EQUITY KNOWLEDGE GAP

Many participants in the private equity industry have been shocked by the reputational mauling their industry has received. The likely reason that the private equity industry has become capitalism's current *bête noire* is a failure to communicate, and the experience has been a salutary reminder of the need for disclosure. The private equity industry has a pressing need to tell its story and in this appendix I suggest how it should do so.

The outside world does not really understand the private equity economic model, and the bits that it can see worry it. Private equity's limited time horizon, and its urgent desire to make money and exit, are a disconcerting form of capitalism for people more familiar with settled, long-term ownership. As a result, views have become polarized on the following lines:

The industry view

Private equity practitioners see acquired firms made more efficient and strategically repositioned to enhance their growth opportunities. They explain this transformation in terms of private equity's superior governance model. Senior management are energized by private equity ownership and, if the company was formerly quoted, are freed from the onerous compliance requirements of listed equity markets. They are much better incentivized, but also much more closely monitored. Finally, through their new owners, managers get access to the highest quality external advice.

The critique

The typical critique of private equity is as follows. Private equity employs the best financial and strategic minds. But it can take businesses that were not bust and did not need fixing, and use its skills to aggressively expropriate value from others stakeholders. It radically increases acquired firm's borrowings and sells off their assets, followed by large cash withdrawals by the owners. This hollowing-out of the firm's resources shifts risk to other stakeholders. It ignores long-standing relationships and breaks implicit contracts with employees and suppliers. Meanwhile, the general partners in private equity firms seem to make a lot of money.

There are two key questions for private equity. The first is how private equity creates value and, in particular, whether it enhances economic efficiency, or simply transfers value from other stakeholders. Even critics concede examples of private equity doing good work, just as industry insiders privately acknowledge occasions when they don't. So when are we likely to observe value creation and when, value transfer?

The second concerns the costs of private equity governance. The private equity governance style is clearly extremely effective in transforming the companies it acquires, but how does it compare in cost to other ways of effecting economic change?

Takeovers by public companies are a good comparison. In contrast to private equity, we have very long experience of public takeovers and a lot of published research on the economics of public takeovers. This informs the quite sophisticated public debate that often accompanies the announcement of major takeovers. The discussion usually revolves around the industrial logic of the merger and, in particular, the existence or non-existence of synergies, and the costs of reorganization.

In the case of private equity, the compelling logic of synergies is absent and the story has to be about improvement in a stand-alone entity. This is a less familiar argument, and it is vulnerable to the response – why could the acquired company not have done this for itself? The story will be more convincing when private equity firms are sector specialists and bring strong strategic and industry expertise and networks, and less so when they deploy generic financial engineering tools.

Disclosure on value attribution

Private equity could explain its economic model by providing a value attribution analysis of acquisitions; that is, an explanation of exactly how the value was created in a takeover and who gets it. To be useful, this would need to be reasonably disaggregate, both in terms of factors and investee companies, describing the impact in terms of *operating efficiencies*, including margin and employment effects, *balance sheet structure*, including working capital efficiencies, asset sales and investment, and gearing, *growth* and *valuation multiples*. It also needs to explain how the value created was shared: the *advisory fees and the returns to general and limited partners*. This is data that private equity firms necessarily have already, for planning and controlling their operations, so the compliance costs of disclosure should be low.

Walker made a similar proposal and this is the most demanding of his proposals, potentially requiring disclosure well beyond what is provided by incorporated holding companies. He asked general partners to give a broad indication of the performance record of their funds, with an attribution analysis identifying how much of the value enhancement flows from financial structuring, 'from growth in the earnings multiple in the market in the industry sector', and from their strategic and operational management of the business. The concern, of course, was that this will only generate a broad indication of value attribution, aggregated across the private equity firm's portfolio. In the end even this requirement was dropped.

The provision of a value attribution at a reasonable level of disaggregation would soon go a long way to closing the 'knowledge gap'. But this is a higher level of disclosure than we get following public company takeovers. The acquirers' subsequent financial statements usually give little visibility, ex post, about what happens to the acquired firm after takeover by a public company. If the acquired firm still files accounts, they may give some limited insight.

The need for oversight

Walker's proposals are for a voluntary disclosure code. Walker's interim report seemed to see the purpose of disclosure as improving the industry's image. A voluntary code is fine if the goal of financial reporting is PR, but not if we need economic information that may be uncomfortable to disclose.

In fact, much of the disclosure that we receive from companies is discretionary, so in that sense, voluntary. It is rather hard to legislate into existence disclosures that are necessarily complex and context specific and, instead, GAAP is cast in broad terms and it is up to the company to apply the rules appropriately; in UK parlance, to provide a 'true and fair view'. Developments such as narrative reporting reinforce this challenge.

In principle, public companies receive close scrutiny on a continuous basis from investors, analysts and media commentators. Investors bear the costs of equity analysis out of expected returns and firms bear the costs of information provision, and the costs of being listed, in the belief that it lowers their cost of capital. In practice, even amongst large public companies there is great variation in the quantity and quality of disclosure while many smaller public firms live in obscurity most of the year – they have negligible analyst coverage and make few announcements. In the case of private equity, absent the incentives and resources provided by an active securities market, generating a high level of scrutiny and disclosure is a challenge.

Reputational risk appears to provide an alternative lever on firms, evidenced by notable successes by corporate-social-responsibility activists in modifying the behaviour of certain companies. Walker suggests that trade unions may fulfil a similar role in monitoring private equity disclosures. However, unions lack the resources to do so in any systematic and comprehensive way. Nor is clear they have the incentive; when unions acquire valuable company-specific information they generally prefer to use this in bargaining rather than to create a public good.

An independent oversight agency is needed, responsible for monitoring disclosures on a regular basis. One model is that of the US SEC. All SEC registrants submit their financial reports to the SEC prior to publication, including the mandatory narrative disclosures. The SEC employs a large secretariat of skilled officers who undertake a detailed review both of the quantitative and narrative disclosure, against the template of GAAP rules and of the SEC's internal practices. It is common now to depict the US as over-regulated and to point to the increasing defections from US-listed status. This may or may not be true of governance regulation, post-Sarbanes Oxley. But in terms of its seriousness about the accountability of public companies, the US is exemplary.

The existing UK financial reporting scrutiny process is lighter in touch. The Financial Reporting Council (FRC) investigates financial reports after they have been published, looking at cases that have been referred to it, and focusing on particular issues of concern. The UK is unlikely to move to SEC-style scrutiny of public and private company disclosures. But if the UK takes these issues seriously, it should at least bring private equity disclosure into the FRC scrutiny process.