

**ACCOUNTING TREATMENT FOR VENTURE CAPITALS :
A PERCEPTION OF VENTURE CAPITAL COMPANIES IN MALAYSIA**

By

FADZILLAH MOHD FARUK

Research report in partial fulfillment of the requirements for the degree of

Masters of Business Administration

May 2006

**ACCOUNTING TREATMENT FOR VENTURE CAPITALS : A
PERCEPTION OF VENTURE CAPITAL COMPANIES IN MALAYSIA**

FADZILLAH MOHD FARUK

UNIVERSITI SAINS MALAYSIA

2006

DEDICATION

ALHAMDULILLAH

Praised be to ALLAH the Almighty for endowing me with
perseverance to endure all the challenges.

An appreciation to

My humble and caring husband, Gani

for his love and kind support.

A dedication to my parents and my sisters

With the hope to inspire them to achieve excellence

INSYAALLAH

ACKNOWLEDGEMENT

First and foremost, I would like to place on record my most sincere appreciation and gratitude to my supervisor, Associate Professor Dr Hasnah Haron, for her invaluable guidance, patience and undying support in supervision throughout this entire research project. Also my sincere thanks to co-supervisor, Dr Sofri Yahya for his much-needed assistance and opinions in order to complete this project paper.

I also wish to acknowledge my sincere gratitude to my friends, Mr Veda, Kak Lin, Rosa, Salmi, Dayang, and Shidah for their inspiration, comments, criticisms, and suggestions for the development of this study. Equally my sincere thanks to all my friends and colleagues in Maybank (Regional EFS P/P/K/P, Plaza MWE, Penang) whose friendship and encouragement have been helpful in my completion of this project.

Finally, special and heartfelt thanks to my beloved husband, Gani, parents and my sisters, Fatimah, Faizah and Fazrina for their love, support and encouragement throughout my years of study.

TABLE OF CONTENTS

DEDICATION	ii
ACKNOWLEDGEMENT	iii
TABLE OF CONTENTS	iv
LIST OF TABLES	vii
LIST OF FIGURES	ix
ABBREVIATION	x
ABSTRACT	xi
ABSTRAK	xiii
Chapter 1 INTRODUCTION	
1.0 Introduction	1
1.1 Background	1
1.2 Problem Statement	5
1.3 Research Objectives	8
1.4 Research Questions	9
1.5 Definition of Key Terms	9
1.5.1 Accounting Treatment	10
1.5.2 Venture Capital Companies (VCCs)	10
1.5.3 Definition of Other Important Key Terms	10
1.5.4 Difference Between Joint Venture and Venture Capital	12
1.6 Significance of the Study	14
1.7 Organization of Remaining Chapters	15
Chapter 2 A REVIEW OF VENTURE CAPITAL	
2.0 Introduction	16
2.0.1 Definition of Venture Capital	16
2.0.2 Investment Philosophy	19
2.1 The Venture Capital Process	21
2.2 Assessing Investee Companies	22
2.3 The Stages of Venture Capital	24
2.4 The Importance of Venture Capital	26

2.5 Overview of the Malaysian Venture Capital Industry	27
2.6 Comparison of Malaysian Venture Capital Industry Against Other ASEAN Countries	36
Chapter 3 LITERATURE REVIEW	
3.0 Introduction	41
3.0.1 Relevant Accounting Standards for Venture Capital Firms	41
3.1 Business Combinations	41
3.2 Consolidated and Separate Financial Statements	42
3.2.1 The Impacts of IAS 27 on Financial Statements of Venture Capital Companies	44
3.3 Investments in Associates	45
3.4 Interests in Joint Ventures	46
3.5 Basis for Conclusions	47
3.5.1 International Accounting Standards Board (IASB)	47
3.5.2 Financial Accounting Standards Board (FASB)	47
Chapter 4 METHODOLOGY	
4.0 Introduction	59
4.1 Research Design	59
4.1.1 Type of Study	59
4.1.2 Population	59
4.1.3 Sample Frame	60
4.1.4 Unit of Analysis	60
4.1.5 Sample Size	60
4.1.6 Sampling Methods	61
4.2 Data Analysis	61
4.3 Data Collection	61
4.4 Questionnaire Design	62
4.5 Summary	63

Chapter 5 RESULTS	
5.0 Introduction	64
5.1 Frequencies Statistics of Variables	64
5.1.1 Disclosure of Investments in the Notes to the Accounts	79
5.1.2 Common Exit Strategy for Investments in New Venture Companies	79
5.2 Analysis of Annual Reports	79
5.3 Summary of the Findings	82
Chapter 6 DISCUSSION AND CONCLUSION	
6.0 Introduction	83
6.1 Recapitulation of the Study	83
6.2 Discussion of the Findings	84
6.3 Implications of the Study	86
6.4 Limitations of the Study	87
6.5 Suggestions for Future Research	88
6.6 Conclusion	89
REFERENCES	91
APPENDICES	
APPENDIX A SAMPLE QUESTIONNAIRE	
APPENDIX B LIST OF RESPONDENTS OF THE STUDY	
APPENDIX C FREQUENCY STATISTICS	

LIST OF TABLES

Table	Title	Page
1.1	Definitions of Other Important Key Terms	10
1.2	Different Type of Joint Ventures	12
2.1	The Compounded Annual Return At the Different Stages of Financing	25
2.2	Participants in the Venture Capital Industry	31
2.3	Venture Capital Investment	32
2.4	List of Venture Capital Backed IPO Listing in MESDAQ as at August 2005	35
2.5	Venture Capital Backed IPO's Listed in Main and Second Board of Bursa Malaysia as at August 2005	36
2.6	ASEAN Venture Capital Industry Profile from Year 2003 to 1H2005	40
3.1	Differences in Accounting Standards of Malaysia, UK, USA and Australia	48
3.2	Accounting Treatment With or Without Consolidations	56
3.3	Arguments For and Against Consolidation of Investments in Investee Companies	57
5.1	Frequency Distribution for Years Established	65
5.2	Frequency Distribution for Average Total Assets Per Last Three Years	65
5.3	Frequency Distribution for Average Turnover Per Last Three Years	65
5.4	Frequency Distribution for Size of Board of Directors	66
5.5	Frequency Distribution for Average Size of Board of Directors Ownership in the Company	66
5.6	Frequency Distribution for Characteristic of the Firm	67
5.7	Frequency Distribution for Total Venture Capital Funds Available	68
5.8	Frequency Distribution for Total Investment in Venture Companies as to date	68
5.9	Frequency Distribution for Number of Investee Companies as to date	68

5.10	Frequency Distribution for Venture Capital Companies Should Consolidate Their Accounts With Their Investee Companies	69
5.11	Frequency Distribution for the Appropriateness of ED46 Proposal	70
5.12	Frequency Distribution for There Should Be A Separate Accounting Standard for Venture Capital Companies	71
5.13	Frequency Distribution for the Major Impacts on Accounting Treatment Upon Adoption of ED46	72
5.14	Frequency Distribution for the Investors is More Interested in the Fair Value of the Investments than in the Consolidated Accounts	73
5.15	Frequency Distribution for Main Objective is to Gain Dividends Income	74
5.16	Frequency Distribution for the Existing Accounting System has the Ability to Provide Consolidated Accounts	75
5.17	Frequency Distribution for the Need to Invest More Resources in Preparing the Consolidated Accounts	75
5.18	Frequency Distribution for Alternative Accounting Treatments for Investment in New Venture Company	76
5.19	Frequency Distribution for Benefits from Consolidation will Outweigh the Additional Costs	77
5.20	Frequency Distribution for the Definition of Controls	77
5.21	Frequency Distribution for Capitalization of Pre-Invest Costs	78
5.22	Summary of Findings of Annual Report	80

LIST OF FIGURES

Figure	Title	Page
2.1	Venture Capital Outstanding Investments According to Sectors, Year 2002	17
2.2	The Process of Venture Capital Investment	22
2.3	The Stages of Venture Capital Financing	25
2.4	Progress of Malaysian Venture Capital Industry from Year 1992 to 2002	29
2.5	Utilisation of Funds for Year 2003 and 2004	33
2.6	Investments by Sectors	34
2.7	ASEAN – Venture Capital Pool from Year 1995 to 1H2005	38
2.8	ASEAN – New Funds Raised from Year 1995 to 1H2005	39

ABBREVIATION

VCCs	: Venture Capital Companies
IPO	: Initial Public Offering
BOD	: Board of Directors
MASB	: Malaysian Accounting Standards Board
IASB	: International Accounting Standards Board
FASB	: Financial Accounting Standards Board
AASB	: Australian Accounting Standards Board
FRS	: Financial Reporting Standards
MESDAQ	: Malaysian Exchange of Securities Dealing and Automated Quotation

ABSTRACT

This paper attempts to (1) explore the history and development of venture capitalists in Malaysia, (2) compare and contrast the various accounting standards for venture capital companies (VCCs) that are in existence locally and internationally, (3) examine the current accounting practice of VCCs, and (4) explore the perceptions of VCCs in Malaysia with regards to the new standard for consolidating accounts. From the existing various accounting standards, there is no specific accounting standard being issued by the Malaysian Accounting Standards Board (MASB), International Accounting Standards Board (IASB), Financial Accounting Standards Board (FASB) and Australian Accounting Standards Board (AASB) for VCCs. The accounting treatments of VCCs are covered under Business Combinations (FRS 3), Consolidated and Separate Financial Statements (FRS 127), Investments in Associates (FRS 128) and Interests in Joint Ventures (FRS 131). The new requirement of IAS 27 effectively changed the consolidation principles that existed for over 40 years. Companies now are required to consolidate certain entities on the basis of economic risks and rewards rather than simply a direct majority ownership. Previously, a company would consolidate the financial statements of equity only if it controlled more than 50 percent of the voting interests in the other entity. However, there are arguments (IASB's conclusions) to indicate that the VCCs do in fact have control over the investee companies even though they do not own more than half of the voting rights of the shares of the investee companies. In Malaysia, FRS 127 which is equivalent to IAS 27 requires all companies to consolidate their accounts. The FRS 127 is effective for companies with financial year beginning 1 January 2006. The sample of the study was obtained from listings under Malaysian Venture Capital Association website and listings from Malaysian Venture Capital Management Berhad (MAVCAP). As such,

this study comprised of only 10 active VCCs (fund provider and equity investor) based on the existence and availability of annual reports. The data of this study comes from (1) primary source which was collected from questionnaires and (2) secondary source which was collected from annual reports of VCCs for the year-end 2004/2005. The findings revealed that the VCCs are not currently consolidating their accounts and also do not agree that they should consolidate. They are of the opinion that VCCs involve high levels of risks and the investment was made for capital appreciation (short-term gain) and so on. However, the input of this study had generated necessary feedback and information to the Malaysian Accounting Standards Board (MASB) and other relevant bodies to regulate the venture capital industry and address their needs. In view of the foresaid, we opine that there's a need to review this new requirement on consolidation of accounts for VCCs looking at the arguments and debate discussed in this study.

ABSTRAK

Kertas kerja ini bertujuan untuk (1) mengkaji sejarah dan pembangunan Modal Teroka (VC) di Malaysia (2) mengenal pasti perbezaan di antara pelbagai standard perakaunan untuk Syarikat Modal Teroka (VCCs) pada masa kini yang diguna pakai di Malaysia dan peringkat antarabangsa, (3) menilai kaedah perakaunan yang dipraktikkan Syarikat Modal Teroka (4) mengkaji persepsi Syarikat Modal Teroka di Malaysia berhubung pengenalan standard baru penggabungan perakaunan. Berdasarkan pelbagai standard-standard perakaunan yang sedia ada, tidak ada standard khusus yang di keluarkan oleh Lembaga Piawaian Perakaunan Malaysia (MASB), Lembaga Piawaian Perakaunan Antarabangsa (IASB), Lembaga Piawaian Perakaunan Kewangan (FASB) dan Lembaga Piawaian Perakaunan Australia (AASB) untuk Syarikat Modal Teroka. Pengendalian perakaunan untuk Syarikat Modal Teroka terkandung dalam Kombinasi Perniagaan 3 (FRS 3), Penggabungan dan Penyata Kewangan Berasingan 127 (FRS 127), Pelaburan di dalam Syarikat Bersekutu 128 (FRS 128) dan Kepentingan dalam Usahasama 131 (FRS 131). Syarat baru Standard Perakaunan Antarabangsa 27 (IAS 27) secara efektif telah mengubah prinsip penggabungan yang telah wujud selama 40 tahun. Pada masa kini, syarikat-syarikat adalah diwajibkan untuk menyatukan sesetengah entiti atas dasar risiko ekonomi dan pulangannya berbanding dengan hakmilik majoriti secara langsung. Sebelum ini, sesebuah syarikat akan menggabungkan penyata kewangan ekuiti sahaja sekiranya ia mempunyai kawalan lebih daripada 50 peratus kepentingan mengundi di dalam entiti yang lain. Walau bagaimanapun, terdapat perdebatan (kesimpulan IASB) untuk menyatakan bahawa Syarikat Modal Teroka juga mempunyai kawalan atas syarikat pelaburan sungguhpun mereka tidak memiliki separuh daripada hak kuasa mengundi ke atas saham syarikat pelaburan. Di Malaysia, Standard Pelaporan Kewangan 127

(FRS 127) yang bersamaan dengan Standard Pelaporan Antarabangsa 27 (IAS 27) memerlukan semua syarikat untuk menggabungkan akaun-akaun mereka. Standard Pelaporan Kewangan 127 ini berkuatkuasa untuk semua syarikat mulai tahun kewangan yang bermula pada 1hb Januari 2006. Sampel untuk kaji selidik ini diperolehi daripada senarai nama yang terdapat dilaman web Persatuan Modal Teroka Malaysia (MVCA) dan senarai nama yang diperolehi daripada Pengurusan Modal Teroka Malaysia Berhad (MAVCAP). Kajian ini hanya merangkumi 10 Syarikat Modal Teroka (penyumbang modal dan pelabur ekuiti) yang aktif berdasarkan kewujudan dan laporan tahunan yang boleh didapati. Data untuk kaji selidik ini dikumpulkan melalui dua sumber (1) sumber utama dikumpul daripada soal selidik dan (2) sumber kedua dikumpul daripada laporan tahunan Syarikat Modal Teroka bagi tahun berakhir 2004/2005. Hasil kajian menunjukkan bahawa pada masa kini penggabungan perakaunan tidak dipraktikkan oleh Syarikat Modal Teroka dan mereka juga tidak bersetuju untuk menggabungkan akaun-akaun mereka. Mereka berpendapat bahawa Syarikat Modal Teroka melibatkan risiko yang tinggi dan pelaburan adalah bermotifkan penambahan modal (jangkamas pendek) dan sebagainya. Walau bagaimanapun, input kaji selidik ini telah menjana maklumbalas dan informasi tertentu kepada Lembaga Standard Perakaunan Malaysia dan badan-badan lain yang berkaitan untuk mengawal dan mengetengahkan keperluan Modal Teroka. Berdasarkan hujah di atas, kami berpendapat bahawa ada keperluan untuk menilai semula syarat baru mengenai penggabungan perakaunan untuk Syarikat Modal Teroka berdasarkan hujah-hujah yang dibincangkan dalam kertas kerja ini.

Chapter 1

INTRODUCTION

1.0 Introduction

This chapter introduces the research outline of the study. It illustrates the background of the study, problem statement, research objectives and questions, definitions of certain key terms, significance of the study and organization of the remaining chapters.

1.1 Background

There are many complications before an enterprise starts operating. The success or downfall of an enterprise depends on a number of parameters. It is essential that a promoter has qualities such as experience, integrity, prudence and a good command of the market. These are qualities that can be acquired. However, there are aspects that an entrepreneur is unable to monitor. Timely infusion of funds is one of them. For this, expertise of a venture capitalist is sought. Venture capital financing is one of the best approaches and oldest measure to increase capital growth.

Venture is defined as 'risk'. A venture capitalist is attracted when a business enterprise has potential but has a doubtful level of success, thus it is in need of financial back up. Venture capitalists have the monetary capacity and are able to provide the financing by shares or loan stocks or other measures to support such enterprises. By contributing financial aid, a venture capitalist shares the risk. Furthermore, venture capitalists are also known to impart valuable contacts, market expertise and compatible strategic plans to ensure the success of the business venture and security of the investments (Malaysian Venture Capital Association, VCCC Secretariat, 2002).

The industry of venture capital in the United States of America (USA), has taken almost 20 years to reach its present position which was supported by cutting edge technology. Even before the silicon boom, USA has successfully deployed venture capital in their industry. As to date, USA still maintains as one of the pioneer capital markets around the globe. According to Venture Capital Impact (2004), a report on Venture Capital Benefit to the USA economy revealed that companies backed by venture capitalists employed more than 10 million workers and generated \$1.8 trillion in sales in 2003. The report also highlighted that more than 70 million Americans have benefited in terms of quality of life as a direct result of venture backed diagnostic and therapeutic innovation. This data is clear evidence that venture capital financing should be employed by many growing and developing economies of the Asia Pacific region including Malaysia as well.

In a knowledge-based economy that is focused on knowledge as well as information, communication and technology (ICT), economic growth and job opportunities depend upon breakthrough innovations. This means that the results of research and development (R & D) must contribute effectively into commercial outcomes. Innovation without the aid of finance is useless, hence venture capital is vital as a specific type of finance that has been developed to fund these high-risk projects.

Many technological revolutions which resulted in the transforming industries have been led by venture capital-backed firms. For example, the firms that launched new generation of computer technology (such as personal computers, software, etc.) were backed financially by venture capitalists. Some of America's most successful companies which grew with the help of venture funding are Intel, Digital Equipment Corporation (DEC), Apple, Microsoft, Sun Microsystems, Federal Express,

Genentech and Netscape (IBBM – Monetary Economics and The Malaysian Financial System (DP01), 2000)

Our former Prime Minister, Tun Dr Mahathir Mohamad, during his speech in conjunction with the launching of Malaysian Venture Berhad in 1984, remarked that venture capital is not devoid of risks. However, if these risks can be manipulated, then the rewards are invaluable. As such, for a developing country like Malaysia, venture capital industry will aggravate the search for more innovative ideas and activities which will subsequently help to establish and foster better managed companies (Extracted from speech by Tun Dr Mahathir Mohamad during the launching of Malaysian Ventures Bhd, 1984).

During 1980s, the venture capital industry in Malaysia was only in the incubative stage. However, it has progressed to play a leading role which is instrumental in funding the growth of small and high-growth companies through the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) market. In the year 2004 alone, venture capital investment rose by 20.36 percent and exceeded RM1 billion, while the total number of investee companies increased by 11.4 percent to 332 companies. In addition, MESDAQ achieved its potential as a channel to improve the access of small high-growth companies to the capital market through attracting an increasing number of issuers. Applications that were approved for listing on MESDAQ rose significantly from 22 previously to 38 in 2004. Some of the key players in the Malaysian venture capital industry are BI Walden Management Sdn Bhd, Malaysian Venture Capital Management Berhad, Mayban Ventures, CAV Private Equity Management Sdn Bhd, and OSK Ventures (Securities Commission Annual Report, 2004).

Similar to other organizations, venture capital companies (VCCs) are required to prepare their Annual Audited Financial Statements in compliance with relevant accounting standards that are internationally accepted. Financial statements as the centre of business reporting are crucial in determining the true and fair value of the firm. Furthermore, financial statements need to reflect the actual financial position of an entity. Such information is useful in making economic decisions and serves as a measure to gauge the entity's future cash flows after taking into account their timing and certainty. It also reiterates how well the management has stewarded the resources (Lazar, Huang and Arshad, 2006).

As for Malaysia, parallel with the government's policy in nurturing new ICT and Biotechnology firms, venture capitalists will be an important intermediary to fund the projects of these firms. However, before this can be done, the government needs to know whether the VCCs have a proper accounting system that will be able to capture the increase, and presumably more complicated transactions in the near future.

Reportedly, to date there is no specific accounting standard for VCCs in Malaysia. Therefore, it would be timely to explore the alternative accounting practices that are available to VCCs, both locally and internationally. Accounting practices for VCCs of various countries such as United Kingdom (UK), USA, Australia and the European countries will be explored. Furthermore, comparisons will be made between these standards and the existing accounting standards in Malaysia. The study hopes to be able to identify the accounting practice that is best suited to the VCCs in Malaysia.

1.2 Problem Statement

As highlighted under the background, the Malaysian VC industry still at embryonic stage as compared to other countries such as USA, UK and Japan whereby the VC industry has been one of the major contributor for the economic growth. Our checking with En Norazharuddin Abu Talib, Chief Executive Officer of MAVCAP and En Rusman Amir Bin Zaihan of MAVCAP via email and telephone conversation revealed that the Malaysian VC industry has been picking since year 2002 but as at year 2004/05 the growth has been reducing gradually and one of the contributing factor is the proposed changes in the Malaysian Accounting Standards which requires more transparency in the presentation of the Financial Statements. The proposed ED46 on consolidation of Financial Statements has created dissatisfaction and dispute among VCCs and which indirectly has affected the growth of VC industry.

From the existing various accounting standards, it can be noted that there is no specific accounting standard being issued by the Malaysian Accounting Standards Board (MASB), International Accounting Standards Board (IASB), Financial Accounting Standards Board (FASB) and Australian Accounting Standards Board (AASB) for VCCs. In the Malaysian context, the relevant standards that are applicable to the accounting treatment for VCCs are Interest in Joint Ventures (FRS 131), Consolidated and Separate Financial Statements (FRS 127), Business Combinations (FRS 3) and Investments in Associates (FRS 128).

FRS 131, Interest in Joint Ventures defines Joint Venture as when two or more parties enter into a contractual agreement whereby they share equal control over an economic entity and the financial and operating decisions relating to that entity. No one party has control over the other or the control is jointly exercised. Therefore, no consolidation of financial statements is required (Lazar, Huang & Arshad, 2006).

FRS 127, Consolidated and Separate Financial Statements outlines that the parent or holding company is required to prepare a consolidated financial statement. This is because the parent company is assumed to have a control over the subsidiary companies. Control is present when the parent acquires more than 50 percent of the voting rights of the subsidiary companies. According to Lazar, Huang and Arshad (2006), control still exist even though the parent owns less than 50 percent of the voting rights if the parent company has the power to govern the financial and operating policies of the company, power to appoint or remove the majority of the members of Board of Directors (BOD) and power to cast the majority of votes at the meeting of BOD. In other words this implies that control still exists if the parent company holds less than 50 percent of the subsidiary companies if majority of the BOD of the subsidiary companies comprise of members of the parent company.

FRS 3, Business Combinations requires that the parent company prepare a consolidated financial statement for the group. As is stated in Lazar, Huang and Arshad (2006), FRS 3 also mentioned that control is said to exist even though the parent owns less than 50 percent of the voting rights if the parent company has the: (1) power to govern the financial and operating policies of the company, (2) power to appoint or remove the majority of the members of BOD and (3) power to cast the majority of votes at the meeting of BOD. As highlighted above, this implies that control still exists if the parent company holds less than 50 percent of the subsidiary companies if majority of the BOD of the subsidiary companies comprise of members of the parent company.

FRS 128, Investments in Associates defines an associate as an entity over which the investor has a significant influence and that is neither a subsidiary nor an interest in the joint venture. According to Lazar, Huang and Arshad (2006),

significant influence over the investee enterprise exists if the investor holds directly or indirectly, 20 percent or more of the voting rights of the investee but the investor has no control over the financial and operating policies. If the holdings is less than 20 percent, the investor will be presumed not to have significant influence, unless such influence can be clearly demonstrated as evidenced by one or more of the following :-

- (1) Representation on the BOD.
- (2) Participation in the policy-making process.
- (3) Material transactions between the investors and the investee.
- (4) Provision of essential technical information.

There are two methods to account for associates; (1) equity and (2) cost. Equity is when the investment in the associate was initially recorded at cost and the carrying amount is increased or decreased by the investor's share of the post acquisition profit or losses of the investee companies. Cost method is when the investment is stated at the cost of acquisition and is not effected by the investor's shares of the post acquisition profit or losses of the investee companies.

One of the requirements that investor companies are exempted from consolidating their accounts for associates using the equity method is when an investment in an associate is acquired temporarily or with the intention to dispose of it within 12 months from the date of acquisition. In other words, if the investor company holds the shares of the investee companies for a short-term measure, the investor is allowed to use the cost method.

As mentioned in the British Venture Capital Association (1997), VCCs invest in the investee companies by acquiring shares in the company for short-term measure but have no control over the company. In this instance it is quite similar to FRS 128, Investments in Associates and thus requires no consolidation by the investor

companies and because the investment is for short-term holding, their investment in the investee companies is stated at cost.

However, there are arguments (IASB's conclusions) to indicate that the VCCs do in fact have control over the investee companies even though they do not own more than half of the voting rights of the shares of the investee companies. This is because they might hold convertible preference shares that do not make up for the percentage of investment in the investee companies and these shares can be easily (at any time) converted in the near future to common shares. The VCCs might also have a majority of their members in the BOD of the investee companies. Also the intention to hold for short term is not clearly define as they might find that the companies they invest in are profitable and thus would hold the investment for a long-term period.

Due to all these uncertainties and debatable issues, this study attempts to explore the current practices of VCCs and to understand whether they are in support or against consolidation and the reasons for why they opt for a certain stance. We are expecting more accounting issues to be raised by VCCs and our current accounting standards on equity financing and debt financing may need to be more specific in the treatment, recording and presentation of financial statements. Probably certain specific guidelines on accounting for VCCs in Malaysia should be established.

1.3 Research Objectives

Therefore, this study attempts to accomplish three main objectives as follows:

- (1) To explore the history and development of venture capitalists in Malaysia.
- (2) To compare the various accounting standards for venture capitalists, that are in existence locally and internationally.

- (3) To examine the existing accounting practice of venture capital companies in Malaysia.
- (4) To examine the perception of venture capital companies in Malaysia as to whether they would consolidate or not consolidate the accounts of their investee companies.

1.4 Research Questions

In order to achieve the above-mentioned objectives, this study will try to answer the following research questions;

- (1) What are the comparisons between various accounting standards for venture capitalists, that are in existence locally and internationally?
- (2) What is the existing accounting practice of venture capital companies in Malaysia on presentation of Audited Financial Statements? For example, the practice of preparing either consolidated or non-consolidated Audited Financial Statements.
- (3) What is the perception of venture capital companies in Malaysia regarding consolidating the accounts of their investee companies?

1.5 Definition of Key Terms

Before further discussion, it is important to define certain major terms used throughout the study. It will be appropriate to share a common understanding of the concepts such as accounting treatment, venture capital companies (VCCs) and others. These definitions are extracted from relevant Financial Reporting Standards (FRS) for Malaysia (Lazar, Huang and Arshad, 2006).

1.5.1 Accounting Treatment

Methods, processes and decisions as to how a transaction is to be presented, recorded or are handled in compliance to Generally Accepted Accounting Principles (GAAP) and all applicable statutes.

1.5.2 Venture Capital Companies (VCCs)

This is generally an organization that manages venture capital fund set-up within the entity as well on behalf of other VC fund. There were two types of VCCs known as VCCs which are fund provider but without equity investment in the investee companies and VCCs which are fund provider but with equity investment in the investee companies. This study will be looking at the group of VCCs which are fund provider with equity investment in the investee companies and also manages more than one fund company.

1.5.3 Definition of Other Important Key Terms

Table 1.1 below shows the definition of other important key terms used in this study.

Table 1.1

Definitions of other important key terms

Key Terms	Definition
Control	The power to govern the financial and operating policies of an entity and also to obtain benefits from its activities.
Fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial Reporting Standards (FRS)	Standards and Interpretations adopted by the Malaysian Accounting Standards Board (MASB). This standard comprised of 2 major components namely Financial Reporting Standards and Interpretations originated by the Issues Committee (IC) or the former Interpretations Committee.
Financial Statements	A complete set of reports comprised of balance sheet, income statement, a cash flow statement, notes (e.g. comprising a summary of significant accounting policies and other explanatory notes) and a statements showing either all changes in equity or changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders.
Consolidated Financial Statements	The financial statements of a group presented as those of a single economic entity.
Associate	An associate is a business entity whereby the investor has significant influence (e.g. power to participate in the financial and operating policy decisions) and it can be either a subsidiary or a joint venture of the investor. If an investor holds, directly or indirectly, 20 percent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated otherwise.
Cost method	A method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.
Equity method	A method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The income statement reflects the investor's share of the results of operations of the investee.

1.5.4 Difference between Joint Venture and Venture Capital

Lazar, Huang and Arshad (2006) defined joint venture as a contractual arrangement whereby two or more individuals operate and economic entity which is jointly controlled. Control is equally shared and jointly exercised by both parties. Even though, all the venturers have joint control but either one of the party is allowed to manage the venture. Joint venturers are categorized under three forms namely (1) jointly controlled operations, (2) jointly controlled assets and (3) jointly controlled entity.

Table 1.2

Different type of joint ventures

Type of joint venturer	Characteristic
Jointly controlled operations	<ul style="list-style-type: none">• No separate business enterprise is established• Separate accounting records are not kept but management accounts may be prepared• Uses individual assets and incurs own expenses and liabilities and raises own finance• An agreement of profits/losses sharing• In the separate and consolidated financial statements, the venturer are required to disclose the assets it controls, incurred liabilities, share o revenue and expenses incurred in relation to joint venture
Jointly controlled assets	<ul style="list-style-type: none">• No separate business enterprise is established• Involve the joint control and often the joint ownership of assets in relation to the joint venture• Each venturer usually takes a share of the output and bears and agreed share of the expenses• In the separate and consolidated financial statements, the venturer are required to disclose the assets it controls, incurred liabilities, share o revenue and expenses incurred in relation to joint venture

- Jointly controlled entity
- Involves the incorporation of a separate entity namely a company, partnership and so on but the venturers have joint control over the joint venture
 - The joint venture entity will have its own set of financial statements and they are also entitled to a share of the results of the joint venture
-

Meanwhile, venture capital is a financial commitment on an unproven business or the monetary contributions made in relatively high risk situations, usually to new and expanding companies. A venture capitalist (VC) is a person who makes investments. A venture capitalist fund provider is a partnership that primarily invests the financial capital of third party investors in enterprises that are typically too risky for ordinary bank loans. Financial contributions take the form of either equity participation, or a combination of equity participation, debt obligation and often with convertible debt instruments that become equity if a certain level of risk is exceeded (Richard & Philemon, 2004).

In all cases, the venture capitalist becomes part owner of the new venture. With an ownership stake, a venture capitalist will share the risk. Sometimes, due to capital requirements from venture capitalists, they may own a majority of the shareholdings and demand a voice in managing the company. However, they are not likely to wrest control away from the investee if the investee grow progressively and provide substantial expected return to VCs.

Most investments are structured as preferred shares – the common shares often reserved by covenant for a future buyout, as VC investment criteria usually include a planned exit event such as merger with another company; acquisition by another company, IPO or management buyout. They recoup their investment and profits at the end of the investment period, which is deemed by the exit. The most popular exit

strategy is via IPO listings as this type of exit offers numerous advantages namely efficient valuation, ensures liquidity, gives greater profile, facilitate raising of additional capital and attract a wide spectrum of investors (Richard & Philemon, 2004).

1.6 Significance of the Study

This paper will contribute to both theory and practice in the area of accounting treatment for Malaysian VCCs. In theory, this study will help to formulate special/specific standards for VCCs. Further, in terms of practicality the result of this study can generate necessary feedback and information to the Malaysian Accounting Standards Board (MASB) and Securities Commission to regulate the venture capital industry and address their needs.

This is an important study since it will help to provide feedback to VCCs particularly in Malaysia to improve reporting of their accounting format and subsequently on preparation of Audited Financial Statements. On the other hand, external individuals such as regulatory bodies, practitioners, shareholders, and investees will benefit with up-to-date information on the progress and future opportunity in venture capital industry and importantly in the area of preparation of Audited Financial Statements in compliance with the International Accounting Reporting Guidelines.

Furthermore, the revelation on the presentation or reporting of the Financial Statements will shed some light on the governance and control processes of the firms. It is also hoped that the findings of this study would contribute to the existing accounting standards and the outlined guidelines or reporting format in compliance with Malaysian Accounting Standards Board (MASB) or other international

standards. In addition, this study might help policy makers to review and improve on the existing accounting standards and to implement a standardized practice of accounting standards specifically for VCCs.

Finally, these favourable initiatives by the policy makers to promote venture capital will help an inundation of venture capital funds into the region. As a consequence, Malaysian venture capital industry can be expected to see strong growth in the near future.

1.7 Organization of Remaining Chapters

This study comprises of six chapters with chapter one concentrating on the background of this study and arguing the importance of having accounting standards for venture capital companies. Next, chapter two highlights the history, progress of venture capital industry in Malaysia and makes comparison against other major countries. Subsequently, chapter three reviews the literatures which outlines the relevant Malaysian and International accounting standards and guidelines. Accordingly, the data and variables section which discusses the sample and defines the variables in this study will be presented in chapter four. Consequently, the result section in chapter five will argue the analysis of the sample. Finally, chapter six presents the discussions and conclusions of the study.

Chapter 2

A REVIEW OF VENTURE CAPITAL

2.0 Introduction

2.0.1 Definition of Venture Capital

Nef (1998) defined venture capital as a high-yield, high-risk form of investment and generally with low or limited liquidity for a fixed amount of time. Despite providing financial backgroup, the return is never guaranteed, unlike a loan. Venture capital investors will be repaid only to the extent that the operation is profitable. In certain scenario, it takes the form of a non-controlling, but significant amount of existing stock in an established company namely if a new line or product is developed.

Ostrovski (1998) defined venture capital as a financing/investment tool. It is used to provide long term financing to support enterprises that must go through rapid developing stages. These stages comprised of seed investment for the development of research, tools to generate marketable technologies, products or processes and finally to the acquisition of on-going enterprises with products and technologies. Further, he also reiterated that venture capital does not involve in loans or debts but acts as an equity in the enterprise. There is more risk in this sort of investment but it addresses one of the key issues in the economy. The venture capital takes equity positions in companies that have minimal assets which can serve as collateral.

Megginson and Weiss (1991) reiterated that there are major sectors that would benefit with the existence of venture capital especially in the development, implementation and commercialization of new technology such as biotechnology and

overnight shipping. Their existence as investors ensures that the offering price of the issue reflects all available and relevant inside information.

Another source defined venture capital (VC) as an ‘independent, professionally managed, dedicated pools of capital’ that focus on equity-linked investments in privately held, high growth companies (Gompers & Lerner, 2001). This study supported that venture capital as one of the key elements of the infrastructure of innovation. In the Malaysian context, this is evident with the growth of venture capital industry mainly in the fields of research and development and high level of innovations such as ICT and advanced technology. Figure 2.1 shows the venture capital outstanding investments according to sector for year 2002.

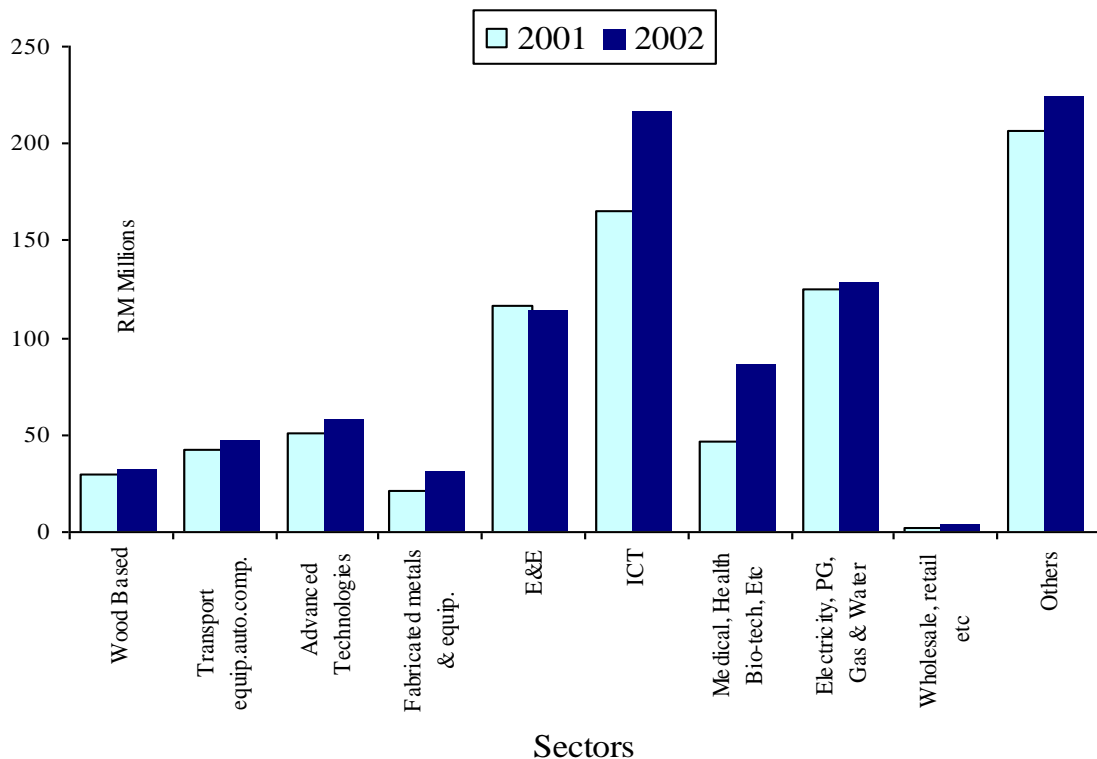


Figure 2.1 : Venture Capital Outstanding Investments According to Sectors, 2002

(Source : Bank Negara Malaysia (BNM) Annual Report, 2002)

British Venture Capital Association (1997) highlighted the distinguished and distinctive characteristics of this mode of business financing as follows :

- (1) Venture capital provides long-term, committed, risk sharing equity capital to help unlisted companies to grow and strive to entrench in the market.
- (2) It helps to upgrade the firm's value without the intention of taking control.
- (3) Fund providers such as banks have a legal right to interest on a loan and its repayment. However, the borrower's success or failure, ensures the venture capital investor's returns.
- (4) Owner is required to sell part of their share in their companies (generally a minority stake) to the venture backer, who may seek a non-executive board position and attend monthly Board meetings.
- (5) Venture capital investors do not only support financially, but also supply experience, business referral and advice when required, which sets higher than other sources of business capital.

According to Malaysian Venture Capital Association, VCCC Secretariat (2002), private partnerships or closely held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves form professionally managed capital firms. Venture capitalists generally:

- (1) Provide funding to finance newly set-up and rapidly developing firms.
- (2) Buy equity securities.
- (3) Helps in the process of development of new products or services.
- (4) Actively involved to increase value to the company.
- (5) Involve high level of risks with the expectation of high rewards.
- (6) Involves a long-term commitment.

Finally, venture capitalists mitigate the risk of investing by developing a portfolio of young enterprises in a single venture fund. If there is a possibility of high risk, venture capitalists co-invest with other professional venture capital firms to reduce the possibility of loss. In addition, this also gives them an opportunity to invest in other businesses. Reportedly, for decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job opportunities, economic growth and international competitiveness. Some of companies that received venture capital in the early days of their growth are Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech (National Venture Capital Association Yearbook, 1999).

2.0.2 Investment Philosophy

The basic principal underlying venture capital is investment in high risk projects with the expectation for high returns. With the high return, venture capitalist invest in several fledging enterprises, which require funding in view of unavailability of other source of financing such as banks and other financial institutions. Typically pioneer generation entrepreneurs starts their businesses without any major collateral to offer as security, hence banks and financial institutions are to decline their request for funding. Venture capital funding prefers investment in the equity of the new enterprise, though they are willing to combine debt and equity (Malaysian Venture Capital Association, VCCC Secretariat, 2002).

Another study by Lefton (1998) indicated that venture capital investment is achieved through a broad range of vehicles, ranging from the fairly new projects which consist of new products to the acquisition of well established companies. The

main characteristic which set venture capitalists apart from other sources of financing is the willingness to undertake higher risks which creates a critical gap in the financing available to Small and Medium Enterprise (SMEs). In addition, venture capitalists also frequently provide necessary management support for their investee. This contribution assists in the realization process of the company's potential growth and improves the venture capitalist's chances to 'exit' profitably from the investment.

Despite risks, a venture capitalist ventures into investments without worries about failure of an investee company, because there are other projects that succeeds netting a very high return on the investments. The returns are generated from the selling of the stocks when they get listed on the stock exchange or by selling the stake in the company to a potential buyer. This was mainly to cash in on an increased appreciation of the share value of the firm at the time of disinvestments in the investee company. If the venture fails (more often than not), the entire amount invested is written-off. Probably, that is one reason why venture capitalists assess carefully the viability of the project such as management team and marketability before undertake or invest in several projects (Malaysian Venture Capital Association, VCCC Secretariat, 2002).

To conclude, a venture financier is one who comes forward to funds a start up company. A venture capitalist does not play the role of a lender, but act as an equity partner. They do not thrive on minimalism, but are driven by maximization of wealth. Venture capitalists are a source of expertise for the companies they finance. Exit strategy or cease to invest in investee companies is preferably through listing on stock exchanges (Malaysian Venture Capital Association, VCCC Secretariat, 2002).

2.1 The Venture Capital Process

The venture capital investment process differs between industry, timing and region. But activities in a venture capital fund still follow a normal process flow. The various stages in an investment cycle are generating a deal flow, due diligence, investment valuation, pricing and structuring the deal, value addition and monitoring and exit. In generating a deal flow, the venture capital investor creates a 'deal' known as investment opportunities that they would consider for investment. This is achieved namely through venturing into an appropriate channel of venture capital funds/investors. The next step is due diligence which is the industry jargon for all the activities which involves analysis of investment proposal (e.g. reference checks on management team, products/services, technology and market). Quality of an investment opportunity is the most important criteria that venture capital due diligence focuses on.

The most critical events in the investment process is the investment valuation process which is an exercise aimed at achieving 'a reasonable value'. Further, structuring follows a set of chronological order that is the negotiation process with the entrepreneurs to accept a venture capital's proposal and closing the deal. The role of venture capitalist does not cease after the investment is made in the project. The final process is monitoring, follow up and exit. There are several exit routes, one of which is where the promoters purchase back the venture capital shares, sell to other venture capitalist or sell during the Initial Public Offering (IPO) and others (Malaysian Venture Capital Association, VCCC Secretariat, 2002).

Figure 2.2 below shows the process of venture capital investment.

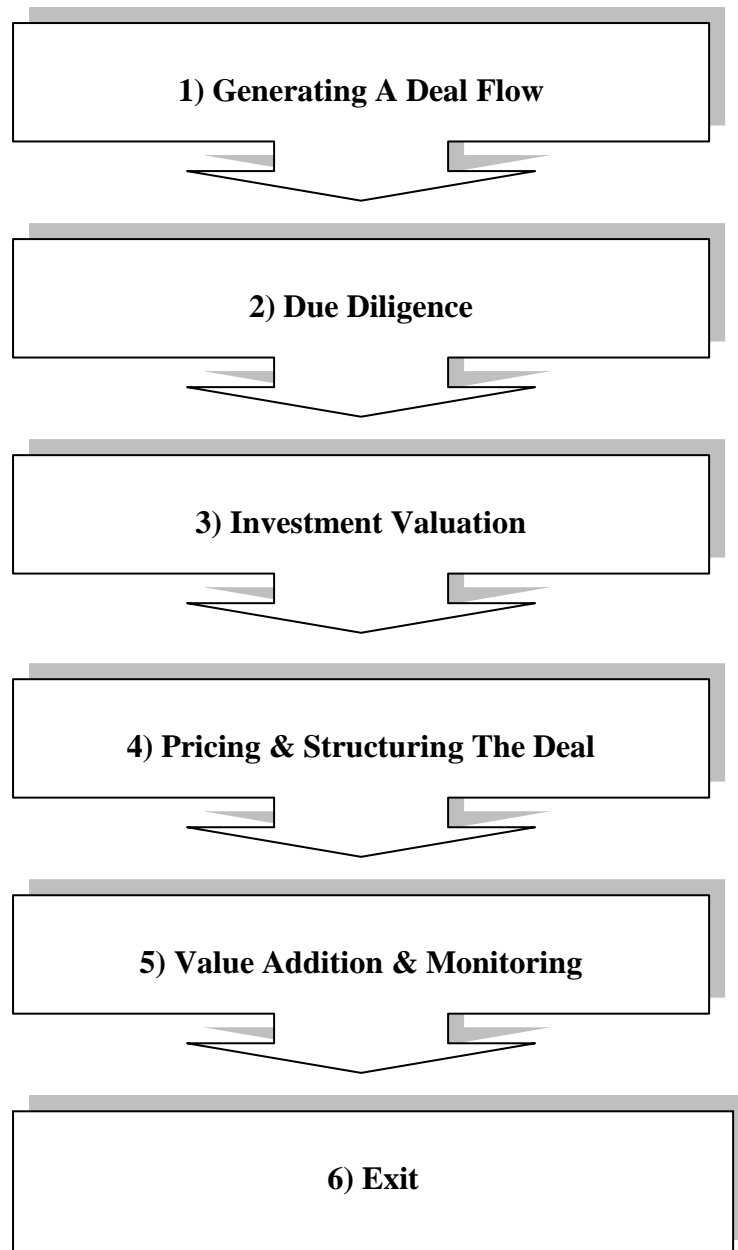


Figure 2.2 : The Process of Venture Capital Investment

2.2 Assessing Investee Companies

This section will highlight the approach to an investor and the entire process that goes into investment in the investee company. Noted, that there are standard parameters used by venture capitalists which are widely practiced in any other investment decision. Basically, venture capitalist requires the investee company to present a detailed and comprehensive business plan. The business plan is defined as a proposal

that comprised of the management team (e.g. background of BOD, shareholders), product/services, marketing plan, capital costs and mode of financing and profitability statements. The key factors in the business proposal that are required by the venture capitalist are as follows :-

- (1) The history of the business enterprise (e.g. date incorporated, paid-up capital, geographical location, management team).
- (2) The business opportunity or potential growth.
- (3) The estimated capital.
- (4) The industry, the market conditions and the competitive forces (e.g. political stability, economic condition, social environment).
- (5) The analysis of current and potential competitors.
- (6) New technologies and products that might affect the competitive environment.
- (7) The background details of the management team such as the BOD and shareholdings.
- (8) Financial forecast, including profit and cash flow for a number of years, expected capital requirements, how the funding would be used, and any other relevant information.
- (9) The short and long term goals, vision or mission of the firm.

In summary, venture capital funds go through a number of due diligence to close the deal. This comprises of evaluation of the management team, strategy, execution and commercialization plans. Lastly, this will be additionally supported by legal and accounting due diligence which will be normally carried out by an external agency (Richard & Philemon, 2004).

2.3 The Stages of Venture Capital Financing

The venture capital financing comprised of four stages namely seed finance, start-up finance, expansion finance and later stage finance. *Seed finance* is the first stage which involves small investment that allows an entrepreneur to verify the feasibility and viability of the projects which involved a provision to finance to a company with a business venture or idea that has not yet been established. The second stage is *start-up finance* whereby an investment to operationalize a firm which comprised of recruitment of employees, development of prototype, implementation of marketing strategy and development of corporate strategy.

The next stage of financing is *expansion finance* which consists of investment to industrialize the production, upgrade the production facilities and employ more manpower. At this stage venture capitalist may assist the firm to source additional funding, buyers and suppliers. Finally, the last stage of financing is *later stage finance* whereby financing are generally provided to established, medium-sized companies that are matured or operating profitably. The funding is normally used to finance strategic moves such as expansion, growth, acquisitions and management buy-outs. As such, this stage focuses on investment to assist the firm to become a market leader and unleash its earning potential, preparing it for trade sale or Initial Public Offering (IPO) (Bottazzi & Da Rin, 2002).

Figure 2.3 below shows the different stages of venture capital financing and the Table 2.1 displays the compounded annual return of a typical venture capitalist at the different stages of financing a business enterprise (Richard & Philemon, 2004).