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Using accounting information to support venture capital (VC) decisions

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Abstract

Accounting information has traditionally played a crucial role in business valuations (Arnold and Moizer, 1984). However, the role of accounting and a company's information system in the assessments and valuations of investee firms by VC investors is poorly understood. This is especially true for VC investors in developing nations such as countries in the Middle East. The current chapter examines the importance placed on accounting data and an investee's information system by Saudi VCs who operate throughout the Middle East. The analysis is based on interviews with a group of Saudi VC investors as well as several entrepreneurs who were seeking VC funding at that time. The results suggest that in the Saudi context, accounting information can play a crucial role in the VC decision to invest in a company; although the type of accounting information used (audited v internally produced) varied according to the maturity of the investee company.

Keywords: venture capital, accounting information, audit, Saudi Arabia

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6.1 Introduction

Financial information has traditionally played a crucial role in investment decisions (Arnold and Moizer, 1984). Despite the limitations associated with such information (Amir and Lev, 1996), the valuation of businesses on the basis of earnings, dividends, assets or cash flows has a long pedigree dating back to Graham and Dodds (1934). These pioneers suggested that investors could estimate the fundamental value or intrinsic worth of a business based on financial statement numbers. A comparison of this intrinsic value with the current price of a listed entity would then help investors to identify undervalued companies that were suitable for investment. Several academics have suggested trading strategies for investors based on such mispricing of securities that appear to yield abnormal returns (Alexakis et al., 2010; Lewellen, 2002; Oppenhiemer, 1984; Ou and Penman, 1989). Although there is significant literature about the use of accounting numbers in decision-making processes by investors (see, for example, Arnold and Moizer, 1984; Imam and Spence, 2016; Pike et al., 1993), its role in decision-making within the VC industry is not well understood[1].

Venture capitalists (VCs), unlike shareholders who invest in public companies, have different information needs, and face different constraints in terms of the financial information available. The nature of the environment where VCs operate is different from that of typical investors who purchase a stake in a listed company. In particular, obtaining information about unquoted companies is more difficult (Hassen and Leece, 2007) since they have fewer disclosure requirements and do not need to comply with stock exchange listing rules[2]. Obtaining this information from the unquoted companies themselves is often problematic since issues such as information asymmetry and adverse selection arise (Amit et al., 1993). In addition, the legal protection afforded to investors in private companies may not be as robust since of the safeguards associated with share ownership are conditions linked to stock exchange

rules. The remainder of this chapter will discuss the role played by accounting information in aiding VC investors to decide on which enterprise should be funded. Specifically, this chapter will identify the extent to which VC investors in Saudi Arabia use financial statement information when arriving at their investment decision. Saudi Arabia was selected for the research site because a thriving VC market has developed in the country as a result of the Kingdom's attempt to reduce its dependence on oil; this desire to diversify the economy of the country was signalled in the government's Vision 2030 plan which was published in 2016 (Kingdom of Saudi Arabia, 2022). The plan has sought to encourage entrepreneurs who want to set up their own non-oil related businesses and aid those who seek to fund such ventures. As a result, the VC market in Saudi Arabia has become one of the largest in the Middle East and one of the fastest growing outside of Europe and the USA. The Saudi VC industry has grown tremendously during the years 2019-2021; most of this growth has been attributed to two main funds: the Saudi Venture Capital Company and JADA[3] which were established by Saudi government in 2018 with initial grants in excess of $1bn each to stimulate venture capital investments in start-ups as well as to encourage angel investments in the Kingdom (JADA, 2021; Saudi Venture Capital, 2022). The total amount of subsequent funds raised by these and other Saudi VCs for investment in start-up businesses has increased from $59m in 2018 to $584m in 2021; as a result, Saudi Arabia has achieved the second highest rate of growth in this form of funding within the Middle East/North Africa (MENA) region after United Arab Emirates (UAE)[4]. Yet very little is known about the information which Saudi VCs require or the details which Saudi entrepreneurs are willing to supply in order to secure funding. Very little research has investigated the relative importance of financial or non-financial information in Saudi Arabian VC funds. Further, no research exists about the different sources of information available to VC investors or the emphasis placed on an investee-firm's information systems when Saudi VCs are deciding to take a stake in a potential investee company. Whilst

such questions have been addressed in the USA and in Europe, the current chapter examines these issues in an emerging market setting where the legal framework governing VC investment is still developing[5]. Thus, the current chapter seeks to plug these gaps in the literature by addressing two research objectives: first, the chapter examines the importance of financial and non-financial accounting information in the VC decisions about investment in Saudi companies; the usefulness of financial data relative to non-financial information is considered. Second, the chapter gathers perceptions about the role played by an investee firm's accounting information system in VC decisions. These objectives are examined in a context characterised by very few financial analysts and limited non-financial information where the venture capital investment community is relatively new.

6.2 Insights from the mainstream literature

Studies about VC practices in developed countries suggest that before investing, VC investors follow three steps when deciding on whether or not to invest in a firm. These are: collecting investee company information, using this information to estimate the risk and expected return from the possible investment, and applying an appropriate valuation method to calculate the percentage of equity they would require for the funding they are willing to provide (Hassen and Leece, 2007). A debate exists in the literature about these steps on whether or not financial statement information is relevant for VC investors. Studies have highlighted that the importance attaching to accounting information contained in business plans such as income statements, balance sheets and unaudited management projections varies across countries and regions. For example, evidence indicates that more importance is given to financial information amongst European VC managers than among their counterparts in the USA (Manigart et al., 1997; Manigart et al., 2000). Manigart et al. (1997) attributed this difference to the fact that

fewer VC investors in the USA concentrate on early-stage companies relative to their VC counterparts in Europe; early-stage companies suffer from a lack of available financial information. In addition, Hand (2005) argues that financial information is less significant for early-stage businesses seeking VC funding since the emphasis is on innovation and business growth. As firms mature, however, financial information becomes more important in the VC investment decision. With mature firms, greater importance is placed on assets and financial capital when arriving at company valuations. In contrast, early-stage firms tend to suffer from a shortage of physical and financial assets, relying mainly on human capital (Zimmerman, 2015). When Armstrong et al. (2006) examined the financial statements of early-stage companies, they found that certain costs were used by VC firms when looking at a broad range of industries. They found items such as the cost of sales, selling, marketing, and general administrative expenses as well as R&D expenditure, were seen as crucial variables that influenced a VC's decision to invest since they provided information about the revenue-generating potential of an investee firm.

Cassar (2009) has examined the role of interim financial reports in securing VC funding for new ventures in the USA. In the absence of any disclosure requirements, Cassar (2009) found a positive relationship between (i) the frequency with which interim financial statements were produced by entrepreneurs seeking VC funding and (ii) the need for external financing, the level of competition among VCs to supply funding, and the stage of an investee firm's product development. The author concluded that "*non-stewardship factors, ... that reduce competitive and fundamental uncertainty, [were] influential*" (Cassar, 2009, p. 28). This suggests that the provision interim financial statements by entrepreneurs reduced information asymmetry and helped secure VC funding at more competitive rates. This was especially true for the income statement and cash flow information; very little emphasis was placed on balance

sheet data[6]. Also, projections and forecasts were more frequently prepared in start-ups that involved patents and R&D (Cassar, 2009).

Zimmerman (2015) built on Cassar's (2009) work by exploring the role of accounting information in the valuation of investee firms by US VCs. He argued that the importance of accounting information is declining due to the growth of knowledge-based capital and other intangibles amongst start-ups seeking VC funding. He found that within companies with predominantly human-based capital, current earnings were a very poor predictor of future income and growth (Zimmerman, 2015). However, other accounting information appeared to be used by US VC investors such as revenues, cash flows, cost reduction targets, and working capital (Zimmerman, 2015).

Consistent with Zimmerman's (2015) findings, Smith and Cordina (2014) argue that accounting information only plays a limited role in investment decisions by VC investors within a European context. They interviewed a number of representatives from early-stage VC associations representing investors in the UK and mainland Europe between August and December 2011. They found that VC investors tended to use financial statements as a 'starting point' to conduct their due diligence on funding applications from entrepreneurs. VCs within the UK considered projected rather than historical financial statements arguing that 'historic financial statements are not a very major component of due diligence; … when you are investing, you are investing in future value, not past value.' (Smith and Cordina, 2014, p. 316). The respondents in Smith and Cordina's European study indicated that VCs never relied entirely on financial statements to produce a holistic view of the company's value; indeed, one of the investors interviewed by Smith and Cordina (2014 p.316) highlighted that "*financial statements are always not the whole truth and sometimes they're not even very close to the truth.*" Although VC investors were sceptical about the figures provided by entrepreneurs within the Annual Report, they suggested that financial statements might still be useful except

"*when talking about intangibles [where] there is always an issue about the degree of uncertainty around some of the assumptions [employed]*" (Smith and Cordina, 2014, p. 316).

Hassen and Leece (2007), Manigart et al. (1997) and Wright and Robbie (1996), have all explored the common sources of information used by VC investors in different national settings. They have highlighted that the VC firm's own due diligence reports are the most important source of information; the financial information provided by the entrepreneur in the business plan which accompanied the funding application was ranked second. Manigart et al. (1997) and Wright and Robbie (1996) found income statements, unaudited financial statements, and management projections for the coming year were influential among VCs in preparing to value an investee firm.

However, the literature suggests that the views of VC managers in Europe vary from country to country; for example, Wright and Robbie (1996) indicated that a VC's own due diligence reports were considered more important than the due diligence documents of a third party (i.e., an accounting firm) in the UK. By contrast, Manigart et al. (1997) and Manigart et al. (2000) found external due diligence reports to be more critical in mainland Europe. Further, some accounting information, such as a qualified audit report and long-term management projections, were used more in mainland Europe than in the UK (Manigart et al., 2000). This led the authors to conclude that VC managers in Europe were more financially oriented while their counterparts in Anglo-Saxon countries (such as the UK) were more business-focussed (Manigart et al. 1997; Manigart et al., 2000; Sapienza et al., 1996).

Lockett et al. (2002) compared the different approaches used by VCs in the US, Hong Kong, India, and Singapore when gathering information on which to base their investment decisions. They suggested that information sources that a VC can trust might be more culturally determined rather than easily transferred from a country to another. As a result, there are less

trusted sources of information for a VC use in developing countries compared to US market. However, the rationale behind such differences were unclear. Joshi and Subrahmanya (2019) suggested that this lack of trust was greater (and risk higher) where the "nationality" of the VC firm and the location of the investee company were different.

Other researchers have considered different influences on the sources of information used by VCs when arriving at their funding decision. For example, Wright et al. (2004) documented no relationship between the source of information used by VCs and the VC type when looking at different countries. However, Hassen and Leece (2007) found differences across three different types of VC (independent, captive, and semi-captive)[7] both in terms of their usage of accounting data and the source of that information. According to Hassen and Leece's analysis, semi-captive VCs tended to use accounting information to a greater extent than the other two because they worked within a parent company; they needed to manage risk and justify their funding decision to the main board of their parent entity and used accounting information for this purpose (Hassen and Leece, 2007). Hassen and Leece (2007) suggested that the three types of VC had different organizational structures and invested at different stages of the start-up's journey leading to different agency risks. As a result, a greater emphasis was placed on some information sources rather than others by the three types of VC. However, all of the VC firms consulted believed that publicly available sources of information such as articles in the financial press and trade journals were ranked as unimportant by VC investors (Wright and Robbie, 1996; Hassen and Leece, 2007).

Given the differences in information (and information sources) used by VCs when evaluating potential investments, further research is needed; especially relating to VCs investing in a developing country such as Saudi Arabia. The current chapter attempts to address this need for research; specifically, it examines the usage of financial as opposed to non-financial information by VCs in the Kingdom of Saudi Arabia (a developing country) and

investigates the common sources of information which VCs employ. Finally, the chapter looks at the role of an enterprise's accounting information system in the decision by a VC to invest in a business seeking funding.

6.3 Research method

This research employed semi-structured interviews to tackle the issues being investigated. [8] Specifically, each interviewee was asked about the sources of information used by (or supplied to) a VC as part of a funding application. Their views were also ascertained on perceptions about the relative importance of different types of financial information in the VC funding application process. Finally, participants were asked about the relative importance attached to the accounting information system in the potential investee firm by a VC when making their investment decision. Each interview lasted for between 1 and 1.5 hours. The interviews took place between November 2020 and December 2021. All of the interviews were conducted online via Zoom/Microsoft Teams because of travel restrictions and responses to questions were transcribed in Arabic and translated into English for the minority of interviews that did not take place in English. Each transcript was read several times and the responses of the interviewees distilled into a brief comment which was entered into an Excel spreadsheet. These comments were then summarised in tables, following a thematic analysis (King, 2004), and quotes extracted from the transcripts in order to illustrate the views being expressed. Therefore, a deductive approach was employed drawing on the themes from the questionnaire and the concepts from the literature (Johnson, 2004).

Table 6.1 shows an overview of the research participants. Some 11 worked for VCs while 8 were owners of investee, or potential investee firms. All of these investees (5 interviewees) and potential investee firms (3 interviewees) had either secured VC funding in the recent past or were actively looking for a VC investor to take an equity stake in their

business. Thus, perspectives from the two main "sides" of the VC funding decision were consulted for this research. Obtaining the perspective of investees/potential investees and VC investors was crucial as the literature indicates that the two groups can often hold different and conflicting views about the issues being considered in this chapter (Zacharakis et al., 2010). Participants worked in a range of different size VCs or firms; thus, the views expressed should not be unique to any size-category of entity. Sixteen of the interviewees were male and 3 were female; such a mix is not unusual in Saudi Arabia where the presence of female VC investors and female entrepreneurs is relatively low (Danish and Lawton Smith, 2012). All of the participants were experienced having spent many years, on average, either working as a VC investor or operating as an entrepreneur; as such, the views expressed should be insightful since participants were knowledgeable about the issues being discussed.

Table 6.1: An overview of the research participants

Participant	*Type*	*Firm size*	*Gender*	*Education level*
P1	VC	Medium	Male	BSc
P2	VC	Small	Male	MSc
P3	VC	Large	Male	MSc
P4	VC	Small	Male	MSc
P5	VC	Large	Male	MSc
P6	VC	Small	Male	MSc
P7	VC	Large	Male	BSc
P8	VC	Medium	Male	BSc
P9	VC	Small	Male	MSc
P10	VC	Large	Male	BSc
P11	VC	Large	Male	BSc
P12	Investee firm	Medium	Female	MSc
P13	Investee firm	Medium	Male	MSc
P14	Potential Investee firm	Small	Female	GradD
P15	Potential Investee firm	Small	Female	BSc
P16	Investee firm	Medium	Male	BSc
P17	Potential Investee firm	Small	Male	MSc
P18	Investee firm	Medium	Male	MSc
P19	Investee firm	Medium	Male	BSc

Note: the second column shows classification of participants weather from the VC side or from investee side. The third column shows the firm size, measured by the number of start-ups that they have funded for those who are VCs and company assets for those which are Investee or Potential Investee firms. The final column shows the highest education level attained by the respondent where GradD refers to a graduate diploma, BSc refers to a bachelors degree and MSc refers to a masters qualification.

6.4 Results

This section is divided into two parts: (i) the first will present the views of participants from VCs; (ii) the second part will discuss the perceptions of entrepreneurs working in investee (or potential investee) firms.

6.4.1 The VC investors' perceptions

All of the VC participants agreed that their investment decisions were characterised by uncertainty and information asymmetries; the VCs and the entrepreneurs operating the investee firms/potential investee firms often had different goals – especially in the pre-investment phase of the funding process. Thus, the quantity and quality of information provided to VC investors was often described as problematic. VC participants highlighted that they were targeting privately-owned, relatively-small and often young businesses to make an equity investment. These businesses typically had limited data available compared to publicly listed companies. This was especially true of financial or accounting data which VCs needed in order to estimate the equity stake that they should demand for their investment, the likely rate of return which they might achieve, and the time needed before an exit strategy could be acted upon. The information systems of the potential investee firms were typically less sophisticated as these businesses concentrated on production or marketing strategies to achieve market share. Table 6.2 summarises the views of the VC research participants on the usefulness of different accounting information in the VC funding decision. In contrast to findings from the literature, a sizeable majority of the participants believed that accounting information was useful for Saudi VCs when deciding to invest in a business. Most of the VCs interviewed indicated that accounting information was always useful; only two VCs suggested that the information was sometimes useful. Subtle differences about the usefulness of accounting information emerged amongst the interviewees when the stage of the investment and other factors were considered.

Table 6.2: The usefulness of accounting information in the VC industry: perceptions of VC participants

Participants	Usefulness of Accounting Information for VCs	Type of Accounting Information Consulted	
		Internal management accounts	Audited financial statements
P1	Always Useful	Yes	Yes
P2	Always Useful	Yes	Yes
P3	Always Useful	Yes	No
P4	Always Useful	Yes	No
P5	Always Useful	Yes	No
P6	Always Useful	Yes	Maybe
P7	Sometimes Useful	Yes	No
P8	Always Useful	Yes	No
P9	Always Useful	Yes	No
P10	Sometimes Useful	Yes	No
P11	Always Useful	Yes	No

According to the interviewees, the management accounting information system was still viewed as useful for making an informed decision about whether or not to invest in a business although such management accounting information might lack complete accuracy, or it might exhibit a high level of optimism (when it came to forecasts); the VC interviewees suggested that information produced by entrepreneurs who were seeking to securing funding tended to be positive and biased in an upward direction. For some VC investors, accounting information was seen as a crucial factor in deciding on whether or not to take an investment opportunity further. For example, participant P2 explained that *"[within his VC fund, they] do not invest in a company that does not have financials; [his VC fund] has invested in a company that did not have an audit but they must have financials"*. This participant stressed that his fund would pass up on an investment opportunity if they learnt that an applicant did not produce any management accounts. As with Smith and Cordina (2014), this management accounting information acted as a starting point for the investment analysis of this participant's VC. He

argued that without this source of accounting information, understanding the current financial position of the applicant was problematic. He stated that *"making decisions in a vacuum or [where financial information was] non-existent is always dangerous".* He added that *"starting from somewhere and then building on it always [leads to] a better decision".* Participant P1 supported this view. He highlighted that his fund took the applicants' internally produced *"financials and [went] ... forward from there".* The management accounts were viewed as a building block upon which the VCs valuation could be constructed.

A key issue was whether the usefulness of management accounting information related to the current financial position of the company or whether it played a role in in helping VC investors to differentiate possible high growth deals from other applicants with less potential. Such information was seen as essential from a very early-stage. Participant P11 highlighted the predictive ability of management accounting information, stating that "*it helped [his VC] to verify the past and forecast [the future allowing his firm to check] those assumptions, relating to new customers and growth".* He stated that his VC firm was interested in how *"costs were going to play out so [accounting information] was seen as very important".* P9 added that this management accounting information needed to show whether or not the company was performing in a satisfactory matter. For example, he stated that:

> "If you do not have financial information, how can you know if this company is actually selling something? How do you know if the start-up is getting a lot of customers? Part of the financial information is not only the income statement, the balance sheet and the cash flow statement. [In addition], I want to know what [certain ratios such as] the mark-up [indicate]."

Participant P8 highlighted that any sensitivity analysis or scenario planning involving this management accounting information was not focused solely on making predictions about the future but evaluating the plausibility of the information being considered. For example, he highlighted that:

> "We [don't] want to see [only] healthy financials; we want to see entrepreneurs who know what is going on [with their business] - not only presenting [the VC] with any kind of numbers which might make them appear in a more favourable light. There is a difference. Sometimes we see a company with a weak financial position, but [the information] is genuine, and there is no evidence of fraud. Others just give you information that shows you tremendous growth that will never happen. We don't like that".

The alignment between the management accounting information and the narrative supplied by the investee firm was seen as crucial for P6. It gave him reassurance about the veracity of the financials and likely success of the applicant's business plan. His VC based their investment *"on two things: narratives (the story about the business) and the numbers in the financial statements."* His VC wanted *"to see alignment between narratives and numbers".*

Participant P7 expressed a different opinion when commenting on the usefulness of financial information for VCs. He argued that the importance of the financials depended on the maturity of the potential investee firm being considered. Indeed, for some early businesses, the role of non-financial information was crucial:

> "We invested in some companies that did not have adequate financials as long they were in the early-stage [of their lifecycle]. In such cases, the big problem was not the [lack of] financial [information] but the validation of the product, the adoption of the product, the happiness of the customers, scalability issues, and growth potential. All of these things were much bigger problems than the financial [situation]."

Similar to Hand (2005), P7 suggested that *"the financials were not seen as a priority for some VC investors."* He admitted that a *"better financial position for a company was definitely desirable but VCs had much bigger issues to consider [such as sales, market penetration and production] before looking at the financials".*

A smaller number of participants suggested that the annual reports of investee or potential investee firms were used by VCs - confirming the view expressed by Wright and Robbie (1996). They argued that any financial information provided by a business needed to be externally verified in order to be credible for the VC. This view depended on the stage of

the investment, with several participants attaching greater weight to audited financial statements if the business being considered for investment was relatively mature. For newer businesses, the availability of audited financial statements was less common, and VCs did not require such information due to the cost and time constraints that this requirement would impose. For example, Participant P5 highlighted that *"if you are looking for audited financial statements in early-stage companies … by the time you have them, they might be out-of-date – they might be 6 to 10 months old".* However other participants were more supportive of the usefulness of audited financial statements for VC investment decisions. These audited financial statements provided some VCs with further assurance about the financial information being analysed. For instance, Participant P1 highlighted:

> "I'll be honest the most important thing in my personal opinion [is that the financial statements need to be audited]; maybe, it's because I am finance guy. In addition, the financials really need to be audited by a decent auditor. So, if it is not [one of the] big four, at least it should be one of the top 10. That really helps to give me comfort, whatever the founder or the company is saying is great; we need validation".

Other participants (P2, P5, P6, and P10) used their own checks in the absence of audited financial statements. They suggested that VC investors could perform different tests to examine the reliability of the accounting information provided. For instance, Participant P1 noted that conducting interviews with the employees of the entity itself usually gave a lot of insight about what exactly was going on in the organization. Others sought additional details by asking the management team at the potential investee firm "*multiple questions from different angles about the accounting information supplied*". However, they admitted that this approach was "*not as easy as one might think*" as the answers received were not always truthful since some of these entrepreneurs were keen to see the business' funding bid succeed even if the accounting information provided was less accurate. For example, P2 highlighted that his VC verified the financials by asking for "*a monthly breakdown [of what the business] claim[s] that they sold*

this past year" noting that "*sometimes the monthly breakdown doesn't add up [to the annual revenue figure in the business' annual report]*". In addition, P2 highlighted that his VC occasionally asked for the applicant's revenue which they multiplied by "*the percentage profit margin in order to compare with reported earnings*"; in his view, "*there are multiple ways of testing any accounting information provided*". More recently, P2 noted how VCs were seeking access to an applicant's dashboard; they looked to "*find any misalignment between the [information from the] dashboard and the [numbers reported in the] financial statements*".

If questions arose about the accounting information after performing checks, recourse to an auditing firm was a possible option according to P10. This individual mentioned that "*If [an applicant has no] audited financial statements, [his VC met with the entrepreneur] and [went] through numbers with them; [his VC] ask[ed] the [business' owners] questions to verify the numbers but had hired external auditors to verify the financials [previously], before investing"*. Another option highlighted by P9 involved the VC's accountant talking to the investee firm's accountant (if the investee firm had an accountant) about the financial statement numbers.

However, these "VC-audit" procedures did not apply to established applicant companies that had been trading for two/three years or those which were raising a sizeable amount of funding. In these cases, VC investors required such applicants to have audited financial statements. Participant 3 stressed that if the company has been operational for a long time and does not have audited financial statements, this will raise a lot of "red flags" and give rise to questions about the reliability of the management. Participant P6 clarified that although his VC fund required companies at the later stages of development to have audited financial statements, sometimes his fund made an exception because some of those applying for funding may have radically changed their business in recent months. He stressed that it was not uncommon for companies to "*pivot the business based on market inputs*"; in these cases "*the*

historical data in terms of financials" would not reflect the new path that the company was taking. Only data for the most recent months might reflect a business' current strategy however, such data was still unaudited. Therefore, his VC skipped the requirement of having audited annual reports for such potential investees.

Some participants explained that if the potential investee firm was incorporated as a company, they had to submit audited financial statements according to Saudi government requirements. Thus, the interviewees suggested that the use of audited annual reports by VCs was unrelated to whether the potential investee firm was raising a sizeable amount of funding. Instead, it was linked to the legal status of the applicant - whether it was incorporated or not. Participant P11 agreed and commented that most Saudi companies had to file their accounts on an annual basis for tax purposes certified by a public accountant if they had been in business for more than a year. As a result, audited financial statements were available for such entities and typically consulted by VCs.

Participants were invited to comment on the sources of information which they consulted when making an investment decision. Although VC investors mentioned a number of different external information sources, an inspection of the interview transcripts showed that the two most common sources of information were the investment file which the VC produced (including a checklist), and the financial information provided by the potential investee firm. If VCs needed further details, they went back to the applicant and asked them to provide additional information. This is consistent with the observations of Reid and Smith (2007). An analysis of the results showed that VCs adopted different approaches to the sourcing of information: a checklist was typically prepared by VCs and sent to the entrepreneur requiring the disclosure of specific items that the VC was interested in; the potential investee firm had to complete the checklist. Participant P3 described this process as follows:

> "[Our VC] usually shares a list of questions or a checklist [with the applicant]; basically, this checklist helps us gather specific information which [is] really helpful [for] learning quickly about the company; it is an efficient method of conducting the due diligence on each opportunity and really helps improve our basic analysis and decision-making [about the applicant]."

The second method was to ask for a set of financial reports about the business applying for funding including a balance sheet and an income statement. The investment team at the VC then reviewed these reports internally, checking every detail. As participant P4 explained:

> "We take the details they provide us with, whether it was actual accounts or projections. Those are the two main things we ask them [to provide], and [from these] we see if [the financial information] makes sense; if the projections are too optimistic; if they have done sensitivity analysis [or considered] different scenarios. If not, we will have to do [it]. Then we check if [their] valuation [of the business ties in with] their projections. So, if they're asking for a certain [amount of funds linked to a specific equity stake based on their] valuation, does that make sense with their current financial information and the amount they are raising."

Subsequently, VC investors may check further external sources to validate the information supplied, as documented in the literature by Fried and Hisrich (1994). In doing so, it is not necessarily new information that VCs are trying to find from different sources. Rather participant P7 suggested that they *"dig deeper and deeper to verify more of the information that they got in general terms at the beginning".* Participant P7 declared that such validation did not take place at the beginning but rather with the due diligence as the VC decides on whether or not to proceed with an investment:

> "We usually don't do intense validation at the screening stage; [for that], we [rely on] what the founders say about the company. Then in the due diligence [phase of the process], we try to validate every aspect [of the information supplied] by asking for the raw data on all of their company's transactions to make sure that what they said is true. So, the full validation comes in the due diligence phase of the analysis"

Participant P2 agreed, explaining that his VC "*start[ed] with the information [that the business had provided] and then grill it to see if it is credible or not*". After this, his VC brought in their

own "*information from [other] sources*". His VC either did this "*exercise internally or found research that support[ed]*" what the applicant was claiming. Such an approach was not uncommon. Indeed, participant P1 indicated that his VC had *"recently signed up with a service which helped find technical advisors who were able to come in and [offer advice] on a certain technical matter if so needed."*

6.4.2 The views of investee firms

Having reviewed the thoughts of VC investors, this section will discuss the views of those participants from the investee side of the process. These participants were invited firstly to comment on whether they believed that VC investors relied on accounting data when taking a decision to invest in a business. The vast majority of respondents in Table 6.3 believed that such information was useful to VCs. However, participant P13 argued that accounting data offered only a partial perspective on the possible risk associated with an investment in a business. He suggested that "*VCs don't [rely fully on accounting data] because there is a risk [that the owners] will close the business after a couple of months*". He thought that VCs "*ask[ed] for the financial [data] just to understand how the company is doing and [whether] there is an opportunity and potential for the company to scale up the business in a couple of months*". In his view, most VCs "*invested in the person*"; they invested "*in the entrepreneur [once] they saw his passion, his energy and the time he put into the start-up*". In his opinion, therefore, "*the reports, the numbers [and] the financials, [were] just to make the VCs feel [more] secure*."

Participants working in investee firms were also asked about whether VCs focus on the accounting information system of the start-up company when deciding to invest. In addition, their views were sought on whether VCs expectations about the accounting information system

varied according to the investee firm's maturity. An analysis of the interviews revealed that newer, younger start-ups in Saudi Arabia typically did not employ a full-time accountant; the founders themselves usually recorded financial transactions and prepared financial reports. Participant P16 suggested that VC expectations regarding the availability of accounting information varied according to business size and age as well as industry norms. He agreed that "*start-ups do not hire an accountant at first*". As the company grows "*then this would be the time that you should hire an accountant*"; but he noted that such an individual "*is only a bookkeeper [who is hired to process] the invoices and [keep] track receipts*". He indicated that the accounting function in such firms "*will not be very sophisticated*" with most of the work being "*done by the founders*". P16 noted that after they had secured some initial funding, his firm "*hired a CFO*" to produce the "*financial numbers… need[ed] by the lawyers and the VCs*".

Table 6.3: The usefulness of accounting information in the VC industry: perceptions of entrepreneurs

Participants	Usefulness of Accounting Information for VCs	Type of Accounting Information Consulted	
		Internal management accounts	Audited financial statements
P12	Always Useful	Yes	Maybe
P13	Always Useful	Yes	Yes
P14	Always Useful	Yes	NA
P15	Always Useful	Yes	No
P16	Always Useful	Yes	Maybe
P17	Always Useful	Yes	No
P18	Always Useful	Yes	No
P19	Always Useful	Yes	No

A variety of accounting information systems (AISs) were used by these investee firms including Xero, Google Drive, QuickBooks, Dashboards, and the ARB system. Participant P16 described how his firm used Google Drive to store accounting data:

> "We built our data rooms on Google Drive; we structured it in a way that the VC investor [could] check each and every file in the easiest [possible] way. So [we designed] a very nice archiving system that [allows transactions to] be tracked; we put it in a secure file, and we call[ed] it 'the data room'. This data room includes every detail about the company; then once the VCs start their due diligence, we share a list of [our files in] the data room, and they can check each file one at a time."

The interviews revealed that investee firms often had to change their accounting information system after a VC invested in a firm. For example, P13 reported that his business "*used a [particular accounting information system] in one of [their] companies [and now that the AIS had changed, the company was] not going back to the old system … as the VC ask[ed] [them] to submit a legally-audited financial report [using the new AIS] to them … certified by an accounting firm in Saudi Arabia*". Participant P14 attributed the change in the AIS in his business to a change in the governance of the firm following the involvement of a VC (consistent with Sahlman,1990). He highlighted that:

> "After the VC investment, it became different. We now have a strong governance body that controls our communication with them. We define exactly what kind of reporting they will receive, how frequent [it will be] and if they have a seat on the board [as a] member or not. [We agree at the start if the VC] is playing an advisory role or not. So, we literally define our communication with the VC … at that moment when they decide to invest."

The interviewees supported the model developed by Fried and Hisrich (1994). The results from the participants revealed that investee firms categorised the accounting information provided to VCs into two kinds: where investee firms tended to share a limited amount of information before the VC investors showed an interest in making a deal; then VCs were given access to an online data room when they were performing a due diligence investigation of the firm which usually happened after the investment became more likely. The difference between the two is that the initial data supplied includes information about the financial model, revenue streams, costs, and financial statements of the business; but the data room includes detailed

records of company's management accounts, documents, contracts, liabilities, and every single transaction relating to the company. Participant P12 provided an example of the information that her business provided to VCs at a very early-stage of the discussion about the possibility of investment. She reported that:

> "a good presentation of the … the business [was needed]; what kind of problems [that they were] solving as well as the vision [of the future]; what [the business was] trying to do or what was the next step. Information about the management team was important as well; what kind of team [had the business] built, market opportunities, market size, and the growth potential? [For our business] the numbers were good because we grew our revenue by [a factor of] three during COVID when everyone else's sales stalled.".

Participant 13 explained that the type of information provided to the VC may depend on what they ask for. He noted that **"***some of them ask[ed] for all the financials, even the budgets - everything from the day you start[ed]. But some VCs didn't ask [for]anything. They just [looked at] the sales and the operating cash in the business and evaluated the potential investment in this way*". However, P13 indicated that "*about 80% of the VCs ask to see the financials. The largest VCs will ask for a financial report certified by an auditing firm*" before they handed over their investment.

Several participants from investee firms highlighted concerns over the confidentiality of their business' records and financial information. They noted that it was difficult to differentiate between VCs who were interested in investing and those who only wanted to get access to the records/financial data and the project's progress in order to benchmark their current investee firms or help their investees to increase their market shares. A number of participants recalled situations where a VC passed their information on to competitors who were in their portfolio or being considered for investment. Non-disclosure agreements were uncommon in the MENA region and VCs mostly refuse to sign these agreements. Even where they were signed, P18 indicated that there was no law in Saudi Arabia to protect a business against any breach of these agreements.

6.5 Conclusion

This chapter has discussed the use of accounting information in Saudi VC investments with the views of both VC investors as well as investee/potential investee firms being represented. Looking at the views of those who worked in VCs, the analysis showed that accounting information played a crucial role in the investment decision; management accounting information was scrutinised for new, young start-up firms while audited financial statements were consulted for more mature businesses. The management accounting information was used cautiously since the VC investors were concerned about any optimistic bias present in the data. The accounting information helped VCs to predict the potential growth and profitability of the investee firms which fed into VC valuations and decisions about the equity stake which VCs would demand for the funds being sought; one might argue that even when using the accounting information as the "starting point" of investment analysis it helped to mitigate the risk associated with making an investment decision in the absence of other data. The results also revealed that audit played a less important role in VC investments compared to investing in publicly listed companies. Looking at the views of investee/potential investee firms, the participants highlighted difficulties faced in preparing detailed accounting information at very early stages of their companies' life due to the dearth of resources available. They were also concerned about the cost of audit if the VC required the financial information to be assured. The relative of financial information varied depending on the stage of the investee company's development. For younger, less-mature companies, greater reliance was placed on non-financial data. As companies grew, the role of audited financial information became more important. Accounting information systems played a role in facilitating the exchange of accounting information between the two parties (the VCs and the investee/potential investee firm) at different stages of the company's life. The relationship

between the VC and the investee was therefore a multi-stage process; the accounting used and the AIS employed by the investee firm changed to take account the nature of the relationship between the two parties. Indeed, as firms matured, the emphasis placed on audited financial statements increased at the expense of internally produced management accounting data.

6.6 References

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[1] A notable exception to this generalisation is Wright and Robbie (1996).

[2] Holmes and Nicholls (1988) investigated the use of accounting information in Australian small businesses. The authors identified many factors that might affect the nature and the amount of published accounting information, namely: Business size, Business age, industrial grouping, and the owner/manager's level of education.

[3] JADA was launched following a resolution of the Council of Ministers in Saudi Arabia, with an investment capital of SAR 4 billion (approximately 861m GBP). It aims to provide funding to Saudi small and medium sized entities through VC and private equity investments. JADA was a key component of Saudi Arabia's economic and social development plan - Vision 2030.

[4] Indeed, Saudi Arabia was ranked second both in terms of the total amount of VC funding raised as well as the number of deals agreed between VCs and businesses (MAGNITT, 2022). The largest deals by Saudi VCs were in the Food and Beverage industry, followed by the Fintech, Logistics and E-commerce industries. The industry which received the smallest amount of VC funding was the IT solutions sector (MAGNITT, 2022)

[5] It is worth noting that the government of Saudi Arabia has recently updated the legal system underpinning VC investment. These changes are expected come into force by the end of 2024. For example, Antaki (2022) noted that a new type of company will be permitted to meet "*the needs of entrepreneurship and venture capital growth*".

[6] Cassar (2009) attributed this emphasis on the income statement and cash flow data to the lack of assets amongst start-ups which could be used as collateral.

[7] A captive VC firm is typically a subsidiary of a large financial institution. This type of VC firm receives financing from the parent company (Osnabrugge and Robinson, 2001; Hassen and Leece, 2007). Independent VC firms receive financing from different external sources such as individual investors and pension funds (Hassen and Leece, 2007). The semi-captive firm is established when a subsidiary of a large institution establishes its own fund and invites external investors to contribute funding (Hassen and Leece, 2007).

[8] These semi-structured interviews were guided by a questionnaire document split into eight different sections. The first section sought background information about the respondents. The next two sections asked interviewees about the pre-investment stages of the VC cycle. Interviewees views on the role of financial information, valuations and the importance of non-financial information were elicited in the following three sections. Post investments considerations were included in the final two sections of the questionnaire.