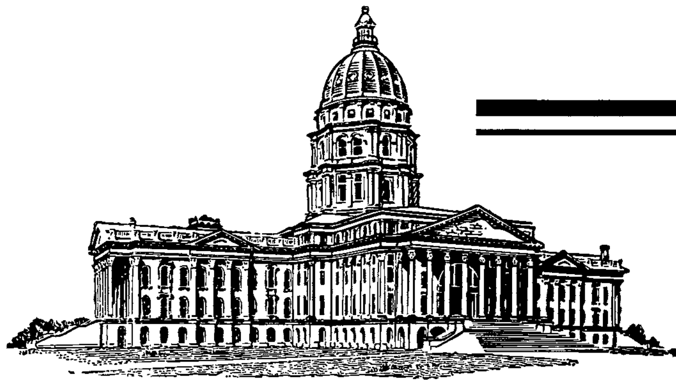

PERFORMANCE AUDIT REPORT

Criteria for Awarding Venture Capital Moneys Through Kansas Venture Capital, Inc.

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
March 1990

90-44

Legislative Post Audit Committee

Legislative Division of Post Audit

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PERFORMANCE AUDIT REPORT

CRITERIA FOR AWARDING VENTURE CAPITAL MONEYS THROUGH KANSAS VENTURE CAPITAL, INC.

OBTAINING AUDIT INFORMATION

This audit was conducted by Allan Foster, Senior Auditor, and Cindy Denton and Rakesh Mohan, Auditors, of the Division's staff. If you need any additional information about the audit's findings, please contact Mr. Foster at the Division's offices.

90-44

TABLE OF CONTENTS

Criteria for Awarding Venture Capital Moneys Through Kansas Venture Capital, Inc.

Summary of Legislative Post Audit's Findings

In 1987, legislation was passed to create a Statewide risk capital system in Kansas. To create a private risk capital pool for investment in Kansas small businesses, the legislation authorized the Pooled Money Investment Board to invest up to $10 million in Kansas Venture Capital, Inc., a licensed, small business investment company. The firm provides high risk equity capital, loans, and management assistance to small Kansas businesses. Since mid-1987, the firm has made 15 venture capital investments totaling $4.8 million in 11 firms. As of January 1990, the State's investment in the firm totaled $5 million.

Legislative concerns have been raised about the criteria that have been established for awarding moneys through Kansas Venture Capital, Inc. This audit addresses those concerns by answering the following questions:

What criteria have been established for awarding venture capital moneys through Kansas Venture Capital, Inc., and have they been followed? Federal and State laws and regulations and Kansas Venture Capital, Inc., Board policies place limits on such things as the type of companies Kansas Venture Capital, Inc., can invest in, the amounts of money it can invest, the interest it can charge on loans, and the amount of control it can assume over any company. In considering potential investments, the firm's officials also use numerous unwritten guidelines to evaluate the management, product, market, and potential return on the investment.

We found that Kansas Venture Capital, Inc., generally followed the specific federal, State, and Board requirements we identified regarding its venture capital investments. We were unable to fully assess whether Kansas Venture Capital, Inc., adhered to all its unwritten guidelines for evaluating investments because, in many instances, the firm did not keep documentation showing the kinds of analyses and determinations called for by those guidelines. Maintaining that documentation would provide the Legislature with greater assurance that the firm's staff is making prudent investment recommendations to its Board of Directors. The firm has taken steps to improve its documentation in this area.

How do the criteria established for awarding venture capital compare with criteria established for similar programs in other states? Kansas' venture capital program is unique. We were able to identify only three other states that had venture capital programs somewhat similar to Kansas' program, and those programs were more closely tied to their state governments. Many of the basic criteria these other state programs used in making investment decisions were similar to the criteria used in Kansas.

The report recommends that the firm consider formalizing its unwritten criteria and continue in its efforts to document the work performed. We would be happy to discuss the recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

Meredith Williams
Legislative Post Auditor

Criteria for Awarding Venture Capital Moneys Through Kansas Venture Capital, Inc.

Kansas Venture Capital, Inc., is a licensed small business investment company that has been in business since 1976. It exists to provide high-risk equity capital, loans, and management assistance to small Kansas businesses having potential for growth and long-term equity appreciation. It invests in early-stage or start-up companies, established companies with the prospect of rapid growth, and companies that need additional funding to turn their businesses around. It also participates in acquisitions and leveraged buyouts.

In 1987, the Kansas Statewide Risk Capital System legislation was passed to help meet the risk-capital needs of the various regions of Kansas. To create a private risk capital pool for investment in Kansas small businesses, the legislation authorized the Pooled Money Investment Board to invest up to $10 million in Kansas Venture Capital, Inc. To date, $5 million in State funds has been invested.

Legislative questions have been raised about several aspects of this program; namely, what criteria have been established for awarding moneys through Kansas Venture Capital, Inc., whether those criteria have been followed, and how those criteria compare with similar programs in other states. This audit answers the following questions:

1. **What criteria have been established for awarding venture capital moneys through Kansas Venture Capital, Inc., and have they been followed?**

2. **How do the criteria established for awarding moneys through Kansas Venture Capital, Inc., compare with criteria established for similar programs in other states?**

To identify mandated investment criteria, we reviewed federal and State laws and policies of the Board of Directors of Kansas Venture Capital, Inc. We also interviewed the firm's officials to identify any unwritten criteria they may use. To determine whether these criteria were followed, we reviewed the firm's investment files for all investments made during 1988 and 1989, and reviewed the Small Business Administration's recent audit of the firm. In addition, we interviewed officials representing states that have venture capital programs somewhat similar to the one in Kansas, and asked them to provide us with general information about their programs and the criteria they use in making investment decisions. In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office.

We found that existing laws, regulations, and Board policies place limits on such things as the type of companies Kansas Venture Capital, Inc., can invest in, the amount of money it can invest, the interest it can charge on loans and bonds, the percentage of its portfolio that can be invested in any one company, and the amount of control it can assume over any company. In addition, the firm's staff have numerous

Venture Capital Investments

Venture capital investments are high-risk investments that provide financing to new or existing companies that have the potential for a high level of success, yet are unable to secure necessary financing through conventional sources. These companies are often entrepreneurial types of businesses in the early stages of development; however, venture capital investors also provide financing for business expansions or leveraged buy-outs. The venture capital company is often actively involved in the company to add value to its investment. Venture capital is also known as equity, risk, or speculative investment capital.

Such investments involve a high degree of business and financial risk, and in return they offer the opportunity for significant capital gains. The biggest risk associated with venture capital investments is that these investments are made in companies with little or no history of successful operations. The other risk factors faced by venture capital investors include:

- many of the businesses may operate at a loss, or may require additional capital to support the needed expansion or to maintain a competitive position in the market place
- there may be little or no collateral to protect investments
- there is intense competition from other venture capital companies
- because no active public trading exists for the common stock of these companies, it may be difficult to sell the securities or to determine their proper market value

unwritten guidelines they consider in evaluating potential investments. These guidelines call for the staff to consider factors like the potential rate of return, the potential for growth and "staying power" in the marketplace, and management's experience, commitment, and past performance.

In general, Kansas Venture Capital, Inc., appeared to follow the specific federal, State, and Board requirements we identified regarding its venture capital investments. We were unable to fully assess whether Kansas Venture Capital, Inc., adhered to all its unwritten guidelines for evaluating investments; in many instances, the firm did not keep documentation showing the kinds of analyses and determinations called for by those guidelines.

We also found that the Kansas venture capital program is unique; we were able to identify only three other states that had venture capital programs somewhat similar to Kansas' program, and those programs were more closely tied to their state governments than the Kansas program. Many of the basic criteria these other state programs used in making investment decisions were similar to the criteria used in Kansas. These and other findings are discussed in the sections that follow.

An Overview of Investment Practices by Kansas Venture Capital, Inc.

Kansas Venture Capital, Inc., maintains three offices: one each in Overland Park, Topeka, and Wichita. It has a staff of seven employees: the president, two vice-presidents, two administrative staff members, one secretary, and one newly hired financial analyst. The president and the two vice-presidents are responsible for evaluating investment opportunities and monitoring investments that have been made.

The firm's Board of Directors is elected by its common stockholders. The Board's 15 members include eight representatives of Kansas financial institutions, two venture capital investors or investment counselors familiar with the types of investments made by the firm, and five representatives of Kansas business sectors such as manufacturing. Each member serves a three-year term.

Kansas Venture Capital, Inc., was originally formed in 1976 by the Kansas Development Credit Corporation and 188 Kansas banks to encourage and assist economic development in Kansas. In 1977, it was licensed by the Small Business Administration as a small business investment company. This designation gives the firm access to federally funded, long-term financing at competitive interest rates. It also makes the firm more attractive to people seeking venture capital funding, because they have the assurance that the firm will not attempt to take control of their company or charge excessive rates of interest.

In June 1987, the firm reorganized to obtain State funds under the Kansas Statewide Risk Capital System Act. As a part of this reorganization, it reduced the size of its Board of Directors to 15 members, conducted a nationwide search for a new president with considerable experience in venture capital investing, and changed its investment orientation.

With reorganization, the Board decided to shift from making loans to primarily making equity investments because of the greater opportunity for significant capital appreciation. (An equity investment involves purchasing stock, or ownership in the company.) The firm's investment options now include the following:

- **Common stock**. Ordinary capital shares of a corporation entitling the owner to dividends and other rights of ownership in the company.
- **Preferred stock**. The portion of a corporation's stock having a priority or preference over common stock in the distribution of assets.
- **Loans with stock warrants attached**. Stock warrants provide options to purchase a fixed number of shares of common stock at a predetermined price during some specified time period.
- **A combination of loan and equity investments.**

Because of the high level of risk in venture capital investments, the firm's officials indicated that they look for a high rate of return, generally equal to at least 25 percent per year. That return may not come in equal amounts each year. According

Stages of Company Development for Venture Capital Financing

Six stages of funding are provided by venture capital firms. The stages are as follows:

Seed capital—the actual company does not yet exist. Funding is to develop a concept, product, or a business plan. (This is usually funded by the entrepreneur instead of a venture capital company.)

Start-up—the company is usually less than a year old. Funding is to establish a production facility or to cover initial expenses.

Early stage—the company is in the initial stage of production. Funding is usually for working capital.

Expansion—the company is ordinarily two or three years old and needs additional funding to increase production, expand geographically, or broaden its product line.

Turnaround—the company's profitability has declined and the company needs additional financing to regain its market share.

Acquisition or leveraged buy-out—the company is mature and may be in the position to be acquired. The financing may be used to restructure the business to make it more attractive for acquisition.

to those officials, to help ensure that companies have the capital required to grow, the firm often combines loan and equity financing so that it gets a relatively small return throughout the period of the investment, but hopes to get a very large return at the end.

For example, the firm may structure a 10-year investment loan so that only the interest is due the first several years, at a rate of 12 percent. In addition, the terms of such an investment may also allow the firm to purchase up to 49 percent of the common stock of a company at a prearranged price. At the end of 10 years, the firm is hoping that its percentage ownership of the company, combined with the interest it will collect, will be worth enough to yield a return equal to approximately 25 percent per year over the 10-year period.

Other investments the firm makes may be structured as a purchase of two different types of preferred stock. One type of preferred stock pays dividends throughout the period of the investment and the company can gradually repurchase it from Kansas Venture Capital, Inc., beginning in the fifth year. The other type of preferred stock is convertible to common stock at the end of the investment period.

The firm continues to make a small number of straight loans; however, these are made only as follow-up investments to companies that the firm already has an equity investment in. Firm officials reported that some of these loans have been made to protect their original investments in certain companies.

Since it reorganized in mid-1987, Kansas Venture Capital, Inc., has made 15 venture capital investments totaling $4.8 million in 11 firms. At the end of 1989, it also had approximately $5.2 million in short-term liquid investments. All but two of these venture capital investments were equity investments of some type. Financing for these companies ranged from $100,000 to $650,000. Investments were made in six companies in the expansion stage, three leveraged buy-outs, three in the start-up stage, two in the early stage, and one in the turnaround stage. Five of the investments were follow-up investments in companies already in the portfolio.

The types of companies financed and their distribution across the State are diverse. For example, Kansas Venture Capital, Inc., has invested in a biological products manufacturer, a contract machine shop, and a clothing manufacturer. Seventy percent of the companies are in the urban areas of northeast or south central Kansas. The others are in the more rural areas of central Kansas. Firm officials said one reasons they opened the Wichita office was to increase their exposure in rural areas.

The Pooled Money Investment Board made its first investment of $4.3 million in Kansas Venture Capital, Inc., in July 1988. Under State law, once the firm had sold $3.5 million in common stock to private investors, the Board was required to match that amount by purchasing preferred, non-voting stock in the firm. After the initial investment, the Board could make subsequent investments equal to the amount of additional common stock sold by the firm, up to a total of $10 million. To date, the State has invested $5 million in the firm. The following table shows the sources and uses of moneys available for the firm's investments and operations in 1988 and 1989 combined.

Sources and Uses of Moneys Available for Investments and Operations
1988 and 1989 Combined

Moneys Available for Investments and Operations, January 1, 1988		**$2,401,318**
Moneys Received:		
Investments by the State of Kansas (a)	$4,335,000	
Investments by Others	1,511,106	
Interest Received	1,159,465	
Moneys Received from Investments in Venture Capital Businesses	1,172,228	**$8,177,799**
Moneys Disbursed:		
Operating Costs	$1,010,324	
Investments in Venture Capital Businesses	4,341,801	**($5,352,125)**
Moneys Available for Investments and Operations, December 31, 1989		**$5,226,992**

(a) The Pooled Money Investment Board made a second stock purchase in the company in January 1990. The amount of this second investment was $665,000.

What Criteria Have Been Established for Awarding Venture Capital Moneys Through Kansas Venture Capital, Inc., And Have They Been Followed?

Federal and State laws and regulations and Board policies place limits on such things as the type of companies Kansas Venture Capital, Inc., can invest in, the amount of money it can invest, the interest it can charge on loans and bonds, the percentage of its portfolio that can be invested in any one company, and the amount of control it can assume over any company. In addition, the firm's staff have numerous unwritten guidelines they consider in evaluating potential investments. These guidelines call for the staff to consider factors like the potential rate of return, the potential for growth and "staying power" in the marketplace, and management's experience, commitment, and past performance.

We found that Kansas Venture Capital, Inc., generally followed the specific requirements we identified regarding its venture capital investments. We were unable to fully assess whether the firm adhered to all its informal guidelines for evaluating investments; in many instances, the firm did not keep documentation showing the kinds of analyses and determinations called for by these guidelines.

Criteria or Requirements Established by Federal and State Laws and Board Policy Generally Limit the Types or Amounts of Investments the Firm Can Make

This section addresses these criteria and requirements in general terms; specific criteria are presented in the box on page eight.

Kansas Venture Capital, Inc., must comply with federal regulations to maintain its status as a small business investment company. The Small Business Administration oversees the operation of such firms through regulations that cover the size of the companies that can be invested in, the length of the investment period, the amount of interest that can be charged on loans and bonds, the amount of control the venture capital company can assume over the company, the percentage of the firm's portfolio that may be placed in any one investment, and conflict of interest.

Many of these federal regulations mandate specific investment criteria. For example, they require firms to invest only in businesses that have a net worth of less than $6 million and an average net income over two years of less than $2 million.

Under the Kansas Venture Capital Act, Kansas Venture Capital, Inc., must comply with a number of requirements to receive yearly certification from the Department of Commerce. (This certification allows investors in venture capital firms to receive a tax credit against their Kansas income or privilege tax liabilities equal to 25 percent of their cash investment.) Some of the State requirements that address investment criteria impose limits on the type of businesses that can be financed and on the percentage of a venture capital firm's portfolio that may be invested in any one business. In addition, the Act requires Kansas Venture Capital, Inc., to invest all its funds in Kansas businesses.

Procedures Used by Kansas Venture Capital, Inc., to Evaluate a Potential Investment

According to Kansas Venture Capital, Inc., officials, the firm's investment procedures are not formalized. They provided the following description of the steps they take in evaluating potential investments.

Companies in search of venture capital are usually referred to Kansas Venture Capital, Inc., by contacts of the firm's management team and shareholders. At the initial contact, the prospective company is evaluated for eligibility in accordance with State laws, federal regulations of the Small Business Association, and the Board of Directors' policies. A brief review is made of management and the industry. According to the firm's officials, about 75 percent of the applicants are screened-out at this stage.

If the company successfully meets the initial evaluation, a face-to-face meeting is set between the company management and Kansas Venture Capital, Inc., officials. As part of their evaluation process, the officials indicated they are most interested in knowing about the company's management. The company is also asked to provide Kansas Venture Capital, Inc., with a business plan, a detailed document that describes the following topics:

- the industry, company, and products produced by the firm
- the market, including information on market size, trends, competition, customers, and market share
- the financial plan, including a detailed three- to five-year statement of profit and loss, balance sheet, cash flow, and break-even projections
- the amount of financing requested, securities offered, and the proposed use of the funds

Kansas Venture Capital, Inc., officials review the management of the company. They evaluate the management team's experience and ability to manage, cooperative attitude, personal character, and personal financial commitment. The officials check references provided by the company, and may also contact other people such as the company's accountants, lawyers, or customers.

Kansas Venture Capital, Inc., staff evaluate the company's product or service by reviewing its history, determining the existing or potential market and competition, projecting the achievable sales growth, and comparing the company projections with industry projections. The firm's staff obtain such information by reviewing the business plan and literature on the industry, and by contacting competitors, vendors, customers, and advisors. Staff members indicated they are interested in how the industry is doing in Kansas as well as how it is doing overall in the economy. They also analyze the company's financial history for the last five years by comparing the company's financial trends to industry trends, and investigating favorable and unfavorable aspects of the financial history.

Once final terms and conditions are agreed upon by all concerned parties, Kansas Venture Capital, Inc., staff prepare an investment recommendation report for the members of the Investment Committee, which is made up of six members of the firm's Board of Directors. The investment is discussed through a telephone conference and a decision is made.

In 1987, the Board of Directors of Kansas Venture Capital, Inc., developed a set of investment policies for its staff. Those policies require the firm's investments to have equity features to provide a reasonable rate of return, and limit the amount of funding that can be provided to businesses at certain stages of development.

Kansas Venture Capital, Inc., Also Uses a Number of Informal Guidelines in Making Investment Decisions

The written criteria discussed above are used to weed-out prospective companies early in the investment process. After these initial reviews, the staff consider numer-

Criteria Used To Evaluated Prospective Investments and Make Investment Decisions

Written Investment Criteria

Federal Regulations

- The business' net worth must be less the $6 million and its average net income over two years must be less than $2 million
- The venture capital firm must acquire less than 50 percent of the investment's voting common stock
- Financing cannot be provided for the acquisition of farm land
- Financing cannot be provided for relending, reinvestment, other small business investment companies, foreign investment, passive business, or for paying an associated supplier of the venture capital company
- No more than 20 percent of the venture capital firm's private capital may be invested in one company
- The venture capital firm cannot provide financing to any of its officers, directors, employees or agents, or their close relatives; or any company in which any of the previously mentioned people is an officer, director, or shareholder

Kansas State Laws

- All the firm's investments must be made in Kansas businesses
- No more than 20 percent of the firm's assets can be placed in any one company
- Financing cannot be provided for the following industries: oil and gas, real estate development, banking, lending, service, or retail

Board of Directors' Investment Policy Guidelines for Kansas Venture Capital, Inc.

- All the firm's investments must be made in Kansas business
- No more than 10 percent of the firm's assets can be placed in one company without the approval of the Board of Directors
- Between July 1987 and July 1989, early-stage and turnaround investments required co-participation by other investors
- Between July 1987 and July 1989, total investments in early-stage companies could not be more than 20 percent of the total portfolio, and turnaround companies not more than 10 percent of the total portfolio
- After July 1989, the target for portfolio distribution is 30-40 percent early-stage companies, 10-15 percent late-stage companies, 10-15 percent turnaround companies, and 35-40 percent acquisitions
- Investments will be structured to have equity features to provide a reasonable rate of return
- Investments in the agriculture, aerospace, and energy industries in aggregate will be limited to 30 percent of total available funds

Unwritten Criteria

Investment Guidelines Considered by the Staff of Kansas Venture Capital, Inc.

- The company's management must have experience in the industry of the proposed investment
- The company owner's past performance must show that the individual has management ability
- The company's owner must have a significant financial commitment in the company
- The company's management must have a cooperative attitude in dealing with the firm's staff
- The company's management must have reputable personal character
- The expected rate of return for the investment must be at least 25 percent
- The industry in which the company operates should be economically stable
- It is preferable that the company has proprietary right on new products
- The company must have a potential for growth
- The product should have the potential to continue to grow for five-seven years
- The projections for the market trends, both locally and nationally, should be good
- The projections for the product's market share should be good
- The existing competition should be manageable
- The existing or potential market should be good
- The cost and time needed for the product to enter the marketplace should be reasonable enough to yield the expected financial return
- The proposed use of funds should be appropriate
- The firm's estimate of achievable sales growth should be favorable
- Firm officials should consider the company's past financial history

ous unwritten guidelines in evaluating investments. We worked with Kansas Venture Capital, Inc., officials to develop a list of these guidelines. According to those officials, these criteria are informal and unwritten because each company is different and the criteria must be considered in relation to many other factors in determining whether the investment has good potential.

While federal, State, and Board requirements primarily place limitations on the types of companies the firm can invest in or the amounts of money it can invest, these unwritten guidelines are generally "prospective" in nature. That is, they call for the staff to consider things like the potential rate of return (the expected rate is at least 25 percent), and the company's or product's growth potential in the market, given existing competition and any patents or other proprietary rights. Other guidelines call for the staff to consider the company management's experience, attitude, financial commitment, and record of past performance with the company, both management-related and financial.

Generally, Kansas Venture Capital, Inc., Followed the Specified Federal, State, and Board Requirements

To determine whether officials of the firm adhered to these formal written federal, State, and Board requirements in making investment decisions, we reviewed the available documentation for 12 investments made by the firm in 1988 and 1989. We also reviewed the investment recommendations the staff presented to the firm's Investment Committee (made up of six members of the firm's Board of Directors), business plans submitted by the companies, and the firm's investment files. Finally, because the Small Business Administration audits the firm's adherence to federal regulations, we reviewed the latest available audit of the firm.

The 12 investments we reviewed had to meet 10-12 unique written requirements each. (Two of the requirements did not apply to all investments.) Our review showed that 10 of the investments met all the specific written requirements. In the other two investments, documentation was not available to allow us to assess the firm's adherence to all the requirements. In one investment, adherence to the two requirements concerning the total assets and average net income of the company were not documented. In another investment, there was no documentation of adherence to the requirement that other investors participated in turnaround investments.

In addition, our review of the latest audit of the firm by the Small Business Administration showed that no compliance problems were identified for any of the written federal requirements.

We Were Unable to Fully Assess Whether Kansas Venture Capital, Inc., Adhered to All Its Unwritten Criteria for Evaluating Investments

In evaluating potential venture capital investments, the staff reported that they call competitors and customers, analyze financial data, compute market and sales trends, and the like. However, the firm's officials told us that, during 1988 and 1989, they did not keep much documentation of their review and analyses of investments. Therefore, we reviewed the files for indications of the work they did in evaluating potential investments.

The 12 investments we reviewed had to meet 13-18 unwritten investment guidelines, as listed in the box on page eight. (Five of the firm's internal investment guidelines did not apply to all investments.) In none of the 12 investments were we able to tell whether the firm's officials considered all the applicable unwritten investment guidelines. In one investment we found documentation that the staff considered all but one of the guidelines; at the other extreme, for one investment we could find documentation for only eight of the firm's unwritten guidelines. Generally, factors like the attitude and personal character of the management and projections of market share were rarely documented. Overall, there was evidence that about two-thirds of all the applicable unwritten guidelines had at least been considered in evaluating the companies' investment potential.

For the 12 investments we reviewed, the firm's officials indicated that they had considered each applicable unwritten criterion in all but three instances, but we were unable to make that assessment independently where no documentation was available.

We also found that there was little back-up documentation showing the actual work or analyses performed in investigating the companies. For example, the investment recommendation report submitted by the staff to the Investment Committee generally showed sales growth figures calculated by the firm's officials, but documents detailing those computations were not kept in the file.

Although the firm is not required to keep documentation of adherence to its unwritten evalulation criteria, maintaining that documentation would provide the Legislature with greater assurance that the firm's staff is making prudent investment recommendations with public moneys. Keeping such documentation also would provide the firm's management and Board with greater assurances in this area. However, our review showed that the president of the company had considerable experience in venture capital investments, worked closely with the staff, and appeared to be knowledgeable about each of the companies in the firm's investment portfolio. Those things— together with the firm's small size—can help compensate at the management level for the lack of documentation. However, we concluded that keeping documentation of the work performed was still important to provide the Legislature with greater assurances that the staff are gathering and analyzing the information they need to make prudent investment recommendations.

One factor that should help improve the situation is that the firm recently hired a financial analyst to assist in investigating and evaluating companies. The analyst is responsible for reviewing and summarizing business plans, performing various types of financial and rate-of-return analyses, and researching the market, product, and industry. The analyst has begun to retain documentation of all work performed, and firm officials indicated that such documentation would be retained in the future.

Conclusion

Kansas Venture Capital, Inc., adhered to the specific federal, State, and Board requirements for awarding venture capital moneys to small Kansas companies. Most of these requirements place limitations on the types of companies the firm can invest in or the amount it can invest in any one company. The firm's staff also considered a number of additional unwritten factors in evaluating potential investments, including the potential rate of return on the investment, the potential for the company's or product's growth in the marketplace, and the company management's experience, commitment, and past performance. Because the firm did not keep documentation showing the kinds of analyses and determinations made to address those unwritten guidelines, we could not always tell whether the officials had followed them. The firm has taken steps to improve documentation in this area, which would provide the Legislature with greater assurances that the firm's staff is gathering and considering the information needed to make prudent investment decisions. In addition, as the firm and its portfolio of investments grow, it will become increasingly important to formalize the firm's investment guidelines to ensure that they are applied uniformly and appropriately in evaluating potential venture capital investments.

Recommendations

1. Kansas Venture Capital, Inc., should consider formalizing and distributing its unwritten criteria for evaluating venture capital investments to all staff members and members of its Board of Directors. If those internal criteria are changed or refined over time, updated guidelines should be made available to all appropriate staff members to help ensure that such evaluations are carried out in a complete and uniform manner.

2. Kansas Venture Capital, Inc., should continue its efforts to document the research conducted and analyses performed in making venture capital investment decisions.

How Do the Criteria Established for Awarding Moneys Through Kansas Venture Capital, Inc., Compare With Criteria Established for Similar Programs in Other States?

The Kansas venture capital program is unique; we could locate only three states that had somewhat similar programs. Most of the criteria established for the venture capital companies in those states are also required of Kansas Venture Capital, Inc. These findings are discussed in detail in the following sections.

No Other State Has a Venture Capital Program In Operation With the Features of the Kansas Program, But We Reviewed Three State Programs That Had Some Similarities

Our review of the literature showed that states may have the following types of venture capital investment arrangements:

- providing tax credits to those who invest in venture capital companies
- providing seed capital to small businesses
- investing in companies that have high-technology prototype products
- providing consultation services to prospective venture capital investors and high-risk businesses seeking financing
- investing pension funds in private venture capital companies
- investing in quasi-governmental venture capital organizations
- operating their own venture capital firms

Some states have combinations of these types of programs. We limited our search to states that make equity investments and have invested at least $1 million in their capital venture programs. We did not consider states with programs similar to Kansas Technology Enterprise Corporation, because such programs are significantly different from the Kansas venture capital program.

We could find no other state that operates a venture capital program that combines the following features of the Kansas program:

- combines public and private funds
- makes equity venture capital investments
- gives investors in venture capital companies a tax credit
- has a board of directors elected by the stockholders
- is currently in operation

In the absence of any specifically comparable state programs, we selected three states to review and describe, whose programs have aspects that are somewhat similar to the Kansas program. These states are Massachusetts, Michigan, and Nebraska. Each of those states' programs are more closely tied to their state governments than the Kansas program, and have other characteristics that make them different. The information we received from officials in the three states is briefly discussed on the following page.

Massachusetts: The Massachusetts Technology Development Corporation was established in 1978 as a quasi-governmental organization. The Corporation is governed by an 11-member board of directors—eight board members are appointed by the governor from the private sector and three are public officials. The Corporation focuses its investments on technology-based companies that need seed capital, start-up, or early-stage financing. As of fiscal year 1989, Massachusetts had appropriated $4.2 million to the Corporation. These state appropriations were restricted to equity investments only. In 1986, the Corporation also started investing part of the Massachusetts Pension Reserves Investment Trust. Massachusetts did not appropriate any money to the Corporation in fiscal years 1988 and 1989 because the Corporation is now self-sustaining. Through fiscal year 1989, the Corporation had 32 Massachusetts-based companies in its portfolio, and had invested a total of $13.9 million.

Michigan: Michigan operates its own venture capital program through the Department of Treasury's Venture Capital Division. The Division, established in 1982, focuses its investments on later-stage technology-based companies. It invests in both private venture capital companies and high-risk businesses. As of calendar year 1989, the Division had invested approximately $391 million in 83 companies. The majority of investments were in businesses located within the state.

Nebraska: The Nebraska Research and Development Authority is a private, non-profit organization that became operational in March 1987. It is governed by a nine-member board of directors appointed by the governor. Seven members of the board represent the private sector, one represents the public sector, and one comes from the education or research community. The Authority invests in companies in any stage of development, and it does not limit its investment to any particular industry. The Authority does not invest in other private venture capital companies. Between fiscal years 1986 and 1989, Nebraska appropriated $7.5 million to the Authority; as of fiscal year 1988, the Authority had invested nearly $1.5 million in five companies located in Nebraska.

The Basic Criteria Established for Kansas' Venture Capital Program Are Similar to Those Established for the Other States We Reviewed

According to officials we interviewed in Massachusetts, Michigan, and Nebraska, the following general criteria have been established for those states' venture capital investment programs:

- the business must be located within the state (required by state law)
- the business must have a reasonable chance of success (required by state law)
- the business must have the potential for high rate of return (at least 25 percent) (required by state law)
- proprietary rights are preferred
- the management must submit a detailed and well-thought-out business plan
- the business must have a strong management team with experience in the proposed area of business, commitment and endurance to launch the business, ability to make the business grow, and no history of dishonesty or lack of integrity

- companies must be able to leverage private investments through conventional lending sources or other private venture capital companies (Kansas Venture Capital, Inc., uses a combination of public and private funds, which essentially accomplishes the same thing.)

These criteria are similar to ones established for Kansas' program. However, all three states had some limiting or restrictive requirements regarding potential investments that Kansas does not have, as described below. Many of these criteria related to the underlying goals of the states' programs, some of which are different from the Kansas program's goals.

- investment must be in technology-based companies (required by state law)
- companies must be having difficulty securing financing from conventional sources
- companies must have the potential for creating jobs within the state (required by state law)
- companies must export 80 percent of their goods or services to other states
- companies in the growth stage must have been in business for at least two years, and must have been generating revenues for at least 12 months

Conclusion

The Kansas venture capital program is farther removed from state government control than the three most similar programs we could find. Despite these organizational differences, many of these states' criteria for awarding moneys were similar to Kansas' criteria. The other states did have some requirements that were limiting in ways that the Kansas Legislature has not specified and that Kanasas Venture Capital, Inc., has indicated are not necessary.

APPENDIX A

Agency Response

On March 16, 1990, we provided a copy of the draft audit report to Kansas Venture Capital, Inc. Their response is included in this Appendix.

Kansas Venture
Capital, Inc.

Rex E. Wiggins
President

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March 22, 1990

MAR 23 1990

Mr. Meredith Williams
Legislative Post Auditor
Legislative Division of Post Audit
109 West 9th, Suite 301
Topeka, Kansas 66612-1285

Re: Performance Audit Report (Draft)
"Criteria for Awarding Venture Capital Moneys
Through Kansas Venture Capital, Inc."

Dear Mr. Williams:

Thank you for providing me with a "Draft" copy of the Performance Audit Report for my preliminary review and comments.

We are very pleased with the final conclusion in the Report that Kansas Venture Capital, Inc. adhered to the specific Federal, State, and Board requirements for investing venture capital funds to small Kansas companies. We will continue to make prudent professional venture capital investments in that vein.

However, I wish to comment on the "unwritten guidelines" as additional criteria to consider in evaluating potential investments which appear to be the basis for the opinion of the remainder of the Conclusion Section and Items 1 and 2 of the Recommendations listed on page 11 of the Report.

The list of the unwritten criteria as listed on page 8 of the Performance Audit Report were established by the KVCI staff to serve as "additional guidelines" only to be considered by KVCI staff who have the experience and expertise to make investment decisions. Please be reminded these guidelines are effectual to KVCI staff only and were developed merely as a subset of criteria that KVCI staff analyzes during the investment process to assist us in the final analysis. There are too many variables unique to each potential investment which must be considered to formalize and distribute an "unwritten criteria" list as outlined on page 8.

It would be impossible to develop a standardized list. The criteria as deemed pertinent by the expertise of KVCI staff is formally documented in the Investment Recommendation furnished to the Investment Committee as an investment decision is made.

It is therefore our conclusion that any further documentation other than that required by the Federal, State, and Board could prove to be misleading, time consuming and not in the best interest of the shareholders.

Sincerely,

Rex E. Wiggins

Rex E. Wiggins
President

REW:cjl