

Venture Capital and Private Equity Accounting: Performing In-House vs. Outsourcing – Cost vs. Benefit Analysis

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Introduction

There are a number of non-investment-related decisions that an investment manager must contend with in building the infrastructure of a venture capital or private equity firm. These decisions involve personnel, marketing, real estate, legal matters, and accounting, among others. The purpose of this white paper is to analyze the factors related to outsourcing your back-office accounting based on IPS's experience in providing back-office accounting solutions.

Some of the factors to be considered in deciding whether to outsource your back-office accounting include: quality of personnel, best use of resources, quality of work, intellectual capital, credibility/independence, industry perspective, and cost.

Quality of Personnel

The more resources you invest in creating and maintaining your back office, the more you will get out of it. We've seen firms where an inexperienced person (often an office manager or junior accountant) has handled the accounting function for multiple funds and entities. We have also seen larger firms where experienced accountants were hired to handle the accounting for each separate fund.

In the former situation, firms will typically encounter problems with timeliness and accuracy. Often a firm will lose credibility with its investors because tax forms and account statements are not created on a timely basis or an investor or the advisor to an investor notices a distribution or allocation that is not calculated accurately.

The latter situation is ideal if your firm can afford it. We have seen this situation at billion-dollar-plus firms where economies of scale make the large investment worthwhile. These firms view the cost as low compared to their overall management fee and expenses, and well worth the avoidance of any issues with their limited partners.

For funds that handle their accounting in-house, we recommend they first hire a CFO or controller who has a CPA and a minimum of five years' experience. Having this person ensures that your back office has the ability to complete accounting tasks accurately. After that, the number of experienced accounting personnel required depends on the number and the complexity of the funds.

Best Use of Resources

One of the challenges of setting up a firm is making the best use of limited resources. The firm will have certain income targets for each member of the general partner and substantial salaries to cover for key employees. For a firm to properly handle the accounting in-house, one of those key employees would be a well-compensated CFO/controller. Generally, this person would be paid by the manager and would spend most of his or her time dealing with fund accounting issues. Administration is typically paid for directly out of the fund. Therefore, hiring an outside administrator frees up management fee revenues for other resources required by the management company.

Quality of Work

IPS has been called in many times when a less experienced accountant is handling work for a firm. In some cases, the firms had difficulties getting tax returns to limited partners by April 15th. In other cases, the auditors requested they get help. In still other cases, limited partners found errors on their account statements. Incidents such as these can reduce a firm's credibility with their clients and impair future fundraising.

As mentioned above, a firm that handles its accounting in-house should hire an experienced CPA with deep expertise. The alternative to hiring a full-time CPA is hiring an administrator with a strong reputation and experienced team.

Intellectual Capital

Another problem that firms run into is their dependence on one key employee. Many times, a firm will have one employee who maintains all aspects of the administration for the fund, including accounting, maintaining limited partner data, and maintaining deal data. If that person leaves, a firm can be left in disarray for months or quarters until a new key person is hired and able to get the firm's back office under control.

An independent administrator should have at least three fund professionals handling your fund needs. If one professional were to disappear, the other two would be able to continue as normal.

Credibility/Independence

An outside administrator provides investors with additional comfort in that the books and records of a fund are being maintained by an independent third party. In addition to using a credible, known independent audit firm and having an established banking relationship, hiring an independent administrator to keep your books and records will further improve your investors' comfort level.

Industry Perspective

Using an administrator allows a manager to better keep pace with industry technical changes as they occur. By working with numerous managers, an administrator is exposed to technical developments long before most managers. Quite often, IPS will advise clients on trends in fund structuring and raise issues for clients to discuss with their legal counsel related to achieving tax, financial, and operational objectives.

Cost

Another consideration for the firm is the cost of hiring an administrator versus maintaining a full accounting staff in-house. As mentioned above, administration fees are generally paid from fund resources and not management fees, so in most cases, it is a better deal for the manager. However, no matter who is footing the bill, administration is generally less expensive than handling the books and records in-house.

Sample Budget for In-House Accounting

Below is a sample, modest budget for handling the accounting for a fund in-house. Please note that this budget assumes the firm hires one qualified individual with about five years of experience at a CPA firm.

Industry-Standard Accounting System	\$ 25,000
Salary	\$120,000
Benefits	\$ 14,500
Additional office space	\$ 5,000
Additional supplies and services	\$ 10,000
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	\$174,500

For a small or mid-sized fund, an administrator should be able to provide this service for a fraction of this budget.

Summary

There are a number of factors to consider when deciding whether to use a fund administrator. These include the quality of accounting-related personnel, best use of resources, intellectual capital (dependence on one key individual), credibility/independence, and industry perspective. Economies of scale generally render administration as the more cost-effective solution.

About the Authors

John A. Dafulas, CPA

John Dafulas is a Member of IPS. John has more than 15 years' experience working in the investment management industry, serving a wide variety of investment entities. These include foreign and domestic registered funds and nonregistered private investment partnerships, limited liability companies, and offshore corporations. John has worked with smaller funds holding several million dollars in net assets and large funds holding several billion dollars in net assets. Prior to joining IPS, John was a Vice President of Operations at Citi Fund Services. John has also worked as a Senior Manager within Investors Bank and Trust's Fund Administration group and as a Manager at PricewaterhouseCoopers.

Robert A. Herlihy, CPA

Rob Herlihy is a Member of IPS. Rob has been servicing investment partnerships and their related entities since 1995. Prior to founding IPS in 2001, Rob was a Manager at KPMG where he serviced clients with millions to billions in assets under management. Rob has provided services to various entities, including partnerships, limited liability companies, offshore entities, subchapter S corporations, small business investment companies, and business development companies.

About IPS

Investment Partnership Services (IPS) is an administrator that focuses on the accounting and compliance needs of small and mid-sized venture capital and private equity funds.
<http://www.ipsfundservices.com>

