Partners Group
ART OF FINANCE

**Partners Group**

**To:** **IASB**

**From:** **Partners Group, see appendix 1**

**Comments to Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement; day 1 and day 2 profits (July 2004)**

**Question 1**

Question:
A) Do you agree with the proposals in this Exposure Draft? B) If not, why not? C) What changes do you propose and why?

Answer:
**A)** No

**B)** AG76A states, that the application of AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. It also states, that the best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received). In its clarification in BC16 b) of the exposure draft, the board concluded, that a day 2 profit should only be recognised after initial recognition to the extent it arises from a change in a factor (including time) that market participants would consider in setting a price.

The transaction price may be affected by certain constraints, such as

- seller needs to sell urgently (time pressure, i.e. liquidity problems of the seller)
- there are limited players in the market, willing to purchase a given financial instrument
- depending on the size of the investment, there is a limited liquidity
- the buyer may have a different view on the value of the underlying investment
- negotiating skills of the buyer / seller
- quality of the financial security and the number of bidders for the same piece

As a result, although the fair value of the financial instrument may be at 100, the purchase price may be at 95 or even less. The situation this is occurring may well be viewed as "not going-concern", since the seller must sell, thus resulting in a different transaction price / fair value, as if regarded under a going-concern scenario.

At subsequent measurement, the buyer will have to determine the fair value of the investment purchased. The measurement most likely will not be affected by the above-mentioned factors, since the basis is on a going-concern scenario and the buyer has the positive intent to keep the investment in his portfolio.

The result of applying AG76A will lead to a calculation at subsequent measurement of "fair value of the financial instrument ./. initial discount". This method is inconsistent with the fair value determination under IAS 39, since

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- it does not reflect a price determined in arm's length transaction
- it does not reflect a price determined under a going-concern scenario
- it takes into account liquidity and size constraints, although the investor does not have a positive intent to sell the investment

In comparison with financial instruments with the same fundamental background, which haven't been purchased in the same manner, the treatment will result in an inconsistent treatment of the overall portfolio, leading to a mixture of fair values and "adjusted fair values", differing from the requirements for measurement of portfolios of assets in IAS 39 and seems to be conceptually incorrect. As indicated above, the adjustment of the fair value for a liquidity discount or premiums is again inconsistent with the principles laid out in IAS 39.

**C)** Allow the application of "day 2" profits, if an investment was purchased under the above-mentioned circumstances and the buyer has the positive intent to keep the investment on his books.

The current wording "to the extent it arises from a change in a factor (including time)" leaves room for a lot of interpretation, since it is not clear, what is meant with "including time". Is it to be interpreted as the release of a day 1 profit on a time proportionate basis (straight-line or otherwise) irrespective of whether additional factors have become observable or whether the full amount would need to be deferred until the instrument is derecognised.

Accordingly, AG76A and especially the two last sentences of AG76A would need some further clarification, in order to allow circumstances as described and avoid misunderstandings. In our view, "the factor that market participants would consider in setting a price" would indeed change in a subsequent measurement, since a going-concern treatment versus a "secondary valuation" treatment is a material factor to be looked at when estimating the fair value. However, the way the standard is currently interpreted, this distinction would not allow for day 2 profits.

***Example on financial instruments affected:***
As laid out in the annex, PG is a large private equity player. In the private equity industry, there is a distinction between primary and secondary investments. If an investor enters into a private equity partnership (typical legal form in private equity) at one of the closing stages of such partnership, the investment is considered to be a primary investment. If an investor purchases the interest in such a partnership from an existing partner, the investment is considered to be a secondary investment. Since these partnerships are closed-ended structures and the interest usually cannot be returned to the partnership, the sale/purchase of the secondary piece typically happens at a discount, although the investment remains fundamentally the same and just receives a change of ownership.

Applying the current day 2 interpretation as proposed would therefore lead the following situation:

We invest in "investment A" in a primary transaction and buy "investment A" again in a secondary transaction one year later from a third party, however at a discount of 10 %. If we have to neglect a "day 2 profit", then we would keep the same investment at two different values, although it is the same investment. This seems to be against the fair value concept as followed in IAS 39.

**Question 2**

Question:
A) Do the proposals contained in this Exposure Draft appropriately address the concerns set out in paragraph 5 of the Background on this Exposure Draft? B) If not, why not and how would you address those concerns?

- no comments from our side

**Question 3**

Do you have any other comments on the proposals?

- no comments from our side

**Appendix 1**

Background

Partners Group is one of the largest alternative asset managers worldwide focusing on Private Equity and Hedge Funds. Partners Group was founded in 1997 with currently USD 7 billion under management.

Partners Group provides discretionary and advisory services in both segments and supports its clientele in structuring tailored long-term financial solutions. On the Private Equity side, in addition to traditional Private Equity partnerships, Partners Group is involved in direct and co-investments, secondary transactions and publicly traded Private Equity investment vehicles.

Since the secondary business has become an increasingly important market, the valuation and the accounting treatment of secondary interest purchased are of utmost importance.

Partners Group issues its consolidated financial statements under IFRS since 1999; all the private equity and hedge fund products managed by Partners Group and accounted for also issue their financial statements under IFRS.