PRIVATE EQUITY COUNCIL

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October 6, 2009

Proposed Edits to ED 10, Consolidated Financial Statements

- Subsequent to the July 13, 2009 conference call between representatives of the Private Equity Council ("PEC") and the IASB's Consolidation Project Staff (Patrina Buchanan – Project Manager, Michael Buschhueter – Project Manager and Barbara Ruane – Technical Associate), the PEC is proposing an approach that will reflect the substance of the relationship between the investment fund (the "fund") and its portfolio companies as well as the substance of the relationship between the fund's asset manager and the fund investors which will improve the financial reporting for the activities conducted by asset managers and investment funds under ED 10 for the users of their financial statements.

- The following edits reflect the proposed approach by the PEC which primarily focuses on two areas within ED 10: i) differentiating between activities of investment funds and other types of entities and ii) the consideration of removal rights in determining which party controls. Proposed additions are underlined and deletions are ~~struck out~~:

Control of an entity

4 **A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.**

4A Notwithstanding the definition above, when the activities of the reporting entity are limited by contract, regulation or other legal arrangements to acquiring, holding and disposing of investments in other entities for the purpose of maximizing income during the holding period and capital appreciation the reporting entity shall initially recognize its investment in that other entity at cost, and subsequent measurement shall be at fair value, with changes in fair value reported through profit or loss, in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*.

4B In applying the guidance in paragraph 4A, the criteria necessary to meet this condition would include:

(a) The reporting entity has no other substantive activities other than its investments activities;
(b) The reporting entity does not have the ability to change any restrictions on its activities;

(c) The equity holders of the reporting entity manage their interests on a fair value basis (e.g., net asset value in the case of investment funds and other similar entities);
(d) The reporting entity cannot use the assets of the other entity to gain access to liquidity or to settle other liabilities of the reporting entity; and
(e) The reporting entity does not guarantee or is not directly obligated for the repayment of the debt of the other entity.

4C In addition to the criteria in paragraph 4B being met, the reporting entity shall also evaluate other facts and circumstances related to its investment in other entities including, but not limited to:

(a) Whether the life of the reporting entity is limited by contract, regulation or other legal arrangement;
(b) The measurement attribute that is used for the redemption of equity interests in the reporting entity; and
(c) The nature of any restrictions on the activities of the reporting entity.

Assessing control

12 When assessing control, a reporting entity shall consider power and returns together, and how the reporting entity can use its power to affect the returns.

13 A reporting entity's exposure to the variability of returns from another entity may ~~power to direct the activities of another entity is~~ generally be correlated to its power to direct the activities of ~~with its exposure to the variability of returns from~~ that other entity. However, no presumption should exist that the party exposed to the majority of the variability of returns is in fact the party which controls that other entity without assessing all facts and circumstances.

14 A reporting entity shall consider all relevant facts and circumstances when assessing control.

22A A party that has, by contract, the power to direct the activities of another entity, but can be removed of that power by a substantive action of the equity holders or other appropriate parties would be deemed an agent and therefore would not have the power to direct the activities of the another entity for purposes of applying this Standard.

Appendix B – Application guidance

Agency relationships

B3 An agent is a party engaged to act on behalf of another party or parties (the principal(s)). An agent might have the ability to direct the activities of an entity, for example by making decisions concerning the operating and financing activities of the entity. However, that ability is governed by agreement, law or fiduciary responsibility that requires the agent to act in the best interests of the principal. The agent must use any decision-making ability delegated to it to generate returns primarily for the principal.

Removal rights

B4 Removal rights, which include liquidation rights as defined in the Emerging Issues Task Force 04-05, ~~can~~ may indicate an agency relationship. However, the absence of removal rights, in itself, does not indicate that there is no agency relationship. A principal often has the substantive right to remove, without cause, an agent that is empowered to direct the activities of an entity for the principal. That substantive ~~unconditional~~ right to remove the agent ensures that the principal has the power to direct the activities of the entity. Rights to remove a party only in circumstances such as bankruptcy or on breach of contract by that party are protective rights. In evaluating whether removal rights are substantive, the reporting entity shall consider all facts and circumstances including, but not limited to, the following:

(a) The removal rights can be exercised by a single party or a vote of a simple majority of the principals holding such rights which shall be unaffiliated to the agent or its related parties.
(b) The principals holding the removal rights have the ability to exercise those rights at all times and there are no significant barriers to the exercise of the rights.

Remuneration of an agent

B5 An agent is remunerated for the services it performs by means of a fee that is commensurate with those services. Fees that are not commensurate with the services performed indicate involvement with an entity beyond that of an agent and, therefore, might indicate control.

B6 Any of the following factors might indicate that fees are not commensurate with the services performed:

(a) The fees are more than would be received for similar services negotiated on an arm's length basis.
(b) The fees represent the majority of ~~are large relative to~~ the total expected returns of the entity to which the services are provided.
(c) The expected variability in the fees represent the majority of ~~is large relative to~~ the total expected variability of the returns of the entity to which the services are provided.

B7 The remuneration of an agent can be a fixed or performance-related fee. If the agent receives a performance-related fee, the agency relationship can be difficult to distinguish from a controlling relationship. This is because the agent can use its ability to direct the activities of the entity to affect its remuneration. However, if this ability is limited by the agent's responsibility to act in the best interests of the principal, the performance-related fee that the agent receives is remuneration for the services it performs and does not indicate involvement with the entity beyond that of an agent so long as expected variability in the performance-related fee represents less than the majority of the total expected variability of the returns of the entity.

~~B8 A performance-related fee of an agent is often distinguishable from the returns of the investors for whom the agent is acting. For example, an investor in a fund will benefit from increases in the value of the fund and suffer from decreases in the value of the fund. In contrast, an agent might be paid a performance-related fee for a specified period~~

~~and the agent is unlikely to be required to contribute to the fund (ie refund fees already received) if the value of the fund decreases.~~

B8 Clawback provisions in fee arrangements are merely an extension of the period over which the performance fee is measured. As such clawback provisions are considered consistent with an agent relationship for fees that are deemed commensurate with services performed.

Basis of Conclusion

Scope

~~BC27 The Board therefore decided that it should not propose exempting investment companies from the principle that a reporting entity's consolidated financial statements should include all entities that the reporting entity controls. The Board confirmed its reasoning set out in paragraph BC27 in the Basis for Conclusions on IAS 27:~~

~~The Board concluded that for investments under the control of private equity entities, users' information needs are best served by financial statements in which those investments are consolidated, thus revealing the extent of the operations of the entities they control. The Board noted that a parent can either present information about the fair value of those investments in the notes to the consolidated financial statements or prepare separate financial statements in addition to its consolidated financial statements, presenting those investments at cost or at fair value. By contrast, the Board decided that information needs of users of financial statements would not be well served if those controlling investments were measured only at fair value. This would leave unreported the assets and liabilities of a controlled entity. It is conceivable that an investment in a large, highly geared subsidiary would have only a small fair value. Reporting that value alone would preclude a user from being able to assess the financial position, results and cash flows of the group.~~

Agency arrangements

BC91 In some cases, the line between principal and agent is blurred. An agent may have a dual role. For example, a fund manager may act in a fiduciary capacity and have a direct investment in the fund it is managing. In such situations a fund manager shall carefully assess whether it has sufficient power over the activities of the fund to generate returns primarily for itself as a principal or whether the fiduciary responsibilities imposed on the fund manager by virtue of law, regulation, or agreement limit such power in a way that prevents it from acting other than in the sole interest of all investors.