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bvca The voice of long-term investment

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International Accounting Standards Board
30 Cannon Street
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11 November 2009

Dear Sirs,

The BVCA is the representative body for private equity and venture capital in the UK. Our 450 members cover the whole investment spectrum, from venture capital firms investing into high growth technology start-ups, to the largest global buyout funds turning around and growing mature companies.

We note that a number of respondents to ED 10 *Consolidated financial statements*, including ourselves and some large accountancy firms, recommended that the Board add a project to its agenda relating to reporting by investment companies, amongst which private equity and venture capital entities are included. The suggestion made in those comment letters was for the Board to explore whether an entity managing its investments on a fair value basis should be required to measure them on that basis. The responses also proposed that any project should also include a definition of an investment company. As a contribution to that effort, this letter proposes a set of criteria that will help a reporting entity to distinguish between an investment subsidiary and an operating subsidiary.

The principal features of an investment subsidiary are:

- it is held for capital appreciation, although dividends may be received, rather than for integration into the reporting entity's own operations; and
- the reporting entity has agreed with the owners of its equity instruments that this is the purpose of the investment and that it is to be managed and reported on a fair value basis.

We are proposing that investment subsidiaries would be consolidated with the unit of account being the fair value of the investment rather than being broken down into underlying line items; this unit of account would be measured at fair value in accordance with IAS 39 as FVTPL.

As well as more accurately reflecting the commercial reality of the relationship we consider that this treatment, and disclosure, will be more closely aligned to the needs of users, many of whom have explained that consolidation at the level of underlying line items is of no practical use to them.

The proposal includes some suggested disclosure which addresses the requirements of current standards. We have not included the requirement for financial statements of investment subsidiaries prepared in accordance with IFRS to be made available on request. The need of users to have access to underlying financial information is substantially addressed by disclosure point (b) whilst the burden on private companies, some of which will be in a start up phase, of producing full IFRS accounts when not required by local rules is unduly onerous and is a departure from current requirements for investments under both IAS 39 and those investments excluded from equity accounting under IAS 28. The BVCA believes that the requirements for private companies under Private Equity and Venture Capital ownership should be on a level with other private companies with respect to the information they have to

produce. Otherwise there is a disincentive for companies to receive investment from Private Equity and Venture Capital which itself is not in the public interest.

This proposal has been developed by the Legal and Technical Committee of the BVCA. A list of its members is attached. We have also discussed the proposals with the European Private Equity and Venture Capital Association who have indicated their support.

We look forward to your response. In the meantime, if you have any questions, please do not hesitate to contact Simon Page on 020 7420 1808.

Yours faithfully

Simon Walker

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A Reporting Entity that has been established with the principal objective of generating and distributing income and/or capital gains through the acquisition and disposal of investments must not consolidate controlled investments but instead must report all of its investments at fair value in accordance with IAS 39, if the following conditions are met:

1. The Reporting Entity's constituting documents (such as a prospectus, scheme of arrangement, placement memorandum or partnership agreement) contain an explicit commitment, made to a group of investors in the reporting entity, who are not related parties, that the purpose of holding the portfolio of investments by the Reporting Entity is to generate and distribute income and/or capital gains through the acquisition and disposal of these investments. Disposals are within a limited period of time, typically within ten years of acquisition.

2. All of the Reporting Entity's investments (whether or not controlled) are managed, and their performance evaluated, on a fair value basis, in accordance with a documented risk management or investment strategy. Information about the Reporting Entity's investments is provided internally on a fair value basis to the entity's (1) key management personnel (for example the entity's management committee and chief executive officer) as defined in IAS 24 Related Party Disclosures, as revised, and (2) Chief Operating Decision Maker (as defined by IFRS 8).

3. The Reporting Entity accounts for all of its non-controlled investments in associates at fair value, in accordance with IAS 39, in line with the conditions in IAS 28.1.

4. None of the Reporting Entity's investments provide other than incidental* operational or strategic benefits or synergies to either the Reporting Entity, the Reporting Entity's other investments or other related parties of the Reporting Entity.

5. There is no trading# between the Reporting Entity's investments other than on terms that are available to unrelated entities

6. Any performance related compensation paid by the Reporting Entity is either linked to the amount of proceeds received from the holding and realisation of the investments held by the Reporting Entity, or to the fair value of Reporting Entity's portfolio of investments, sometimes as measured against a benchmark.

7. Providers of debt to the Investments of a Reporting Entity have no direct recourse to the Reporting Entity's other investments.

*Incidental operational or strategic benefits. Examples of this may be: (a) when the Reporting Entity has purchased a payroll provider for investment purposes. The provider may provide payroll services to the Reporting Entity (or a related party thereon). The payroll services are provided on terms that are available to unrelated entities and the provision of these services is incidental to the investment purchase, as evidenced by the investment plan. (b) when the Reporting Entities Investments join an organisation made available by the industry to achieve benefits of scale.

Another example may be when investee companies sign up to a scheme run by a different, unrelated, company that seeks to gain discounts in the negotiation of joint contracts with service providers. In this case the negotiation of these discounted terms is incidental to the acquisition of these entities by the Reporting Entity.

#Trading here might refer to the sale of software products by one investee company to other investee companies.

For these purposes investments may be individual entities or groups of entities which prepare consolidated accounts themselves.

Where a reporting entity is recording all its controlled investments at fair value under IAS 39, in accordance with IAS 27, then, in addition to the IFRS 7 disclosures required in respect of financial instruments, the following disclosures in respect of the underlying controlled investments which would otherwise be consolidated as subsidiaries must be provided,:

(a) The latest available summarised financial information for each material controlled investment, including amounts of assets, liabilities, debt, revenues and profit or loss;

(b) The latest available summarised financial information of any other remaining non-material controlled investments, on an aggregated basis, including assets, liabilities, debt, revenues and profit or loss;

(c) the nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements or regulatory requirements) on the ability of controlled investments to transfer funds to the Reporting Entity in the form of cash dividends, or repayment of loans or advances.

The above should be presented alongside the fair value disclosures required by IFRS 7 (27, 27A , 27B and 28) which will, *inter alia*, disclose the valuation techniques utilised and the assumptions applied in determining fair values of each class of financial assets, as well as classifying the fair value measurements using the IFRS 7 fair value hierarchy.

Excerpt from IFRS 7

"Fair value

25 Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

26 In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

27 An entity shall disclose for each class of financial instruments:

(a) the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. If there has been a change in valuation technique, the entity shall disclose that change and the reasons for making it.

(b) whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique (see paragraphs AG71–AG79 of IAS 39).

(c) whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e., without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, total equity.

(d) if (c) applies, the total amount of the change in fair value estimated using such a valuation technique that was recognised in profit or loss during the period.

[Amended by Improving Disclosures about Financial Instruments (March 2009)]

27A To make the disclosures required by paragraph 27B an entity shall classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy shall have the following levels:

(a) quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);

(b) inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices) (Level 2); and

(c) inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

The level in the fair value hierarchy within which the fair value measurement is categorised in its entirety shall be determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. For this purpose, the significance of an input is assessed

against the fair value measurement in its entirety. If a fair value measurement uses observable inputs that require significant adjustment based on unobservable inputs, that measurement is a Level 3 measurement. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgement, considering factors specific to the asset or liability.

[Added by Improving Disclosures about Financial Instruments (March 2009)]

27B For fair value measurements recognised in the statement of financial position an entity shall disclose for each class of financial instruments:

(a) the level in the fair value hierarchy into which the fair value measurements are categorised in their entirety, segregating fair value measurements in accordance with the levels defined in paragraph 27A.

(b) any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level shall be disclosed and discussed separately from transfers out of each level. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.

(c) for fair value measurements in Level 3 of the fair value hierarchy, a reconciliation from the beginning balances to the ending balances, disclosing separately changes during the period attributable to the following:

(i) total gains or losses for the period recognised in profit or loss, and a description of where they are presented in the statement of comprehensive income or the separate income statement (if presented);

(ii) total gains or losses recognised in other comprehensive income;

(iii) purchases, sales, issues and settlements (each type of movement disclosed separately); and

(iv) transfers into or out of Level 3 (eg transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.

(d) the amount of total gains or losses for the period in (c)(i) above included in profit or loss that are attributable to gains or losses relating to those assets and liabilities held at the end of the reporting period and a description of where those gains or losses are presented in the statement of comprehensive income or the separate income statement (if presented).

(e) for fair value measurements in Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, the entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to a reasonably possible alternative assumption was calculated. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in other comprehensive income, total equity.

An entity shall present the quantitative disclosures required by this paragraph in tabular format unless another format is more appropriate.

[Added by Improving Disclosures about Financial Instruments (March 2009)]

28 If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG74–AG79 of IAS 39). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e., the fair value of the consideration given or received), unless conditions described in paragraph AG76 of IAS 39 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:

(a) its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph AG76A of IAS 39); and

(b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference".