AGENDA PAPER 5 – APPENDIX 2
18-22 FEBRUARY 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

21 December 2012

Dear Mr Hoogervorst

The purpose of this letter is to seek an interpretation from the IASB of how to determine the unit of account when measuring the fair value of investments in unquoted companies.

Background

This letter is submitted jointly by the British Venture Capital and Private Equity Association ("BVCA"), the European Venture Capital and Private Equity Association ("EVCA"), the International Private Equity and Venture Capital Valuation Board ("IPEV") and the Association Francaise des Investisseurs pour la Croissance ("AFIC").

The BVCA, AFIC and EVCA are the private equity and venture capital industry associations representing the UK, France and Europe respectively. IPEV was established in 2005 to prepare valuation guidelines for the industry, releasing updated guidelines on 17 December 2012 and whose previous 2010 guidelines were endorsed by 40 national associations.

This letter follows earlier discussions between representatives of BVCA and IPEV with Hilary Eastman and Sarah Geisman in October and November 2012 and a meeting BVCA had with you on 30 October 2012.

Issue

We believe that the accounting guidance within IFRS 13 and IFRS 9/IAS 39 on unit of account in the context of measuring the fair value of investments in unquoted companies is limited and ambiguous. We note that there is a range of views on how to interpret existing guidance and that a view with support from leading accounting firms is that the unit of account should be an individual financial instrument (a so called "single share" basis).

We believe that this conclusion is contrary to the "market participant" philosophy embedded within IFRS 13 and is inconsistent with how market participants transact. Our contention is that nobody would buy or sell a single share in a private company in a standalone transaction

and we do not believe market participants should be compelled by accounting standards to assume hypothetical transactions that never occur with market participants who do not exist.

The principal consequences of assuming the unit of account to be an individual instrument are considered in our detailed submission which is attached as an appendix to this letter.

We note that US GAAP allows the unit of account to be determined at the enterprise level and believe that a similar conclusion is necessary under IFRS if that framework is to remain relevant to the private equity industry. We note the progress made with regard to "Investment Entity" accounting rules and feel a favourable resolution of the unit of account issue ambiguity is necessary to allow that new accounting basis to be widely adopted.

Our request

We request that the IASB considers our submission and issues guidance which will allow market participants to interpret accounting standards in a way which is consistent with how they measure and evaluate their economic activity.

Please contact Iain Bannatyne representing BVCA at +44 (0) 20 7311 8664 or David Larsen representing IPEV at +1 415 693 5330 if you would like to discuss any of the issues in this letter.

Yours faithfully

Simon Witney

Chairman, BVCA Legal and Technical Committee

cc Hilary Eastman, Sarah Geisman

Appendix – submission to IASB on unit of account

Purpose of IPEV guidelines

The IPEV valuation guidelines represent a valuation framework which is not intended to be GAAP but guidelines aimed at producing a GAAP consistent result. These have been developed with input from preparers (General Partners), users (Limited Partners) and service providers (auditors/valuation experts), are long established as the best source of industry developed valuation guidance and are required by many investment entity fund formation agreements. Staff from IASB and FASB has also contributed to the drafting process.

The guidelines seek to provide a meaningful result for both experienced and new investors into the PE sector; they are designed to be understandable to non-accountants and seek to provide consistency in approach across the market.

The guidelines were recently updated to reflect IFRS 13 and that process has highlighted the difficulties in applying that standard in a private equity context.

Basis of existing PE market practice

A summary of how market participants currently measure the fair value of their investments is as follows:

- Fair value represents a hypothetical exchange price – the value of what you have today given the market conditions today.
- In other words, given individual facts and circumstances, how much would a market participant pay for the investment in a hypothetical orderly transaction at the measurement date?
- If market participant assumptions are not used and if facts and circumstances are not properly considered, there is a risk that the fair value of an investment would be measured at an amount which differs from the amount of cash or other consideration that would be received in an orderly exit transaction at the measurement date.
- Investors and users of fund financial statements must have fair value estimates of the underlying investments (generally articulated as NAV) to allow fund interests to be reported at fair value in their own financial statements.
- Most private equity backed businesses are unquoted and valuers have historically used the fair value of the enterprise on an aggregated basis as a starting point for the equity valuation.
- Deduction is then made for higher ranking instruments – typically debt. Change of control clauses are typical which means that in an exit transaction all debt is repaid.

Therefore debt is deducted at "par" (for purposes of determining the fair value of equity) given the market participant assumption that the remaining term is zero on change of control.

- Valuing the equity investment in aggregate is market convention: it reflects how a market participant would view a transaction and is consistent with the way PE firms actually transact.
- Additionally, there are other situations where characteristics stemming from the size of the holding determine the accounting approach. For example where a holding company (which is not an investment entity) has a controlling stake in a business then that business is consolidated as a subsidiary.
- Where a fund has both a debt investment and a controlling equity position then the debt investment may be held at par assuming a change of control provision exists.
- Where a fund has an investment only in a debt instrument, or debt plus a non controlling equity position then the debt instrument is valued at FV.

Unit of Account

We believe that the unit of account guidance contained within existing IFRS standards is limited and ambiguous. IFRS 13 introduces the concept of the 'unit of account' – this is the first time it has been recognised explicitly within IFRS.

The principal references are:

- IFRS 13.14: *"the unit of account shall be determined in accordance with the IFRS that requires the fair value measurement, except as provided in this IFRS"*
- IFRS 13.BC47 *"In IAS39 and IFRS 9 the unit of account is generally an individual financial instrument"*

In many cases the unit of account can be inferred, however, for a financial asset that is an investment in a subsidiary, joint venture or associate it is not clear because the investment held by the entity comprises a number of individual shares or other instruments.

IFRS 13 also emphasises the market participant view:

- *"...fair value is a market based measurement, it is measured using the assumptions that market participants would use..."* (IFRS13.3)
- *"...an entity shall measure the fair value of an asset using the assumptions that market participants would use..."* (IFRS13.22)

What exceptions are anticipated in IFRS 13.BC47 through the use of "generally"?

Is this emphasis on a market participant view an exception anticipated in 13.14 allowing an entity to depart from the BC47 general assumption?

ASC Topic 946 under US GAAP is mostly silent on unit of account, which allows a market participant perspective to be used reflecting unit of account at an enterprise level.

Prior to the issuance of ASU 2011-4 and IFRS 13, limited unit of account guidance was mitigated through the "highest and best use" and "in-use" valuation premises. The ability to use market participant perspectives in assessing unit of account is diminished through the prohibition of using these concepts for financial instruments.

Consequences of unit of account being an individual share

We believe that there are two principal consequences of the unit of account being the individual share.

Firstly, value associated with control could not be recognised as this is unlikely to be a characteristic of an individual instrument. This would result in a day one loss where the purchase of an enterprise includes an identifiable or theoretical control premium and most importantly would provide unusable information for investors (what purpose is served for an investor to report an immediate loss only because of a unit of account interpretation?)

Secondly, the measurement of equity value would usually deduct debt at fair value (which may not equal par value) from enterprise value as change of control is unlikely to be triggered on the realisation of an individual share. This has the potential to overstate or understate the fair value of an equity instrument from the perspective of a market participant.

Industry view

We believe that the following represents an accurate summary of the view of valuation teams within the PE industry:

- Unit of account should be determined at the level of aggregation that a market participant would enter into an orderly transaction to maximise fair value. We believe that this is consistent with the concept of "value maximisation" within IFRS 13.BC67.
- Some private equity managers invest in multiple securities or tranches issued by the same portfolio company.
- If a potential buyer would be expected to purchase all securities/ tranche positions in the same underlying portfolio company simultaneously, then fair value would be measured for the aggregate investment in the portfolio company.
- If individual tranches of securities are purchased by market participants, then the unit of account and the basis for determining fair value would be the individual tranche
- Enterprise value is generally the best starting point for determining fair value, even for non-controlling positions.

Private equity returns are generally not disproportionate and when an enterprise is sold the minority owner receives the same pro-rata value as do the controlling shareholders.

- In addition, PE investors often work in concert with one another and value is realised through the sale of an underlying business.
- Compelling PE managers to treat an individual share as the unit of account would be fundamentally in conflict with the market participant approach and would result in financial information that is not meaningful to investors. Not having meaningful FV financial information could mean that investors are misstating the FV of their investment.
- In the "real world" nobody would buy or sell a single share in a private company in a standalone transaction. Why force people to assume hypothetical transactions that never occur with market participants who do not exist?
- This could be framed conceptually as allowing those entities qualifying as "Investment entities" under the new IFRS standard to establish Unit of Account at the level of aggregation at which the Investment Entity is expected to transact.

Guidance needed

We are seeking IASB guidance on the determination of unit of account for Level 2 and 3 financial assets and whether it is acceptable to establish the unit of account at the level the market participant is likely to transact (either on its own or in concert with other funds/ co-invest arrangements).

We would also welcome confirmation that a similar approach can be taken for minority positions (ie the starting point for the measurement of fair value would be the enterprise value) subject, depending on the facts and circumstances, to a potential discount (demonstrated to the extent applicable via calibration at entry) reflecting the inability of the owner of the minority position to direct the timing of a sale, if the owner is not working in concert with other investment entities.

Consequences if no IASB guidance

We believe that there would be a number of negative consequences if the IASB is unable to confirm an interpretation of unit of account which is consistent with how the private equity industry transacts:

- The uptake of IFRS across the private equity community would be extremely limited causing the efforts on the Investment Entity accounting framework to be undermined.

- Structural solutions might develop such that legal form dictates the accounting conclusion (for example, an 80% interest in a private company could be legally constructed as a single share).
- The same definition of fair value used in IFRS and US GAAP could result in different fair value estimates because of unit of account interpretations.
- The lack of convergence between IFRS and US GAAP would provide additional reasons for the US SEC to vote against adopting IFRS.
- Private equity firms would be likely to retain national or quasi national GAAP or migrate to US GAAP.
- Investors in private equity with US GAAP reporting obligations would have difficulty estimating and reporting the "US GAAP fair value" of their fund interests prepared using IFRS, if any, in their own financial statements and adjustments may be required.
- Investors in private equity with IFRS reporting obligations would have difficulty estimating and reporting "IFRS fair value" of their fund interests in their own IFRS financial statements given the day one loss imposed by a single share unit of account interpretation.