International Accounting Standards Board
30 Cannon Street
London
EC4M 5XH

4 January 2011

Dear Sirs

I am writing on behalf of the British Private Equity and Venture Capital Association ('BVCA') in response to the IASB exposure draft on Investment Entities.

The BVCA is the industry body for the UK private equity and venture capital industry. With a membership of over 450 firms, the BVCA represents the vast majority of all UK based private equity firms and their advisers. This submission has been prepared by the BVCA's Legal & Technical committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

As major investors in private companies, and some public companies, our members have an interest in financial reporting matters relating to those companies and the burdens placed on their management.

General

We welcome this exposure draft.

Our experience is that fair value accounting of investments is what investors and other stakeholders want, and is consistent with the way private equity funds manage their investments. On the other hand, consolidation of financial statement line items is of no practical use to investors. Indeed, it may even be counterproductive as investors seek to make comparisons between periods when the entity may have bought or sold investments which, instead of being shown at fair value, would be a consolidation of different entities. In addition, in many cases, consolidated accounts will be extremely hard to produce. Therefore, the proposed standard is likely to encourage the use of IFRS by the private equity community and, in situations where IFRS is mandatory, improve presentation of financial statements for the benefit of their users.

Our view is that the whole private equity community should be able to use fair value accounting, including fund of funds, infrastructure funds, sovereign wealth funds and organisations owning private equity funds. If users of financial statements are analysing similar organisations with similar business models which are accounting for their businesses in two completely different ways, much of the benefit being sought by the IASB will be lost, particularly if it is the way the entity is structured that leads to the different treatment, rather than the underlying business model. While the majority of private equity fund structures are organised such that the investment management activity is conducted separately to the investment entity itself, in some cases the investment manager could be a parent or subsidiary or under a common holding company. The cost and practicalities of line by line consolidation would place a considerable burden on these businesses. For that reason, we approve of the allowance that an entity may manage its own investments but consider that this should be extended to managing those of a third party.

We have prepared an estimate of the likely first year cost of complying with a requirement to consolidate in Appendix A for two hypothetical private equity firms.

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We would have preferred a principles based approach rather than a list of mandatory criteria; however, we understand the IASB's aim to exclude the ability to structure operating businesses to meet the definition. Nevertheless, we believe that the IASB's aim could be achieved by having a number of mandatory attributes, together with a number or rebuttable indicators, recognising that there should be substantive reasons for any rebuttal.

However, the main issue for private equity is that the criteria as proposed require the "only substantive" activities to be investing activities, and the proposal does not allow a non investment entity parent to use the accounting treatment adopted by an investment entity subsidiary.

With respect to the criteria, we believe that Investment Entities should be entities that have, within their organization, investments which are owned for capital appreciation, investment income (such as dividends or interest), or both and that, for those businesses, the entity makes an explicit commitment to its investors concerning the above business purpose and has an exit strategy or a strategy of gradual realisation of its investments over a finite period of time, by way of receipt of income or capital gain or both.

We believe that it is essential that an investment entity should be able to carry out other business which would not be fair valued, such as investment management, investment trusteeship, and also to have investments which are not fair valued, such as corporate debt to be held to maturity.

We would expect those funds' predominant or primary activity to be investment activity or for those other businesses to be consistent with being an investor (such as external investment management activity) and for the investments to be predominantly managed on a fair value basis.

We would consider the other 'criteria' (c. and d.) listed by the IASB more as indicators. A blended model such as this should lead to private equity funds being treated consistently using fair value accounting for their equity investment activity and line by line consolidation for other businesses.

We would welcome an opportunity to discuss this response with you.

Questions proposed by IASB for Investment Entity Draft

Question 1
Do you agree that there is a class of entities, commonly thought of as an investment entity in nature, that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

Answer
We agree that such a class of entity exists and that they should measure equity investments at fair value through the profit and loss account ("FVTPL").

Investments made by such entities should 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 investors and other stakeholders, many of whom have explained that consolidation at the level of underlying line items is of no practical use to them as they obtain value from the underlying components. Further evidence for this is provided by the fact that investor mandated reporting typically requires the fair values of underlying investments rather than consolidated accounts.

For the investment entity itself consolidation will usually be at best very expensive and in some cases impracticable.

Question 2
Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

Answer
As stated above, we consider that the criteria and application guidance are too narrow and would exclude many legitimate private equity investors from fair value accounting.

We do not believe that fair value accounting should only apply where the entity's "only substantive" activities are investing activities.

We consider the business purpose to be essential to the definition and should also refer to a stated realisation strategy which might include complete exit or a series of partial exits over time, or realisation by distributions.

We consider that fair value performance evaluation by management is key to those investments which are to be accounted for at fair value, but it is consistent with being an investment entity to have some investments which are not managed or accounted for on a fair value basis such as other investment related business or certain debt investments.

We do not consider that unit ownership and pooling of funds by multiple investors are critical to definition and would regard them as indicators.

However, we understand the IASB's objective to ensure that businesses cannot structure themselves to avoid line by line consolidation so we would ask the IASB to consider the term 'predominant' or 'primary' rather than 'only substantive', so that the entity's 'predominant' or 'primary' business is investing in multiple investments. Alternatively to allow activities that are consistent with being an investment business (e.g. investment management for external clients) to be carried out alongside the holding of financial investments (both equity and debt).

In addition to the above, we believe that it would be helpful to state explicitly in the Application notes that trading between investees that is done on an arm's length basis would not be 'creating benefits that are unavailable to other unrelated investors'. We also believe that it should be made clear that active involvement in investee companies should not preclude the owner from being an investment entity as long as it is consistent with the fiduciary duty towards investors. This would include board membership, the provision of advisory services and more active involvement in times of crisis or major events. Furthermore, such involvement in day-to-day activities is consistent with the control principle under IFRS.

Question 3
Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:
(a) its own investment activities?

(b) the investment activities of entities other than the reporting entity?
Why or why not?

Answer

(a) Yes

(b) Yes

While the majority of private equity structures are organised such that the investment management activity is conducted by a general partner or manager separate to the investment entity itself, there are a number of structures where the investment management activity is undertaken within the same group as the investment entity. The investment management will often be undertaken by an

operating subsidiary of the investment entity itself and these investment activities may be undertaken for entities other than the reporting entity; for example, funds that are partially or only invested in by third parties.

Where this is the case, we do not agree that this activity should preclude an entity that would otherwise qualify as an investment entity from adopting the fair value accounting option for investments.

If an entity is carrying out investment management activity on its own investments we consider that it would be consistent with being an investment entity to leverage that expertise to external investment management.

Question 4

(a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?

(b) If yes, please describe any structures/examples that in your view should meet the definition and how you would propose to address the concerns raised by the Board in paragraph BC16.

Answer

(a) An entity with no more than one investor should be able to qualify as an investment entity. There are a number of cases, such as when a fund set up for multiple investors has, on inception, only a single investor or a group of funds where one has only a single investor.

(b) We believe that the following structures would meet this criterion:
- Structures set up where the clear intent is that there will be multiple investors or where there have previously been multiple investors.
- Investment entities with a single investor where the entity has been set up as a co-investment vehicle, ie it invests along another investment entity in a number of investments.
- A sovereign wealth fund (which governments have established solely for the purpose of acting as investment vehicles) or feeder fund which is likely to have only a single investor but fulfil all the other criteria for an investment entity.
- A group of funds where most but not all have multiple investors.

We propose that the concerns expressed in BC16, ie that an investment entity could be inserted into a larger corporate structure to achieve off balance sheet accounting, are already addressed by the three key criteria relating to business model, declared strategy and fair value evaluation. We therefore think that multiple investors should be a rebuttable indicator.

Question 5

Do you agree that investment entities that hold investment properties should be required to apply the fair value model in IAS 40, and do you agree that the measurement guidance otherwise proposed in the exposure draft need apply only to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*? Why or why not?

Answer

We agree that entities that hold investment properties should be required to apply the fair value model in IAS 40 as most entities already do so and we would support the additional consistency that this requirement would bring.

Question 6

Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the Board's concerns?

Answer
We do not see why the accounting treatment of an investment entity should not be rolled up to the parent as has been and is the proposed case in the USA. We consider that this difference would be a major one for users of financial statements to deal with and that the treatment in the USA is right in principle as the nature of the investment entity does not change as you move up the group. We have no objection to a mixed approach to investment by ultimate parents where investment entities are rolled up but other entities are accounted for by consolidation.

We also do not understand why it is proposed that there should be a difference between such controlled investments and associates and joint ventures where the fair value accounting investment, if adopted, can be rolled up, which is an approach that has worked well for associates.

Question 7

(a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?

(b) Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?

Answer

(a) We agree that the objective that disclosure should "provide information to enable users of the financial statements to evaluate the nature and financial effect of the investment activities in which it engages" is appropriate.

(b) We do not see the need for additional detailed disclosure requirements and would prefer to rely on existing requirements together with the objective.

Question 8
Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose instead and why?

Answer
We agree with the prospective application requirements proposed. In particular the proposal should allow early adoption in accordance with IFRS 10.

Question 9
(a) Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not?

(b) As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds? Why or why not?

Answer

(a) We do not agree with amendments to IAS 28. As you have noted in BC 29 the proposed amendment of IAS 28 is likely to "cause fewer entities to be able to measure their investments in joint ventures and associates at fair value through profit or loss, even though in its view this measurement might produce, for some of those entities, more relevant information to users of financial statements than measuring the investments by the equity method."

"Relevance" is a fundamental principle of financial statements and we agree that such investments should be measured at fair value as this provides the most relevant information to users.

(b) We would agree with the proposed amendment that would make the measurement exemption mandatory for investment entities and voluntary for other venture capital organisations. This will ensure that accounting information is relevant for users while still promoting consistency among investment entities.

Yours faithfully

Simon Witney
Chairman, Legal and Technical Committee, BVCA

Appendix A

Introduction

There follows an analysis of the likely additional costs associated with complying with an accounting standard which would cause consolidated accounts to be produced by a UK PE firm.

Scenarios

There are 2 scenarios described for Private Equity firms:

1. A UK Private Equity firm that arranges investments in European companies through leveraged buy-outs.

2. A UK Private Equity firm that arranges investments in UK mid-tier companies through leveraged buy-outs.

It is assumed that each Private Equity firm has been established for over 10 years and, through this period, each firm has formed a number of separate Funds in order to facilitate investment commitments from their limited partner investors (principally, pension funds and insurance companies) into a pooled vehicle. Through the life of the Fund, the Private Equity firm identifies and arranges investments in investee entities with a view to realisation of a capital gain; often the investment is made via newly formed holding companies which in turn invest in the underlying investee entity.

Typically, each Fund will have an expected duration of 10 years; the investment period is over the first 4 or 5 years with the objective of realisation of all investments within 8 years. Typically, to diversify concentration risk, the Limited Partnership Agreement will specify that individual investments cannot exceed 10% of the total investment commitments to the Fund – therefore each Fund might have between 10/15 investments.

Additionally, in order to facilitate the different requirements and characteristics of overseas limited partner investors (eg particular national fiscal rules), when a new Fund is raised it is common for separate parallel UK Limited Partnerships to be established. This enables groups of investors with similar characteristics to be pooled together under one limited partnership entity, although each parallel limited partnership will invest, *pari passu,* in accordance with ratio of its investment commitments to the total commitments of the Fund. It is not unusual to have 4/6 parallel limited partnerships but there are examples of where there are more than 10 in one overall Fund.

Consolidated Accounts

It is assumed that the year end of the Fund is 31 December. The consolidated accounts would need to include comparative information and, in order to produce a consolidated profit and loss account and consolidated cash flow statement, with comparatives, a consolidated balance sheet for a year earlier would need to be prepared, - ie 3 separate consolidated balance sheets are required and 2 consolidated profit and loss accounts and 2 consolidated cash flow statements for the first year of adoption.

An exercise would also need to be undertaken to identify and harmonise the various accounting policies used by each investee entity so that group accounting policies can be disclosed in the consolidated accounts. This would be an extensive exercise because the Fund is not run as an operating group with investee entities unrelated and operating in a wide variety of different industry sectors.

Assumptions

It is assumed that:

i. The shareholders agreement for the investee entity will need to be renegotiated with the other shareholders (management, minority) because it would not have provision for the submission of financial information in a form that contains all the required and relevant information for a set of consolidated accounts.

ii. The UK Private Equity firm, would need to employ a consolidation accountant of at least 4 years post qualification experience and a newly qualified accountant as an assistant in order to organise the gathering of appropriate information and to prepare the consolidated accounts.

iii. The auditors are content that they have sufficient direct audit control and coverage of the group to form an opinion. Typically, this would mean that they were responsible for auditing 70 – 75% of the net assets/profits of the underlying investee entities. Most auditors will follow this rule for the audit of Groups. If the direct responsibility was lower than the aforementioned percentages, then investment entities would need to change to the parent auditor; no allowance has been made for the costs associated with such a change.

iv. Consolidated information for each investee entity can be prepared under IFRS; that 25% of the investee entities have non-coterminous year ends requiring additional audit work to get appropriate and equivalent cut off at 31 December – in other words, an inability to rely entirely on the work of the investee entity's local auditors.

v. The investee entities are not related to one another and operate in a number of different industry sectors. Therefore, an exercise will need to be undertaken to ensure there is congruity of accounting policies for the purposes of the consolidated accounts.

vi. Information is available to determine goodwill arising on the acquisition of each investment and sufficient information is available to evaluate whether there has been any impairment to capitalised goodwill.

vii. The investments made by the European Private Equity fund are in European countries other than the UK. The local audited accounts comply with local GAAP but will need to be converted for the purpose of the consolidation.

viii. There is no restriction in scope or an issue that causes the auditors to qualify or disclaim on their audit opinion.

ix. These costs are estimates based on the experience of accountants. They have not been compiled from a detailed analysis of particular private equity firms and their funds.

Scenario 1

Backgound

Private Equity Firm specialising in European buy-outs of mid market companies with an enterprise value of between €250m - €1,000m at acquisition. The firm has raised 4 Funds in the last 10 years:

(i) in 2000 – $500m. Commitments are 95% drawn. There is one unrealised investment with a fair value of $25m and original cost of $75m.

(ii) in 2003 - $1,000m. Commitments are 90% drawn. There are 4 investments unrealised with a fair value of $175m and original cost $150m.

(iii) in 2006 - €1,500m. Commitments are 70% drawn. There are 10 investments unrealised with a fair value of €1,200m and original cost of €1,000m.

(iv) the most recent, in mid 2008 - €2,000m. There are 5 recent investments with a fair value of €400m which is the same as cost.

The Funds' year end is 31 December. This means that 4 separate sets of consolidated accounts would need to be produced. There are 20 investee entities that would need to be consolidated. 15 of the investee entities are based in Europe and held by overseas holding companies. The local accounts for these entities are produced in compliance with local GAAP (e.g. French or German GAAP) and financial information would need to be converted. Additionally, 5 entities have non-coterminous year ends so additional work will be required to produce financial accounts with the same year end as the Funds.

Costs to Private Equity Firm:	£
Consolidation accountant (salary, bonus, NI and other benefits)	80,000
Assistant accountant (salary, bonus, NI and other benefits)	50,000
Other direct cost	20,000
Costs to Investee Entities:	
Preparation of group reporting packs (20 entities * £10k)	200,000
Advice on conversion (15 entities * £10k)	150,000
Costs to Limited Partnership Funds:	
Legal costs: new shareholders agreements for investee entities	100,000
Additional audit costs at investee entity level (5 with different y/e)	100,000
Consolidation audit costs (4 sets of accounts * £70,000)	280,000
TOTAL COSTS	£ 980,000

Scenario 2

Background

Private Equity Firm specialising in UK buy-outs of companies valued between £20m and £200m at acquisition. The firm has raised 4 Funds in the last 10 years:

(i) in 2000 - £150m. Commitments are 98% drawn. There is one unrealised investment with a fair value of £2m and original cost of £15m.

(ii) in 2003 - £300m. Commitments are 90% drawn. There are 2 investments unrealised with a fair value of £25m and original cost £50m.

(iii) in 2006 - £350m. Commitments are 75% drawn. There are 10 investments unrealised with a fair value of £400m and original cost of £250m.

(iv) the most recent, in late 2009 - £450m. There are 2 recent investments with a fair value of £90m which is the same as cost.

The Funds' year end is 31 December. This means that 4 separate sets of consolidated accounts would need to be produced. There are 15 investee entities that would need to be consolidated into the Fund accounts. All the investee entities are private limited companies and produce UK GAAP accounts. Additionally, 5 entities have non-coterminous year ends so additional work will be required to produce financial accounts with the same year end as the Funds.

Costs to Private Equity Firm:			£
Consolidation accountant	(salary, bonus, NI and other benefits)	70,000	
Assistant accountant	(salary, bonus, NI and other benefits)	45,000	
Other direct costs		10,000	
Costs to Investee Entities:			
Preparation of group reporting packs (15 entities * £10k)		150,000	
Advice on conversion (15 entities * £5K)		75,000	
Costs to Limited Partnership Funds:			
Legal costs: new shareholders agreements for investee entities		75,000	
Additional audit costs at investee entity level (5 with different y/e)			75,000
Consolidation audit costs	(4 sets of accounts * £50,000 each)	200,000	
TOTAL COSTS		£ 700,000	