European Private Equity & Venture Capital Association

POSITION STATEMENT

EVCA Comments on Exposure Draft of Proposed Improvements to International Accounting Standards (IAS) and on Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement.

16 September 2002

EVCA welcomes the exposure drafts, as IAS will probably be adopted by all publicly listed companies by 2005 following the Regulation of the European Parliament and of the Council on the application of IAS. However, EVCA questions whether IAS will be restricted to listed companies only. It is most probable that IAS will also become the standard for most unquoted companies, making the actual consultation procedure a topic of the utmost importance.

Therefore, EVCA would recommend to the IAS Board:

- Extending the exemption to consolidate investee companies under IAS 27 where private equity and venture capital organisations have 50% or more of the voting rights and also exercise control as described in the exposure draft.
- Clarifying the use of fair value for unquoted companies in relation to exemption from IAS 28, IAS 31 and IAS 27
- Treating private equity and venture capital organisations as a specific case.

The following developments present the rationale of these recommendations. The reader will note that the Board has used in its exposure drafts the term “venture capital”, while this document refers to “private equity and venture capital”. While this terminology has still to be globally harmonised, a clear trend is to use “private equity” rather than “venture capital” to name an industry, which invests across the full spectrum, i.e. early stage, expansion and buyout stages.

In the appendix following the exposure draft of **IAS 28**, it is stated that:

> "A3. No Standard specifically deals with the accounting for investments by venture capital organisations, mutual funds, unit trusts and similar entities. As a result, depending on the extent of control or influence over an investee, one of the following Standards is applied:
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> (a) IAS 27 (revised 2000), Consolidated Financial Statements and Accounting for Investments in Subsidiaries,
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> (b) IAS 28 (revised 2000), Accounting for Investments in Associates, or
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> (c) IAS 31 (revised 2000), Financial Reporting of Interests in Joint Ventures.
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> A4. The Board considered whether another approach is appropriate for these investments and concluded that it is. The Board noted that use of the equity or proportionate consolidation methods for investments by venture capital organisations, mutual funds, unit trusts and similar entities often produces information that is not relevant to their management and others and that fair value measurement produces more relevant information. The Board also noted that fair value information is often readily available for these investments.
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> A5. In addition, the Board noted that there may be frequent changes to the level of influence or control for these investments and that financial statements are less useful if there are frequent changes in the method of accounting for an investment.
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> A6. Accordingly, the Board decided to propose that investments by venture capital organisations, mutual funds, unit trusts and similar entities be excluded from the scope of IAS 28 and IAS 31, Financial Reporting of Interests in Joint Ventures, when they are measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice in the industries involved. The Board understands that use of fair value measurement is a well-established practice for these investments.
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> A7. The Board decided, however, that if an investment qualifies as a subsidiary under IAS 27, the investment should be consolidated without exception. The Board concluded that if an investor controls an investee, the investee is part of a group and part of the structure through which the group operates its business and that consolidation of the investee is appropriate."

While EVCA agrees with paragraphs A3 to A6, EVCA disagrees with the statement made in paragraph A7 and is therefore against the statement made in the exposure draft of the **IAS 27** where it is stated that:

> "13A. A subsidiary is not excluded from consolidation simply because the investor is a venture capital organisation, mutual fund, unit trust or similar entity."

EVCA would recommend the opposite solution where private equity and venture capital houses would be exempted from carrying out a consolidation of their portfolio companies under **IAS 27** when they have 50% or more of the voting rights and/or exercise control as expressed in the exposure draft. EVCA would argue that the reasons exposed by the Board regarding the exemption of the application of **IAS 28** and **IAS 31** to portfolio companies in which a private equity and venture capital organisation has 20% or more of the voting rights are valid regardless of the percentage of voting rights held by a private equity and venture capital organisation. Forcing a consolidation will lead to meaningless financial statements due to the particularities of the private equity and venture capital industry.

Although several structures are available in Europe, the most common vehicle for making private equity and venture capital investments is the limited partnership. Usually the General Partner (i.e. the private equity and venture capital house, or "venture capitalist") has a small percentage of the shares of the limited partnership (also called the fund) but has effective control of the partnership. As stated in the actual draft of **IAS 27**, this effective control would lead to consolidation at the level of the General Partner.

> "6. […] A subsidiary is an entity, including an unincorporated entity such a partnership, that is controlled by another entity '(known as the parent)."

At this point, it should be noted that private equity and venture capital houses exercise control over the portfolio companies of the different funds they manage in order to protect their investments and the money invested in these funds by various investors (Limited Partners such as pension funds, insurance companies, etc.).

This control does not signify a structure through which the group operates its business. The notion of "group" cannot be applied to several funds managed by a General Partner nor can it apply to the pool of investors participating in a fund. Indeed, the different contracts signed between the Limited Partners and the General Partner in the different funds managed contain clauses of diversification of risk (i.e. a company cannot represent more than a certain percentage of the total assets of a specific fund). In addition, contracts contain binding clauses designed to protect the interest of the different Limited Partners that have invested in the different funds managed by the General Partner (e.g. Chinese walls, investment focus (in terms of sector, geography, stages of development of the investee companies)), which impede the development of a group strategy. In other words, consolidation of the portfolio companies "controlled" by the private equity and venture capital house through their different funds will lead to a completely misleading picture of the true economic power of the pool of undertakings. Because of the different contractual clauses between a General

Partner and the Limited Partners, the transfer of resources and information between the different companies "controlled" by the General Partner through its managed funds is strictly limited and does not correspond to the degree of freedom observed in a trade group, eliminating de facto coordinated group policies. The same argument applies to a single fund. In other words, consolidation at either the level of the General partner (i.e. including all portfolio companies "controlled" through the different funds managed) or at the level of one specific fund (i.e. companies "controlled" through a single fund) is inappropriate for the private equity and venture capital industry.

Therefore, EVCA would like to stress that the current draft of **IAS 27** will lead to misleading financial information as well as a costly process for producing irrelevant accounts. Limited Partners (investors such pension funds, etc.) will not gain a better understanding of the financial situation of the limited partnership in which they have invested. This also applies to the shareholders of the private equity house itself.

The Board asked the following question in the beginning of the draft of **IAS 28**:

> **"Question 1**
> Do you agree that IAS 28 and IAS 31, Financial Reporting of Interests in Joint Ventures, should not apply to investments that otherwise would be associates or joint ventures held by venture capital organisations, mutual funds, unit trusts and similar entities if these investments are measured at fair value in accordance with IAS 39, Financial Instruments: Recognition and Measurement, when such measurement is well-established practice in those industries (see paragraph 1)?"

As already stated above, EVCA would strongly recommend the extension of this concept to companies "controlled" by a private equity and venture capital house and subject to the treatment proposed in **IAS 27**. However, it is questionable whether one should restrict this possibility to the use of fair value. As stated in the draft exposure of **IAS 39**, fair value can, under certain circumstances, not be estimated for unquoted equities:

> 102. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 69(c) and 89A) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

Moreover, in the draft exposure of **IAS 32** it is mentioned that:

> 77A. If investments in unquoted equity instruments or derivatives linked to such equity instruments are measured at cost under IAS 39 because their fair value cannot be measured reliably, that fact shall be disclosed together with a description of the financial instruments, their carrying amount, an explanation of why fair value cannot be measured reliably, and, if possible, the range of estimates within which fair value is highly likely to lie. Furthermore, if financial assets whose fair value previously could not be reliably measured are sold, that fact, the carrying amount of such financial assets at the time of sale, and the amount of gain or loss recognized shall be disclosed.
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> 85. If investments in unquoted equity instruments or derivatives linked to such equity instruments are measured at cost under IAS 39 because their fair values cannot be measured reliably, information about fair value is not required to be disclosed. Instead, information is provided to assist users of the financial statements in making their own judgements about the extent of possible differences between the carrying amount of such financial assets and financial liabilities and their fair value. In addition to an explanation of the reason for not disclosing fair values and the principal characteristics of the financial instruments that are pertinent to their value, information is provided about the market for the instruments. In some cases, the terms and conditions of the instruments disclosed in accordance with paragraph 47 may provide sufficient information. When it has a reasonable basis for doing so, management may indicate its opinion on the relationship between fair value and the carrying amount of financial assets and financial liabilities for which it is unable to determine fair value reliably.

A crucial question for the competitive environment between private equity and venture capital houses is the following: if a venture capitalist cannot measure fair value for its investments under the terms of IAS 39 exposure draft, but provides in its financial statements information concerning the range of estimates where fair value could be, would this General Partner be exempted from treatment under IAS 27, IAS 28 and IAS 31? If this were not the case, it would lead to a severe distortion of the competitive environment between funds investing in early stage companies, where fair value suffers from high variability in the range of estimates, and funds investing in later stage companies, where there is a lower variability in the range of estimates.

Therefore, with the stipulation that extra information be provided by the General Partner, including situations in which fair value estimates are below the value at cost of the investment, EVCA would strongly recommend that the inability to estimate fair value according to the IAS 39 exposure draft would mean an exemption of treatment under IAS 27, IAS 28 and IAS 31.

Finally, EVCA would encourage the Board to study the possibility of specific treatment for the private equity and venture capital industry, leading to a set of rules that would contain EVCA's proposals as presented above. This would allow the Board simultaneously to prevent circumvention of the different clauses mentioned above and to develop an accounting regulation that will not impede the development of an industry in Europe, which is widely recognized as an important engine of economic development (see for example the Risk Capital Action Plan adopted by the European Union).

Of course, EVCA would welcome further discussion on these views and any comments.