On behalf of the Public Affairs Executive of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY


25 May 2018

Introduction:

The European private equity industry (PE) welcome the opportunity to respond to the EFRAG Discussion Paper (DP) on IFRS 9. Invest Europe’s members cover the whole investment spectrum, including the institutional investors investing in a broad range of private equity funds, as well as the firms raising such funds. Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe’s leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them. It is for this reason that the PE industry is well-positioned to comment on the effect of IFRS 9 on long-term investment.

Comments on Discussion Paper:

Issue with Equity Investment Fair Value in IFRS 9 for PE:

The main difficulty with IFRS 9 for investments in PE funds relates to the concept of fair value. For listed equity investments, the amount at which an asset could be exchanged between knowledgeable and willing parties in an arm’s length transaction, i.e. the fair value, is determined by reference to the market price of the shares, which are generally freely tradeable on a liquid public exchange.

For investors in PE funds, the interim Net Asset Value (NAV) gives an indication of the progress of the underlying companies between the investment being made by the fund in the unlisted company and the fund realizing its investment in the company (either by a sale of the shares or a listing of the company on a recognized stock market). Only at the point the investment is realized is the true value of the unlisted equity investment known.

Interim NAVs are not the same as listed stock market share prices. More significantly, a change in the unrealized gains and losses in unlisted equity investing, as expressed by changes in the interim NAV of a PE fund, is not the same thing as a change in the listed price of a share. For example, a change in an interim NAV could simply reflect: an injection of new capital to acquire new plant or machinery; the company significantly exceeding/underperforming its forecasts or a significant change in the nearest listed market comparable used in helping to determine the NAV.

In the current regime unrealized gains and losses of PE fund investments (i.e. the change of NAV from quarter

---

1 The term private equity refers to both private equity and venture capital. Where there are specific characteristics relating to the venture capital industry only, we use the term venture capital.
to quarter resulting from the assets’ appreciation or depreciation in value) are shown in the other comprehensive income (OCI); only realized gains and losses are shown in net income. Thereby net income is only reflective of effectively realized investment performance and not the interim arbitrary changes in asset valuations. Nevertheless, also under the current regime those changes in asset valuations are reflected in shareholders’ equity in the consolidated balance sheets – hence the arbitrary valuation changes are not reflected in net income but are perfectly visible in the balance sheet. For investments in PE funds IFRS 9 would require the immediate recognition of those arbitrary changes in valuations of the underlying assets in net income, thereby rendering net income meaningless as it would no longer be a measure for fundamental earning power.

The fair value through profit or loss (FVTPL) classification is mandatory for certain debt instrument assets unless the option to use FVTPL is not taken. Whilst for equity investments, the fair value through the statement of other comprehensive income (FVTOCI) classification is an election. The requirements for reclassifying gains or losses recognised in OCI are different for debt and equity investments. For debt instruments measured at FVTOCI, interest income (calculated using the effective interest rate method), foreign currency gains or losses and impairment gains or losses are recognised directly in profit or loss. The difference between cumulative fair value gains or losses and the cumulative amounts recognised in profit or loss is recognised in OCI until de-recognition, when the amounts in OCI are reclassified to profit or loss. This contrasts with the accounting treatment for investments in equity instruments designated at FVTOCI under which only dividend income is recognised in profit or loss with all other gains and losses recognised in OCI and there is no reclassification on de-recognition.

Potential Solution for Investors in Unlisted Equity Investments via PE Funds:

The current standard does not permit the recycling of amounts from OCI to profit or loss, for equity investments, although transfers within equity reserves are allowed. We note that the IASB has commented on the potential lack of prudence in accounting that can arise from recycling gains and losses from OCI to the profit and loss statement (P&L). It highlights the potential for investors to use recycling as an earnings management tool: to smooth earnings or avoid/reduce losses.

We can understand this concern but would point out that in the case of unlisted equity investing through PE funds this is not something to be concerned about. The interim NAV of the fund is determined independently of the investor, as is the timing and quantum of any change in interim NAV. More importantly however, is that the timing of the realization of the underlying investment, and determination of what it is sold for, is completely independent of the investor. The timing of when a gain or loss recognized in OCI (and the amount) is recycled into the P&L is, therefore, not in the hands of the investor.

We believe that if an investor were required on the day it subscribed to the fund to make a one-off election (that could not be changed during the entire period in which it was invested in the fund) as to whether it wished to recognize unrealized gains and losses in OCI, then recycle to the P&L, or if it wished to recognize unrealized gains and losses in the P&L straight away, then this would not enable the investor to use recycling as an earnings management tool.

A case has already been made to enable investors to make such an election in the case of strategic listed equity investments. We believe the case for being able to make a similar election for investments in unlisted PE funds is equally justified.
Impact of IFRS 9 on long-term investing:

We understand the negative feedback regarding the inability to recycle under IFRS 9 has been largely confined to the insurance and pension funds that responded to the EFRAG DP and that a lack of concern expressed by banks may indicate they do not share these concerns. An alternative view may be that as it is now much harder for banks to invest in PE funds, they have already reduced their exposure to unlisted equity investing and that is the reason they have not commented on it.

The EFRAG DP refers to the long-term business model, but from the description it does not appear to refer to unlisted equity investing. In paragraph 2.4, the Paper states that in a long-term investment business model, “entities acquire assets in order to generate a stream of revenue from period to period. Nevertheless, the ultimate cash inflow from the asset is often through sale in the market in which it was originally bought and, generally, in a similar “condition” as when it was bought.”

This description could not be further from the reality of long-term investing in unlisted equity. In unlisted equity investing assets are acquired not to generate an income stream, but to realize a capital gain after several years, during which the company invested in is generally likely to have gone through a significant transformation. When the equity investment is then sold, it is often not into the same market in which it was bought (it may be acquired by a trade buyer or listed on a public market) and invariably would not be described as being in the same “condition” as when it was bought. We believe the focus of the discussion on long-term investing in the DP is in the context of listed equity investment, rather than unlisted equity investment and, therefore, has not taken into account the nature and specificities of unlisted investing in considering the consequences of recycling.

Conclusion:

While we are mindful of the concerns around recycling and the previous debates which have taken place on this topic, the PE industry is a long-term asset class and is well-placed to offer this insight as to the unintended consequences of the introduction of the IFRS 9 accounting standard. We urge EFRAG to consider similar treatment of equity and debt investments where FVTOCI is used. We stress however that we would not like to see a situation where there is a divergence between IFRS as adopted by the EU and the “pure” IFRS used elsewhere, especially where funds are listed on a recognized exchange in the EU, where “pure” IFRS must be followed. We believe that to create an environment conducive to long-term investment - which is the basis of this review as part of the Capital Markets Union - EFRAG and subsequently the European Commission should strive to adjust the IFRS standard at IASB level in order to create a truly suitable environment for long-term investment internationally. We note that the European Commission prefers full adoption of any international accounting standard and that it views carve outs as both exceptional and temporary. However, given the limited time available prior to the year-end and should our proposal be deemed appropriate by EFRAG, the European Commission, IFRIC and the IASB, we urge the European Commission to permit this exception, as a temporary measure.
Contact

Thank you in advance for taking our comments into account as part of the negotiation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Danny O’Connell (danny.oconnell@insteurope.eu) at Invest Europe.

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe’s private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe’s leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members’ role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry’s professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.insteurope.eu