



European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

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LETTER OF COMMENT NO. 24

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EACB Comments on Preliminary Views - "Financial Instruments with Characteristics of Equity"

Dear Ms. Bielstein,

The European Association of Cooperative Banks (EACB)¹ gladly takes the opportunity to comment on FASB's Preliminary Views Paper – "Financial Instruments with Characteristics of Equity". While primarily relevant for accounting in the USA, the substance of FASB's views might become highly relevant for cooperative banks in the EU that are preparers of IFRS accounts.

Therefore, we have carefully assessed the FASB's suggestions and discussed them among the experts of our member organisations. Their views, which are shared by the supported by the management of their banks and organisations, are expanded in the following pages.

We welcome any question regarding our comments

Yours sincerely,

Christopher PLEISTER
President

Hervé GUIDER
General Manager

¹ The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. With 4,500 locally operating banks and 60,000 outlets co-operative banks are widely represented throughout the enlarged European Union. They play a major role in the financial and economic system, serve 130 million customers. The co-operative banks in Europe represent million members and 700,000 employees and have a total average market share of about 20%.

AN ASSOCIATION ON THE MOVE



I. GENERAL REMARKS

Today, accounting standards, such as the IFRS, are applied in a wide number of jurisdictions and by a wide range of companies. And in fact, it is the definite aim of standard setters to develop high quality standards for global application. On the other hand preparers have no choice but to apply such standards, either since there is no other standard or, as a general rule, since their national legislator imposes those standards on them: EU Regulation (EC) No 1606/2002 on the application of international accounting standards obliges all listed companies, including the issuers of bonds only, to prepare their consolidated accounts according to the IFRS standards.

With this in mind, we think that an accounting standard that is designed for universal application, should, while defining clear-cut principles on one hand, reflect to a maximum differences of business models and forms of company on the other hand.

However, the basic ownership approach takes a very specific approach to ownership and business that may not correspond to all forms of ownership. It presumes that the benefit of an activity lies in the profit that is generated via any activity, while it does not seize the value that an activity itself can have for the "owner" of a company and that the importance of the profit is of a secondary nature. The ownership approach is based on the presumption that an economic agent is acting to draw a maximum return from an activity. It does not leave room for an approach according to which a certain aim is to be achieved with a minimum of means, although both are the occurrence of the same economic principle. It is mainly the latter principles that are inspiring co-operatives.

However, the application of the ownership approach to EU co-operatives would lead to the result that there is no ownership interest at all [for a more detailed analysis see annex 1]. In other words: from a FASB point of view there is no owner². While such a result may appear to be consequent from the perspective of the approach, we seriously doubt that it reflects realities and that the FASB perspective will be shared by the wide public. Members of a co-operative will certainly consider themselves as owners.

We would like to recall as well that in many companies there are different classes of stock capital, where holders do not participate in the profits in equal terms. The reasons for this can be manifold. However, whenever there is a restriction to the "full-reward principle" this would lead to a liability treatment.

There are other approaches, such as EFRAG's loss absorption approach, which are more open in this respect and therefore seem to lead to more appropriate results regarding co-operative shares.

² See Nr. 60.



II. RESPONSE TO QUESTIONS

Basic Ownership Approach

1. *Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of these Preliminary Views and provide minimal structuring opportunities?*

A. Liability Treatment as a Consequence of a "simplistic" standard

For the reasons stated above, the members of the EACB do not think that the basic ownership approach would represent an improvement in financial reporting. In addition, we feel that there is quite a danger in applying a "simplistic approach". We feel that such result is not a satisfying outcome of a standard-modifying process, unless this specific result is really intended.

FASB states "The basic ownership approach is designed to draw the necessary line in the simplest and most informative way that the Board could devise. Simplicity means making the reported information easy to understand by those who prepare, audit, and use that financial information. In this case, a valuable by-product of simplicity is that it would reduce the opportunities to structure very similar transactions or arrangements differently to achieve a different financial reporting result (structuring opportunities).

Co-operative shares are financial instruments that exist for decades, if not more than a century with the same features and characteristics. They are not referenced throughout the Preliminary Views Paper. Accordingly we presume that it was not FASB's intention to treat them as some sort of structuring opportunity.

It seems more that the liability treatment of co-operative shares is the result of the categorical simplicity of the principles of the ownership approach and certainly less a matter of intent. Therefore we think that the liability treatment of co-operative shares also shows the danger of the simplicity of the approach: While carving a very sharp picture of equity, we doubt that its results are satisfying with regard to the complex considerations that are required by economic realities when defining equity.

B. Equity classification of retained earnings

While FASB underlines that *"All other instruments and components, including perpetual instruments like some preferred stock, would be classified as assets or liabilities, as appropriate"* it does not seem to give a clear-cut response on why reserves/retained earnings should be treated as equity. One may argue that reserves/retained earnings are just relevant part of the net



assets to which the holders of an equity instrument is entitled to. However, without equity shares in a co-operative, this rule can not be applied.

By consequence, we do not see that the principles of the ownership approach give a reasonable explanation in this respect. Instead, a rule is required to come to the appropriate result.

C. The Proprietary Perspective

The ownership approach seems primarily based on a purely investor-oriented perspective. While the framework (still) points out that financial states are to serve also the objectives of other capital providers, in particular creditors³. We seriously doubt that from a creditor perspective the highly restrictive notion of capital is helpful. To the contrary, we think that from a creditor perspective the distinction may not be very useful. In fact, as FASB points out with regards to opponents of the ownership approach, we think that a creditor perspective requires an approach that is far more based on an entity perspective. The FASB tackles capital with regard to its capacity to fully participate in losses and profits, while for creditors the latter is not relevant for the perspective of a creditor, who requires information on the ability of an enterprise to serve its obligations.

By consequence, the proprietary approach of FASB is probably valuable for an equity investor, but not necessarily for a bond investor. It has to be taken into account, however, that not all users of IFRS are companies, whose shares are listed and that also issuers of bonds have to apply the IFRS.

It may now be argued that Standards Setters do not decide on who should use their standards. If, however, this is so, they should clearly indicate that the standards are exclusively designed for the purposes of companies, whose shares are listed.

³ Providing Information Useful in Making Investment and Credit Decisions

S2. The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.

Information Useful in Assessing Cash Flow Prospects

S3. To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.

Information about an Entity's Resources, Claims to Those Resources, and Changes in Resources and Claims

S4. To help present and potential investors and creditors and others in assessing an entity's ability to generate net cash inflows, financial reporting should provide information about the economic resources of the entity (its assets) and the claims to those resources (its liabilities and equity). Information about the effects of transactions and other events and circumstances that change resources and claims to them is also essential



D. Usefulness of Equity/Liability distinction in other areas

From the perspective of banks it has to be pointed out that the ownership approach is of very little value for a prudential perspective. Current discussions at the Committee of European Banking Supervisors (CEBS), make quite evident that important "prudential filters" will be necessary to come to an equity definition that is useful for prudential purposes: for such prudential purposes the "unlimited reward" aspect is not relevant, while the aspect of loss-absorption and permanence of capital play quite an important role.

While it can certainly be argued that prudential aspects are not to be considered as standard setters, we would nevertheless like to express our concern that with the ownership approach FASB moves away from a "universality" of accounting standards.

E. Relevance of the upside of capital

In particular we doubt that the strong focus on the upside of capital, i.e. the requirement of an "unlimited reward" should be relevant. We agree with the recent PAAinE discussion paper *Distinguishing between Liabilities and Equity*, which argues (in paragraphs 3.13 and 3.14) that:

Every financial instrument comes with risks and benefits. If these were symmetrical in the sense that both risks and benefits are either limited or unlimited, there would be no need to refer to participation in both losses *and* profits, since one would automatically come with the other.

A closer look reveals that this is not necessarily the case: Plenty of financial instruments traded in the market contain a participation feature that is linked to a positive performance of the entity only while guaranteeing a minimum return or at least the notional amount. In other words, capital that participates in losses will also participate in profits – even if not proportionally – whilst the opposite would not hold true.

For that reason we agree with the recent PAAinE discussion paper. In our view, it is the loss participation element that distinguishes risk capital from any other form of financing instrument and, therefore, best provides a user of financial statements with decision-useful information about an entity's types of capital. Capital that is not sharing in losses has a common characteristic: The instrument is not linked to a negative performance of the entity, i.e. the instrument's return does not decrease if the entity does not perform well. Due to this "fixed return" such instruments could force the entity into liquidation if it continuously suffered losses. In contrast, risk capital absorbs losses incurred because the claim to the capital provided is automatically reduced. By that, →loss-absorbing capital serves as a buffer or cushion in protecting the claimants of non-risk capital. It is for this reason that we believe that the *participation in losses* is the decisive factor in distinguishing risk capital from all other types of capital. Furthermore, *we came to the conclusion* that using the loss absorption criterion, being a broad criterion, makes the use of additional features like 'sharing in profits' or 'subordination' redundant.



In particular, when considering that financial reporting is to deliver meaningful information to all kinds of investors, but also to creditors and possibly supervisors, we seriously doubt that the ownership approach will meet this requirement.

F. Compatibility of the FASB models with the future conceptual framework

In the light of the aforementioned, the proposed approaches to equity liability distinction do not seem to be consistent with other on-going projects related to the objectives of financial reporting. In this respect, we would like to pay closer attention to the common (single) converged framework currently being developed by the FASB/ IASB.

We understand that the general purpose of financial reporting is directed at the reporting by an entity to its capital providers rather than reporting from the perspective of a particular class of capital providers. We see, however, that the basic ownership approach complies with the needs of only a part of the capital providers – investors.

Therefore, it is not understandable how the concept of equity, presented in the FASB Preliminary Views, will fit into the general objective of the future common conceptual framework to 'develop standards that are principles-based, internally consistent, internationally converged, and that lead to financial reporting that provides the information needed for investment, credit, and similar decisions'.

Perpetual Instruments

- 2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?*

We regret that FASB rejects the idea to consider perpetual instruments as equity⁴. IAS 32 stressed the aspect of "permanence of capital" by classifying every instrument as a liability, which includes a contractual obligation to deliver cash or another financial asset to another entity. Accordingly, instruments which are not expected to give rise to an outflow of resources shall be recognized as equity/ or assets. On the basis of this notion, some puttable financial instruments currently qualify as equity, either under the provisions of IFRIC 2 or the latest amendments to IAS 32.

⁴Nr. 63 ss.



Indeed, the durable availability of sufficient resources is of paramount significance from an entity perspective. It is also a vital feature for all creditors of the entity, who have little interest in the distribution of profits among investors as long as the entity serves its obligations. For creditors, full participation/ limited participation in profits is not a decisive criterion.

In other words, the notion of permanent availability of capital in the definition of the accounting concept of equity is highly valuable and delivers meaningful information from creditors' point of view.

With regard to our comments under Nr. 1, we ask FASB to reconsider its approach and also to allow an equity treatment of perpetual/non-puttable instruments, as currently stipulated by IFRIC 2.

Redeemable Basic Ownership Instruments

4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

While the subhead for paragraph 20 reads "Redeemable Basic Ownership Instruments," the definition used for redeemable in the first sentence states "mandatorily or at the option of the holder." Redeemable at the option of the holder describes puttable instruments, as noted in footnote 3. Cooperative shares of the IFRIC 2 type are neither mandatorily redeemable nor are they be categorized as puttable instruments because they generally are not redeemed at the option of the holder. The redemption is entirely in the discretion of the co-operative. Accordingly, when co-op shares are not mandatorily redeemable and they meet the criteria in paragraph 18, they should fall under the definition of basic ownership instruments and be classified as equity.



Annex:

CHARACTERISTICS OF COOPERATIVE SHARES IN THE EU

European Co-operative banks characterize themselves as *variable-capital entities*. However, they differ from other entities similarly labeled. The holder of equity in a variable-capital entity typically has a right to a proportionate share of the entity's net assets. For example, shares in a mutual fund are redeemed at an amount equal to the proportionate value of net assets. As outlined below, this is not true for some co-operative banks.

In most jurisdictions, laws governing the operation of co-operative entities characterize members' shares as equity.

Co-operative entities are formed by groups of persons who view a co-operative as the best vehicle for meeting common financial needs. National laws define a co-operative using language like "a society endeavouring to promote its members' economic advancement by way of a joint business operation (principle of self-help)." The principle objectives of a co-operative are the satisfaction of members' economic and/or social goals.

Co-operative entities operate under the principle of self-management. In some jurisdictions (notably Germany), co-operatives have both a Board and a Supervisory Board. In other jurisdictions, a single Board exercises responsibilities delegated to it by the members.

Co-operative entities also operate under a principle of personal responsibility. Accordingly, a member/shareholder's exposure to loss may exceed the amount paid to purchase shares. The governing charter sets the amount of exposure, referred to as the *reserve liability*. In some co-operatives, when the subscriber of shares leaves the cooperative (with variable capital), he or she remains committed to cover potential losses (arising from the period of his shareholding) for five years. This rule gives cooperative banks a legal basis for deferring up to five years the repayments of shares, in order to ensure deduction of any potential losses from the amount. However, in other cooperatives, members' exposure to loss is limited to the amount of their investment in shares (as would be the case in most other corporations).

In Europe, a bank must have at least €5,000,000 in *own funds* (equity). As a practical matter, this means that a newly formed co-operative must have member shares with a nominal value of €5,000,000 to begin operation as a co-operative bank.

Purchase of Shares

In European co-operative banks, a customer need not become a member/shareholder to open an account or borrow. The member/shareholder, when acting as a customer, has the same rights and obligations as a customer who is not a member/shareholder. In the past, some co-operative banks required membership before making loans. However, this is no longer true of the large majority of entities. Competitive pressures make it impossible to offer special terms to members.



The co-operative charter or governing Board often establishes a maximum number of shares that a member/shareholder may purchase. The acquisition of shares begins with an agreement to contribute capital within a period defined by the entity's governing charter. It is then completed by payment from the member/shareholder and receipt of the shares.

A member/shareholder may own one share or many. However, a member/shareholder is entitled to only one vote in shareholders' meetings. While some jurisdictions allow voting based on shares owned, few co-operatives adopt voting based on shares owned.

Even when share voting is permitted, it is often limited to a fairly small proportion of the total votes (for example, 0.25%) or a fairly small number of votes (for example, 3 to 5). The voting rules apply to all matters, unless the governing charter provides otherwise.

A member/shareholder purchases shares for a fixed amount, regardless of the amount of net assets in the co-operative before the purchase. The fixed amount is established in the entity's governing charter and cannot be changed without an amendment to the charter.

Dividends

Dividends on shares are approved at the annual meeting and are not guaranteed. In most cases, dividends can be paid only from accumulated earnings. It is common practice (sometimes mandated by the entity's charter) to distribute only a portion of each year's earnings. In some jurisdictions, law or the entity's governing charter limits dividends to the amount that would be paid on bonds of a specified quality.

Dividends are paid in cash. In most jurisdictions, dividends paid by a co-operative are taxed in the same manner as dividends paid by other corporations.

Most co-operative banks do not pay "patronage dividends" based on the volume of business that a member/shareholder conducts with the entity.

Redemption of Shares

In general, a member/shareholder who presents shares for redemption will receive the same amount paid to acquire the shares. While undistributed earnings generally do not increase the amount paid to redeem shares, accumulated losses reduce the amount paid by a proportionate share of the accumulated loss.

In the event of insolvency, member/shareholders and former member/shareholders can be assessed for a portion of any amounts necessary to pay creditors. In general, additional contributions are required only in the event of bankruptcy or liquidation. Most European jurisdictions have additional regulations or laws governing the time period during which a former member/shareholder is subject to call for additional contributions or refund of amounts paid to redeem shares.



A member/shareholder may transfer shares to another party rather than presenting the shares for redemption. However, all transfers are subject to approval by the governing board and the requirements of the entity's governing charter.

Depending on the entity's governing documents, a member/shareholder may be able to present a portion of shares for redemption.

A member/shareholder who wishes to redeem shares must obtain permission of the governing board. In some cases, permission cannot be granted until the annual meeting and approval of accounts.

The entity's ability to refuse a redemption request varies among jurisdictions and among entities with a jurisdiction. In some situations, the entity has an obligation to make payment, subject to solvency or other regulatory restrictions. In other situations, the co-operative or its board have the unconditional right to decline requests for redemption.

Representatives of the industry indicate that gross redemptions of member shares in any year average about 1% of outstanding shares.

Liquidation

The entity's governing charter describes the distribution of net assets on liquidation of the co-operative bank. In some jurisdictions, the net assets are distributed, either proportionately to the number of members/shareholders, or based on the number of shares owned.

In other jurisdictions, the member/shareholder receives only the amount paid for shares, and any remaining net assets are distributed to another cooperative organization, a charitable organization, a sponsoring organization (like a municipality or church), or to a guarantee fund. Such reserves/retained earnings are considered "indivisible". In some jurisdictions members/shareholders have the right to determine to whom the remaining funds will be allocated.



ASSESSMENT: COOPERATIVE SHARES AND CAPITAL UNDER THE OWNERSHIP APPROACH

It seems that from the perspective of the basic ownership approach, the following assessment can be made regarding co-operative shares:

1. Most residual claims

The question is whether co-operative shares are the most residual claim to a co-operative. According to FASB⁵ *"Equity has historically been identified as a residual interest in an entity, and this Preliminary Views retains that general idea. A residual interest is one entitled to what is left over, that is, to the residual from the entity's activities."* In this context FASB uses the term of the "most ultimate rewards inherent in an entity and its activities"⁶

- a) This is certainly the case where the reserves/retained earnings of the co-operative are distributed, no matter on what basis, in case of liquidation. Where the charter of the cooperative stipulates that the reserves are transferred to another entity, one may say that there is no important difference, as long as this mode of distribution is based on the decision of the members, who simply decided not to take it for themselves. In so far the situation may not be different to a situation in another company, where it is decided at liquidation to transfer the funds to a new company. The latter reflection shows that the perception of these aspects should not be too formal.
- b) Where the distribution of retained earnings/reserves to members is excluded by law, one might argue that the retained earnings/reserves, which are passed to another entity, are the most residual claim. However, in this context one may have to consider as well, that when there are no reserves left, the remaining share capital is most residual. It could also be argued that where members have the right to determine to which third party the remaining assets are to be transferred. In such a case, the reserves are kind of the members'/shareholders' claims that they can dispose of, though in a more limited number.

While in both cases it is possible to find arguments for considering co-operative shares as most residual claims and as "most ultimate", there can be no denying that this is far more easy for the situation under a).

2. A claim to a share of the net assets

In this context FASB demands that *"the holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available."*

⁵ Nr. 53.

⁶ Nr. 55.



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- a) Following the distinction made above, there does not seem to be a difficulty regarding co-operatives, where members can decide to distribute the reserves among themselves. One difficulty could be however, that as a general rule, the remaining net assets are distributed in proportion the number of members and not in proportion to the shares. However, in most jurisdictions, members are free to adapt the distribution mode to the mode required. In some cases, the results may be just the same, since the limitations regarding the number of shares a member can buy (one member, one share).
- b) As regards co-operatives where members do not have immediate access to reserves/retained earnings in case of liquidation, they normally have, as stated above, nevertheless a right to decide on the allocation of any remaining surplus and to determine to which entity it may be transferred. While it may be argued that they are not entitled to the "ultimate reward", there is not denying either that it is in their hands to decide to which such reward goes. It seems highly important whether there is no determined other party to which the "ultimate reward" would go. Thus, it is finally the holder of the co-operative share to whom such reward is allocated.

By conclusion, the assessment is quite similar to the one under 1.

3. Redeemable Instruments

While at least some co-operatives seem to meet the aforementioned criteria without difficulties and others with the help of some reasonable explications, it is the conditions imposed for redeemable instruments that seem to create barriers for cooperative shares that they will not be able to pass. Under Nr. 20 FASB requires that *"the redemption amount is the same as the share of the issuer's net assets to which the holder would be entitled if it were to liquidate on the classification date;"* or at least under Nr. 21: *"The redemption formula is designed to approximate fair value of the instrument or the share of assets to which the holder would be entitled;"*.

While some co-operatives give their member access to the net assets in liquidation, they do not give that access on a going-concern-basis, when a member leaves the co-operative. In fact the redemption amount is neither the same nor an approximation of what the holder would be entitled to in liquidation.

As for co-operatives, where members do not have access to reserves, one might argue that here the entitlement is the same in liquidation as on a going-concern-basis. However, if we maintain the presumption that such co-operatives fulfill the first two criteria as reasoned above, we have to realize that there is no equivalent for the right of disposal on the reserves as is the case in liquidation. The "link" that can be established between the "indivisible reserves" and the holder of the instrument in liquidation, is not available when approaching the matter on a going-concern-basis.

By consequence, we see have to conclude that co-operative shares would have to be treated as liabilities under the FASB approaches.