INTERNATIONAL
CO-OPERATIVE
ALLIANCE

Route des Morillons 15
1218 Grand-Saconnex
Geneva
Switzerland

Tel: (41 22) 929 88 38
Fax: (41 22) 798 41 22
E-mail: ica@ica.coop
Website: www.ica.coop

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Geneva, 5 September 2008

Dear Sir/Madam,

On behalf of the international co-operative community of 800 million members, we are writing to you to comment on the IASB discussion paper on *Financial Instruments with Characteristics of Equity* and its potential impacts on co-operative businesses.

The International Co-operative Alliance (ICA), established in 1895, is an association of 221 national co-operatives in 88 countries. Our members are highly concerned about the adoption of new international accounting standards and their impact on the co-operative model of business.

Co-operatives – a significant part of the global economy

The co-operative sector represents a significant contribution to our global economy. According to the ICA annual survey, Global 300, the top 300 co-operatives around the world had nearly US$1 trillion in revenues in 2005. That is only slightly less than the economy of the world's ninth largest economy, Canada. Co-operatives create over 100 million jobs, more than all of the multinational corporations combined. Co-operative enterprises contribute to every sector of the economy and are among the largest businesses in the world.

A Different Business Model

Our members have worked hard all over the world to inform accounting standard setters about the co-operative model. But we have often found in the past that standard setting organisations reached simplifying assumptions that would treat the co-operative business model as synonymous with the investor-owned business model.

According to the co-operative standards established by the ICA General Assembly under the "Statement on the Co-operative Identity" in 1995 and fully incorporated into ILO Co-operatives Promotion Recommendation 193/2002, the co-operative business model has some key features that distinguish it from the investor-owned business model:

- **Combination of the needs of the owners with the needs of the users**. Whereas the primacy of capital is ever present in an investor owned company, co-operatives are formed to address the specific needs of their members. In co-operatives, the interests of the members or users of the products and services are aligned with the owners of the co-operative. In an investor owned company, the shareholder's interest is not typically aligned with that of the consumer's.

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- **Profit making but not profit oriented**. Co-operatives typically generate earnings and offer their membership a return of capital whereas investor-owned companies have shareholders to pay and must generate a profit in excess of the earnings to ensure a return on capital for investors.

- **One member one vote**. In a co-operative, the voting rights are not based on the amount of investment, as in investor owned companies, but rely on the one member, one vote principle, creating equal voting rights for each member.

- In investor owned companies, the more money you invest, the higher your returns. But in co-operatives, **the "return" is often focused on your patronage or use of the co-operative**. Many co-operatives remunerate their members by paying a patronage dividend, which represents an adjustment, aimed to compensate the members for what they paid in excess or received less in their transactions with the co-operative.

The main characteristics of co-operative member shares

As co-operatives are member-owned businesses, their equity is provided by their members. A co-operative member will make an equity investment, often nominal, in a co-operative upon becoming a member. This investment represents a member's ownership interest in the co-operative.

Although co-operative legislation can be very different from one country to another, co-operative member shares have common characteristics.

Member shares are recognised by members as risk capital. In the unfortunate incidence of a bankruptcy, member shares participate in losses if the co-operative's own funds (which are usually comprised of retained earnings) cannot cover the losses.

In most cases, there is no active market for co-operative shares. The member's interest is generally not transferable and shares can only be exchanged with the co-operative itself. Unlike publicly held investor-owned entities, an individual or business typically can join a co-operative only after meeting the requirements for membership and after approval of the Board of Directors, or in some cases, the membership.

Co-operatives have a variety of arrangements regarding the redemption of members' shares or the refund of equity interest: in some countries or sectors, co-operative boards of directors have the unconditional right to refuse the redemption of the members' shares, in other countries or sectors, the co-operative has an obligation to redeem the members' shares or refund equity interests when a member decides to withdraw from the co-operative or when he is excluded from the co-operative.

Some co-operatives repurchase the shares of members or refund the equity interest upon their withdrawal from the co-operative, upon death, upon reaching retirement or a certain age. The redemption amount is generally limited to the book value of the member's shares. Other co-operatives have a policy of revolving equity of the co-operative over a period of time once specific equity levels are achieved or if the financial condition of the co-operative allows it.

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Why Is the Classification of Risk Capital as Equity Important?

Publicly traded, investor owned companies are valued every day through the public market, which provides the price the market is willing to pay for their shares. The market fluctuates for a variety of reasons, many of which are not related to the value of the company itself. Analysts do not rely solely on the market and must use a variety of factors to determine the value and profitability of the company.

Co-operative shares typically are not traded on the market and the value to a member or interested investor on any day depends on the relationship the member has with the co-operative.

Users of co-operative financial statements fall into five categories -- potential members, vendors that wants to do business with the co-operative, potential outside investors, lenders and members. In each of these cases, the information the users would need would include the amount of equity held by the co-operative.

- Potential member: When small businesses, farmers, workers or consumers decide whether to join a co-operative, one of their criteria will be its financial status. This user wants to know if the co-operative can meet his or her needs in the marketplace, whether the co-operative is sustainable and can meet earnings expectations. The equity side of the balance sheet is essential to make those decisions.

- Vendor: Vendors, many of which may be quite small, rely on financial information to determine whether the co-operative can meet its obligations. Many of the vendors may not be familiar with co-operatives and may view the lack of equity negatively.

- Potential outside investor: We have heard from many co-operatives that they face challenges in describing the way in which capital is held and distributed by co-operatives to potential investors. This task would be made that much more difficult if co-operative equity was reclassified.

- Lender: Many co-operative's lenders require the co-operative to meet certain covenants which may include ratio requirements such as Times Interest Earned Ratio etc. Additionally, lenders may require a co-operative to maintain a certain minimum level of equity. Also, rating agencies typically consider the equity level of a co-operative to be an important characteristic of the ratings process.

- Co-operative members: Current members have an obvious need for information about the equity in their co-op. They may not only want to see the value of their ownership interest but information to assess whether the co-operative is financially sound and well-managed.

The impact of international accounting standards on co-operatives

Though co-operatives function differently around the globe, their basic structure is similar and needs to be recognised by relevant accounting standards.

Under IAS 32 and IFRIC 2, co-operative member shares are accounted for as equity as long as the co-operative has an unconditional right to refuse their redemption.

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The international co-operative community rallied and made significant compromises to comply with this approach. Indeed, for many co-operatives, it forced some changes in their national or regional laws, bylaws and structure of their organisation.

This approach has been in place and working for many co-operative financial institutions for more than 2 years. It accommodates the co-operative business model in many countries, though it does not everywhere as some national laws state that co-operatives have an obligation to redeem their member shares at the option of the holders.

The FASB three exposed approaches take a specific approach to ownership that does not correspond to all forms of ownership.

In many jurisdictions and particularly in Europe, the application of the FASB **basic ownership approach** to co-operatives would lead to the result that there is no ownership interest at all in the co-operative, which is inappropriate as co-operative shareholders are clearly the owners of their co-operative.

The **ownership-settlement approach** could be acceptable for some co-operatives. Indeed, when co-operatives dispose of the unconditional right to refuse the redemption of their shares (as stipulated by IFRIC 2), those instruments are neither mandatorily redeemable nor redeemable at the option of the holder. Accordingly they should qualify as perpetual instruments under the ownership-settlement approach. Nevertheless, many co-operative shares at an international level do not fulfil these criteria and could therefore be accounted for as liabilities under this approach.

This being said, the EFRAG/PAAinE loss absorption approach would certainly represent the best approach for co-operatives at an international level. Indeed, all co-operative member shares, which are loss absorbing capital, would be accounted for as equity under this approach, which is not always the case neither under the current IFRS nor under the FASB three exposed approaches.

We hope that any approach ultimately adopted by IASB will lead to a classification of co-operative member shares as equity.

We look forward to working with IASB to ensure that international accounting standards take into account the needs of the international co-operative community.

Yours sincerely,

Ivano Barberini
President of ICA

Annex: Replies to the invitation to comment

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B1 Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?

Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

The three approaches expressed in the FASB Preliminary Views document would be difficult to implement for most co-operatives in their present formulation, as they could lead into classifying many co-operatives shares as liabilities.

To be more accurate, **under the basic ownership approach**, many co-operative member shares would not be accounted for as equity.

Co-operative member shares are generally the most subordinated interest in a co-operative and do not have priority over any other claim upon liquidation, so they meet the "subordination criterion" (18.A)1 of the FASB basic ownership approach.

The "ownership criterion" of the basic ownership approach (18.B)2, is more problematic or less universal: it is fulfilled by some co-operatives, particularly American co-operatives, but it is not clearly fulfilled, in its present drafting, by other co-operatives at the international level. Indeed, many co-operatives have specific laws or rules which forbid them to redeem their shares, upon or before liquidation, above their nominal value.

As a consequence, even though the co-operative members holding co-operative shares:

- are "entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied",
- are entitled to a share of the co-operative assets which depends on their share of the total claims with the lowest priority,
- can lose 100% of their share value (no lower limit), those shares could nevertheless be accounted for as liabilities under the current formulation of criterion (18.B).

Indeed, there is an upper limit to the members' rights to the co-operative net assets, which is usually the nominal value of the co-operative member shares.

Criterion 18.B seems to exclude these shares from the definition of Basic ownership instruments, which seems inappropriate as these instruments are in the most subordinate category of instruments and participate in potential losses.

The two other approaches expressed in the FASB Preliminary Views document raise more or less the same questions.

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[1] This criterion of the FASB Basic ownership approach stipulates that: *the holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made;*

[2] This criterion of the FASB Basic ownership approach stipulates 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.*

The ownership-settlement approach could be acceptable for some co-operatives. Indeed, when co-operatives dispose of the unconditional right to refuse the redemption of their shares (as stipulated by IFRIC 2), those instruments are neither mandatorily redeemable nor redeemable at the option of the holder. Accordingly they should qualify as perpetual instruments under the ownership-settlement approach.

Nevertheless, many co-operative shares at an international level do not fulfil the IFRIC 2 criteria and could therefore be accounted for as liabilities under this approach.

- *Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?*

The EFRAG/PAAinE « Loss absorption approach" is an alternative approach to the FASB expressed approaches that would improve and simplify IAS 32.

This approach holds promise not only for co-operatives but for all businesses that operate with at risk capital, as it defines capital that has the potential to cover losses from a creditor's perspective as equity. The basic idea of the "Loss absorption approach" takes into consideration both investors' interests and the concerns of non-listed companies, in particular co-operatives. This approach provides a broader range of users with decision-useful information concerning entities in different legal forms across different jurisdictions.

The "Loss absorption approach" would also appear to be consistent with a principles-based approach -- the principle being that capital available to absorb losses is ownership capital – and it is simple.

This approach has potential appeal to co-operatives around the globe because member shares would be classified as equity regardless of any other consideration (redemption conditions, claims on the net assets at liquidation,…).

As a consequence, we fully support this approach which is very promising for co-operatives and which would lead, if it were adopted by the international accounting standard setters, to an appropriate accounting classification of co-operative member shares.

B2 Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?

The scope of the FASB project, as set out in paragraph 15 of the FASB Preliminary views document, is limited to basic ownership instruments (whether or not they are ownership instruments in legal form) , other instruments that are ownership interests in legal form and any other contract that is settled with basic ownership instruments or whose fair value is determined by prices of basic ownership instruments.

This scope is quite restrictive, as it is limited to financial instruments and does not include other elements such as retained earnings and reserves, which constitute an essential part of most co-operatives' equity. Even if these elements are not financial instruments, it must be made clear that they must be accounted for as equity.

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B3 Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to which type of entities or in which jurisdictions are they inappropriate, and why?

The basic ownership approach takes a specific approach to ownership that does not correspond to all forms of ownership. As exposed before, in many jurisdictions and particularly in Europe, the application of the basic ownership approach to co-operatives would lead to the result that there is no ownership interest at all, which is inappropriate as co-operative shareholders are clearly the owners of their co-operative.

B4 Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance). If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

No comments

B5 Please provide comments on any other matters raised by the discussion paper

No additional comments