

European Financial Reporting
Advisory Group
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Brussel 25th July 2008

Discussion paper „Distinguishing Between Liabilities and Equity“

Dear Sir or Madam,

Cooperatives Europe, the common platform of cooperative bodies in Europe, warmly welcomes the discussion paper „Distinguishing Between Liabilities and Equity“ published by Pro-Active Accounting Activities (PAAinE) in Europe in January 2008 submitted by the PAAinE as a result of an European joint project. You will find our detailed comments on the following pages.

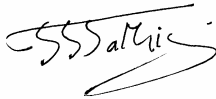
We are very fond of its key concept, the loss-absorption approach, as a really universal and clearly principle-based concept: It takes account of the interests of the investors as well as of the large variety of non-listed companies like cooperatives, having a legal form different from stock corporations. In so far it is far better than all other proposals that are currently discussed and provides for confidence among for cooperatives. Furthermore, it meets the expectation of the European Parliament as expressed in European Parliament resolution of 25 April 2008 on IFRS and the Governance of the IASB. The European Parliament points out that the IASB should incorporate in IAS 32 a definition of 'own funds' equity which will enable all forms of company, including in particular cooperative societies and partnerships, to declare capital provided by shareholders members and partners as equity in the balance-sheet.

In particular, we estimate highly positive the general focus on the ability of equity to absorb losses. The concept of "capital at risk" properly reflects business realities and information needs. Parts of the present paper are quite theoretical nature; therefore, a differentiation of many instruments can up till now be carried out only on a hypothetical basis. We strongly encourage EFRAG and the drafting team to continue its work and to improve the paper in this respect.

When doing so, we suggest to even more clarifying the advantages of the loss-absorption approach towards the FASB and IASB approaches by reducing the preponderance of references to listed companies.

Please feel free to contact us, if you have any further questions or desire any further exchange of information.

Best regards,



Agnès MATHIS
Deputy director

Answers to the questions

Q 1 – Do you believe that defining two different classes of capital on the credit side on the balance sheet does provide decision-useful information, even if the entity’s capital structure is in fact multi-dimensional (the so-called “list claims”-approach, pars. 13 ff.) If not, why?

We consider a distinction into two classes of capital on the credit side as appropriate and decision-useful, as the information about the financial situation corresponds to the circumstances of the entity and allows for an overview of the liquidity situation and the liquidity requirements already arising out of the balance sheet.

Even if the characteristics and form of the equity instruments are complex and therefore represent its multidimensional criteria, we consider an explanation or distinction of equity exclusively in the Notes for insufficient, if not even misleading.

Defining more than two classes of capital would lead to multiple categories of claims, with multiple definitions and multiple lines to draw between the different classes of capital, which would increase complexity and would not improve the understanding of the balance sheet for external users.

Q2 – Do you believe that listing all claims to the entity’s assets, ranking those claims by a certain criterion and providing additional information on all other characteristics of the claims in the Notes to the financial statements would have merit (pars. 1.3 ff)? Why? If not, why?

As already explicated in Question 1, we take the view that a dichotomy in equity and liabilities in the balance sheet offers decision-useful information. At least a first overview of the situation of the equity and liabilities in the balance sheet is required. Details regarding the form of the several items and instruments should be presented in the Notes.

Any modification to the dichotomy of equity and liabilities would require an impact study to test this approach on empirical cases and see if it could provide a clear and useful information for financial statements users.

Q 3 – Do you agree with the analysis of the different characteristics of capital as the basis for distinguishing between equity and liabilities (pars. 1.14 ff.)? If not, why? Do you think that any other characteristics should be considered? If yes, which?

We agree in principle with the analysis and the individual explanation of the characteristics of equity and liabilities. In particular, we consider loss absorbing as the relevant criterion for distinguishing between liabilities and equity instruments.

We highly appreciate that the section is largely formulated neutrally, what we strongly welcome. Nevertheless, in some parts the paper seems to present predominantly ordinary stock as the basic form of equity instruments. In order to even enhance and underline the neutral character of the paper and the universality of its loss-absorption approach, we suggest improving this in future documents. We fear that an orientation on the basic form of one single instrument of equity will regularly lead to problems in interpretation and implementation.

Q 4 – Do you agree with the analysis in the paper on whether to base a capital distinction on one or more than one criterion (pars. 1.33 ff.)?

As explained, we consider loss absorbing as the decisive criterion for the classification of equity instruments. From our point of view, this criterion is sufficient for distinguishing between liabilities and equity instruments.

While we feel that it is definitely an advantage of the loss-absorption approach that it is based on this one criterion, we would definitely not subscribe to the general idea that an approach is superior because it is based on one single criterion.

Q 5 – Do you agree with the analysis in this paper that, in order to classify capital, either an entity view or a proprietary view has to be applied (pars. 1.40 ff.)? If not, why not? Do you agree with the paper’s description of the implications of each approach (pars. 2.35 ff., 3.22 ff.)? If not, why?

The discussion paper defines the loss absorbing function of capital as the relevant criterion to distinguish between liabilities and equity. The possibility of different interpretations of the loss absorbing-criterion subject to an entity view or a proprietary view and hence a different classification of the same instrument should be discussed further.

With respect to the definition of the loss absorbing-criterion perspectives either the entity view, the proprietary view or the creditor view should be mandatory. Accordingly, we consider further explanation regarding the topic ‘Entity versus Proprietary View’ desirable.

Furthermore, we share the view that for a final evaluation of the loss absorbing-criterion, it needs to be defined mandatory at first, from which perspective a participation in losses has to be assessed.

Q 6 – Do you agree with the analysis of the needs of the users of financial statements in the context of classifying capital (pars. 3.1 ff.)?

We consider that the users of financial information are a multidimensional group. Therefore information provided by the entity is interpreted and assessed differently, respectively, according to the interests of the various stakeholders. According to the IFRS framework, investors in their capacity as providers of risk capital will usually have the most comprehensive information need of all users.

In a co-operative, the “investors”, who are the co-operative members, do not have exactly the same needs than the investors in a publicly traded entity: Very often, the services provided to them by the co-operative are far more important than any financial return they may receive on the equity provided.

Q 7 – Do you agree that basing the distinction between equity and liabilities on risk capital would provide decision-useful information to a wide range of users of financial statements about entities in different legal forms (pars. 3.5 ff.)? If not, why? Is there any other basis for the distinction that you would consider providing more useful information? If yes, which and why?

We agree that a distinction between equity and liability based on the definition of risk capital provides decision-useful information for users of financial statements. In this case, we understand risk capital as capital, which participates in losses (Section 3.14), hence takes over a loss absorbing function. With regard to the multidimensional character of the user group, the definition of risk capital and accordingly of the loss absorbing function will have to be neutral regarding business models and different legal forms.

Q 8 – Do you agree with the analysis of losses as either economic losses or accounting losses in the context of classifying capital as equity or liabilities (pars. 4.1 ff.)? If not, why? Would you agree that the Loss Absorption Approach should focus on accounting losses?

Focusing the definition of accounting losses purely on the current reporting periods and on the figures of the profit and loss account seems to be problematic. On the one hand, there is the possibility not to include losses in the profit and loss account but to recognize them directly in equity. On the other hand, the restriction on loss absorbing in the current reporting period suppresses the participation in losses in case of liquidation.

Q 9 – Do you think that the Loss Absorption Approach is explained sufficiently clear in this paper (Section 4)? Do you agree with the definition of loss-absorbing capital in par. 4.16? If not, why? How could this definition be improved?

Overall the Loss Absorption Approach depending on the criterion of loss absorption is a proper approach. It should be explained even more elaborately and defined in more detail.

The definition of loss absorbing capital, mentioned in section 4.16, refers to the definitions of risk capital and loss absorption and contains an explicit reference to the entity view. Thus, the same questions are posed as described in the remarks to questions 7 and 8.

Q 10 – Do you agree that classification of an instrument as equity or liability should be based on the terms and conditions inherent in the instrument? Do you agree that the passage of time should not be the trigger for reclassification of an instrument (pars. 4.22 ff)? If not, why?

In principle, we agree to the statement that the decision for a classification of an instrument is based on the terms and conditions inherent in the instrument. This classification should also endure. Therefore, we consider a reassessment in certain intervals dispensable also with regard to the principle of consistency.

Q 11 – Do you agree with the discussion on linkage (pars. 4.13 ff.)?

We do agree with the view expressed in the discussion paper on linkage - that instruments issued at the same time should be considered together if they are part of the same arrangement between the transacting parties to avoid structuring opportunities.

Q 12 – Do you agree with the discussion on split accounting (pars. 4.36 ff.)?

According to the current state of the discussion, in our view, the question cannot be finally answered, as without concrete criteria of differentiation you can only hardly assess, under which circumstances certain instruments should be split off.

Q 13 – Do you agree with the discussion of the different approaches to distinguish equity from liabilities within a group context in general and with regard to the Loss Absorption Approach in particular (section 5)? If not, why? Would you prefer the approach set out in par 5.1(a) or the approach in par. 5.1 (b)? Why?

An explicit procedure for the identification on the level of (subsidiary) entity cannot clearly be concluded out of the discussion paper. Accordingly, from these criteria hardly any conclusions for the presentation, if done in a group context, can be drawn.

For an analysis of the consequences which would result from the chosen procedure further explanation on this topic and the preceding questions (minority interests, profit transfer agreement) would be necessary.

This being said, there can be no doubt that the outcome must be that equity on solo level should not differ from equity on group level.

Q 14 – Do the examples in section 6 illustrate the loss-absorption principle well? Would you have reached a different conclusion (or classification)? Why? Are there any other aspects of the Loss Absorption Approach that need to be illustrated?

The described examples of section 6 illustrate the principles of the Loss Absorption Approach quite well. We do not think however that this illustration is exhaustive and therefore sufficient to clarify the treatment of all kinds of instruments. We therefore encourage EFRAG and the drafting team to come up with a more elaborate paper in this respect.

Q 15 – Do you believe that the Loss Absorption Approach is sufficiently robust to be prescribed in an accounting standard? If not, why? If you are concerned about structuring opportunities what would be your suggestion to limit the structuring opportunities?

As already explicated in our answer relating Q 9, we consider loss absorbing as the basic principle appropriate for a differentiation between equity and liability and we are quite optimistic about its suitability for a standard. However, since the current document in parts is still quite theoretical in nature, it is not possible to make a clear statement regarding the suitability for a future accounting standard. We therefore strongly encourage EFRAG and the drafting team to carry on with their work and to tackle the unsolved questions raised in this discussion paper (circularity, application within a group context) are further developed.

Q 16 – Do you think the Loss Absorption Approach should be simplified? If yes, how could the Loss Absorption Approach be simplified?

As regards the present paper we currently see no possibilities for a simplification.

Q 17 – This Discussion Paper is based on the view that the current IFRS approach to distinguish equity from liabilities has shortcomings. Do you agree with the analysis of the current IFRS approach to distinguish equity from liabilities (section 2)? Do you agree that the current approach has shortcomings as identified in this paper (pars. 2.17 ff.)? If not, why? Do you see any other shortcomings? Do you see advantages of the current approach?

We agree to the analysis and share the view that the current IFRS approach has shortcomings. This being said, we have to underline, however, that solutions for some shortcomings in IAS 32 have been developed (i.e. IFRIC 2, IAS 32 (amendments in February 2008). However, the core problem remains that IAS 32 is based on an imperfect definition of equity.

From the point of view of co-operatives, IAS 32 and IFRIC 2 stand for a treatment of capital that is accepted by some, but not by others: The international co-operative community rallied and made significant compromises to comply with these standards. Indeed, for many co-operatives, it forced changes in their national or regional laws, bylaws and structure of their organization. This approach is in place and working for many cooperatives, in particular financial institutions, for more than 2 years. It accommodates the cooperative business model in many countries, though not everywhere as some

national laws state that co-operatives have an obligation to redeem their member shares at the option of the holders.

Finally we suggest that an improved version on this paper should include an analysis of the recent amendment of IAS 32 (puttable instruments) in order to show that it does not solve the problems of many entities such as cooperatives.

Q 18 – Do you believe that the Loss Absorption Approach would represent an improvement in financial reporting over the current IFRS approach? Do you think that the distinction based on this approach provides decision-useful information? If not, why? Do you have any other comments?

In our view the proposed approach represents an enormous improvement compared to substantial shortcomings of the current equity definition in IAS 32 and the deficiencies of FASB's proposal (Basic Ownership Approach). Additionally loss absorbing is an appropriate basis to determine regulatory capital of banks which is usually linked to equity concerning financial statements.