National Cooperative Business Association ■ www.ncba.coop

July 28, 2008

EFRAG
13-14 Avenue des Arts
1210 Brussels
Belgium

via email: Commentletter@efrag.org

Re: Comments to Discussion Paper Distinguishing between Liabilities and Equity Issued January 2008

Dear Working Group Members:

The National Cooperative Business Association (NCBA) appreciates the opportunity to comment on the Loss Absorption Approach as outlined in the Discussion Paper Distinguishing between Liabilities and Equity.

The NCBA represents cooperatives across all sectors of the US economy—including agriculture, childcare, electricity, finance, food retailing and distribution, healthcare, housing, insurance, purchasing and shared services, telecommunications and many others -- and is a member of the International Cooperative Alliance (ICA).

Cooperatives have been monitoring and commenting on various equity reclassification proposals issued by the US and international accounting standard setters. NCBA supports the goal of a more simple, principles-based approach to accounting standards. Please see the attached comment letter that contains a description of how co-ops work and some of the issues they face with regard to equity classification.

As stated in the enclosed comment letter in response to the FASB Preliminary Views document, the loss absorption approach holds promise as a simple approach that focuses on the loss-absorbing nature of capital. For cooperatives in the US, the basic ownership approach contained in the Preliminary Views document is also promising as it improves upon the previous proposals issued by FASB and would simplify the classification system. The problems for cooperatives with the basic ownership approach (outlined in the attached comments) may be resolved by focusing on the loss absorbing characteristics of the capital.

An example: Some cooperatives have an upper limit that applies in liquidation to some of the shares held by members. For some co-ops, these limits are imposed by law and for others by governing documents. The capital is at risk – if the co-op suffers losses, that capital would be used and the holders may lose all the capital. Under the basic ownership approach, that capital may not be classified as equity because it is subject to a ceiling though it represents the most subordinated interests. But it is loss-absorbing capital and should be classified as equity. It is also part of the member's total equity interest in the co-op that participates in the gains and losses of the co-op and as such should be classified as equity.

An approach that includes some aspects of the basic ownership and the loss absorption approaches may combine to create a very useful and workable approach to classifying equity and liabilities. While the idea of using a single criterion to define capital may be appealing in its simplicity, it may also result in misrepresenting the true nature of the capital in an entity. A criterion such as most subordinated capital may include much of the at-risk, loss absorbing capital of an entity but would not classify all of such capital as equity. Non-voting, preferred shares, for example, are partially loss absorbing but their categorization as debt could result in financial statements that are not decision-useful. For cooperatives looking for outside capital through the sale of preferred shares (where preferred shares take preference at liquidation), a single criterion classification system may have a significant and negative impact.

We want to make sure that the cooperative form of business can thrive and be supported by accounting standards that accommodate the structure. Co-op shares may be categorized as equity under more than one criterion or definition of equity but they should be categorized as equity under any approach or combination of approaches upon which the standards setters agree.

Thank you for considering the views of cooperatives in your work.

Sincerely,

Paul Hazen
CEO

Mary Griffin
Senior Policy Advisor

May 30, 2008

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Re: Comments to Preliminary Views on Financial Instruments with Characteristics of Equity, Issued November 30, 2007
Ref. # 1550-100

Dear Sir or Madam:

The National Cooperative Business Association (NCBA) is the nation's only national organization representing cooperatives across all sectors of our economy—including agriculture, childcare, electricity, finance, food retailing and distribution, healthcare, housing, insurance, purchasing and shared services, telecommunications and many others. We appreciate the opportunity to comment on the impact the proposals in the Preliminary Views document would have on cooperatives.

In general, NCBA supports the standard setters' objective to move to a more principles-based approach to accounting standards. To achieve this objective, the standards should be transparent, simple, and provide decision-useful information. It is essential that any approach adopted create a reliable and consistent classification system to minimize confusion and unpredictability for users and preparers of co-op financial statements.

In response to the Summary of Issues in the Preliminary Views (PV) document, we agree that the basic ownership approach represents an improvement in financial reporting. The basic ownership approach is a simpler and more universally applicable approach than the ownership-settlement or the reassessed expected outcome approaches outlined in the PV document. As explained in more detail below, the basic ownership approach could be enhanced and clarified to help ensure its application to cooperatives as a distinct business model results in simple, clear, and decision-useful information for users.

Cooperatives – Operating in Every Sector of the Economy around the World

Cooperatives are businesses that are owned and democratically controlled by their members — the people who buy the goods or services provided by the cooperative — rather than by outside investors. In the U.S., cooperatives represent a significant contribution to the economy. With an estimated 150 million members, cooperatives employ more than 600,000 Americans, with aggregate payrolls of more than $15.5 billion annually. These cooperatives generate total annual revenues in excess of $273 billion.

And in the global economy, the top 300 cooperatives had nearly $1 trillion in revenues in 2004. Co-ops worldwide create more than 100 million jobs, more than all of the multinational corporations combined. Cooperative enterprises contribute to every sector of the economy and are among the largest businesses in the world.

A Different Business Model

Cooperatives operate differently from investor-owned companies. Accounting standards may affect co-ops differently than they do investor-owned companies. Though we have explained the cooperative structure in previous communications with FASB, it is important to reiterate and explain these differences in order to provide an analysis of the impact of the basic ownership approach on co-ops.

- In cooperatives, the needs of the owners are aligned with those of the users/patrons. Whereas the primacy of capital is ever present in an investor owned company, cooperatives are formed to address the specific needs of the members. Cooperatives typically operate on an at-cost basis, returning net earnings or net margins, the excess of amounts retained to cover expenses.

- The democratically controlled governance structure of the cooperative relies on the one member, one vote principle. In cases where there is proportional voting, it is based on the member's use or patronage in the cooperative, not his or her financial investment.

- In investor owned companies, the more money you invest in the company, the higher your expected returns. But in cooperatives, the "return" is focused on a member's patronage or use of the cooperative. Cooperatives typically pay a patronage dividend, which represents an adjustment, aimed to compensate the members for what they paid in excess in their transactions with the cooperative.

Cooperatives fall into four categories:

- Producer-owned cooperatives—these are cooperatives owned by farmers or craftsmen who form a co-op to jointly market, process or produce a like-product. There are 1,600 farmer- or rancher-owned marketing or processing cooperatives in the U.S., most of which are local co-ops.

- Consumer-owned cooperatives—representing the largest category of co-ops, these cooperatives are owned by the consumers who buy the goods or services of the business. They range in size but many are local in nature and include credit unions, rural electric and telecommunications cooperatives, retail food co-ops, housing co-ops, parent-owned childcare co-ops, and consumer-owned HMOs.

- Worker-owned cooperatives—these are cooperatives that are owned and controlled by their employees. They are similar to companies with Employee Stock Ownership Plans (or ESOPs) in that the workers own the company. But members of worker-owned co-ops receive annual taxable dividends on the company's earnings, rather than waiting for retirement to cash in their stock as occurs in ESOPs.

- Purchasing and shared services—these are cooperatives that are owned by individuals or small businesses that band together to jointly buy goods or services as a group, thereby lowering their input costs. Unlike buying clubs, the members of purchasing cooperatives actually own the company, ensuring that it is acting only in their best interests in procuring inputs and services. This is a growing segment of the co-op sector, as more and more small businesses see purchasing co-ops as the key to their survival. An estimated 50,000 independent businesses are members of purchasing co-ops.

Because co-ops are member-owned businesses, their equity is provided by their members. Generally speaking, co-ops do not issue public debt, though there are a few exceptions to this rule. A co-op member will make an equity investment in a cooperative upon becoming a member. This investment represents a member's ownership interest in the cooperative, an interest that participates in the gains and losses of the cooperative.

What distinguishes cooperatives from other forms of business is that they distribute all or a portion of the net margins, their "profits," to their members in the form of end of year dividends based on the amount or value of business a member did with or for the co-op. These are referred to as patronage dividends. Members receive dividends at the year's end in the form of cash or as equity held by the co-op and allocated to individual members—often known as allocated capital or capital credits—or both. Cooperative patronage capital therefore is the accumulation of capital from revenues in excess of expenses over time.

Allocated equity is how a cooperative—and often the only way—builds up equity in the company. It is recognized by members as risk capital. In the unfortunate incidence of a bankruptcy, co-ops may never return equity to members. Debt holders are paid first. Upon liquidation, the member may receive the initial investment or base capital, e.g., common stock, allocated equity and previously unallocated patronage income/equity share, and their share of any excess net assets remaining. The member may also lose his or her initial equity investment if there aren't enough assets.

The concept of subordination of capital is integral to the cooperative structure. Economic benefits arising from the co-op's business and the governing control of the cooperative remain with the members rather than with outside equity investors. The net savings that accrue to the cooperative from the business activities it transacts with its members will largely be to the benefit of those members rather than to outside equity investors. This allocation ensures that the cooperative remains faithful to its purpose -- providing services at reasonable or best possible prices to its members.

Each category of co-op or individual sector may use sector specific language to describe member equity capital but it all functions in the same way – as at risk capital. For example, in purchasing co-ops, all members are required to make an initial equity investment in the cooperative upon joining, often a substantial investment and typically referred to as stock. That amount remains until the member withdraws from the cooperative, at which time the member may receive, at the discretion of the board, the par value of the stock plus any retained patronage earnings accumulated during membership.

Food co-ops may call the initial investment a membership fee, which entitles the member to participate in the co-op, or they may allow the members to use a part of their patronage refund as their equity interest. Electric co-ops use "capital credits" to refer to the member's equity stake. Marketing cooperatives often use base capital plans, which may include an upfront investment requirement or "per unit retains," which are deductions from the proceeds of sales for the member, based on either dollar value or volume of products marketed through the co-op.

There is no active public market for co-op shares. Unlike publicly held investor-owned entities, an individual or business typically can join a cooperative only after meeting the requirements for membership and after approval of the Board of Directors, or in some cases, the membership. In general, the member's interest is not transferable and shares can only be exchanged with the co-op itself. Valuation of patronage capital is extremely difficult since there is no objective benchmark to facilitate the valuation.

In the United States, co-op boards of directors, which are elected by members, retain the ultimate discretion as to how or whether to return allocated equity to members. Co-ops have a variety of arrangements regarding redemption of members' shares and different terms may be used depending on the sector.

Some co-ops repurchase the shares of members upon their withdrawal from the co-op, upon death, upon reaching retirement or a certain age. Other cooperatives have a policy of revolving equity of the cooperative over a period of time once specific equity levels are achieved or if the financial condition of the co-op allows.

Unlike shareholders of investor-owned firms, former member owners who leave the co-op may continue to have an equity interest in the assets of the co-op. This recognizes the contribution of the member, who may receive the equity when the Board makes a decision to redeem their equity or at liquidation when the former owners have a claim on a share of the net assets.

Redemption decisions may be based in board policy, practice or in the co-op's bylaws. And some co-ops may never redeem member equity. Co-op boards make such discretionary redemption decisions based on the financial and other needs of the cooperative.

The Basic Ownership Approach Applied to Cooperatives

Though there are some issues related to its scope and application, the basic ownership approach represents a narrow but workable approach for equity classification in cooperatives. We appreciate the simplicity of the approach and its focus on the most subordinated capital. Member shares of most cooperatives should meet the criteria enunciated in paragraph 18 because:

- Co-op shares are the most subordinated interest in a cooperative. They do not have priority over any other claim in liquidation.
- Co-op members holding shares or ownership instruments are entitled to a percentage of the assets of the entity and, in the US, these instruments, taken together, typically are not subject to any upper or lower limit except for the amount of assets available.

While most member shares in the US would meet the criteria, there are potential problems with the narrow approach when put into practice and applied to cooperatives. As we have explained to FASB in the past, a member's equity interest in a co-op can take the form of more than one instrument or share. While a member provides an initial equity amount that may be nominal, it gives him or her the right to participate in the losses and gains of the co-op through, for example, patronage based on his or her use of/relationship with the co-op. Since all of the member's ownership interest, taken together, in the cooperative represents the most subordinate, the basic ownership approach should classify it all as equity, even in instances where a portion of the ownership interest may be subject to an upper limit.

The following are issues that need to be addressed or clarified to ensure co-op member shares and equity interests continue to be classified as such.

- **Redemption of cooperative shares:** As explained above, cooperative shares in the US are not mandatorily redeemable nor are they generally redeemable at the option of the holder, the definition of puttable instruments in the PV. The board retains the right to refuse redemption and chooses when and how to redeem shares.

  <u>Because 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</u>. If that is not the view of FASB, we would like to discuss this issue to determine how it can be resolved. The IFRIC 2 (see below) approach supports this view in that it classifies as equity those instruments in which the board retains the ultimate authority to refuse redemption.

  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.

If co-op shares are considered mandatorily redeemable or redeemable at the option of the holder in some instances, the shares would meet the criteria of paragraphs 20 and 21 and be classified as basic ownership instruments. Due to various restrictions that may apply to some co-ops, particularly in other countries, the criteria in paragraph 20(a) may be difficult to meet. In some situations, the holder may be entitled to less at liquidation where there are upper limits imposed on the amount of net assets to which the holder is entitled. <u>Since it may be difficult to assess the amount to which the holder is entitled at liquidation, we urge FASB to change paragraph 20(a) to the amount the holder would be entitled if the instrument were redeemed on the classification date.</u>

- **Preferred shares:** Cooperatives have limited means to bring in outside capital. Offering non-voting preferred shares is one way to obtain outside capital without threatening the member-owned structure of the cooperative enterprise. We believe preferred shares should be classified as equity because they are at risk capital and represent an ownership interest.

  We understand that preferred shares have taken many forms over the past few years and sometimes have been used in place of what should clearly be liability instruments. Another approach may be to provide a narrow, classic definition of preferred shares – a class of ownership different from common shares, generally with stated dividends, priority in liquidation, and without voting rights – and treat these shares as split or separated instruments, where the dividend is classified as a liability and the share is treated as equity.

  We recognize that under the basic ownership approach, an entity could issue “preferred” shares that would be classified as equity and pay dividends on them as long as they would not take preference in liquidation. However, such shares may still be subject to an upper limit, e.g., par value, and would therefore still be considered a liability under the basic ownership approach as proposed. <u>We urge FASB to preserve the equity classification of preferred shares within the basic ownership approach.</u>

- **Shares of former member owners:** As mentioned, shares of former owners may be held by the cooperative for the former owners to be distributed at some point in the future or they may be reallocated among remaining current members. Upon liquidation, the former owners may be entitled to a share of the net assets and would not take preference over current members. If less than the full amount of their share is available, their share is pro rated by a certain formula that may be different from the formula for current members, e.g., 25 cents on the dollar versus 50 cents on the dollar. <u>We urge FASB to make clear that under paragraph 18, as long as the former owners share in the net assets with current owners as the most subordinated claim, their shares would be classified as equity.</u>

- **Various classes of shares:** Cooperatives often issue various classes of shares and members typically participate in more than one class. For example, a member owner may own three classes of shares – one class representing the member’s voting rights, another class for the member’s patronage, and a third serving as the member’s share from their production in the cooperative. <u>As FASB states in the PV document, as long as the classes all participate in the net assets and there is no priority among the classes, they would all be classified as equity under the basic ownership approach.</u>

- **Limits on participation of assets:** Since the basic ownership approach hinges on there being no preference at liquidation for holders of equity, why would it matter that some shares may be subject to a ceiling? There are instances in cooperatives in which a portion of a member’s interest may be subject to an upper limit. As we discussed above, this usually would only represent a portion of the member’s equity interest and should be considered as such. Since the member’s capital is at risk, it shares in the gains and losses of the co-op, and the member has a claim to the residual assets at liquidation, this should not affect the member's shares classification as equity. However, in some cases, it may be the member's total or residual interest that is subject to an upper limit. See example of Co-op B below.

In many countries, especially in Europe, there are caps imposed by legislation on the amount a member may contribute as initial equity and receive in liquidation as part of net assets. A requirement that instruments represent proportional claims to shares of the net assets of the entity either before or at liquidation could not be fulfilled by many cooperatives due to statutory provisions and national co-operative legislation in many countries.

<u>We urge FASB to consider requiring only that the instruments represent the most subordinated interest and alleviate the requirement that the holder's share not be subject to an upper limit on the claim to net assets.</u>

In the alternative, we would ask FASB to clarify that where participation in the residual net assets is limited by law or other restrictions such as those in corporate governing documents, shares subject to a ceiling can be treated as equity as long as they do not take priority in liquidation.

- **Members distributing net assets to a fund or other charitable entity upon dissolution:** In many countries and for some US co-ops, upon liquidation or dissolution the net assets of members are contributed to a cooperative fund or other charitable entity. Since laws in various countries dictate that co-ops direct these net assets to various funds at liquidation and the assets are otherwise owned by the members, those shares should be treated as equity. In the US, some co-ops have bylaws or articles of incorporation that require this approach. <u>We urge FASB to clarify this situation so that co-ops subject to laws or restrictions that direct assets to another entity at liquidation can continue to carry their member shares as equity.</u>

Examples that may be problematic under basic ownership approach

These examples illustrate the issues cited above that may be problematic for cooperatives under the basic ownership approach:

- Co-op A issues four classes of shares to the member as the member's equity investment in the co-op. The classes all share in the net assets in liquidation but one class of shares has a par value with no dividend rights. The share is subject to a ceiling but the member could lose all of that class of shares if assets were not sufficient at liquidation.
- Co-op B issues three classes of shares to a member as his ownership interest and the member later leaves the co-op. When the member leaves, he redeems two classes of shares, including any patronage, but the third class is left in the co-op, in the form of outstanding shares with a stated value of $X per share with no patronage earnings attributed to it. Upon dissolution, the former member is entitled to share in the net assets up to the value of the shares but would not be entitled to any appreciation in book or exchange value above the stated value; however, he would share equally in residual book or exchange value were it to fall below the stated value of the shares.
- Co-op C issues shares that have a fixed value because the law in the state or country in which it operates puts a limit on the amount of the share. The member participates in the earnings of the co-op through patronage but upon dissolution, the member's claim to the net assets is subject to the limit.
- Co-op D issues preferred shares available for purchase by non-members. The shares pay a cash dividend and at liquidation would take preference with a payout limited to par value, which could be reduced to zero if assets were insufficient.

Alternatives to Enhance the Basic Ownership Approach

While the basic ownership approach could work for cooperatives, we urge FASB to consider alternative approaches that may more easily accommodate different business structures. This would allow FASB to achieve its goal of using a principles-based, uniform approach with more simple, clear and decision-useful standards that can be applied to all types of entities.

- **Loss Absorption Approach**

  The loss absorption approach presented by the Pro-Active Accounting Activities in Europe (PAAinE) and the European Financial Regulatory Advisory Group (EFRAG) and mentioned in Appendix E of the PV holds promise not only for cooperatives but for all businesses that operate with at risk capital. The approach would appear to be consistent with a principles based approach – the principle being that capital available to absorb losses is ownership capital – and is simple.

  Elements of this approach have potential appeal to cooperatives around the globe because member shares would be classified as equity regardless of whether there were limits on the amount or value of the shares owned by members. In the typical case where cooperative shares do not receive a dividend or other distribution in years when no surplus is made, and absorb loss if reserves have already been depleted, the shares would be equity under loss absorption. If reserves are not sufficient to cover the shortfall, the member shares would be reduced on a pro rata basis to cover the losses.

  The examples cited above may be classified as equity under an approach that incorporated some of the elements of the loss absorption approach whereas they may not be under the basic ownership approach as proposed. This would include situations where members have no claim on the residual assets in the event of dissolution due to either legislation or the bylaws of the cooperative itself.

  We urge FASB to incorporate elements of the loss absorption approach into the basic ownership approach. As highlighted in the EFRAG document, the loss participation elements are what distinguishes risk capital from other forms of financial instruments. Such capital serves as a buffer or cushion in protecting claimants of non-risk capital. Incorporating the loss absorbing characteristics of risk capital into the basic ownership approach could allow for more equity interests and meet the needs of all corporate models of business.

- **IFRIC 2 Approach**

  The International Financial Reporting Interpretations Committee (IFRIC) adopted IFRIC 2 to ensure that instruments such as co-op shares would continue to be classified as equity under International Accounting Standard 32 (IAS 32) as long as the boards of the entities issuing the shares had the right to refuse redemption. IFRIC 2 has been in place and working for co-ops and cooperative financial institutions for more than 2 years. While there have been recent modifications to IAS 32, IFRIC 2 remains a reasonable and necessary provision that accommodates the cooperative business model. We urge you to consider retaining this approach for cooperatives and other mutual entities. One way would be to incorporate the concepts of IFRIC 2 into the basic ownership approach to make clear that where corporate boards have the ultimate authority to refuse redemption and the instruments represent the most residual claims, the instruments would be classified as equity. At a minimum, no shares considered equity today under IFRIC 2 should be declassified into liability as the result of any future changes to the equity classification.

Reasons the Classification of Risk Capital as Equity is Important for Cooperatives

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.

Cooperative 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 cooperative, which means the amount of patronage and need the member has for the services of the cooperative.

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

- Member-owners: Member-owners have their capital at risk and often rely on the cooperative to conduct their business or may be employed by the cooperative, as in the case of worker-co-ops. The amount of equity in the cooperative would inform them about the value of their ownership interest, the management of the cooperative, the co-op's ability to continue to operate in the relevant market, etc.
- Potential member: When small businesses, farmers, workers or consumers decide whether to join a cooperative, one of their criteria is the co-op's financial status. This user wants to know if the co-op can meet his or her needs in the marketplace, whether the co-op 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-op can meet its obligations. Many of the vendors may not be familiar with cooperatives and may view the lack of equity negatively.
- Lender: Many cooperative's lenders require the cooperative to meet certain covenants which may include ratio requirements such as Times Interest Earned Ratio etc. Additionally, lenders may require a cooperative to maintain a certain minimum level of equity. Also, for those cooperatives that issue publicly-rated debt, rating agencies typically consider their equity level to be an important factor in the ratings process.
- Potential outside investor: We have heard from many cooperatives that they face challenges in describing the way in which capital is held and distributed by cooperatives to potential investors. This task would be made that much more difficult if co-op equity was reclassified.

We appreciate the opportunity to comment on the Preliminary Views document and to explain its impact on cooperatives. We understand that FASB wants to create a universal principles-based approach that allows for the appropriate classification of at risk capital as equity. We hope that any approach ultimately adopted ensures that cooperative member shares are categorized as equity.

Sincerely,

Paul Hazen

Mary Griffin

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Mary Griffin
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