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Contribution to IASB consultation on “Conceptual Framework for Financial Reporting”

International Accounting Standards Board IASB
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Comment letter on IASB’s Discussion Paper DP/2013/1
“A Review of the Conceptual Framework for Financial Reporting”

General remarks

Cooperatives Europe supports the revision of the existing IFRS Conceptual Framework. Several counterintuitive financial presentations enforced by IFRS provisions – notably the liability classification of equity of cooperatives – reveal existing lacks and inconsistencies of the current framework. We believe there is a general need for enhanced guidance for the IASB respecting the characteristics of cooperatives. Therefore we recommend storing the relevant features of cooperatives in a specific section or an appendix to the framework. The proposed business model concept is a step in the right direction. Our principal concern is that IFRSs are not appropriate to the unique cooperative business model.

Cooperative entities are different compared to corporations. Following the specific business model the information needs of the members and of business partners of cooperative entities differ in many aspects from those of corporations. Becoming a member of a cooperative goes far beyond ‘buy-or-sell’ decisions of investors seeking for profits on financial investments. Returns to members – the so called ‘member value’ - involve a wide range of economic, social and cultural benefits comprising dividend payments or share values as a rather subordinated incentive. Applying existing concepts of IFRSs to the business model of cooperative entities exhibit shortages.

We recommend following three main targets: at first we would like to encourage the IASB to establish relevant accounting characteristics matters of cooperative entities on a firm basis within the revised Conceptual Framework. Secondly, we would urge the IASB to consider a revision of the equity definition in IAS 32. Thirdly, reliable practises of equity classification for cooperatives following current requirements in IFRIC 2 should be grandfathered.

Comments on section 1 'Introduction'

Question 1
Paragraphs 1.25–1.33 set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that: (a) the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and (b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the *Conceptual Framework*, and the reasons for that departure, in the Basis for Conclusions on that Standard. Do you agree with these preliminary views? Why or why not?

Regarding the specific business model of cooperative entities as outlined in our general remarks the Conceptual Framework should also enable the IASB to take into account specific business models in the development of financial reporting standards. The framework concepts as well as particular IFRSs should be made more flexible in order to reflect different information needs following different economic circumstances.

Regarding the example of capital contributions of members to a cooperative the definition of equity according to the principles of IAS 32 initially enforced a counter intuitive classification as financial liabilities. It took the further complex technical interpretation (IFRIC 2) adjusting the obviously insufficient principles of IAS 32 to eliminate risks undermining the financial presentation of sound economic entities in a fundamentally inequitable way. This example shows that the underlying principles of IFRSs are too restrictive as to be applied properly to specific conditions.

In general, in our view applying IFRSs to cooperative entities should not require a departure from the principles of the Conceptual Framework rather than being in line with the fundamental concepts. Any exceptions, additions and specific interpretations for cooperatives add complexity to IFRSs and harm clarity. Additionally, cooperatives experience disadvantages in their credibility being classified as 'exceptional' or 'abnormal' entities.

Again, we propose to back-up the main characteristics of cooperative entities in a specific sector of the Conceptual Framework or an appendix. This will assist the IASB to remain mindful of the cornerstones of the cooperative business model when amending existing standards or developing new provisions.

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Comments on Section 2 'Elements of financial statements'

Question 2
The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16. The IASB proposes the following definitions: (a) an asset is a present economic resource controlled by the entity as a result of past events. (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events. (c) an economic resource is a right, or other source of value, that is capable of producing economic benefits. Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

Question 3
Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36. The IASB's preliminary views are that: (a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources. (b) the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability. (c) the recognition criteria should not retain the existing reference to probability. Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

The proposed definitions of assets and liabilities (question 2) seem appropriate if being applied properly and flexibly to specific economic situations. Therefore we see no merit in deleting the concept of probability and uncertainty for the question whether an asset or a liability exists.

Regarding the example of repayable capital contributions of members in cooperative entities, the deletion of 'expected' inflows or outflows in the proposed liability definition could be misleading. Cooperative laws in numerous countries establish the right of resigning members to recall their capital. Nevertheless, the general right of a member to redeem its capital should not establish a present obligation of the cooperative to transfer economic resources equivalent to the total share capital to third parties. Instead, the virtual repayment of the full amount of capital reflects a scenario of little relevance as it effectively assumes the dissolution of the cooperative. For this

reason, we firmly believe that the "going concern" concept implies the treatment of co-operative share capital as equity.

We disagree with the view expressed in par. 2.35 a(ii) stating that for the definition of a liability "it need not be certain that a present obligation will result in a transfer of an economic resource, but the present obligation must be capable of resulting in a transfer of economic resources." In our mind, financial statements should present most probable in- and outflows rather than hypothetical worst-case scenarios.

Comments on section 3 'Additional guidance to support the asset and liability Definitions'

Question 6

The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63–3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

(a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.

(b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.

(c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

Question 7

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

In our mind the proposed meaning of 'present' in the definition of a liability could be misleading. On the one hand we agree that the existence of a liability can be determined by reference to benefits received by the entity. On the other hand inverting that sentence makes less sense. That means, the receipt of benefits (cash, services or other resources) by an entity cannot always be seen as establishing a present obligation for the entity to re-transfer resources. In the case of capital contributions of owners transferred in the assets a cooperative enterprise the cash received cannot be seen as establishing a 'present obligation' of the entity to repay those funds.

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The discussion paper (par. 3.63 et seq.) rightly distinguishes between ‘present obligations’ (that need to be presented) and ‘possible future obligations’ (which are not liabilities at the reporting date), the existence of the latter is contingent on the future events. Below the examples listed in par. 3.70, the IASB enumerates the right of a shareholder to request redemption of his share capital. This option of the shareholder is said to turn on future events outside the control of the entity with the conclusion, that this ‘stand ready obligation’ of the entity represents a ‘present obligation’ at the reporting date. Those obligations are stated to exist irrespective of the execution of the obligating event (shareholder’s request for the funds) and regardless the possibility of an outflow of capital.

We oppose this conclusion. Regarding cooperatives the right of a member to recall his or her capital – after deduction of losses and other amounts attributable to the share capital – could only ever be seen as a ‘possible future obligation’ of the cooperative but not as a ‘present obligation’ unless the member has decided to cancel its membership. However, we propose to clarify that those principles to distinguish between a ‘present obligation’ and ‘possible future obligations’ should not be relevant for the distinction between liabilities and equity but should. Once an inflow of capital payments received from owners qualifies as equity the distribution of equity should be governed by specific provisions apart from rules for ‘normal’ financial liabilities. It should be clarified that a redemption mechanism to re-transfer funds to shareholders or members should not result in a classification as a ‘present obligation’ respectively a liability unless decisions have be taken to transfer these resources.

Regarding question 6 we have sympathies with views 1 and 2 but reject view 3. View 3 states that it is sufficient for a ‘present obligation’ to be arisen from past events, irrespective of the entity’s possible future actions. View 3 ignores possibilities of the entity to avoid the re-transfer of resources at least in theory (par 3.85). However, to retain these possible actions of the entity to avoid liability classification of its share capital is essential. We would like to remind you that the right of the entity to refuse a request to redeem capital is the central conclusion stipulated in the interpretation IFRIC 2. For cooperatives, IFRIC 2 has proven as a practical guidance widely accepted by the preparers and users of IFRS financial statements. The IASB’s Conceptual Framework project should not undermine this reasonable compromise (see also comments on question 10).

Comments on section 5 ‘Definition of equity and distinction between liabilities and equity instruments’

Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB’s preliminary view:

(a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.

(b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:

  (i) obligations to issue equity instruments are not liabilities; and

  (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).

(c) an entity should:

  (i) at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.

  (ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.

(d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Due to its particular relevance for cooperatives we primarily respond to question 10(d). The question involves the wrong conclusion that a cooperative is an entity that “has issued no equity instruments.” We definitely reject this presumption.

In paragraphs 5.55-5.59 the discussion paper refers to the exception in IAS 32 treating some ‘puttable instruments’ like redeemable shares of some cooperatives or partnerships ‘as if they were equity instruments’. On the one hand, the scope of this exception applies only to very few cooperatives in Europe. This is because the redemption amount normally refers to the paid in capital rather than an amount equivalent to the pro rata share of the residual interest as required by IAS 32. On the other hand, we agree that the general reasons given in par 5.56 for creating exceptions are still valid for the vast majority of cooperatives and justify appropriate provisions. In general, treating equity instruments of cooperatives as liabilities results in counter intuitive

reporting information and is not a faithful representation of the financial position of these entities. Therefore we very much appreciate the intention of the IASB that "the revised Conceptual Framework should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments" and "thus payments to holders (…) might be regarded as akin to distributions of equity" (par. 5.57).

Having said that, we see no merit in further restricting this valuable modification of the Conceptual Framework with the additional requirement that "this treatment might be appropriate if the obligations are the most subordinated (lowest ranking) class of instruments issued by an entity (such as some co-operatives or mutuals) that would otherwise report no equity" (par. 5.57). Firstly, the Conceptual Framework should be limited to general concepts and not entail too detailed provisions. Secondly, this technical discussion should be attached to a subsequent revision of IAS 32. Thirdly, several cooperatives issue shares with slightly different features but not only the lowest ranking class comprises equity features. Classification of only the most loss-absorbing capital as equity could also distort the behavior of entities, and lead to a misleading view of their financial position being reported. (added by Uk)

Nevertheless, in our mind the proposed introduction of an exception for cooperatives in the Conceptual Framework goes not far enough. It puts cooperatives again in the corner of 'abnormal' entities accounting contrary to core IFRS principles. Therefore we request that the widely accepted and proven accounting treatment of cooperative shares as equity – following technical provisions in IFRIC 2 – has turned into a 'generally accepted principle' that should be adopted by IFRSs. The Conceptual Framework should no longer ignore but integrate this feature of enormous significance for cooperatives and other entities issuing redeemable equity shares.

The principle we propose to adopt in the framework simply states that equity contributions of members in a cooperative regularly qualify as equity for accounting purposes and that a redemption mechanism for distributing capital to members who are leaving should not prevent the classification as equity. This principle is consistent with the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities (question 10(a)). The amendment also needs to be added to the liability definition.

Regarding question 10(b) a lot of current problems with IAS 32 result from the insufficient requirement in IAS 32 that cooperative shares are classified as equity only if they do not exhibit characteristics of a liability and a 'present obligation' of the entity. Thus, we do not concur with both of the proposed concepts to distinguish between liabilities and equity in par. 5.30, neither the narrow equity approach nor the strict obligation approach while the first one could be a starting point.

Indeed, the method of equity classification, which starts by testing the features of a liability, is compliant with the definition as a residual interest. But as stated in our comments on question 6 above the existing liability definition based on the stipulation of a 'present obligation' is too narrow. Again, the possible distribution of equity to owners should not be treated as a 'present obligation'. This material extension could either be included in the liability definition and/or a standalone definition on equity. We propose that the liability definition as stated in question 10(b)(i) that "obligations to issue equity instruments are not liabilities" should be extended by the addition of the following sentence: "obligations to redeem equity instruments are not liabilities".

We see serious technical problems and low informational merits in the proposal (question 10(c)) to update measurement of each class of equity at the reporting date. In our mind, measurement of equity contradicts the definition as a residual amount after deducting liabilities from assets.

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Finally, we disagree with the proposal expressed in par. 5.54 (a)(iii) that “puttable shares should be separated into an equity host and an embedded put option” with the latter classified as a liability. This proposal has been put forward several times (starting by draft Interpretation SIC – D34 as of November 2001) but has proven to be too complex. The desired result to reclassify amounts of equity to be redeemed as liabilities could be reached much more easily if only cancelled shares are reclassified from equity to liabilities.

Comments on section 9 ‘Other issues’

Question 23
Business model The business model concept is discussed in paragraphs 9.23–9.34. This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities. Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not? If you agree, in which areas do you think that the business model concept would be helpful? Should the IASB define ‘business model’? Why or why not? If you think that ‘business model’ should be defined, how would you define it?

We encourage the IASB to follow up the business model concept. As argued in our general remarks the business model of cooperatives show significant differences compared to those of investor-oriented incorporations. The business model should be relevant in all areas of the IFRSs and especially in relation to equity classification. It predetermines the priorities preparers and users of financial information set in making business contracts for or with the specific entity. Thus its sets a ‘filter’ for the relevance and usefulness of financial information.

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