

Accounting Treatment of Cooperative Banks Member Shares:

An Overview of the Cooperative Banks interests in the International Accounting Standards Definition

Executive summary

Cooperative banks have grown over years to become global players in the world economy. Full-fledge actors in a globalize economy they less and less fly under radar of regulators. Increasingly subjects to international accounting standards, cooperative banks specificities nevertheless remain largely ignored by financial regulators resulting in inappropriate regulations that threat their model and its economic viability.

Representative of the changing pool of influence, the international accounting standards are today a central concern for all cooperative financial actors. What are those international accounting norms? Who are the stakeholders? What are concretely the cooperatives interests in this field?

This document is an overview of an eight years, and still ongoing, lobbying work lead by international cooperative instances, among which ICBA, to defend the cooperative banks interests in the definition of international accounting standards.

List of Acronyms:

- **EFRAG:** European Financial Reporting Advisory Group, *Europe instance which technical expertise to the European Commission concerning the use of IAS within the Europe*
- **FASB:** Financial Accounting Standards Board, *the American based standard setter*
- **GAAP:** United States Generally Accepted Accounting Principles made by the FASB
- **IASB:** International Accounting Standards Board, *the London based International Accounting Standards setter.*
- **IAS:** International Accounting Standards, *IASB norms former denomination*
- **IAS 32:** International Accounting Standards which aims at establishing principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.
- **ICA:** International Cooperative Alliance
- **ICBA:** International Cooperative Banking Alliance
- **IFRS:** International Financial Reporting Standards, *IASB norms new denomination*
- **IFRIC:** International Financial Reporting Interpretation Committee, *the interpretative body of the IASB*
- **IFRIC 2:** IAS 32 Interpretation text that recognized cooperative specificities
- **SAC:** Standard Advisory Council, *the IASB advisory council*

International Cooperative Banking Association:

The International Co-operative Banking Association (ICBA) is a sectoral organization of the International Co-operative Alliance ([ICA](#)). Founded in 1895, the International Co-operative Alliance is an independent, non-governmental organization which unites, represents and serves co-operatives worldwide.

*The ICBA mission is to **contribute to the sound development, growth and competitiveness of co-operative banks in the marketplace by defending their interests and by promoting worldwide their important contribution to the economic and social well-being of the population and their communities.***

Objectives of ICBA :

- *to facilitate the promotion at the international and regional levels of the distinctive co-operative values of co-operative banks and of the advantages of using them over other banks*
- *to facilitate and encourage the exchange of information amongst members on key co-operative banking issues and foster inter-cooperation in the finding of solutions*
- *to support regional committees and their members, individually or collectively with specific challenges*
- *to encourage inter-cooperation with other types of co-operatives and various bodies of the ICA*



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What are International Accounting Standards?

Over the few past decades, the global financial landscape has undergone important transformation. National borders are less and less relevant for financial actors and the world financial centre's influence have grown significantly interconnected. In a globalised economy, high quality information is central, that's why developing comprehensive international accounting standards has become a central issue.

In 1973, accounting experts representative instances gathered to create the International Accounting Standard Committee, which became the International Accounting Standard Board (IASB) in April 2001, **an independent, privately-funded accounting standard-setter based in London, England. IASB goal is to develop a single set of high quality understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles.** IASB is responsible for **developing International Financial Reporting Standards (IFRS)**, and promoting the use and application of these standards. The IASB is composed of *trustees*, representative's instances of different international financial system stakeholders, *a Board*, an *interpretative committee*, and of an advisory council, the *SAC*.

The other main actor in the definition of the international accounting standards is the Financial Accounting Standards Board (**FASB**), a private, not-for-profit organization whose primary purpose is to develop **generally accepted accounting principles (GAAP)** within the United States.

The IASB and FASB, encouraged by G20 members, are going since 2007 through a **convergence process** to reduce the differences between both sets of accounting standards (IFRS and US GAAP) and thus create and promote a set of internationally recognized and applied accounting standards.

Why are cooperative banks concerned?

Cooperative financial actors are today global players in the world economy, holding prominent rankings in many countries. As part of the international financial system they are more and more subject to respect international accounting norms.

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According to an ICA research lead in 2008, almost half of the cooperative banks and credit union in the ICA Global 300 rankings, ranking of the biggest cooperatives in the world, used IFRS norms and twenty per cent of them use US GAAP norms.

The real turning point occurred in 2002, when the IASB published an amendment project to the IAS 32 norm “*Financial instrument: disclosure and presentation*” that triggered an important debate in the cooperative sector.

Indeed, the adoption of this norm directly threaten the cooperative model since **their member shares-which mainly constitute their capital- were, according to this new classification principles, no longer accounted for as equity but classified as liabilities**. Consequently cooperative banks financial ratios and financial performance indicators would have been dramatically modified which would have retained their access to capital.

Beyond the financial consequences that it implied for cooperatives, and more importantly for cooperative banks, the application of the IAS 32 norm put at stake the viability of the cooperative structures by ignoring the cooperative model specificities and more particularly their ownership originality.

An active lobbying process was lead to make the cooperative banks member shares accounted for as equity. A compromise was found with the IASB in June 2004.

The IAS 32 interpretative text, **IFRIC 2, allows cooperatives member shares to be classified as equity as long as the cooperative has an unconditional right to refuse their redemption¹**.

This recognition of the cooperative shares specificities was a success for cooperative since this solution allows many cooperatives banks to keep, by introducing new requirement in their statutes, the classification of their member shares as equity. But this compromise excludes some cooperatives member shares from equity since some national laws impose cooperative shares redemption when member choose to withdraw from the cooperative.

What is the situation today for cooperative banks?

IFRIC 2 is still applied in many countries and offers a fitted solution for many cooperative banks, but the situation has evolved and may offer new opportunities.

¹ IFRIC 2 states that members’ shares would be classified as equity if either of the following conditions is met.

- (a) **The entity has an unconditional right to refuse redemption of the members’ shares.**
- (b) Redemption is unconditionally prohibited by local law, regulation or the entity’s governing charter.

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As mentioned, the IASB and FASB are going since 2007 through a **convergence process** to reduce the differences between both sets of accounting standards (IFRS and US GAAP). The issue of equity and liabilities definition is thus back on the top of the international regulator's agenda and is currently under discussion.

The IASB and FASB are today, thanks to the active lobbying of cooperative representative instances, fully aware of their work impacts on cooperatives businesses.

In addition to the accounting aspect, the **prudential standards**, to which cooperative banks are subject, definition is **closely linked to the accounting equity classification**. In the wake of the financial crisis the Basel Committee and the Committee of European Banking are working on the renewal of banks prudential regulatory framework to enhance their resilience, notably by increasing the minimum "core capital" requirement. Thus, the recognition of cooperative member shares as equity, and even more as core capital, is a burning issue for cooperative banks even more so since it meddles with their first and central activity: their ability to finance the economy.

In the joint IASB-FASB ongoing project on instruments with characteristic of equity, several solutions which would lead to an equity classification of cooperative shares as equity have been considered; here is a synopsis of the most satisfying ones for cooperative banks.

The loss absorption approach:

Introduced in a meeting in April 2007 in London by EFRAG, this approach proposed as an equity classification criterion the **ability of a financial instrument to participate in losses, which means that it is available for the entity to cover losses that might be incurred, as a simple criterion for the equity definition**. In the event of insolvency of a cooperative bank, a member can be assessed for a portion of any amounts necessary to pay creditors. The value of a members share can fall below the nominal value when losses occur. Thus the loss absorption approach would allow cooperative member shares, but not only, to be accounted for as equity. This approach, strongly supported by the German cooperative movement, has not been at the time adopted by the IASB and FASB.

The maintaining control approach:

In the last IASB-FASB joint project on instruments with characteristics of equity draft, the classification principle according which *"the instrument's terms require, or permit the holder or issuer, to require redemption to allow an existing group of shareholders, partners or other participants to maintain control of the entity when one of them chooses to withdraw"* might provide

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a solution for cooperatives. Indeed, cooperative bank are non listed entity, and the **acquisition or redeem** of a new member share is subject to the approval of the General Assembly. These specificities are relevant mechanisms to ensure that members (considered as an “existing group of shareholders”) have the power to maintain control of the cooperative. This approach, if developed in the right way, could thus provide a fitted and universal solution for cooperative member shares classification as equity as it relies on one of their most basic and universal principles: **the fact that cooperatives are jointly owned and democratically controlled by their members.**

The membership approach

In the above mentioned exposure draft, a second option can allow cooperative member shares to be accounted for as equity. This solution was drawn for cooperatives, it states that instruments that “*the holder must own in order to engage in transactions with the entity, or otherwise participate in the activities of the entity, and the instrument terms require, or permit the holder or issuer to require, redemption when the holder ceases to engage in transactions or otherwise participate*” This principle describes the fact that membership is often a first condition to transact with a cooperative and that the end of the transaction with the cooperative bank requires or permit the redemptions of the member share.

However, many cooperatives don’t offer in **an exclusive way** their services to their members and this could prevent the application of this principle to their member shares.

IASB, FASB, IFRS, IFRIC...under all those opaque acronyms we can see that there is one central issue here: the accounting treatment of cooperative banks member shares as equity.

After a consultative period the IASB and the FASB announced the release of an update exposure draft on “instruments with characteristics of equity” joint project for the first quarter of 2011.

ICBA is closely following this project and will keep its members informed and mobilized to defend the cooperative banks significant interests in this process.

IFRIC 2 offers a fitted compromise for many cooperative and its maintaining in the updated project would keep this status-quo. But ICBA believe that more appropriate solutions for cooperative banks exist and that a shared reflexion among its members and in collaboration with the others concerned cooperative organizations will be the key of success.