World Council of Credit Unions

November 25, 2015

Filed electronically

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

Re: *Conceptual Framework for Financial Reporting* Exposure Draft(ED/2015/3)

Dear Sir or Madam:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the International Accounting Standards Board (IASB) exposure draft on the *Conceptual Framework for Financial Reporting*.[1] World Council is the leading trade association and development organization for the international credit union movement. Credit unions are cooperative financial institutions that operate to promote thrift and to provide their members with loans and other financial services at fair rates. Worldwide, there are 57,000 credit unions in 105 countries with USD 1.8 trillion in total assets serving 217 million physical person members.[2]

Question 1(c): Do you support the proposal to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form?

Question 3(b), (c): Do you agree with the proposed definitions of equity and liabilities?

World Council does not support, and therefore strongly opposes, the IASB's proposal to add the following statement to paragraph 2.14 of the Conceptual Framework:

> "A faithful representation provides information about the substances of an economic phenomenon instead of merely providing information about its legal form. Providing information about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation."

We urge the IASB not to finalize the proposed addition to paragraph 2.14 because it is not compatible with paragraph 4.8's statement that rights to an asset are "established by contract, legislation or similar means . . ."

World Council opposes this proposed addition to paragraph 2.14 because we are concerned that this statement, if finalized as proposed, will not produce clear and consistent accounting treatment

[1] IASB, *Conceptual Framework for Financial Reporting Exposure Draft* (ED/2015/3) (May 2015), *available at* http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf.
[2] World Council of Credit Unions, *2014 Statistical Report* (2015), *available at* http://www.woccu.org/publications/statreport.

for credit union shares. If finalized as proposed, the addition to paragraph 2.14 appears likely to create a system where it is not clear whether or not an instrument is equity or a liability.

We do not think that the Exposure Draft is clear regarding how the legal form or terms and conditions of a financial instrument can differ materially from the "substance of an economic phenomenon" given that the a claimants rights to an asset are "established by contract, legislation or similar means . . ." under paragraph 4.8(a)(i) of this Exposure Draft. The nature of the claimant's rights (or lack thereof) are essential to determining whether there is a "present obligation" that would create a liability is established under paragraph 4.4.

We believe that the IASB finalizing the proposed addition to paragraph 2.14 would be detrimental to the international credit union movement because not all accountants are familiar with the corporate structures of credit unions and other cooperatives. We are concerned that accountants who are not familiar with credit unions may choose to classify all credit union shares as liabilities even if the same accountant would classify joint-stock company shares with the same terms and conditions as equity.

Traditional Credit Union Shares are Equity Instruments which are Virtually Identical to Traditional Joint-Stock Company Shares

Traditional credit union shares are equity instruments that have an original issue price which is the same as the shares' par value. A traditional credit union share issuance therefore creates paid-in capital, which is a fundamental element of any corporate entity's equity. Credit union shares typically form an important part of a credit union's regulatory capital that protects its depositors from institutional losses even if share redemptions are allowed under limited circumstances.

Most classes of credit union shares are equity instruments based both on economic substance and on legal features such as the shares' terms and conditions. These credit union shares are non-withdrawable and also either non-redeemable under any circumstances or redeemable only under limited circumstances, such as only being redeemable at the credit union's option, only being redeemable if the credit union remains well capitalized after the redemption, or only being redeemable after a multi-year call period has elapsed.

It is true that a few types of credit union shares have terms and conditions modeled on deposit products—such as "share draft accounts" that are equivalent to bank checking accounts and current accounts, or "share certificates" that are equivalent to bank certificates of deposits—and these classes of withdrawable credit union shares are therefore properly classified as liabilities. The reason that these types of deposit accounts are called "shares" instead of deposits is the result of opposition from the banking lobby that prevented credit union from using traditional banking terms such as "current account" or "certificate of deposit."

Non-withdrawable credit union shares, however, represent paid-in capital on an accounting basis and represent equity as a legal matter, and would not create a "present obligation" within the meaning of the Conceptual Framework. It is also essential for these types of credit union shares to be classified as "equity" on an accounting basis in order to qualify as Common Equity Tier 1 (CET1) capital under Basel III and national interpretations of that Basel standard such as Canada's capital adequacy requirements (CAR) guideline issued by its Office of Supervision of Financial Institutions.[3]

Non-withdrawable credit union shares are sometimes mistaken for liabilities because they have a par value and resulting paid-in capital that is equivalent to the shares' original issue price. Paid-in capital is a form of equity and we urge the IASB to continue to recognize paid-in capital resulting from the issuance of credit union shares as equity even though modern joint stock companies have generally moved away from issuing shares at par value because of reasons related to securities law compliance and avoidance of income tax.

For example, a credit union membership share may have a par value and an original issue price of $5 while a modern joint-stock company share typically has a par value of $1 but a higher original issue price (with the difference between the joint-stock company share's issue price and par value being accounting for as "additional paid-in capital"). An individual must invest in at least one credit union membership share and fully pay-in that share to par in order to become a credit union member.

In most jurisdictions these shares are non-withdrawable, uninsured, and at risk of loss if the credit union's losses exceed retained earnings (in which case the par values of the class of membership shares would be written down *pari passu* in order to satisfy the loss). Also, all types of credit union shares legally represent equity—as a cooperative, a credit union is owned by its shareholders, who are called "members"—whether or not these shares qualify as equity or a liability on an accounting basis.

Credit union shares in their traditional form are virtually identical to joint-stock company shares as they existed in the 19th Century. The Rochdale Society of Equitable Pioneers, which formed the first cooperative in 1844, modeled cooperative shares on the terms and conditions of contemporary joint-stock company shares but with a "one-member-one-vote" voting rule (i.e. additional shareholdings beyond the member's initial membership share do not confer additional voting rights).[4]

In the 19th Century, joint-stock companies issued shares that had an original issue price that was the same as the share's par value—which is where the concept of par value originated—and investors were required to pay in these shares to par. In addition, these joint-stock company shares typically traded at par value and rarely fluctuated in value unless the company's capital level became impaired

---

[3] *See* Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* at 14-15 (June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf; Office of Supervision of Financial Institutions, "Capital Adequacy Requirements (CAR) 2014" (Dec. 2014), *available at* http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/pages/car_index.aspx.

[4] J. Carroll Moody & Gilbert C. Fite*, The Credit Union Movement: Origins and Development, 1850-1970* at 2 (1971) ("The group of workers who organized the Rochdale Society of Equitable Pioneers subscribed to shares, payable in small amounts weekly, in order to raise capital to buy goods at less than retail costs and sell them to their members at a savings. Members were paid 5 percent interest on their shares and were entitled to a proportionate division of the society's savings or profits at the end of the year.")

by losses that exceeded retained earnings. Investors' main return on these joint-stock company shares came in the form of dividends, much like bonds.[5]

Joint-stock companies eventually moved away from the 19th Century approach to stock issuances, but not for accounting reasons. Joint-stock companies typically lowered the par values of their shares and created the concept of additional paid-in capital in order to comply more easily with securities "blue sky laws" that focused on whether or not a share had been fully paid-in to par:[6]

> In earlier days, the incorporation documents required to be filed with a state official specified the total amount of capital to be raised from the stockholders, thereby providing notice to prospective creditors as to what the corporation's financial strength would be at the outset. This total capital figure was normally described as divided into a specified number of shares . . . . Each share then bore the figure designating the factional portion of the total capital that the share represented, [such as] $10. Eventually, lawyers referred to this figure as the share's par value . . . . However, over the years the ingenuity of lawyers has undermined the legal capital system . . . . One notable weakness in the legal capital system developed when corporations where permitted to issue shares without any specified par value.

While credit union members have always paid in cash for their shares, joint-stock company shareholders often made in-kind contributions of business equipment or intellectual property that had uncertain values in exchange for shares. For that reason many joint-stock companies lowered the par value of their shares to a nominal amount such as $1 or eliminated par value altogether so that the legally required minimum par value would always be fully paid-in even if the true value of the business equipment or intellectual property was actually worth less than the total value exchanged for the shares at their original issue price.

Similarly, with the advent of income taxation and capital gains taxation, many joint-stock companies moved away from issuing regular dividends because investors' dividends are subject to personal income tax. In order to avoid the incidence of income tax on their shareholders, joint-stock companies began allowing the values of their shares to fluctuate as a dividend substitute so that their shareholders could better control when they would pay capital gains taxes related to their shareholding investments.

Credit unions and other cooperatives never had a need to alter the terms and conditions of their shares in this manner because credit union members pay for shares using cash and because credit union members did not seek to avoid income tax.

---

[5] *See, e.g.*, Jason Zweig, *At Long Last, Could the Dividend Revolution Be Here?*, WALL STREET JOURNAL, Dec. 29, 2012, *available at* http://www.wsj.com/articles/SB10001424127887323291704578199632820722650 ("In pursuing this approach, companies like Diamond hark back to another age: the 19th century, when U.S. corporations sought to pay out high dividends, often ranging from 6% to 10% of their 'par value,' or original issue price. As profits waxed and waned, the companies varied their dividends accordingly. As a result, 'the stock price stayed relatively steady,' says economic historian Peter Rousseau of Vanderbilt University. Nearly all the returns on U.S. stocks in the 19th century came from dividend income—much the way, over time, the yield on bonds tends to account for nearly all their investment performance. 'Equities in the 19th century functioned much like bonds do today,' Prof. Rousseau says, 'except that the dividends fluctuated much more.'").

[6] David R. Herwitz & Matthew J. Barrett, *Accounting for Lawyers* at 46-48 (4th ed. 2006).

Credit Union Shares Absorbed Billions of Dollars in Losses during the Financial Crisis

Credit union shares absorbed billions of dollars of losses during the recent global financial crisis. During that crisis, several wholesale credit unions in the United States of America called "corporate credit unions" failed as a result of impairment of their investments in private-label mortgage backed securities. These credit unions' capital shares absorbed several billion dollars in losses that exceeded the institutions' retained earnings.

All of these credit union shares were fully paid-in with cash and the wholesale credit unions typically had two classes of non-withdrawable capital shares: (1) perpetual "Paid-In Capital" (PIC) shares that were not redeemable; and (2) Membership Capital Accounts (MCA) that were redeemable only after a three-year call period had elapsed.

According to a U.S. National Credit Union Administration (NCUA) issuance about the depletion of the PIC and MCA of the then two largest wholesale credit unions in the United States—U.S. Central Federal Credit Union (U.S. Central) and Western Corporate Federal Credit Union (WesCorp)—as a result of losses on their investments in private-label mortgage back securities:[7]

> **Exhaustion of Capital.** The essential function of PIC and MCA is to serve as an additional reserve of capital to absorb losses in excess of retained earnings. Therefore, when there is a retained earnings deficit in a Corporate [credit union], the PIC and MCA are depleted to the extent necessary to resolve the deficit. PIC and MCA are at-risk capital reserves and because they are so designated, a Corporate has no legal obligation or authorization as a going concern to restore, replenish or recoup depleted PIC and MCA out of future retained earnings, even if retained earnings substantially improve. This is the case regardless whether generally accepted accounting principles (GAAP) classify PIC or MCA as a liability or equity.
>
> ***********
>
> **Exhaustion of Capital to Date.** To date, U.S. Central PIC has been exhausted, and 23 percent of their MCA has been depleted. WesCorp PIC and MCA have both been exhausted. The precise measure of PIC and MCA depleted to absorb losses is reflected in member statements issued by U.S. Central and WesCorp. This information is relevant to each member's determination of the level of asset impairment, as explained above, that must be recognized in its statement of income.
>
> U.S. Central previously reported to its members that 100 percent of PIC was exhausted and 63 percent of MCA were depleted by losses exceeding retained earnings. Though U.S. Central's best estimate of credit losses is still $2.3 billion, discounting the cash flows from these losses in accordance with GAAP results in a reduction in other-than-temporary impairment (OTTI) charges to $1.8 billion.
>
> As a result, MCA depletion is 23 percent, not 63 percent as originally reported on April 30.

---

[7] *See* U.S. National Credit Union Administration, "Matters Related to 'Paid-In Capital' and 'Membership Capital' of Corporate Credit Unions," Letter to Credit Unions 09-CU-10 (May 2009), *available at* http://www.ncua.gov/Resources/Documents/LCU2009-10.pdf.

The exhaustion of WesCorp members' PIC and MCA was insufficient to resolve the deficit in undivided earnings. Thus, NCUA has authorized WesCorp to operate with special assistance under a "prior undivided earnings deficit" (PUED). Once a credit union's capital is exhausted, a PUED provides for regulatory segregation of the retained earnings deficit to capture the permissible accumulated deficit position. As a result, WesCorp is able to continue providing uninterrupted service to members, including the payment of dividends on regular shares (*i.e.*, share, share draft and share certificate accounts).

The NCUA ultimately liquidated U.S. Central and WesCorp, but these institutions' PIC and MCA had been exhausted on a going-concern basis well before their liquidation. The retail-level credit unions that held these capital shares lost their investments and will not have any recovery. The ability of credit union capital shares like PIC and MCA to absorb losses on a going-concern basis to the same extent as joint-stock company equity items is not in dispute.

Credit Unions Shares Represent Equity Because the Shareholders Own the Credit Union

Due to unintended consequences occurring from the intersection of older credit union laws and newer accounting standards, credit unions in some jurisdictions do not currently have equity shares on an accounting basis even though their shareholders (i.e. the members) own the credit union as a legal matter.

The shares of credit unions in these jurisdictions are considered liabilities on an accounting basis because, for example, the shares are withdrawable and/or are insured by a savings guarantee scheme. However, these shares represent equity as a legal matter, confer corporate voting rights, and also have a claim on the residual assets of the credit union in liquidation in the same manner as joint-stock company shares.[8]

We believe that the shares with the most subordinate claim on an institution's undivided equity should qualify as equity because the holders of this class of shares are the owners of the institution.

Question 4—Present obligation: Do you agree with the proposed description of a present obligation and the proposed guidance to support that description? Why or why not?

Currently, the IASB defines a liability as a "present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits." The IASB notes that a challenge arises when an entity has "some limited ability to avoid a future transfer" but is not clear regarding <u>how</u> limited that ability must be for the entity to have a "present obligation."

[8] *See, e.g.*, 12 U.S.C. § 1757(6) ("To receive from its members . . . payments, representing equity, on shares which may be issued at varying dividend rates . . ."); 12 C.F.R. § 710.6(b) ("After all assets of the Federal credit union have been converted to cash or found to be worthless and all loans and debts owing to it have been collected or found to be uncollectible and all obligations of the Federal credit union have been paid, with the exception of shares due its members, the books shall be closed and the pro rata distribution to the members shall be computed. The computation shall be based on the total amount in each share account as of the liquidation date or the date on which all share drafts have cleared, whichever is later.").

The IASB is proposing to define a liability as a "present obligation of the entity to transfer an economic resource as a result of a past event" which occurs when the entity has "no practical ability to avoid the future transfer" of resources pursuant to paragraph 4.31(a) and as further defined by paragraph 4.32 ("An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.")

The *Oxford English Dictionary* defines "practical" as follows:[9]

> "Available or applicable in practice; suitable for a particular purpose; functional; (of an idea, plan, or method) likely to succeed or be effective in real circumstances; feasible"

Even when a credit union share has some limited redemption rights, credit unions have the practical ability to refuse redemption especially when the credit union is undercapitalized or is experiencing losses. Credit unions' right to refuse redemption exists in the terms and conditions of the share, the credit union's by-laws and/or through regulatory requirements (e.g., under applicable regulatory capital rules the credit union typically has an unconditional right to refuse redemption, or redemption is not allowed if it would reduce the credit union's regulatory capital below a specified level). Under these circumstances the redemption right is not "legally enforceable" within the meaning of paragraph 4.32.

Credit unions' practical capacity to refuse redemption of shares that have a redemption feature has worked in practice—it is not theoretical—on occasions when credit unions have been wound up and resolved, including in the context of the failed wholesale credit unions' MCA class of shares, discussed above, that absorbed billions of dollars in losses in 2009 even though they could have been redeemed in theory after a three-year call period.

Credit union shares in these situations have absorbed losses and, consequently, their redemption features disappear. Under these circumstances credit unions clearly have a "practical ability to avoid the future transfer" of resources when these instruments are written down even if the possibility of a share redemption exists as a theoretical matter under limited circumstances.

Question 5—Other guidance on the elements: Do you have any comments on the proposed guidance?

World Council supports the following statement in paragraph 4.8(a)(i) regarding a claimant's rights to an asset:

> "Rights that constitute economic resources may take the following forms: rights established by contracts, legislation or similar means, such as: rights arising from a financial instrument, for example, an investment in a debt instrument or in an equity instrument . . . ."

[9] "practical, adj. and n." *OED Online*. Oxford University Press, September 2015. Web. 25 November 2015.

World Council supports this statement because credit union members' rights to their investments in credit union shares (i.e. a type of asset), as well as their claims on the credit union's residual equity in a liquidation, are typically set by legislation, the credit union's bylaws, or by the shares' terms and conditions.

Accounting standards should be consistent with these legal requirements because the law sets rules for economic activity. Accounting, as a representation of underlying economic realities, cannot faithfully represent economic reality without taking into account the legal and regulatory standards governing economic activity.

We strongly urge the IASB not to untether its accounting rules from the rule of law.

We thank the IASB for considering our comments in response to its *Conceptual Framework for Financial Reporting* exposure draft. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and General Counsel
World Council of Credit Unions, Inc.