

# EQUITY-LIABILITY ACCOUNTING DEBATE IN WORKER CO-OPERATIVE ENTITIES MEMBERS' SHARES

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## ABSTRACT

It is generally accepted that common high quality financial information standards are essential in a global economy. The comparability of financial information is necessary in order to facilitate the decision-making process with regard to capital flows between different countries. This complex

harmonization process focuses attention on investor-owned business. Nevertheless, this process cannot progress without an appropriate analysis of the nature of other types of entity. General criteria may be insufficient or inadequate when applied to entities, such as co-operatives, in which there is a difference from the basic ownership parameters of a company.

International accounting standards setters are involved in a project that reconsiders the principles that should determine the distinction between equity and liabilities. Many of the specific characteristics of co-operatives have a bearing on the recognition and measurement of their equity in the balance sheet.

The aim of this paper is to contribute to this debate by analysing the features of co-operatives that need to be visualized and better understood in order to obtain an appropriate solution via the accounting harmonization process for co-operatives. We analyse the possible consequences for co-operative member shares accounting of the different approaches studied by international accounting standards setters. We highlight the impact of some of the tentative decisions adopted in the IASB and FASB joint project in the case of worker co-operative members' shares.

**Keywords:** *Equity, Cooperative Entities, International Financial Reporting Standards, Harmonization.*

## INTRODUCTION

### *The International Debate on Equity-Liability Distinction Criteria*

The search for criteria that will enable a suitable distinction to be drawn between equity and liabilities has been the subject of a debate that has now become commonplace within accounting. Despite the fact that such a distinction would appear straightforward in simple financial instruments, the complexity and diversity of current financial instruments makes it difficult to offer a suitable solution for all of them. These innovative financial instruments have been created in order to meet needs in financing and financial risk management, and by adding elements that make them attractive so as to make it easier to place them among investors. Thus, the basic qualities of conventional equity and liability financial instruments have become intertwined, giving way to hybrid instruments, which makes their classification more complex from the accounting standpoint.

In view of this challenge, the main regulatory bodies have reacted with projects that seek to clearly identify the essence of equity and liability instruments that may enable suitable distinguishing criteria to be established that are applicable in practice. With this aim in mind, it is essentially the FASB and IASB that have been working since 2003 both individually and in a coordinated manner on the Financial Instruments with Characteristics of Equity project. This project has been developed alongside other financial reporting improvement and harmonization projects, including the Conceptual Framework project which, although it does not constitute a directly applicable accounting standard, sets out the

objectives of financial reporting and the basic principles that should guide the development of future standards.

Among the most relevant works, the FASB issued the Financial Instruments with Characteristics of Equity (Preliminary Views) document in 2007, with the aim of opening up a debate that would enable such a distinction to be drawn more clearly. The Board's preliminary view was that the "*basic ownership approach*" was the appropriate method for determining which instruments should be classified as equity instruments. The first characteristic underlying this approach is that the most subordinate claim in the entity is classified as equity. Only the type of instrument that has the lowest priority would be classified as equity. As a second characteristic, the holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holders of this type of instrument are viewed as the owners of the entity. Other claims that reduce the net assets available to the owners are classified as liabilities.

The Board also considered a further two approaches which were not supported by the respondents. The ownership-settlement approach includes the basic ownership approach and opens up the equity consideration to perpetual instruments (such as preferred stocks) and other indirect ownership instruments settled by issuing related basic ownership instruments. Instruments that lack settlement requirements or that represents the most subordinate claim are classified as equity. Its implementation would have similar results of the existing IFRS and US GAAP. The third proposal was the reassessed outcomes approach. Uses probability-weighted outcomes

to separate and classify financial instruments. Classification would be determined by the counterparty's return. Constant reassessment of their components would be necessary. In both approaches, more instruments will be separated in components making the process more complex than in current accounting requirements.

In order to contribute to this debate in January 2008, the European Financial Reporting Advisory Group (EFRAG) published a discussion paper titled *Distinguishing between Liabilities and Equity*. The EFRAG emphasizes the current distinction between liabilities and equity based on the non-existence of an obligation is not a robust principle. Conceptually, the EFRAG considers the claims approach to be superior to any other approach.

The claims approach was proposed by the IASB in their deliberations regarding phase B of the Conceptual Framework: elements and recognition in 2007 (IASB Agenda paper 3). With the proliferation of new financial instruments that combine features of both debt and equity, it is difficult to establish a clear line of separation, and so there is a need for a different approach. As the primary objective of financial statements is to provide information about the financial position of the reporting entity, there is a need for information about its economic resources and the claims against that entity, and the changes in them. The distinction between two types of claim - liability and equity - is a secondary classification problem; the claims approach implies that the claims are displayed against the entity in order of priority. The distinction between liabilities and equity is not considered so relevant.

However, the EFRAG considers further research and time is needed in order to fully evaluate the consequences arising from this approach. Meanwhile, if the splitting of equity and liabilities on the financial resources side of the balance sheet is accepted as being useful for the decision-making process, the EFRAG considers that the loss-absorbing capability of capital is the approach that provides the most decision-useful information. The loss-absorption approach classifies instruments as equity if the instrument claim on net assets is reduced if the entity incurs losses over a given period. The loss-absorption capability implies that the capital is available to the entity in order to absorb losses without any preliminary legal decision or contractual agreement. The claims of instruments classified as equity will decrease each period when a loss is recorded.

Meanwhile, the IASB issued another document in February 2008 titled *Financial Instruments with Characteristics of Equity*. The aim of this document was to study the two main lines of criticism received, namely:

- How the principles contained in IAS 32 should be applied.
- Whether the application of those principles results in an appropriate distinction being drawn between equity and non-equity instruments.

As is known, IAS 32 classifies financial instruments depending on compliance or not with the definition of liability. Despite the fact that the standard defines equity instruments as any contract that evidences a residual interest in the assets of an entity, deducting all of its liabilities, the key question is how liability is defined within the conceptual framework. If

the financial instruments involve an obligation for the issuer entity, the instrument will be classified as a liability.

Among the circumstances in which the IASB draws an inappropriate distinction between equity and liabilities is that in which companies end up without financial equity instruments as a result of all issued instruments have been classified as liabilities. This could well be the case with co-operatives in which members have not waived their unconditional right to request redemption of shares.

The IASB document suggests discussing the proposals that the FASB included as an alternative to the current criteria used to distinguish between equity and liabilities. It makes no reference to the proposal put forward by the EFRAG, as it was published just a few days before the discussion paper issued by the IASB.

After the comment period end, the IASB and the FASB discussed, in a joint meeting, all the proposals and the contributions of the comment letters. They resolved to outline the principles for future deliberations of the project based on the 'perpetual approach' and the 'basic ownership approaches'.

The Boards consider that principles under these approaches are, not too complex to be applied, and more coherent with the concepts that both institutions were developing in the conceptual framework joint project.

Under the perpetual approach, an instrument is classified as equity if it lacks a settlement requirement, and entitles the holder to a share of the entity's net assets in liquidation. It allows consider as equity perpetual instruments, others than the common shares, such as shares with a preference in liquidation, and

callable shares, which was one of the major problem of the basic ownership approach for respondents. In contrast, instruments that obligate the issuer to deliver assets, provide services, or issue financial instruments would be classified as liabilities (forward contracts, options, and convertible debt). Despite the fact that is quite similar to the IAS 32 classification proposal, the simple principle underlying the perpetual approach makes easier define equity. This equity concept is wider than proposed by the basic ownership approach and it is more coherent with the entity concept and liability concept used in the conceptual framework joint project.

During the deliberations process the boards discussed, among others, the classification of puttable, mandatorily redeemable and perpetual instruments. None of both approaches permits the classifications of all these instruments as equity. While under the basic ownership approach perpetual instruments would be classified as liabilities, under perpetual approach puttable and mandatorily redeemable instruments are which would be classified as liabilities. The boards acknowledged both approaches have cases where may not work.

In the deliberation process to identify the circumstances where instruments should classified as equity the board have adopted some tentative decisions that are of special interest to co-operative entities. In this sense, the IASB board (IASB Update, March 2009) decided tentatively that in the case of an ownership instrument that is redeemable at the option of the issuer and an ownership instrument that is puttable or mandatorily redeemable, only the holder's retirement or death should be classified as equity. The board emphasizes the fact that the term retirement is used broadly to

include events such as termination, resignation or the fact of ceasing to be a member in a co-operative. An instrument that is puttable at the option of the holder or mandatorily redeemable if specified dates or events other than death or retirement occur would generally be classified as a liability. The FASB took an identical provisional decision just some days earlier.

In September 2009 (*Agenda Paper 2 Financial Instruments with characteristics of Equity: classification Approach*) the IASB suggested, designating as "Approach 4", the classification principles that continue to be implicit in different decisions which have been taken throughout the project discussion. This is considered to be an alternative to the other approaches proposed. The intention is to develop a comprehensive standard that will simplify and improve financial reporting requirements in this area, which uses the current IFRS model as a starting point and acknowledges that certain amendments are required in the IAS 32 in order to address known issues with this approach. In the case of this approach, the aim is to classify as equity "those instruments that the entity relies on as the foundation of its capital structure. In other words, the objective of the approach could be described as identifying the owners of an entity." The "Approach 4" takes into account claim status and redemption features. The Board considers that claim status means the order in which the claims are met. Equity interests as a group are the claims against an entity with the lowest claim status. Holders of equity instruments may receive distribution of profits only if the issuer's ability to make payments required by other instruments has been considered first. On the other hand, all liabilities have settlement features either on a specified or determinable date or if specified conditions or events occur. The distinction be-

tween settlement and redemption is based on why the instrument is settled or redeemed.

Among the reasons considered by the IASB (September 2009 Agenda Paper 2, par. 11) for *redemption* of equity instruments are the fact that:

*"(c) The terms of the instrument require, or permit the holder or issuer to require, withdrawal of that instrument in order to allow an existing group of shareholders, partners or other participants to maintain control of the entity when one of them chooses to withdraw.*

*(d) The terms of the instrument require, or permit the holder or issuer to require, withdrawal of that instrument when the holder has ceased to engage in transactions with the entity or otherwise participate in the activities of the entity."*

In contrast, *settlements* of liabilities have both of the following characteristics (par 12):

*"(a) The payment date is fixed or determined by events or conditions other than those that determine redemption dates.*

*(b) The issuer may be able to influence the timing of the event that triggers settlement but cannot prevent the event or condition from occurring."*

In November 2009 the Group of 20 Leaders asked the standard setter to re-double their efforts to complete convergence. As a result, both institutions worked together on a common project. In April 2010 a draft document of an Exposure Draft was distributed to a small group of external reviewers. The draft was criticized for its lack of clear principles and

for providing inconsistent results. In general, the reviewers consider that the draft would not change the present classification of many instruments. The reviewers consider that existing highly-detailed liability-equity literature under US GAAP has not been developed in the draft document and, as a consequence, it is likely that current requirements would remain in use.

As a potential solution to dealing with the project, the boards (Agenda Paper A2, September 2010) proposed the following as a basic equity classification principle:

*An instrument is classified as equity if it gives the holder the right to force the entity to settle only if the issuer:*

*(a) chooses to distribute all of its assets or*

*(b) is required by an event (such as bankruptcy) to distribute all of its assets.*

This general principle would need to make exceptions for particular share-settled instruments, mandatorily redeemable and puttable instruments and instruments that are issued by limited life entities. In the case of co-operative entities the exception applicable for mandatorily redeemable instruments is especially interesting. However, many reviewers acknowledge that with the proposals put forward in the draft document they were unable to determine whether some co-operative financial instruments would qualify for equity classification.

Looking through the Agenda Paper of the February 2010 board meeting it is possible to find that it was suggested that mandatorily redeemable and puttable instruments be classified as equity in their entirety, in the case of:

*Instruments with terms that 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.*

*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 whose terms require, or permit the holder or issuer to require redemption when the holder ceases to engage in transactions or otherwise participate.*

The reviewers considered that additional discussion was needed on terms such as “maintain control of the entity”, “engage in transactions with the issuer” and “actively participate in the activities of the issuer.”

In the joint meeting in October 2010, the boards decided to proceed with a targeted improvement approach in areas where reporting causes problems under both sets of standard setters. Mandatory redeemable and puttable instruments were included among the three troublesome areas in which practical problems exist and which staff consider resolvable in the short term. The problems of entities that issue only redeemable or puttable instruments are considered to be similar in the case of FASB and IASB standards.

Although the project on “*Financial Instruments with Characteristics of Equity*” has been temporarily delayed<sup>1</sup>, both standard setters have reached several tentative conclusions that will

<sup>1</sup> The boards acknowledged the fact that they do not currently have the capacity to devote the time necessary to deliberating project issues. Consequently, the boards decided not to issue an exposure draft in the short term as originally planned. The boards will return to this project when they have the requisite capacity. This is expected to be after June 2011.

definitely act as guidelines for improvements in terms of the criteria that will be applicable in the future for the purpose of classifying financial instruments as either equity or liabilities. This future evolution needs to take place in keeping with the conceptual framework, which is also being reviewed by the boards. Any decision should be taken in keeping with the definition of liability in the final conceptual framework.

According to the Objectives of the Financial Reporting, proposed in chapter one of the Conceptual Framework (IASB 2010), "the financial position of the reporting entity is presented through the information regarding its economic resources and the claims against the entity, and the changes in them". As regards the distinction between equity and liabilities, the Board, in drawing its conclusions, explained that claims against an entity are not claims regarding specific resources, but rather, claims against the entity, and will be met using resources deriving from future net cash inflows. In processing information, the entity separates claims by owners from claims by other parties, which we call respectively equity or liabilities.

The boards have tentatively adopted the following as a tentative working definition of a liability on an entity (Project Update, Conceptual Framework. Elements and Recognition, October 2008): A liability of an entity is a present economic obligation for which the entity is the obligor. Within the context of co-operative entities, we consider especially relevant the fact that the boards emphasized the term "present", which means that on the date of the financial statements both the economic obligation exists and the entity is the obligor. The boards have also announced

that present obligation distinguishes a liability from a general risk. A present economic obligation conceptually exists when an entity is committed to a particular action(s) that is capable of resulting in cash flows and that there is a mechanism to enforce that economic obligation against the entity. The boards also agreed that laws and regulations are examples of mechanisms and do not, by themselves, constitute present obligations. At the moment, the discussion about "Definitions of elements, recognition and derecognition", Phase B of the Conceptual Framework project, is pending a future agenda.

### **SPECIFIC FEATURES OF CO-OPERATIVE ENTITIES MEMBERS' SHARES**

The very nature of the organisational model of co-operatives adds clearly innovative features to traditional financial instruments such as the contribution of capital by members.

The situation regarding co-operatives is diverse and therefore the contribution of capital by members will have different connotations depending on the activity carried out by the co-operative (agricultural co-operative, education co-operative, housing co-operative, worker co-operative, etc). Furthermore, the regulatory framework to which each country is subject will evidence distinguishing features and, therefore, the features of these entities may ostensibly vary from one country to another.

Being aware of this situation, the European Association of Co-operative Banks (EACB) (2006) in cooperation with Co-operative Europe, promoted a survey in eight European countries in order to provide an inventory with regard to the specific features of co-operative shares. Subsequently, Polo, López-Espinosa

and Maddocks (2010) carried out a similar survey on six European countries, adding the standpoint of the Canadian and US cases.

The first result of the EACB survey enabled four major groups of financial instruments issued by co-operatives to be identified:

- Classical co-operative shares
- Privileged member shares and members' certificates
- Non-user member shares
- Tradable co-operative shares and investment certificates

The last three shares or certificates modify one or more of the characteristics of classical co-operative member shares. In this section we would like to emphasize the main specific features of classical co-operative member shares:

- The acquiring of the status of member of the co-operative will be associated with compliance with the requirements demanded in the company statutes. These requirements will include a minimum mandatory contribution of capital.
- The status of member of the co-operative is that which grants the right to vote. This vote is not associated with the amount of capital or the number of shares. In a primary co-operative, where all members are natural persons, the rule will be one member one vote. The democratic control by the members will remain at other level co-operatives. When the co-operative is made up by other co-operatives, or when there are

different types of member in the co-operative the voting rights will be allocated by the contribution of each member to the activity of the entity.

- When co-operatives' accounting results allow this, the capital provided by members will be remunerated via payment of interest, which will be subject to different types of legal and statutory limitations. Additionally, members will participate in the positive or negative results in proportion to the transactions, services or activity carried out with the co-operative.
- Limitations of transfer to the other party. Shares are not generally transferable and can basically be exchanged only with the co-operative.
- Redemption values based on their nominal value. In general, members have no claim on pro-rata amounts exceeding their nominal value. This feature is even transferred up to the time of settlement by the co-operative. After attending to all cases of creditor redemption, members' shares are then redeemed. The resulting final equity will, after meeting claims for capital by members, be made available to the local co-operative association.

Co-operative capital loses two of its main features in trading companies: apart from lacking the capacity to structure the right to vote, it is not used as a basis for distributing profits or absorbing losses. On the other hand, the entry or withdrawal of members directly entails modifications to the amount of capital, which adds volatility to that amount. When members withdraw, the most common option is to recover any capital invested directly from the

co-operative. In the Spanish case, the transfer of capital is confined to transactions between members, or by *mortis causa* to the benefit of heirs if they happen to be members and, if they are not, following acceptance as such.

Members have the right pursuant to the Law governing Co-operatives to voluntarily resign at any time, and within the terms established in the company statutes, being duty bound to give advance notice in writing to the Governing Board of their decision. If a member resigns, the Law governing Co-operatives or the co-operative's own statutes provide for precautionary measures in order to protect the company's interests. In the event that a member decides to abandon the co-operative, they are entitled to redemption of the capital they had contributed once any losses accumulated by the co-operative that may be attributed to that member have been deducted.

### **WORKER CO-OPERATIVE ENTITIES MEMBERS' SHARES**

The worker co-operatives members' shares present the general features of co-operative members' shares discussed in the previous section, but additionally have some other remarkable elements. In worker co-operatives, their members assume a dual role as a provider of financial resources and as a worker of the company. Besides, their members seek to generate profits with the activity through the common organization of the production of goods and services for third parties. They differ from other co-operatives such as housing or education co-operatives whose business purposes are to provide services at the best prices and conditions for their members and, therefore, are not for profit oriented. Although worker co-operatives seek for making profits

their singularity comes from the way they manage and share those profits.

The International Co-operative Alliance (ICA) General Assembly adopted in 2005 the *World Declaration on Worker Co-operatives* promoted by the International Organisation of Industrial, Artisanal and Service Producers' Co-operatives (CICOPA), a sectoral organisation of the ICA. This document identifies three basic modalities to carry out occupational activities of human beings:

- Independently as self-employed,
- As wage earners
- Under worker ownership, in which work and management are carrying out jointly. Among these, those organised through worker co-operatives, where workers democratically manage entity, have the highest level of development, at present, worldwide.

A global declaration was considered necessary in order to define some basic characteristics and internal operational rules that are exclusive to this type of co-operatives. Furthermore, it was also necessary to emphasize the role of worker co-operatives as defenders of one of the most advanced, fair and dignifying forms of labour relations, and generation and distribution of wealth.

Following this world declaration the basic characteristics of workers' co-operatives are:

- They have the objective of creating and maintaining sustainable jobs and generating wealth, in order to improve the quality of the workers members.

- Free and voluntary membership.
- Work shall be carried out by the members.
- The worker-members' relation with their co-operative shall be considered as different to that of conventional wage-based labour and to that of autonomous individual work.
- Their internal regulation is formally defined by regimes that are democratically agreed upon and accepted by the worker-members.
- They shall be autonomous and independent to the state and to third parties in their labour relations and management, as well as in the usage and management of the means of production.
- Practice democracy in decision-making.
- Ensure ongoing education and training.
- Contribute to the improvement of the living conditions of the workers' families and the sustainable development of the community.
- Combat their being instruments aimed at making the labour conditions of wage-earning workers more flexible or precarious.

The world declaration also considers that a worker co-operative must take into account the following internal functioning rules. They shall:

- Compensate the work of their members equitably, taking into consideration the function, the responsibility, the complexity and the specificity requested by their positions, their productivity and the economic capacity of the enterprise.
- Contribute to the capital increase and the appropriate growth of indivisible reserves.
- Provide the workplaces with physical and technical facilities.
- Protect the worker-members with appropriate systems of welfare, social security and occupational health.

Most of the characteristics are related to the worker condition of the member. In a worker co-operative the ultimate goal of the link between member and co-operative is to establish a working relationship. However, capital contribution will be a necessary requirement for achieving the membership. After assuming the status of member, the worker will have full access to participation in the management of the co-operative, being granted political power and access to co-operative profits.

While they remain worker-members, they are – in addition to receiving a salary – entitled to periodically receive part of any profits made by the co-operative which will be distributed according to their participation in co-operative activity. Usually, following an initial stage or trial period as a salaried worker, it will be proposed as a member of the co-operative for which purpose they will need to agree to the minimum mandatory capital contribution. When taking this decision, the essential bond that the member establishes will be via a stable working relationship with the co-operative. This process generates links that do not exist in other forms of contribution of equity.

## IMPLICATIONS OF THE EQUITY/LIABILITY INTERNATIONAL DEBATE ON WORKER CO-OPERATIVE MEMBERS' SHARES ACCOUNTING

The application of the principles for classifying financial instruments as equity or liabilities in co-operative entities by the IAS 32 required the issue of an interpretative document titled *Members' Shares in Co-operative Entities and Similar Instruments (IFRIC 2)*. As has already been stated and in accordance with IAS 32 *Financial Instruments: Presentation* (2003, paragraph 18), the existence of an option for the holder to put the financial instrument back to the issuer for cash or another financial asset means that the puttable instrument corresponds to the definition of a financial liability. Among the main decisions taken in the IFRIC 2, attention should be drawn (in paragraph 7) to the fact that members' shares are considered to be equity if the entity has an unconditional right to refuse redemption of such shares. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are considered to be equity.

Later, in 2008, the IAS 32 was revised. The standard introduced an exception to the definition of a financial liability in the case of puttable financial instruments. As a result of the revised standard, an instrument that includes such an obligation could be classified as an equity instrument if it corresponds to the features mentioned in paragraphs 16A<sup>2</sup> and B<sup>3</sup>. In our opinion, even when the majority of the characteristics are met by co-operative members' shares, the first of the features mentioned in paragraph 16A is not generally extendable to these financial instruments. This feature requires that the instrument entitle the

holder to a pro-rata share of the entity's net assets in the event of settlement on the part of the entity. The entity's net assets are those assets that remain after all other claims on its assets have been deducted. Polo, López-Espinoza, and Maddocks (2010, p 21) refer to some cases in Canada and Italy that could correspond to this feature. However in co-operatives is common to redeem members' shares at par, therefore, it is not generally applicable the exception of the revised IAS 32.

The main threat to the consideration of co-operative entities members' shares as equity comes from the legal right to request redemption of capital in view of a withdrawal as member. However, the debate opened at the main reg-

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- 2 As an exception to the definition of a financial liability, a puttable instrument is classified as an equity instrument if it has all the following features:
    - (a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets.
    - (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments.
    - (c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.
    - (d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.
    - (e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).
  - 3 For an instrument to be classified as an equity instrument, in addition to the instrument having all the above (A) features, the issuer must have no other financial instrument or contract that has:
    - (a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and
    - (b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

ulatory accounting bodies regarding elements involving financial information and the criteria to be applied in distinguishing between equity and liabilities does, provide new hope with regard to the future classification of co-operative members' shares.

Under the working definition of liability developed within the joint project involving a review of conceptual framework, it could be understood that it is necessary for member of co-operatives entities to make such a request in order to classify the relevant members' shares as a liability. The existence of a present obligation requires a particular action that is capable of resulting in cash flows and there is a mechanism to reinforce that economic obligation against the entity. In the case of co-operatives, the mere existence of the legal right to request redemption would be considered as a financial risk attached to the business and information about it should be provided in the company's annual report. The legal right to request would not be sufficient for the purpose of considering the capital contribution by members as a liability. Even without considering other links and characteristics of the capital contribution of co-operative's members, the evolution of liability working definition could be enough to classify it as equity. This point would entail a major advance in considering co-operative members' shares as equity.

In our opinion, notes to financial statements is the right place for disclosure about the risk arising from the possible withdrawal request of members. We think it is important that financial statement include data that enable user to make predictions of redemptions of members' shares for the next accounting periods. The forecast for the years of members' retirement does not entail any particular difficulties. In this

regard Beaubien (2011) proposes the "redemption contingency" concept to report the estimation of the shares that might be redeemed. This author suggests that shares, included in the redemption contingency concept, should not be considered equity.

On the other hand, the international debate concerning the criteria that should govern the classification of equity and liability has given rise to various elements to which we would like to refer to in order to analyse their repercussion over worker co-operatives members' shares accounting.

The puttable and redeemable instruments have been subject of a permanent debate during the project. There have been different tentative decisions that endorse the evolution towards a more open consideration of co-operative entities members' shares as equity. The IASB and FASB have expressed support for the consideration as equity of an ownership instrument that is puttable or mandatorily redeemable only on the holder's retirement or death. The boards emphasize the fact that the term *retirement* is used broadly to include events such as termination, resignation or the fact of ceasing to be a member in a co-operative. The boards have maintained the need to consider those instruments as equity under different approaches<sup>4</sup>

At the beginning of 2010 the boards decided not to adopt any of the approaches that they had previously considered. Instead, they asked the staff to analyse a possible amendment to IAS 32 Financial Instruments: Presentation. Once again, among the amendments that the board specifically mentioned, remains the requirement to classify as equity shares puttable only in case of the death or retirement of the holder. This stance was maintained in the

draft project jointly submitted by the FASB and IASB to a small number of reviewers throughout 2010. It was suggested that mandatorily redeemable and puttable instruments be classified as equity in their entirety in the two cases:

- Instruments with terms that 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.
- 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 whose terms require, or permit the holder or issuer to require, redemption when the holder ceases to engage in transactions or otherwise participate.

In our opinion, the consideration of co-operative members' shares as equity is clearly endorsed in this proposal. Both conditions, which require that mandatorily redeemable instruments be considered as equity, make a clear reference to the profile of co-operative members' shares. On the one hand, the entity's control group is required to remain unaltered when a member withdraws. The single vote status associated with a member's participation in the co-operative is, without doubt, a guarantee of the fact that this requirement will be clearly met.

The second case constitutes a reference that is closely linked to another basic quality of the co-operative model - in which the ownership of members' shares is no other than a

means for gaining access to participation in the co-operative's activity. This second feature is adhered to co-operatives, albeit in a special way in workers co-operatives. In this type of co-operative, when a new member contributes initial mandatory capital, they will be essentially seeking a stable job rather than an investment alternative. The contribution of capital by the member is linked to the search for a working relationship, and this association will remain indissoluble while the member remains at the co-operative. The continuity of this link in terms of working relationship prevents the right to redemption of the resources that the member has capitalized in the co-operative. Only in those cases in which the co-operative assembly decides as to how these resources are distributed will they be able to access them. As set out in the second feature mentioned in the draft of the Exposure Draft, the ceasing of this working relationship with the co-operative in the case of worker co-operatives means that this will enable the member to be entitled to right to redemption of their capital. The recovery of invested capital is associated with the loss of the working relationship and, logically, of any benefits or privileges that the member may have had via participation in the co-operative.

This association of capital with participation in co-operative activities may, in turn, entail a protective mechanism for the co-operative itself, which will be entitled to expel the member where the latter's actions fail to correspond to the principles and norms established set out in the company statutes and which the co-operative enforces on them. Similarly, this becomes a mechanism that enables the entry of members who do not share the co-operative's objectives/values to be controlled/restricted.

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<sup>4</sup> Perpetual approach; Basic ownership approach ; Approach 4. w

The complete view of the link generated via the contribution of capital reinforces the idea of a long-lasting relationship between members and co-operative entities, particularly in worker co-operatives. Even where free and voluntary entry and withdrawal form part of the essence of the member's contractual relationship with the co-operative, we believe the substance of this relationship to be permanent. Therefore, we consider the tentative decisions taken by the international accounting standard boards to be appropriate. As the reviewers themselves have pointed out, there are many finer points that need to be included in order to accept and define some of the terms used, although we believe that they constitute a step in the right direction. If they became definitive, they could help the accounting model to provide better information about the financial position of co-operative entities.

The Exposure Draft project has been subject to criticism by reviewers who consider it is not based on clear principles and offers inconsistent results. Taking this into consideration the boards have proposed to include in their deliberations a new classification principle based on the holder's right to force the entity to settle only where the issuer distributes all of their assets or is required by an event to distribute all of their assets. The applicability of this principle is not clear in the case of co-operative members' shares. On the one hand, the right to redemption of co-operative members' shares would seem to clash together with the criterion that has been set out. Nevertheless, the boards believe that the general principle would need to make exceptions, particularly, for some mandatorily redeemable instruments. On the other hand, the distribution of all assets is not applicable in the case of co-operative entities. In co-operatives members'

shares redemption is based on their nominal value. In general, members have no claim on pro-rata amounts exceeding their nominal value<sup>5</sup>. Besides in a liquidation process, the remaining equity will be made available to the local co-operative association. This singularity is deep-rooted in the features of solidarity typical of the co-operative model. However it is clear that members' shares are the instruments that have the lowest priority in claims status. The disinterested waiver of part of the net assets that could be accumulated during a settlement process in favour of the co-operative movement itself should not be considered an argument that can be used to cast doubt on the status of co-operative members' shares as equity. In our opinion whatever the classification decision is taken for instruments with fixed redemption prices or upper limits should consider separately the special circumstances of co-operatives members' shares.

Lastly, we would like to refer briefly to the loss-absorbing capability approach proposed by the EFRAG (2008). In our opinion, the applicability of this proposal would enable co-operative members' shares to be classified as equity. The members' shares remuneration model recognises the need to remunerate the capital factor at a fixed percentage, without any fluctuations according to the amount of profits obtained during the financial year. Nonetheless, the accounting result will affect the member's capital both if they are losses or profits. The member will be affected owing to their involvement in co-operative activity rather than because of the amount of capital contributed. In our view, we believe that this should not constitute any impediment regarding adherence to the principle proposed by the

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<sup>5</sup> They may be entitled by local Law to some reserves.

loss-absorbing approach, despite the fact that the member-capital association may give rise to specific features in the mechanism used to attribute losses to capital.

## CONCLUSIONS

Co-operative entities' interests are now being appropriately taken into consideration in the debate concerning the project about financial instruments with characteristics of equity.

Organisations linked to the co-operative model have managed to convey the problems and specific features of these entities to the debate. Despite the fact that the guidelines for the regulation process focus on companies of a capitalist nature, monitoring of the process and the numerous letters containing comments that have been sent by different co-operative organisations have meant that both, the FASB and the IASB, have tried to search for principles that also address co-operative interests. In our opinion this is a path in which co-operatives must insist on following in the future in order that the accounting standard-setting process is able to take into account the economic substance of the contractual relationship that the contribution to co-operative members' shares implies.

In co-operative entities the amount of financial resources provided by the members will not be related to political power and financial benefits, as is usual in investor-owned businesses. The financial contribution is a requirement for being able to attain member status, and is this status that allows access to political power and to the economic benefits of the co-operative. These benefits will be distributed based on the activities of the member in the co-operative. It is essential to observe the dual condition that links the member with the co-operative via the

financial contribution of capital yet essentially via participation in co-operative activities. The redemption of shares has consequences that cannot be analysed from an investor point of view. It should be analysed taking into account the implications in terms of loss of membership in the co-operative.

The diverse types of co-operatives require a detailed analysis of the different cases of the contractual relationship that being a member of a co-operative entity implies. Our work focuses on worker co-operatives. In our opinion, members' shares are a permanent resource for worker co-operatives. These entities need the financial resources to establish the partnership and to carry out economic activity with the ultimate goal of developing employment options. Members accept the capital contribution with the ultimate goal of establishing an employment relationship. The link between a worker co-operative and their members must be understood through participation in the entity's activity. Member status is innate to financial contribution, but at the same time enables access to steady jobs. This situation in particular creates more lasting ties among worker-members within the co-operative than in other entities.

The classification of co-operatives members' shares is one of the factors that have been the driving force behind the current international debate about the principles that need to guide the distinction between equity and liabilities. In our opinion, the IFRIC 2 does not offer a solution that is able to deal with regulatory diversity and different types of co-operative societies.

The boards still haven't reached a consensus principle suitable for the diversity of finan-

cial instruments and entity types. However the main approaches proposed throughout the international debate mean, a clear evolution for co-operatives, as the IASB and FASB are more receptive to consider the co-operatives members' shares as equity. During the discussion process the boards have adopted some tentative decision that clearly refers to co-operative entities. They have expressed support for the consideration as equity of puttable or mandatorily redeemable instruments that the holder must own in order to engage in transactions with the entity or otherwise participate in the activities of the entity, or permit the holder redemption when the ceases to engage in transactions. Before similar consideration were made for mandatorily redeemable or puttable instruments redeemable only on the holder's death or retirement. The boards emphasized the fact that the term *retirement* is used broadly to include events such as termination, resignation or the fact of ceasing to be a member in a co-operative. In our opinion, any of the exceptions mentioned enable co-operatives' member shares to be considered as equity, and once again, the position of worker co-operatives is specially protected by these exceptions.

The complete view of the link generated via the contribution of capital reinforces the idea of a long-lasting relationship between members and co-operative entities, particularly in worker co-operatives. In this type of co-operative, when a new member contributes initial mandatory capital, they will be essentially seeking a stable job rather than an investment alternative. The contribution of capital by the member is linked to the search for a working relationship, and this association will remain indissoluble while the member remains at the co-operative. Even where free and voluntary entry and withdrawal form part of the essence

of the member's contractual relationship with the co-operative, we believe the substance of this relationship to be permanent. Therefore, we consider the tentative decisions taken by the international accounting standard boards to be appropriate.

Within the context of a project concerning the conceptual framework, the boards agreed that the existence of a present obligation distinguishes a liability from a general risk. The existence of a present obligation requires a particular action that is capable of resulting in cash flows, so there should be a mechanism to reinforce that economic obligation against the entity. The law and regulations are given as examples of mechanisms that enforce an economic obligation, but the boards agree that they do not, by themselves, constitute present obligations. Transferring this argument to the context of the co-operative model, one could understand from this that it would be necessary for the members to effectively exercise their request for redemption in order to classify their members' shares as a liability. Therefore, the mere existence of a legal right would become considered a financial risk for the business about which information should obviously be provided in the annual report. This point would, in our view, mean a huge advance towards considering co-operative entities members' shares as equity.

It is important that the notes to financial statements provide information that explains the main features of the different financial instruments issued by the entity. It would be particularly useful to explain the different nature of co-operatives members' shares, emphasizing their redemption conditions and giving details about redemption forecasts over the coming years. Notes to financial statements might

include the number of present worker members of the co-operative that, for instance in 3 and 5 years, will reach the age of retirement. It could provide parallel data of the amount of capital of such members up to date of financial statement. In our opinion, it is objective information based on present data, that has clear interest to users, and can help in their decision making process. The definitive withdrawal of members owing to retirement will consider cases and circumstances that it can't be predicted but, in our opinion, the essence of the financial instrument is better reflected if these notes are added. ■

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