Co-operative Accounting: Disclosing Redemption Contingencies for Member Shares

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The extant literature argues that co-operatives are unique organisational forms, different from investor owned companies. As such, they conduct business differently and have differing constituting structures. Although some aspects of the organisation may appear similar – owners shares and members shares – they have significant differences. Existing practice in co-operatives has been to try to make business and reporting fit accounting standards that were developed for investor owned companies. The results of these adaptations have been equivocal at best. As a remedy, this paper provides the example of member equity as it might be reconsidered within the principles of *how co-operatives actually function*; and therein suggests a new practice for reporting the value of member shares.

Introduction

Co-operatives are present in almost every industry in which investor owned companies (IOC) also operate, such as, banking; healthcare; housing; retail; and production, and represent significant components of the economy (Katz and Boland, 2002). While the co-operative form of organisation faces similar challenges as IOCs in terms of access to capital, efficient service of customers, and competition from local and international sources; they have different goals. The generally accepted focus for IOCs is to generate and maximise wealth for shareholders. By contrast, co-operatives are established to meet member and community needs, and are governed by seven guiding principles, including: voluntary and opened membership; democratic member control; member's economic participation; autonomy and independence; education, training and information; co-operation among co-operatives; and, concern for community (International Co-operative Alliance, 1995).

Because of the differences in goals and desired outcomes, co-operatives are not accommodated well in the financial reporting standards that are associated with, and developed for profit-driven, IOC organisations. If accounting standards are imperfect in their attention to non-IOC organisations, "they may not faithfully represent the reality of the financial performance and position of the entity" (Barton, 2005: 148). This raises the question; can accounting standards accommodate relevant, reliable, comparable and understandable financial information for co-operatives with respect to equity represented by members' shares?

Co-operative Business and Accounting

Katz and Boland (2002) note that one of the most significant strengths of co-operatives is their co-operative base; that being the membership that constitutes the co-operative. This 'base' provides economic capital to the co-operative and is characterised by shared values that tie the member and the larger co-operative together (Ferguson and McKillop, 1997). However, Mathews (1999) suggests that co-operatives may not gain substantive benefit from members when choices are based on significant economic differences. In other words, co-operatives must not create an economic penalty for members to conduct business, yet the co-operative's actions should be consistent with member expectations.

Quarter et al (2003) suggest the difficulty of existing accounting standards and practices to accommodate co-operatives lay in the standards' origins: the standards were constructed with a focus on reporting which is inconsistent with the focus of community based organisations (ie a co-operative) (see also: Ridley-Duff, 2007; Unerman et al, 2007). These forms of reporting fail to account for a "systematic analysis of the effects of the organisation on its community(ies), stakeholders and stakeholder concerns" (Quarter et al, 2003, 76). Robb, Smith and Webb (2010) assert the notion of Co-operative Capital should be considered as a form of share equity distinct from IOC share equity – given the different operating goals, outcomes and environment of co-operatives. The authors contend because of the orientation of co-operative business, that share equity will be deployed differently and have a different character, and as such should be recognised in financial reports and statements.

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The governing standard concerning the reporting of owner and member shares for IOCs and co-operatives in the International Financial Reporting Standards is IAS 32, "Financial instruments: disclosure and presentation"[1]. In this standard, among other implications for co-operatives, is the indication that for co-operatives whose members may request and require redemption of their shares, those shares must be categorised as a liability. To meet the existing provisions for the entity to classify the shares as equity, the co-operative must be able to control the redemption of shares. In light of any window that may allow for the redemption outside of the co-operatives' control, the shares must be classified as liabilities. The implication of this classification presents a dangerous situation for co-operatives, as this reallocation of equity as a liability seriously weakens a co-operatives financial position and may impact its ability to secure credit, conduct operations, or facilitate growth (Detilleux and Naett, 2005).

IAS 32 was first issued in 2002 and has subsequently been subject to much review, comment and interpretation by the International Accounting Standards Board, the governing body responsible for the issuance of the IFRS. As co-operatives mobilised to address the emerging issue of IAS 32 and the implications it might have for their operations and financing, an argument in principal was put forth: co-operative shares meet neither the definition for debt or for equity as articulated by IAS 32. The definition of a debt liability is:

> A contractual obligation:
> (i) To deliver cash or another financial asset to another entity; or,
> (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (International Accounting Standards Board, 2005).

By contrast, the definition of equity is simply:

> Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities (International Accounting Standards Board, 2005).

Members' shares are contributions to the capital base of the firm, and are used as such, and members have a clear interest in the residual assets of a co-operative in their concern for the co-operative to remain an ongoing entity and contributor to the community. The repayment of any members shares is done based on established reserves or yearly earnings and is secondary to the payment of any contractual obligations, such as short term bank debt, long-term capital debt or accounts payable. As such, co-operative shareholders enter a risk/ownership relationship, making co-operative shares resemble share equity in IOC firms. However, by contrast, patronage repayments (dividends) are not a function of the volume of shares one owns (as co-operative members all own equal portions); it is a reflection of the transaction volume with the co-operative. And further, as a function of the formative concepts of a co-operative allowing and encouraging the free-entry of members into the co-operative, the share price does not appreciate or depreciate in a speculative market. Most significant to the consideration of the shares as debt is the fact that members can demand redemption at any time, unlike a common shareholder in an IOC firm.

In 2004, IFRIC 2 was issued and was met with a degree of satisfaction from co-operative entities as it allowed members' shares to considered equity if certain conditions are met. Those conditions are[2]:

- A co-operative has the unconditional right to refuse redemption of members' shares;
- A co-operative's constitution or existing laws specifies the level below which capital cannot fall. This minimum amount will be considered as capital.

This solution was not acknowledged as a complete success, as some jurisdictions require co-operatives to redeem shares on the demand of the membership, regardless of organisational mandates. However, it was viewed positively as many co-operatives would be able to maintain existing business practices and would be able to satisfy the requirements of the interpretation. Thus, IFRIC 2 became a workable compromise, but remains an imperfect solution (Detilleux and Naett, 2005).

The question remains, is the interpretation associated with IFRIC 2 an appropriate application of accounting standards. While it may not be suitable to adopt IOC models for business operations and reporting for co-operatives, this interpretation does not

adequately reflect the realities of a co-operative either. It is true that membership shares would not appropriately be considered as a debt or other liability in toto. These share purchases are contributions by the membership to the organisation, and a risk is accepted in their acquisition. However, the fact remains that redemption is possible, and while it may be delayed by virtue of internal or external rules; once requested a redemption will eventually require satisfaction if the co-operative remains an ongoing concern. This raises the question:

> Is there a model, other than the debt vs liability model, within the IFRS that might provide for an effective model for financial reporting for co-operatives?

Lessons from Warranties and Allowances

A provision for warranty repairs or payments is a contingent liability held by a company, and is typically measured based on historical experience. Some examples of forms of measurement include estimating the contingency as a percentage of sales, an estimate based on past warranty repair costs, and industry averages for repair costs. The contingent nature of warranty liabilities is such that a certain portion of payments will have to be made against warranty claims, though all claims may not be paid. Alternatively, it is possible that more warranty claims may be made than the estimated contingency. The logic behind a warranty contingency is simply a reflection of likely possible payments that will be required, based on past experience. It is entirely possible that co-operative shares might fit a similar definition, and might benefit from a similar treatment.

As an exemplary case, assume a large co-operative's financial statements are reviewed over a ten-year period, and share redemptions average approximately two per cent of the member share equity. This historical standard can be used as an estimation tool for the member share redemptions that may be required in future years, and may be a useful vehicle for financial reporting. If, for example, the co-operative's member shares holdings were $1,000,000 a "redemption contingency" would exist in the amount of $20,000. This approach would allow a co-operative to deploy the capital of member shares as equity, while retaining a reasonable reserve to satisfy any redemptions which might be made.

The question then arises as to whether the redemption contingency should be disclosed in the notes to the financial statements, or recognised in the financial statements themselves. Guidance from the International Accounting Standards Board suggests that issues of materiality, defined as:

> Omissions or misstatements of items are material if they could, by their size or nature, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements (International Accounting Standards Board, 2005)

are paramount in the consideration of when an expense, or expected liability might be incurred. Additionally, the IFRS Framework requires recognition of a liability when a present obligation, such as the redemption of members' shares, will result in an outflow of assets and if the amount can be reliably measured (in time and value) and presents a faithful representation of the organisation.

Bernard and Schipper (1994) maintain that it is difficult to empirically determine whether recognition, as opposed to disclosure *should* matter. However, there is a preponderance of studies that suggest that recognition is more influential for investors in making decisions (Imhoff and Thomas, 1988; Amir, 1993; Imhoff et al, 1993). Johnson and Storey (1982) note, items that are not recognised are those whose existence or value remains highly uncertain. In these situations, disclosures are often inferior means of communication owing to difficulties in the assimilation and processing of the information in notes as compared to elements recognised in the financial statements.

Hirst, Hopkins and Whalen (2004) assert that the most significant component of the debate is the ability for the users of financial statements to make informed decisions, and in that capacity they argue disclosures are a poor substitute for communicating essential details to managers and investors for decision making purposes. Barth, Clinch and Shibano (2003) draw similar conclusions, affirming recognition provides superior decision making abilities, and if reliable measurement is possible, recognition should trump disclosure.

Given the guidance in accounting standards and the balance of academic inquiry, the

recognition of a redemption contingency would be likely to provide a better tool for communicating the realities of how business unfolds in co-operatives. The recognition of the contingency would not deplete the available equity any further than it would otherwise be expected to diminish, given the method of estimation. The advantage to such an approach allows an accounting problem (ie how are member shares reported?) to be solved by an accounting solution; rather than by an exigent solution of laws and regulations (eg co-operatives are permitted to refuse redemption in certain circumstances) or constitutional policies of the co-operative itself (eg requiring a minimum capitalisation), both of which may fundamentally contradict the foundational principles of co-operatives (Robb et al, 2010; Detilleux and Naett, 2005).

A Case Example: United Farmers of Alberta

The financial statements of the United Farmers of Alberta (UFA) detail the total value of members' shares and the amount of member share redemptions. Data from the fiscal years 2006 to 2010 detail UFA member shares which hold a par value of $5 and:

> are redeemable at the option of the holder at par value when the member reaches age 65, moves out of the trading area or, at the request of the member's estate, upon the member's death.[3]

Additionally, UFA allows members to hold investment shares, which pay a dividend of the bank prime rate charged against retained earnings. The par value of the shares is $100, and "are redeemable at par value at the option of the holder."[4] A summary of member shares, investment shares, and redemptions for both classes of shares is provided in Table 1.

The above data suggests that if UFA had adopted a redemption contingency approach to financial reporting in 2010, based on the average from 2006-2009 (.7%), UFA would have recognised an appropriate amount for redemption payments for member shares. If UFA had estimated 2010 redemptions for investment shares based on the average of the four preceding years (5.9%) UFA would have under-estimated the redemptions by approximately $529,000.

The case of UFA suggests an increasing reliance on the use of investment shares to generate capital, the number of shares having more than doubled in the five years under scrutiny. The data also suggests a higher volatility of redemption amounts, as compared to ordinary member shares. Redemptions of $5.5 million were 6.5% of total investment shares in 2010 ($5.3 million; 7.3% in 2009) and this amount can be considered material given UFA's reported net loss of $64 million in 2010 (loss of $5 million in 2009). As investment shares exhibit a relatively high volume of redemption as compared to member shares, and given the fixed annual dividend, these shares appear to take on the appearance of debt instruments (with some reaching maturity at redemption), rather than equity. However, consistent with the concept of equity (perhaps more like a preferred shares in an IOC) is the assumption of risk, in that dividend payments are secondary to debt obligations or other required payments. Additionally, an interest remains in the ongoing residual assets of the co-operative, and assuming the continuance of the organisation – an investment share could theoretically be held indefinitely.

Table 1: Member and Investment Shares and Redemptions 2006-10 (expressed in 000s)

	Member Shares	Redemption	Percentage Redeemed	Investment Shares	Redemption	Percentage Redeemed
2006	$27,260	$219	.8%	$38,515	$2,205	5.7%
2007	$28,304	$195	.6%	$48,125	$2,726	5.6%
2008	$29,638	$204	.7%	$59,259	$2,946	5.0%
2009	$30,806	$221	.7%	$72,237	$5,295	7.3%
2010	$30,729	$222	.7%	$84,070	$5,489	6.5%
Average (2006-10)			.7%			6.0%

Note: This table does not present acquisition of new member or investment shares; share values are shown at beginning balance

By contrast, the member shares at UFA experience a low redemption rate (averaging .7%) and are seemingly more restricted than investment shares in the qualifications for redemption (eg death, age, and departure of region). While this may not decrease the number of redemptions that occurs in any one year, it does make the volume far more predictable. Members' shares appear to function more consistently with the definition of equity associated with IOCs.

Considering "Redemption Contingency" Reporting

As Robb et al (2010) point out, there are substantial reasons why the equity of a co-operative should be examined differently from that of an IOC. A founding principal of the co-operative movement is the inherent possibility of the goodness of people, and the desire to improve the community, however it might be defined in a given co-operative context (ibid; International Co-operative Alliance, 1995). The membership of the co-operative is open to those that can join and are willing to accept the responsibilities of membership and the activities of the business. In IOC companies shareholders purchase equity in a speculative fashion and seek to enrich themselves, and the responsibility of IOCs is to enhance the wealth of the shareholders alone, not the wider community (Bakan, 2004). Additionally, the conceptual and legal design of the corporation is intended to facilitate (but not require) the separation of owners from the management of the activities of the business (ibid). Another fundamental difference between IOCs and co-operatives in terms of equity structure is the democratic notion of ownership. Voting rights, and control in IOCs is attributed based on the volume of shares one can accumulate. In a co-operative, members own a share and have one vote and cannot purchase additional influence through the acquisition of more equity.

Robb (2006) develops a conceptual approach to examine how accounting standards for co-operatives should be different from IOCs. Quarter et al (2003) adopt a similar perspective arguing that there are fundamental differences in the way that co-operatives operate, and this is not reflected in existing concepts of mainstream accountancy. And, if such concepts remain foreign in accountancy, there is little chance standards will adequately reflect the unique organisational form and processes of co-operatives. There is a lacuna of reflection on how accountancy should reflect the operations of a co-operative, and the interpretation in IFRIC 2, which many co-operatives found acceptable, is not an adequate solution (Detilleux and Naett, 2005). In fact it pushes co-operatives further down a path they should not travel.

Detilleux and Naett (2005) detail the emergence of IFRIC 2, which might best be described as a compromise (ibid) following the issuance of the exposure draft for IAS 32, which would classify co-operative member shares as debt. The authors detail the mobilisation of political and organisational interests and the articulation of logic that suggested co-operative member shares behave more like equity than debt, especially when certain restrictions are placed upon them. One such restriction is the co-operative's establishment of a minimum level of capitalisation and the right of refusal to redeem member shares under certain circumstances, such as jeopardising the minimum capitalisation levels. However, the presence of such restrictions would seem to conflict with the foundational concepts of co-operatives which require the ability for members to redeem shares (International Co-operative Alliance, 1995).

The argumentation to allow member shares to be categorised as equity under conditions is a reorientation of the co-operative, such that its operations and structures come to conform to the operating ideals of IOCs. Rather than examining the principles of the operations of a co-operative and developing an interpretation for what co-operative member shares are, in the context of a co-operative; IFRIC 2 allows co-operatives to make adjustments to themselves in order to fit a concept of accounting standards defined by IOCs, organisations whose operating logics often conflict with those of co-operatives. Additionally, the classification of member shares as equity is disingenuous on the part of co-operatives. Redemptions of shares should and do occur. Regardless of what comparisons to IOC shares might be legitimate, one difference remains and is critical: redemption payment. When a share is redeemed the co-operative must pay that redemption. Thus, rather than try to alter the constructs of the co-operative to make member shares fit the traditional definition established to describe IOCs, co-operatives should argue for a new concept of equity in their own context –

suited to the organisational form and business activities of a co-operative.

Developing a concept such as "Redemption Contingency" allows the co-operative to fairly report in their financial statements an estimation of the shares that might be redeemed in the year ahead. The share value represented as a "redemption contingency" meets the pertinent definition of a contingency under IFRS, which is:

> A contingent liability is: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity (International Accounting Standards Board, 2005).

These shares should appropriately not be considered equity, as they will not (likely) provide for the ongoing capital needs of the co-operative. However, those member shares that are outside of the redemption contingency should appropriately be considered as equity, for they represent a form of capital the co-operative can rely on has an element of stability and can be accessed in the course of business.

The past history of redemptions may not provide complete information concerning the likelihood of future share redemption requests. Future redemptions may increase or decrease for a number of reasons. Overall economic conditions may motivate co-operative members to seek redemption of shares, or conversely to decrease redemptions (especially if investment shares, as in the case above, are present, which may see investment levels increase in certain economic conditions). Internal factors specific to the co-operative itself may impact its ability to remain an ongoing concern, or effectively perform business activities and may also impact the volume of redemptions. One solution that may improve, but not perfect, the quality of information provided by a redemption contingency is a disclosure included in the management discussion and analysis, or as a note specific to the redemption contingency. Such a disclosure, through the inclusion of qualitative data might make the investor more able to judge the accuracy of the estimate provided in the redemption contingency.

In conclusion, the notion of redemption contingency is one possible way to recast accounting practice in the co-operative environment. It provides a method to produce financial reporting that is fair to the co-operative in terms of demonstrating is true value of capital, but provides information to stakeholders on contingent expenses that may impact the co-operative in the coming period. Member equity is reported in a fair fashion that is consistent with the operating principles of the co-operative, although it is neither consistent with existing accounting practice, nor with IAS 32 and IFRIC 2. The development of accounting practices, based on the principal of how co-operatives operate, rather than on trying to make co-operatives fit a mould that was created for IOCs is an approach that may generate financial information and reports for co-operatives that are more valuable to all stakeholders – not least of which is the co-operative and its members.

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Notes

1 Similar features can be found in the US Financial Accounting Standards Board, FAS 150.
2 International Accounting Standards Board, IFRIC 2, paragraphs 7-9.
3 UFA unabridged financial statements 2010, page 52.
4 UFA unabridged financial statements 2010, page 53.