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Co-operatives and the Equity-Liabilities Puzzle: Concerns for Accounting Standard-Setters

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SYNOPSIS: The IASB/FASB joint project on Financial Instruments with Characteristics of Equity (formerly Liabilities and Equity) has highlighted the complexity and the associated difficulty of drawing the line between liabilities and equity. While classification difficulties have been identified for investor-owned businesses (IOB), the inconsistency of the different approaches being considered is clearer when applied to classification of the financial instruments of co-operatives whose ownership characteristics differ from the IOB model. In co-operatives the existence of an upper limit on members' claims on the net assets while the co-operative is a going concern is a key ownership characteristic. We have examined the characteristics of co-operative member shares in six European countries as well as in the U.S. and in Canada, in order to analyze the application of the various classification approaches under discussion by the IASB and FASB. The results of this analysis indicate that classification criteria based on ownership must take account of the fact that ownership is multidimensional and contingent on the type of firm.

Keywords: equity-liabilities distinction; IASB; FASB; joint project; co-operatives; member's shares.

JEL Classifications: M41, P13.

BACKGROUND

The International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board's (FASB) joint project on financial instruments with characteristics of equity seeks to both improve and simplify current financial reporting requirements. Its objectives include eliminating more than 60 pieces of current U.S. accounting literature to support

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convergence of U.S. and international standards with the aim of providing investors with more decision-useful information (FASB 2007).

The joint project has considered a number of approaches and has sought to develop standardized criteria and a universally applicable solution, which can define equity instruments irrespective of differences in the type of ownership of the firm. Those financial instruments that fail to meet the stated equity criteria are then considered liabilities. As such, liabilities are a residual category. However, in this process, standard-setters start from the position that the predominant type of firm is the investor-owned business (IOB) and that therefore the reporting requirements of IOBs form the foundation for the universal standards.

At the same time, the FASB Statement of Financial Standard 141 Business Combinations (FASB 2007) provides an implicit recognition of the existence of different kinds of ownership across business entities when describing equity interests: "the term equity interests is used broadly to mean ownership interests of investor-owned entities and owner, member, or participant interests of mutual entities." Despite this recognition, the push towards standardization conflates these key differences in ownership and control in different types of business entities and therefore excludes exploration of the differences that exist in the equity-liability distinction for a range of other non-IOB firms.

Given that not all businesses have the same ownership characteristics, a financial instrument classification approach that rests purely on IOB ownership characteristics is unlikely to achieve universal applicability. Indeed an approach that does not recognize and address differences in ownership characteristics risks a misclassification of equity and liabilities for different forms of enterprise. Rather than providing a full catalog of different kinds of firms together with similarities and differences relevant to an equity-liabilities distinction debate, this paper seeks to improve understanding and add to the discourse on the equity-liabilities distinction project by considering the adequacy of the different approaches considered by the FASB/IASB project through a focus on a well-defined sector—co-operative firms. Co-operatives are a distinct form of mutual entity that typically transact with members of the co-operative as well as nonmembers.

It is by focusing on co-operatives as a specific type of member-owned business (MOB), or mutual, that the problem of developing a universal approach to equity-liabilities distinction can be illustrated.[1] Furthermore local and international standards already acknowledge differences with regard to co-operative ownership and associated reporting requirements, as outlined in the FASB statement above as well as: in Canada the EIC-72 Presentation of Members' Shares in a Co-operative Organization as liabilities or equity (CICA 1996a) and EIC-68 Patronage Allocations

[1] For example, Cooperatives Europe's comment letter regarding the Preliminary Views of the FASB states, "We think that an accounting standard that is designed for universal application should be suitable to different industries and legal forms of company. All types of enterprises and companies, regardless of their legal structure, may distinguish between assets and liabilities in a way that is conducive to economic substance capital contributed by the entities' owners. It is important to ensure that international differences in corporate law and capital instruments commonly used by businesses are adequately reflected.

However, the basic ownership approach takes a very specific approach to ownership that does not correspond to all forms of ownership. It is based on the presumption that an economic agent is acting to draw a maximum return from an activity and pass this return back to its shareholders. The *Preliminary Views* paper is clearly based on that kind of business as a starting point of view solely adequate for publicly listed companies rather than for cooperatives. It does not leave room for differing approaches to business and legal form. We encourage the FASB to review its point of view." A number of comment letters to Preliminary Views of FASB point out co-operative differences to IOB ownership. Approximately one third of the comment letters were from co-operatives and co-operative organizations including: the National Society of Accountants for Cooperatives (NSAC 2008), the National Cooperative Business Organization, and the Federal Home Loan Banks. Similar comment letters can be found, for instance, to IASB Exposure Draft of proposed Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation (IASB 2006) and to IASB Exposure Draft of Proposed Amendments to IAS 32 and IAS 39 (IASB 2002).

(CICA 1996b); in America, the American Institute of Certified Accountants' Statement of Position 85-3 (AICPA 1985) *Accounting by Agricultural Producers and Agricultural Cooperatives* and *Audit and Accounting Guide Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* (AICPA 2004); and in Spain, Order EHA3360/2010, December 21, in which the Accounting Standards for Specificities of Cooperatives was approved (ICAC 2010).

In addition co-operatives play a significant role in many economies. The International Co-operative Alliance provides details of the top 300 co-operatives worldwide (ICA 2008). The ICA Global 300 website notes that in 2008, the global co-operative sector aggregate turnover was 1.1 trillion USD. This is comparable to the size of the tenth economy of the world in 2008. At the same time, there appears to be relatively limited research and discourse on co-operatives in relation to generally accepted accounting principles (GAAP) and financial reporting. Thus, there are benefits in developing a deeper understanding of the nature of co-operative entities and in particular the characteristics of co-operative member shares including differences between member ownership characteristics and investor ownership characteristics.

Furthermore, the classification of financial instruments based on ownership requires development of an approach that recognizes and addresses the issue of unallocated equity (net assets held in common or held collectively) present in some forms of enterprise including co-operatives. The characteristics of co-operative member shares differ substantially to those of IOB shares. We suggest that key to understanding the difference is that there are two types of ownership evidenced in co-operatives, collective ownership and individual ownership, which when taken together represent the full amount of equity in a co-operative. This is in line with a multi-dimensional view of ownership (Hopkins et al. 2009) and suggests using only IOB ownership characteristics when classifying financial instruments as equity or liabilities is problematic.

The paper draws on accounting theory and theory of the firm (Singleton-Green and Hodgkinson 2010; Biondi et al. 2007) and examines co-operatives in six European countries (U.K., Spain, Germany, France, Italy, and Portugal) as well as North America (the U.S. and Canada), and identifies a number of co-operative member share characteristics. The impact of these characteristics is then considered in relation to the various proposals made regarding approaches to classifying financial instruments. The paper proceeds as follows. In the second section we describe the different approaches to debt/equity classification that have been proposed by FASB and IASB. In the third section we consider the characteristics of co-operative member shares in the countries studied. In the fourth section, drawing on the co-operative share characteristics identified in the previous section, we study co-operative member share classification under each approach and the adjustments that would be required to make the approach more relevant to the co-operative model of member ownership. In the fifth section we summarize our conclusions.

APPROACHES TO DISTINGUISHING BETWEEN LIABILITIES AND EQUITY

The classification of financial instruments as equity or liabilities is a complex and much debated issue (see Botosan et al. 2005, for an overview). This complexity and lack of clarity or agreement on equity-liabilities distinctions can have significant consequences. For example, Hopkins (1996) suggests that accounting classifications are used by financial analysts to interpret information, and that the balance sheet classification of hybrid financial instruments as liabilities or equity can influence common stock valuation judgments in respect of the price effect observed for straight debt and common equity security. Furthermore, Kimmel and Warfield (1995) suggest that redeemable preferred stocks do not have a debt-like impact on systematic risk, therefore their classification as a debt would not be adequate, while Clark (1993) affirms that only common shareholders' equity should be classified as equity and Kirschenheiter et al. (2004), for the case of employee stock options, conclude that a system that adopts a narrow view of equity is preferable to a system based on projections of future cash flow statements or diluted earnings per share calculations.

Moreover, alongside the innovations in financial markets, there has been an accompanying development of new financial instruments, some with the characteristics of equity and some with the characteristics of liabilities. While the academic community recognized these complexities and sought to address issues over time, this has tended to be reactive and related to specific, narrow issues. As such, the literature is viewed as inconsistent, subject to restructuring, or difficult to understand and apply (FASB 2007), leading some board members and others to question the current conceptual differentiation between liabilities and equity as set out in the Conceptual Framework (FASB 1990). This follows a substantial amount of work undertaken by the FASB following the addition to their agenda of a broad financial instruments project in 1986.

The first key document of the FASB project was the publication of the FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments, and Accounting for Instruments with Characteristics of Both* (FASB 1990). Later, in 2000 two Discussion Papers were issued and finally in 2003 the FASB Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (FAS150) was issued. Shortly after the issuance of FAS150, stakeholders, including co-operatives, raised questions about the classification of certain types of redeemable instruments. A number of them requested changes or delays.[2] In particular, co-operatives expressed concern over the FAS150 requirement that "a mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity." Co-operatives with redeemable member shares faced the prospect of seeing these shares reclassified from equity to liabilities.

As a result, and by means of FASB Staff Position (FSP) 150-3, the effective dates for applying the provisions of FAS150 to mandatorily redeemable shares of certain nonpublic interest entities, including member shares in co-operatives and certain mandatorily redeemable noncontrolling interests, were indefinitely deferred.

The FASB's new approach was to start over and attempt to develop a convergent set of classification principles that would avoid the issues raised by Statement 150, as well as resolve any remaining issues. Paralleling this activity, the IASB had also been considering the issue of equity-liabilities classification, which led to the revision of IAS 32 in 2003. However, as with FAS150, similar problems regarding the classification of co-operative shares were recognized and this led to the subsequent issuing of IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments* (IASB 2004). IFRIC 2 provided an equity classification solution for some co-operatives where the Board of the co-operative has the discretion to refuse to redeem member shares, but the IASB recognized that more work needed to be undertaken regarding the classification of financial instruments. [3]

By 2004, the FASB and IASB had decided to work together on equity-liabilities distinction and they added a joint project to their agendas to develop an improved, common, conceptual framework. Decisions on liabilities-equity classification were to be considered in conjunction with proposed amendments arising from the conceptual framework project.

[2] FASB Staff Position (FSP) 150-3 mentions a number of areas of concern expressed by various entities including the issue of the classification of mandatorily redeemable shares, what approach to take regarding purchase accounting for mandatorily redeemable noncontrolling interests, and unresolved implementation issues.

[3] IASB started a short scope project to amend IAS 32, issuing an Exposure Draft in June 2006 (*Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation*) and the final amendment in February 2008 (*Financial Instruments Puttable and Obligations Arising on Liquidation*).

This led to the publication, in 2006, of a Memorandum of Understanding (MoU): a roadmap for convergence between IFRSs and U.S. GAAP—2006 to 2008. One of the goals set out in the MoU is, "to have issued one or more due process documents relating to a proposed standard" on the distinction between liabilities and equity. This was quickly followed by *Preliminary Views on Financial Instruments with Characteristics of Equity* (FASB 2007), which describes three approaches for distinguishing liabilities and equity, a brief explanation of which is useful as all three classify basic ownership instruments as equity while also allowing for certain other instruments to be classified as equity.

The three approaches set out in the *Preliminary Views* of the FASB are:

- Basic Ownership Approach
- Ownership-Settlement Approach
- Reassessed Expected Outcomes Approach

The objective of the Basic Ownership Approach is to identify the owners of an entity and the instruments that will or may affect the net assets available to those owners. Under this approach, basic ownership instruments are classified as equity. All other instruments are liabilities or assets. In addition, puttable instruments can be basic ownership instruments if they meet two specific conditions.[4]

Two aspects of the Basic Ownership Approach are fundamental to a definition of equity: subordination and residual interest. Only instruments in the most subordinated class that are also entitled to a percentage of an entity's assets without limits (upper or lower) are equity. The basis for using these two characteristics is that holders of basic ownership instruments bear the ultimate risks and are entitled to the ultimate rewards of the firm. For the business entity, they are viewed as the one class of claimants without which the entity could not exist or operate. All other interests are potentially dilutive of the residual interest attributable to basic ownership interest. As we will discuss further in the "Classification of the Co-operative Member Shares under the Different Approaches" section, the requirement of no upper limit on entitlement to a percentage of the entity's assets is problematic for co-operatives.

Under the Ownership-Settlement Approach three types of financial instruments are classified as equity: the previously mentioned basic ownership instruments, perpetual instruments, and indirect ownership instruments. A perpetual instrument is defined in the glossary of *Preliminary Views* as an instrument that has no settlement requirement and entitles the holder to a portion of the issuer's net assets on liquidation. A perpetual instrument may be callable by the issuer provided that the issuer may settle the instrument but is not required to do so. They are seen as equity because they do not represent a present obligation. Indirect ownership instruments are based on and settled with direct ownership instruments. They are viewed as nascent equity whose holders become owners.

An instrument is separated into equity and non-equity components if it embodies an obligation and has both equity and non-equity outcomes with differing counterparty payoffs at the outcome date. All other instruments that are not equity instruments or are not separated are classified as either assets or liabilities.

Finally, the main objective of the Reassessed Expected Outcomes Approach (hereafter, REO) is to achieve the same accounting treatment for financial instruments with similar economic outcomes regardless of how the instruments are structured and issued. REO utilizes a probability-based measurement approach based on contingent claims modeling techniques. The approach is designed to determine the probability of an equity or non-equity payoff at the outcome

[4] They are: (1) The redemption amount is the same as the share of the issuer's net assets to which the holder would be entitled if it were to liquidate on the classification date; and (2) The terms of the instrument prohibit redemption if redemption would impair the claims of any instruments with higher priority than other basic ownership instruments.

date and to separate and classify the instrument's components accordingly. As a result, in addition to basic ownership instruments, this approach classifies as "equity" those instruments or components of instruments whose fair value changes and moves in the same direction as the fair value of a basic ownership instrument, and as "contra-equity" those instruments or components whose fair value changes in the opposite direction.

The FASB concluded that the Basic Ownership Approach was the preferred option (FASB 2007). The reason given was that it classifies only the lowest residual interests in the entity as equity. This was seen as the clearest and most unambiguous way of determining which financial instruments are equity. In the opinion of FASB, it is simpler and easier to apply than the other two approaches, and its narrow definition of equity limits the number of opportunities to structure instruments and arrangements for the achievement of a given desired accounting treatment. However, following analysis of the comment letters, the IASB and the FASB (hereafter the Boards) noted that the majority of respondents did not support the Basic Ownership Approach and identified several criticisms of it. The Financial Reporting Policy Committee from the American Accounting Association concluded that the principles underlying the Basic Ownership Approach were not clearly defined, were not consistent with the extant conceptual framework, and would increase the heterogeneity of financial instruments reported in liabilities (see Hopkins et al. [2009] for a more detailed discussion). Increased heterogeneity would, it was argued, reduce decision usefulness of reported equity and liabilities information.

In response, in 2008, the Boards considered a number of other approaches: the Loss Absorption Approach; the Participation Approach; the Claim Approach; and the Mezzanine Approach, as well as IAS 32 (without modification and including IFRIC 2) and a modified IAS 32 with amendments made to the standard to address issues identified by respondents during consultation.

Both the Claim and the Mezzanine approaches were rejected. The former, which eliminated the distinction between liabilities and equity, was not regarded as resolving the question of which claims affect the net income and how the claims are measured. The latter proposed a new element between liabilities and equity, and was viewed as avoiding classification and failing to address how to measure and report the instrument in the income statement. The Loss Absorption Approach, elaborated on by the Proactive Accounting Activities in Europe Working Group (PAAinE), considers participation in losses as the key factor for distinguishing equity from liabilities. Capital is classified as equity if the amount of its claim on the entity's net assets is reduced if the entity incurs a loss. The Participation Approach classifies an instrument (or component) as equity if it participates without an upward limit in the proceeds of a disposal of the reporting entity (or a business within that entity).

From this deliberation, the Boards used the principles underlying the Perpetual and the Basic Ownership approaches as their starting point, resulting in "Approach 4" (in October 2008 followed by 4.1 and 4.2).

The following year, in May 2009 the Boards declared tentatively that, "Claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument. However, they may help to classify otherwise borderline instruments." In October 2010 the FASB and IASB acknowledged that they did not currently have the capacity to deliberate on the project issues and decided to return to this project when they had the requisite resources.[5] However, at the time of writing the equity-liabilities distinction project shows important, albeit at this stage tentative, changes, with the inclusion of perpetual instruments and the classification of certain redeemable

[5] According to information on FASB web pages, the project was reassessed as a lower priority project and further action was not expected before December 2011. According to IASB web pages, IASB paused the project in 2010 due to capacity limitations. If and how the IASB will proceed with the project will depend on the outcome of IASB's ongoing deliberations about its future work plan.

instruments as equity.[6] Significantly, this could mean that co-operative member shares will be classified as equity because holders own these instruments in order to engage in transactions with the entity or otherwise participate in the activities of the entity, and the instrument's terms require, or permit the holder or issuer to require, redemption when the holder ceases to engage in transactions or otherwise participate.

CO-OPERATIVE MEMBER SHARE CHARACTERISTICS

As suggested in the introduction, the proposed equity-liabilities characteristics and criteria are not inclusive of the range of ownership models that exist. We have suggested that co-operatives, like other non-IOBs, are different and find the current approach to the classification of financial instruments to be problematic. While this is also true of other different organizational forms and ownership models (for example partnerships)[7], the difficulties associated with applying a universal standard based on IOB characteristics are more starkly highlighted when looking specifically at one distinct type of non-IOB entity; in this case co-operative firms.

In this section, we identify and explain co-operative member shares characteristics—one of the key differentiators of MOBs from IOBs. We look at co-operative shares in a number of countries in order to identify those characteristics that are universal and fundamental to co-operative ownership. This also provides an opportunity to identify ownership characteristics that differ between countries, mainly in relation to rights to residual assets, which can impact on the classification of member shares as equity or liabilities. Following this, in the "Classification of the Co-operative Member Shares under the Different Approaches" section, we review the classification of co-operative member shares under FASB's *Preliminary Views* approaches.

Birchall (2011) suggests that co-operatives can be usefully defined as a form of member-owned business (MOB), and offers the following definition of a MOB: "A business organization that is owned and controlled by members who are drawn from one (or more) of three types of stakeholder—consumers, producers, and employees—and whose benefits go mainly to these members" (Birchall 2011). In this respect, co-operatives do not have the same distinction between shareholders (for MOBs substitute shareholders for members) and other stakeholders (Arruñada 1998) as that which is applicable to IOBs. Furthermore, in their discussion of property rights in co-operatives Chaddad and Cook (2004) characterize traditional co-operatives as having the following attributes: "ownership rights are restricted to member-patrons, residual return rights are nontransferable, non-appreciable, and redeemable; and benefits are distributed among members in proportion to patronage." They sum these up as representing a "vaguely defined" property rights structure.

In relation to co-operative member share characteristics we can identify a number of points of difference from IOB shares. The member share typically is both a vehicle for gaining membership rights while also providing one form of member owner capital.[8] Voting rights and economic benefit through operational transacting are attached to membership rather than to each individual member

[6] Decisions reached at the October 22, 2010 FASB/IASB meeting.

[7] A general partnership is classified as equity in the *Preliminary Views* under the three approaches (see example Number 3 of Table 2 in the *Preliminary Views*). In common with IOBs, general partnership residual claims are based on the number of shares held and do not contain an upper or lower limit. But, we cannot say that a general partnership or any partnership could be considered an IOB. There are important differences between them. Partnerships are closed firms where residual claims are restricted to decision agents, furthermore in these firms the involvement as partner is more than simply a capital investment (shares held). Many partnerships can establish complex equity agreements, for example income sharing, distribution provisions, etc., that are not typical of IOBs in a corporate structure. Partnerships are a further example of a type of firm that has been under addressed in the *Preliminary Views*.

[8] The member share is not always the only avenue through which the member provides capital to the co-operative; however, regardless of the amount involved, the member share does always represent one form of member owner capital.

TABLE 1

Differences between Co-operative and Investor-Owned Businesses

Areas of Difference	Co-operative	Investor-Owned Businesses
Ownership structure	Members	Shareholders
Capital structure	Includes: • Member shares are issued and redeemed at par value • Reserves held in common	Includes: • Member shares are issued and redeemed at fair value (either under going concern [if member shares are redeemable] or at the liquidation of the entity) • Reserves belong to shareholders
Nature of owners' stake	Capital provider and day-to-day user and/or employee of co-operative	Investor
Residual risk	Resides with members	Resides with shareholders
Management accountability	Member Board	Board of directors
Ownership change	Shared collective ownership for life of membership	Buying/selling of shares

Source: Lewellyn (2004).

share. Because members are necessarily users of the co-operative, member shares usually have limited transferability and subsequently are typically redeemable when members finish their relationship as users of the co-operative. When members leave, they leave some assets (net assets held in common) in the co-operative, for the continuation of co-operative activities in meeting existing and future members' needs (Myners 2004). Because of this, the residual rights of members are usually limited and co-operative member share-redemption value is frequently limited to its par value. Table 1 summarizes a number of key differences between co-operatives and investor-owned businesses.

Co-operative legal structures, of course, vary from one country to another. In our study we found countries where co-operatives have particular legal forms (Canada, Germany, Italy, Portugal, and Spain). In other countries (France, U.S., and U.K.) co-operatives do not have their own particular legal form, but rather have a range of options concerning the type of registration, incorporation, and governing document adopted. Although there are differing national legal environments, underlying these frameworks is a common concept of "co-operative." This is promoted through the International Co-operative Alliance Statement on the Co-operative Identity (ICA 1995), which sets out a number of co-operative values and principles.[9] These include a particular member ownership structure; principally: open membership, democratic member control, and member economic participation in the co-operative for the benefit of members.

While noting the variations to be found across sectors and jurisdictions, we identify a number of common characteristics of co-operative member shares that indicate key differences from the IOB common share (see Table 2).

The associative structure of co-operatives impacts the characteristics of member shares. Member shares provide the co-operative with risk capital and provide members with access to membership, voting rights, and access to economic benefit linked to participation. While members are members, they control the assets of the co-operative, control distributions of accumulated surplus, bear the risks, and receive the benefits of economic participation. When members leave the

[9] The seven principles are viewed as the practical expression of co-operative values.

TABLE 2
Share Characteristics

Share Characteristics	Co-op Member Share	IOB Common Share
Dual function	Yes	No
Issue price	At par (nominal) value	Unrestricted
Right to elect Board	Yes	Yes
Right to attend AGM	Yes	Yes
Economic benefit primarily from membership participation	Yes	No
Economic benefit primarily from shares held	No	Yes
Entity imposed ceiling on dividends and interest	Yes	No
Transferability	No or limited	Yes
Redeemable at cessation of membership	Yes	No
Redeemed at par value	Yes	N/A
Voting rights	Vote attached to membership	Vote attached to each share
Net assets held in common	Yes	No
Limited liability	Yes	Yes
Most subordinated class	Yes	Yes
Absorb losses	Yes	Yes

co-operative they redeem their shares; lose their ownership, voting, and control rights; and leave behind the net assets held in common in the co-operative.[10]

Two key differences between co-operative member shares and IOB common shares, and relevant to the equity-liabilities distinctions are:[11]

- Redeemable shares
- Restrictions on the distribution to members of residual assets in the event of liquidation of the co-operative

Typically, member shares are redeemable when a member leaves the co-operative. Most member shares are redeemed at par (nominal) value. Although we have found some small variations across the countries studied,[12] in almost all cases the redemption value is not based on the value of the total net assets of the co-operative.[13] Furthermore, redemption value is not guaranteed, as previous losses may have to be deducted.

[10] Myners (2004) mentions the special ownership relationship found in mutuals and considers it equally applicable to co-operatives.

[11] For accounting classification purposes the redemption amount of members' shares is studied under two scenarios: going concern and liquidation of the cooperative. The scenario of conversion of a co-operative to an IOB is not considered because it is not central to the discourse on accounting classification. Nevertheless, there are cases such as Spain where the individual ownership interest is limited usually at par value of shares and there may be cases where there is no limitation on co-operative equity. In Spain, in the case of conversion, assets above liabilities in excess to par value of shares have to be transferred to another co-operative or co-operative association.

[12] Par value can be written up through capitalization in Italy, Spain, and in some cases in France. In Portugal, voluntary reserves can be distributed on the basis of patronage. In Canada, no-par-value membership shares can be issued.

[13] In some cases in Canada, redemption value would be based on the full net assets of the co-operative (i.e., where no-par-value membership shares redeemable at fair value existed). In Italy, the reimbursement of members' shares of Banche Popolari takes place at a value determined by the General Assembly and based on the net assets reported in the last approved balance sheet (European Association of Co-operative Banks [EACB] 2007).

In the case of Canada, there are par-value membership shares that are issued and redeemed at par value and non-par-value membership shares that are issued at a set price or formula, which is set out in the statutes of the co-operative or if any price or formula is not set out, at fair value. In the case of the U.S., some co-operatives redeem members' shares upon withdrawal, while some co-operatives have a policy of releasing allocated patronage returns (members' patronage allocations held by the co-operative) over a period of time and as the financial condition of the co-operative allows (National Cooperative Business Association [NCBA] 2008). In both cases redemption of member shares has to be approved by the Board and is also dependent on there being sufficient funds available to carry out redemption without impacting on the financial viability of the co-operative. Furthermore the amount redeemed is no more than the nominal amount of member shares and the allocated equity (allocated patronage returns).

Redemption of co-operative member shares, therefore, clearly differs from redemption of shares in an IOB. Issuance and redemption of membership shares at par makes sense within the context of a membership relationship to the co-operative. As Chloupkova (2002) points out, the financial objectives and concerns of members are more likely to center on their participation in and interaction with the co-operative, as workers, suppliers, or consumers. In contrast with IOBs, the co-operative-member relationship has less to do with maximizing return on shares and more to do with, for example: improving access to markets, goods, and services; and employment, wage, price, stability, work environment, safety, and assurance.

Where a co-operative is liquidated, the redemption value of co-operative member shares is frequently limited to par value, after pro rata deductions for losses. Usually members can decide how the remaining funds are used within limits (e.g., transferred to another co-operative, co-operative association, or other public interest entity). There are some exceptions in the U.K., and Italy (EACB 2007).[14] In Portugal, disposal of residual co-operative assets is very restricted; only voluntary reserves[15] can be distributed if the governing documents of the co-operative specifically establish this right. Similarly in Spain, voluntary reserves can be distributed if so established by the co-operative governing documents and/or the general meeting agreement.[16]

In Germany, the law does not set out any limitations on the distribution of residual assets, therefore once all shares are redeemed at par value, the remaining net assets can be distributed between members. However, this distribution is on a per capita basis based on the number of shareholding members and not the number of shares. In addition, governing documents can establish limits on the distribution of net assets and other distribution criteria. According to EACB (2007), member co-operatives of Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR, the central organization of the co-operative banking group) do not set limits or other criteria. Also, analysis of governing documents of some German agricultural co-operatives indicates that they do not set limiting criteria in relation to the distribution of residual assets.

Typically, U.S. co-operatives allow for the distribution of net assets to members in the event of liquidation of the co-operative. All residual assets in excess of membership shares and allocated equity are distributed to current and former members, however, once again, this is not in proportion to shareholding. Rather it is in accordance with the members' patronage over the life of the organization, to the extent that it is practicable to calculate. According to the NCBA (2008), former members may receive a differing proportion from that applied to current members. This could result

[14] For example, member co-operatives of Banche Popolari in Italy and some co-operatives in the U.K.

[15] Voluntary reserves are discretionary and can be established by the co-operative's general assembly or its equivalent. They are not mandatorily established by law or statutes.

[16] Specifically in Spain, if a member of the liquidating co-operative is going to join another co-operative, the member can demand that a proportion of all remaining residual net assets (calculated on per capita basis) be transferred to the co-operative they are joining.

in a smaller distribution for former members and, depending on the characteristics of bylaws, may be limited to the face amount of allocated equity.

In Canada, co-operative governing documents can establish the criteria for distribution of the remaining net assets after the payment of shares (usually par value) between the members in any manner. Options include equal distributions to members, a formula based on patronage returns, or a requirement for members to vote on distributing the remaining net assets to charities, non-profit organizations, or co-operatives.

CLASSIFICATION OF THE CO-OPERATIVE MEMBER SHARES UNDER THE DIFFERENT APPROACHES

We now consider the resulting classification of co-operative member shares when applying the different approaches discussed in the "Approaches to Distinguishing between Liabilities and Equity" section. Drawing on the characteristics identified in the Co-operative Member Share Characteristics" section, Table 3 summarizes the characteristics of member shares that are determinants found in the various approaches to the classification of financial instruments.

Co-operative member shares in all the countries studied are the most subordinated financial instrument, i.e., they have no priority over any other claims on the net assets of the co-operative if the co-operative were to liquidate. Table 3 takes account of their subordinate status and reflects the redemption value of a member's shares in two scenarios:

a. The withdrawal of the member from the co-operative where the co-operative continues operating (going concern basis).
b. The redemption value of shares and claim on net assets in the event of liquidation of co-operative.

To classify co-operative member shares it is necessary to know the redemption amount under the two scenarios because of the treatment of puttable instruments under the Basic Ownership Approach. In order to qualify as equity under the Basic Ownership Approach, when the holder exercises the put option, the instruments have to be redeemed with an amount that is the same as the share of the issuer's net assets to which the holder would be entitled if it were to liquidate on classification date.[17] Figure 1 represents the redemption values of co-operative member shares in the case of an existing member, i.e., a member leaving the co-operative, where the co-operative continues operating (going concern).

Line (1) reflects a financial instrument that fully participates in the net assets of the entity. This is the case in Canada for no-par-value membership shares when no price formula or price is set out in the governing document, which can then be redeemed at fair value; and the members' shares of member co-operatives of Banche Popolari in Italy. Line (3) reflects the traditional member's share that is redeemed at par (nominal) value.

Line (2) reflects a low participation in the net assets of the co-operative above the par value of the share. This is the case for some co-operative member shares in Spain, Italy, France, and Portugal, where par value can be written up through capitalization and/or distributing free reserves.

In the case of the U.S., when a co-operative redeems a member's shares upon their exiting the co-operative, the redemption value of member's equity is close to Line (1). This is when unallocated equities are a small part of the co-operative's equity.

[17] Preliminary Views Financial Instruments with Characteristics of Equity (FASB 2007, para. 21).

TABLE 3

Redemption Value of the Members' Shares and Claim on Net Assets

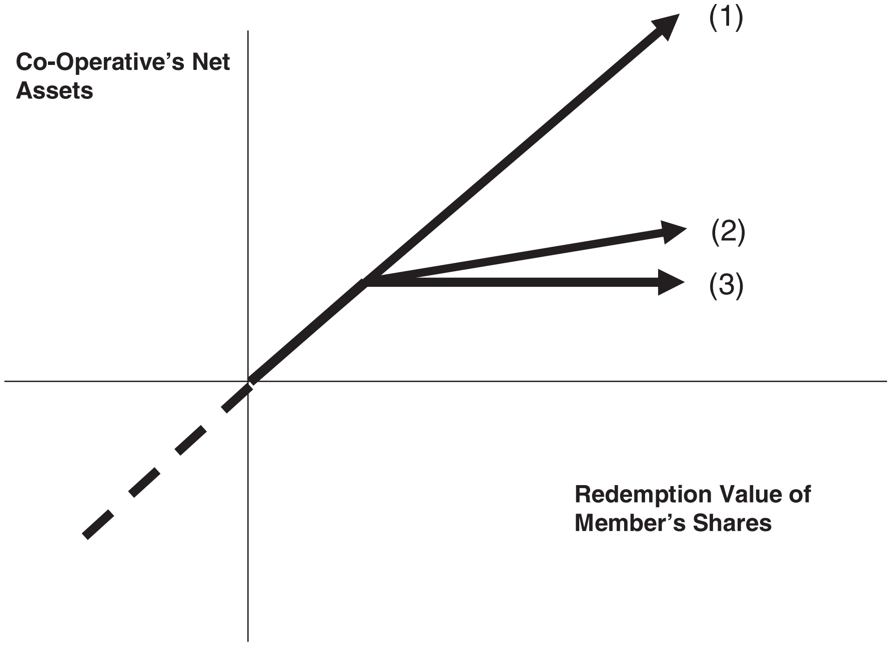
Country	Cooperative Going Concern (Withdrawal of the Member)	Liquidation of the Co-operative
Canada	• Par-value membership shares: limited to par value after deduction of any losses allocated to the member share on a pro rata basis, or • Not-par-value membership shares: at price or formula that is set out in statutes or at fair value if any price or formula is established.	After the redemption of membership shares, remaining net assets can be distributed: (a) among the members at the time of dissolution, in any manner, including equally among the members irrespective of the number of membership shares or amount of member loans, if any, held or made by a member; (b) among the members at the time of dissolution on the basis of patronage returns accrued to those members during a stated period before the dissolution; or (c) to charitable organizations or co-operative entities.
France	At par value, after deduction of all pro rata losses.	At par value. Remaining net assets are distributed to other co-operatives, co-operative associations, or general interest organizations.
Germany	At par value, after deduction of all pro rata losses.	Law does not impose upper limit. After all shares are redeemed at par value, remaining net assets are distributed on a per capita basis (pro rata to the number of shareholders).
Italy	At par value, after deduction of all pro rata losses. Exception: in co-operatives of the Banche Popolari, at the value of the shares, as determined by the General Assembly according to the outcome of the last approved balance sheet and on the basis of the net assets.	At par value. Remaining net assets are distributed to Mutual Funds for the promotion and development of co-operatives. Exception: in co-operatives of the Banche Popolari, net assets are distributed to members without upper limits.
Portugal	At par value, after deduction of all pro rata losses.	At par value. Remaining net assets are distributed to another co-operative or co-operative association.

(continued on next page)

TABLE 3 (continued)

Country	Cooperative Going Concern (Withdrawal of the Member)	Liquidation of the Co-operative
Spain	At par value, after deduction of all pro rata losses.	At par value. Remaining net assets are distributed to another co-operative or co-operative association, or, if either of these options are not available, then to the State.
United Kingdom	At par value.	At par value. Distribution of residual assets depends on rules set out in the cooperative's governing document/s. Some UK co-operatives would distribute residual assets to other co-operatives, co-operative development agencies, or charities. Other UK co-operatives would distribute residual assets to members, applying formulas set out in their governing documents or decided on by the existing membership.
U.S.	In cases where a co-operative redeems shares, membership shares and allocated equity are redeemed at par value.	At par value (membership shares and allocated equity). Distribution of residual assets is dependent on local legislation and regulation as well as the co-operative's bylaws. Usually U.S. co-operatives would allocate residual assets to members on a patronage basis, others may apply other formulas, and some may allocate residual assets to a co-operative or charitable fund.

FIGURE 1
Co-operative's Net Assets and Redemption Value of the Members' Shares (Going Concern)



Line (1): Member's share redeemable at fair value; Line (2): Member's share redeemable at par (nominal) value plus a little participation in net assets; Line (3): Member's share at par (nominal) value.

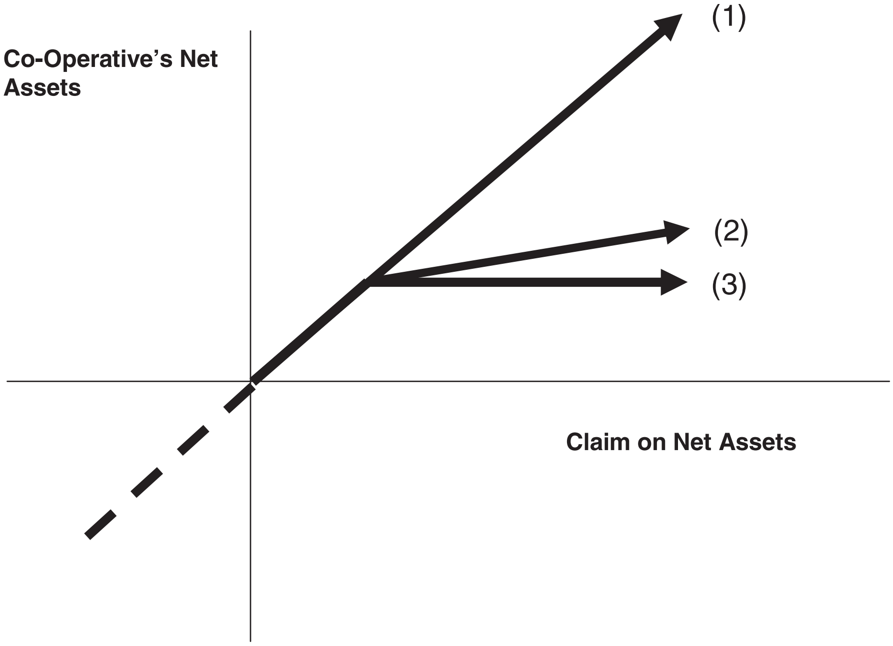
The common line segment is equal to all co-operative member shares; it reflects full participation in net assets when they are less than the nominal amount of members' shares (full downside participation), because in all of the variations, member shares are the most subordinated financial instrument and are not guaranteed. The dotted line reflects some cases where members' liability for potential losses is not limited to par value.

Figure 2 represents the members' claim on net assets in the event of liquidation of the co-operative. Although Figure 2 shows the same lines as in Figure 1, redemption value could be different in the case of liquidation as opposed to the case of a going concern, depending on country, legal form, and/or governing document of the co-operative.

In the U.S., when members' shares are redeemed upon exiting the co-operative, the total redemption amount, in the case of both a going concern and liquidation of the co-operative, could be similar but not the same. This is because only unallocated equities would be distributed in the event of the liquidation of the co-operative. In Germany, members' claims in the event of liquidation differ from claims where the co-operative is a going concern. On liquidation of the co-operative there are no upper limits on members' claims to the residual assets and they are distributed on a per capita basis.

While there are variations, the other countries studied generally adopt the same approach for co-operative members' claims in the event of liquidation as with going concern situations. That is, where claims on net assets are limited to the par value of the share less all pro rata losses.

FIGURE 2
Co-operative's Net Assets and Claim on Net Assets (Liquidation of the Co-operative)



Line (1): Claim on net assets without upper limit; Line (2): Claim on net assets with upper limit at par (nominal) value plus small participation in net assets; Line (3): Claim on net assets with upper limit at par (nominal) value.

The classification of typical co-operative member shares, exemplified by Line (2) in Figure 3, has not been addressed in the FASB and IASB Summary of Principles of each approach. This is because these documents are focused on financial instruments of public IOBs.

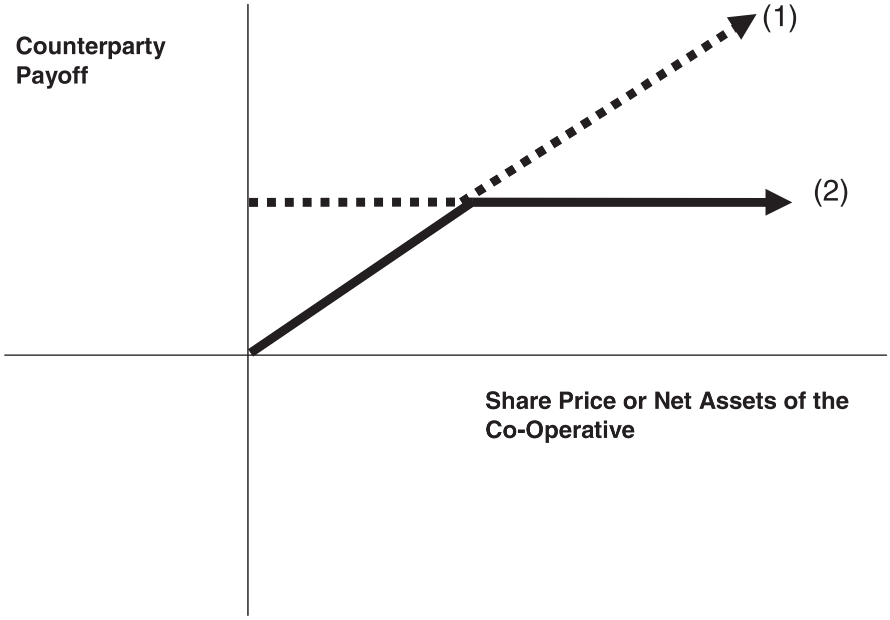
If we look at the classification examples of the *Preliminary Views* of FASB[18] seeking a similar instrument to member shares, we find an instrument that is puttable at fixed price. However, if we compare the payoff of a share puttable at fixed price (FASB 2007, Appendix C of the Preliminary Views, Table 2, example number 16), shown in Figure 3, Line (1), to a co-operative member's share redeemable at par value (Line (2)), they result in just the opposite payoff.

The IOB share puttable at fixed price has a guaranteed claim. When the share's price is below that fixed price the holder can put the share at the fixed price, and it does not have an upper limit when the share's price is above the fixed price. In contrast, the co-operative member share does not have a guaranteed redemption value and does have an upper limit, which is the par value of the share. Therefore, we can affirm that the characteristics of co-operative member shares differ substantially to those of IOB puttable shares.

Now we turn to the classification of co-operative member shares under the approaches explained in the "Approaches to Distinguishing between Liabilities and Equity" section. Basic ownership instruments are classified as equity in all the approaches set out by the FASB and IASB. We will therefore first analyze classification under the Basic Ownership Approach.

[18] Preliminary Views Financial Instruments with Characteristics of Equity (FASB 2007, Appendix C, Table 2).

FIGURE 3
Share Puttable at Fixed Price and Co-operative Member's Share



Line (1): Share puttable at fixed price; Line (2): Co-operative member's share redeemable at par (nominal) value.

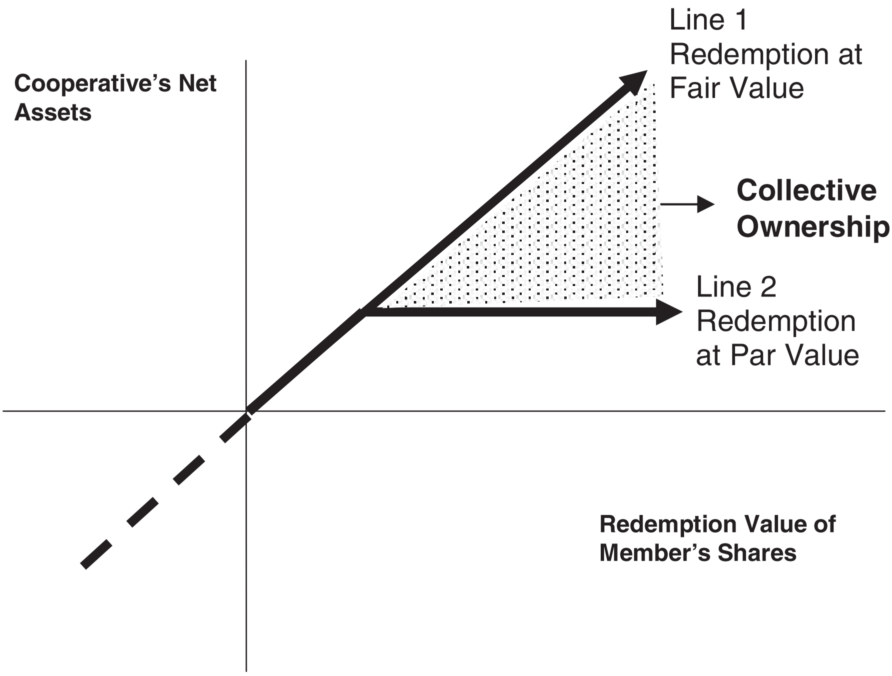
Classification under the Basic Ownership Approach

Co-operative member shares are usually redeemed at nominal value (upper limit), and for this reason they are classified as liabilities under the Basic Ownership Approach. Only if co-operative member shares are redeemable at fair value[19] will they be classified as equity. In the case of U.S. co-operatives, as explained earlier, the redemption amount may differ depending on whether the member is exiting a going concern or a co-operative undergoing liquidation. Therefore such shares do not meet the definition of basic ownership instruments. However, as NCBA (2008) pointed out, a typical U.S. member share is neither a mandatorily redeemable instrument nor a puttable instrument, because decisions by the co-operative regarding redemptions are discretionary.[20] Therefore, the redeemable characteristic of the instrument would be more akin to a callable share.

Based on the classification of a callable share at fixed price as equity under the Ownership Approach (FASB 2007)[21] it would be reasonable to conclude that most U.S. co-operative members' shares would be classified as equity. Similarly, German co-operatives that can refuse redemption of shares would classify their member shares as equity because there is no upper limit on members'

[19] Banche Popolari in Italy and member shares redeemable at fair value in Canada.
[20] Board of Directors of the co-operative has the authority to determine whether and when a payment may be made.
[21] See classification example number 19 (FASB 2007). But this classification is not argued in any document. Callable common shares at fixed price are classified as equity under the old Ownership Approach because they are perpetual (see Summary of Principles of Ownership Approach [FASB 2006]). The old Ownership Approach comprised perpetual equity and basic ownership instruments, but the Basic Ownership Approach only treats basic ownership instruments as equity and not perpetual instruments.

FIGURE 4
Collective Ownership



Line 1: Member's share redeemable at fair value; Line 2: Member's share at par (nominal) value.

claims on net assets in the case of the liquidation of the co-operative. Co-operative member shares in other countries and shares of former co-operative members in the U.S. usually would be classified as liabilities, because they have an upper limit on their claim to the net assets of the co-operative.

Yet, the Basic Ownership Approach would be workable for co-operatives if the concept of collective ownership were introduced. The redemption value of co-operative member shares is usually limited. The difference between redemption at fair value and the actual redemption value is a "social return," also called collective ownership.[22] This contributes to the continuation of the co-operative in the case of withdrawal of the member, or the support of other co-operatives in the event of liquidation. This is an important difference to an IOB, where the redemption is at fair value.

If we take collective ownership and individual ownership together, then the total payoff is similar to that found with IOB common shares. Therefore, it is clearly arguable that taken together, collective ownership and individual ownership represents the full amount of equity in a co-operative. To further illustrate this point, Figure 4 shows the maximum collective ownership as the difference between the redemption at par value and the redemption that could take place at fair value.

[22] Collective ownership refers to the indivisible reserves retained by the co-operative to meet the needs of future members and assist in resourcing the future development of the co-operative. In the event of liquidation of the co-operative, the collective reserve is transferred to another co-operative, co-operative association, or similar entity. Therefore there are no individual member claims on the collectively owned reserve.

The amount of collective ownership, that is the social return of the co-operative, will depend on the legislation of each country and the governing document of each co-operative. Collective ownership, therefore, can vary within the range of possibilities allowed by the applicable legislation.

To develop a classification criterion based on ownership, it is necessary to take account of the fact that ownership is multidimensional and contingent upon the type of firm. In co-operatives, the existence of an upper limit on members' claims on the net assets while the co-operative is a going concern is an ownership characteristic. The risks and rewards of co-operative ownership derive substantially from membership that combines the benefits arising from doing business with the co-operative with participation on distributions of surpluses based on the volume of member transactions with the co-operative and not solely on the proportion of shares held.

Classification under the Ownership-Settlement Approach

The difference from the previous approach is related to the classification of equity as:

a. Other perpetual instruments in addition to basic ownership instruments
b. Indirect ownership instruments settled by issuing basic ownership instruments

Under this approach more co-operative member shares would be classified as equity. In addition to basic ownership instruments, all co-operative member shares considered to be perpetual instruments would be classified as equity. This approach retains the current classification found under the IFRIC 2.

Co-operative member shares that the co-operative can refuse to redeem satisfy the definition of perpetual instruments because they lack a settlement obligation and entitle the holder to a portion of the issuer's net assets on liquidation. The *Preliminary Views*[23] establish that the portion of the net assets can be fixed or variable. In addition co-operatives commonly issue some perpetual instruments; therefore consideration of this approach is relevant to co-operatives.

Co-operatives do not usually have indirect ownership instruments. This is because they are MOBs and the main purpose of co-operatives is to benefit members by means of their economic participation in the day-to-day business activities of the co-operative. Becoming a member is commonly subject to approval of the Board of the co-operative and/or based on specific criteria to be met linked to member participation. Consequently, indirect ownership instruments would not be expected to arise under co-operative member ownership.

Classification under the Reassessed Expected Outcomes Approach

Application of REO to co-operative member shares appears to give rise to confusing results, in particular where co-operative member shares have upper limits on claims to the businesses' net assets. Figure 3 shows two different outcomes. The share is classified as equity when the member share is redeemed at less than par value and represents a proportional claim on net assets (either in an ongoing basis or on liquidation of co-operative). The share is classified as a liability when the member share is redeemed at par (nominal) value and does not represent a proportional claim on net assets. Therefore, co-operative member shares are initially separated into equity and liability components, based on the probability of the occurrence of each outcome. At each reporting date, the two components would be remeasured, taking into account the revised probabilities of each outcome. This would result in a very small equity component. The equity component would increase when the probability of the redemption amount at less than par value increases. Therefore,

[23] FASB (2007, para. A3).

REO would report a greater equity component when the co-operative performs poorly and a greater liability component when the co-operative performs well. This result could be seen as misrepresentative. If we consider that both payoffs (par value and less than par value) are results of the ownership relationship in a co-operative, under REO the quantity of members' shares reported as a liability is greater when the co-operative performs well, yet in these circumstances the co-operative would be more financially stable.

Classification under Other Approaches

Under the Loss Absorption Approach, co-operative member shares are classified as equity because they fully participate in the down side. In contrast, under the Participation Approach, co-operative member shares are classified as liabilities because they have an upper limit on their claim on net assets.

The study of the classification of co-operative member shares under alternative approaches enables us to see the resulting variability in their classification as equity or liabilities. For co-operatives, this variability is linked to their MOB model.

CONCLUSIONS

The current project on liabilities and equity has once again revealed the complexity and the difficulty of deciding where and how to draw the line between liabilities and equity. The FASB started with the Ownership-Settlement Approach as the preferred method, later changed to the Ownership Approach, modified this to the Ownership Approach with only basic ownership instruments classified as equity and renamed it the Basic Ownership Approach. Following the comment period, the IASB and FASB started over, using the principles underlying the Perpetual and Basic Ownership approaches. But under both approaches traditional co-operative member shares redeemable at par value would be classified as liabilities.

Pursuing an approach based on ownership requires developing a definition of ownership that does not rest purely on the IOB model and their related share characteristics and that would tackle the issue of unallocated equity (net assets held in common). The notion of common, collective ownership, present in other forms of enterprise including co-operatives, has to be considered in order to avoid a misclassification of equity and liabilities between different forms of enterprise.

With the issuing of *Preliminary Views Financial Instruments with Characteristics of Equity* (FASB 2007), FASB has indicated that they currently view the Basic Ownership Approach as providing decision-useful information for investors and a simplified accounting approach. Tentative decisions made after *Preliminary Views* in the long-term FASB/IASB project have adopted, at the time of writing, an equity-liability distinction based on perpetual instruments that, contrary to the Basic Ownership Approach, also states, "claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument." Moreover some exceptions are included. In particular, one exception relates to co-operatives. Financial instruments where the holder must own the instrument in order to engage in transactions with the entity or otherwise participate in the activities of the entity, and the instrument's terms require or permit the holder or issuer to require redemption when the holder ceases to engage in transactions or otherwise participate, will be classified as equity.

In our view these exceptions are recognition of the need to take account of differing ownership characteristics found in different types of organizations. This includes situations where financial instruments are redeemable. This characteristic of ownership found in certain types of organizations, including co-operatives, is not captured strictly by the residual claimant characteristic. This paper does not offer a solution or a set of criteria for distinguishing equity and liabilities, but rather points to the need to take account of different types of business ownership and their differing ownership characteristics when developing classification criteria that define equity based on ownership.

We agree with Hopkins et al. (2009) in that proprietary ownership is multidimensional, and that each dimension must be recognized. Furthermore, these dimensions are contingent on the type of business; this adds complexity and makes it extremely difficult to distinguish equity and liabilities based on a single criterion.

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