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## WHAT ARE SHARES IN THE CAPITAL OF A CO-OPERATIVE

A co-operative is a company and a “share” represents a fraction of that company’s capital. This applies in national law and it also applies in EU law<sup>1</sup>.

Therefore, shares in the capital:

- cover the risks to which co-operatives are exposed, in the sense that the enterprise’s losses are charged to them,
- confer on all co-operators a right to the reserves when the cooperative is dissolved,
- earn a dividend, deducted at the end of the financial year, from the distributable profit,
- are transferable or negotiable,
- grant a right to vote at the General Assembly, thereby making it possible for the shareholder to participate in company policy.

Thus, shares in the capital have the same fundamental characteristics as the instruments of capital in corporate undertakings generally or as shares in a company based on a share capital structure (where a co-operative is constituted in the form of a company with share capital). This is so even if their specific implementing regulations may not always be obvious to the casual observer.

This memorandum will seek to prove the way in which shares in the capital of a co-operative are totally compatible with the definitions given in IAS 32 §5.

In effect, IAS 32 states that:

- an **equity instrument** is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.
- that a **financial liability** implies a contractual obligation to pay (...) in cash to a third party.

<sup>1</sup> Council Regulation No. 1435/2003 of 22 July 2003 on the European Co-operative Society (article 1 §2)



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### **A share in the capital is an equity instrument...**

In the case of the resignation, expulsion or decease of a shareholder-member, shares in the capital shall not be refunded (cf. infra) at the General Assembly that had approved the accounts for the year in which resignation occurred until they have been charged to losses entered into the balance sheet at the face value of the shares. Moreover, shareholder-members who tender their resignation from the co-operative remain bound for five years to all their commitments existing at the time of resignation. This is a provision that could not apply to an instrument of liability.

Similarly, where a co-operative is dissolved, the net assets remaining, following payment of debts and refund of shares in the equity at their face value, become the property of other co-operatives. This makes it perfectly clear that the capital of a co-operative is not an instrument of liability.

Where shares in the capital do not confer on the bearer an individual right to the reserves, they nonetheless confer a collective right on all co-operators, a right totally alien to any idea that equity is considered a liability.

All in all, shares in the capital of a co-operative grant entitlement to a residual interest in the entity's equity.

### **...and not an instrument of liability**

Shareholder-members in co-operative societies are not only individuals who subscribe capital on a par with shareholders in a company based on a share capital structure. They are also co-operators; in other words, they use the co-operative's services. This implies that they cannot be co-operators unless they are also shareholders. It is the basic co-operative principle; a “**duality**” that became reality in Great Britain in the mid-19<sup>th</sup> century (by the equitably-minded Rochdale Pioneers) and recalled at each of the brick-laying stages in the world co-operative movement, notably at the colloquium in Liege in 1966 and more recently at a Congress in Manchester.

It is this principle of “dual membership” that induced all co-operative societies to adopt the “**variable capital rule**”. The principle would be unworkable under a fixed capital structure in that it would prevent a user from joining and, by so doing, spell an end to the entity's existence. It could be speculated that a client could not bank with a co-operative bank prior to the latter authorising a capital increase under the conditions and within the time limits prescribed. Such a state of affairs would be surrealistic because new clients would find that they were being compromised. For example, the same could be said of a transport company seeking to join a co-operative society in the transport business...

The same reasoning applies the other way round: when users resign, when they cease to be co-operators and request the refund of their shares in the capital.



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For all that, it is not just because capital is variable that shares in the capital are not liabilities. They have none of their attributes: **they have no fixed date to maturity, they carry no fixed rate of interest at the time they are subscribed nor do they uphold the accepted principle whereunder they are to be redeemed at par.**

The fact of the matter is that repayability is inherent in the variable nature of the capital which, as has just been explained, correlates with its status as a co-operative. Treating the authorised capital of a co-operative as a liability, merely because it is variable, would not only be a profound misrepresentation legally. It would be acting in such a way **that accountancy (an accounting standard) would be creating a right whereas the standard can only reflect it.**

How is it conceivable that what is equity from a legal point of view can become a liability for accounting purposes?

The fact that the capital in co-operatives is variable does nothing whatever to jeopardise its stability owing to the legislative and regulatory framework within which co-operative shares are repaid and, secondly, by the acceptance of new capital shares arising from implementation of the “duality” principle. Moreover, a study recently undertaken in Germany shows that the rate at which shares in the capital of co-operatives rotates is extremely low and would not amount to more than 0.2%.

It would also be advisable to remember that the fixed nature of capital in joint stock companies is largely diluted by legally-sanctioned national options to repurchase.

To consider that the capital of co-operative societies is not equity because of its variability would be to **“kill off” the newly-authorised European Co-operative Statute** that reposes on the variability of capital and that **prohibits fixed capital.**

October 2003



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## SHARES IN THE CAPITAL OF CO-OPERATIVES ARE SHAREHOLDER-MEMBERS' EQUITY

### INTRODUCTION

1. Co-operatives are anxious to have a financial basis appropriate to their development. That anxiety is particularly evident in co-operative banks because of changes that will occur in the future when the new prudential ratio is introduced, in other words, the McDonough ratio.
2. Despite the fact that they have very little access to capital markets owing to their specificities, co-operatives manage to accumulate sufficient equity. This is so because they systematically allocate most of their operating surpluses to reserves and raise capital from their users and shareholder-members whose number increases as the co-operatives themselves expand.
3. That is why they are worried about any challenge to this logic, particularly unsuitable accounting regulations.
4. In the process leading to the adoption of IAS (standards), the Commission has sought to take these preoccupations into consideration. It has isolated IAS 32 from the other standards so that it can be studied with the IAS Board in depth before any decision is taken.
5. This memorandum aims to explain to the IAS Board and the Commission the reasons why shares in the capital of co-operatives must not be considered debt instruments: hence entered into the accounts as equity.

**1.- Since, with certain exceptions, shares in the capital of co-operatives do not respond to the definition of instruments of liability under the criteria selected for IAS 32, they should be treated as shareholder-members' equity**

1.1 The main provisions selected for draft IAS 32 seem to be the following :

The general principle is that what is not an instrument of liability constitutes equity. To that end:

- Equity or liability must be classified at the time the financial instruments under the contract are issued,

- It is the content and not the legal form of the financial instrument that determines its classification (even if the two concepts usually relate to one another),



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- The criterion used for differentiation is the existence of a contractual obligation under which the issuer must repay the bearer in cash or financial assets on terms that are potentially unfavourable to him/her. At this point, it becomes a debt, regardless of regulatory procedures. The same applies even when external constraints are involved (exchange controls, authorisation from an authority, etc.),

- If there is no contractual obligation to repay, it is a component of capital (it usually earns a rate of return but this is not a contractual obligation),

- A financial instrument, share or bond, the repurchase of which may be required under circumstances that do not depend on either the issuer or the lender, is an instrument of liability,

- Shares in UCITS, mutual funds and certain co-operatives may confer on bearers a right to repurchase at any time at a price proportional to their share of the net assets. Even if the legal form of the instrument allows a right to these assets, the existence of the right to repurchase is enough to turn these shares into instruments of liability.

1.2 - First, it is noticeable that these provisions mention certain co-operatives for some of their instruments. Therefore, one would be justified in thinking that IAS 32 leaves the discussion open as to how to classify the financial instruments issued by co-operatives as a whole.

1.3 - Shares in the capital have features that show why they cannot be treated as instruments of liability:

a- shares in the capital issued when a co-operative is being established constitute subscriptions to the society's formation, and not advances, from shareholder-members who, by virtue thereof, are entitled to rights in the society's transactions. Moreover, the risk involved in corporate formation makes it highly likely that losses will be charged to authorised capital. This renders the prospect of resignation somewhat hypothetical in so far as it carries an obligation to refund arising from the rules prescribed for companies with variable capital.

b- throughout the life of the co-operative, shares in the capital cannot earn a rate of return unless a sum of money is deducted from profits made during the financial year or from any previously constituted reserves. The amount of that rate of return, if any, is therefore determined a posteriori by the general assembly called to close the accounts. It is not a contractual obligation. The rate of return earned is a distribution of the profits made and not a payment deductible from overheads as would arise in the case of a contractual obligation<sup>2</sup>.

c- in the actual running of a co-operative, the refund of shares in the capital does not only depend on the will of the bearer, but stems from the environment in which the co-operative conducts its business.

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<sup>2</sup> French fiscal law, for example, offers a tax credit to dividends payable on shares held in the capital of co-operatives, just like all other company shares, a system totally different from interest earned on bonds or other debt instruments.



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#### 1. 4.- If one takes the case of France :

The General law on co-operatives puts an upper limit on the extent to which capital – measured against the highest level attained – can be reduced by refunds (the proportion is higher for co-operative banks than for other categories of co-operative).

Moreover, the law on companies with variable capital and the legislative texts proper to each category of co-operative set a time span during which shareholder-members must remain bound to their commitments. It is a 5-year period. Thus, it allows for the adoption of statutory provisions that vest in the Board of Management, subject to approval by the General Assembly, the power to defer refund of the shares in the capital throughout this period.

In most co-operatives, the variability of capital represents the logical extension of the dual nature of being both user and shareholder-member. The capital subscribed by a shareholder member is closely correlated with his/her status as user. This means that the volume of capital is proportional to the co-operative's activity;<sup>3</sup> hence the need for equity in one sense as much as in the other.

Generally speaking, shares in the capital of co-operatives are not repaid until the shareholder-member's resignation becomes effective. This ensures that the co-operative's own funds will allow it refund the capital without prejudice to its financial capacity. It is like buying back shares as decided and practised by commercial companies when they believe their equity levels and prospects permit them to undertake such transactions.

The variability of capital, subject to conditions that do not allow shares be treated as instruments of liability, is accompanied by an obligation to allocate an important share of the surplus to a legal reserve (15% under French co-operative law) and by the principle whereunder reserves are indivisible. Even if this is not standard practice in all countries, it is one of the principles adhered to by the International Co-operative Alliance. Of course, this restriction on the right to participate in the net asset base in the event of dissolution must not be interpreted as constituting a fundamental difference with the characteristics of ordinary equity capital instruments. They are a set of conditions laid down by law or regulations binding on individuals who establish a co-operative voluntarily or who ultimately become shareholder-members of a co-operative. By contrast, reserves in a traditional corporation may be distributed and hence struck off the balance sheet.

1.4 – For all these reasons, shares in the capital of co-operative societies do not respond to the characteristics of debt instruments as set out in IAS 32.



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## **II. – Explicit recognition of the equity nature of shareholder-members' shares in the capital would be desirable.**

2.1- Such recognition would be desirable since the first set of comments produced by accountants are largely based on particular cases and omit the considerations mentioned above.

It would be desirable, in the light of the forthcoming discussions on co-operative banks' prudential ratios, to use an explicit decision to support our argument and not *de facto* considerations, regardless of how well-meaning and soundly-based they may be.

2.2 – That is why the IAS Board is being asked to include a statement in IAS 32 to the effect that **shares in the capital of co-operatives shall be considered shareholder-members' equity.**

2.3 – The European Commission is invited to support this request to the IAS Board, while taking into consideration arguments that involve technique, legality and finance as set out in point 1 above. It is also urged to do so on the strength of the concept of the European public interest to which regulation no. 1606/2002 of 29 July explicitly refers.

2.4 – That request concerns all co-operatives in all the Union's Member States. It goes beyond provisions that may be introduced in the Member States under the subsidiarity principle mentioned in the same text and beyond distinctions that may be drawn depending on whether or not a public call is made for savings. Not only is it motivated by the legal and technical considerations set out above, but by the reality of the contribution co-operatives have been making to the Member States and to the European Union for over a century.

2.5 – It is easy to see how and why, in a specific legal and financial context, co-operatives have demonstrated their ability to strengthen their equity capital base. It is because they have rendered services to a growing number of people and thereby increased their capital subscriptions in proportion to a greater volume of activity.

2.6 – More particularly, it is easy to prove how European co-operative banks have been able, on a par with reserves built up over the years, to continue adding to their capital made up of subscriptions/shares. This policy encloses their 'own funds' in a manner that will allow them grow in a sound and solid fashion in keeping with the expansion of their activity (what cannot be said of a certain number of commercial banks, voluntarily or otherwise, over this period).

2.7 – Thus, the reason why the European Union recently confirmed, by adopting the European Co-operative Statute, the legitimacy of the form of company with variable capital is well



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founded. Moreover, the Commission, in its draft Communication currently in course of consultation, has recognised the contribution of co-operatives to the European Union's objectives and the desirability of seeing them expand, and equally into the accession countries<sup>3</sup>.

### **Conclusion**

**In the light of these conditions, it would be desirable for the IAS Board and the Commission to reach agreement on incorporating into IAS 32 (and into the attached commentaries and instruments) a statement making it clear that shares in the capital of co-operatives have characteristics that allow them be considered shareholder-members' equity.**

J.CI. DETILLEUX 15/10/03

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<sup>3</sup> It is recalled that resolution no. 1093 of the BIS invites all States (i.e. the group of States making up the European Union) to encourage the expansion of co-operatives