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An approach to the effects of reclassification of Members' Shares in cooperatives

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Summary

Spain has recently undergone a process of accountancy reform driven by the new European accounting standards that adopt the International Financial Reporting Standards. These changes have especially affected cooperatives because the traditional capital of the cooperatives (members' shares) would be reclassified from equity to liability. In this paper we carry out an exploratory study by means of interviews with experts, to allow a preliminary evaluation of the possible effects of the reclassification especially in relation to the financing of cooperatives.

This study is important because the main source of external funding is bank finance and banks use accounting information to grant or not funding.

Background

Cooperatives have special characteristics that differentiate them from other firms. The aim of this type of companies is not to obtain a profit, but to meet the economic and social needs of the members through business activities.

This type of companies plays an important role in the business fabric of Spain and European Union, how shows its important participation in terms of wealth, creation and employment.

The aim of this study is to make a preliminary evaluation of the possible impact of the reclassification of cooperatives' members' shares from equity to liabilities by virtue of the new accounting standards. This change is currently in progress, so there are no historical data to enable us to make a final evaluation.

In view of the possible negative effects of this accounting reclassification, the national law on cooperatives and to date most of the regional laws have been modified to accommodate, in addition to the "traditional" contributions to the capital (members' shares), redeemable when the member leaves the cooperative, other contributions whose redemption can be refused unconditionally by the cooperative. These latter contributions would retain their classification as equity under the new accounting standards. The legal modifications establish options for configuring the members' shares, the cooperatives opting for one or another.

If accounting information plays an important role in the credit technologies used by the financial institutions, the accounting reclassification will affect access to, and cost of, finance, and cooperatives will have incentives to modify their Charter by incorporating a regime of capital contributions that will retain the classification of members' shares as equity; if on the contrary accounting information does not play an important role in the credit technologies used, the cooperatives will not have incentives to modify their capital regime, on the basis that the change is incentivised by the accounting reclassification and is of no interest in itself, but quite the contrary. The cooperative world has seen it as problematic as it affects their firm characteristics.

This is what is called a "natural experiment" and we have found no similar studies of the impact on access to bank finance of an accounting reclassification in the same sense as that described. The only antecedent that we found is that by Levi and Segal (2005), who documents how the reclassification from equity to financial liabilities of hybrid financial instruments by virtue of SFAS 150 has decreased the issue of such financial instruments, showing that the accounting classification of the financial instrument affects its use.

Credit Technologies

Banks currently use different credit technologies when evaluating whether or not to grant finance to firms. Udell (2004), for example, enumerates six different categories of loan techniques.

One of the technologies used by financial entities is the economic-financial method. This technology is based on an analysis of the firm's financial statements by means of ratios that indicate the trend and situation of the firm in relation to the sector and to other competing firms. This method is suitable for application to high-value operations.

Another credit technology that uses financial information is credit scoring. This technology embraces all the statistical models and techniques that help lenders to make decisions linked to the granting of credit. Credit scoring implies the processing of the data on the firm and its owner by means of statistics. The result is a score or statistic summarising the borrower's future behaviour with regard to the loan (Feldman, 1997 and Mester, 1997).

Another method that has been gaining importance in recent years is relationship banking. The basis of this new trend is that a close relationship between banks and borrowers can be economically beneficial.

Methodology

Because this is an ongoing situation for which we do not have data, in order to perform a preliminary evaluation to assess whether the reclassification of members' shares has had effects on cooperatives we carry out an exploratory study by means of in-depth interviews.

The in-depth interview serves for a person to transmit orally to the interviewer his/her definition or personal vision of a particular subject, in this case, the reclassification undergone by the cooperatives.

With the in-depth interview, the interviewer wants to know what is important and significant for the respondent, wishes to reach an understanding of how he/she sees and interprets the situation.

Some advantages of the in-depth interview are that it is a very valid technique when one has little information on a subject and wants to make an exploratory study; it allows valuable information to be obtained; and as only the interviewer and the respondent are present there is a free exchange of information without any kind of pressure (for example, social pressure if a group session is carried out).

The in-depth interview can be performed in two ways (Sarabia Sánchez, 1999):

- Free, non-structured interview: no specific guidelines are followed for the interview and it is simply monitored that the respondent does not stray too far from the subjects of study.
- Semi-structured interview: the interviewer uses a script with the subjects or general lines to be dealt with in the interview, controlling the process of information gathering more directly.

We use the semi-structured interview, in order to control better the aspects a priori of greatest interest. Other studies in accounting have also used in-depth interviews, e.g. Arquero et al. (2009) or in marketing, Wright (1996)

The interviews are with experts in the subject belonging to different collectives, with the aim of obtaining a broad vision. Among these collectives we have auditors, external advisers, the financial managers of medium or large sized cooperatives, professionals of financial institutions and accounting specialists of cooperatives' representative organisations. The interviews also permit us to test for possible differences between the opinions of each professional group. Finally 6 in-depth interviews were carried out.

Conclusions

The principal conclusion that we can draw from the in-depth interviews is that most of the experts consider that this reclassification will have a negative effect on the cooperatives' access to financing.

The experts consider that the larger-sized cooperatives and those in which the members' shares are a important percentage of the equity and liabilities (B side balance sheet) will have more difficulties of access to financing, mainly because in these the financing operations will be for larger amounts, in consonance with the size of the firm, and the relationship with the financial entity will be less close. Various respondents highlight that agricultural cooperatives may be more affected, as the members' contributions are usually high, while in other cooperatives, such as workers' cooperatives, the capital is not as important as for example the work provided by the members. Other respondents consider that access to financing will depend on the behaviour, the strategy or the way of operating of the cooperative.

They agree that this reclassification will affect the granting of finance, since the credit entities use various tools into which they introduce the economic data to be found in the balance sheet and in the profit and loss account and which provide them with a score, on which they base their decisions to grant financing or not. The auditors, external advisers, and financial directors of the cooperatives consulted agree that the risk analysts of the financial entities base their decision on the accounting information contained in the balance sheet and the profit and loss account.

However, the point of view of a professional of a financial entity (a credit cooperative) is different; he explains that the first thing the financial entity does is to calculate a score, but the decision whether or not to grant financing is influenced by other credit technologies, such as relationship banking, i.e. the financial entities base their decision on their knowledge of the cooperative, and the closeness of their relationship with it. Evidently, if this relationship does not exist, as will be the case of a cooperative that is a new customer, the financial entity has no data or clear references, and therefore, what matters is the data contained in financial statements.

We also considered it important to know whether debt covenants are used. These are defined as financial conditions established by the financial entity that must be met for the loan to be maintained, as if they are used it is evident that the reclassification of capital will have effects on the financing already granted. We were told that this tool is not very usual either in operations with cooperatives, or with other types of firms. In some cases this tool has been used by the financial entity in refinancing operations, but when obtaining the first finance it is not usual for the financial entity to use these clauses. All agree that adding additional information to the notes of the financial statements will not improve the correct interpretation of the balance sheet and of the profit and loss account, because as remarked above, the end users of the accounting information in the case that concerns us, the financial entities, look at the accounting data and do not analyse much the notes.

This will involve, in the best of cases, a greater effort on the part of the cooperatives, as it will be they who, when requesting financing, try to explain to the financial entities the reclassification of members' shares as liabilities and the effects that this change has produced in their firms' balance sheets.

Furthermore, it may also affect the image that the cooperatives present to suppliers, customers and even to new members.

The laws on cooperatives permit various options for configuring capital: the traditional redeemable members' shares; members' shares whose redemption is completely refusable by the cooperatives; partly-refusable redemption; or modifying the transfer regime for members' shares. For this reason it is interesting to know what options cooperatives will choose and when they will decant for one or another.

In some Autonomous Communities where the law on cooperatives has not yet been modified they are awaiting the modification of the law before making a decision. Indeed, some autonomous community is trying to make redemption or non-redemption dependent on the overall percentage and not on the individual percentage of each member.

As to the path that the cooperatives will take, there is no consensus. One group considers that the redemption of members' shares should be 100 % refusable.

On the other hand, others have opted in the Charter to set a percentage (5% or 6%) of the capital at the start of each year whose redemption may not be refused, the rest (95% or 94%) remaining as equity.

Other cooperatives, however, will not modify their Charter. This is detected in some particular cases of large cooperatives, that are self-financing to a high degree and do not need to seek bank finance, that have not modified their Charter, and more generally in small workers' cooperatives that have little capital, reduced to the legal minimum. Generally financial entities ask for personal guarantees from the members in order to grant financing to the cooperative.

Other aspects that have been observed include a general perception that there has been a lack of faithful representation motivated by the standards to the case of the cooperatives. Some experts have suggested that a probabilistic model based on historical data might have been more suitable for classifying members' shares.

It has also been stated that modifications of the Charter may generate conflict in the life of the cooperative, for example between young members and old members, when the latter, closer to retirement, are more reluctant to give the cooperative the unconditional right to refuse redemption.

Finally, one respondent declared that the new accounting standard and the modifications of the laws on cooperatives could in future involve a reduction in the creation of new cooperative firms due to the increased complexity of the regulation of cooperatives.

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