

# STEWARDSHIP: THE CORE OF COOPERATIVE ACCOUNTING

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**Alan Robb**

*Adjunct Professor, Saint Mary's University,  
NS Canada*

**ABSTRACT**

Stewardship is a core feature of accounting for cooperatives in contrast to investment oriented accounting for capitalist companies.

The right to redemption of capital in cooperatives had no parallel in investor-owned companies and is central to understanding cooperative accounting.

Generally accepted accounting principles for business enterprises in the twentieth century were influenced by distortionary concepts such as the pre-eminence of income measurement and the matching concept.

The development of formalized accounting standards based on the needs of investor-owned businesses has been at the expense of stewardship function.

Cooperatives and other mutuels are right to resist the pressure to conform to such standards and should report in ways that recognize the importance of stewardship in the twenty-first century.

## INTRODUCTION

Stewardship - or the accounting for all amounts received and paid together with the resulting balances - was historically the earliest stage of accounting and is acknowledged to be the most basic of accounting functions (Firmin, 1957, 569). As such it was the base for all types of accounting entities, sole traders, partnerships, local authorities.

The development of the limited liability company was intended to grant limited liability in return for accountability to shareholders, the suppliers of capital.

However, businessmen have always treasured secrecy and so *“they and their accountants began to devise ways of circumventing the financial publicity laws”* (Chambers, 1993).

In most cases this was by the creation of secret reserves through the deliberate understatement of assets and income or the overstatement of expenses and liabilities in the name of conservatism. In some cases there was an outright refusal to disclose any information. Naylor (1969:120) cites the following from an 1847 Directors' Report:

*On more occasion than one, the question has been mooted at the general meetings as to the publication of the accounts of the company, and the opinion has been expressed by the board, that the period had not yet arrived when it would be expedient to do so, and at the same time the proprietors have been informed that it was not in their interest that such a course should be pursued. ...*

Proprietors at a distance, forming their opinion of the the future position of the company from the published accounts of past

transactions could scarcely avoid arriving at erroneous conclusions ... but the directors entertain the hope that the proprietors will rest content with the assurance that the establishment is carried on with every regard to economy consistent with efficiency...”

In contrast to this, in 1844 the Rochdale Equitable Pioneers Society had included within its rules a requirement for quarterly general meetings at which members would receive audited financial reports of the cooperative (Birchall, 1994: 54).

*Accountability and stewardship were inherent in cooperatives from the beginning.*

A second stewardship principle in the Rochdale cooperative was that added in 1854; the disposal of net assets without profit to members.

This meant that no-one would be tempted to break up the cooperative for personal gain. Members were entitled to draw out their contributions and any allocated dividends standing in their name - and the cooperative accounted to them on a quarterly basis for their equity.

Unallocated surpluses were held for the benefit of future generations, arguably one of the earliest instances of accounting for intergenerational equity.

Knowledge of the value of assets and liabilities was equally important to cooperators because they could expect to withdraw their equity if/when they ceased trading with the cooperative.

Good stewardship was inseparable from cooperative principles and values. It was at the heart of cooperative accounting.

## REPORTING NET PROFITS

Investor-owned accounting was dominated by the balance sheet until the collapse of the Royal Mail Steam Packet Company in 1931. No financial report was required of revenue and expenditure. If presented it was not covered by the audit report. Therein lay the opportunity for misleading financial reporting.

The Royal Mail company issued a prospectus in 1928 which appeared to show that the company had been profitable for many years. In fact it had been operating at a trading loss since 1928 but undisclosed transfers from secret reserves had obscured this unpalatable fact (Ashton, 1986).

Despite protestations from the accountancy profession that undisclosed transfers to/from secret reserves were an acceptable part of business new legislation was passed requiring major changes in accounting disclosure and in auditing. Among other things it became obligatory to present an audited profit and loss statement (in much less detail than is required today). This inevitably drew attention to income and income measurement.

A series of cases from the late 19th century had established clearly that income or net profit was the net increment arising from periodical asset valuations. The relevant value of assets was their value in exchange or net realizable value:

*It is the duty of a partnership to ascertain in any way it can the value of the assets; and any diminution in the selling value is a loss*

*and any increase the the selling value is a profit, and is dealt with accordingly.* (Salisbury v Metropolitan Railway Company (2), 1870.)

*In order to ascertain the profits earned and divisible at any time, the balance sheet must contain a fair statement of the liabilities of the company, including its paid up capital; and on the other hand , a fair or more properly bona fide valuation assets, the balance, if in favour of the company, being profits.* (City of Glasgow Bank v Mackinnon, 1882).

*The word profits has ... a well defined legal meaning, and this meaning coincides with the fundamental concept of profits in general parlance ... This can only be ascertained by a comparison of the assets of the business at two dates. For practical purposes these assets, in calculating profits, must be evaluated and not merely enumerated. ... Even if the assets were identical at the two periods it would by no means follow that there had been neither gain nor loss, because the market value - the value in exchange - of these assets might have altered greatly in the meanwhile.* (Spanish Prospecting Co Ltd, In re The, 1910, 576).

Knowledge of assets, liabilities and residual equity (based on market values) was thus originally as important for investor-owned companies as for cooperatives. But unlike members of a cooperative, investors in a limited liability company could not withdraw their equity if they chose. They were dependent on other investors being interested in buying their shares; that in turn depended on the expectation of the company making profits.

## THE GROWTH OF THE MATCHING CONCEPT

From the 1930s onwards the approach to income measurement came to be dominated by the matching concept. An early example was expressed by Scott (1925) but the major influence was Paton & Littleton's *An Introduction to Corporate Accounting Standards* in 1940:

*Interested parties need test readings [of the outcomes of business activity] from tie to time in order to gauge the progress made. By means of accounting we seek to provide these test readings by a periodic matching of the costs and revenues that have flowed past "the meter" in an interval of time. (Paton & Littleton, 1940:14)*

Belief in the supremacy of matching costs and revenues was echoed by the American Accounting Association, “

*Income is measured by matching revenues realized against costs consumed or expired, in accordance with the cost principle” (AAA, 1941:55); May (1943:26) “gain is a difference and must be measured by matching costs and expenses against revenue”; Gilman (1944:115) “we can never complete a structure of accepted principles of accounting without basing such principles upon a logical, consistent convention of matching costs with revenues” and Fitzgerald (1948:46) “Perhaps the greatest advance ever made in explaining accounting theory is the concept that the preparation of a profit and loss account is a process of matching cost with income.”*

*Consequently the investor-owned balance sheet changed from being a stewardship report showing the values of resources entrusted*

*to being a “tabular statement or summary of balances (debit or credit) carried forward after an actual or constructive closing of books of account kept by double entry methods according to the rules of accounting” (AIA, 1941).*

Matching depended on the notion that costs “attach”:

*It is a basic concept of accounting that costs can be marshalled into new groups that possess real significance. It is as if costs had the power of cohesion when properly brought into contact.*

*Ideally, all costs incurred should be viewed as ultimately clinging to definite items of goods sold or services rendered. (Paton & Littleton, 1940: 13,15)*

## REJECTION OF MATCHING

Paton was later to regret the influence that the Paton & Littleton monograph had:

*For a long time I've wished that the Paton and Littleton monograph ... had never been written, or had gone out of print twenty-five years or so ago. Listening to Bob Sprouse take issue with the “matching” gospel, which the P&L monograph helped to foster, confirmed my dissatisfaction with this publication.*

*The basic difficulty with the idea that cost dollars, as incurred, attach like barnacles to the physical flow of materials and stream of operating activity is that it is at odds with the actual process of valuation in a free competitive market. The customer does not buy a handful of classified and traced cost dollars; he buys a product, at the prevailing market price.*

*And the market price may be either above or below any calculated cost figure...*

*...the central element in business operation is the resources (in hand or in prospect) ... I am further convinced that the most significant measure of any resource is what it is currently worth ... How can we determine where we stand, what earning rate we are achieving, or where we should go from here without knowing the value of employed resources? I object, vigorously, to certified statements showing land and timber at a fraction of their demonstrable current market value... (Stone, 1971)*

### **UNWARRANTED PRIMACY OF THE INCOME STATEMENT**

The increasing attention to income measurement went so far as to result in claims that the income statement was the most important financial report:

*It is probably fairly well recognized by intelligent investors today that the earning capacity is the fact of crucial importance in the valuation of an industrial enterprise, and that therefore the income account is usually far more important than the balance sheet. (AIA, 1932)*

*Perhaps the most significant change of all is the shift of emphasis from the balance sheet to the income account, and particularly to the income account as a guide to earning capacity rather than as an indication of accretions to disposable income. (May, 1943, 5)*

Quite how enterprises could be ranked in terms of profitability or earning capacity (return on assets) without an accurate and reliable balance sheet was not explained.

By 1953 stewardship had been redefined:

*The modern emphasis on enterprise income rather than solvency suggests that reporting on management's stewardship is now better done through the income statement than through the balance sheet. (Littleton, 1953, 21).*

No longer was stewardship a report on resources held on behalf of another and one's ability to repay them when requested. It was now a report on what profits were being made - not a report of profitability, for that would require computation of the profits in relation to the assets employed.

Such investor-focussed accounting had become incomplete and uninformative. The balance sheet had become "a means of carrying forward unamortized acquisition prices, the not yet deducted costs" (AIA 1939). It was merely a connecting link between successive income statements (Accountant, 1946). As such "it provides little information because it lacks interpretability" (Hendriksen, 1982, 255).

### **RELEVANCE FOR COOPERATIVES**

Because members of investor-owned companies have never had a right to withdraw their equity it is understandable that they should have been pre-occupied with the profits recorded by their company (and managers and directors may at times have been preoccupied with manufacturing such profits when they did not actually occur).

In contrast, members of a cooperative and their boards have, of necessity, been disciplined to keep a strong balance sheet with sufficient liquid resources to allow redemption of capital as required.

Profits and profitability have had less relevance for cooperators than for investors. Firstly because shares are not traditionally seen as an investment in the cooperative but as an equitable contribution to the resources needed to supply the goods or services the member requires.

Secondly, in contrast to investor-owned companies where profit maximization is the prime objective few types of cooperatives have objectives that can be measured in terms of profits. A housing cooperative may seek to provide affordable accommodation; a workers cooperative may seek to provide regular employment at better-than subsistence wages; a finance cooperative or credit union may seek to narrow the gap between interest charged and interest paid (profit minimization?); a supply cooperative will seek to provide inputs at the lowest cost to members and a marketing cooperative will seek to return the greatest amount to those members who have supplied the best quality products.

What is common to all types of cooperatives is that the board must account to members for the way in which the resources entrusted to it have been used, must ensure that equity can be redeemed when the members cease to be transactors and they must ensure intergenerational equity by not allowing one generation to enrich themselves at the expense of another generation.

This requires a balanced approach to reporting stewardship. Such balance requires the timely and comprehensive disclosure of revenues and expenses, cash inflows and outflows and financial position that is 'evaluated and not merely enumerated.'

## INTERNATIONAL FINANCIAL REPORTING STANDARDS

Such a balanced approach is not provided by international financial reporting standards. The International Accounting Standards Board (IASB) objective is to develop standards that are useful for "investors, lenders and other creditors" in making decisions involving "buying, selling or holding equity and debt instruments and providing or settling loans and other forms of credit" (IFRS 2012).

The IASB claims that its standards are 'sector-neutral' but this is disputed by a number of authors (Ellwood & Newberry, 2007; Robb & Newberry 2007; Newberry & Robb 2008).

The IASB and FASB downplayed the concept of stewardship in their Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting* by arguing that it was covered by the 'resource allocation decision-usefulness objective' above.

That view was not accepted by EFRAG and the European National Standard Setters whose analysis of responses to the Discussion Paper shows that 78 per cent of respondents were of the view that stewardship/accountability should be a separate objective of financial reporting (PAAinE, 2007: 2).

## CONCLUSIONS

It is undeniable that cooperative companies differ materially from investor-owned companies. The right to redeem equity upon ceasing to be a transacting member is one of the most obvious differences. The obligation to make an equitable contribution to equity is a reminder that shares are not an investment in



the cooperative as they would be in an investor-owned company.

The financial statements of cooperatives continue to be primarily a report of stewardship where this has fallen to a lesser role in investor-owned companies. Stewardship basically involves accounting for the value of assets (and the existence of any liabilities) in terms of their value in exchange so that members can see whether their shares can be redeemed should that be their choice.

The building up of unallocated equity is encouraged in cooperatives as being good stewardship for future generations and to provide protection for the present against unplanned capital redemptions.

Cooperative accounting faces a challenge today from the imposition of international financial reporting standards developed for and by investor-owned companies. Such standards are not 'sector neutral' and need to be resisted if cooperative boards are to be able to report in a meaningful manner as faithful stewards■

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