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Business combinations in cooperatives. A critical view of accounting standards

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ABSTRACT

Cooperatives have a different ownership structure compared with investor owned firms, which causes frictions in the development of accounting standards. This paper critically reviews the history of cooperatives in the accounting standards for business combinations and identifies and studies five problematic aspects of the application of the acquisition method. A guidance to identifying Business Combinations Under Common Control between cooperatives is proposed. Incompatibilities between the cooperative law and accounting standards are identified, a modified cost of business combination is proposed, inequalities between members arising in the application of the acquisition method are indicated and above all it is shown that the IASB's decision to allow only one method has proven ineffective in avoiding accounting arbitrage.

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1. Introduction

Cooperatives are a different kind of firm, both in having an aim that is not to obtain a profit, but rather to meet the economic and social needs of its members through business activities, and in having a different governance system, being democratic organizations controlled by their members, usually under the “one member one vote” rule.

However, economic globalization makes business concentration strategies fundamental and the acquisition of companies and mergers can also be seen as outstanding concentration strategies for cooperatives, which need to respond to more concentrated markets to gain economies of scope in R&D and branding (Meliá-Martí & Martínez-García, 2015). Accounting in these operations has a long history (Amel-Zadeh et al., 2016); currently, accounting standards refer to them as business combinations and three main accounting methods can be highlighted: the purchase (acquisition) method, the pooling of interest method and the fresh start method.

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The fact that accounting standards setters take the investor owned firm as the reference in developing accounting standards has resulted in a recurrent history of frictions between cooperatives and accounting standards. This has been especially exemplified in the equity-liability distinction (Lopez-Espinosa et al. (2012), IFRIC 2 (IASB, 2004a)).

The objective of this paper is to critically review the application of the accounting standards for business combinations to cooperatives, to identify problematic aspects of the acquisition method in mergers between cooperatives and to provide practical guidance, using the Spanish context as reference but drawing conclusions with aim of generalization. To achieve these objectives we have structured the article as follows: [Section 2](#) provides a summarised critical review of the accounting standards for business combinations; [Section 3](#) relates the history of cooperatives within the development of accounting standards for business combinations; [Section 4](#) describes the Spanish regulatory context for mergers between cooperatives and justifies why the conclusions that can be drawn from this context will be generalizable in nature. In [Section 5](#) we apply the acquisition method to cooperatives, identifying five problematic aspects, and finally, in [Section 6](#), we summarise our conclusions.

2. Mergers and acquisitions in accounting standards: business combinations

Mergers and Acquisitions (M&A) are the most important corporate operations of business concentration. Accounting for M&A has a long and fraught history (Amel-Zadeh et al., 2016). Accounting standards created their own term, business combinations, to refer to business concentration operations, thus avoiding the use of legal terms (e.g. Mergers). In this history three main methods for business combinations can be highlighted: the purchase method, the pooling (or uniting) of interest method and the fresh start method.

Before World War II, purchase accounting was the most common method (Li & Meeks, 2016). However, the years following 1958 saw pooling on a large scale, with a permissive attitude to relative size (Briloff, 1967).

In the USA, the regime became much more restrictive in 1970 with the Opinions 16 and 17 (AICPA (1970a, 1970b)) and finally only the purchase method is allowed in SFAS 141 (2001).

At international level, the then International Accounting Standards Committee (IASC) regulated business combinations for first time in 1983 with IAS 22 'Accounting for Business Combinations', which was revised in 1993 and later in 1998 and, in essence, distinguished acquisitions and uniting of interest. According to IAS 22, acquisitions are present in virtually all business combinations where one of the combining enterprises obtains control over the other combining enterprise, thereby enabling an acquirer to be identified. Uniting of interest is seen only under exceptional circumstances, where the shareholders of the combining enterprises join in a substantially equal arrangement to share control over the whole, or effectively the whole, of their net assets and operations. The substance of a uniting of interests is

that no acquisition has occurred and there has been a continuation of the mutual sharing of risks and benefits that existed prior to the business combination.

Thus, in practice, two methods were allowed; the purchase method for acquisitions and, residually, the pooling of interest method for uniting of interest.

Under the purchase method, assets and liabilities of the acquired businesses are measured at fair value and goodwill can arise;¹ in other words, the acquirer accounts for the cost of the acquisition by restating the identified assets and liabilities acquired at their fair value and anything in excess of this cost is recognized as goodwill. Assets and liabilities of the acquirer entity are carried forward at previous accounting values.

Under the pooling of interest method (also known as the merger method), there is no acquirer and all assets and liabilities of all the combining entities are carried forward at previous book values in the combined entity. There is no accounting change, except for the effect of establishing a unique set of accounting policies.

The purchase method is seen as asymmetric, since only the assets and liabilities of the acquired businesses are restated at fair value plus goodwill. Additionally, it may be highly problematic to identify an acquirer. However, while the pooling of interest method is symmetric, it can be seen as excessively conservative, resulting in a large amount of hidden reserves and moving the financial statements away from the true and fair view (Fernández Del Pozo, 2009). Furthermore, it may be considered as less complete, since it does not reflect assets acquired and liabilities assumed that were not included in the pre-combination financial statements of the combining entities. The use of historical book values enable managers “to make huge acquisitions, record them at a fraction of their cost, report less expenses² in subsequent periods and leave barely hardly a trace of what may have been an ill-advised or excessively costly acquisition in post-combination financial statements” (Nurnberg & Sweeney, 2007). Therefore, the resulting financial statements from a business combination recorded using the pooling of interest method are seen as less relevant and reliable and the method inconsistent with the historical cost model.

The fresh start method interprets the business combination as a new entity and all the assets and liabilities of all combining companies are reported at fair value as of the combination date. This method was under consideration in phase I of the International Accounting Standard Board (IASB) Business Combinations project, which resulted in the International Financial Reporting Standards (IFRS) 3 (2004) (IASB, 2004b), but was finally dismissed, although not without relevant criticisms³, as the primary aim of that phase was to seek international convergence on the method(s). On the other hand, the IASB recognized that a case might be made for using the “fresh start” method to account for combinations where one of the combining entities does not obtain control of the other and, in a future phase of its Business Combinations project, the IASB committed itself to exploring whether the fresh start method might be applied to some combinations.

As we will see in the next section, mutuals and cooperatives were excluded from the scope of the application of the IFRS 3 (2004), given the complications in applying the acquisition method to them. Business Combinations Under Common Control and business combinations in which separate entities or business are brought together to form a joint venture were also excluded. However, the IASB was concerned about

its decision to eliminate the pooling of interest method, which would have created incentives for business combinations to be structured to meet the definition of a joint venture, thus avoiding the application of the acquisition method. The IASB amended the definition of joint control to require the unanimous consent of the parties.

Despite the self-commitment of the IASB to exploring whether the fresh start method might be applied to some combinations, little effort was made, and in spite of the IASB acknowledging that some multi-party combinations (those commonly referred to as roll-up or put-together transactions) might not be acquisitions, the IASB finally required the acquisition method to be used to account for all business combinations, including those that some might not consider to be acquisitions according to IFRS 3 (2008).

The reason given was “*that the acquisition method has generally been used to account for them*” (IASB, 2008)⁴ and it was decided not to change the practice at that time. This argument is not consistent, given that, before the practice was imposed by IFRS 3 in 2004, the pooling of interest method was the most widespread in accounting this kind of business combinations. The real reasons lie elsewhere: the IASB was afraid that if it replaced the pooling of interest by the fresh start method, it would therefore allow more than one method, thus providing opportunities for accounting arbitrage⁵. The IASB observed that respondents to the Exposure Draft (ED) Amendments to IFRS 3 Business Combinations (IASB, 2005) and other constituents were unable to suggest any unambiguous and non-arbitrary boundary for distinguishing true mergers or mergers of equals from other business combinations and concluded that developing such an operational boundary would not be feasible. In addition, the IASB see true mergers as very rare or virtually non-existent⁶ and this led them, in their pursuit of the qualitative characteristic of accounting information (“comparability”), to allow only one method: the acquisition method.

After the issuance of the IFRS 3 (2008), it underwent a Post-implementation Review (PIR) in 2014 (IASB, 2015). Neither a possible consideration of the fresh start method nor specificities regarding business combinations between mutuals and cooperatives was included among the areas on which the PIR was focused. Despite this, as we will see in the following sections, we still consider this issue to be problematic and unresolved.

3. Cooperatives and accounting standards for business combinations

Cooperatives have their own history regarding business combinations. To best understand this history, we need first to understand what a cooperative is. The International Co-operative Alliance (ICA) defines a cooperative as “... *an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically controlled enterprise*” (ICA, 1995).

Members are necessarily users of the cooperative and as a result, members’ shares are usually non-transferable and redeemable. When members terminate their relationship as users of the cooperative, their shares are usually redeemed at nominal value. In other words, members’ shares are not appreciable and cooperatives present

“common ownership” in that there are no individual rights (Lopez-Espinosa et al., 2012), that is, the assets are collectively owned.

When we apply the notion of business combinations to cooperatives, as defined in IFRS 3, conceptual frictions arise. Firstly, business combinations, as acquisitions, rest on the notion of control, but cooperatives are democratic organizations, usually according to the “one-member one-vote” rule. It is not possible to legally acquire a cooperative by transferring members’ shares, and the cooperative must first be demutualised and converted into a corporate enterprise (investor-owned firm).

Some respondents to the ED on Business Combinations argued that, economically, mergers (in the sense of uniting of interest/union of enterprises) are virtually identical to acquisitions, as in-substance acquisitions (IASB, 2008)⁷, and some noted as exemplification that shares could be issued for cash and that cash then used to effect the combination, with the result being economically the same as if shares had been used to effect the combination as consideration transferred. This rationale does not work, however, for cooperatives, as a cooperative cannot issue shares to collect cash from a financial market. Shares are attached to membership, therefore not even a cooperative can buy the members’ shares of another cooperative with the final aim of buying that cooperative. A transfer of shares means a transfer of members and a transfer of the economic activity between the members and the cooperative.

Therefore, it is not only difficult to always identify an acquirer in these situations, but it could also be forced and misrepresent the economic reality.

Despite the previous issues, ED 3 *Business Combinations* (IASB, 2002) did not propose excluding business combinations between mutual or cooperative entities from the scope of the IFRS, but instead proposed delaying its application to such transactions, given the complications in applying the acquisition method to them, which we will look at below.

Secondly, a business combination, seen as an acquisition and following the acquisition method, is a “cost allocation” model. The “cost” is the fair value of the consideration transferred (equity instruments, cash, etc.) in exchange for control of the acquiree. Business combinations in mutuals and cooperatives usually do not involve the payment of any reliably measurable consideration. Thus, difficulties arise in estimating the cost of the business combination and any goodwill acquired in the combination.

The IASB and the Financial Accounting Standard Board (FASB) observed that these differences between the ownership structures of mutual entities (such as mutual insurance companies or mutual cooperative entities) and those of investor-owned entities give rise to complications when applying the purchase method, and therefore mutuals and cooperatives were excluded from the scope of the IFRS 3 (2004) and SFAS 141 (2001).

Both boards undertook projects to address business combinations in mutual entities: the ED of proposed Amendments to IFRS 3 “Combinations by contract alone or involving mutual entities” of the IASB (2004c) and the “Combinations between mutual entities” of the FASB. These were short-term projects searching for interim solutions to the difficulties of the application of the acquisition method to cooperatives until phase II of the business combinations project was completed.

The ED of IASB proposed the following “modified” acquisition method to combinations between mutual entities (including cooperatives):

“The acquirer shall measure the cost of a business combination:

(a) as the aggregate of the following amounts when the combination is one in which the acquirer and acquiree are both mutual entities:

(i) the net fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities [...]; and

(ii) the fair value, at the date of exchange, of any assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree.”

Some respondents considered this to be a flawed modification of the acquisition method. In fact, the arithmetic of the measurement of the cost of a business combination under this method implies that any consideration transferred in exchange for control (any assets given, liabilities incurred or assumed, or equity instruments issued) equals recognised goodwill, while no consideration transferred implies no recognised goodwill nor a gain from a bargain purchase (negative goodwill). Therefore, the design of this measurement of cost of a business combination precludes a gain from a bargain purchase as a possible result. The ED does not provide any economic foundations nor any rationale for such a modified acquisition method. The application of this method would result in a combination being overstated whenever any consideration given by the acquirer in exchange for control of the acquiree exceeds the amount of goodwill of the acquiree, but would otherwise result as understated.

The comment letter of the DGRV (German Cooperative and Raiffeisen Confederation), (2004) to the IASB’s ED is a remarkable summary of these criticisms: *“We are really surprised about that creative way of accounting. In no way does this accounting method reflect the economic substance of a business combination, nor is that method supported by any accounting theory or academic fiction we are aware of nor is it practicable for cooperatives. Some facts may show this to you: 1) Control in a cooperative cannot be obtained by purchasing or issuing members shares; 2) the principle of shares being non tradable and the principle the nominal amounts of shares prohibit calculating fair value of member shares; 3) the amount of shares issued to new members equals the paid in capital- this amount is not linked to the acquired goodwill”*

The IASB’s ED and the FASB’s ED were not carried forward, considering that any potential advantages of using this interim (and open to criticism) solution for combinations involving only mutual entities would be outweighed by the disadvantages of having two versions of the acquisition method, which could mislead users.

Following this, a joint IASB-FASB ED “Amendments to Business Combinations” was issued in 2005 and similar arguments were posed by the Boards, giving rise to the current revised IFRS 3 (2008) and revised SFAS 141 (2007) which are applicable to business combinations between mutuals and cooperatives.

4. Business combinations in cooperatives: the Spanish context

In Spain, business combinations were regulated for the first time with the current Spanish General Accounting Plan (SGAP) of 2007. Before the SGAP, a draft plan was

issued on accounting for mergers and spin-offs in 1993, in which the pooling of interest was the main method and the purchase method secondary. This was justified in terms of prudence (Fernández Del Pozo, 2009), but, given its very conservative character, it was not approved (Gonzalo Angulo, 2014).

The SGAP 2007 introduced the IFRS 3 (2004), but unlike the IFRS, made it applicable to all kind of business entities including mutuals and cooperatives. The Recognition and Measurement Standard (RMS) 19 deals with business combinations and was modified in 2010 to introduce the revised IFRS 3 (2008). Nevertheless, the changes in the definition of control established in the IFRS 10 “Consolidated Financial Statements” have not yet been introduced in the Spanish GAAP.

Another difference between the SGAP and the IFRS is that the SGAP regulates the Business Combinations under Common Control (BCUCC) currently being addressed under an IASB research project, which at this moment is in line with SGAP and therefore its study can anticipate international regulation of these transactions and its effects. The RMS 21, Section 2.2 concerning mergers and spin-offs between group companies, establishes that the assets and liabilities acquired shall be measured at the amount at which they would be recognised in the consolidated financial statements. This means that the acquisition method is applied at the consolidated financial statements level when the investment is made. The later merger or spin-off between group companies carries forward the consolidated financial statements’ book values. If the preparation of those consolidated financial statements is exempted by the consolidation standards, the amounts recognised in the individual financial statements of the contributing company prior to the transaction shall be used.

On the other hand, in Spain, cooperatives are a separate legal entity from corporate enterprises, which allows for easy identification. The legal framework for cooperatives is multi-legislative, characterised by a State Law and sixteen regional cooperative laws, all of which regulate mergers, and present specialities compared to the standard corporate enterprise.

Laws indicate that the merger project has to establish the system to set the amount recognized for each member of the extinguished cooperatives as contribution to the capital of the new or absorbing cooperative, computing divisible voluntary reserves when they exist. Social funds (reserves from retained earnings and others) of dissolved societies will become integrated into those of the same class of the new or absorbing cooperative. Last but not least, results arising in a business combination (in the “acquired” cooperatives) must be allocated the minimum percentage established in the cooperative Law to the Mandatory Reserve Fund⁸, which is not divisible even in case of liquidation of the cooperative.

The Spanish regulation on mergers between cooperatives regarding divisible and indivisible reserves is an example of regulation in line with the Co-operative Principles of the ICA⁹. The fact that common ownership, following the 3rd Co-operative Principle of the ICA, is a common place (EACB, 2007; Lopez-Espinosa et al., 2012) and that Spanish GAAP are in line with IFRS’s, which are widespread around the world¹⁰, allow us to say that the conclusions that will be drawn later are general in nature.

5. Applying the acquisition method in business combinations involving cooperatives: critical aspects

After detailed study, we identified the following points as problematic:

1. Is the transaction a Business Combination Under Common Control?
2. Inequalities arising in the application of the acquisition method to cooperatives.
3. Identifying the acquirer cooperative and opportunities for accounting arbitrage.
4. Proposal of a modified acquisition method regarding the cost of the business combination.
5. Difficulties regarding the integration of the social funds in the new or absorbing cooperative.

5.1. *Is the transaction a business combination under common control?*

The first step to address in the accounting of business combinations is to assess if it really qualifies as a business combination. This requires that a business has to be transferred and the acquirer has to obtain control of the business. The transaction can be carried out through different legal forms, such as a merger, the spin-off of several companies, or the acquisition of all assets and liabilities of a company or a portion comprising one or more businesses.

Taking merger as an example; when two or more cooperatives merge into a new or existing cooperative, the question is if the merging cooperatives formed a group before the merger, in other words if they were under common control. Although cooperatives cannot form a subordination group — given the nature of cooperatives, no cooperative can be a subsidiary or parent of another cooperative — they can, however, form a coordination group. Thus, cooperatives pertain to a group and a merger between them will be a Business Combinations Under Common Control (BCUCC) when:

- The merging cooperatives formed a legal cooperative group (e.g. article 78 Spanish State Cooperative Law¹¹).
- A second-tier cooperative¹² merges with its first-tier member cooperatives when these first-tier member cooperatives¹³, acting together, control the second-tier cooperative, or the second-tier cooperative is solely managed by first-tier member cooperatives in accordance with statutory clauses or agreements.
- A second-tier cooperative merges with its first-tier member cooperatives, when, under agreements, the second-tier cooperative controls the first-tier member cooperatives.

In the above cases, the merger is between cooperatives which form a group and no cooperative obtains control, and therefore cannot be considered properly a business combination, as control was already held by the management of the group. These situations are referred to as BCUCC. These are not yet regulated under IFRS, but are under Spanish GAAP and the acquisition method is not applicable. The RMS 21 establishes that assets and liabilities transferred to the new or absorbing cooperative are registered in accounting at the book values of the consolidated financial

statements of the group or, if that preparation of consolidated financial statements is not required, at the amounts recognised in the individual financial statements prior to the merger of the merging cooperatives which are going to dissolve.

In other cases, mergers between cooperatives must apply the acquisition method, which is developed in SGAP in the RMS 19 and requires:

- a. Identifying the acquirer;
- b. Determining the acquisition date;
- c. Measuring the cost of the business combination;
- d. Recognising and measuring the identifiable assets acquired and liabilities assumed; and
- e. Determining the amount of goodwill or negative goodwill.

5.2. Inequalities arising in the application of the acquisition method to cooperatives

The acquisition method implies that cooperatives considered as acquiree have to reevaluate their identifiable assets and liabilities at fair value on the acquisition date, but the acquirer cooperative keeps their assets and liabilities at previous book values.

Therefore, in acquired cooperatives the business combination produces results derived from the revaluation of assets and liabilities at fair value. According to cooperative law, these results must be allocated in the minimum percentage to the Mandatory Reserve Fund, which is not divisible even in case of liquidation of the cooperative. Usually the minimum percentage is 50%, therefore the remaining 50% is divisible between the members or can be used for computation in the system to set the amount recognized as contribution to the capital of the new or absorbing cooperative for each member of the cooperatives that are extinguished. In other words, it can be used to determine the exchange ratio. However, as has been pointed out by Meliá Martí (2008), this is not possible in the acquirer cooperative, giving rise to inequalities between the merging cooperatives. In short, the acquisition method affects the divisible equity of the cooperative, that is, the recognized individual right over the net assets of the new or absorbing cooperative.

5.3. Identifying the acquirer cooperative and opportunities for accounting arbitrage

In each business combination, one of the combining entities must be identified as the acquirer. As mentioned, identifying the acquirer is difficult in mergers of cooperatives, especially when the two merging cooperatives are of similar importance or in case of a merger between several cooperatives (multi-party combinations).

Currently IFRS 3 (2008) establishes that guidance in IFRS 10 “Consolidated Financial Statements” shall be used to identify the acquirer. The notion of control in IFRS 10 is based on the investor-investee relation, and states that an investor controls an investee when it is exposed to, or has rights to, variable returns from its involvement with the investee and has the ability to affect those returns through its power

over the investee. Therefore, control requires three elements, i) power over the investee, ii) exposure to, or rights to, variable returns and iii) the ability to use its power over the investee to affect the amount of the investor's return. When the guidance of IFRS 10 cannot provide a clear identification of the acquirer, IFRS 3 (2008) establishes the following additional factors to be considered:

- In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.
- In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests¹⁴. However, other pertinent facts and circumstances shall also be considered, including:
 - a. The relative voting rights in the combined entity after the business combination — the acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity.
 - b. The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest.
 - c. The composition of the governing body of the combined entity — the acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.
 - d. The composition of the senior management of the combined entity — the acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.
 - e. The terms of the exchange of equity interests — the acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.
- The acquirer is usually the combining entity whose relative size is significantly greater than that of the other combining entity or entities.
- In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.
- If a new entity is formed and issues equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer. However, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

Almost the same criteria are established by the Spanish GAAP (RMS 19)¹⁵, but in addition (RMS 19) states that criteria a) and b) above will be applied preferentially.

Given the possible inequalities that the acquisition method could cause in mergers of cooperatives, cooperatives have incentives to avoid this method. The above-mentioned criteria leave room to structure the operation in such a way that a desired outcome could be achieved. In other words, accounting arbitrage is far from being avoided when the acquisition method is the only method allowed.

To illustrate this point, let us look at the example of four cooperatives of similar size merging in a new cooperative: equity interest is exchanged, former members of the merging cooperatives have similar voting rights in the new cooperative and the remaining criteria does not provide a clear identification of the acquirer. The new cooperative cannot be the acquirer according to the above-mentioned criteria and to identify one of the combining cooperatives as acquirer is difficult and not substantive. If the new cooperative issues “traditional” members’ shares classified as liability according to IFRIC 2, the new cooperative can be identified as the acquirer, as if the fresh start method had been applied.

However, if the same four cooperatives prior to merging formed a legal cooperative group¹⁶, the merger of cooperatives pertaining to a cooperative group is a BCUCC, which are not yet regulated by IFRS. It therefore allows participating cooperatives to establish an accounting policy to register this merger, and to carry forward the previous book values with a result as if the pooling of interest method was applied. Other accounting policies can be applied, such as evaluating the identified assets and liabilities at fair value, or even the fresh start method. If cooperatives apply Spanish GAAP, according to RMS 21 only an accounting policy is allowed, and assets and liabilities transferred to the new cooperative are registered in accounting at the book values of the individual financial statements¹⁷, that is as if the pooling of interest method had been applied.

5.4. Proposal for a modified acquisition method regarding the cost of the business combination

As we saw in [Section 3](#), difficulties in applying the acquisition method were the reason for excluding cooperatives from the scope of IFRS 3 (2004) and for the proposal of a modified acquisition method in the ED of IASB “Combinations by contract alone or involving mutual entities”.

The current cost of the business combination as defined in RMS 19, in line with IFRS 3 (2008), is the aggregate of the assets given, liabilities incurred or assumed and the equity instruments issued by the acquirer and the fair value of any consideration contingent on future events or compliance with certain conditions (contingent payments).

The identified assets and liabilities of the acquiree are revaluated at fair value and if their net value is less than the cost of combination, a goodwill is recognised; however, if the net value is superior to the cost of the combination, a negative goodwill is recognised, that is, the acquirer shall recognise a gain. A negative goodwill is seen as exceptional and the cooperative shall reassess whether it has correctly identified and measured the identifiable assets and liabilities. In summary, identified assets minus liabilities at fair value plus goodwill (or minus negative goodwill) equals the cost of the business combination.

If we apply this definition literally in a business combination between cooperative entities, it generally results in a negative goodwill, which, as noted, is seen by the Accounting Standard as an exceptional case. This is due to the common ownership of the acquiree not being considered in the equation. Equity in cooperatives

comprises members shares and other funds over which the member has an individual right and common ownership.

RMS 19 also states that when the fair value of the business acquired is more reliable, this shall be used to estimate the fair value of the consideration given, although no further regulation is provided on how to determine the fair value of the acquired business in the case of it being a cooperative. However, IFRS 3 (2008) provides special considerations in applying the acquisition method to combinations of mutual entities. Paragraph B47 establishes that the fair value of the equity or member interests in the acquiree (or the fair value of the acquiree) may be more reliably measurable than the fair value of the member interests transferred by the acquirer. The term equity (member) interest in IFRS 3 (2008) is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of mutual entities. Therefore, it has an investor viewpoint. In addition, paragraph B49 establishes that a fair value measurement of a mutual entity should include the assumptions that market participants would make about future member benefits, as well as any other relevant assumptions market participants would make about the mutual entity. It also quotes as example the present value technique to measure the fair value of a mutual entity, and the cash flows used as inputs to the model should be based on the expected cash flows of the mutual entity, which are likely to reflect reductions for member benefits, such as reduced fees charged for goods and services.

IFRS 3 (2008) and RMS 19 seem to confound the evaluation of members' interest (members' shares) with the evaluation of the whole mutual or cooperative entity, ignoring the two main components in the equity of a cooperative — common ownership and individual members' rights on the net assets of the cooperative. IFRS 3 (2008) also contradicts itself, stating on the one hand that fair value of a mutual entity should include member benefits, while on the other, when quoting the present value technique, it establishes that expected cash flows used probably reflect reductions for member benefits.

Concerning this, we would point out that the present value technique could be highly unreliable given the necessary assumptions and, above all, that present value cannot represent the reality of the transaction. In many instances, the shares issued by the new or absorbing cooperative in exchange for the shares of dissolving cooperatives are seeking to balance the contributed capital by the members (members' shares) in the different participating cooperatives in the merger, and that balance is based on the intended use by the member of the cooperative services.

Given the unsuitability and the imprecision of the accounting standards, we propose a modified acquisition method regarding the cost of the business combination. This method is based on the recognition of common ownership. By cooperative law, social funds of the of dissolved societies will become integrated into those of the same class of society of the new or absorbing cooperative. Social Funds can be classified as equity (Mandatory Reserve Fund) or liability (Education and Promotion Fund) according to the Spanish Accounting Standards for Cooperatives (EHA/3360/2010), therefore equity of the new or absorbing cooperative is increased by the shares issued and the Social Funds received classified as equity. To determine the cost of the business combination it is as if "common ownership" were issued and it is included in the cost of the business combination, with the resulting equation:

Identified assets minus liabilities at fair value plus goodwill (or minus negative goodwill) = cost of the business combination (members' shares issued + common ownership received (Mandatory Reserve Fund and others).

Failure to include the common ownership received implies that almost every business combination presents a negative goodwill, a gain from a bargain purchase, which would be recognised as an income in the net income of the cooperative and could be at least partially distributed between the members of the new or absorbing cooperative, something contrary to cooperative law.

This method allows for a truer and fairer recognition of goodwill compared to the modified method proposed in the IASB's ED "Combinations by contract alone or involving mutual entities". When shares issued plus common ownership received exceeds identified assets minus liabilities at fair value, a goodwill is recognised and the measurement of goodwill is based on the reality of the transaction, that is, the achieved agreements on exchange ratio. These agreements can be reached based on different variables, among which may or may not be the discounted cash flows of the cooperative or the members' shares.

5.5. Difficulties regarding the integration of the social funds in the new or absorbing cooperative

Spanish cooperative laws establish that social funds (reserves from retained earnings) of dissolved cooperatives will become integrated into those of the same class of society of the new or absorbing cooperative. This conflicts with IFRS 3 (2008), paragraph B47, which establishes that "*the acquirer in a combination of mutual entities shall recognise the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings, which is consistent with the way in which other types of entities apply the acquisition method*". This requirement can be seen as a forced harmonization of accounting between different types of entities (e.g. cooperatives or mutuals versus investor-owned entities) and had an important economic effect on the Credit Unions of USA (Johnson, 2006), where only retained earnings are computed as "net worth" for regulatory purposes, but not the acquired equity as resulting from the previous requirement. Finally, the Federal Credit Union Act was amended to redefine "net worth" to include the pre-merger retained earnings.

This misalignment between cooperative law and accounting standards could be solved by means of presentation in the financial statements, for instance subheadings under a capital heading. This would allow compliance with cooperative laws that only permit specific provisions of the Mandatory Reserve Fund and whose violation would result in the loss of cooperative status. More detailed guidance would be very useful for preparers of financial statements and auditors, given the importance of the issue.

6. Conclusions

Business combinations is one of the most complex areas of accounting, and within this cooperatives have their own history.

Accounting harmonization and the seeking of comparability has forced the establishment of a single method of accounting. Of the three main methods in business combinations, the chosen method is, not surprisingly, the acquisition method, which sees business combination from the perspective of an investor and is more suitable for investor-owned firms.

However, by allowing only the acquisition method, IASB observed that the different ownership structure of mutual entities (including cooperatives) gives rise to complications when applying the acquisition method to business combinations between mutual entities, excluding mutuals and cooperatives from the scope of the IFRS 3 (2004). The posterior IASB ED of Proposed Amendments to IFRS 3 “Combinations by contract alone or involving mutual entities” offered a modified acquisition method which failed to properly measure the cost of a business combination between cooperative (or mutual) entities.

From a starting point of the Spanish context, where cooperatives have their own legal entity and are clearly identified and regulated, but with the aim of generalization, we have critically reviewed the application of the acquisition method to business combinations between cooperative entities. Five issues have been addressed.

The first is the consideration of whether the Business Combination is Under Common Control. Despite the particularities of cooperatives, where a subordination group formed by cooperatives is not possible, cases of BUCC are identified. Their identification as BCUCC has important implications, as the acquisition method is not applicable to them.

The second issue is that the application of the acquisition method could give rise to inequalities between the members of the different cooperatives intervening in a business combination. The cooperative considered as acquirer cannot revalue identifiable assets and liabilities at fair value nor recognise its own goodwill and this fact can affect the basis for calculating the exchange ratio.

The third issue derives from the above. These inequalities provide incentive for cooperatives to avoid the acquisition method, and, as in addition there are difficulties in identifying the acquirer, the result is that there is room for so-called accounting arbitrage. We have shown that a similar transaction can be structured in different ways to result as if the fresh start method or the pooling of interest method had been applied. This highlights the fact that accounting arbitrage is far from being avoided by means of allowing only the acquisition method. This has important implications for the Standards Setters, as the IASB’s decision to allow only one method has proven ineffective in avoiding accounting arbitrage. However, another reading must be made, that this is not merely a matter of accounting arbitrage, in the pejorative sense, seeking creative accounting, but in fact highlights an inadequate interpretation of the economic reality by the accounting standards.

The fourth issue is the measure of the cost of the business combination as specified in the accounting standards. This measure shows flaws, as usually a negative goodwill should be recognised, whereas this is seen as exceptional by the accounting standards. We have proposed a modified cost of business combination which considers the different ownership structure of cooperatives by the inclusion of the common ownership. This modified cost of business combination reflects the achieved agreement in the operation.

The final issue addresses difficulties caused by incompatibilities between accounting standards and the regulation of the merger in the cooperative law. A way to a solution is provided by means of presentation in the financial statements, although more detailed guidance would be useful for preparers of financial statements and auditors.

The generalization of the above issues is based on two facts; that common ownership in cooperatives is not a particular Spanish case, but a general characteristic of cooperatives following the Third Co-operative Principle of ICA and that Spanish GAAP are in line with IFRS and these are adopted in 166 countries. While this generalization presents limitations, it is a rationale subject to verification. Case studies in different countries can be developed to verify the generalization. This would require a deep normative knowledge in each jurisdiction. Consequently, we propose the extension of this study to other countries as a future line of work.

Additionally, future empirical research, from a database to be compiled of business combinations in cooperatives, which addresses issues such as the identification of the acquirer, cost of business combination, information disclosure and its determinant factors, etc. would complete this field.

To conclude, the very history of the cooperatives in the accounting standards for business combinations shows us that a forced accounting harmonization and comparability at the expense of disregarding the fact that there are different types of firms has not made it possible to achieve an adequate accounting uniformity that really takes into account the underlying economic differences.

Notes

1. Or a bargain purchase (or negative goodwill): that is, an excess of the net assets of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost.
2. Book values are lower than fair values, resulting in lower amortization, and impairment charges are not reported.
3. There is a dissenting opinion of one Board member, Geoffrey Whittington, as well the American Accounting Association Financial Accounting Standards Committee (Maines et al, 2004) who see the IASB as sceptical on "true mergers".
4. IFRS 3 (2008), Basis for conclusions, paragraph BC27.
5. Incentives for so-called "accounting arbitrage" arise because the different methods of accounting for business combinations are not economically neutral (Baker et al., 2010).
6. IASB (2008), Basis for conclusions, BC35.
7. IFRS 3 (2008), Basis for conclusions, paragraph BC34.
8. 50% in the State Cooperative Law.
9. See 3rd Cooperative Principle, Member Economic Participation states, ICA (1995).
10. According to the IFRS Foundation (2020) IFRSs are adopted in 166 countries.
11. A cooperative group is a set of cooperatives in which the group head entity has the power to issue mandatory instructions for the grouped cooperatives.
12. A cooperative whose members are (first-tier) cooperatives.
13. A first-tier cooperative is a cooperative whose members are individuals.
14. Except for the case of the so-called "reverse acquisitions", that is, when the entity that issues the securities is identified as the acquirer on the basis of the guidance provided.
15. Except for the possibility of identifying the new entity in the last point as acquirer. But on the other hand, RMS 19 also states that the company that obtains control shall be

identified based on the economic reality of the business combination. Along these lines, the ICAC's Query number 5 of 2018 leaves room for the new entity to be considered as the acquirer.

16. See definition in section 5.1.
17. This legal cooperative group is not required to prepare consolidated financial statements, therefore the acquisition method is not applied. If not, the acquisition method would have been applied when consolidated financial statements had been prepared for the first time.

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