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The Law regulating Co-operatives and the Auditor

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General

The Co-operative Societies Act 1978 was brought into force twenty years ago, on the 16th April 1979. This Act incorporates most of the rules that regulate co-operatives in Malta and it replaced an earlier law, the Co-operative Societies Ordinance 1946, which had been adopted on the 8th July 1946. There are today about forty-two active co-operatives in operation.

The 1978 Act was passed by Parliament after a rather lengthy debate, which reflected both the importance given to the subject and the length of the Act itself. The Act consists of 117 sections and two schedules. It is a very interesting piece of legislation which has not, in my view, received sufficient credit and analysis. Things are however on the move, and under the title "*Co-operatives law to be changed to promote expansion*", The Times of 17th February 1999 reported that "*The government plans to amend the law regulating co-operatives in the coming months, social Policy Minister Lawrence Gonzi said yesterday*". A week later, an editorial in the same newspaper reported rather cheerfully that "*Few things could ring more pleasantly upon the ear than the news that in the coming months the government plans to amend the law regulating co-operatives in order to encourage the formation of new ones.*"

One can say with a degree of safety that the present Act should have been to co-operatives what the Commercial Partnerships Ordinance has been to commercial partnerships. I have always expressed the view that the CPO was a great success, which lived up to the explicit targets and objectives of its drafters. The 1978 Act certainly was a huge improvement on the 1946 Ordinance, but it failed to rally the interest and the results achieved by the CPO. As we all know, the CPO is for most reasons no longer with us, having been replaced by a new and more complex and sophisticated model. The impetus towards change has now, twenty years later, also reached the Co-operative Societies Act. Indeed, some parts of it are showing signs of fatigue, and a broad agreement of sorts exists that this Act needs some updating and that certain features need to be re-appraised and revised.

Interesting parallels may be drawn between these two laws, but this subject will have to be dealt with elsewhere. However, with certain reservation, it may be claimed that structurally, co-operatives are like companies of a different kind. Although there are several similarities, I hope to be able to demonstrate that there are also many substantial and striking differences.

It is the objective of this brief article to, first, indicate certain sections and areas which I feel should be included in the amendment exercise being currently undertaken, and, second, to highlight some of the provisions that auditors should be properly aware of.

Proposals for Possible Amendments

Certainly, one needs to take a fresh look at the diverse roles and functions that the Act has attributed to the Co-operatives board. This Board is a regulatory body entrusted with numerous responsibilities which directly or indirectly affect co-operatives from the cradle to the grave. It is central to the whole framework. It may register a new co-operative and assign to it separate juridical personality, and it would eventually have the responsibility to authorise its dissolution and eventual striking off. In between, it monitors the co-operative's performance. In my view, too many intrusive powers and responsibilities have been thrust upon this Board, and it is now time to trim some of these

feature allowing co-operatives to stand more and more on their own two feet and to operate autonomously as competitive commercial enterprises. The law expects too much from the Board. Some illustrations: why should the Board be obliged to oversee the auditing of co-operatives; should it really need to have to approve every single amendment to a society's statute; should it have the power to approve or to disapprove certain investments, loans and overdrafts which a co-operative wishes to take in pursuance of its business activities? The other side of the coin sees co-operatives being unduly pampered and often hampered in their administration and commercial activities.

Another feature, which needs to be re-appraised, is the rather elaborate process for establishing a co-operative. Too many requirements and procedures are currently imposed in the law. Compared to the ease and speed with which companies are regularly registered every day, the time consumed in setting up a co-operative seems like ages. The application form set out in the first schedule and the requirement relating to the "formation committee" may need to be looked at.

While companies may now be set up with just one single member, co-operatives still need a minimum of seven members. Many foreign legislation have recognised the notion of small co-operatives, and allow them to be set up by say four or five members. The co-operative model has proved less flexible and adaptable than the private company model in several other respects. Over 27,000 limited liability companies have been incorporated since 1965 compared to the less than 100 co-operatives set up since 1946.

We also need to review whether the present two-tier management and supervision structure has worked. The Act requires every co-operative to have both a committee of management and a supervisory board. It is no secret that some co-operatives have been unable to find enough members to sit on the two management organs. Are two heads inevitably better than one? Or should we be looking at the company management model with a single tier management represented by the Board of Directors. In other words, can we do away with the supervisory board? One good management body should be sufficient particularly in small enterprises, even in the light of the broad supervisory powers that may be exercised by the Co-operatives Board over the performance of a co-operative.

Finally, there seems to be no further justification for what I would term as the anachronistic and paternalistic roles that the 1978 Act has assigned to the competent Minister. In some respects, the Minister is made to act as a forum of appeal from the Co-operatives Board, thereby finding himself converted into a super regulator. In other respects, he is expected to exercise a judicial function and to determine disputes (see sections 109-110). Most of these direct powers of intervention by the political level have no place in a modern democratic society, are in my view of doubtful constitutional validity, and serve mainly to embarrass the holder of the office.

Another area which needs to be clarified, refers to the scope of the Apex organisation. The present law contains a number of often inconsistent provisions on this subject scattered all around the Act (e.g. sections 2, 10(4), 53, 66(4)). This has occasioned uncertainty and confusion. The relevant provisions should be simplified and brought together into one streamlined section.

The Auditor and the Cooperative Societies Act 1978

More than fifty years ago, in his Report of the *Registrar of Co-operative Societies for the year 1947–48*, dated the 14th January 1949, Mr. O. Paris, the then Registrar of Co-operative Societies, explained:

"The audit of the accounts of the societies was carried out solely by the staff of the department. One society had its accounts audited four times during the year, one society three times, four societies twice and five societies once. No audit was carried out in the case of two societies registered late in the year.".

Times have clearly changed, but as we have seen certain anachronistic features have survived to this day. The 1978 Act discloses a degree of scepticism and uncertainty towards the figure of the auditor. Whereas it recognised the development that had been introduced in the Commercial Partnerships Ordinance, which had clearly placed the qualified auditor on the Maltese legal map, certain sections reveal a sense of distrust to the point that the Co-operatives Board is actually required to oversee their performance. In fact, the Act requires the Board to approve the appointment of the auditors of every single co-operative, to approve their professional fees, and to supervise their activities.

A co-operative society is obliged to keep proper financial records and to forward to the Co-operatives Board copies of its annual audited financial statements and relative audit report (section 40). Section 111 assigns power to the Board to prescribe "*the accounts and books to be kept by a society*". It would seem that this power is exercisable in relation to particular societies, and is not restricted to rules of general application.

Every co-operative has to have its accounts audited annually. Only an auditor who is authorised to audit limited liability companies is qualified to serve as auditor of a co-operative. Before accepting appointment, the auditor must obtain the approval of the Board. The Board may limit this approval to one or more specific co-operatives, or it may choose to issue a general approval which would extend to any registered co-operative (section 39). Sections 41 to 43 need to be fully examined and understood by any auditor engaged to provide his services to a co-operative. These sections set out various precise reporting duties which auditors should clearly note.

The status and role of the auditor under the Co-operative Societies Act represent some important differences from the company law position. One of the more note-worthy provisions specifically requires the auditor of a co-operative to assist the Co-operatives Board in the latter's efforts to ensure compliance with the provisions of the Act and with good accounting practice. This objective is considered sufficiently important as to prevail over the auditor's ordinary duty of confidentiality to his client. This obligation anticipated the similar approach

adopted in such later laws as the Investment Services Act 1994 and the Banking Act 1994, both of which now contain a similar provision. In these two Acts, the auditors of a licence-holder are obliged to notify the competent authority of any material irregularity or deficiency raising regulatory concerns that may result during the course of an audit.

The relevant section here is section 41, which starts innocently enough by explaining in simple terms the duties of the auditor in regard to the audit of the financial statements of a co-operative. The auditor is specifically required to confirm "*whether the financial statements show fairly the financial transactions and the state of affairs of the society*". But then, in what may probably be described as our oldest whistle-blowing provision, an auditor is also obliged to report directly to the Board "*any irregularity disclosed by the inspection and audit that is, in the opinion of the auditor, of sufficient importance to justify his doing so*". Accordingly, an auditor who stumbles on some irregularity in the course of an audit has his position very clear – he does not have the luxury or the burden of dithering in a '*to be or not to be*' situation. The auditor is here required to reveal his findings to the regulatory authority "*forthwith*", and in doing so he does nor risk breaching his professional duty of confidentiality to his co-operative client. This provision emphasises the auditor's watchdog function. Failure to disclose his findings as required would be a breach the 1978 Act, and the defaulting auditor would probably suffer disqualification by the Board from ever acting again for a co-operative society. The failing would probably also be reported to the Accountancy Board.

The Co-operatives Board is rendered responsible under section 96 for the overall supervision of the auditing of the financial records of all registered co-operatives and Section 96(1) states that "*The Co-operatives Board shall supervise the auditing of every society so as to ensure that the audit is conducted effectively and in accordance with the provisions of this Act.*". Accordingly, in order to be in a position to carry out their respective tasks, both the Board and the auditor have free access to the books and accounts of every co-operative, and may request "*material information in regard to any transaction of the society...*" from any officer or employee thereof.

I will end this part by referring to a peculiar provision which may easily be overlooked. Section 96 also covers a situation where an Apex organisation has been set up. In simple terms, this is a type of organisation, unique to the co-operative movement, which functions as a federation of co-operatives. This federation would itself take the form of a secondary co-operative (i.e. a co-operative of co-operatives), and its object is the provision of educational and advisory services to its members and the promotion of co-operative principles, education, training and development (sections 10 (4) and 24)(3)).

Section 96 (3) envisages that this Apex organisation may set up what is referred to as "*an audit section approved by the Co-operatives Board*". In the event that it is duly established and has received the blessing of the Board, this unit can proceed to carry out the audit of those co-operative societies which are members of the organisation. In other words here we have a form of self-help system, whereby co-operatives are encouraged to help themselves even to the point of assuming certain functions originally handled by the Board and by independent auditors.

One final note of caution: an auditor should keep on reminding himself that a co-operative society is not a company. The two structures share some common elements but they differ radically in others. The very last section of the 1978 Act specifically excludes the application of company legislation to co-operatives. Consequently, when engaged on the audit of a co-operative, an auditor should carefully consider the often peculiar regulatory structure and the framework of duties and responsibilities arising under this Act.