The Co-operative Federation of Western Australia Inc.
(ABN 36 154 246 364)

19th August 2004

Chairperson
D8 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir/Madam,

Submission on AASB 132/IAS 32 Financial Instruments: Disclosure and Presentation and IFRIC Draft Interpretation D8 Members Shares in Co-operative Entities

The Co-operative Federation of Western Australia Inc (CFWA) is the peak representative body for co-operative companies in the state of Western Australia. Members of the Federation are trading co-operatives with an aggregate annual turnover in the order of AUD 2 billion. The Western Australian co-operative movement has in excess of 25,000 members and is a very significant business sector. We therefore welcome the opportunity to comment on AASB 132 *Financial Instruments: Disclosure and Presentation* and IFRIC Draft Interpretation D8 *Members Shares in Co-operative Entities.*

CFWA members are substantial businesses in their own right and have elected highly professional and skilled executives from within their entities to administer the CFWA through an eight person Council. That Council has taken advice from ACCORD and other sources on the matter of AASB 132 and its equivalent under the International Accounting Standards. That advice supports Council's own view and as such we submit:

> **That any business registered as a co-operative company under co-operatives legislation in Australia and domiciled in Australia, be permitted to classify co-operative shares as 100% equity so that the company's financial statements fairly reflect the substance of the relationship between the co-operative and its members.**

SUITE 1, PEER HOUSE, 2 CANNING HIGHWAY SOUTH PERTH WA 6151
TELEPHONE: (08) 9368 5155 FAX: (08) 9368 5680 EMAIL: cfwa@cfwa.org.au

Our organisation is extremely concerned about the requirements of AASB 132/IAS 32 which could result in the share capital of co-operative companies being classified as liabilities rather than equity. This concern is clearly not alleviated by IFRIC Draft Interpretation D8.

Nature & significance of co-operatives

A co-operative is a democratic organisation owned and controlled by the people it serves who join together for a common benefit. Co-operatives are based on the values of self-help, self-responsibility, democracy, equality and equity. Unlike investors, co-op members join a co-operative in order to benefit from the goods and services it offers, not to make a substantial return on their initial investment. A co-operative member will make an equity investment in a co-operative on becoming a member. Such investments in co-operatives are long term in nature with the equity stake growing or declining depending on the co-operative's requirements for funding long term working capital and fixed asset acquisition costs.

The co-operative sector in Australia has an annual turnover in the tens of billions of dollars.

Co-operative companies are involved in a wide range of economic and social activities and contribute significantly to the Australian economy. The activities of co-operatives include providing services to agriculture, food processing, processing fish and other seafood, processing wool, manufacturing garments, printing and publishing books, in the wholesale and retail industries, in freight transport services and taxi services, in housing, legal services, providing hospital facilities and medical services, in pre- and post-school education, and providing welfare and charitable services. There is generally a limit to the number of shares a member may hold in a co-operative company and a person will remain a member while they meet the prescribed 'active membership test'. There is no right for repayment of capital while a member is 'active'.

Member shares and similar instruments in a trading co-operative company have the characteristics of equity, including voting rights and rights to participate in dividend distributions and entitlements to a return of capital in a solvent liquidation. Shareholders normally have the right to **request** redemption for cash or another financial instrument, although that right may be subject to limits on whether the instruments will be redeemed. This right to request does not preclude classification as equity under AASB132 however, under most co-operative legislation in Australia, where a person ceases to meet the 'active membership test', the Co-operative Board is **required** to write to the member giving one month's notice of cancellation of membership. Where membership is cancelled, the Board is **required** to refund share capital. It is this unconditional obligation which is of concern to the co-operative sector in the context of classification of member shares.

AASB 132/IFRIC D8 Interpretation

Under AASB 132, an equity instrument is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities. A financial liability is any liability that is a contractual liability to deliver cash or another financial asset to another entity. The criterion used for differentiation between debt and equity is the existence of a contractual obligation under which the issuer must repay the bearer in cash. The critical point as to classification of members' contributions is whether or not the co-operative has the discretion under the contract with its members to avoid making a payment. If there is no contractual obligation to repay, shares are a component of equity.

On 30 June 2004, the International Financial Reporting Interpretations Committee released for public comment a draft Interpretation D8 Members' Shares in Co-operative Entities. D8 proposes that co-operatives consider all the terms and conditions of the financial instruments in determining classification as financial liabilities or equity. Member's shares will be equity if the co-operative has an unconditional right to refuse redemption of the members' shares.

Under various Australian state co-operative legislation, where a person ceases to meet the active membership test, the co-operative's Board is **required** to write to the member giving one month's notice of cancellation of membership. Where membership is cancelled, the Board is **required** to refund share capital. There is real and justified concern that this legal requirement where there is no right of the Board to refuse payment, will result in classification of the share membership as a liability.

Co-operatives Legislation

We are aware that in separate submissions references have been provided in respect of specific Australian legislation. Australia is comprised of sovereign states that can and do enact their own laws in particular areas. Legislation of co-operative companies is currently, and for the foreseeable future, controlled by state governments. Nevertheless the proposition put forward in this submission is put forward on the basis that it applies to Australian co-operative companies irrespective of the jurisdiction in which it operates.

New Zealand Situation

We are aware that the very sizable New Zealand co-operative company sector has very similar concerns to those being raised in Australia. In terms of the close economic ties between Australia and New Zealand we encourage the International Board to take into account the need to harmonise economic reporting in the Australasian basin.

It is our understanding the Board has been made aware of views of the New Zealand co-operative sector and that those views are totally consistent with the views emanating from their Australian counterparts.

Impacts of reclassification of member shares

There are a number of potentially significant negative consequences of reclassifying member shares from equity to debt:

- it would disrupt the financial ratios and complicate access to finance;
- many co-operatives would find themselves in technical default on their loan agreements which require particular levels of equity;
- a balance sheet that reflected zero equity would make it difficult for co-operatives to secure new debt financing;
- vendors and suppliers who utilise the balance sheet to assess credit worthiness would be confused over the lack of equity and may withhold credit arrangements or force onto co-operatives added credit compliance costs;
- the classification may result in the preparation of misleading financial statements for co-operative companies that will confuse rather than assist members' understanding of those financial statements.

Discussion

D8 notes that it is the content or substance of the contractual agreement and not the legal form of the financial instrument that determines its classification. If the terms of an instrument create an unconditional obligation to transfer cash or another financial asset, circumstances that might restrict an entity's ability to make the transfer when due do not alter the classification as a financial liability. Thus a financial instrument, share or bond, the repurchase of which may be required under circumstances that do not depend on either the issuer or the lender, is an instrument of liability. Basis of Conclusions BC19 of the draft Interpretation (quoting para.BC7 of the Basis for Conclusions on IAS32) states that the classification as a financial liability is "independent of considerations such as when the right is exercisable, how the amount payable or receivable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity".

Under this definition, the unconditional obligation on a co-operative board to repay membership on cancellation of active membership could render the membership shares as liabilities.

Request for consideration

Under AASB 132, if shares have one liability characteristic, albeit contingent on a future event, this will result in the entire instrument being classified as a liability, despite a large number of equity characteristics. In the co-operative sector, this has significant implications for the classification of member shares. If the share membership of co-operatives must be classified as a liability rather than equity, the potential financial consequences could negatively impact on the future viability of the sector. In making this submission we also draw your attention to the existence of laws in Australia that require Directors to act in the interests of creditors. These laws provide significant penalties, including incarceration, for breaches. The law also addresses issues relating to the clawing back of preferential payments in an insolvency situation, providing some comfort for creditors.

As such these additional aspects of co-operative law in Australia warrant special consideration of our submission

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Please feel free to contact me at any time regarding this submission.

Yours sincerely,
For: **The Co-operative Federation of Western Australia Inc**

J W Carstairs
Chairman

The Australian Centre for Cooperative Research and Development (ACCORD) is a joint venture of the University of Technology, Sydney and Charles Sturt University. It is the only dedicated agency charged with research and development of the cooperative sector in Australia.