QUALITY
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Thursday, 20 January 2005

The Secretary
Parliamentary Joint Committee on Corporations & Financial Services
Suite SG.64
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam,

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

Norco Co-operative Limited is a dairy co-operative based in northern New South Wales with interests in food marketing and manufacturing and a number of retail stores spread throughout our region. With a turnover of $A170m, we are one of the larger co-operatives in Australia.

Norco welcomes this opportunity to comment on AASB 132 *Financial Instruments: Disclosure and Presentation* and IFRIC Draft Interpretation D8 *Members Shares in Co-operative Entities.* Our organisation is extremely concerned about the requirements of AASB 132 which could result in the share capital of co-operatives being classified as liabilities rather than equity. This concern is not alleviated by IFRIC Draft Interpretation D8. While we imagine that you will be familiar with the arguments (below) put forward on the subject of debt versus equity, this is of particular significance to our co-operative.

Norco is embarking on a strategic programme of expansion, which will require increased debt financing. It is, therefore, of great concern that changes to our balance resulting from the proposed changes in accounting standards will impinge upon our ability to borrow funds at rates that properly reflect the risk profile of our business. We therefore support, and subscribe to, the arguments outlined below.

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[1]. Co-operatives are based on the values of self-help, self-responsibility, democracy, equality and equity. Unlike investors, co-operative 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 essentially long term in nature with the equity stake growing or declining depending on the co-operative's profitability.

There are about 1,300 co-operative type organisations in NSW. About 800 of these organisations are general co-operatives while the rest are mainly financial co-operatives. The

[1] NSW Office of Fair Trading website

general co-operatives are administered by the Registry of Co-operatives under the Co-operatives Act 1992 and the Co-operative Regulation 1997. Financial co-operatives include permanent building societies, credit unions and some friendly societies which are administered by the Australian Prudential Regulation Authority (APRA)[2]. The co-operative sector in NSW alone has an annual turnover of $4.4 billion, with combined assets of $2.5 billion.

The general co-operatives in NSW are involved in a wide range of economic and social activities and contribute significantly to the economy of NSW. A number of agricultural industries in Australia are dominated by co-operatives eg dairy, rice growing and processing, and fishing. Agricultural co-operatives incorporated in NSW have approximately 25,000 members[3]. 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.[4]

There is also a distinction between trading and non-trading co-operatives. A non-trading co-operative would have no distributions to members and therefore there is no need to be a share co-operative. For trading co-operatives however, members must pay a minimum membership. There is a limit to the number of shares a member may hold and a person will remain a member while they meet the 'active membership test' prescribed in the co-operatives legislation. There is no right for repayment while a member is 'active'; this is solely at the discretion of the Board.

Member shares in co-operative entities and similar instruments have some characteristics of equity, including voting rights and rights to participate in dividend distributions. They also give the holder 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 the co-operatives legislation, where a person ceases to meet the 'active membership test', the Co-operative Board is **required** to write to the member giving one months 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.

[2] ibid
[3] Lyons, M., 2001, Co-operatives in Australia – A Background Paper, ACCORD Paper No.1.
[4] ibid

Under the co-operatives legislation, where a person ceases to meet the active membership test, the Co-operative Board is **required** to write to the member giving one months notice of cancellation of membership. Where membership is cancelled, the Board is **required** to refund share capital. There is 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

Part 6 of the *Co-operatives Act 1992 No 18* covers the requirements of 'active membership'. Section 119 of the Act requires the board of a co-operative to ensure that the rules of the co-operative contain active membership provisions. Section 127 deals with the cancellation of membership of an inactive member. Specifically, the board of a co-operative must declare the membership of a member cancelled if:

(a) the whereabouts of the member are not presently known to the co-operative and have not been known to the co-operative for at least the required period before that time, or

(b) the member is not presently an active member of the co-operative and has not been an active member of the co-operative at any time during the required period immediately before that time.

The inactive membership clauses provide protection against possible takeover of the assets of a co-operative by 'dry shareholders' (inactive members).

Under s 134 of the Act, if the membership of a member of a co-operative is cancelled ..., the co-operative must, within 12 months after the date of cancellation ...repay to the former member the amount due to the member in respect of that cancellation ....The amount due to a member in respect of the cancellation of membership includes any amount paid up in respect of shares forfeited as a result of the cancellation of membership.

Co-operative equity, in most cases, consists largely of, or in many cases solely of, member equity, therefore a change in the classification of member shares may result in co-operatives having no equity in future balance sheets.

Impacts of reclassification of member shares

There are a number of potentially significant consequences of reclassifying member shares as equity:

- it would disrupt the financial ratios and complicate access to finance;
- many co-operatives may 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 may utilise the balance sheet to assess credit worthiness. Lack of equity may preclude credit arrangements with other traders;
- 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.

Norco submits that those businesses registered as co-operatives under the co-operatives legislation be permitted to classify co-operative shares as equity so that financial statements fairly reflect the substance of the relationship between a co-operative and its members.

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

Yours sincerely,
NORCO CO-OPERATIVE LIMITED

MURRAY RICHARDSON
Chief Executive Officer