JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Inquiry Into Australian Accounting Standards

SUBMISSION NO:	13
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DATE:	21.01.05
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Co-operative Federation of NSW Ltd

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Australia

Sue Bachelard
The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
Canberra ACT 2600

January 20, 2005

Dear Ms Bachelard

Inquiry into the Australian Accounting Standards tabled in compliance with the *Corporations Act 2001* on 30 August and 16 November 2004

The Federation wishes to bring to the attention of the Committee the fact that the adoption of International Accounting Standards will not only affect companies but also all other reporting entities in Australia. As such, co-operatives, our particular area of concern, will be significantly impacted.

The Standard of urgent concern to co-operatives is AASB 132. As detailed in the attached copy of the submission made by the Federation to the International Accounting Standards Board late last year, co-operatives around the world have developed different administrative and legislative environments in which to act. In Australia there is a concept of "active membership" in the State legislation. This measure was introduced to prevent dry (investor) shareholders from controlling co-operatives to the detriment of members who may be less numerous but actually involved in and committed to the enterprise being undertaken. The membership (and shares) of any member who becomes inactive is automatically cancelled - ie shares are redeemed, not sold. There is no discretion on the part of the co-operative on this matter.

Co-operatives exist to enable members to jointly achieve results which would not be possible individually, and, unlike companies, are not primarily investment entities. The definition adopted by AASB 132 catches co-operatives in a manner not intended by the drafters of the standard. In simple terms, the Standard says that if there is a contractual obligation to repay funds at some future date then the funds are and always were debt, not equity. As any co-operative member is capable of becoming inactive at some future point, however far down the track, all co-operative shares will be interpreted to be debt, not equity. There will be no members shares as equity in balance sheets, despite the fact that members obviously own co-operatives and are not merely lenders.

On behalf of the sector in NSW we ask that you consider the consequences of AASB 132 on co-operatives and recommend that International Accounting Standards not be adopted in Australia without any consideration of local conditions. The special situation of co-operatives needs to be taken into account and exemptions or similar arrangements duly made.

Please refer to the attached submission to the IASB for further clarification.

Yours sincerely

Helen McCall
Executive Officer

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September 7, 2004

D8 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Email: CommentLetters@iasb.org

Dear Sir/Madam

IFRIC DRAFT INTERPRETATION D8
Members' Shares in Co-operative Entities

As the organisation representing co-operatives in N.S.W., the Federation recently organised a working party to consider the impact of the changes in interpretation of IAS32, as presented in D8, upon co-operatives in Australia. As a result of those discussions we wish to bring to your attention the concern of the sector. Adequate attention does not appear to have been given to the different situation for co-operatives in Australia and the concern is that shares may be seen as debt when in substance they are equity.

Nature & significance of co-operatives

A co-operative is a democratic organisation owned and controlled by the people it serves who have joined together for a common purpose. 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. Prospective members only qualify for membership, however, if the board has reasonable grounds for believing that the prospective member will be an "active member." 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 800 organisations incorporated as co-operatives in NSW, administered by the Registry of Co-operatives under the Co-operatives Act 1992 and the Co-operative Regulations 1997. The sector has an annual turnover of \$4.4 billion, with combined assets of \$2.5 billion.

Co-operatives are involved in a wide range of economic and social activities and contribute significantly to the State economy. 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[1]. 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

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

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services, providing hospital facilities and medical services, in pre- and post-school education, and providing welfare and charitable services.[2]

There is also a distinction between trading and non-trading co-operatives. A non-trading co-operative can make no distributions to members and therefore there is no need to have shares. For trading co-operatives however, members must buy a minimum number of shares. There is a limit to the number of shares a member may hold and a member will retain membership whilst the 'active membership test,' prescribed in the co-operatives legislation, is passed. However, there is no right for repayment of shares 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 IAS32 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.

IAS 32/ IFRIC D8 Interpretation

Under IAS 32 , 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.

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 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:

[2] ibid

(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. It also does not give any consideration to the probability of this eventuality arising.

Request for consideration

Under IAS 32, 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.

We urge the IASB to make every effort to ensure the ensuing IFRIC Interpretation, and hence UIG Interpretation, be appropriate and applicable to the Australian co-operative model. We submit 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 cooperative and its members.

Yours sincerely,

Helen McCall
Executive Officer

PARLIAMENT OF AUSTRALIA

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES
PARLIAMENT HOUSE, CANBERRA ACT 2600

21 January 2005

Ms Helen McCall
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Dear Ms McCall

Inquiry into Australian Accounting Standards

Thank you for your submission to the Committee's inquiry.

All submissions to this inquiry become Committee documents upon receipt and are made public only after a decision by the Committee. You should not give your submission to others before the Committee makes it public. Submissions are covered by parliamentary privilege but their unauthorised release is not.

If you wish to make your submission available to others, please contact me to confirm that the Committee has authorised its release.

You should note that, upon its publication, your submission including your name and address will be posted on the Committee's website. If you have concerns about this matter please contact me urgently.

On behalf of the Chairman of the Committee, thank you for your interest in this inquiry. Please contact me, on (ph) 02-6277 3171, if you need further information.

Yours sincerely

Sarah Bachelard

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Committee Secretary

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