COMMENTS OF CICOPA ON THE IASB’S EXPOSURE DRAFT OF 2005 ON AMENDMENTS TO “IFRS 3 – BUSINESS COMBINATIONS”

The International Organisation of Industrial, Artisanal and Service Producers’ Co-operatives, or CICOPA, is a sectoral organisation of the International Co-operative Alliance. It has a membership of 57 organisations from 39 countries. Most of those cooperatives are characterized by the fact that the members are the staff of the enterprise.

GENERAL REMARKS

CICOPA is pleased to provide the IASB with its own comments regarding the 2005 “Exposure Draft of proposed amendments to IFRS 3 – Business Combinations”. We take note that this exposure draft comes as a follow up to last year’s business combinations project phase I, and among others continues with its intention of including “mutual entities”, a term that appears to include mutuals and cooperatives.

Following the analysis of all responses to the 2004 IASB consultation on the inclusion of the “mutual entities” within the IFRS3, CICOPA wishes to point out to the IASB that 78.6% of all respondents then rejected the inclusion of “mutual entities”, including all business economic actors, and that this rejection was not only a matter of timing or retroactive application but one related to the nature of the entity and the way in which it is structured. Consequently, according to the due process, the 2005 proposed inclusion of cooperatives and mutuals into the IFRS3 should not proceed.

CICOPA is also convinced that business combinations among mutuals and cooperatives cannot be properly accounted for under the present proposal, nor that an entity can acquire a cooperative as explained under the proposed amendments.

Consequently, CICOPA encourages the IASB not to go ahead with its intention of including mutuals and cooperatives within the scope of the standard and to defer this decision until a more adequate method could be found in the third phase of the business combinations project. We suggest that the different stakeholders be consulted over any future method, so as to assess at an early stage all the implications for cooperatives and mutuals.
DETAILED REMARKS

1) Business entity concept and appropriate accounting treatment

To start with, CICOPA would like to call the IASB attention to the understanding of the term "mutual entity" that appears to cover both the mutual and the cooperative concepts. We object to the IASB proposed definition as the concept is unclear in its boundaries and mixes different business structures that cannot be accounted for in the same manner.

Along the text, there are only examples, such as "mutual insurance companies" "mutual cooperative entities", (BC 184, p 54), "credit unions" (BC 182), a "wholesale buying cooperative" (ibid) etc. Apart from the fact that the denomination "mutual cooperative entity" is, to our knowledge, totally unknown in the world, the problem with defining a concept with partial examples is that the latter can only illustrate but cannot define, and that they cannot be used to infer a more general category even if they refer to it. In addition, the fact of giving only partial examples makes the limits of what is included into "mutual entities" unclear: nowhere does the IASB state that "mutual entities" are exclusively composed of cooperatives and mutuals, nor that they are composed of all cooperatives and mutuals, nor that they may also be composed of other types of enterprises or not.

Furthermore, there is a main difference between the two entities (cooperative and mutual) as cooperatives issue member shares but mutuals do not. For mutuals, their difference with the IASB’s “mutual entity” concept is even clearer: mutuals have neither nominal nor transferable shares whatsoever. Membership in a mutual is often (but not systematically) granted upon payment of a fixed entry fee which does not carry any right to the member and is never negotiable.

Beyond these two differences, the description of "mutual entity" that emerges along the text does not fit with what cooperatives and mutuals are and how they have been internationally defined.

Cooperatives already have world standards of their own. According to the Statement on the Cooperative Identity, agreed upon by the International Cooperative Alliance and its entire world membership in Manchester in 1995, and incorporated in full in International Labour Organisation Recommendation 193 on the Promotion of Cooperatives, approved at the 2002 session of the International Labour Conference of the ILO in Geneva by all governments, employers’ organisations and trade unions1, defines the 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” (para 2).

Thus, a cooperative is, first of all, as “an association of persons”, not of capital, its entrepreneurial nature being explicitly instrumental (“through a .... enterprise”), a fundamental characteristic which does not appear so far in the IASB concept of “mutual entity”.

The objective of the cooperative per se is for its members “to meet their common economic, social and cultural needs and aspirations”, not the distribution of dividends or other forms of benefits as the IASB’s “mutual entity” concept appears to imply, even though the cooperative, through its entrepreneurial function, obviously needs to be as competitive as possible in the market economy.

1 Except for the abstention of one government and one employers’ organization. In total, 128 governments (including, among others, the USA, Canada, all 25 present EU member states, and Japan), 94 national employers’ organizations and 107 national trade union organisations voted in favour.

CICOPA © RUE GUILLAUME TELL 59B © BE — 1060 BRUSSELS
TEL. (32/2) 543 12 40 – 543 10 33 © FAX (32/2) 543 10 37 © BROELANTS@COMIUSERVE.COM
In the case of cooperatives from CICOPA's constituency, where the members are the staff of the enterprise, the main objective is the creation of sustainable jobs.

In terms of corporate governance and control, the cooperative is "jointly owned and democratically controlled". Those concepts are linked to the second cooperative principle (democratic member control), which stipulates that "cooperatives are democratic organizations controlled by their members" with "equal voting rights (one member one vote)", irrespective of the amount of financial involvement of the different members. If the cooperative was primarily driven by, and focused on, the distribution of dividends or other forms of benefits as "mutual entities" are supposed to be, it would not be coherent with the worldwide standard principle and practice of the "one member one vote" system, a fundamental mode of operation (also shared by mutuals) which is not mentioned in the IAS Board's concept of "mutual entity".

In terms of redistribution of surpluses, the aspect of highest relevance in the present discussion, the fourth cooperative principle (members' economic participation) stipulates that "members contribute equitably to, and democratically control, the capital of their cooperative", part of such capital being the "common property" of the cooperative, and that "members usually receive limited compensation, if any, on capital subscribed as a condition of membership" (underlining added). The usual practice is the equivalent of a bank interest rate, in order to avoid the depreciation of the cooperative shares which otherwise remain at nominal value. Concerning the allocation of surpluses, "members allocate surpluses for any or all of the following purposes: developing their cooperative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the cooperative; and supporting other approved activities of the membership" (underlining added).

As we can see, the allocation of surpluses to 'benefiting members in proportion to their transactions with the cooperative', the only part of the whole statement on the cooperative identity which appears to be included in the definition of a "mutual entity" as it emerges from the Exposure Draft, fundamentally differs from such definition because:

- Under the "mutual entity" concept, the benefits appear to be an inherent right of the owners and not to be submitted to any particular limit, as is the case in any conventional business, whereas in a cooperative the allocation of surpluses to dividends to members is only a possibility defined by the cooperative itself through its general assembly, and in any case is always partial.
- The allocation of dividends in a cooperative is not a "gain" nor a "profit" as described under the "mutual entity" concept, but only an adjustment aimed to compensate the members for what they paid in excess or received less in their transactions with the cooperative. It is for this reason that those dividends are generally taxed to the cooperative members as individuals, not to the cooperative.
- If dividends are distributed, it is only on part of the surpluses, the most substantial part of which is usually destined to reserves, the development of the cooperative, or other activities beneficial to the community at large. In particular, when the cooperative also provides goods or services to third parties that are not members, the surplus of such activities is often destined to indivisible reserves or educational activities. In turn, the IASB's "mutual entity" appears to allocate profit exclusively to the capital owners.
- Distributing dividends is not part of the objectives of a cooperative, which in turn are stated in the definition of cooperative ("to meet their common economic, social and cultural needs and aspirations"). Indeed, since the owners are also the users (a more appropriate term than the more commercial term of "customers" used in the Exposure Draft to define "mutual entity" members), it is difficult to understand why their objective in the cooperative would be to generate lucrative profits on their own transactions with the cooperative, and then redistribute such profits among themselves later. Members do not join a cooperative in order to make a lucrative profit out of the dividends, because if that was the case they could make other investments that would be specifically oriented to this end, such as the acquisition of shares in a conventional profit-oriented enterprise. In turn, the main motivation of members in joining a cooperative is to obtain, together with other members, the satisfaction of a
specific need, according to the type of cooperative, such as creating sustainable employment, building their own housing, accessing credit, ensuring access to food of quality at the most reasonable cost, accessing electricity in marginalized and rural areas, ensuring a fairer income to individual farmers through joint commercialization of their products, etc.

- Concerning the IASB's consideration that "interests of members of a mutual entity ... usually include a right to share in the net assets of the mutual entity in the event of its liquidation or conversion", it is obvious that this cannot be the case in the many countries of the world (e.g., an important part of EU countries, Latin America, India, Africa etc.) where part of the surpluses are allocated to reserves that are indivisible even in case of liquidation or conversion. Even in the countries where the legislation does not include such provision, we usually do not observe substantial liquidations or conversions of cooperatives, which, again, shows that cooperatives are not driven by lucrative profit but by another objective.

**JUSTIFICATION OF DIFFERENT TREATMENT**

- The IASB affirms that "the unique attributes of mutual entities were not sufficient to justify an accounting treatment different from that provided for other entities", developed also in BC 180-183. As seen above, CICOPA would like remind the IASB that there are fundamental characteristics which distinguish mutual and cooperative societies from capital companies and thus objects to this statement.

- A mutual or a cooperative society is "controlled" collectively by its members insofar as the latter (or their delegates) elect its executive directors at the general assembly according to the "one person, one vote" principle, not according to the amount of shares or any other voting system.

- With regard to BC 180 a, mutuals and cooperatives provide their members not only with financial but above all with non-financial advantages (e.g., actions relevant for local community and socio-economic development, responses to poverty and exclusion; etc.).

2) Acquisition and resulting control under a relationship of mother-subsidiary applied to cooperatives

The new definition of business combinations given in IFRS 3 relies on the premise that an entity takes over or holds the control of another one. This entails that for every merger, the acquisition method should be applied and that, consequently, an acquirer should in each case be identified.

According to the new definition that emerges in the Exposure Draft, the "purchase method" has become the "acquisition method" in order to cover intangible assets. The IASB considers customer relationships as intangible assets, and declares that "mutual entities" are composed of members who are both customers and owners\(^2\). Indeed, the main difference between "mutual entities" and conventional businesses, according to the IAS Board, is that the owners are also customers (a commercial relationship with a different meaning from "users"). According to the IAS Board, the owners of a "mutual entity" will supposedly either seek the payment of dividends (as a fixed-term investor in any conventional business) or a reduction of the cost of what they buy (as any customer) or both.

The new draft clearly states that the relationship after acquisition is one of control, namely of parent to subsidiary. A new paragraph to IFRS3 is even being proposed on how to settle the acquisition date of a hostile takeover\(^3\). Although "mutual entities" are not mentioned in this

---

\(^2\) op. cit, A25, p. 61

\(^3\) "In the case of a hostile takeover, the earliest date that a substantive agreement between the combining parties is reached is the date that a sufficient number of the acquiree's owners have accepted the acquirer's offer for the acquirer to obtain control of the acquiree" (op. cit, BC, proposal of amendment to paragraph 139, p. 121)
particular paragraph, it appears to apply to them as well, especially if we take into account the following sentence: "For example, an entity acquiring a co-operative entity should consider the value of the member discounts in its determination of fair value." It seems that any type of entity acquiring a cooperative including its members as customer relationships, even through a hostile takeover.

It is not clear whether the members' interests in a "mutual entity" are considered to be transferable or not: on the one hand, the IASB states that "interests of members of a mutual entity generally are not transferable"; on the other hand, members' interests are portrayed as transferable in an "example" of assets to be calculated as part of "the fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree".

Being an association of persons and not of capital, cooperative membership is nominal, and each person is free to join and to leave the cooperative. In this sense; cooperative members' shares cannot be sold as customers' relationships. Even if one cooperative "acquired" another one as proposed by the IASB, cooperatives are open to all, and the old members of the acquiree business could immediately join the acquirer cooperative as new members and have the same control of the acquirer as they had of the acquiree one (one person- one vote). At best, this operation may be useless, at worst it may open the door to inside and outside manipulation.

In any case, a cooperative being an association of persons cannot be sold as such, because this would mean selling persons: certainly, the members as persons cannot be sold. Only in the case of non-members business relationships could there be a conception of intangible assets. To sell its business, a cooperative must be first terminated as an association of persons by the democratic sovereign decision of its general assembly. Only after its necessary conversion into a capital company, the business can be sold. At this stage, what is being sold is not the cooperative (which exists no more) but a conventional capital company. This is why cooperatives cannot be included in the scope of IFRS3.

Concerning becoming a subsidiary, this is not possible for a cooperative, as it must be democratically controlled in a sovereign manner through the one-person-one-vote in its general assembly. Otherwise, it is simply not a cooperative. It may however, be merged in a merger of equals or its business sold after its termination and conversion. It may also enter into network relationships as a peer, partner, etc. but must always remain autonomous as its recognized worldwide definition clearly establishes.

Regarding the identification of the acquirer in a merger among two cooperatives, and taking into account the above paragraph, it could still be possible in some cases to identify an acquirer. But in many mergers this shall probably not be the case. There are many true mergers in particular in the sense that no definitive control is exerted by one entity over another. Owners are the same before and after the combination and they remain with equal powers and control of the combined venture. This, as the cooperative world definition clearly states, is closer to the idea of a joint venture. As we all know, joint ventures have a working group that has not yet issued conclusions and so far they are excluded from the scope of IFRS3. Until a more appropriate accounting treatment may be found for cooperatives and mutuals, the pooling of interest should continue to be used in the case of these true mergers.

---

4 op.cit, BC63, page 22
5 Exposure draft of proposed amendments to IFRS3 Business Combinations, June 2005, BC182 (b) p 54
6 op cit, Consideration Transferred 21 (a) p. 30 and A25 p. 61
3) the utilization of fair value in accounting “business combinations” between “mutual entities”

The book value has so far been the most widespread type of accounting value among cooperatives because book value is based on historical figures, while fair value is based on future hypotheses and is useful to external investors, which is irrelevant for cooperatives.

Furthermore, the IAS Board in the document uses ‘fair value’ to cover a range of measurements, resulting in a diversity of methods which shall result in neither comparability nor standardization. In itself, this is a weak point of the draft, and therefore one worthy of concern. The various types of measurement proposed all have in common a speculative approach which is not functional to cooperative needs. As cooperative shares are not transferable, and since members are not looking for the maximum possible profit, the exercise of fair value is not meaningful. And as almost all cooperatives in the world are not listed at the stockmarket, information is basically for the members, not for external agents such as stockmarket investors and analysts.

In a number of cases historical cost could well give a reasonable approximation of net realisable value. A formal revaluation to net realisable value would then only be necessary when the governing board of a cooperative had reason to believe that historical cost materially understated the value of the co-operative’s assets.

Finally, the value of the membership in a mutual or cooperative comprises financial as well as non-financial advantages. Consequently, the notion of fair value, which makes sense for investors, seems ill-adapted to cooperatives and mutuals. Cooperative accounting should among other issues take into account the various components of the value of membership.

4) Proposal to the IASB

- CICOPA request the definitive exclusion of cooperatives and mutuals from IFRS3 (on which there is a wide consensus within the cooperative movement already as we saw in the consultation last year) and, instead, the utilization of the “pooling of interest” method; technical arguments can be found in last year’s communications and in section 2 of this document. Furthermore, after the request for exclusion last year by 78.8% of all respondents, the due process has not been really complied with.
- CICOPA strongly emphasises that cooperatives and mutuals as they function and as they are configured around the world do not correspond to the concept of “mutual entities” as described along the exposure draft, nor with the wider concept of “profit oriented entities” which exclusively includes conventional enterprises and “mutual entities”, and therefore requests that the internationally-agreed distinctive characteristics of cooperatives and mutuals be clearly recognized.
- CICOPA underlines the fact that the technical knowledge is still lacking and the need of rethinking a distinctive accounting category for cooperatives, appropriate to their distinctive nature, function, mission and modes of operation as described in ILO Recommendation 193. This category could be common with mutuals provided that the differences between the two models are explicitly clarified, and provided that this common category is clearly different from the present “mutual entity” concept. In particular, since the concept of control is becoming central in the IAS Board standards, the permanent practice of joint ownership plus

---

7 Those approaches include the “income approach” (discounting future cash flows) which is neither verifiable nor objective, and involves speculation about future amounts, speculation about their timing, and speculation about the rate at which to discount them; the cost approach which is also concerned with speculation or expectations about the future - what it might cost to acquire a substitute asset of “comparable utility” after speculating further about its obsolescence; and the fair value to be estimated “with significant entity inputs”, reportedly one of the reasons why Enron’s financial reports proved to be so unreliable.
democratic control (i.e., common control) in cooperatives and mutuals should become a central element in a distinctive accounting treatment for these types of enterprises in the future. The book value would be maintained in general, and, in order to address possible needs of revaluation of assets, specific methods (e.g. the calculation of 'net realisable value') should be developed.

- CICOPA proposes the establishment of a specific working group on this topic with the participation of experts on accounting specialised in cooperatives and mutuals from around the world.

Bruno ROELANTS
General Secretary
broelants@compuserve.com