Sir, David Tweedie, Chairman
IAS Board
30 Cannon Street
UK- London EC4M6XH

Dear Sir,

COMMENTS BY THE COOPERATIVE AUDIT AND SUPERVISION CORPORATION (COASCO) ON THE IASB’S EXPOSURE DRAFT OF 2005 ON AMENDMENTS TO “IFRS3- BUSINESS COMBINATIONS”

1. BACKGROUND TO THE CO-OPERATIVE AUDIT AND SUPERVISION CORPORATION OF TANZANIA (COASCO)

COASCO is corporation established by an act of parliament in 1982 that deals with provision of Audit and Supervision services of cooperative societies in Tanzania.

1.1 According to section 4(1) of the Co-operative Audit and Supervision Act of 1982, the functions of the Corporation are as follows:-
1.1.1 To provide audit and supervision services to Co-operative Societies in Tanzania.

1.1.2 To give advice on audit and accounting procedures and to formulate audit and accounting policy for adoption by Societies.

Merits:

COASCO wish to submit its comments regarding the 2005 IASB’S exposure draft on amendments to “IFRS 3 – Business combinations”. To ISAB 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.

COASCO wish to reminds the IASB that 78,6% of all respondents to the 2004 ISAB consultation on inclusion of the ‘mutual entities’ rejected the inclusion of “mutual entities”. This rejection was related to the nature of the entities and the way business are conducted by such entity. Hence, the 2005 proposed inclusion of cooperatives and mutuals into the IFRS3 should not proceed as it is not agreeable to many stakeholders for genuine reasons. Such will frustrate the performance of co-operatives.

Business combinations among mutuals and cooperatives cannot be properly accounted for under the present proposal. However, an entity can not acquire a cooperative as explained under the proposed amendments. COASCO suggests that the IASB should drop its intention of including mutuals and cooperatives within the scope of the said standard. The decision should be stopped to give cooperative accounting professional time for the different stakeholders to be consulted for, to have fully participated and give their comment and advices.
THE DEFINITION OF BUSINESS ENTITY

1) The term “mutual entity” 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. Terms like “mutual insurance companies” “mutual co-operative entities”, (BC 184, p 54), “credit unions” (BC 182), a “wholesale buying cooperative” (ibid) appear just like examples and are not adequately defined it give rooms to ambiguity of meaning.

COASCO also restates that there is a main difference between cooperative and mutual because cooperatives issue member shares but mutuals do not. 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.

THE COOPERATIVES AND GLOBALIZATION

Cooperatives are governed by the Statement on the Cooperative Identity, agreed upon by the International Cooperative Alliance and its entire world membership in Manchester in 1995. The same was also incorporated in full in International Labour Organisation Recommendation 193 on the Promotion of Cooperatives, which was approved at the 2002 session of the International Labour Conference of the ILO in Geneva by all governments, employers’ organisations and trade unions.

From the above it is quite clear that the Cooperatives already have their own international recognitions, which can easily be co-opted in IFRS of IASB. These cooperative standards 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).
Further more this definition it is clear that a cooperative is not governed by share rights and options capital, but member based which is communally owned and controlled of the members. This fundamental characteristic does not appear in the IASB concept of “mutual entity”. The primary objective of the cooperative is “to meet members’ 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. However the cooperative, through its entrepreneurial function, obviously needs to be as competitive as possible in the market economy and should also earn adequate profits to optimize its members social and economic wealth.

The cooperatives are “jointly owned and democratically controlled” to ensure good governance and control. Those concepts are linked to the second cooperative principle 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”. This is a fundamental mode of operation 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 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.

For the cooperatives the usual practice of return on capital invested is not divided but rather is the equivalent of a bank interest rate, in order to avoid the depreciation of the
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cooporative shares which otherwise remain at nominal value. The appropriation of surpluses is governed by the cooperative act, rules, regulations and bylaws approve by the member in which the members allocate surpluses for any or all of the following purposes: setting up reserves to develop their cooperative. Part of which at least would be the portion that is indivisible is distributed to the members in proportion to their transactions with the cooperative; and supporting other activities approved by the membership”

This differs much from what is be included in the definition of a “mutual entity” as it emerges from the Exposure Draft, because of the following:

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 dividends to members is only a possibility defined by the cooperative itself through its general assembly, and in any case is always limited.

The allocation of dividends in a cooperative is not a “gain” or 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.

Then, 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 for social inclusion, education, health and the fight against poverty. When the cooperative 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
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the capital owners, contrary to the cooperative International standards discussed above.

Incase of Tanzania cooperatives members allocate the cooperative surplus for:-

• Statutory reserve Fund
• Bad and doubtful debts (loan loss) provision account for those societies giving out loans or credit.
• Share transfer Fund
• The remainder of annual net balances may be disposed of as decided by general meetings as:-
  o Payment of dividend or share income
  o Recapitalization of member shares
  o Contribution to a development fund
  o Contribution to any charitable, education, medical or any other purpose in accordance with the act

THE CONFLICT OF OBJECTIVES

Distributing dividends is not part of the objective, as of a cooperative, stated in the definition of cooperative i.e. “to meet their common economic, social and cultural needs and aspirations”. 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 is not to generate lucrative profits on their own transactions with the cooperative, and then redistribute such profits among themselves later.

However, members do not join a cooperative in order to make a lucrative profit out of the dividends. 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, interalia 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, and
ensuring a fairer income to individual farmers through joint commercialization of their products.

**THE RIGHT TO SHARE IN THE NET ASSETS**

The IASB considers 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 (eg 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.

On the basis of the above-mentioned characteristics, the emerging global policy framework around cooperatives is clearly based on that universally accepted Statement on Co-operative Identity. ILO Recommendation 193/2002 on the Promotion of Cooperatives formulates a whole policy framework at the world level. The ILO has also stated that "Co-operatives have proved to be a key organizational form in building new models to combat social exclusion and poverty. A cooperative member learn from each other, innovate together, and by increasing control over their livelihoods build up the sense of dignity the experience of poverty destroys".

Different Treatment is Justified:-
- 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. However, COASCO objects to this statement, and reminds the IASB of the fundamental characteristics which distinguish them from capital companies as follows:-
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, mutual and cooperative 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);

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.

We can refer to ILO, Working out poverty, In the Exposure Draft, the "In the case of 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. 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.

Although "mutual entities" are not mentioned in this paragraph, it appears to apply to them especially when 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.

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 acquire business could immediately join the acquirer cooperative as new members and have the same control of the acquirer as they had of the acquire 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 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”

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.
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.

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 it 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.

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 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 stock market, information is basically for the members, not for external agents such as stock market investors and analysts.

However 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 cooperative’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
COASCO requests the definitive exclusion of cooperatives and mutuals from IFRS3 on which there is a wide consensus within the cooperative movement.

COASCO strongly emphasizes 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.

COASCO underlines the fact that the technical knowledge is still lacking and the need of re-thinking 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 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. 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.

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

With cooperative greetings,

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H A. NYANGE
FOR DIRECTOR GENERAL