

Defeating a Demutualisation: a case study

Connect Credit Union is a successful mutual organisation in Tasmania, Australia. In 2003 its members were suddenly told that the Board proposed demutualising and seeking listing on the Australian sharemarket.

Opponents to the Board's plan were given very little time to mount a campaign to challenge the proposal. However, drawing on international support and information from co-operators, they were able to defeat the proposal. A leader of the campaign was elected to the Board, with the highest polling, at a subsequent meeting of members.

This paper examines the situation which resulted in the surprise demutualisation proposal, the tactics used to defeat it, and the financial performance of the organisation both before and after 2003.

It provides lessons for other co-operatives and mutuals which may face unwanted calls for demutualisation.

Defeating a Demutualisation: a case study

Alan J Robb and Neil A Crombie

All that is best and finest about mutualism has its antithesis – its dark side – in demutualization.
Race Mathews (2003)

Introduction

In many countries, the ownership structure of the financial sector has undergone substantial change in the last two decades. Government-owned enterprises have been privatised as monetarist economic theory has been adopted, often uncritically and without frequently without delivering the promised benefits. Often, it seems, the architects of change move rapidly on, selling their recipe for reform to new clients before the impact of the first changes can be observed. For example, the driver of the 1980s' structural changes in New Zealand, finance Minister Roger Douglas, subsequently became an international consultant advising on privatisation and structural reform in countries as various as Russia, Brazil, Mexico, Pakistan, Canada, Peru, Vietnam, China, Australia, South Africa and Singapore (Douglas, 1993).

It is not surprising if it has seemed that the speed with which such changes have occurred is almost overwhelming. Douglas (1993: 220-222) cites two principles for the successful implementation of change:

Speed is essential. It is almost impossible to go too fast.

Once you build the momentum, don't let it stop rolling.

In a phrase worthy of Machiavelli, Douglas advises 'If you take your next decision while opponents are still struggling to mobilise against the last one, you will continually capture the high ground...'

Against such political tactics individuals can easily feel disenfranchised and powerless. This is especially so for those who sense that the pro-demutualisation arguments are based more on dogma than verifiable data.

The case study which follows will show that demutualisation need not be inevitable. It can be successfully opposed, even in an environment where the pro-demutualisation forces seem at first to be in the ascendancy.

The Australian demutualisation scene

A study by the Reserve Bank of Australia (Reserve Bank, 1999) reports that since 1985 demutualisations in Australia have involved assets totalling over \$183 billion. They have been concentrated among building societies and life offices and only one credit union had demutualised at the time of the study.

The Reserve Bank report noted that ‘the three most recent demutualisations were initiated by management’ (Reserve Bank, 1999:3).

The Bank noted that a driver had been changes in legislation which made demutualisation more attractive. It also cited the usual reasons such as ‘to access external capital to enable expansion, to diversify activities, or to compete more effectively with publicly listed companies’ (Reserve Bank, 1999:2).

There is no evidence that the authors of the Bank report were aware of research which challenges the assertion that mutuals are less effective than investor-owned companies. For example, an Australian study by Hutcheson & Sharpe (Marks, 1998) of 31 Victorian building societies (17 mutuals, 6 share-owned, and 8 that converted from mutuals to share owned in the 23 years examined) found ‘against expectations’ that ‘mutuals provided a more efficient mix of services than did the

share-owned societies...'. Earlier, Thomas & Logan (1982:109) in their analysis of Mondragon showed that 'the co-operatives are more efficient than many private enterprises' and 'there can be no doubt that the co-operatives have been more profitable than capitalist enterprises.'

The law in Australia has been criticised by Mathews (2000:2) for failing to provide protection for mutuals. '(F)or all practical purposes (it) fails to acknowledge their existence as distinctive entities. ... There is no counterpart in Australian law for amendments to Canada's Insurance Companies Act in 1999 disqualifying directors, managers and employees of demutualising mutuals from benefits other than the entitlements of eligible policy-holders.'

The effect of this can be gauged from the one credit union which had demutualised at the time of Reserve Bank report was the Sunstate Credit Union. It merged with the first provincial Building Society, a publicly listed company. At 30 June 1997, Sunstate was a viable credit union which could have either remained in business on its own or preserved its mutualist character through a merger with another credit union. Its capital adequacy ratio of 12.9% comfortably exceeded the minimum prudential requirement; its operating profit of \$371,000 was expected to increase by 18%; its reserves totalled over \$8 million.

Mathews criticises the demutualisation as being 'grossly inequitable' – denying some members their interest in the assets of the credit union and unfairly enriching directors and employees. Of the 4 million shares in the new entity, 200,000 were reserved for directors and 200,000 for employees. 'The effect was to make directors eligible for benefits roughly 300 times greater than those likely to be available to other members of the credit union. Twenty-five thousand shares were reserved for the former General Manager of the credit union, who also had an entitlement to take up such further unreserved shares as might turn out to be available.' (Mathews, 2000:8).

The members were not treated equitably as between themselves. '(M)embers who did not wish or could not afford to take up their entitlement to shares – or were not qualifying members – were effectively denied their interest in the assets of the credit union, and received nothing whatsoever in

return. Estimates at the time of the amalgamation suggest that 86% of the members of Sunstate were unlikely to receive anything in exchange for forfeiting their entitlements to its reserves, and only 14% to benefit' (Mathews, 2000:8).

Mathews posed the question: 'Given that six of the seven directors of Sunstate had held office for periods in excess of twenty years and the seventh director for ten years, ... on whom can credit unions rely to protect their mutualism?' (Mathews, 2000:9).

The case of the Connect Credit Union shows that member activism can prevail over managers and directors if action is taken quickly.

Connect Credit Union

Connect originated in Tasmania as the Savings & Loans Credit Union in November 1959. It and other credit unions were established to meet a demand for personal loans primarily for public servants supported by simple banking services in the form of savings accounts. Significant growth occurred in the later 1970s due to restrictive practices by the major banks, strong demand for credit, particularly housing and substantial deposit funds being made available by an increasingly sophisticated financial market. Connect admitted non-State public servants to membership in the 1980s.

Significant mergers occurred in 1990 with the Police Credit Union and Teachers Credit Union agreeing to merge, which in turn merged with Savings & Loans Credit Union in 1998. That last merger created Connect as it was in 2003.

At 30 June 2003 Connect operated 7 branches across Tasmania, employed approximately 168 equivalent full time staff, had some 59,000 members and assets of \$528 million. It was the second largest of the three credit unions based in Tasmania and had an estimated 8% market share of deposits. It was operating profitably. Operating profit after tax had risen 23%. It had a capital adequacy ratio

of 12.8%, comfortably exceeding that statutory requirement of at least 8%. Its High Quality Liquid Asset ratio of 11.6% exceeded the statutory minimum of 9% of liabilities. Credit quality standards were sound with a delinquency rate of 0.57% and loan provisioning of 0.43%.

Upon joining the organisation each member subscribed for one \$10 redeemable share. The shares were classified as a current liability in the balance sheet. Equity of \$34.8 million comprised \$0.6 million of capital profits reserve and \$34.2 of general reserves. In accordance with traditional principles of mutuality each member had one vote at meeting.

The announcement

When the annual report for the year to 30 June was released members were told that the directors had resolved ‘to propose to members a reconstruction (demutualisation) and subsequent capital raising of \$10.8 million with a view to seeking listing’ on the Australian Stock Exchange. (Connect, 2003:14). This was the outcome of ‘an 18-month rigorous process of deliberation’. Members were told that they would be considering a Scheme of Arrangement ‘on or about 13 October’. (Connect, 2003:14).

Although the annual report was signed off by the board on 31 July (Connect 2003:14) the results were not released until 29 August (Mercury, 2003a) and the announcement of the proposed demutualisation was not made until 1st September (Mercury, 2003b).

On 20 September it was announced that the information pack detailing the scheme of arrangement, voting information, proxy forms and prospectus would be distributed and that the date of the meeting would be 29 October. However, it was not until 7 October before the 103-page documentation (dated 17 September) was mailed to members. This allowed very little time for members to consider the proposal.

The proposal

In return for giving up their existing membership shares each member of Connect would receive 400 fully paid ordinary shares in a new company Connect Group Ltd (CGL). The 23.6 million shares thus issued would be about 62% of the proposed capital of CGL. A further 14.4 million shares in would be issued at 75 cents and members would be entitled to subscribe for these as part of the new issue. In order for the scheme to be adopted a majority of 75% of the votes cast at the meeting would be required.

Based on there being retained equity of \$34.8 million and 59,000 members, each member would therefore be giving up equity of \$590 in return for shares worth \$300. This point was not made in the proposal document.

The reaction

As early as 20 September concern was being expressed by some members about the principle of demutualisation. One report on 26 September noted that the first credit union to demutualise, Sunstate, had been 'taken over by first Provincial Building Society and subsequently by Bendigo Bank in 2000' (Moullakis, 2003).

Statements from the chief executive to the media stressed that alternatives to demutualisation had been investigated and rejected by the Board. The Board was unanimous that the scheme was in the best interests of members who 'like to own their institutions' (Mercury 2003c).

Some members were prompt in condemning the proposal, pointing out that the privatisation of other Tasmanian financial institutions had resulted in ownership soon being lost (Mercury 2003c). Attention was also drawn to the fine print of the proposal which showed that it was envisaged that the directors would receive an 82% rise in remuneration (Mercury 2003c). Another member was appalled

that the directors were presenting a *fait accompli* without there having been any consultation with members.

By 13 October a spokesman for a group of concerned members, Jeff Briscoe, was reported as saying that both sides of the demutualisation proposal needed to be presented fairly. ‘The directors have known for two years that they were doing this but they didn’t inform us, so it seems to me that it is a *fait accompli* and it will be a real David and Goliath battle to overturn the directors’ decision.’ (Mercury, 2003d).

Many letters appeared in the Tasmanian newspapers in the following days from members, both for and against the proposal. Very quickly it appeared that the call for a more balanced discussion of the demutualisation proposal was wanted. This was rejected by the chief executive who claimed that it would be illogical to promote a ‘no’ case after the board had unanimously resolved that corporate reconstruction was the course to take. (Mercury, 2003e).

By 18 October the Briscoe group had lodged official complaints with the Australian Securities and Investment Commission about errors in the voting forms. They also continued to press for more information to be available on the case against demutualisation. On 20 October the Board relented and gave permission for a pamphlet to be available from Connect branches provided the credit union is satisfied the information was ‘reasonable and accurate’ (Mercury, 2003 f). One member wrote expressing concern that when she had rung the help line for information the Connect staff member ‘tried to convince me to vote yes and couldn’t answer any of my concerns’ (Mercury, 2003g).

With only a week before the meeting the pamphlet was printed (Appendix 1) and made available at Connect branches.

The meeting

The proposal was narrowly defeated. The elation of the Briscoe group can be gauged from the following emails written two days later:

It was a stunning win. The Directors shenanigans were a sight to behold. They continue to cry 'foul' today and I suspect that a new attempt to demutualisation will not be too far down the track. But at least we live to fight another day.

We managed to get the Directors to allow us to put a small Vote No paper on the Branch counters (I hastily put it together but by all accounts it was well received), a copy of it is attached. We also produced some fluoro coloured VOTE NO Posters and put those up in branches to try and counter the some 20 odd VOTE YES posters in each branch (Not counting the Staff 'Yes' badges, and the flyers and leaflets on the counters, and the 'Yes' badges attached to the Proxy/Voting paper ballot boxes etc etc.). This coupled with Letters to the Editor and Media releases to assist in advising the general membership of lack of due process, were the mainstay of our campaign.

The tactics on the floor of the General Meeting last night decided the issue. There were about 800 people present and some 11,000 proxies were submitted – about 8,000 for and 3,000 against, which meant that they needed a significant majority of members present to vote yes. They fell short by some 150 votes.

Of interest to us was that we received information that Directors and senior management went into panic mode on the late Tuesday afternoon and commenced a phone campaign to urge family, friends and acquaintances to attend the meeting as they needed all the Yes votes they could muster. We suspect that Computer Share (The Victorian Co. to whom proxies were sent) actually advised them of the numbers for and against, ahead of the General Meeting which in turn sent them to panic stations. We have yet to confirm this but investigations are continuing. If true it would, in my view, be most improper!!

(Butler 2003)

I was going to email you the result as you were the first university person to alert us (interesting no comment from our university personnel publicly) to the problems/disadvantages of demutualisation. The process seems to fit in with your view of the exercise of demutualisation fills the coffers of the Directors, Management and those hungry corporate raiders and others down the food chain.

During our fight we discovered a number of serious governance issues, but the three week period springing the proposal on members reeks of an intentional strategy. By the way the Board spend over 1.2m dollars and we (as a quickly gathered opposition) spent less than \$1,000. The role of the watchdog bodies should be questioned here – and we will ask ASIC and other relevant bodies to continue to investigate the processes used.

(Briscoe 2003)

The aftermath

At the following annual meeting two new board members were elected with the leader of the anti-demutualisation group, Jeff Briscoe, receiving the most votes. (Mercury, 2004a). A motion to consider strategic directions (including demutualisation) was narrowly passed at the same meeting. By July 2004 it had been decided that any plans to demutualise and seek listing on the Australian Stock Exchange should be set aside ‘indefinitely’ (Mercury, 2004b). Connect has continued to operate successfully without any apparent restrictions caused by its remaining a mutual organisation.

financial data before and after the proposed restructuring is shown in the following table:

\$m	2002	2003	2004	2005
Assets	\$393	\$410	\$455	\$466
Surplus				
- before tax	\$3.8	\$4.6	\$4.3*	\$7.5
- after tax	\$2.6	\$3.2	\$2.4*	\$5.2
Total Equity	\$31.6	\$34.8	\$37.2	\$42.4
Net Cash flow from Operations	\$3.2	\$5.9	\$4.9*	\$7.1
Capital Adequacy Ratio (minimum 8.0%)	12.8%	12.8%	12.5%	13.5%
* Surplus and net operating cash flow are after \$1.6 million non-recurring expenses associated with the reconstruction proposal.				

Profitability and operating cash flow were affected in 2004 by the \$1.6 million of costs associated with the restructuring proposal, but both remained well above the average of previous years.

The 2005 results showed sustained growth compared with the figures for 2003, immediately prior to the announcement of the proposed restructuring. Total assets increased by 14% and surpluses before and after tax by 63%. Net cash flow from operations rose by 20% and total equity by 22%

At the time of writing the 2006 financial results have not been released, although Connect has announced an increase of 21.57% across its lending portfolio. It described this as “an extraordinary results in an otherwise relatively flat market.” (Connect 2006).

Concluding comments

Briscoe's observation that springing the proposal on members with a very short time period reeks of an 'intentional strategy' is consistent with the change strategy advocated by Douglas (1993).

The Board had clearly failed to remain close to the members of the organisation and the presentation of an unwanted restructuring met with opposition from the time it was announced. The opposition was perhaps strengthened by members' awareness of other demutualisations in Australia, such as the AMP and NRMA, which had promised much and delivered little (except to management and consultants).

A similar distrust of pro-demutualisation arguments was discernable in the community. A survey by the Australian National University of social attitudes of 5,000 Australians revealed that almost half (49%) believed that demutualisation had been a mistake in the insurance sector; only 19% believed that co-operatives were old fashioned. (ICA 2004:2).

Finally, the overwhelming support for Briscoe in the subsequent election indicates that members of mutual organisations will respond to a 'David' who is prepared to stand up for traditional co-operative values and principles. Demutualisation need not be inevitable.

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Appendix 1

VOTE NO

To the Directors Recommendations

A group of concerned members have come together as 'Friends Of Connect Credit Union' and have prepared this brief outline of why we believe that demutualization is not in the best interests of the Membership of Connect Credit Union as a whole. We trust that you will find it helpful. We urge you to exercise your right to vote and hope that you will agree with us and either cast a NO vote at the General Meeting on the 29th October 2003, or indicate you are against the directors reconstruction on your proxy form which must be received by 6pm on the 27th October 2003.

Why we are Members of a Credit Union

A credit union is formed around a recognised group of individuals who share a common interest or 'bond'. This **Common Bond** can exist between people who live or work in the same locality, belong to the same association or work for the same employer. This common bond establishes a degree of mutual accountability amongst the membership that minimises the risk of default on loans, as well as encouraging active support and a responsible attitude from the members towards their credit union.

*"Because credit unions are co-operatives, they are democratically controlled and owned by their membership. As shareholders, all members have equal voting rights and an influence over credit union operations and services. The credit union is managed by a Board of Directors elected from **within** the membership."* www.walescop.com.uk

"The members of co-operatives expect the co-operatives to be service driven rather than profit-driven for they are users of the co-operative rather than investors in the co-operative." David Griffiths re WCBF demutualisation

We all chose to be members of a Credit Union - not a Bank or some other undefined financial institution. Our own website says it best.

"CONNECT is a cooperative, based on the concept of members supporting members and we ask that new members of CONNECT commit themselves to the principle of mutual support by making a positive contribution to the financial welfare of the organisation and its members." www.connectcreditunion.com.au

Concerns about the process

The Directors reforms have been presented to members as almost a fait accompli. By their own admission they have been investigating this proposal for some eighteen months, yet it was announced to the Members, Staff and public at the one time, some few short weeks ago. Hardly an inclusive, open process, and certainly not one that fits with the mutuality concept inherent in the credit union ethos.

The saturation presence of Vote Yes posters, badges and propaganda throughout the organisation is worrying. Until this late stage there has been no allowance for an alternative point of view to be displayed. (The Friends of Connect Credit Union have produced and funded this small commentary).

There are some 59,000 Connect Credit Union Members yet the Directors have stated that they expect that only 10% will vote. A poll conducted in much the same way as we elect Directors may have achieved a better return and may have been far less complex than the proxy/voting form provided. Members living outside Hobart are disadvantaged by distance from attending the general meeting and entering into the debate. If the above method of balloting had been adopted then general meetings for debate purposes could have been held around the State. Additionally, our current constitution allows for video conferencing of general meetings. This could have been another option.

Some disadvantages of demutualisation

- Connect will cease to be formally bound by the traditional credit union principles of mutuality. Section 3.3, Scheme Booklet
- We will lose the right to be called a 'credit union'. Section 3.3 Scheme Booklet
- Reconstruction involves members exchanging their member shares and rights for new shares in a company called CGL (Connect Group Limited) which has a different constitution and different rights.
Note: Connect warn that Members need to assess whether they are satisfied that they are not disadvantaged by the exchange Section 3.3, Scheme Booklet
- We are all members, which allows us to be customers, however post demutualisation the interests of a customer (who will no longer be a member) may be in conflict with the interests of shareholders in CGL and CGL itself. The interests of shareholders seeking a return are not necessarily the same as customers seeking a fair deal.
- Without the mutual ownership restriction it may be easier for Connect to be a takeover target or for one person to acquire a significant interest. Section 3.3, Scheme Booklet
Note: Connect advises that it will cap share ownership at 5% and have trading restriction for the first two years only – after that market forces will prevail!
- The reconstruction costs will be about \$1.2 million. Section 3.3, Scheme Booklet
- If the new company, CGL, is successful in its listing application to ASX there will be additional costs arise from being a listed company. Section 3.3 Scheme Booklet
- Members who are in possession of Centrelink payments may have to register that they are shareholders.
- Connect is a shareholder in CUSCAL (Credit Union Services Corporation Australia Ltd). CUSCAL provides support services including:
 - Providing data processing systems to Reditellers
 - Electronic funds transfer network
 - Debit User agreement
 - Credit Card program
 - BPay, Visa, EFT, EFTPOS etc

If Connect is no longer a credit union CUSCAL can't keep supplying services to it. It will have to seek the approval of its other credit union members and then change its constitution to allow Connect to stay on board.

Connect advises that the legal right of CUSCAL to terminate its services is "an inherent risk that could impact Connects activities and performance".
 "The absence of a binding banking services agreement with CUSCAL is a major risk"

*"In the event that a change of service provider is required.....a changeover would take approximately 6 months to complete at an **estimate of approximately \$1 million**. This would have an adverse effect on profits"* Section 3.11 (a), Scheme Booklet

- *Connect licenses its primary computing software from CUTD (Credit Union Technology Development Pty Ltd). The "terms of the license provide that CUTD can only license Credit Unions". Connect may need to negotiate to replace the license. if it ceases to be a credit union "There is a potential cost to Connect in this **including the loss of.....\$608,498 held by CUTD**"* Section 3.11(c), Scheme Booklet
- *The host computing agreement that Connect depends upon is a company called CUFSTAS (Credit Union Financial Services (Tas) Pty Ltd). Upon Connect ceasing to be a credit union CUFSTAS will lose the GST dispensation granted to it by the Australian Tax Office. The cost of this to Connect is **budgeted at \$10,000 per month.**"* Section 3.11 (d), Scheme Booklet

This is by no means an exhaustive list of disadvantages. You will, no doubt have considered many others yourself.

Some Risk Factors

Future revenue and performance of Connect shares can be affected by many factors which are outside the control of the Company

- *"Factors such as Inflation, currency fluctuations, interest rates, natural disasters, war civil commotion, terrorism, government economic and fiscal policy, economic cycles, business confidence and industrial disruptions all may have an impact on lending rates, borrowing rates, operating costs, demand for Connect products and services and market conditions in general."* Section 3.5, Scheme Booklet
- *"General movements in national and international stock markets, and economic conditions could all affect the market price of CGL shares. The price of shares may rise or fall depending upon a range of factors and stock market conditions beyond Connects control".* Section 3.5, Scheme Booklet
- *"There has been no previous market for CGL Shares or shares in Connect and there can be no assurance that an active trading market will develop in CGL shares even if or when they are quoted on the ASX. **SHARE PRICES CAN GO UP OR DOWN**" (the emphasis is ours) Section 3.5, Scheme Booklet*
- *"The price of CGL shares may also be affected by a range of factors including financial performance and by changes in the business environment in which Connect operates."* Section 3.5, Scheme Booklet

Connect warns that:

- ***There is no guarantee that CGL Shares will be quoted on the ASX. It is possible that the capital raising under the prospectus will not be successful in which case the CGL's application to list on the ASX will not be approved. In that event there will be no official market for CGL Shares and it may be difficult for Members to realise their CGL Shares or to purchase additional CGL Shares.***

FOR FURTHER INFORMATION PLEASE CONTACT THE FRIENDS OF CONNECT CREDIT UNION ON 62488051 OR (M) 0418 127 311

VOTE

NO

TO THE DIRECTORS RECOMMENDATIONS

Authorized by Jeff Briscoe on behalf of the FRIENDS OF CONNECT CREDIT UNION

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