



November 28, 2005

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: SOA
File Reference: 1204-001

Dear Chairman Herz:

Thank you for inviting us to participate in the FASB Roundtable discussion held on October 27. We appreciate the opportunity to express the concerns of cooperatives directly to Board members. This letter is a response to your inquiry about the "at cost" structure of cooperative entities and the requirement in the Exposure Draft of FAS 141 that all acquirers of business combinations utilizing the acquisition method be valued at fair value rather than historical cost. You stated that you presumed that accountants or valuation experts would take into account a requirement for at cost operations by using the book value as fair value. We agree that is the correct presumption and we urge FASB to clarify that for at cost operations, book value is the appropriate measure of fair value.

We have urged FASB/IASB to permit a different accounting method for business combinations between cooperatives. As we have explained in our comments, the cooperative structure is fundamentally different from that of investor-owned businesses. One of the key differences stems from the core principle that the members/patrons own and democratically control the business entity. A related and equally important principle is that proceeds from the cooperative's operation revert back to the members in proportion to each member's participation in or use of the cooperative, not according to the amount invested. Therefore, any earnings or margins in excess of the cost of the products sold and expenses of operation of the cooperative are *returned* to the members in the form of patronage refunds/dividends allocated to each member in proportion to his or her patronage or participation in the cooperative. The members enjoy a return *of* their capital, not a return *on* their capital. Essentially, through the return of patronage capital to the member/owner, the cooperative operates "at cost."

Federal income tax statutes and case law permit cooperatives to exclude from the proceeds of the cooperative operations, for income tax purposes, patronage refunds/dividends. Patronage refunds/dividends (except those attributable to personal, living or family items) are taxed but at the member level, not at the cooperative level. Provisions in federal tax law specifically provide exemptions for certain types of cooperatives and in some instances specifically require that the

cooperative operate at cost. The tax treatment of cooperatives -- treating the cooperative as an agent or trustee for the income allocated to its members -- stems from the fact that the entity is held in common for the mutual benefit of its members. For a more detailed explanation and history of federal tax law as it applies to the cooperative structure, please see NCBA's testimony submitted to the House Ways and Means Committee, April 2005, which we attached to our comments submitted to FASB on October 27.

The types of cooperatives that are not specifically exempted under the tax code are permitted to exclude patronage dividends from their income as long as they operate on a cooperative basis. Various court decisions as well as IRS private letter rulings have permitted cooperatives to exclude from income tax under Subchapter C the patronage dividends or refunds where the entity operates on a cooperative basis. The three principles described as fundamental to cooperative operation are subordination of capital, democratic control by members, and operation at cost. "The requirement of operation at cost is met if the cooperative's net earnings or savings are distributed to the cooperative's patrons in proportion to the amount of business conducted with them." IRS PRIV.LTR.RUL. 200504035, November 2, 2004 (emphasis added) citing as support *Puget Sound Plywood, Inc. v. Commissioner of Internal Revenue*, 44 T.C. 305, 1965 (worker cooperative treated as nonexempt cooperative association; patronage dividends excluded from proceeds for income tax purposes at cooperative level).

Whether cooperatives offer refunds/discounts in advance or allocate surplus revenues in the form of patronage refunds/dividends, they must operate at cost to qualify for the tax exclusion at the cooperative level. The pooling of interests method is appropriate for cooperatives that operate at cost because it is based on historical cost. The acquisition method introduces the concept of fair value that is ill suited to the cooperative operation. Regardless of which accounting method is required for entities that operate at cost -- fair value or historical cost -- the result typically will be cost or book value because any excess above cost cannot be accounted for other than as an impairment. In other words, why would members of a cooperative agree to "charge" themselves for the fair value of the same assets they were previously paying for based on historical cost?

We have asked FASB to permit cooperatives to continue to use the pooling method. We understand, however, FASB's desire to apply the acquisition method to all business combinations. We agree that fair value should be considered book value where the entity is required to operate at cost. We suggest that FASB recognize the book value as fair value for at cost operations. This would maintain the goal of uniformity but at the same time would serve the needs of the users of a cooperative's financial statements. In addition, we urge FASB to include clear guidance about the use of book value for fair value where at cost operations are required as part of its fair value hierarchy work.

Sincerely,



Paul Hazen
President & CEO