



October 27, 2005

Technical Director
Financial Accounting Standards Boards
File Reference No. 1204-001

Re: Comments on Exposure Draft – *Business Combinations* (a replacement of FASB Statement No. 141).

On behalf of the National Society of Accountants for Cooperatives (NSAC), I am pleased to offer our comments regarding the Exposure Draft on the revised Statement No. 141 – *Business Combinations*. The NSAC would like to thank the Board and the staff of the FASB for their willingness to listen to our views, with regard to this very important topic to future business combinations of cooperative enterprises, and to engage in helpful dialogue about the unique nature of these transactions in a cooperative business environment.

Respondents to the Exposure Draft are asked to comment on the questions raised in the Exposure Draft, our comments are as follows:

Question 1:

We continue to believe that the vast majority of combinations of cooperative entities (mutual enterprises) are unique, in that no consideration (above the book value of their existing equity interest) is paid to the members of one cooperative when combining/merging with another cooperative. Since the members' equity interests of combining cooperatives are most often simply pooled together at book value, there is no "purchase cost" to the acquiring cooperative (leaving aside for the moment the difficulty of identifying an acquirer in these combinations) with which to objectively measure the basis of an acquisition (also leaving aside for the moment the difficulty of determining the fair value of the acquired entity). We believe there are substantial reasons to retain the pooling method, and outline those reasons below.

Appendix B of the Exposure Draft, specifically paragraphs B13 – B17, and B45 – B47, rightly states the reservations the cooperative community has regarding the objective of utilizing only the acquisition method for all business combinations. We would ask the

Board to consider whether and how much relevant information is conveyed to the users of these financial statements by requiring the application of the acquisition method.

Statement of Financial Accounting Concepts No. 2 *Qualitative Characteristics of Accounting Information* (CON2) sets forth part of the conceptual framework and, building on Statement of Financial Accounting Concepts No. 1 *Objectives of Financial Reporting by Business Enterprises*, provides essential guidance to our comments. CON2 paragraph 46 begins the outline of relevance of accounting information – “In discussions of accounting criteria, relevance has usually been defined in the dictionary sense, as pertaining to or having a bearing on the matter in question. That broad definition is satisfactory as far as it goes – information must, of course, be logically related to a decision in order to be relevant to it. Mistaken attempts to base decisions on logically unrelated information cannot convert irrelevant information into relevant information any more than ignoring relevant information makes it irrelevant. However, the meaning of relevance for financial reporting needs to be made more explicit. Specifically, it is information’s capacity to “make a difference” that identifies it as relevant to a decision.” In the context of decision making for cooperative entities regarding potential combinations, the fair value of neither entity is relevant to the transaction. That is, the members’ deliberations and decisions are focused on future economic benefits to be gained from a potential combination, but those benefits will normally be derived from future operational efficiencies etc... and have no bearing on the theoretical fair value of either existing entity. Since there is no purchase price being negotiated in the transaction, the fair value of the acquired cooperative is not relevant (does not make a difference) to the members. Indeed, the interjection of notions of current fair value (fair value prior to the expected merger benefits) and measurement of fair value will, more than likely, impede the decision making process for most cooperative mergers – leading us to not only question the relevance, but the neutrality of the proposed Statement.

CON2 also addresses representational faithfulness as an aspect of the reliability of accounting information (beginning with paragraph 63) – “Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations.” The owner/members of cooperative entities most often view proposed combinations as a common enterprise wherein they pitch together and pool their respective volumes of business, and economic resources and obligations, to gain future benefits. To be sure, those economic resources – including the various assets of each entity – have a value that probably differs from their historical cost basis (aside from liquidation value). That value and the theoretical value of ownership of the entity cannot be separated from the members’ own use of those resources. In other words, the cooperative has going concern value only as long as its members patronize the cooperative. This means that the member/owners of one cooperative are not really acquiring the rights to a future benefit stream from the owner/members of another cooperative – the basis for determining fair value in most valuation models - they are all

dependent on each others continued patronage. Any goodwill intrinsic in that transaction would be derived from the patronage of the acquired cooperatives members – the combined entity would then be allowed/required to increase its assets and equity for something no one paid for or owns and that exists as a complete abstraction largely dependent on the volume of business they continue to do with themselves. Another aspect of cooperative practice that makes the pooling model more appropriate, from the standpoint of representational faithfulness, is the practice of operating on the basis of cost. The Board is familiar with this concept and that it is unique to cooperatives – whether they are marketing cooperatives or supply cooperatives. Profits earned from member/patronage activity are allocated to the patrons based on their patronage, effectively either increasing the amount received for a marketed product or decreasing the cost of a supplied product to the member patron. “Operation at cost” includes depreciation/amortization of existing assets based on their historical costs. From the standpoint of evaluating proposed combinations of cooperatives, it is entirely right to continue to use the combined historical cost basis for determining future depreciation/amortization. Those are the future costs (assets) brought into the combination by each entity and the basis that is reflected in the equity interests brought into the combination. To break the continuum of historical cost basis to value one side of the combination at an estimated fair value, and use that value to depreciate/amortize, skews the operating results of future periods by reflecting a cost/expense that never existed – since no consideration was paid. In like manner, if we understand paragraph 53 of the Exposure Draft correctly, the offsetting credit to valuing the acquired entity at fair value (assuming that fair value of the assets exceeds book value) will create permanent equity that also never existed through investment or retained equity by/from the owner members.

Taking up the topic of determining the acquirer and the acquired party in a combination between two cooperatives, we note that one board member dissented from the majority view (paragraph B212) and acknowledged the difficulty of determining the acquirer party in the Board’s field visit. These types of combinations are very common and even when one entity may be slightly stronger than another or have slightly more representation on its governing board the success of the combined enterprise requires the patronage of both. We also note that this Board member expresses a preference for fresh-start accounting in those instances where it is especially difficult or even arbitrary to identify an acquiring entity. We are sympathetic to the use of fresh-start accounting in all those instances where a “true merger” occurs – that is no consideration is paid by either party and the proportional or equal representation of the members from each party will continue on the combined entity’s governing body. We believe the Board member has a valid point in noting that fresh-start accounting would be more representationally faithful to the phenomena of cooperative combinations than is the application of the acquisition method. We would broaden that application to include those types of true mergers mentioned above.

In light of relevance, reliability (representational faithfulness) and neutrality, we believe an exception should be made for cooperative entities in the application of the proposed statement. As an alternative, we suggest that the Board continue to allow the pooling method for those combinations where no consideration – acquisition price – is paid from one entity to the other. In those instances where consideration is paid, in the form of cash or issuance of redeemable debt or additional equity, that purports to compensate the owner/members of an acquired cooperative for their ownership interests, we believe the acquisition method can be applied. As an additional alternative, we would prefer to see the Board adopt fresh-start accounting for both entities (or all entities in a combination involving more than two cooperatives) as ultimately more representationally faithful than the acquisition method.

Question 4:

Paragraph A24 seems to imply, through this statement – “...the fair value of the acquiree and the fair value of the member interests exchanged as consideration are presumed to be equal” – that member equity instruments i.e., qualified or non-qualified equities that are exchanged should reflect the fair value of the transaction. In the majority of mergers, a member’s equity would not be changed by the transaction, would remain at book value, and indeed could not be increased arbitrarily. We think the Board means that the combined equity will reflect the fair value of the acquired entity by increasing overall equity with a “purchase equity credit”. The approach to this point should be clarified.

Taking up the topic of determining fair value, Paragraph A26 rightly notes that cooperatives will show a different stream of economic benefits than other businesses assessed by marketplace participants and proper adjustments should be made. This point should be clarified and expanded to provide guidance to preparers, auditors and users.

Question 7:

We agree that these costs are not assets.

Question 11:

Paragraphs 59 – 61 could be misconstrued by mutual enterprises to propose some consideration to the members of the acquired entity, not contemplated by paragraph 53, and obtain a bargain purchase gain for transferring less than fair value for that interest. The Statement should be clarified, beyond the discussion in paragraphs B168 – B182, as such circumstances might specifically pertain to mutual enterprises.

Once again, we appreciate the opportunity to respond to the Exposure Draft and to offer this letter of comments regarding the proposed Statement. We would be glad to discuss these points, or any other points, with the Board and staff as they might require.

Sincerely,

Gregory O. Taylor, Chairman – Accounting and Auditing Committee, National Society of Accountants for Cooperatives