

June 27, 2005

Letter of Comment No: \preceq File Reference: 1400-BCU

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

Re: Application of Acquisition Method to Combinations between Cooperatives

Dear Chairman Herz:

On behalf of the members of NCBA, we are writing to comment on FASB's proposed business combinations standard, which would require the acquisition method of accounting for all business combinations. While we understand that the Exposure Draft of the proposed Statement will be issued within the next month and we will have the opportunity to comment on that Draft, we wanted to clarify and reiterate our position about the need to account for the different economic structure of cooperatives in the business combinations rule.

We understand and are sensitive to the IASB and FASB's effort to apply a single approach to all combinations but such an approach does not take into account that cooperatives are different and imposes significant short-term and long-term costs on cooperatives without any corresponding benefits. In the Equity and Liabilities Project context, FASB has recognized the fundamental difference between cooperatives and investor-owned companies by proposing to permit the use of book value for nonpublic entities where there is no traded or market value. We applaud that decision and suggest there are similar reasons that warrant different treatment for mergers between two or more cooperatives and ask that FASB permit cooperatives to continue to use the pooling method for combinations between cooperatives.

Structure of Cooperatives Justifies Alternative Method of Accounting for Combinations

In its basis for conclusions, FASB stated that more than one method of accounting for business combinations could be justified only if the alternative method provides more useful information to users of financial information and unambiguous and nonarbitrary boundaries could be established that distinguish when one method is to be applied rather than another. Cooperatives present a compelling justification. The pooling method is more useful for cooperatives and their stakeholders and the boundary for when the pooling method could be applied would be clear -- combinations between two or more cooperatives. The following presents the reasons we believe an alternative method should be used for business combinations between cooperatives.

Cooperatives – True Mergers of Equals

While shareholders of investor-owned businesses seek to maximize returns on their investment, members of a cooperative join it primarily to receive services, not a return on their investment in the cooperative. Cooperatives combine in order to provide their members with better or additional services.

In proposing to do away with the pooling method and require the acquisition method for all business combinations, FASB has stated its belief that true mergers of equals are nonexistent or so rare as to be virtually nonexistent. FASB's assumption about the investor-owned world -- that nearly all combinations are acquisitions -- does not apply to the cooperative sector. In co-ops, the reverse is true. Nearly all combinations are true mergers -- where there is no consideration, no change in voting power of the existing owners, and no exchange of member interests.

The typical combination of investor-owned businesses is a purchase by the acquirer of the majority voting interest of common stock in the acquiree. This cannot happen with cooperatives, because the principle of "one-person-one-vote" prohibits one member from taking control of the majority of the voting rights. Member shares, which are not publicly traded and are non-transferable, are issued and redeemed on a nominal basis, and therefore do not have a market value which an acquirer would be willing to pay.

The lack of a clearly identifiable acquirer and acquiree

It is not mere semantics, or ideology. It is a business reality that owners who do not wish to relinquish control and who are not seeking consideration will not support a business combination that fundamentally identifies a buyer and seller. The owners are not "selling" anything. Co-ops are in business to serve their member owners. If members of one cooperative were to view a "sale" as impeding their ability to control the co-op and ensure it continues providing a service, it is a sound business decision to reject the combination of the two cooperatives.

FASB has stated its belief that the pooling method assumes that transactions are between the owners of the combining entities rather than the entities themselves. But in the case of cooperatives, the transaction is between the owners of the entities. We fail to see how a combination between cooperatives can be considered an acquisition where members are the owners and there is no change in control. Identifying an acquirer and implying an exchange of member interests fundamentally changes the dynamic of the negotiations surrounding the combination. On the other hand, we believe the acquisition method is appropriate in the case of the sale of a cooperative to an investor owned enterprise since there is actually consideration in this case.

The difficulty determining fair value of a cooperative.

There is a lack of market information that can be used to determine the fair values of cooperatives. Cooperative equity is not traded on any exchange; and there is no active market for cooperative shares. Unlike publicly held investor-owned entities, an individual may only join a cooperative after meeting the requirements for membership and after approval of the Board of Directors, or in some cases, the membership. The member's interest in the cooperative is not transferable. Since there is no universally recognized method of valuation of cooperatives, requiring fair value measurement could result in financial statements that would not be comparable as different

accounting firms may take numerous and possibly conflicting approaches to the question of how to determine the fair value of a cooperative.

In response to questions about how to determine fair value, cooperatives have been directed to sections of the tentative business combinations decisions for guidance. In paragraph A19 of the tentative decisions, FASB states that in certain instances, including mergers between mutual enterprises, the "fair value of the business acquired is determined to be more clearly evident, and, thus, more reliably measurable than the fair value of the equity or member interests transferred by the acquiring entity." In paragraph A24, FASB reiterates that position and adds that a fair value measurement of a mutual enterprise must consider assumptions about future member benefits, e.g., lower fees, that market participants would make to ascertain the fair value of the enterprise.

It appears that FASB assumes the interests of members/owners come in the form of economic benefits but then argues away these benefits when it states that the value of the business acquired can be measured more reliably than the fair value of the member interests. The result would be to measure a cooperative as one does any other business, but include some assumptions about future member benefits. But future member benefits, such as potential cost savings, are extremely difficult to measure in a reliable way. Investor-owned companies that promise synergies and cost savings from mergers are not required to quantify those promised future cost savings.

For cooperatives, a reliable fair value measurement of either member economic benefits or the acquired entity is extremely difficult. Fair value measurement generally assumes an external equity market which does not exist with cooperatives in which the members of the cooperative are its owners. The economic benefits of membership are not readily apparent to external parties nor are they easily measured. Even if a comparable market were found and a ratio selected upon which the fair market value was determined, fair value under this approach may be considered inflated because it cannot be recovered from the cooperative's members because they would have no incentive to voluntarily raise their costs paid to the cooperative simply to recover a fictitious (from their point of view) accounting value. Unless any such arbitrarily determined fair value were immediately rationalized with the level of revenues the newly combined cooperative could support, subsequent impairment of an inflated fair value may affect the cooperative's ability to secure loans or meet debt covenants.

Another option to determining fair value is the income approach, in which one would look at the combined revenue stream of two merged cooperatives to assess the fair value of their balance sheets. This option, however, produces the same results as the application of the pooling method since the members of the newly combined cooperative would have no incentive to raise the rates they pay the cooperative for products or services since they operate on a not-for-profit basis. Cooperatives may be required to incur substantial costs and staff time to apply the income approach but would derive no additional benefit.

Fair value measurement would result in book value – the example of the electric cooperative

How the income approach produces the same results as pooling is illustrated by electric cooperatives. Under the pooling approach, if a merger took place between electric cooperatives, both balance sheets essentially would be combined at book value. If, however, under the acquisition approach, the acquiree (assuming one could be identified) was required to write up the value of the assets to fair market value, the electric cooperative's debt would not be revalued since

its debt is not tradable in the public markets and the terms of the debt would not change. Therefore, the difference between the new fair value of the assets and the book value of liabilities would be recognized as equity.

For electric cooperatives, rates are set at a level to recover the book cost of assets and meet the debt covenants of cooperative lenders. In this situation, if one applied the income approach to determine fair value, the electric cooperative would be required to write the value of the assets down to book value because that is the level of assets that the newly combined electric cooperative's rates will support.

The following table illustrates that the application of the acquisition method to an electric cooperative merger would, in this simplified example, ultimately result in accounting that would have been the result had the pooling of interest approach been utilized.

	Coop A	Coop B	Fair Value	Impairment	Final Result
Assets	\$1,000	\$1,000	\$5,000	(\$3,000)	\$2,000
Liabilities	\$800	\$900	\$1,700		\$1,700
Equity	\$200	\$100	\$3,300	(\$3,000)	\$300
	\$1,000	\$1,000	\$5,000	(\$3,000)	\$2,000

Although the electric cooperative industry is one example and the extent of cost recovery for electric cooperatives is set by the cooperative's board, the same reasoning would apply to many other industries in the cooperative sector. The rationale is that when cooperatives operate on a not-for-profit basis, they must set revenues to recover their costs and provide whatever level of equity the membership deems appropriate since, in most cooperatives, the only source of equity is the member shares.

Members and other users will not benefit from the use of acquisition method

FASB has stated its concern about the need for better financial information to assist users in comparing financial results and to promote the usefulness of financial statements. For cooperatives, a change to fair value creates the risk of confusing the entity's financial picture, making it more difficult for users to assess the cooperative's financial status, particularly because there is no universally recognized method of valuation. Showing fluctuations in value resulting from various valuation techniques would not promote the goal of providing financial statements and information that is relevant to the cooperative's stakeholders. Such a process may inflict an element of volatility that would actually be counterproductive and less useful to an important group of cooperative financial statement users: lenders that are in the business of financing cooperatives.

In addition, the application of the acquisition method may have a potential negative impact on credit standing of cooperatives. Many cooperatives issue public debt and so have ratings from one or more credit agencies. Obviously, any post combination impairment of the cooperative's assets may result in the cooperative being downgraded or placed on the credit watch.

The short- and long-term costs of applying the acquisition method to a combination are untenable for most small and mid-size cooperatives

The acquisition method would add considerable costs to cooperatives. Based on some estimates from a public accounting firm, the impairment analysis alone could cost \$10,000 to \$12,000, at a minimum, for a small cooperative. Though these amounts may not sound excessive, in the context of a small cooperative, such amounts could significantly reduce equity or require cost cutting that may impede a cooperative's operations. Depending on the complexity of the intangible assets, that cost could go up significantly more. In addition, in certain instances the cost of calculating the fair value of fixed assets such as property, plant and equipment with no readily identifiable market would also be significant and on top of normal auditing costs. In addition, the annual valuations required by the acquisition method would add yet another financial burden to cooperatives.

Requiring cooperatives, most of which are small businesses, to pay such transaction costs results in a burden on already limited resources. Cooperatives operate at a disadvantage to investor-owned companies because they rely on member equity rather than outside investors. It is more difficult for cooperatives to grow or diversify. These additional costs would hamper cooperatives already limited ability to grow and access outside capital, making it more difficult for them to compete with investor-owned companies. As stated previously, these costs add little or no benefit to members or users of financial information.

The acquisition method will discourage mergers between cooperatives

The FASB concluded that the accounting standards for business combinations "should not seek to encourage or discourage business combinations." But there is clear agreement among cooperatives in the U.S. that requiring the acquisition method will actually deter mergers. When asked of the implications if the parties had to name an acquiree at the time of their merger, the nearly universal reply is that the merger would not have happened. By deterring mergers, the proposed standard reduces the ability of co-ops to remain competitive, affecting their long-term business viability. Accounting requirements should not be a roadblock to sound business judgments.

In discussions with FASB members last year about the business combination rule, it was suggested that the Fresh Start approach may be a better alternative to the acquisition method for cooperatives. We were asked to provide examples of when Fresh Start would be more appropriate for mergers between cooperatives. While we have been looking for those examples, we have found that there is a great deal of confusion over the meaning of Fresh Start among cooperative accountants in the context of business combinations. We ask FASB for more guidance as to what is meant by the Fresh Start approach to cooperative combinations. Once we have a better understanding of the meaning and its application, we will be happy to provide you with some examples where Fresh Start may be the preferred approach.

We look forward to working with you on this issue and will provide more detailed comments to the Exposure Draft after it is issued.

Sincerely,

Paul Hazen, CEO

Paul Hogen