# Farmers Telephone Cooperative, Inc.

30 October, 2003

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

VIA: Electronic Submission

RE: Comments Regarding the Application of SFAS 150 to Rural Telephone

Cooperatives

#### Dear Chairman Herz:

The Farmers Telephone Cooperative is a rural telephone cooperative entering it 50<sup>th</sup> year of providing telephone service to the people of Northeast Alabama. Like its counterparts across the nation, this cooperative was organized to fill the need for telephone services to an area that the investor owned companies refused to serve. We were originally financed under the telephone program of the Rural Electrification Administration (now Rural Utilities Service) and continue to be financed with a mixture of debt and equity.

This respondent comes now before the board and presents its concerns with the broad and unilateral application of SFAS 150 to the patronage capital of cooperatives. Since the Rochdale Pioneers first laid down the principles of the cooperative enterprise, this form of organization has fulfilled a need that led such noted scholars as Israel Packel to define them as "economic associations for self help". Owing to the determination and independent nature of Rural Americans, the cooperative became the form of choice for both electrifying and providing modern telecommunications to that portion of our great nation. While these comments are tailored, for the board's convenience, primarily to the rural telephone cooperative, this respondent believes that its comments also have broad application to rural electric cooperatives given the similarity of the industries.

## Foundation:

For many reasons, those involved with rural telephone cooperatives have always been careful to distinguish their organizations from their privately owned counterparts. There is much justification for these efforts given that in many cases the public policy of the United States was based in part on rendering assistance to those sections of the populace that demonstrated they were willing to help themselves. Thus, our government took rest in the fact it was aiding its citizens directly as they strove to improve their quality of life

rather than simply and directly subsidizing just another type of industry. Further, a number of tax and regulatory schemes were also predicated on the unique nature of the cooperative enterprise as opposed to private industry. While true, these well know distinctions (most notably the means by which surpluses are allocated to owners) have often obscured the central fact that cooperatives are still an economic enterprise. As such they are businesses that function in many similarities just like any other business. One central similarity that must be considered in this discussion is that cooperatives still have two component sources of capital; debt and equity.

In a cooperative the principle form of equity is patronage capital; surpluses retained and allocated to members on the basis of their patronage. This, however, cannot obscure the fact that patronage capital retains all the basic qualities of equity found in any other form. It is capital furnished by investors in the enterprise who are willing to place that capital at risk in consideration of a possible return. Arguably, for the typical cooperative member, that return will take the form of receiving an otherwise unavailable service at an affordable price or an available service in some superior manner. None-the-less, this does not change the fact that patronage capital is still equity because it is capital at risk for which there is no guarantee of return.

## The Danger:

Given this understanding, what then is the danger posed to cooperatives by an otherwise well intentioned SFAS? To understand the answer, two facts must first be understood.

- First, most cooperatives routinely refund their patronage capital on a predetermined cycle.
- Second, many cooperatives allow for the premature distribution of patronage capital at the point a member withdraws from membership.

If either of these facts is construed unilaterally as triggering the unconditional and certain events clauses of the SFAS, then their simple existence, by default, would seemingly require the unilateral reclassification as debt of the entire equity section of the enterprise's balance sheet. As recently as in the past 90 days at a technical symposium, this respondent has even heard one practitioner in the field of public accounting specializing in cooperative financial reporting purport as much in response to a questioner. Further his comments were completely without regard to mitigating circumstances or the effect of such reclassification. The simple fact is that the mere presence of either of these practices should not require or even suggest the appropriateness of such an SFAS 150 required reclassification. The reasons are thus stated.

## Formal Refund Practices

Cooperatives that choose to refund patronage capital usually do so under the provisions of a carefully reasoned equity management plan. The plans typically call for target

equity levels that support the business plans of the organization and provide for the requisite capital in proportions of debt and equity that give rise to, among other things, desirable weighted average costs of capital. Further refund of equity usually gives rise to an ongoing rotation of capital that balances the needs of both older patrons and well as those currently patronizing the organization. In virtually every case older equity is usually replaced, at least to some extent, by the allocation of current operating surplus resulting in an orderly rotation that maintains the desired equity level. What is often less understood is that the refund or retirement of patronage capital is seldom a required event except in the case of dissolution. Even though prescribed in some cases as a requirement for favorable tax treatment, the actual refund of equity is still an event that is contingent upon one factor. That factor is a determination by the organization's governing board that the financial condition of the cooperative warrants such a refund. Once this finding has been made and the retirement decision formally made, GAAP would clearly require that the portion of Patronage Capital Assigned that is subject to refund be reclassified as Patronage Capital Retired and Payable. This reclassification of equity to that of a liability would follow, in almost exact form, the reclassification of Retained Earnings as Dividends Payable that occurs in an ordinary corporation at the point dividends are declared and become payable. The presence of an orderly and well crafted equity management plan calling for the systematic retirement of patronage capital does not obviate the fact that the actual decision to retire patronage capital is still an event wholly contingent upon the board's finding that it is, in fact, appropriate to do so. And it is appropriate to make equity to debt reclassification only upon the actual determination to declare such equity retired and payable.

## Early Retirement Practices

Most troubling to some cooperatives is the presence of formal provisions allowing for the early or premature distribution to members of their share of patronage capital in the event they withdraw from membership. Perhaps most common in the event of death, this provision is a widespread practice. Members who have withdrawn from membership ostensibly have no means to continue to receive any return from or return of their capital though the capital continues to be at risk. For this reason, many cooperatives have adopted, usually through board resolutions as opposed to by-law requirements, provisions for the early return of that patronage capital under specified conditions. There are those who fear that if events such as the death of a member are considered in the same light the Board has viewed death of a shareholder in the presence of a buy-sell agreement the extension of such provisions would again trigger the unilateral application of SFAS 150's reclassification requirements. Again, this respondent believes such an application would be egregious.

First and foremost, the provisions are usually, once again, contingent upon the provision of the organization's board finding such retirements to be appropriate. Further and perhaps more importantly, it is also often a requirement that the affected member or their estate elect the early retirement provision and that the retirement itself is subject to a discounting process. Such is the case with this respondent. There is an arguable premise that to force or allow the early retirement of patronage capital at its par value is in fact

economically discriminatory against those who do not meet the early retirement criteria. Policies or procedures that in effect give rise to disparity of standing between members is generally anathema to the cooperative philosophy and may also run counter to several of the requirements found in the IRC of 1986. For this reason, discounts based on formulas driven by the normal retirement practices of the organization are applied against the par value of early retirements in order to reduce them to their present value. This discounting is also coupled with an election by the member to accept the discounted value of the patronage capital in settlement of their account. If this is not acceptable to the withdrawing member or their estate, then the member may elect to receive the refund at its regularly scheduled retirement should such a retirement ever be declared. This voluntary election removes another discriminatory argument and reduces the actual monies involved to a level economic playing field. For purposes of this discussion, these factors constitute a series of voluntary elections that constitute contingencies which in this respondent's opinion make unilateral reclassification based upon the mere existence of such practices both unnecessary and inappropriate.

There is also the argument that it is highly improbable for an entire membership base to withdraw for any reason, including death, at or near the same time. There is simply no way to relate the potential death of a member in a large cooperatively owned enterprise to the death of a shareholder in a small business corporation and the subsequent triggering of a buy-sell agreement that places material obligations on the company. Even the aggregate effect of multiple withdrawals of members during any given period usually has little material effect on the organization. Since any retirement, early or normal, of patronage capital is generally subject to equity management considerations, the effect of such aggregate withdrawals are contemplated and allowed for in the final determination regarding retirements in the first place.

## Conclusion:

In conclusion we offer that the accounting profession is under great scrutiny in light of the events that have threatened the stability of the financial reporting systems we hold so crucial. While we respect and admire the Board's efforts at insuring that financial obligations that have debt characteristics be classified as such, we submit there is always a danger of financial professionals acting in an arbitrary manner under the fear of sanctions if their judgment should ever, in hindsight, prove questionable. We firmly believe, however, that the judgment of properly trained and certified financial professionals, acting in the most prudent professional and ethical manner possible, is not a factor that can be displaced by rules of arbitrary and unilateral application. While we believe in and support this Board's role in the issuance of standards and principles, we also believe firmly that those rules, and in this case SFAS 150, must allow for variances in the forms of enterprise and for assessments based upon the unique circumstances and provisions relating, in this case, to telephone cooperatives. Arbitrary and unilateral application based upon the mere presence of factors which appear on the surface to mirror instances found elsewhere in the economic marketplace is bad. It is bad because reclassifications resulting from such application would cause many organizations to technically default on mortgage covenants, some of which date back to the 1950's.

It is bad because it would cause confusion in the financial markets which all too often are skeptical of the unique nature of "non-profit" organizations, such as cooperatives, to begin with. But perhaps the Board's biggest concern should be that such application would cause the one thing this board desires to avoid most of all; the material misstatement of an organization's financial position.

This respondent therefore begs the Board to consider the facts and circumstances before it and to allow for the application of specific facts special to the cooperative form of enterprise. It further pleads that the Board prohibit the arbitrary and unilateral imposition of the equity to debt reclassification portions of SFAS 150 without clear determinations by financial professionals that such reclassifications are in fact warranted.

# Respectfully submitted,

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