



LETTER OF COMMENT NO. 38

May 29, 2008

Technical Director

File reference 1550-100

Financial Accounting Standards Board

401 Merritt 7

Norwalk, Connecticut 06856-5116

Re: *Preliminary Views – Financial Instruments with Characteristics of Equity* – File Reference 1550-100

Dear Sir or Madam:

The National Society of Accountants for Cooperatives (NSAC) is a national service organization representing approximately 1,500 individual accountants and other financial and legal service providers employed by cooperatives or by firms providing auditing and assurance services, consulting and legal services to cooperatives. Our membership represents a broad array of different types of cooperative entities including producer owned local and regional agricultural cooperatives, federated agricultural cooperatives, consumer owned electric utility and telephone cooperatives, Federal intermediary credit associations, retail and wholesale grocery and hardware cooperatives, as well as many other types of consumer owned cooperatives.

The NSAC appreciates the opportunity to provide our comments to the Financial Accounting Standards Board (Board) regarding the *Preliminary Views Document – Financial Instruments with Characteristics of Equity*.

The broad spectrum of mutual enterprises represented by the NSAC's membership gives us a unique perspective on the overarching issues addressed by this Preliminary Views Document and the possible impact of its requirements on the treatment by cooperatives of various financial instruments currently treated as equity by these entities in their statements of financial position. These financial instruments include: common stock, allocated equity, per-unit retains, and preferred stock.

As outlined in the Preliminary View Document, we will attempt to address the issues and questions raised by the Board and staff as follows:

Questions on the Basic Ownership Approach

- 1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?**

While the Basic Ownership Approach provides the narrowest definition of equity of the three approaches considered by the Board, we believe that this approach would represent an improvement in financial reporting. The approach considers that the holders of financial instruments with the most subsidiary claim to the assets of the entity upon theoretical liquidation have true ownership risk, therefore an equity stake - that is risk capital invested with no guarantees of redemption or preference to any other instruments in liquidation. With respect to what constitutes a basic ownership instrument, the underlying principles are clear and appropriate and readily understandable. This narrow view of equity does significantly simplify the accounting for financial instruments within the scope of this document and would provide minimal structuring (accounting arbitrage) opportunities.

From the viewpoint of cooperative entities, the Basic Ownership Approach – as outlined – does include some uncertainties that we would like to address in some detail. Most of these uncertainties arise due to the legal priorities of liquidation addressed in the bylaws of most cooperatives – as will become evident in the discussion below. As the Board and staff are aware, cooperative entities – by definition – have distinctly different operating principles from investor owned entities. Broadly speaking, these principles require that earnings in any particular year, generated from member patronage, be allocated to the members based on their patronage with the cooperative in that year. In practice, this principle leads to the issuance of written notices of allocation to the members for their share of the earnings of a particular year. The portion of this allocation not returned in the form of a cash dividend (patronage dividend paid in cash), is retained by the cooperative as allocated equity. Over time, these yearly layers of allocated equity accumulate to form, in most instances, the largest amount of equity capital on a cooperative's balance sheet. Over time, as well, most cooperatives seek to redeem or retire these allocated equities, utilizing a number of possible methods for capital management; usually defined in the bylaws of each association.

In order to gain access to membership in a cooperative and the right to participate in the governance of that cooperative, many, if not most, cooperatives require that a patron purchase some amount of common stock or put up some amount of capital. This initial entry capital may be as small as one dollar or as large as hundreds of thousands of dollars (in some “new generation” cooperatives). On the other hand, many small and large cooperatives require no entry capital, simply allowing new members the right to participate in the earnings and governance of the cooperative by the act of patronizing the cooperative. With regard to the definitions set forth in paragraphs 18 and 19 of the Preliminary Views for a basic ownership instrument, the existence of common stock, alongside allocated equity, may be problematic for some cooperatives. Most bylaws treat shares of common stock as the most subsidiary claim in the event of liquidation. For those cooperatives having common stock that is immaterial – one dollar per member for example – these bylaw provisions might safely be discounted. For those with large initial common stock or delivery right amounts, the cure may not be so simple. Within the scope of the definitions set forth in paragraphs 18 and 19, it appears to us that the most reasonable cure would be for the affected cooperatives to amend their bylaws to put shares of common stock and allocated equity on the same level of priority in liquidation. We would like to hear from the staff about their opinion as to the feasibility of such arrangements within the intent of the Preliminary Views and the definition of a basic ownership instrument.

The issue of membership and the right to participate in the governance of a cooperative are important concepts within the cooperative business model. As the Board and staff are aware, given the unique nature of allocated equity, depending on the timing and approach to redeeming allocated equity, and the changes in its constituent patrons/members over time, a cooperative may have a significant amount of allocated equity held by former members. Continuing membership in a cooperative requires continuing patronage of the cooperative, and discontinuance of patronage, for whatever reason, generally leads to the loss of membership rights. With regard to the amounts of allocated equity held by former members in a cooperative, in view of the definitions set forth in paragraph 18 of the Preliminary Views, our interpretation is that these instruments are equity so long as they maintain a proportional claim upon net assets in liquidation; until they are fully redeemed or satisfied. Most cooperative bylaws require just such a treatment. The definitions set forth in paragraph 18 of the Preliminary Views are an improvement, from our perspective, over those included in paragraph 20(a) of the Milestone Draft, that required participation in the net assets of the entity **before or at** liquidation, and we appreciate the consideration of the staff and the Board of the problems this definition represented for cooperatives with respect to the status of the allocated equity of former members. However, we are still unclear as to the application of the “upper limit” requirement in all circumstances. That is, a former member will share in liquidation proceeds pro-rata up to

the face amount of his allocated equity. In the event that liquidation proceeds exceed the face amount of all allocated equity, and depending on the bylaw requirements for the disbursement of these excess proceeds, a former member might not participate in liquidation proceeds that exceeded the face amount of allocated equity – effectively creating an “upper limit” of the face amount of these holders allocated equity. We are not necessarily suggesting that the language of paragraph 18 needs to be changed to meet the needs of cooperatives (though we make such a suggestion below), but we are interested to see if it is the intent of the Board and staff that the “upper limit” stricture be applied to such a transaction? We prefer an interpretation of paragraph 18 which views liquidation in excess of allocated equity as a two step process. In the first step a pro-rata approach is required up to the balance of allocated equity, thus meeting the definition of paragraph 18. In the second step, remaining proceeds would be allocated to the patrons of some period (usually defined in the bylaws or by common consent) based on their patronage with the cooperative for that period. We understand that the Board is concerned not to allow artificial limits or guarantees to, in a sense, impede the possible risk of loss or return of capital that might inure to an owner. We do not disagree with that understanding or requirement; there is simply a difference between the investor owned model and the cooperative business model in how a liquidation event would be treated in practice. Given the differences between the investor owned model and the cooperative model, we wonder whether or not paragraph 18(b) might be improved by eliminating the second sentence? That is, paragraph 18(b) would read simply: “The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied.” Such a standard would allow for the possible upper limit or ceiling that some former members might receive, while not preventing the allocation of amounts in excess of the face amount of allocated equity as set forth in the second step discussed above.

In addition to the residual of earnings referred to as allocated equity, many cooperatives raise capital by using an instrument known as a “per-unit retain”. As has been previously set forth for the Board and staff, a per-unit retain represents a hold-back from a stated purchase price, or advance, to a patron that is treated as if the member contributed that amount of retain to the cooperative as equity capital. It has most in common, in comparison to investor owned entities, with paid-in-capital. Many types of cooperatives have both per-unit retains and allocated equity on their balance sheets. Per-unit retains are usually treated separately for liquidation purposes in most bylaws, and are usually subject to their own cycle of redemption. Under the definition of a basic ownership instrument as envisioned under paragraph 19 of the Preliminary Views, it appears that per-unit retains would need to have an equivalent priority with allocated equity, and both have the most subsidiary position in a liquidation, for both to be treated as a basic ownership instrument. Again, we are most interested in the views of the Board and staff as to this equivalency of treatment requirement and if it accurately encompasses their intent.

Perpetual Instruments

2. **Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?**
3. **The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are calculated as liabilities.**

Many types of cooperative entities issue preferred stock (sometimes described as first preferred stock to distinguish it from allocated equity). These instruments may in fact be perpetual and pay a set dividend rate – usually limited by state laws that copy the limitations of the Capper-Volstead Act. Some issues of preferred stock may also pay a dividend rate, whether cumulative or discretionary, and be intended to be redeemed when the cooperative is able. In most circumstances, preferred stock is used as a tool to raise more capital than can be raised from the earnings retained as allocated equity or per-unit retains, for example, to finance needed expansions of facilities without incurring additional bank debt. Access to capital is a perennial problem for many cooperatives and one of the reasons many have supported the Uniform Limited Cooperative Association Act, put forth by the National Conference of Commissioners on Uniform State Laws – also known as the Uniform Law Commission. The position of preferred stock as equity has always held some ambiguity. By its nature, it is unsecured and thus demands a higher rate of return than a secured bond, yet its claim to the net assets of an entity stands above that of common shares, or for purposes of our discussion, allocated equity. It appears to us that this treatment has had practical benefits over time, if not conceptual consistency with the narrow view of equity expressed by the Basic Ownership Approach. While the Ownership Settlement Approach left perpetual instruments with an equity categorization, it was also not as intuitively appealing as the Basic Ownership Approach.

Since many cooperative entities already deal with different types of instruments and would like to continue to treat all of those instruments as basic ownership instruments, it seems the next logical step would be for preferred stock to be treated with an equivalent priority as allocated equity, per-unit retains, and common stock. Indeed, so long as each instrument has no higher priority in liquidation than any other instrument, there appears to be no reason why all cannot be treated as basic ownership instruments. With preferred stock, the issue will be whether potential holders are willing to accept such treatment in

liquidation, or what amount of interest – up to any legal ceiling rate – will be required to obtain such investment. Is such treatment operational for preferred stock – let’s call it a paid-in-capital investment (with interest) since it will no longer be preferred; or other perpetual instruments? Can they be basic ownership instruments with equivalent treatment in liquidation?

With regard to the measurement of perpetual instruments not classified as equity; as discussed at paragraph 34. It appears to us that the most practical treatment would be that in paragraph (a), do not remeasure, but report dividends as an expense either when declared or at regular intervals (if dividends are normally paid each period). This may not be entirely consistent with a present value approach to liabilities, but alternatives (b) and (c) require somewhat arbitrary or subjective estimates be made of market value or expected retirement.

Redeemable Basic Ownership Interests

- 4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined.**

In discussions with the staff, it was made clear to us that paragraph 20 is not intended to apply to mutual entities and cooperatives that **do not** have some type of truly mandatory legal requirement to redeem the equity of holders. That is, absent a legal requirement, a cooperative’s discretion over redemption of allocated equity takes precedence over any established pattern or practice of redeeming allocated equity and therefore, an unconditional obligation (liability under some interpretation of promissory estoppel) cannot be presumed from the past practices of the cooperative. This is an essential point for all cooperatives. Except for those few cooperatives and mutual entities that do have instruments that are puttable by the holder or are subject to some mandatory redemption requirement, the majority of cooperatives in the U.S. have discretion over any and all distributions to patrons, save the required 20% cash dividend commensurate with a qualified allocation – required by the Internal Revenue Service for treatment as a cooperative. It would appear then that paragraphs 20 and 21 would not apply to the majority of cooperatives in the U.S. For those that do have mandatorily redeemable or puttable instruments, we note that the requirements of paragraphs 20 (a) and (b) and 21 (a) and (b) might still be met by those cooperatives and thus maintain basic ownership *instrument treatment for their allocated equities. Such treatment might require that the definition set forth in paragraph 20(a) could be interpreted to be equivalent to that expressed above in our modified paragraph 18(b). Our questions about these paragraphs relate to the meaning of paragraph 20(b) – for example – what is meant by “terms of the instrument” and “impair the claims of any instrument with higher priority”. It is unclear*

to us how these requirements relate to allocated equity or per-unit retains that might be found in most cooperatives that might have mandatory redemption requirements, or puttable instruments. The phrases are simply too broad to be understood within the context of cooperative capital management. Does the phrase “terms of the instrument” in paragraph 20(b) mean that the written notice of allocation sent to patrons should include language similar to that in paragraph 20(b) or at least be understood as such by the patron when they agree to patronize the cooperative; something like consent through a marketing agreement or consent through the bylaws themselves? Additionally, do redemptions of allocated equity or per-unit retains “impair the claims” of secured creditors? In other words, can no redemptions of instruments, seeking to be treated as basic ownership instruments, take place if they occur as part of the cooperatives capital management practices – assuming mandatory redemptions are part of those practices – if there are other instruments with superior claims also outstanding?

The Board and staff are aware that there are several legal cases on record wherein former members of cooperatives, including local producer owners and cooperative owners of federated cooperatives (federated cooperatives are patronized and owned by other cooperatives) sought to force redemption of their allocated equities, and that, even in a case involving a cooperative with seemingly mandatory redemption requirements included in their bylaws, a court has found that the capital requirements of the cooperative and discretion of the board of directors in suspending the bylaw provisions took precedence over the supposed mandatory redemption requirements.

With regard to the question raised about the operationality of criterion (a), it appears that this requirement criterion is meant to cover buy-sell agreements of many private investor owned entities that require some type of valuation of that interest. As stated above, for cooperatives, it would need to be understood that, even for mandatorily redeemable instruments, the strict pro-rata claim to a portion of all net assets at liquidation (after satisfaction of higher claims) may not work for the claims of former members. A more elastic calculation of amounts that can be received by former members – including an accepted ceiling – must be allowed to be interpreted from paragraph 20(a) or it should be reworded to reflect such an understanding. Again, we ask, is that the intent of the Board and the staff?

Separation

- 5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board’s understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a**

transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

It seems to us that the discretion to avoid payment must first be settled from the legal form of the instrument, this follows from the discussion about mandatory redemption. If there is a mandatory dividend payment, it will be obvious from the legal form of the instrument, and should not be intuited from anything other than a legal requirement. If the entity has no discretion to avoid the dividend payment, e.g. cumulative dividend stock, then separation should occur. The issue is how to measure the obligatory amount – the liability component. Similar to paragraph 34(a), we think the most practical option is to periodically accrue the dividend payment at the required amount and continue to periodically accrue at least those amounts. If the basic ownership instrument itself has a mandatory redemption feature that would enable the entity to determine the future benefit stream to an approximate termination date, then a present value of benefits might be accrued.

Substance

- 6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?**

We cannot see - at this time - that the Basic Ownership Approach requires, or is improved by, the language of paragraph 44. An emphasis on “substantial features” was one of the impediments to the Ownership Settlement Approach. While we believe that accounting principles should seek to mirror the economic substance of a transaction or group of transactions, we also believe that accounting principles, if properly conceived, should not require such emphasis on subjective determinations as those put forth in paragraph 44 regarding substance. Substance over form has been a guiding factor in the determinative process since the formation of modern accounting systems, or at least since the Securities Act of 1933 and the Securities and Exchange Act of 1934. Since we are engaged in moving U.S. GAAP towards a more principles based approach (and away

from rules based approach) it is important that the principles we adopt be the least complex necessary to achieve that goal. The Board has accomplished this with the Basic Ownership Approach, and while we may not agree with all of the outcomes implicit in that approach, we still believe that it is superior to the Ownership Settlement Approach that had previously held favor, at least through the Milestone Draft of June 2005.

Presentation Issues

Statement of financial position. Basic ownership instruments with redemption features would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash.

We believe that separate presentation would be helpful for redeemable instruments such as common stock, allocated equity and per-unit retains of most cooperatives, these instruments are redeemable, but in most instances are not "mandatorily redeemable", therefore, we believe that such voluntarily redeemable instruments as allocated equity and per-unit retains should be included in a "voluntarily redeemable" category.

In the case of liabilities required to be settled with equity instruments rather than cash, we believe that such items should be reported separately from those required to be settled with cash.

Other Issues

While not raised specifically in the Preliminary Views Document, the interim period between the issuance of that document and the comment deadline has seen the issuance of a discussion document from the International Accounting Standards Board (IASB) regarding this document with some commentary from the IASB about the approach of the Preliminary Views document and the IASB view of equity, which might most readily be termed the residual approach; comments on this discussion paper are due by September 5, 2008. Also in this interim, the European Financial Reporting Advisory Group (EFRAG) has issued a discussion paper regarding distinguishing between liabilities and equity. The approach favored by the EFRAG group is termed the loss absorption approach (LAA); comments on this discussion paper are due by July 28, 2008. While the LAA deserves further study, we have some concern about the theory underlying this approach. While allocated equity in a cooperative entity is usually subject to allocation of member patronage losses, this is by no means a requirement, and is sometimes

prohibited by regulators. A common approach to losses is for the cooperative to carry the loss forward and offset it against future patronage earnings, thereby reducing the potential ownership interests of future patrons; not holders of current instruments. The NSAC will be commenting on both the EFRAG paper and the IASB paper at the proper times. In light of the convergence process with the IASB, we believe it is important to assess the practices of “cooperatives” in other countries to see how those practices compare to those most prevalent in the U.S. We understand that two items of contention for foreign cooperatives is that many do have mandatorily redeemable instruments upon the exiting of a member, and that many others have liquidation requirements that transfer any net proceeds to non-profit entities or to the state. The former such arrangements might not meet the definitions in paragraphs 20 and 21 of the Preliminary Views Document, and the latter probably do not meet the strict letter of paragraph 18, though it can be argued that these liquidation proceeds are deemed to be donations on behalf of those holders of allocated equity.

Conclusion

We believe the Basic Ownership Approach, as put forth in the Preliminary Views Document, represents a significant positive milestone in the FASB’s deliberation and redeliberation of this important project. Given the comments and questions raised by us in this letter, we are confident that in the end, this process will result in a more readily understandable definition of basic ownership instruments for all entities, cooperative and non-cooperative alike. We are in broad agreement with the principles laid out in the Basic Ownership Approach, and believe that they are operational.

We continue to be grateful to the Board and to the members of the FASB staff that have patiently listened to our concerns in the past and who continue to engage in discussions about these issues and their importance to cooperatives. We are most anxious to continue that discussion concerning the ultimate outcome of an equivalency treatment for the different types of instruments issued by cooperatives.

Sincerely,

s/Gregory O. Taylor

Chairman – Accounting and Auditing Committee

National Society of Accountants for Cooperatives