



**National Rural Electric  
Cooperative Association**

A Touchstone Energy Cooperative 



LETTER OF COMMENT NO. 40

May 30, 2008

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Re: File Reference 1550-100

Via Email

Dear Sir or Madam:

The National Rural Electric Cooperative Association (“NRECA”) is the not-for-profit national service organization representing approximately 930 not-for-profit, member- owned rural electric cooperatives. The great majority of these cooperatives are tax-exempt distribution cooperatives that provide retail electric service to over 40 million consumer- owners in 47 states. NRECA members also include 65 generation and transmission cooperatives that supply wholesale electric power to their distribution cooperative member-owners.

On behalf of our membership, we are responding to the request for comments to the Preliminary Views document *Financial Instruments with Characteristics of Equity* which was released in November 2007.

**Occam's razor**

Considering all the permutations which the liabilities and equities project has been though since its inception, we believe that the Financial Accounting Standards Board (FASB) staff has crafted an elegant solution to the question of which financial instruments constitute equity. We have followed the history of the project very closely since its inception, and have observed the evolution in thought that has occurred while the project has been underway.

We believe that the FASB as effect tively employed Occam's razor when determining the solution to a complex problem. As noted in Wikipedia “Occam's razor is a principle attributed to the 14<sup>th</sup> Century English logician and Franciscan friar William of Ockham. The principle states that the explanation of any phenomenon should make as few assumptions as possible, eliminating those that make no difference in the observable predictions of the explanatory hypothesis or theory. In other words, when faced with competing theories of what constitutes equity, the FASB is proposing the basic ownership approach.

This theory of equity is preferred because it adequately defines equity in a manner that contains the fewest possible assumptions.

Also, the basic ownership approach is a more principled based approach than prior attempts to define equity. It seems to us that previous attempts to define equity based on an exhaustive examination of all the possible permutations of the marketplace would always place the eventual standard behind the curve of financial innovation. We greatly appreciate the FASB going back to basics with regard to the concept of equity.

### **Mandatorily Redeemable Instruments**

SFAS 150 defined mandatorily redeemable instruments as follows:

*A financial instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.*

With regard to rural electric cooperatives, no payment of capital credits may be considered to be unconditional, in that a cooperative's board of directors, in their reasoned judgment, has the sole authority to determine if, and when a payment may be made. Similarly, when a patron leaves the cooperative, his or her share may be redeemed at some point in time in the future, but such redemption is not mandatory and is also subject to approval by the cooperative's board of directors.

It is our understanding that the concept of mandatory redemption in so far as cooperative shares are concerned, only relates to mandatory redemption by the holder (as opposed to the issuer) of an instrument. We concur with this approach. It is our belief that the reasoned action of a rural electric cooperative's board of directors determines when redemption may occur, and, as we stated above, in any event, redemption of prior year margins is not redemption of the instrument itself. In no instance are the shares of a member of a rural electric cooperative in the United States puttable at the option of the holder.

### **Redeemable Ownership Instruments**

It is our view that shares in rural electric cooperatives are not redeemable ownership instruments. That is, as long as the member continues to take service from the cooperative, the member's shares will still be outstanding. Additionally, the member cannot transfer his or her membership share to another party. If the member leaves the cooperative, that share may be redeemed if the board of directors makes such a determination.

The act of a rural electric cooperative paying capital credits (which is a member's share of the margins that he or she contributed to the cooperative in a prior year or that the cooperative earned in transactions with nonmembers) is not the redemption of the

member's share in the cooperative. The payment of capital credits is not required by a rural electric cooperative's by-laws. Also, since rural electric cooperatives operate on a not-for-profit basis, the allocation of capital credits is in fact a deferred price adjustment. In this regard, for accounting purposes, the act of paying capital credits is more analogous to a corporation paying dividends out of earnings. Once the cooperative's board of directors has approved the payment of capital credits in any given year, the cooperative may be required to disclose that payment obligation as a liability. Otherwise, the accumulated margins from all of the cooperative's patrons should be considered to be equity as is the case for a traditional corporation.

### **Puttable Instruments**

As far as rural electric cooperatives in the United States are concerned, we believe that the basic relationship between a member and a rural electric cooperative does not embody a puttable instrument by either the holder or the issuer. As a practical matter, we believe that the concept of puttable instrument only has meaning if the instrument in question is puttable by the holder.

### **Preference Issues**

Some cooperatives may issue preferred stock either to their members or to the general public. We believe that, so long as the preferred stockholders do not have a preference in liquidation under the cooperative's bylaws, and so long as the holders of preferred stock receive a pro-rata distribution on liquidation, preferred shares should be considered equity as well if they otherwise meet the definition of a basic ownership instrument.

### **Separation**

We do not consider shares in a rural electric cooperative to have required dividend payments since a board of directors must approve the payment of any capital credits that takes place. Additionally, rural electric cooperatives typically have mortgage covenants which prohibit the payment of capital credits when equity levels fall below a certain threshold. Consequently, in our case, we believe that it would be a fallacy to assume that a rural electric cooperative has little or no discretion to avoid the payment of capital credits.

### **International Considerations**

It is our understanding that IAS 32 considers equity instruments to be either instruments with no contractual obligation to deliver cash or other financial assets to another entity, or is a puttable instrument, or an instrument that imposes on the entity an obligation to deliver to another party a pro-rata share of the net assets on liquidation.

It is also our understanding that cooperative shares are considered to be equity under IAS 32 as a result of the International Financial Reporting Interpretations Committee (IFRIC) 2 which specifies that members' shares are equity if the entity has an unconditional right

to refuse redemption of the member's shares. This unconditional right may be absolute or partial, but must be in place if cooperative shares are to be equity under IAS 32.

While rural electric cooperatives in the United States would be entirely comfortable with the IFRIC 2 interpretation, we are not certain that IFRIC 2 will survive the convergence process intact.

We believe that much of the concern of the international cooperative community revolves around the application of their local laws or practices which may mandate redemption of their shares in certain circumstances. Since the International Accounting Standards Board (IASB) is going to be reconsidering IAS 32 *Financial Instruments: Presentation* as part of the convergence project on liabilities and equities, we suggest that the IASB consider revising their concept of mandatory redemption to exclude instances in which the cooperative entity is bound by local or national law to redeem their shares.

We submit that cooperatives that operate under such laws are not making an economic decision to redeem their shares, but are compelled to do so. Since it is the stated view of the IASB and the FASB to ensure that accounting for the substance of economic events across all forms of entities be done in as close to uniform manner as possible, the decision to treat as a redeemable instrument one that the cooperative is compelled by law to redeem seems to us to be inconsistent with that view.

One possible solution, of course, is to define mandatory redemption as being at the option of the holder, rather than the issuer. We urge the IASB to reconsider the concept of mandatory redemption to ensure that shares of all cooperatives will be, and should be considered to be equity, regardless of the application of local law.

Some opponents of the basic ownership approach have stated that the Preliminary Views document is contrary to the entity approach to financial reporting which is embodied in the Conceptual Framework project. We believe that the fundamental determination of whether an instrument constitutes equity is the primary focus of the basic ownership approach. How such instruments are reported in the complete set of financial statements is not, in our view, the primary consideration. Further, we believe that it is in the best interests of all stakeholders that issues as basic as what is an equity instrument be clearly determinable.

### **The Loss Absorption Approach**

The loss absorption approach as proposed by the European Financial Regulatory Advisory Group (EFRAG) and the Pro-Active Accounting Activities in Europe (PAAinE) is a possible alternative to the basic ownership approach of the Preliminary Views document. While we have read the white paper on loss absorption, we are not entirely sure that we understand all of its ramifications for rural electric cooperatives and we reserve the right to comment on this approach at the appropriate time.

One potentially serious concern that we have regarding the loss absorption approach is whether, in order to have a financial instrument deemed to be equity, a rural electric cooperative would have to allocate losses to its members. Currently, rural electric cooperatives in the United States do not typically allocate losses to the membership. Instead, the loss from any single year is retained and offset with margins from future years. In subsequent years, the net amount remaining after the loss is fully absorbed is allocated to the membership. As a consequence, the membership bears the loss as a practical matter even though the loss may not be formally allocated as are margins. This approach does not otherwise restrict the amount of net assets which would be available to the member in the event of a hypothetical liquidation. We would oppose any attempt to define equity in a manner which would require that losses be actually allocated on an annual basis to our membership.

Another concern we noted is that at risk capital may come from many different sources, not strictly from owners of the enterprise. We believe that any definition of equity should be limited to holders of instruments who are also owners under laws applicable to the organization in question.

#### **Questions on the Basic Ownership Approach in the Preliminary Views Document**

1. Do you believe that the basic ownership approach would represent an improvement in financial reporting?

We believe that the basic ownership approach is a vast improvement in financial reporting. The exponential growth of financial innovation over the past several years has introduced great complexity in the nature of financial instruments with multiple characteristics. We believe that the Preliminary Views document correctly avoids the temptation to attempt to address on an individual basis the many permutations of financial engineering. We urge the FASB to resist such urges since we believe that the likely outcome would be obfuscation in financial reporting-something which would certainly be counterproductive at this point in time.

2. Are the underlying principles clear and appropriate?

We believe that the fundamental determination of whether an instrument is a basic ownership instrument is quite clear and entirely appropriate.

3. Do you agree that the approach would significantly simplify the accounting for instruments within the scope of the Preliminary Views and provide minimal structuring opportunities?

We do believe that the basic ownership approach would significantly simplify the accounting for instruments with characteristics of equity. We also believe that if the Preliminary Views were adopted as proposed, that the end result would be much less opportunity to “game” the system by those seeking to promote form over substance in their financial reporting.

4. 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?

As we stated previously, preferred shares which have no preference upon liquidation, and otherwise meet the criteria of a basic ownership instrument should be considered equity. We believe it is appropriate that the dividends payable on preferred shares should be considered to be a liability.

5. 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?

While we do not believe that the shares in a rural electric cooperative in the United States would be considered redeemable ownership instruments under the Preliminary Views document, we do have concerns about the operational viability of the criteria in paragraph 20. As a practical matter, the current language in paragraph 20 would appear to require that the redemption be functionally equivalent to a liquidating distribution. This is, we suspect, not practical and is typically not the case when redemptions occur. We urge the FASB to reconsider the language in paragraph 20 to ensure that it reflects the actual operations which occur upon redemption, if indeed, it would be possible to do so in a manner consistent with the concept of a basic ownership instrument. In other words, the payment of a dividend by a traditional corporation does not taint the character of the entities equity simply because it is not measured on a liquidating basis. We think that payment of rural electric cooperative's capital credits should be treated in a similarly consistent manner.

6. Especially, is the dividend an obligation that the entity has little or no discretion to avoid?

We believe that the obligation to pay dividends is avoidable, and that there is abundant evidence of this assertion within the functioning of public and private companies over many years.

7. Do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

We do believe that the basic ownership approach will properly categorize the vast majority of instruments that are equity instruments. There will, of course, be questions about the many forms of hybrid instruments which are so prevalent in the financial markets, but we strongly believe that there must be a fundamental determination of whether such instruments actually constitute equity.

### Conclusion

We urge the FASB to remain true to the principles of Occam's razor and make the definition of equity simple and elegant and reductionist. We believe that equity, by its very nature, is best described as those instruments which would be eligible to receive a final distribution of the entities remaining net assets in a hypothetical liquidation. In instances in which local or national law would render the practical application of the concept of a liquidating distribution impossible, we urge the FASB and IASB to consider that in these instances, the patrons of the cooperative in fact received a deemed distribution of assets and, by operation of law, were compelled to take some other action which may not have constituted a reasoned economic decision on their part. Since neither the FASB nor IASB are compelled to have legal consequences determine the accounting for economic events, we believe this would be a more equitable solution to the international problem of what is the member's interest in a cooperative.

Of course, all of our comments are contingent upon the determination that shares in a rural electric are not redeemable instruments, nor puttable instruments. Should this change, we would be please to work with the FASB and IASB to ensure that a member's interest in their rural electric cooperative would continue to be considered equity.

If you have any questions, or if I may be of assistance in any capacity, please do not hesitate to call upon me.

Kind regards,

/s/Russell D Wasson  
Director, Tax, Finance and Accounting Policy