October 27, 2005

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

Re: Business Combinations -- File Reference 1204-001

Dear Chairman Herz:

On behalf of the members of the National Cooperative Business Association (NCBA) and its Cooperative Finance and Tax Council (CF&TC), we are providing comments to the Exposure Draft on the Proposed Standard on Business Combinations. Please consider this letter, along with those sent to FASB on June 27, 2005 and September 23, 2005 (Summary of Key Issues for Roundtable Consideration), as our comments on the Exposure Draft.

As we have asserted in previous correspondence, cooperatives should be excluded from the business combination standard and allowed an alternative accounting method. The issues and problems with the application of the proposed standard to cooperatives as discussed below illustrate the need for an alternative approach to accounting standards for cooperatives.

We appreciate that FASB is addressing the issue of whether there is a need for alternative approaches for small and/or other types of businesses through its Small Business Advisory Committee, in which Jane Hoffman, our CFO, participates. We also appreciate FASB’s work to accommodate cooperative specificities in the Equity and Liabilities Project.

We are concerned that if cooperatives’ unique structure is not recognized in the accounting standards, cooperatives as a business model may be undermined by the imposition of more costs and by being forced to “fit” into the investor-owned model. To help ensure that accounting standards meet both the goals and objectives of FASB and the needs of cooperatives and users of cooperative financial statements, we urge FASB to continue to explore alternative approaches that do not impose unwarranted burdens or costs on cooperatives.
With regard to the Exposure Draft, most of our comments are in response to Question #1 and #4. We provide information about specific concerns with the Exposure Draft’s approach and offer alternatives that would address some of the problems.

Question #1 – Are the objective and the definition of business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

The objective and the definition of business combination are not appropriate for combinations between cooperatives. We understand the objective is to have all business combinations accounted for by one method, the acquisition method, and measured at fair value. This objective fails to take into account the distinct characteristics of mergers between cooperatives -- there is no change in control, there is no acquirer and acquiree in the transaction, and fair value is inappropriate for the typical cooperative that operates at cost and provides no return on capital. The objective also conflicts with FASB’s goals to provide more useful information to users of financial statements and promote comparability.

In a co-op merger, there is no identified acquirer because there is no change in control. FASB defines a business combination as “a transaction or other event in which an acquirer obtains control of one or more businesses.” In a co-op merger, there is typically no financial consideration nor does “control” of the new cooperative vest to one of the previously existing cooperatives. Even when one cooperative is larger than the other in a merger, the members retain their same allocated ownership equity and interest in the “new” cooperative as well as their ability to vote. Accordingly, voting control does not exist in a cooperative combination because most cooperatives operate on the principle of one person -- one vote.

In 3(f) of the Exposure Draft, the FASB defines control as having the same meaning as “controlling financial interest” in paragraph 7 of the Proposed Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries. Paragraph 7 provides that “the usual condition for a controlling financial interest is ownership of a majority voting interest (emphasis added) and, therefore, as a general rule ownership by one company, directly or indirectly, of more than 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation.”

This definition of control simply does not apply in the cooperative context. There is no majority voting interest because the members own and govern the cooperative on an equal voting rights basis. No member of a cooperative could take control even if the member owned more shares because members are limited in their voting rights to “one member one vote”. Democratic control and ownership are fundamental differences between co-ops and investor-owned entities. The proposed standard does not recognize this distinction and is therefore not appropriate for application to cooperatives.

Fair value does not accurately reflect the way a cooperative operates. Cooperatives are motivated to serve their members, not necessarily to generate a profit. And their members join the cooperative as owners to enjoy the services the co-op provides, not to make a return on investment. In cooperatives, the interests of the owners and customers are aligned because owners are customers, a
distinction recognized by FASB in paragraph A25. In investor owned companies, shareholders have separate goals from customers, e.g., shareholders want return on equity, customers want better prices or services, and those goals may be at odds with each other.

**Book value accounting is widely used by and more appropriate for cooperatives.** Book value is more appropriate for cooperatives because it is based on historical costs while fair value is based on future assumptions in an external market that are more useful to external investors. As explained previously, cooperatives typically operate at cost. In some instances, they are required by law to operate on an at-cost or not-for-profit basis and cannot recover more than cost. To better understand the importance and relevance of this concept, please see the attached testimony of Paul Hazen, submitted in April to the Ways and Means Committee in the House of Representative.

Cooperatives pay a return OF capital not a return ON capital. Therefore, there is no incentive to pay more than the cost. Why would an objective of the cooperative be to generate lucrative profits on their own transactions with the cooperative and then redistribute such profits among themselves later? To ask a member to pay more to recover the fair value of the asset to meet the needs of an accounting standard is a costly financial exercise that results in no discernible benefits to the members. As you might expect, the members would refuse to pay for such an “accounting markup” which may lead to asset impairment. This would return the balance sheet of the cooperative to historical cost, the basis of the initial compact between the member and the cooperative.

The definition of mutual entities in paragraph 3(m) misstates the nature and objective of cooperatives. The main objective of a cooperative is not to provide dividends or economic benefits to members. Members form and join a cooperative to meet their common social, cultural and economic needs not merely to receive dividends and other economic benefits. The primary motivation could relate to the type of services or products provided or to reach a market otherwise unattainable, e.g., purchasing or marketing cooperative. This issue points again to the difficulties involved in applying a standard developed for investor-owned entities to cooperatives.

We believe FASB should make an exception for mergers between cooperatives because their structure and economic reality do not fit well with that of investor-owned companies. FASB should make an exception to ensure that FASB’s goals of providing more useful information and promoting comparability are achieved. And FASB should make an exception for cooperatives to avoid unnecessary costs and work by cooperatives, users, and FASB itself. Further, we are concerned that by assuming that cooperatives are no different from investor-owned entities, over time, as the standards setting process evolves, financial statements prepared under Generally Accepted Accounting Principles will become less useful and relevant to the users of those financial statements, the cooperative’s members and stakeholders. This should not be desired outcome by the FASB.

**Suggested Preferred Alternative for Mergers between Cooperatives is the Pooling Method.** The pooling method is appropriate for cooperatives because it allows cooperatives to bring all the members together to form a new entity without having to identify the acquirer. The method employs historical cost accounting or book values, which are more appropriate for cooperatives. Cooperatives believe there is no need for more intricate, complicated accounting for the fairly simple transactions in which they are involved.
• **Narrow pooling exception:** If FASB does not agree to a general exception for mergers between cooperatives, we suggest a more narrow exception that allows certain mergers of cooperatives to use the pooling method. The exception would be permitted where:
  - The new board/governing entity is drawn equally from those of the prior cooperatives;
  - New chair and CEO or other management drawn from both/all cooperatives; and
  - No consideration has been exchanged (typical of mergers between cooperatives).

• **Fresh start method:** Another alternative that some have suggested is fresh start. Cooperatives generally do not favor this approach over the pooling method because it requires fair value measurement of both entities but it does alleviate the need to identify the acquirer and acquiree. We understand fresh start to mean the individual cooperatives would be measured at fair value and those values would be combined to develop the fair value of the newly formed cooperative entity. There would be no requirement for annual revaluations as is required under the acquisition method. For the reasons stated previously, fair value accounting makes little sense for a cooperative entity that operates at cost and pays no return on capital to its member/owners.

**Question #4 – Do paragraphs A8-A26 provide sufficient guidance for measuring the fair value of an acquiree? If not, what additional guidance is needed?**

**FASB has not provided sufficient guidance on fair value for cooperatives.** There is a lack of market information that can be used to determine the fair values of cooperatives. Cooperative equity is not a security and is not traded on any exchange; consequently, there is no active market for cooperative shares. The member’s interest in the cooperative typically 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.

**FASB recognizes that there is no external market for cooperative equity.** FASB provides guidance in paragraphs A18-26 on the use of various alternative valuation techniques. The guidance is not sufficient and allows for various valuation techniques, which does not promote comparability or standardization. In the guidance, FASB assumes the interests of members 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 is 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, particularly when they are often non-economic.

The suggested income approach, the use of discounting future cash flows to present value, may introduce a great deal of variability into the valuation of cooperatives. For example, under the discounted cash flow approach, an electric cooperative’s assets may be written up to fair value based on the observed value of similar asset transfers between investor-owned utilities but the associated debt on the assets would not subject to a fair value determination since the debt is typically not publicly traded. The electric cooperative’s rates would originally be set to recover the
book cost of assets and retire the original cost of the debt in order to comply with existing mortgage covenants. The membership would refuse to raise the rates it pays the cooperative in order to "pay" for the mark up of the assets to fair value. Consequently, the cooperative would be required to write the assets down to original cost because that is the level of assets the members would be willing to pay for, consequently that is the level of asset recovery that the member’s electric rates would support.

The ultimate result would be the same as if the combination had been subject to the pooling of interest approach but the cooperative would incur additional costs associated with application of the acquisition method that provided no benefit to the member/owners or other cooperative stakeholders such as creditors. Of course, an electric cooperative must pay fair value for the acquisition of any physical asset in the market, but the members have implicitly agreed in advance to such action through the budget process and agreed to furnish the electric cooperative capital sufficient to recover the original cost of any physical asset. We doubt that any member would agree to pay for the marked up cost of assets “acquired” in a business combination simply to conform to the fact that external debt and equity investors of an investor-owned utility may have implicitly agreed to pay the marked up value for an asset that they expect will pay a return on and of their capital.

Cooperatives urge FASB to permit the use of book value/historical cost in valuing assets and liabilities. The use of fair value valuation for cooperatives creates the impression of the possibility of a return on capital as opposed to a return of capital for members and other users. This approach can be deceptive, misleading financial statement users into thinking that the cooperative has access to fair value amounts to settle liabilities when it does not. As long as the cooperative is paying its debt service, a cooperative lender is not primarily interested in the fair value of the assets.

The use of the historical cost model retained by the pooling of interest approach is more appropriate for the cooperative business model. Since cooperatives typically invite their members to join their organizations and the addition of a new member is usually subject to the approval of the Board of Directors, there is typically no “goodwill” that results from the combination of two cooperatives since the interests of the member/owners of both cooperatives pre-combination are the same: to join together to obtain goods or services at cost and this interest continues post-combination. Members continue to do business with the cooperative because they are a member/owner. If they choose to go elsewhere they may cease to become a member/owner. Consequently the cooperative does not have the same relationship to the competitive marketplace as does an investor-owned enterprise.

FASB should develop an acceptable alternative to fair market value that recognizes the unique return of capital structure of cooperatives. Such valuation methods should not ascribe to the assets and liabilities of cooperatives a value that implies a return on capital. For example, we suggest that the FASB might:

- Permit exceptions to the requirement that business combinations be recorded at fair value (allow the pooling method) for those cooperatives, e.g., electric, that operate at cost and are under an obligation (regulatory or otherwise) to recover from their member/owners only the amount required to satisfy debt payments, meet mortgage covenants, and pay for cost of operations.
• Limit the application of fair value to instances in which cooperatives operate separate lines of business in an external, active market, where they may compete for customers -- where observable market data are available and the asset can be sold on the market at any time without major disruption or major change in the entity’s operations.

We request that cooperatives be excluded from the standard and be permitted to use the pooling method for cooperative business combinations. This approach would not only meet the needs of cooperatives, and, more importantly, the users of their financial statements, but would also advance the goals of FASB to enhance comparability and usefulness of financial reporting.

Cooperatives worldwide are becoming increasingly concerned about the efforts of accounting standard setting bodies to force cooperatives to adapt accounting methods that are not appropriate for the cooperative form of organization and reflect the goals and interests of investor-owned enterprises. We believe the objective of financial reporting should be focused on the users of financial statements. The users and stakeholders of all of the world’s cooperatives are not being served by the actions of the FASB or IASB when standards are promulgated that distort the financial relationship cooperatives have with their member/owners. We urge the FASB to reconsider this path that it has embarked upon starting with the applicability of the business combinations standard to cooperative and mutual organizations. We stand ready to work with you and the IASB in this endeavor.

Sincerely,

Paul Hazen
Statement of Paul Hazen  
President and CEO  
National Cooperative Business Association

Committee on Ways and Means  
U.S. House of Representatives  
April 20, 2005  

Hearing on  
An Overview of the Exempt Sector

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The National Cooperative Business Association appreciates the opportunity to submit testimony about cooperatives and their tax treatment. This is a critical issue for cooperatives, their members and the communities in which they operate. NCBA is the nation’s only national organization representing cooperatives across all sectors of our economy—including agriculture, childcare, electricity, finance, food retailing and distribution, healthcare, housing, insurance, purchasing and shared services, telecommunications and many others.

Cooperative taxation principles and specific provisions of the Internal Revenue Code reflect the member-owned and governed structure of cooperatives. Generally, cooperatives themselves do not have taxable income because they pass through that income to their members in the form of patronage refunds. Members pay tax on the patronage refunds they receive. Though cooperatives may not be taxed on income and business derived from their patrons, they typically do pay taxes on non-patron income.

Co-ops operate as not-for-profit businesses in that they return any profits they earn to their members based on the amount of business the members do with the co-op. Some cooperatives are organized under section 501(c) of the Internal Revenue Code and are entitled to a tax-exemption if they meet certain criteria, e.g., operate on an at-cost basis. While these exemptions address different types of cooperatives, they are based on the same tax principles applied to other types of cooperatives. Cooperatives that file under section 501(c), however, are subject to restrictions not applied to other cooperatives.

How successful a cooperative is either in terms of size or meeting the needs of its members should not be a measure of whether and how it is taxed. Cooperatives may be Fortune 500 companies or they may be small, community-based businesses. But regardless of the size or the success of the cooperative, the structure remains the same. They are member-owned and
member-controlled. And the tax principles and provisions that apply to them appropriately reflect that structure.

Cooperatives - A Business Structure that Promotes Ownership and Accountability

Cooperatives are a vital part of the economy. An estimated more than 40,000 co-ops in this country are, by definition, businesses that are owned and democratically controlled by their members. These are the people who buy the goods or services the cooperative provides, rather than outside investors. Cooperatives serve some 120 million members by providing them with agricultural processing and marketing services, childcare, education, healthcare, affordable housing, financial services, group purchasing, food and other consumer goods, electricity and telecommunications services, among many others. Cooperatives and their members generate millions of dollars in economic activity, creating jobs, wealth, and opportunity.

Cooperatives return surplus revenues—that is, income over expenses and investment—to members proportionate to their use of the cooperative, not proportionate to their "investment" or ownership share. Co-ops are motivated, not by profit, but by service to their members. Their goal is to meet their members' needs for affordable and high-quality goods or services. For this reason, outside capital investment is often hard to attract. Co-op equity consists largely or solely of member equity.

Cooperatives' member-owned and member-governed structure also promotes accountability and trust among consumers. A national survey commissioned by cooperative organizations together with the Consumer Federation of America found that consumers trust the cooperative structure more than the investor-owned structure.

Cooperatives fall into four categories:

- **Producer-owned cooperatives**—These cooperatives are owned by farmers or craftsmen who form a co-op to jointly market, process or produce a similar product. There are 1,600 farmer- or rancher-owned marketing or processing cooperatives in the United States. New generation cooperatives—small co-ops that specialize in value-added agricultural processing—are becoming more popular.

- **Consumer-owned cooperatives**—The largest co-op category, these cooperatives are owned by the consumers who buy the businesses' goods or services. They include food co-ops, rural electric and telecommunications cooperatives, credit unions, housing co-ops, parent-owned childcare co-ops, and consumer-owned HMOs.

- **Purchasing and shared services**—These cooperatives are owned by individuals or small businesses that buy goods or services as a group to lower costs. As more and more small businesses see purchasing co-ops as the key to their survival, this segment of the co-op community is growing. NCBA estimates that, nationwide, more than 50,000 independent businesses are members of purchasing co-ops. The nation's 1,600 farm supply and service co-
ops fall into this category, since they are effectively purchasing co-ops for farmers and ranchers.

- **Worker-owned cooperatives**—These cooperatives are owned and controlled by their employees. They are similar to companies with Employee Stock Ownership Plans, known as ESOPs. However, in a worker cooperative, the employees benefit from the profitability of the company earlier than ESOP employees. Members of worker-owned co-ops receive annual taxable dividends on the company's earnings, rather than waiting for retirement to cash in their stock.

The cooperative structure lends itself to addressing economic challenges facing America today, especially in rural areas. Municipalities are using cooperatives to provide needed services at lower costs. Communities are using the cooperative model to provide affordable housing that allows seniors to age in place. Cooperatives are also addressing soaring health care costs and other services for seniors.

Cooperatives also help retain the wealth and purchasing power of communities. Instead of being drained away from communities by outside interests, money is put back into local economies by co-op member-owners. Studies show that the patronage refunds play a significant role in the economy of the communities in which they operate. These refunds can be critical to maintaining the vitality or revitalizing communities, particularly in rural America.

**Cooperative Taxation Reflects Unique Structure of Co-ops**

Cooperative taxation, though addressed under different provisions of the Internal Revenue Code, generally follows the same basic tax principles regardless of the type of cooperative. The principles reflect the common member-owned and member-governed cooperative structure.

Unlike investors, members join a cooperative to benefit from the goods and services it offers, not to make a substantial return on their investment. Farmers join an agricultural co-op to benefit from the leverage the group has in negotiating a price for their crop or the premium enjoyed through the co-op’s product branding. Small businesses join a purchasing co-op to reduce their costs or to reach otherwise inaccessible markets, such as international markets.

Following is a general description of the tax principles common to all types of cooperatives.

**Single Tax Principle: Surplus Member Revenues Not Taxable:** Cooperatives do not pay income tax for surplus revenues generated by member business and distributed to or used in the service of members. For some cooperatives, surplus revenues from member business are returned to members as patronage refunds at the end of the year. Refunds can be either cash or equity held by the co-op and allocated to individual members. The co-op deducts these refunds from its tax liability, creating a single tax treatment of those revenues at the patron level. Patronage refunds effectively constitute patron “overcharges” or “underpayments” returned to members at the end of the year.
Treatment of Non-Member Revenues: Cooperatives pay corporate income tax on non-member surplus revenues. This is the same tax treatment as any other type of corporation. Some co-ops, such as credit unions, serve only members. As a result, they have insignificant or no non-member income. IRS rulings and case law have upheld interpretations of “member business” that allow some non-member revenue to be treated as member revenue and therefore not taxable at the cooperative level. Generally, any income derived from activities for which the principle purpose is serving members is not taxable.

Some cooperatives have no surplus revenues from member business to return to their members. Essentially these cooperatives attempt to operate as close to cost as possible. That is, they offer “refunds” in advance, discounts at the point of purchase, discounts negotiated in advance from suppliers, lower fees, better interest rates on savings, or lower interest rates on loans.

Tax Treatment of Patronage Refunds: Co-ops with surplus member revenue may return those surpluses to patrons in the form of cash or retained equity in the cooperative, or both. In some cases, patrons pay tax on the refund they receive. Patronage refunds arising from personal expenses, such as electricity for the home, groceries and other consumer goods, and interest refunds, are not taxable at the individual level.

Tax Code Provisions Embody Cooperative Taxation Principles

Cooperatives are covered under several sections of the Internal Revenue Code. Subchapter T, section 1381-1388, provides single tax treatment of surplus member revenue, or pass-through treatment, for businesses that operate on a “cooperative basis.” Members are taxed on any surplus returned in the form of patronage refunds. Cooperatives filing under Subchapter T include agricultural and other producer cooperatives, purchasing cooperatives, some banks within the Farm Credit System, worker cooperatives, and some types of consumer cooperatives, such as housing and food co-ops.

Under section 521, certain types of farmer cooperatives are allowed to pass through earnings from non-patron income sources to their patrons. Refunds are taxable at the patron level. To qualify for filing under this section, these co-ops must meet thresholds for member versus non-member business and other criteria.

Some cooperatives file under Section 501(c), which provides six different types of exemptions. These include service cooperatives serving non-profit hospitals, credit unions and educational service cooperatives. While each exemption has its own history, all are based on member ownership and a purpose of serving their members. For example, public law states that “credit unions ... are exempt from federal and most state taxes because they are member-owned, democratically operated, not-for-profit organizations...” PL 105-219, August 7, 1998.
Under section 501, member revenue is generally exempt from taxation if the conditions of the exemption are met. These requirements are in addition to those imposed on other cooperative businesses.

- Section (501)(c)(1) provides tax exemption for "federal instrumentalities" that are cooperative organizations, such as banks for cooperatives. Some Farm Credit Associations receive tax treatment under this section.
- Section 501(c)(3) provides tax exemption for co-ops, such as student housing cooperatives, that operate for charitable or educational purposes.
- Section 501(c)(12) provides tax exemption for rural utility cooperatives—providing electricity, telecommunications, or water—so long as 85 percent of the income comes from members and is for the sole purpose of meeting losses and expenses (i.e., operation at-cost). This is a requirement Subchapter T cooperatives do not face.
- Section 501(c)(14) provides tax exemption for credit unions. It requires them to operate "without profit" and "without capital stock," requirements Subchapter T cooperatives do not face. Credit unions generally cannot serve non-members, a restriction not imposed on Subchapter T co-ops.
- Section 501(e) provides tax exemption for service cooperatives serving non-profit hospitals. Like other tax-exempt cooperatives, these cooperatives face additional operational restrictions.
- Section 501(f) provides tax exemption for educational service cooperatives.

Some cooperatives covered by 501(c) are exempt from federal income tax on non-member revenue under certain thresholds, generally related to whether most of the co-op’s income is for its exempt purpose. This results from the additional statutory or regulatory requirements specific to these cooperatives and does not constitute preferential treatment. Generally, this is consistent with the concept of a “purpose” test applied to non-member revenue for non-501(c) cooperatives—that is, the non-member income that is not taxable meets the primary member service purpose of the cooperative.

**Conclusion**

Co-ops are member-owned and member-run businesses that return any profits they earn to their members based on their patronage with the co-op. This model of business is more accountable and instills more confidence than companies owned by shareholders in search of unrealistic returns. At a time of rising deficits, cooperatives are poised to meet economic challenges such as high health care costs, a growing aging population and senior housing in rural America.

From large agricultural co-ops to the local food co-op, all cooperatives are owned and governed by their members. The tax treatment cooperatives receive reflects their member-owned and member-controlled structure. NCBA urges the committee to retain that treatment.

Thank you for opportunity to provide testimony. We would be pleased to discuss the tax treatment of cooperatives further with the committee.