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Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

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Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856

Dear Chairman Herz:

It has come to our attention that the Financial Accounting Standards Board (FASB) has on the agenda for its August 27, 2003 meeting, a discussion of whether to reconsider if nonpublic entities should be exempt from the provisions of FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. On behalf of the nearly 750 rural electric cooperatives that are currently indebted to the Federal government through the Rural Utilities Service (RUS) Electric Loan Program, we respectfully urge the Board to grant that exemption.

As an Agency of the United States Department of Agriculture, empowered by the Rural Electrification Act of 1936 (RE Act), as amended, RUS provides financing to Rural America for the purpose of furnishing and improving electric, telecommunications, and water and sewer services. RUS provides financing for the construction of plant to approximately 750 electric cooperatives as a part of its mission. As a Federal lender and mortgagee, and in furthering the objectives of the RE Act, RUS has a legitimate programmatic interest and a substantial financial interest in requiring adequate records be maintained by entities borrowing from RUS. For this reason RUS requires, through its standard security instrument, that borrowers in the electric loan program maintain their books, records and accounts in accordance with methods and principles of accounting prescribed by RUS in the RUS Uniform System of Accounts (USOA). This USOA incorporates the USOA prescribed by the Federal Energy Regulatory Commission with modifications. This system of accounts represents a considerable reliance on Generally Accepted Accounting Principles (GAAP). RUS also requires each of our borrowers to have an annual audit prepared by an independent certified public accountant.

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Background

Since the emergence of the cooperative movement in the United States in 1875, public policy has supported this movement. Congress has encouraged the development of cooperatives through favorable legislation including special rules that soften or nullify the effect of antitrust laws and recognition of the cooperative's nonprofit nature by allowing patrons' qualifying distributions be excluded from the taxable income of the cooperative. Most cooperatives are organized as corporations, but do not issue capital stock. Cooperatives differ from other corporations in that the net earnings are allocated to patrons/members on a patronage basis rather than to owners on the basis of equities held. Cooperatives are owned and controlled by their members, generally on the one member-one vote principle.

Cooperatives typically do not have substantial amounts of nonpatron capital. Cooperatives are generally organized with small amounts of original capital and equity is accumulated by retaining allocated earnings and issuing written notices of allocations to patrons. The members of a cooperative are usually its patrons. The cooperative performs a service or provides a product for its patrons and usually agrees to distribute to them, on a patronage basis, any revenues in excess of costs that it derives from performing those services or providing those products. An underlying concept of cooperative ownership and operation is the equitable treatment of all patrons.

Allocations of net earnings to patrons may be made in cash or equity certificates. Equity certificates are credited to the individual patron's account. The earnings are held as patronage capital by the cooperative and used for cooperative purposes. The redemption (retirement) cycle is generally specified in the cooperative bylaws or determined by its board of directors.

Current Accounting Treatment

Under the accounting treatment followed by RUS borrowers and electric cooperatives in general, patronage capital, both assigned (allocated) and assignable is accounted for in the equity section of the balance sheet. As discussed in the background section of this letter, this accounting is uniformly accepted as the proper accounting treatment for excess revenue over cost for cooperatively owned entities. Because of the capital intensive nature of the utilities business, it has become common practice for electric cooperatives to retain patronage capital for 15 to 30 years before retiring it to the patrons of the cooperative. There has, however, been a movement recently to provide for immediate redemptions to decedent estates of patrons. Because the allocated patronage capital is not transferable, early redemptions to decedent estates permit the executor or administrator of the estate the benefit of converting this investment to cash to permit estates to be settled in a timely manner.

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Issues

In reviewing Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, for its affect on RUS borrowers, a number of major concerns have arisen. Because electric cooperatives routinely redeem the assigned patronage capital belonging to decedent estates out of the rotational cycle and because death is an event certain, paragraph 9 of Statement No. 150 could lead some to the conclusion that patronage capital currently accounted for as equity should be reclassified to the liability section of the balance sheet. This reclassification would create a number of problems for the more than 930 electric cooperatives nation-wide, including the 750 electric cooperatives operating within the RUS Electric Loan Program. RUS as any lender would, has equity requirements for our loan programs. This reclassification of all or a portion of patronage capital as debt would place most if not all of the electric cooperatives currently financing their systems through the RUS Electric Loan Program in technical default of their mortgages which require certain levels of equity for compliance. Lending authority through RUS is limited annually by Congress. Currently, many RUS borrowers, especially the generation and transmission cooperatives use the competitive capital markets to secure funding in excess of what RUS is able to provide. In addition, if required to reclassify equity to liability, cooperatives would be unfairly disadvantaged in capital markets and with credit rating agencies that routinely rely on equity levels in addition to other factors to make decisions regarding the extension of credit and the terms under which that credit is extended.

As a Federal agency with fiduciary responsibility to the taxpayers of the United States, RUS is very concerned about the financial viability of our loan portfolio. RUS currently has an outstanding loan portfolio of approximately \$34 billion in the Electric Loan Program alone. This portfolio is backed by 750 financially sound and well managed electric cooperatives, some with as many as 68 years of operating experience, that have worked hard over the years to develop a strong balance sheet and a financially secure future for their members, their employees and the rural communities in which they operate. We believe the FASB Statement No. 150 could have a significant negative effect on these companies if it is interpreted that they are required to implement its provisions.

Additionally, the Department of Energy currently collects financial data on the utility industry including investor owned utilities, municipalities, and cooperatives. If cooperatives are required under FASB Statement No. 150 to reclassify equity to liability, all comparability within the industry will be lost.

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Conclusion

We believe that patronage provided by consumer/members is truly equity. The return of that patronage capital is at the discretion of the individual boards of directors of the cooperatives. We believe that a strong possibility exists that the provisions of FASB Statement No. 150 could be interpreted to require reclassification of some or all patronage capital as debt, therefore, we request that this issue be specifically addressed by the Board by exempting electric cooperatives and all nonpublic entities from the provisions of this statement. We believe that, due to the limited number of users of the financial statements of nonpublic companies, the benefits being sought by this pronouncement will not materialize. We believe that the beneficiaries of the information contained in the financial statements of nonpublic companies, generally, are well informed about the workings of the business entities they are involved with and that this pronouncement will not provide the any measurable benefit to the statements.

Sincerely,



KENNETH M. ACKERMAN
Assistant Administrator
Program Accounting
and Regulatory Analysis