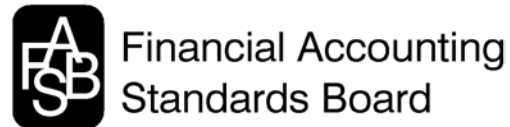
MEETING SUMMARY



To: Board Members

From: Financial Instruments: Liabilities and Equity Team (Arbuckle, ext. 275)

Subject: Minutes of the January 27, 2004 Liaison Meeting with Representatives from Cooperative and Mutual Enterprises

Date: February 10, 2004

cc: FASB: Bielstein, Smith, Petrone, Bullen, Bossio, Cropsey, Richards. Manders, Arbuckle, Belot, Rohrkemper, Swift, Polley, Thompson, Gabriele, Sutay, Lapolla, FASB Intranet; IASB: Leisenring, Ryltsova; CICA: Klompas, P. Martin, Walsh; Liaison Meeting Participants

Topic: Organizations of cooperative and mutual enterprises: issues related to the Board's projects on (1) Distinguishing Liability from Equity and (2) Combinations between Mutual Enterprises.

Basis for Discussion: Meeting information distributed January 22, 2004

Length of Discussion: 9:30 a.m. to 12:00 p.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott

Staff present: Arbuckle, Belot, Bielstein, Bossio, Bullen, Manders, Rohrkemper, Richards, P. Martin (CICA), and Ryltsova (IASB, by phone)

Representatives from mutual enterprises:

Name	**Affiliation**
Robert Beerup	President of the National Society of Accountants for Cooperatives (NSAC), Audit Manager with Illinois Agricultural Auditing Association
Joel Dahlgren	Lindquist & Vennum of Minneapolis, MN, NSAC member
Richard Dines	National Cooperative Business Association

Steve Piecara	National Rural Electric Cooperative Association, NSAC member
Jim Regan	Digital Federal Credit Union of Boston, MA
Barry Silver	National Cooperative Bank of Washington, DC
Dana Stonestreet	America's Community Bankers (ACB)
Greg Taylor	D. Williams & Co, CPAs, NSAC member
Peter Ting	ACE Hardware of Chicago, IL
Skip Wagoner	Southern States Cooperative, NSAC member
Doug Wilhelm	CoBank of Denver, CO

Matters Discussed:

The Board and staff met with representatives from various cooperative and mutual enterprises to discuss the effects of the Board's projects on Liability and Equity and Combinations between Mutual Enterprises on cooperative and mutual enterprises. The meeting was educational and no decisions were reached.

Liability and Equity

After brief introductions from the panel, Ms. Schipper asked the constituents to discuss and respond to the following questions:

I. How are GAAP financial statements and other financial reports used by creditors and regulators of cooperative and mutual enterprises? How would those parties deal with changes in reporting of share capital?

II. How do *revolving plans, base capital plans,* and *special plans* for redeeming members' shares work when members leave or die? What are the relative merits of those kinds of plans?

III. How substantive are requirements for board approvals of return of capital? Discuss *Farmland* and other legal precedents.

Mr. Beerup expressed concern that liability classification would conflict with state and federal laws regarding cooperative enterprises that require those entities to meet certain financial standards in accordance with GAAP for licensing purposes. For state licensing agencies, Mr. Beerup said that there is no uniform standard but that the requirements regarding equity

percentages vary in each state. Mr. Beerup also stated that federal law requires GAAP financial statements for some cooperatives and that these requirements do not vary by state. Mr. Beerup noted that, typically, cooperatives are financially stronger than the noncooperative companies they compete with, but requiring cooperative enterprises to comply with FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, would make their statements of financial position appear worse than they are in reality. He argued that this would give noncooperative companies an advantage to resources and therefore would create more companies in the market that are less financially sound.

Mr. Trott asked that a financier of cooperative enterprises express his view of equity. Mr. Wilhelm noted the similarity of a cooperative's equity to any other enterprise. Entities have financial covenants based partly on net worth or equity and must file GAAP financial statements that have been audited by a CPA firm. Mr. Trott asked Mr. Wilhelm if there is a perceived difference between shares with a required payout and debt. Mr. Wilhelm noted that shares of cooperatives do not have a required payout since the payment is at the discretion of the board of directors. He stated that equity is allocated as a patronage account. Ms. Schipper asked Mr. Wilhelm if reclassification of the shares as liabilities would change his lending decisions. Mr. Wilhelm responded that if it changed the board of directors' discretion, then it would change his lending decisions. Mr. Wilhelm noted that he viewed equity with mandatorily redeemable as features different from general equity.

Mr. Dahlgren stated that in cases in which members have sought legal action to compel cooperative enterprises to redeem equity, the courts have sided with the cooperative enterprises. He expressed concern that, if the shares of cooperative enterprises are required to be classified as liabilities, litigants will cite that classification in court as evidence in support of requiring cooperative entities to pay out patronage capital. Mr. Dahlgren noted that the courts' reasoning for siding with cooperative enterprises is that the patronage capital represents equity. He noted only one case that he was aware of in which the court analyzed the entity's ability to pay and cautioned the entity to pay when it has the means to do so, however the caution had no legal bearing on the court's decision. Mr. Dahlgren stated that no court has compelled a cooperative entity to pay a patronage dividend. Mr. Schieneman asked Mr. Dahlgren if he would like to see the patronage capital presented in the financial statements as temporary equity rather than as a

liability. Mr. Dahlgren stated that he would prefer it be disclosed in the financial statements as a footnote.

Mr. Taylor voiced his concern that the reclassification of shares as liabilities might give the holders standing as creditors in the bankruptcy of a cooperative enterprise. He suggested that the change in classification may allow the shareholders to succeed in taking legal action as creditors to compel payment of their equities or, failing that, combining to bring about involuntary bankruptcy proceedings against the cooperative. Mr. Taylor expressed other concerns, including that such a change may complicate purchases of equity interests from bankruptcy proceedings of a failed cooperative. Mr. Wagoner expressed concern that vendors might not understand the reclassification from equity to debt and that it would be difficult to explain, as many are not up-to-date on accounting matters.

Mr. Batavick asked whether current disclosures provide enough information for users of the financial statements of cooperative enterprises to determine the characteristics of capital accounts. Mr. Beerup replied that the disclosures are inconsistent and do not provide a complete and transparent picture of claim on assets and what might be paid out. Mr. Ting said that disclosures could be improved. Mr. Silver noted that credit decisions concerning the status of patronage capital are not based solely on financial statement disclosures, but that corporate bylaws and other information are taken into account.

Mr. Dines expressed his concern that owners would be troubled by the reclassification of their ownership as a liability. Mr. Trott noted that when he was a partner, he considered his partnership interest as something that would be paid out to him when he left.

Mr. Trott asked Mr. Wilhelm how he would classify mandatorily redeemable shares. Mr. Wilhelm answered that if the shares have more characteristics of debt, he would consider whether the redemption would occur in the near future or in the long-term. Mr. Wilhelm noted that there is no default on the cooperative entity's part if it does not make payment on the patronage capital shares.

Ms. Schipper briefly explained her understanding of *revolving plans* and *base capital plans*. She asked the panel to address the second and third discussion questions. Mr. Ting stated that the cooperative enterprise he represents uses a base capital plan and pays dividends based on volume. Mr. Ting also stated that an owner can terminate his membership agreement, and the

cooperative enterprise will pay the patronage account at the discretion of its board of directors. At his cooperative enterprise, accounts of departing members are paid over several years, usually not in one payment.

Ms. Schipper also questioned whether patronage accounts are mandatorily redeemable at the discretion of the holder. Mr. Ting responded that the cooperative enterprise would say the patronage accounts are not mandatorily redeemable at the discretion of the holder because the cooperative enterprise's board retains discretion over the timing of the payment, and noted that if there were a mass liquidation of accounts, the cooperative enterprise's board would likely defer payments. Mr. Trott stated that if the past practice of the cooperative enterprise is to pay accounts upon termination of membership, the shares appear to be liabilities. Mr. Ting replied that even though the member's action may trigger a payment request, whether to make the payout ultimately is at the board of directors' discretion.

Mr. Dahlgren commented that many bylaws do not have an express provision giving the board of directors discretion relating to liquidation of member shares. He stated that it is generally understood that the cooperative enterprise's board has the discretion. Mr. Trott asked Mr. Dahlgren whether the doctrine of promissory estoppel creates a legal obligation to pay. Mr. Dahlgren stated that the courts have favored the cooperative enterprises—denied the demand for payment—even if bylaws are silent regarding the board's authority relating to redemption of member shares.

Mr. Beerup noted that in his practice as an auditor, the bylaws are generally explicit regarding the board of directors' authority. He stated that it is common for members to request that the cooperative entity redeem their member accounts. Mr. Beerup noted that many cooperative enterprises have long lists of members that have requested a payout for their shares and are still waiting.

Mr. Dahlgren stated that base capital plans work well in perpetual entities, but that most cooperative enterprises have revolving plans. All decisions are at the board of directors' discretion, which is generally a policy, and not a bylaw of the entity. Ms. Richards noted that it appears that the board of directors' discretion to redeem accounts relates only to the timing of the payment since eventually the shares are redeemed in most cases.

Mr. Trott observed that the ability to cancel does not eliminate the liability and gave employer health care plans as an example; he also noted that the obligation to pay is significant. Ms. Seidman noted that she would like to look at court decisions relating to payouts of cooperative entities.

Ms. Schipper asked whether members of a cooperative entity lose ownership rights once they request a payout of their shares. Mr. Silver replied that it depended on the circumstances.

Combinations between Mutual Enterprises

Mr. Crooch briefly summarized the Board's tentative decisions on business combinations as they pertain to mutual enterprises, which require that all combinations between mutual enterprises be accounted for using the acquisition method. He noted that the Board adopted a differences-based approach to considering whether combinations between mutual enterprises should be accounted for in a manner different from other combinations. Mr. Crooch asked the constituents what problems they saw with the FASB's current approach from the perspective of the regulatory agencies and other users of mutual enterprise financial statements.

Mr. Stonestreet stated that many differences exist between mutual combinations and stock combinations. First, he pointed out that, unlike in a stock combination, no purchase price is discussed or negotiated between combining mutual enterprises. Rather, combining mutual enterprises must rely on calculated estimates of fair value, which he believes are unreliable. Second, he stated that the goodwill resulting from a stock combination is calculated as the residual of a known amount—the consideration paid—whereas the leftover capital that results from a mutual combination is questionable since it is determined relative to the *estimated* fair value of the acquired entity. Third, Mr. Stonestreet noted that the factors motivating successful deals are different between stock combinations and mutual combinations. In a stock combination, primarily financial issues drive the deal, and like in a marketplace, a bidding process determines which of the prospective acquirers "wins." The winning bid is usually made by the enterprise that can create the most value as a result of the combination. In a mutual combination, Mr. Stonestreet stated that social issues primarily drive the deal and there is no financially driven bidding process. Rather, the winning mutual enterprise is the one that has the best personal relationship with the target mutual enterprise.

Mr. Crooch asked the constituents why differences between mutual combinations and nonmutual combinations should warrant a different accounting treatment and what problems would be caused by applying the acquisition method to all combinations between mutual enterprises. Mr. Herz added that the basic principle of the Board's tentative decisions is that the acquired enterprise should be measured at its fair value on the balance sheet of the acquiring enterprise.

Mr. Stonestreet responded that he identified two problems with the application of the Board's basic principle to mutual enterprises: (a) for mutual enterprises, the measurement of the fair value of the acquired enterprise (and therefore the amount of goodwill recognized) is unreliable because there is no purchase price and (b) the creation of a goodwill account will necessitate a costly education effort on behalf of mutual enterprises. Mr. Crooch responded that reliance on direct measurement of the fair value of the acquired enterprise is not unique to mutual enterprises and that acquiring enterprises often perform and rely on direct valuations prior to the combination as part of their due diligence.

Mr. Regan added that a significant problem with the Board's tentative decisions from the perspective of credit unions is the impact to the calculation of regulatory net worth. Credit unions are required to maintain certain levels of net worth for regulatory purposes. That net worth is defined by law and is calculated based on retained earnings as determined under GAAP. Mr. Regan noted that while pursuing changes to the legislation is an alternative, that process would be time-consuming and costly. He noted that, in the interim, the effects on regulatory net worth would create a disincentive for credit unions to combine.

Mr. Piecara noted that it is particularly difficult to determine which enterprise is the acquirer in a mutual combination because the combining enterprises are oftentimes of very similar size and membership. Mutual enterprises combine in order to achieve the benefits of combined economies of scale and therefore, the success of a combination is based on whether there will be benefits to both of the combining enterprises. Mr. Wilhelm agreed and noted that most mutual combinations involve significant political or social factors. For example, in the combinations that formed CoBank, a requirement to identify the acquiring bank might have caused the combination to be abandoned.

Mr. Herz asked whether a fresh start method—that is, a method that would require the assets and liabilities of both enterprises to be recognized at fair value—would be an acceptable alternative

for all combinations between mutual enterprises. Some participants, such as Messrs. Wagoner, Taylor, and Piecara, expressed concerns about a broad application of the fresh start method for all combinations between mutual enterprises, but supported the use of a fresh start method in circumstances where an acquirer could not be determined. Mr. Stonestreet disagreed, stating that a fresh start method would be extremely problematic for combinations of mutual banks.

Mr. Schieneman asked the users of mutual enterprise financial statements whether it would be more useful if the assets and liabilities were shown at fair value or book value (carrying value prior to the combination). Messrs. Wilhelm and Silver indicated that they preferred a balance sheet that was based on fair value. However, they also noted that a one-time fair value measurement at the date of combination would be stale for periods following the combination and would not necessarily be more useful than book values. Mr. Beerup indicated that for small cooperative enterprises, the financial statements also are provided for the benefit of the members. In such cases, he noted that additional costs would be incurred to educate these members about the changes in accounting for combinations.

Mr. Crooch asked participants whether any additional guidance would be necessary if they were required to apply the purchase method to combinations between mutual enterprises. Mr. Stonestreet suggested that (a) the credit entry to the capital section under the Board's tentative conclusion be labeled "paid in capital" (with an explanatory footnote), (b) the Board provide additional guidance on how to measure the fair value of the acquired mutual enterprise, and (c) the Board reconsider its decision related to the transition provisions for mutual enterprises that recognized negative goodwill under APB Opinion No. 16, *Business Combinations*. Mr. Beerup suggested that the Board clarify, for combinations between mutual enterprises, how to apply the guidance in FASB Statement No. 141, *Business Combinations,* on determining which enterprise is the acquirer.

Follow-Up Items:

None.

General Announcements:

None.