Statement of Jeannine Kenney
Vice President, Public Affairs and Member Services
National Cooperative Business Association

before the

U.S. Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities and Investment
regarding

The Financial Accounting Standards Board and Small Business Growth

November 12, 2003

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Senator Enzi and members of this subcommittee, on behalf of the National Cooperative Business Association and the thousands of U.S. cooperative businesses that we represent, thank you for the opportunity to testify on the need for clarity on, and resolution of, issues raised by Financial Accounting Standard No. 150.

The National Cooperative Business Association is the 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. Our mission is to develop, advance and protect cooperative enterprise.

Of the many financial challenges confronting cooperatives in recent years, few have generated as much concern and uncertainty as FAS 150. How and whether these concerns are resolved will have enormous impact on the balance sheets of cooperatives, and equally important, on the individual members those cooperatives serve, many of whom are small business people themselves—farmers and ranchers, and the independent owners of local hardware stores, pharmacies, hotels, restaurants, office supply stores, newspapers, and the many other independents served by purchasing cooperatives.

For this reason, NCBA and its members are extremely grateful to FASB for its decision last Friday to indefinitely defer FAS 150 for mandatorily redeemable instruments, other than those that are redeemable on fixed dates. We hope to work with FASB as it reconsiders and evaluates the implementation issues associated with FAS 150. Our comments below reiterate and build upon the comments submitted to FASB in past comment periods for FAS 150.

Co-op Basics: 40,000 strong with 120 million members

To understand why FAS 150 has been so troubling to co-ops first requires an introduction to co-op structure.

The more than 40,000 co-ops in this country are, by definition, businesses that are owned and democratically controlled by their members—the people who buy the goods or services provided by the cooperative, rather than by outside investors. About 120 million Americans are members of a cooperative—or more than half of all adults. To put the importance of the cooperative sector into perspective, note that cooperatives outnumber investor-owned firms by more than two-to-one.

Though many cooperatives are large and well-known businesses—some are included in the Fortune 500—the vast majority of cooperatives are small, community-based businesses such as food cooperatives, electric cooperatives, agricultural marketing and supply co-ops, worker-owned cooperatives, and purchasing and shared services cooperatives that serve tens of thousands of independently-owned businesses across America's towns and cities. These cooperatives and their members generate millions in economic activity, creating jobs, wealth, and opportunity.

Cooperatives fall into four categories:

- Producer-owned cooperatives—These are cooperatives owned by farmers or craftsmen who form a co-op to jointly market, process or produce a like-product. There are 1,600 farmer- or rancher-owned marketing or processing cooperatives in the U.S., most of which are local co-ops. The growth of new generation cooperatives—small co-ops that specialize in value-added agricultural processing—has been spurred by programs and incentives, such as USDA's Value-added Producer Grants program, that have originated in the U.S. Senate. Renewable fuels cooperatives—those that process ethanol, biodiesel, and wind power—are a growing segment of this category.

- Consumer-owned cooperatives—Representing the largest category of co-ops, these cooperatives are owned by the consumers who buy the goods or services of the business. They are largely small and local in nature and include food co-ops, credit unions, rural electric and telecommunications cooperatives, housing co-ops, parent-owned childcare co-ops, and consumer-owned HMOs.

- Worker-owned cooperatives—These are cooperatives that are owned and controlled by their employees. They are similar to companies with Employee Stock Ownership Plans (or ESOPs) in that the workers own the company. 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.

- Purchasing and shared services—These are cooperatives that are owned by individuals or small businesses that band together to jointly buy goods or services as a group, thereby lowering their input costs. Unlike buying clubs, the members of purchasing cooperatives actually own the company, ensuring that it is acting only in their best interests in procuring inputs and services. This is a growing segment of the co-op sector, as more and more small businesses see purchasing co-ops as the key to their survival. We estimate that, nationwide, more than 50,000 independent businesses are members of purchasing co-ops. The nation's 1,600 local farm supply and service co-ops fall into this category, since they are effectively purchasing co-ops for farmers and ranchers.

Co-op Patronage Equity

Because co-ops are member-owned businesses, their equity is provided by their members. Generally speaking, co-ops do not issue public debt, though there are a few exceptions to this rule. Co-op equity, in most cases, consists largely of, or in many cases, solely of member equity.

A co-op member will make an equity investment, usually in nominal amounts, in a cooperative upon becoming a member. This investment represents a member's ownership interest in the cooperative. This equity stake grows or declines depending on the co-op's profitability.

It's important to understand that, unlike investors, co-op members join a cooperative in order to benefit from the goods and services it offers, not to make a substantial return on their initial investment. That is, consumers join food co-ops or credit unions in order to shop at a particular grocery store and enjoy discounted prices to members or better rates and lower fees. Farmers join an agricultural marketing co-op to benefit from the improved leverage that cooperative has in negotiating prices for their crop or the premium enjoyed through the co-op's branding of products. Small businesses join a purchasing co-op to reduce their costs of doing business, and workers join a worker-owned co-op to better enjoy the profitability of that company through annual dividends.

All co-ops operate as not-for-profit businesses in that they return any profits they earn to their members in the form of end-of-year dividends based on the amount of business a member did with the co-op—these are referred to as patronage dividends. Members receive dividends either in the form of cash, or as equity held by the co-op and allocated to individual members—often known as allocated patronage capital or capital credits—or both. Cooperative patronage capital therefore is the accumulation of capital from revenues in excess of expenses over time.

Allocated patronage capital is how a cooperative—and often the only way—builds up equity in the company. It is recognized by members as risk capital. In the unfortunate incidence of a bankruptcy, co-ops may never return equity to members. Debt holders are paid first. Patronage capital is an asset that can be called in by lenders. Holders of equity are paid last, if at all.

By FASB's own definition, allocated patronage equity is true equity. FASB Statement of Financial Accounting Concepts Statement No. 6, defines equity as the ownership interest in the business. In a co-op, the equity shares of members—the owners—is their ownership interest. Further, Concepts Statement No. 6 states, "equity distributions to owners are at the discretion and volition of the owners or their representatives after satisfying restrictions imposed by law, regulation or agreements with other entities."

In the case of cooperatives, the representatives of the owners are the members of the co-op board of directors. Co-op boards of directors, which are elected by members, retain the ultimate discretion as to how or whether to return allocated equity to members. Co-ops have a variety of arrangements regarding redemption of members' shares.

Some co-ops repurchase the shares of members upon their withdrawal from the co-op, upon death, or upon reaching retirement or a certain age. Other cooperatives have a policy of revolving equity of the cooperative over a period of time once specific equity levels are achieved and the financial condition of the co-op allows.

Redemption decisions may be based in board policy, practice or in the co-op's bylaws. However, most co-ops have no provisions in their bylaws, but have a past practice of repurchasing members' shares upon withdrawal, death, retirement or on some revolving basis. And some co-ops may never redeem member equity. Co-op boards make such discretionary redemption decisions based on the financial and other needs of the cooperative. Boards have no such discretion with respect to repayment of true debt obligations.

It's important to note that cooperative boards are elected by the members and change over time. There can be no assumption, then, that the practices and policies of past boards will be adopted by future boards.

Finally, in instances when the discretion of a co-op board to redeem equity has been challenged, courts have consistently affirmed that the board of a cooperative has discretion with respect to redemptions.

Therefore, regardless of redemption policies, co-op patronage capital retains all the characteristics, as defined by FASB, of equity.

FAS 150

FAS 150, in the form approved by FASB in May, raises serious and unanswered questions for cooperatives that affect their financial solvency, their ability to meet loan agreements and ultimately, the ability of the co-op board of directors to exercise its authority over redemption of equity.

Again, we are grateful to FASB for its decision to indefinitely defer FAS 150's provisions regarding mandatorily redeemable shares of nonpublic entities—the provision of greatest concern to co-ops—pending further board action. This will provide time for cooperatives to work with FASB on unresolved issues raised by any new accounting standard.

Cooperatives and their membership organizations have been following FASB's work that culminated in FAS 150 for several years and have actively participated in the comment periods throughout FASB's process. The recent comment period on FAS FSP 105-c—the staff position regarding delay of the effective date—drew more than 70 comments from cooperatives, or roughly 70 percent of all comments FASB received on this staff position.

However, we are troubled that the concerns and substantive arguments of cooperatives, expressed through the series of FASB comment periods and personal meetings, were not heard until the 11th hour. These concerns are similar to those raised by other professions that actively participated in this process—architectural, engineering and construction-related firms.

Key Issues Regarding Mandatorily Redeemable Financial Instruments

At the heart of co-op concern regarding FAS 150 is how the accounting profession will interpret the new rule with respect to cooperative patronage capital and whether it will be considered a "mandatorily redeemable financial instrument" under the varying conditions for redemption. Fundamentally, we believe that co-op patronage capital should be classified as equity, rather than as liabilities, until such time as it will be redeemed.

FAS 150 stipulates that mandatorily redeemable financial instruments shall be classified as liabilities unless redemption is required to occur only upon the liquidation or termination of the reporting entity. FASB defines "mandatorily redeemable" to include instruments that embody "an *unconditional obligation* requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date, or upon an event certain to occur." [Emphasis added.]

FASB defines "obligation" as a "conditional or unconditional duty or responsibility to transfer assets or to issue equity shares." Meanwhile, in the Statement of Financial Accounting Concepts No. 6, FASB notes that an obligation is broader than a "legal" obligation. Concepts No. 6 states that FASB uses "obligation" with "its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility and so forth."

This very broad definition of "obligation" has raised significant questions about what an "unconditional obligation" within the context of FAS 150 will actually mean in practice and how it will be interpreted by the accounting profession.

Cooperatives and their accountants have questioned whether the absence of an unconditional legal obligation with respect to co-op equity redemptions is sufficient to exclude co-op patronage capital from reclassification as "mandatorily redeemable instruments." Though most co-op boards retain discretion on equity redemptions as noted above, past discretionary practices to redeem such equity under different situations could constitute a constructive duty or obligation, even though there is no legal obligation to redeem.

Unofficial conversations between cooperative representatives and FASB staff made clear that this could indeed be an outcome of FAS 150. A history of certain discretionary redemption practices could therefore require reclassification of all member equity as liabilities even if there is no obligation to continue those practices in the future.

Without such clarification, co-ops with a practice of redeeming capital to heirs of deceased members, to retiring members, or of revolving capital run the risk of having all of their equity reclassified as debt even though only a fraction or no capital may be redeemed in a given year. Co-op equity is never redeemed all at once, except upon the sale or dissolution of the cooperative. This would be a nonsensical outcome.

In addition, cooperatives are concerned that FASB has failed to recognize the similarities between co-op patronage capital redemption and similar instruments issued by for-profit companies that are not considered by FASB to be mandatorily redeemable.

For example, allocated patronage capital in a cooperative is analogous to retained earnings in a for-profit firm. Just as for-profit companies may distribute retained earning to owners by paying dividends, cooperatives may return patronage capital to owners by retiring patronage capital. In both instances, the payments are made at the discretion of the board of directors.

The decision to return capital to owners in a co-op is made using the same decision process as that used by for-profit companies regarding dividend payouts for preferred or nonredeemable common stock—by managing the entities' capital structure and cash flow and examining income tax ramifications.

FAS 150 clearly states that for companies issuing nonredeemable common or preferred stock, "Declaration of dividends is at the discretion of the issuer, as is a decision to reacquire shares." It therefore concludes, "Nonredeemable outstanding shares of both common and preferred stock lack an essential characteristic of a liability." This is also clearly the case with co-op patronage capital—in most cases, the co-op has no obligation to redeem member shares. But FAS 150 provides no clarification on this matter for cooperatives.

We are concerned by what will be, without further clarification, disparate treatment of cooperatives relative to for-profit companies exercising similar discretion. If a for-profit company with continuing dividend payouts is not considered by FAS 150 to have mandatorily redeemable retained earnings, it follows that a cooperative that has regular redemptions of patronage capital must not be considered to have mandatorily redeemable patronage capital.

For this reason, cooperatives are seeking greater clarification by FASB that just as companies issuing non-redeemable common stock have no obligation to pay dividends or reacquire shares despite a past practice of doing so, cooperatives likewise have no obligation to redeem member shares, although they may have in the past.

In some cooperatives, the agreement between a member and the co-op does include redemption upon termination of membership. However, since it is unclear when or if such termination will occur, equity associated with such agreements should not be considered mandatorily redeemable. It's important to underscore, here, that regardless of such agreements, a member may never receive equity redemption, depending on the financial state of the business—this is because such equity represents a true ownership interest.

Moreover, we seek clarification that patronage capital shall not be classified as debt until such time as a co-op makes a decision to redeem it and then only that portion of capital would be classified as a liability. Any other outcome seriously mistakes the nature of the relationship between a cooperative and its owners.

Events Certain to Occur

Also unclear in FAS 150 is what constitutes an "event certain to occur." While death falls into this category, it is unclear what other events might be captured.

For example, some cooperatives, such as purchasing cooperatives for small businesses, may have an obligation to redeem a member's equity when that member leaves the co-op. However, in cases where the member is a small business corporation—as is the case for many small business purchasing cooperatives—there can be no certainty that the membership of that corporation in the purchasing cooperative will ever be terminated. In many cases, membership is maintained by the successor owners of the small business. Such obligations to redeem equity should not be reclassified as mandatorily redeemable since the event triggering the redemption is not certain to occur.

Moreover, FASB should reevaluate whether it is appropriate to reclassify equity as debt even for some events that are certain to occur, such as the death of a member. In this example, it is preposterous that all member-owners of a cooperative would die in a given year, bringing into question why the equity of all members should be reclassified as debt, even if there were a mandatory obligation to redeem.

In summary, NCBA and its cooperative members seek greater clarification from FASB on the following:

- Co-op patronage capital represents a true ownership interest of the members of a cooperative and is properly classified as equity.
- Co-op patronage capital shall not be considered a mandatorily redeemable financial instrument until a decision is made or action taken to redeem a portion of that capital, and that only that portion scheduled for redemption is properly classified as a liability.
- For the purposes of FAS 150, unconditional obligations shall include only legal obligations rather than those perceived as "constructive obligations," a "socially imposed duty" or "moral responsibility." Uncertainty in this area could be disastrous for many small businesses around the country.
- That "events certain to occur" be narrowly defined so as not to include events that may or may not occur depending on the nature, type and structure of a business.

Potential Impact of FAS 150 on Cooperatives

The uncertainties associated with the application of FAS 150 to cooperative patronage capital generated significant concern among cooperatives because for many of them, patronage capital makes up the entirety of the business's equity. The new standard, if implemented as originally proposed and without further clarification, could have required many cooperatives to reclassify all of their equity as debt, creating the appearance of insolvency. It is hard to overstate the negative consequences of that outcome.

Other impacts include:

- Debt Financing—The impact of a dramatic increase in liabilities on co-op balance sheets would put many cooperatives in technical default of their loan agreements that require certain levels of equity. Moreover, a balance sheet that reflected zero equity would make it difficult for co-ops to secure new debt financing agreements.
- Relationships with Suppliers—Vendors and suppliers to cooperatives also frequently rely on the business's balance sheet to assess credit worthiness. An increase in a co-op's liabilities could adversely affect its relationships with its suppliers.
- Impact on Members—If FAS 150 would have required co-ops to discontinue discretionary redemptions, co-op members and their heirs would be adversely affected by the standard. For purchasing cooperatives, FAS 150 could jeopardize the financial solvency of the co-op, adversely impacting its ability to serve its small business owners. And to the extent the reclassification would jeopardize the financial solvency of the business, all member-owners of a cooperative would be harmed.

- Reduced board discretion on equity redemptions—If FAS 150 had required reclassification of all member equity, it would have effectively converted what had been discretionary redemptions into mandatory redemptions. That is, the standard could have reduced the discretion of the board in managing the overall financial health of the cooperative by eliminating its ability to determine when and whether equity would be redeemed. This outcome would imperil many cooperatives.

FAS 150 Does Not Improve Transparency of Financial Statements

Though one intent of FAS 150's provision on mandatorily redeemable shares was to improve the transparency and accuracy of financial statements, for cooperatives it would have had the opposite effect. It would have seriously misstated the financial health of financially sound and thriving businesses.

FAS 150 addressed this situation by allowing a business with *only* mandatorily redeemable shares to include them under liabilities listed separately as "shares subject to mandatory redemption," in order to distinguish them from other liabilities. But this allowance tacitly suggests that, in fact, there is something about these instruments that is different from standard liabilities that should not give lenders pause. What is different, of course, is that for cooperatives, the instrument is truly equity.

FASB staff also suggested that the issues raised by cooperatives could be addressed by educating lenders and suppliers regarding the nature of co-op patronage capital. However, changes to accounting standards that require more, not less, explanation cannot represent an improvement in transparency.

Conclusion

NCBA hopes to work with FASB over the coming months to clarify that co-op patronage capital remains properly classified as equity. Moreover, discretionary redemptions in the past should not result in constructive obligation for redemptions in the future.

The satisfactory resolution of these accounting standard questions is critical to the continued health and growth of community-based cooperatives across the U.S., and their ability to serve their members, including the many small businesses that belong to cooperatives.

Mr. Chairman, we thank you for opportunity to testify on this important issue.