Why Accounting Standards Matter

Sudden changes in regulations could threaten the co-op bottom line

BY MARY GRIFFIN

Recent months have given us all pause about the security of our financial markets. Investment firms that survived a century of market corrections and bulls and bears could not withstand losses wrought by the mortgage credit crisis we're now wrestling with. We won't know the full impact of these bankruptcies, takeovers, and bailouts on our own mortgages and pension plans for some time. And as we sit contemplating whether we should stay in the market or get out, we are dumbfounded at how quickly the world's strongest financial system toppled. How could they not know how bad things were?

"They" includes government regulators, including the Securities and Exchange Commission. After Enron and the other accounting scandals, Congress passed Sarbanes-Oxley. The bill established oversight through a private entity, rather than the previous self-regulated system of audits of public companies. The financial statements auditors review must comply with accounting standards set by another private entity, the Financial Accounting Standards Board (FASB). While accounting may not be the sexiest of topics, it is one of the most important to the country's financial well being.

Who's in charge?

Laws require issuers of securities to provide financial reports that accurately depict the financial picture of the company. These reports are intended to protect investors. The SEC relies on FASB to set the standards used in preparing financial statements. Those standards are designated as the primary level of generally accepted accounting principles, or GAAP. GAAP is not a statute, but a framework that includes various levels of standards and pronouncements, including those issued by FASB.

Although GAAP applies to privately held as well as public companies, it is the requirement of publicly traded firms to file reports with the SEC that bring SEC oversight into the picture.

FASB is run by a board appointed by the Financial Accounting Foundation, which is also responsible for assuring FASB's funding. The Financial Accounting Foundation's trustees are selected from its constituent organizations, most of which are accounting and securities organizations. A number of organizations and advisory committees help set FASB's agenda and advise it on technical issues. As issues are added to the agenda, a "due process" develops that could take a few months or stretch over several years, depending on the issue.

What does this have to do with cooperatives?

Cooperatives also must prepare financial statements in accordance with generally accepted accounting principles. Changes to accounting standards can affect how co-ops prepare their financial reports, value their assets and liabilities, and account for changes to their balance sheets. Changes can also be expensive for cooperatives, if they require more work for accountants and auditors. But co-ops, broadly speaking, did not pay a lot of attention to the process of setting accounting standards until 2003, when a new accounting rule proposed to change the way equity and liabilities are classified.

In May 2003, as part of a broader effort to revise accounting rules, FASB issued Financial Accounting Standard No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. Equity, typically the amount remaining after liabilities have been deducted from assets, represents the ownership interest in a firm, or its value. FAS 150 would have reclassified much equity as liabilities, causing major declines in a firm's shareholder equity and net income. That could have caused violations to debt covenant agreements that require a certain level of equity.

And it had the potential to wreak havoc on co-op balance sheets. Among the instruments FAS 150 classified as liabilities were those reflecting a mandatory future obligation for the issuer. For cooperatives, the issue is whether member equity—member shares, member

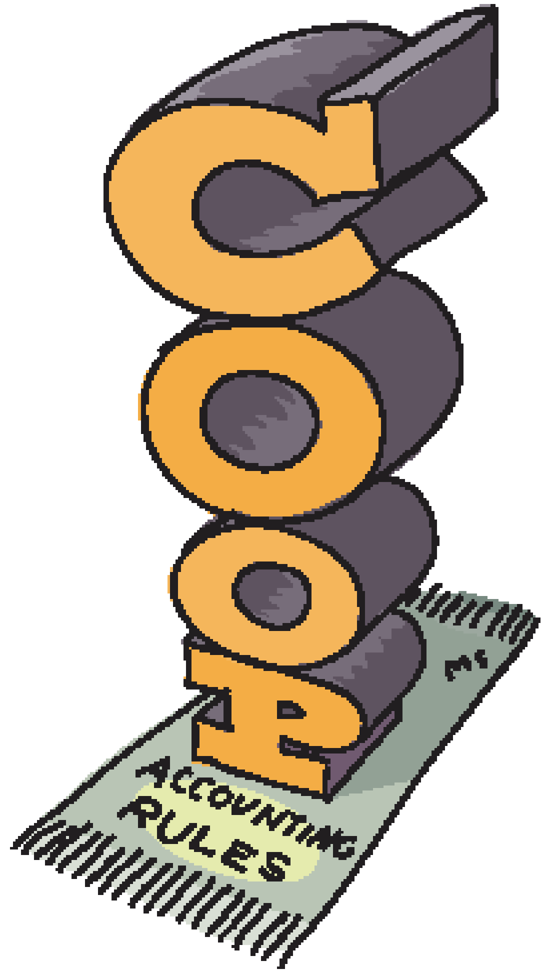

ILLUSTRATION BY MARK SIMONSON

stock, patronage capital, capital credits—would be considered mandatorily redeemable even though co-op boards have sole authority over redemption. Under FAS 150, co-op shares could have been lumped into the mandatorily redeemable category and classified as liabilities.

Many members may not realize that, when they put down money to join a co-op, that money is at-risk capital, with no guaranteed right of return. Many cooperatives revolve equity back to members on a regular basis. But they are not required to. If co-ops had to report more of their equity as liabilities, lenders, vendors and members might jump ship, leaving co-ops searching for a financial lifesaver. When co-op CEOs and CFOs realized the impact of FAS 150, they knew they needed to get active on accounting issues.

The community mobilizes

Once it woke up to the impact of FAS 150, the co-op community mobilized its associations, individual co-ops, and their members. The National Cooperative Business Association established a Cooperative Finance and Tax Council, an in-house entity devoted to identifying and advocating on financial issues affecting co-ops across all sectors. The cross-sector nature of the group allows for a better understanding of the nuances of different co-op structures.

NCBA and other organizations launched a successful grassroots campaign to bring a halt to FAS 150. Eighty percent of the comments on the proposal were from co-ops. That, and pressure from Congress, led FASB to indefinitely defer the implementation of FAS 150 for co-ops and other non-public businesses.

Since the deferral, co-ops have worked hard to educate FASB about their unique financial structure. They took the co-op cause to FASB headquarters in Norwalk, Conn., and helped organize FASB visits to several cooperatives. Co-ops weighed in on proposals addressing mergers, changes to pension reporting, accounting for taxes, and other issues. Co-op accounting experts joined FASB advisory committees and represented co-ops at FASB forums on specific proposals. FASB staff and members now speak routinely at meetings of NCBA and the National Society of Accountants for Cooperatives.

Have co-ops had any success? As often happens when trying to influence policy, it's a big step forward followed by two steps back. FASB knows more about cooperatives today and has made some rule changes to accommodate co-ops' unique structure. But FASB also is striving for uniform and consistent standards. Exceptions to accommodate one class of business or another are not the favored approach. So cooperatives must find ways to argue for changes that apply uniformly but still help co-ops.

A new FASB proposal would classify as equity only the capital that represents the most subordinated interest—a narrow definition aimed at focusing on those left holding the bag, or the last in line to get any assets if a business liquidates. This approach would work well for many co-op shares, but preferred shares—nonvoting, dividend-paying shares that take preference at liquidation—would still be defined as liabilities. Many co-ops have started to use preferred shares as a means of bringing in more capital. But that source could dry up if this FASB proposal is adopted.

Meanwhile, an overarching issue emerged that co-ops—and everyone else—needs to watch extremely closely. It's known as global accounting standards.

The move to international standards

In 2002, as FASB pushed to stop accounting arbitrage and respond to Sarbanes-Oxley, a bigger concern developed. Criticized for issuing rules that are too complex and a process that is too cumbersome, FASB signed an agreement to harmonize its standards with those of the International Accounting Standards Board. It also agreed to move to the more "principles-based" standards issued by the IASB. More than 100 countries now use IASB's standards, and more are considering them.

At first, the idea was to develop joint standards. But the assumption now is that the IASB will be the global accounting standard setter, with FASB's role unclear. The projected implementation date is 2011–2014, and the SEC is sympathetic with IASB.

IASB is an international entity with no direct authority over U.S. companies, but it will be setting accounting standards for them. And some believe the IASB standards are not as strong as the U.S. standards. Depending on your perspective, this creates a better functioning global market, or sets up the next big financial crisis. Despite concerns, Congress has held no major hearings on the topic. The SEC promises to monitor the IASB and protect U.S. interests. That might raise some eyebrows in light of the events of the past few weeks. Plus, the SEC only has authority over publicly traded firms.

NCBA has been working with cooperatives around the globe, through the International Cooperative Alliance and other organizations, to craft a consensus approach on equity classification and to make sure co-ops have a seat at the international table. But rallying cooperatives around often arcane accounting issues is a challenge. In addition, the laws and the structures under which different types of co-ops operate vary greatly. Co-ops must assure that the IASB understands their structure and the value they bring to the global economy. It will be hard tracking the moving target of accounting standards and protecting the co-op enterprise. ■

Protecting Your Equity—What Co-ops Can Do

Get to know your financial structure. While co-ops serve the social and economic needs of their members, they are businesses and must be understood as such.

Check your bylaws. Do they set out a redemption policy? Do they make it clear that the board has the right to refuse redemption? Do your bylaws comply with your redemption practices?

Establish a management of capital plan. A business is always better if it manages its capital and has a plan for the good times as well as the bad.

Check with your accountant or legal counsel to make sure the co-op is holding and distributing capital the way it should and the way it says it is.

Use these issues to **educate your members** about the value of their investment. Equity is risk capital or owner capital. It represents what co-ops are about, ownership by the members. This means participating in both the risks and rewards of business ownership.

Support cross-sector organizations like NCBA, which are working to protect the interests of all cooperatives.