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The Upcoming Changeover to Purchase Accounting

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The "pooling" accounting method is going the way of the horse and buggy. Starting in 2009, cooperatives will be required to use the "purchase" accounting method in connection with business consolidations. The pooling method has not been available to corporations for some time; in 2009 the change will also be applied to cooperatives. This article will provide an overview of the difference between the pooling and purchase accounting methods and highlight a few key issues raised by the changeover.

Pooling vs. Purchase

The difference between the pooling and purchase accounting methods is straightforward. Under the pooling method, a cooperative records the assets of an acquired company at the book value of the assets on the acquired company's balance sheet at the time of the merger. Under the purchase method, a cooperative must record the assets of an acquired company at the fair market value of the assets at the time of the transaction.

Pooling and purchase accounting methods lead to different accounting results whenever the fair market value of assets deviates from book value. The fair market value of assets is often different than book value because book value is simply the original cost of an asset less any accumulated depreciation. To the extent that fair market value deviates from an asset's original cost and accumulated depreciation, book value and fair market value will be different; this difference can be significant, particularly for assets that were acquired long ago or where accelerated depreciation was applied to the assets.

One might question why the Financial Accounting Standards Board ("FASB") would bother mandating a change from pooling to purchase accounting. After all, the change only affects the accounting of a transaction and not the transaction's underlying economic substance. The change can be seen as an effort to make financial statements and disclosures reflect, to the extent possible, current market values, which arguably increases the value of the financial statements to those who use and evaluate them, and adds to the comparability of one company's statements with another company's financial statements.

Another possible reason for the change is to reduce the use of deceptive accounting practices. In the past, companies could (and have) used pooling accounting to artificially inflate earnings. This is done by purchasing a company whose assets are booked at values far below fair market value. After the acquisition, the acquirer sells the assets and records income on the sales – thus artificially improving the appearance of the business.

We do not suggest deceptive accounting is an issue within the cooperative community. On the other hand, and driven also by its desire to conform accounting standards in the United States with international accounting standards, because FASB had previously eliminated the use of pooling for the rest of the business community, FASB then determined that co-ops (and other mutual organizations) were not sufficiently unique to justify the continued use of the pooling method for co-ops.

Parenthetically, the co-op community made a determined effort to persuade FASB to allow cooperatives to continue using the pooling method. While we expect that you may be surprised and perhaps troubled by the application of the purchase method to mergers of cooperatives and other mutual organizations, we think you should know that numerous organizations and trade associations fully aired the co-op community's concerns to FASB.

Issues Raised by the Changeover

1. Increased Awareness of Fair Market Value. The purchase method will more sharply focus everyone's attention on the fair market value of both cooperatives. Historically under the pooling method, co-op boards of directors, consultants and members focused on whether a merger of co-ops created efficiencies that benefited the members and patrons of both cooperatives. Less attention was paid to fair market value so long as the merger created a stronger bottom line and balance sheet for the merged cooperative.

One consequence of purchase accounting is that appraisals will be much more common in cooperative business consolidations than might have previously been the case. These appraisals will likely receive prominent status in merger disclosure documents and generate increased awareness in the co-op community of the fair market value of the assets of various co-ops.

2. Liquidity. There is a difference between the fair market value of an asset and whether a ready market exists for that asset. As recent events in the credit and financial markets have demonstrated, there is no such thing as a guarantee of liquidity. Purchase accounting may create unrealistic expectations in the minds of members as to the amount of cash they could expect to receive if the co-op were put on the auction block. Members may push for sale of the co-op only to discover that no buyer is willing to pay full value.

3. Demutualization. An increased awareness of fair market value may tempt co-op members to reject merger proposals in favor of pursuing a sale of the co-op or its assets. A fundamental principle of co-ops is limited returns on invested capital. This principle goes back to the founding of the cooperative movement, which emphasized returns flowing to those patronizing the co-op. Co-ops were to exist across multiple generations. Increased awareness and focus on fair market value could tempt current members to trade future generation's access to the cooperative for cash today.

Boards may be tempted to allocate gain as a defensive strategy to demutualization, but we suggest that this temptation be ignored to avoid having to resolve expensive legal and accounting issues created by allocating the gain. Please continue reading for more on these issues.

4. The Theoretical Dissolution of the Co-op as a Test. One unintended outcome may be that in determining whether to vote in favor or against the proposed merger, members will inquire about their pro-rata share of the proceeds in a theoretical liquidation of the cooperative. In other words, one can always test how much cash any patron would receive by

considering what would happen in the theoretical dissolution of the cooperative. Liquidating distributions of remaining proceeds will usually be made on the basis of historical patronage, including to former patrons of the co-op.

A portion or all of the supposed gain from the theoretical dissolution of the cooperative at its fair market value could be allocated and assigned to present and former patrons just as if a dissolution of the cooperative occurred. Obviously the gain would be "paid" with an increase in the amount of allocated equity credited to each member and patron on the Acquirer's books rather than with the payment of cash, as would occur in a dissolution. Loss could be allocated and assigned as well, but allocating gain is far more difficult, as we discuss next.

5 **Allocating Gain of *Acquired* Co-op.** All of the following issues weigh *against* allocating gain to members, patrons and former patrons. Gain might be allocated to members, patrons, and former perhaps as a defensive strategy to threatened demutualization. Remember too that under the purchase method, one co-op will always be identified as the Acquirer and one or more will be "Acquired" co-ops.

a. *Example of Acquired's Situation*. Assume that each one dollar ($1.00) of book value equity is expected to be worth three dollars ($3.00) in a theoretical dissolution of the co-op based on an appraisal of the acquired co-op's assets at their fair market value.

b. *Time Value of Money*. How much allocated equity must be offered to compensate for, in this case, three dollars of ($3.00) of fair market (cash) value? Lets assume that an analysis shows that allocated equity can reasonably be redeemed on average in twenty (20) years and that five dollars ($5.00) of allocated equity redeemed that far in the future is worth three dollars ($3.00) in cash today.

c. *FAS 150*. The merged cooperative must be careful not to make promises that will cause a reclassification of its allocated equity as debt on the merged co-op's balance sheet.

d. *Taxes*. Members would recognize gain on their tax returns of $2 of gain for every dollar of allocated equity, depending of course on the conclusion reached under *time value of money* above.

e. *Sale of Securities*. Allocating gain through the issuance of allocated equities raises issues that require compliance with securities laws.

f. *What About the Acquirer's Gain (or Loss)?* Only the assets of the Acquired co-op(s) are adjusted to their fair market value under the purchase method in a merger of two or more co-ops. But the Acquirer will appraise its assets too, and its Board of Directors will be aware of the gain or loss that could be allocated to its members, patrons and former patrons in a theoretical dissolution of the Acquirer. So for example, if we assume that the Acquirer has the same fair market value as the Acquired's, in this situation the Acquirer could obligate itself to redeem $3.00 for every $1.00 of allocated equity that is called for redemption.

g. *Fiduciary Obligations.* The board of directors is a fiduciary to the cooperative first and then to the members. Application of the purchase method to co-op mergers will test the board because it cannot obligate the Acquirer co-op to allocations of gain that will unduly burden the co-op.

h. *Gain Not Allocated.* The stronger course of action is to avoid having to allocate gain to members, patrons and former patrons. Still though, the merger documents and resulting bylaws of the merged cooperative should direct how the "gain" for the Acquirer and the Acquired(s) co-ops will be cordoned off for each group of members, patrons and former patrons so that upon a later dissolution, each group of members and patrons are treated fairly.

6. Free Riders on the Acquirer Co-op. If members of a co-op decide to sell the co-op instead of merge, how will members of a surviving co-op feel if selling members ask to join the surviving co-op after selling their co-op's assets and pocketing the cash? Will the surviving co-op demand an investment of equity from new members and patrons prior to allowing them to patronize the cooperative? Otherwise, one could argue the members of the selling co-op had their cake and were now eating it too.

7. Investments in Other Cooperatives. Auditors are permitted by GAAP to account for patronage refunds received from other cooperatives at their face value. One might challenge auditors that the fair value of those investments should remain the same through a merger because the merger does not change the underlying assumptions about those assets. The application of a fair value analysis to these assets can be expected to result in a reduction of value, probably to the discounted value of future cash flows.

8. Member Communication. A thorough communication plan can avoid concerns about demutualization or having to allocate gain (or perhaps loss). How? By selling the co-op form of business organization as an ideal and by reiterating all the underlying arguments that favor the allocation of financial benefits to users rather than owners.

9. Tax Implications for Co-op. Mergers and consolidations of co-ops and other mutual organizations are typically structured to be "tax-free". The changeover from the pooling method to the purchase method will not affect a co-op's ability to structure tax-free mergers and consolidations.

10. Earnings Measurement Post-Merger. Suppose that the book value of a co-op's assets was lower than the fair market value of those assets. An adjustment of those assets to fair market value would in turn cause a larger depreciation expense against the newly marked-up assets and thus reduce the co-op's earnings. The converse would occur if the fair market value of the assets was lower than the assets' book value.

Reduced earnings bring reduced patronage allocations to patrons. Some experts have suggested that co-op's might use a "loss impairment" technique to reduce the fair market value of assets and thus depreciation expenses back to pre-merger levels. If loss impairment is unavailable, then marking assets to their fair market value presents a number of interesting issues. For example, should reduced patronage allocations be imposed only on the patrons and

members of an acquired co-op or evenly distributed between patrons and members of both acquiring and acquired co-ops? Moreover, does the answer to the preceding question turn on whether depreciation expenses are increased (and hence earnings are reduced) or decreased (and hence earnings are increased)?

11. Should We Rush to Merge the Co-op? Starting at 12:01 a.m. on the first day of your co-op's 2010 fiscal year, the pooling method of accounting for mergers or consolidations ("mergers") will no longer be available for your co-op. Your co-op should not hurry to merge or consolidate just to avoid the purchase method. On the other hand, if your co-op is likely to merger or consolidate in the next twelve months, better to complete the voting process by 12:01 a.m. on the first day of your 2010 fiscal year.

12. Dissenters' Rights? If your state law provides dissenters' rights to those members who object to mergers of cooperatives, the purchase method could increase the size of the payments that are made to dissenters post-merger. The precise impact will turn on the legal interpretation of your statute, and on whether the fair market value exceeds book value.

13. Coordination with Consultants, Auditors and Attorneys. Perhaps it goes without saying, but the issues tipped up by the purchase method will require closer and more intense pre-merger coordination between all of the professionals you rely on to assist in consummating the merger of your co-ops.