



**National Rural Utilities
Cooperative Finance Corporation**

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A Touchstone Energy Cooperative

May 30, 2008

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116



LETTER OF COMMENT NO. 29

Re: File Reference No. 1550-100: FASB Preliminary Views—Financial Instruments with Characteristics of Equity

Dear Mr. Golden:

Introduction

The National Rural Utilities Cooperative Finance Corporation (CFC) is a private, not-for-profit cooperative association headquartered in Herndon, Virginia that was formed in 1969 to provide competitive financing and other state-of-the-art financial products and services to its rural utility members. CFC serves 900 electric distribution and generation and transmission cooperatives which in turn provide electricity to almost 40 million individuals throughout the United States. With outstanding electric loans of approximately \$17 billion as of February 29, 2008, CFC provides relatively low-cost capital to enable the electric cooperative members to acquire, construct and operate electric distribution, transmission and generation facilities.

CFC appreciates the opportunity to provide comments on the Financial Accounting Standards Board’s (FASB’s) Preliminary Views—Financial Instruments with Characteristics of Equity. The proposed guidance contained in the preliminary views document and the related Liabilities and Equity Project is of great importance to our organization and our member cooperatives. Our comments are expressed from the perspective of the electric cooperative industry.

Electric Cooperative Business Entities

Electric cooperatives have a number of unique business characteristics. They are member-owned and democratically controlled business organizations. In contrast to investor-owned utilities which are controlled by common shareholders with voting based on the number of shares of stock held, each customer or patron of an electric cooperative is both a member and owner with an equal vote. Electric cooperatives are more focused on providing the best service at the lowest price rather than on profitability. While typically organized as not-for-profit, membership cooperatives under Section 501(c)(12) of the Internal Revenue Code, electric cooperatives follow the same accounting requirements of for-profit enterprises such as investor-owned utilities (with some modification due to regulatory considerations).

Cooperatives traditionally operate at cost. Annual earnings or margins considered in excess of costs are allocated to members on a proportional basis of the member's respective annual revenue or kilowatt-hour usage. Although the excess margins are allocated to members, the right to the patronage capital is not considered vested until an actual declaration by the cooperative's board after considering the organization's financial condition. Available funds are (a) reinvested in the electric infrastructure, (b) used for working capital or other business purposes or (c) distributed in the form of dividends, commonly referred to as "capital credit refunds", to members. The frequency and method of capital credit distributions varies from cooperative to cooperative.

The electric utility industry is one of the most capital intensive industries in the United States. It typically takes over \$2.75 of investment for each dollar of annual revenue. Electric cooperatives' capitalization structures are frequently leveraged with significant amounts and percentages of debt capitalization. Accordingly, cooperatives and cooperative lenders, like CFC and the U.S. Department of Agriculture, would be concerned by any major change in debt or equity capitalization and the related implications on loan covenants and other related business matters.

It is important to note that descriptive information pertaining to not-for-profit organizations presented in Statement of Financial Accounting Concepts No. 6 is not truly representative of electric cooperatives entities. As noted above, there are a number of characteristics that distinguish cooperatives from other not-for-profit organizations as well as from for-profit business entities. Another contrasting difference from other not-for-profit organizations is that cooperative members do have an ownership interest in the organization. A member's interest in patronage capital is frequently characterized as member' shares even though the interest is not always represented by some form of a membership document. It should also be noted that, unlike publicly-held, investor-owned utility stock, there is no active market or stock exchange for the member's interest or member shares.

Background Comments on Preliminary Views Document

It is well recognized that (a) financial instruments have become more and more complex over the years, (b) there is a considerable amount of piecemeal accounting guidance on the subject of financial instruments, (c) accounting for financial instruments has been a particular cause of confusion which has led to numerous restatements and (d) efforts have sometimes been made to structure form over substance in order to achieve a particular economic and/or financial reporting outcome. Accordingly, FASB and the International Accounting Standards Board (IASB) have identified this subject for a joint accounting convergence project. While the preliminary views document is recognized as strictly FASB's perspective at this time, including their preference for the "basic ownership approach," we understand that the IASB has circulated the FASB preliminary views document along with some opening comments to IASB constituents for their review and comments. Once both parties have received and reviewed their respective constituent comments, they plan to jointly deliberate to craft an exposure draft on the subject.

After thoughtfully considering a number of alternatives, FASB has advanced three primary approaches in the preliminary views for distinguishing between equity and liabilities or assets: (1) basic ownership, (2) ownership-settlement and (3) reassessed expected outcomes (REO). Pursuant to the basic ownership approach, a basic ownership instrument has both of the following characteristics:

1. The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and
2. The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available.¹

It is also understood that (a) financial instruments that do not meet the above definition would need to be classified as either assets or liabilities, which would include perpetual instruments like preferred stock as well as all forward contracts, options and convertible debt, (b) financial instruments that have a basic ownership component and a liability or asset component would need to be separated and (c) changes in the financial instruments that are classified as assets or liabilities will affect net income while changes in equity instruments do not.

We recognize that FASB and IASB have a joint project in progress that is expected to develop and improve a common conceptual framework that will provide a foundation for developing future accounting standards. With respect to the preliminary views document, it is important to note the existing definitions for assets, liabilities and equity are subject to change as they have become outdated over time from their issuance in 1985 in the Statement of Financial Accounting Concepts No. 6:

Assets (paragraph 25)

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities (paragraph 35)

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

¹ Appendix F, Glossary, page 66 of Preliminary Views—Financial Instruments with Characteristics of Equity.

Equity or Net Assets (paragraph 49)

Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

In contrast to past practice, FASB is attempting to define equity (a) in a more conservative manner in the preliminary views document and (b) on a stand alone basis rather than the traditional view of being a residual interest that is defined by and dependent on the definitions of assets and liabilities. As presented in the preliminary views document, equity is the most residual claim of the entity after (a) assets, which are defined as claims that enhance the net assets available to the owners of the entity and (b) liabilities, which are defined as claims that reduce the net assets available to the owners of the entity. Along with the conceptual framework, the evolution of such definitions is fundamental to the FASB and IASB's mutual success in laying the foundation for future, principles based, accounting standards.

Please refer to Appendix I for specific responses to the questions raised in Preliminary Views—Financial Instruments with Characteristics of Equity. While not all questions are applicable to financial instruments typically used by electric cooperatives, we have prepared our comments in response to and in the order of the questions presented in the preliminary views document. As noted above, our comments are expressed from the perspective of the electric cooperative industry.

Concluding Comments

CFC applauds the efforts of FASB in developing principles based standards and in addressing the challenges of international accounting convergence. The global nature of money and capital markets longs for equally global accounting standards.

We appreciate the opportunity to comment on the proposed approaches for distinguishing between equity and liabilities or assets. We hope that you find our comments constructive and, if desired, would be happy to address any additional comments or inquiries that you might have regarding the attached.

Sincerely,

NATIONAL RURAL UTILITIES
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Appendix I

**National Rural Utilities Cooperative Finance Corporation (CFC)
Written Comments Pertaining To File Reference No. 1550-100
Financial Accounting Standards Board (FASB)
Preliminary Views—Financial Instruments With Characteristics Of Equity**

Questions on the Basic Ownership Approach

1. *Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?*

Response: The basic ownership approach would represent an improvement in financial reporting by (a) more clearly defining equity instruments, (b) replacing what has been noted as over 60 individual items of guidance and (c), ideally, alleviating a major cause of financial restatements. The underlying principles appear clear and reasonably appropriate for simplifying the definition and accounting guidance for equity instruments and addressing the perceived abusive practices of some entities to intentionally structure financial instruments in such a manner as to achieve a specifically desired economic and/or financial reporting outcome.

Perpetual Instruments

2. *Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?*

Response: Although presently less of a concern to electric cooperatives due to the limited use of perpetual instruments such as preferred stock, the proposed reclassification from equity to liabilities would likely be an initial cause for confusion for numerous entities and prompt the need for a dramatic re-education effort. For certain entities, it could seemingly result in a range of issues from a basic change in statistical and analytical information to potentially major legal and/or financial problems. This could further escalate to a need to revisit loan covenants and other business agreements to avoid default and/or other negative consequences.

3. *The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.*

Response: Since perpetual instruments such as preferred stock are not commonly used by electric cooperatives, we reserve judgment and comment at this time.

Redeemable Basic Ownership Instruments

4. *Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?*

Response: Electric cooperative capital credit refunds (including estate payments) are generally not considered to be either mandatorily redeemable or redeemable at the option of the holder. Although the aggregation of such payments may be the same or similar to what would be expected at liquidation, the actual amount at liquidation would be subject to the extent of available net assets. Given what many would consider to be an essential service, electric cooperatives are rarely subject to liquidation.

Separation

5. *A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?*

Response: A dividend has traditionally not been considered to be a liability until declared by the respective board. Accordingly, it seems unnecessary and inappropriate to recognize a liability prior to the appropriate declaration. Separating the instrument does not appear to be useful information at this time. Perhaps additional footnote disclosure should be considered if further information is desired.

Substance

6. *Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?*

Response: We are also presently unaware of any unstated factors or circumstances that could affect an instrument's classification under the basic ownership approach. While the substance principle may, therefore, be unnecessary, we are presently unable to make a further determination. Alternatively, if it is still perceived that there is some degree of potential for abusive behavior in structuring financial instruments under the basic ownership approach, the substance criteria may be of importance. The basic ownership approach generally appears to result in a classification that is consistent with the economic substance of the financial instrument.

Linkage

7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

Response: Although we are not aware of such circumstances, we do not have a sufficient knowledge of complex financial instruments to presently make a further determination.

Measurement

8. *Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?*

Response: It is understood that the basic ownership approach will increase the likelihood of such measurements with the related consequences on net income. Although there is some concern for the additional financial volatility, we reserve further judgment and comment at this time.

Presentation Issues

9. *Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about the entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

Response: If such information is warranted, we suggest that additional footnote disclosure be considered.

10. *Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.*

Response: We reserve judgment and comment at this time.

Earnings per Share (EPS)

11. *The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

Response: We reserve judgment and comment on earning per share as it is not a common computation for electric cooperatives.

Questions on the Ownership-Settlement Approach

1. *Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.*

Response: Yes. Although both the basic ownership and ownership-settlement principles-based approaches have merit, we prefer the ownership-settlement approach as it is believed to be more consistent with the prevailing business environment including (a) current U.S. and international accounting standards and (b) the recognition of perpetual instruments such as preferred stock as equity financial instruments. It is difficult to ignore existing business, legal, tax and other related facts and circumstances to conceptually conclude that the more narrowly defined basic ownership approach is the most appropriate choice.

2. *Are there ways to simplify the approach? Please explain.*

Response: Realizing that we are not familiar enough with the full nature and extent of complex financial instruments nor with the perceived abusive, arbitrary structuring of financial instruments to suit an intended purpose, we are presently unable to offer any substantive recommendations.

Substance

3. *Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?*

Response: We are unable to make a determination at this time.

Presentation Issues

4. *Statement of financial position. Equity instruments with the redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?*

Response: If such information is warranted, we suggest that additional footnote disclosure be considered.

Separation

5. *Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?*

Response: We are unable to make a determination at this time.

Earnings per Share

6. *The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

Response: We reserve judgment and comment on earning per share as it is not a common computation for electric cooperatives.

Settlement, Conversion, Expiration, or Modification

7. *Are the requirements described in paragraph A35-A38 operational? Do they provide meaningful results for users of financial statements?*

Response: We are unable to make a determination at this time.

Questions on the REO Approach

1. *Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.*

Response: Not necessarily. Although there is great merit in the resulting determinations, the approach is much too involved for practical application.

Separation and Measurement

2. *Do the separation and measurement requirements provide meaningful results for the users of financial statements?*

Response: We are unable to make a determination at this time.

Earnings per Share

3. *The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?*

Response: We reserve judgment and comment on earning per share as it is not a common computation for electric cooperatives.

Other Alternatives

1. *Some other approaches the Board has considered but rejected are described in Appendix E. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?*

Response: Although we have only reviewed limited and somewhat incomplete information to date, we would encourage the Board to give further consideration to the loss absorption approach before determining whether or not it is another viable approach for distinguishing between financial instruments.