

REBUTTAL TESTIMONY OF

CARL D. HERBEIN, CPA

Appearing on Behalf of the Pennsylvania Association of Milk Dealers

Rebuttal Testimony before Pennsylvania Milk Marketing Board

2013 Over Price Premium Hearing, Part II

June 4, 2014

Rebuttal Testimony of Carl D. Herbein, CPA

Over Price Premium Hearing

I am Carl D. Herbein, CPA, President and CEO of Herbein + Company, Inc. and my address is 2763 Century Blvd., Reading, PA 19610. I am presenting Rebuttal Testimony on behalf of the Pennsylvania Association of Milk Dealers. I attach my Curriculum Vitae, as Rebuttal Exhibit D1, which outlines my education and experience in the dairy industry. This testimony and associated exhibits will relate exclusively to the second part of the Over Price Premium Hearing pursuant to the Board's September 25, 2013 order bifurcating the hearing.

Background and Purpose of Hearing

Pursuant to Bulletin Number 1494 and a Protective Order issued by the Pennsylvania Milk Marketing Board on February 24, 2014 and modified on March 27, 2014, a public hearing is being conducted to receive evidence concerning the over price premium. The over price premium is currently a milk cost factor that is included, consistent with Generally Accepted Accounting Principles ("GAAP"), in the Pennsylvania Milk Marketing Board's monthly price change and appears on the Board's monthly price announcement. The over price premium is updated monthly and the underlying documents from the cross-section of dealers utilized are regularly audited by the staff of the Milk Marketing Board. The over price premium is included in the calculation of the cost of milk on an area by area basis.

Study Conducted

On behalf of the Pennsylvania Association of Milk Dealers, I have reviewed the files and testimony submitted by GNEMMA including the testimony and exhibits submitted by John S. Stoner,

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

CPA of Reinsel Kuntz Leshner LP (RKL) and the testimony of Dean Ellinwood of Dairy Marketing Services LLC, and Troy Cooper of Maryland and Virginia Milk Producers Cooperative Association, Inc. GNEMMA Exhibit 9 (00001 – 000094) has been reviewed and analyzed by me subject to the Protective Order.

Since GNEMMA is claiming that their costs are identical to the costs in receiving lab and field work, I reviewed the accounting and financial reporting requirements and the operational procedures and methods employed in the receiving, lab, and fieldwork cost center. I reviewed the PMMB Form 60 for the various cross-sections of milk dealers utilized for cost replacement purposes. I also interviewed milk dealers that utilize cooperative milk supply, independent producer milk supply, and a combination of each. I am very familiar with all of the cross-section dealers and have visited their facilities.

I also have reviewed the following documents:

1. For the cross section dealers, invoices (for those with cooperative supply) and audited producer obligation worksheets (POWs) were examined to determine current levels of premiums and handling fees paid above the minimum price and Pennsylvania mandated premiums for October 2012 and 2013. I also reviewed invoices for February 2014.
2. PMMB Form 60s were examined and a combined statement of income was prepared, which is included as Rebuttal Exhibit D-2.
3. The points processed by the cross-section dealers used in Cost Replacement Hearings was determined for the receiving, lab, and fieldwork cost center. These points were further analyzed to determine milk and non-milk points so as to allow for an analysis of the dilution of any exclusive milk expenses, which are considered to be added to this cost center. Rebuttal Exhibit D-3.

Findings and Recommendations

Based upon my review of the exhibits submitted by John Stoner and Reinsel Kuntz Leshner (RKL) and a review of their supporting documentation it is my opinion that the Pennsylvania Milk Marketing Board cannot accept the suggested mandated amount of \$0.2783/cwt. and should not mandate that or any other amount to attempt to account for cooperative marketing and plant costs. I will provide support for this opinion with my testimony and exhibits.

Finding No. 1: The calculations and work papers provided in support of the RKL exhibits and testimony (which were reviewed by me) reflect no audit, or review accounting procedures and are simply a compilation of information provided by the six (6) operating units studied. As I will explain, that is not the level of work that can reasonably be relied upon for a cost study that would serve as the sole basis for a new minimum price. I attach as Rebuttal Exhibit D-4 reference material, which explains the difference between a compilation, a review, and an audit. This information can be found at:

<http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/DownloadableDocuments/Brochure%20NonCustomizeable-Difference%20between%20Comp%20ReviewAudit.pdf>

Rebuttal Exhibit D-4 explains that the level of service for a “compilation” is: “the accountant assists management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements”. The Exhibit also describes the audit level of engagement as “audited financial statements provide the user with the auditor’s opinion that the financial statements are presented fairly in all material respects, in conformity with the applicable financial reporting framework.” This reference document is a helpful description of how audit processes can provide greater confidence in the information. At PMMB, Staff and interested parties have historically applied

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

these similar procedures in testing the information submitted by regulated entities when it comes to developing the costs for the wholesale price build up. The Milk Marketing Board's long-standing practice of relying on audited financial information is necessary to ensure the integrity and the reliability of cost studies used to build up the wholesale minimum and retail minimum prices and it should not be abandoned as the literature shows the importance of audit processes and the limitations of compilations.

The work papers provided disclose no basis on which to determine the level of engagement. Another CPA level of services is "agreed upon procedures". It is possible that RKL is functioning in that capacity, however no support has been provided to explain their engagement. Nevertheless, anything short of audit type processes, which I can confidently say were not performed by RKL, is inconsistent with the strict review process historically utilized by the Board to ensure the integrity of the resulting cost factor. The Milk Marketing Board staff (and interested parties such as the milk dealers) regularly perform the audit processes discussed in this literature for the information submitted by interested parties for the wholesale cost build up. Thus, GNEMMA and RKL have chosen a level of professional service that is far less probative and reliable than is utilized in establishing plant costs and the RKL compilation provides no legitimate evidence upon which the Board can rely based upon decades of its own precedent. In this hearing, it is my understanding that staff has not audited the information and based upon my discussions and my review of the RKL work papers they have performed no such audit either. This audit function ensures that the information provided is accurate and verifiable which of course is critical for the Board to know before relying on such information. It also ensures GAAP compliance which is also import in the context of creating a cost for the wholesale minimum price.

I find, based upon my review of the supporting documentation that the financial information presented by the six (6) operating units was accepted by RKL and utilized with little further analysis and

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

testing. Additionally, the six (6) operating unit's financial information was not presented in accordance with PMMB accounting requirements.

Finding No. 2: The RKL work papers reflected that not all units in the study were visited. It is my experience that it is difficult, if not impossible, to understand and interpret accounting results of a facility without an on-site review. During the on-site review, it is important to see how milk is received, personnel involved with the receiving function are observed and interviewed, the presence or lack thereof of on-site silos are observed, extent of laboratory facilities on-site are reviewed (or outsourcing methods and sources reviewed). Additionally, on-site accounting systems are reviewed and discussions held with those responsible for recording expenses into the facility's general ledger. Questions such as where utilities for this function recorded and if they are allocated, what is the basis for allocation? It is also a professional standard that documentation (evidential matter) is retained by a CPA formulating an opinion upon a financial matter. This on-site review is especially important in a cost accounting engagement where specific expenses are assigned and allocated to a function and even more critical the first time a cost factor is being developed for inclusion in the wholesale minimum and resale minimum price build up.

Finding No. 3: **[BEGIN ATTORNEY-EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]** [REDACTED] **[END ATTORNEY-EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER].**

GNEMMA Exhibit 9, which is subject to the Over Price Premium Protective Order includes the financial information to which John Stoner refers in his testimony. However, GNEMMA Exhibit 9 contains no supportive documentation for the limited testing that Mr. Stoner mentions in his testimony.

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

Pennsylvania Milk Marketing Board. Mr. Stoner describes his engagement as cost accounting and thus I believe a careful review and understanding of PMMB accounting practices and policies is imperative in the preparation of information submitted to the Milk Marketing Board.

Finding No. 8: **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED]

[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER]

Finding No. 9: Because of the high standards used to establish cost components of the wholesale price build up historically, including audits and adherence to GAAP (among other reasons), the Board has been able to withstand direct challenges to the wholesale and retail price regulation. The procedures that are followed by the Board for all but the over order premium, which is specifically based on more than a cost study, gave me the confidence and the ability to readily defend the system against challenge

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

when my expert testimony was accepted by Judge Kane in the Cloverland-Green Spring federal court case. Thus, it is my opinion that the Board should maintain its high standards for evaluating cost studies and require faithful adherence to GAAP where applicable. For instance, the incorporation of receiving, lab, and fieldwork expenses incurred by the six (6) operating units simply is not in compliance with GAAP. The development of the receiving, lab, and fieldwork cost center as reported in PMMB Form 60 captures costs incurred by the reporting milk dealer in performing these services. It is my opinion that this recording of actual internal costs is proper in the cost center and that when some or all of these costs are purchased from an outside entity as part of the acquisition of raw milk that those costs should be included in the cost of milk being acquired, not in the receiving, lab, and fieldwork cost center.

Finding No. 10: There is another problem with the cooperative proposal to use a statewide cross section and include it in the six areas for cost center accounting. All other cost centers are developed using the area cross sections. I do not believe that one can make an apples to oranges comparison in the cost center accounting and be consistent with GAAP.

Finding No. 11: GNEMMA recommends that the costs calculated and shown on GNEMMA Exhibit 8 in the amount of \$0.2783/cwt. be included in the cost centers of the dealers purchasing these services. Rebuttal Exhibit D-3 was prepared for the cross-section dealers utilizing the audited PMMB 60s for the year ending December 31, 2012 and it shows the dilution effect associated with GNEMMA's proposal. These financial statements were utilized by PMMB and the 2012 Cost Replacement Hearings. The non-milk points were obtained from the audited work papers utilized in preparing exhibits for the Cost Replacement Hearings.

The effect of GNEMMA's proposal (besides not being a proper application of GAAP) causes a dilution of the economic recovery by those dealers due to the receiving, lab, and fieldwork cost center including non-milk points. Thus any cost included in this cost center would be diluted by non-milk

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

points (not recovered by the dealer). The dilution amounts to 5.2% and annually would cost dealers \$350,732. Rebuttal Exhibit D-2 demonstrates the profitability for the cross-section dealers for 2013 in the amount of \$374,477. Thus, this one aspect of GNEMMA's proposal would eliminate the vast majority of the dealers' profit. This shows how seriously the Board needs to take PAMD's opposition to this proposal. This is not a good time to take actions that we know will harm milk dealers.

Finding No. 12: GNEMMA's position is that the over price premium should be removed from the monthly price sheet and suggests that these costs should be included in plant operating costs. It is my opinion that this is improper accounting as these costs are directly related to milk and if it's a milk cost it should be called a milk cost. My opinion is consistent with GAAP which requires things that are purchased to be recorded in cost of sales.

Finding No. 13: **BEGIN ATTORNEY-EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED] **[END ATTORNEY-EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER].**

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

Finding No. 17: In attempting to justify its proposal to eliminate the remainder of the over price premium without providing for the other premiums in that calculation, GNEMMA indicates that it is unnecessary and burdensome to the Class I price in Pennsylvania to include over price premium paid to independent producers. Mr. Cooper's testimony includes "premiums and/or prices paid to producers or cooperatives in excess of the regulated mandatory premiums are not necessarily for Pennsylvania produced milk that is processed and distributed in Pennsylvania without some erroneous assumptions in calculations." He then says "these 'smoke and mirrors' assumptions translate to an artificially inflated cost that is then used in the minimum wholesale, and ultimately minimum retail cost build-ups." For cost accounting purposes, my focus is whether the premiums are being paid. If so, they must not be eliminated. I have reviewed the audited producer obligation worksheets for all cross-section dealers on a regular basis for many years and I am familiar with the milk supply arrangements utilized by these dealers. The premiums paid over and above the PMMB mandated over order premium reflect quality, quantity (volume), and other incentives paid to Pennsylvania farmers so that they have an incentive to stay with the independent plant rather than join a cooperative. **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED] **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER]** These premiums are real and are audited costs. I am absolutely confident that these are real costs over and above the mandated over order premium that must, in accordance with GAAP, be recognized. If a plant has 25% Class I produced, processed and sold milk, the full over order premium applies to that 25%. At the same time, producers are eligible either for a general premium, or quality, volume or other incentives. Those premiums apply

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

to all of the producers. Those premiums are in fact on top of the mandate and are allocated to the PA produced processed and sold just as it is to the other milk eligible for those premiums. What the milk check reflects is an accounting method by plants to pay based on the plant blend. The unfailing truth is that the Pennsylvania produced processed and sold milk generated premiums of 1.85 (most prevalent combined over order premium and fuel adjuster rate) plus the competitive premiums. If the Board uses anything other than percentages to measure compliance, the Board would be spreading a portion of the 1.85 mandate over milk volumes that are not Pennsylvania produced processed and sold. There simply is no “excess” at all as these additional competitive payments are allocated proportionately across all milk volumes and thus the inclusion in Pennsylvania’s controlled products is not in any way overstated or unnecessary. GAAP also requires the inclusion of all expenses in the reporting of the financial activities of each and every milk dealer. These premiums are legitimate expenses that are paid to all eligible producers, not just that proportion who’s milk comes from or is sent out of state, and thus the portion allocable to Pennsylvania produced processed and sold must be included in the over price premium in order to be in compliance with GAAP.

Finding No. 18: It is also important to understand the implications of not recognizing these costs. From my more than 35 years of consulting work on behalf of milk dealers across the United States, I know that milk dealers generally operate on narrow margins, but Herbein Exhibit D-2, shows those margins are not just narrow but in many cases non-existent (or even negative) in Pennsylvania over the last few years. As a business consultant for any Pennsylvania dealer facing the elimination of the independent premium portion of the over price premium, I would have to advise them that if they cannot charge a price for their Pennsylvania sales to capture those additional premiums, they cannot afford to pay those premiums. I am confident that in the vast majority of cases in Pennsylvania milk dealers will not be able to recover their independent premiums through self help. This is because both at the dealer

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

to wholesale customer level and the store to retail customer level, an announced minimum generally governs the price level. It is said the minimums are the maximums. That is not true at the producer level where we see premiums being charged over and above the Federal and Pennsylvania minimum prices. In my opinion, plants that can no longer pay incentive premiums will lose farmers to cooperatives.

Finding No. 19: The testimony of John Stoner mentions PMMB Form 60 and PMMB Form 62. However, my review of the underlying and supportive work papers showed no use of these important, critical, and audited by PMMB staff forms.

Finding No. 20: **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED] **[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER]**

Other Factors and Rebuttal Exhibits

Rebuttal Exhibit D-2 presents a combined statement of income for the cross-section dealers for the twelve (12) month period ended December 31, 2013 and 2012. The cross-section dealers operating

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

income has decreased from \$23,586,448 in 2012 to a mere \$374,477 in 2013. This serious deterioration of profitability makes it very clear that the dealers can in no way afford to have their profitability negatively affected, which the GNEMMA proposals would do in a number of ways.

[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE ORDER] [REDACTED]

[END ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]

The statement of income for both years reflects less than the statutory level of profit of between 2.5% and 3.5% of net sales. But even leaving aside the statutory level of profit, it shows ailing plants, which in my opinion should caution the Board against taking action that risks adding additional stressors on Pennsylvania’s milk plants.

I also wish to provide the Board with assurances that the reduced net income is not attributable to non-milk or out-of-state sales. Since the Milk Marketing Board stopped segregating controlled and non-controlled operating results on the income statement included in the annual financial statement submitted by cross-section dealers (PMMB 60) we cannot determine profitability on controlled relative

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

to non-controlled products. But, I am confident that the test I have presented to the Board previously is a reliable method for answering the Board's question as to the source of the Pennsylvania dealer profitability issues. At the wholesale discount hearing in November 2013, I presented testimony and exhibits, which discussed the degree and cause of dealer profitability decline and I wish to re-emphasize my findings in light of dealer current profitability.

Discount Rebuttal Exhibit D8 (attached hereto as Rebuttal Exhibit D-6) was prepared to address questions over what is the source of this negative profitability. This exhibit reflects and analyzes the operating income level presented on Discount Rebuttal Exhibit D7 (attached hereto as Rebuttal Exhibit D-7). This exhibit shows that the profit deterioration was far more severe with dealers that are mostly selling PMMB price controlled products. To eliminate that the cause might be from drinks or out of state sales, I eliminated six (6) dealers from the cross-section that sell more than 60% of their milk sales outside of Pennsylvania and I have also eliminated four (4) dealers that have more than 40% of their bottling points from non-dairy packaging. Thus, it can be seen that the deteriorated operating income exists at a significant level for all dealers and even more deteriorated level for those dealers that are heavily focused on PMMB price controlled sales. Following the cost replacement hearings, I believe the dealers have done a good job at containing operational costs but between reduced volume, new high highs for raw milk prices and the need to update the discount adjuster, as well as the need to update our small delivery studies, have combined with the reduction in Class I sales to make the situation for Pennsylvania milk dealers doing significant business within Pennsylvania particularly serious.

RKL Costs Studied

By asking the Board to adopt a new minimum price payable by plants for their milk supply, GNEMMA is seeking to add a new layer to the producer minimum price framework, which excludes an

entire class of producers. **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL –
SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] **[END**

**CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL – SUBJECT TO PROTECTIVE
ORDER].**

Summary and Recommendation

The Board should not mandate the \$0.2783/cwt. for the reasons I explain in my testimony and exhibits. The PMMB system of controls on the processor, retailer, and producer are a strong and well-functioning base, which is subject to periodic change and adjustment. It is my opinion that to further mandate the payment for services rendered by cooperatives to their customers will backfire on the cooperatives, their members, and the customers they serve. Currently, these costs are subject to free market competition and appear to be working properly. The elimination of the over price premium related to independent farm supply should not be done as such an elimination would not be in compliance with GAAP which requires all expenses to be considered in determining net income. Such elimination would also seriously harm the producers (the processors would find it very difficult to pay such premiums if not recovered) and to the processors making such payments if they are not included in

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL REDACTED
PURSUANT TO PROTECTIVE ORDER DATED MARCH 27, 2014**

the in-to store price. PMMB should continue its long-standing practice of subjecting cost submissions to audit procedures that provide assurances about the reliability of the data in the formation of specific plant costs that affect the wholesale price build up. Thank you for your consideration of my analysis and opinions.