

FINANCING COOPERATIVES

A. Financial Structure of Cooperatives

Earlier sections of this Manual discussed what makes a cooperative distinct from other types of businesses. A review of some of the key operating principles of co-ops will illustrate how these differences are related to cooperative financing.

1. User-owner principle

This principle suggests that the co-op members – those who use the cooperative -- should provide equity (ownership financing) in proportion to their use of the co-op.

2. User-benefit principle

Financial benefits of cooperative membership are distributed to members in proportion to their use of the cooperative - unlike other types of businesses, where benefits are distributed according to the amount of investment.

3. User-control principle

The one member-one vote rule by which cooperatives operate serves to distribute power equally among all the current member owners.

4. Limited return on equity

Investors' return is limited by law to 8%. By limiting the return available on investment, co-ops limit the accumulation of wealth by a few owners.

The only fear needed in organizational efforts is the fear of missing the opportunity to invest.

Bill Patrie

North Dakota Assn. of
Rural Electric Co-ops

1. Member Equity

Recall that a cooperative is initiated by a group of people who share a mutual need, and who start a business designed to meet that need. In order to cover the co-op's start-up costs, each member of the group contributes some money (often in the form of capital stock). The money that members invest in the co-op is known as member equity.

Member equity represents the members ownership interests in the assets of the company. As risk capital, it is subject to loss. Member equity is used to purchase equipment, supplies, inventory, and any other assets the co-op needs to get up and running.

If the members of a co-op are unable to generate sufficient funds to cover all of the assets needed, they usually seek a loan. Although co-ops can borrow money from the same lending institutions as other businesses, many co-ops have found that it is helpful to approach a bank that is familiar with cooperatives. Most banks require that the members contribute at least 50% of the total funds needed by the co-op. Members should have a financial stake in the cooperative, evidenced by their investment in it.

Owners, as providers of equity capital, take the business risks and enjoy the profits of their success; they should be the major contributors of capital. The level of equity invested by the owners signals to the banker the commitment of the owners to both the concept and the company.

The inescapable axiom is that control follows ownership. (Members) must provide risk capital if they are to control their cooperative organizations. If others...put in risk capital, then they gain the right to influence and possibly control the organization and claim (its) benefits.

Randall Torgerson

Rural Business-Cooperative Service, USDA

Thus, in most cases, a new co-op starts with some combination of equity from its members and debt from a lending its members and debt from a lending institution. Member equity, however, is the primary source of a co-op's financial stability.

2. Allocation of Equity

Member equity is recorded on the cooperative's books in two different ways. *Allocated equity* is designated (or allocated) to individual member accounts in proportion to their use of the co-op. *Unallocated equity* is not assigned to each member's account, but is left in a general fund. Most co-ops use unallocated equity to build a capital base and to use as a cushion from operating losses.

The requirement that each member's business with the co-op be tracked and their allocated equity account be adjusted to reflect their activities place additional burdens on cooperative accounting. Thus, it is vital that the co-op obtain the services of qualified and experienced co-op accountants.

A sufficient level of capital is crucial to successful and long-term operation of any business.

3. Sources of Member Equity

Not all member equity comes from direct investment as described above. In fact, there are three primary sources of member equity:

1. Direct investment from members
2. Retained earnings
3. Per-unit capital retains

A central business proposition is based on an economic opportunity. This...can be so powerful as to engender sacrifice, commitment and loyalty to the cooperative, helping it to survive.

Bill Patrie

North Dakota Assn. of
Rural Electric Co-ops

The first is direct investment. New cooperatives usually obtain direct investments from their members, often in the form of capital stock shares. These shares are evidence of the members' investment and carry with them all membership and voting rights. With established cooperatives, new members are usually required to make a similar purchase of capital stock or membership certificates, which entitles them to membership and voting rights.

The purchase of one or more shares of common stock is usually the first investment a new member makes in a cooperative. This stock purchase entitles the member to voting rights in the co-op, usually on a one-member, one-vote basis. Non-cooperative businesses pay dividends on stock based on the number of shares owned, but in cooperatives, stock dividends are limited by state law (8% in WI).

The second source of member equity, retained earnings, is another way to generate equity after a co-op is up and running. When a co-op makes a profit on its operations, a portion of those profits (also called net earnings or net income) are usually distributed to the members on the basis of the amount of business they do with the co-op, and a portion is retained by the co-op as an investment in the business.

Many co-ops pay part of their net income (usually 20%) in cash to their members (more about this below under patronage refunds), and retain the remaining funds for future capital needs. These retains are allocated to each member's account,

although some co-ops also keep a portion of the net income as unallocated reserves.

Thus, retained earnings are simply the co-op's profits that are kept by the co-op in order to build it for the future. Conversely, if the co-op loses money, that loss must be absorbed by the members, in Many co-ops design a program to repay the equity of members who no longer use the co-op due to retirement or relocation. Some co-ops have a revolving equity redemption program in which the oldest equity on the books is paid out regardless of whether the members are still active or not. In most cases, the shares are bought back from the member at par or book value, whichever is less.

The third source of member equity, per unit retains, are used primarily by farm marketing cooperatives. The co-op retains deductions from the sale proceeds of each member's goods through the co-op. These per unit retains are calculated either as a percent of sales dollars or as a unit of weight or volume. One advantage of this type of equity is that it is not dependent on the co-op's net income as are retained earnings.

Empowerment and the development of community leadership is in the background of every cooperative. Empowerment opens up a great many options to...develop leaders.

Theresa Marquez
CROPP Co-op

4. Equity from Non-members

Thus far, we have discussed only the types of equity that are generated from members. Outside investors often don't consider co-ops to be good investments, for several reasons: Earnings are distributed on the basis of patronage, not on the basis of the amount of investment; return on investment is limited, usually by state law; stock in co-ops cannot be traded on the stock market and does not increase in value over time; and control of the co-op is usually one-member, one-vote, regardless of the number of shares owned.

Clearly, an investor who is concerned primarily with making a profit on his or her investment would not find a traditional co-op attractive.

However, there are a few mechanisms by which non-members may invest in cooperatives. The primary one is preferred stock.

Most co-op bylaws allow cooperatives to issue preferred stock, which does not provide voting rights. Dividends on preferred stock are paid out before any payments are made to common stockholders. Thus, the sale of preferred stock can be an effective way to attract non-member investors if the co-op desires to do so.

Other methods for cooperatives to build equity from non-members include retained income generated through day to day business conducted with non-members and per unit retains on the sale of goods produced by non-members.

5. Equity Redemption

Allocated member equity is considered temporary capital, thus cooperatives have an obligation to eventually repay equity to their members. Although failure to redeem equity is considered an injustice to members, the co-op board of directors must have the authority to

Equity redemption programs are intended to promote the cooperative principle of having co-ops owned and controlled by current members. However, they also complicate the management of the co-op's capital, and must be done judiciously in order to prevent any adverse financial impact on the co-op. The board of directors and the management must ensure that the co-op is adequately capitalized at all times.

Note that unallocated member equity (equity that is not assigned to individual member accounts) is considered permanent capital. Thus many co-ops use unallocated equity to build a capital base which is not redeemed. It is important that unallocated equity not be allowed to become too large a portion of the total equity in a cooperative, however. Since management, not the members, control unallocated equity, such a situation leads to declining user control in the co-op.

Your co-op's on-going success depends on constant vigilance to business basics and keeping in contact with your members.

Karen Zimbelman
Cooperative Consultant

6. Base Capital Plan

Some co-ops use what is called a base capital plan as an alternative to the equity building and equity redemption methods described above. Under such a plan, each member invests equity in proportion to their use of the co-op over a base period of years. This ensures that each member's investment is in

proportion to his or her use. Base equity plans can also be designed to respond effectively to the co-op's need for capital.

Underinvested members continue to invest over time, using direct investment, retained patronage, or per unit retains to do so. If a member becomes overinvested in relation to their use of the co-op, they can receive a partial refund to correct the balance. As always, the board of directors should have authority over when and how the co-op may return equity to these members.

To build cooperatives is not to do the opposite of capitalism, as if capitalism did not have any useful features. Cooperation must...assimilate the methods and dynamism of capitalism.

Don Jose Maria
Mondragon Pioneer

7. Patronage Refunds

Patronage refunds are a key mechanism by which cooperatives practice their principles. As noted above, when a co-op makes an annual profit, part of this net income is distributed back to the members in proportion to their use of the co-op during the past year. In effect, such patronage refunds are a demonstration of the cooperative principle of benefits in proportion to use.

About 20% of net income is usually distributed to the members. The remaining income is retained by the co-op in order to ensure a firm capital base for the co-op's future. However, the co-op allocates the retained portion to each members account. Tax laws require that co-ops notify each member in writing of their patronage refunds and the total amount allocated to the members account.

Reinvestment of patronage refunds is a key way for members to meet their obligation to provide the capital for the co-op in proportion to their use of it. It is important that co-op policies on patronage refunds be communicated to the members effectively. Members need to understand their role in providing sufficient capital to the co-op so that is able to grow and thrive. Without sufficient communication on this subject, members may have unrealistic expectations regarding when and how much patronage refunds they may receive.