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Understanding Cooperatives: **Financing Cooperatives**

Cooperative Information Report 45, Section 7



**United States
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Service

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All businesses, including cooperatives, need financing. A cooperative uses capital to finance its operations, to cover operating expenses, and to invest in fixed assets such as buildings and equipment. Capital comes in two forms: equity and debt.

Equity capital is the ownership capital in a cooperative. It is provided by members in various forms. Debt capital is money that is borrowed, on either a short- or long-term basis. Having adequate equity and debt capital available to finance the business is essential if the cooperative is going to competitively serve its members.

Equity Capital

Equity capital is money the cooperative obtains from its members without assuming a legal obligation to pay it back at a stated time. This is the opposite of debt capital, which always has a due date. Equity capital is the “risk” capital in an organization. All or part of it can be lost if operations are not profitable.

The way equity capital is obtained from the membership is important in measuring the cooperative’s adherence to cooperative principles. For example, authority over the cooperative’s activities should reside with the membership through voting control represented by equity ownership. Also, ownership and control should be held by the membership who are current users of the cooperative.



Cooperatives obtain equity capital from members in three basic ways — through direct investment, by retaining a portion of net income, or by retaining a portion of proceeds from the sale of members' farm products as per-unit capital retains.

Equity Capital Sources

Equity capital is categorized in two ways. It is either allocated or unallocated. Allocated equity is capital recorded on the cooperative's books which is assigned — or allocated — on a proportional basis to each member. Unallocated equity is capital not assigned or designated to specific member accounts.

Cooperatives obtain equity capital from members in three basic ways — through direct investment, by retaining a portion of net income, or by retaining a portion of proceeds from the sale of members' farm products as per-unit capital retains.

Direct Investment of equity is usually obtained through purchase of common or preferred stock. Common stock is an important source of initial member investment and normally carries voting rights. Preferred stock is a second source of initial equity capital. It is called preferred stock because it has preference over common

stock during liquidation. It may be purchased by members or nonmembers, often pays a dividend, but is generally nonvoting. Equity acquired through direct investment is always allocated.

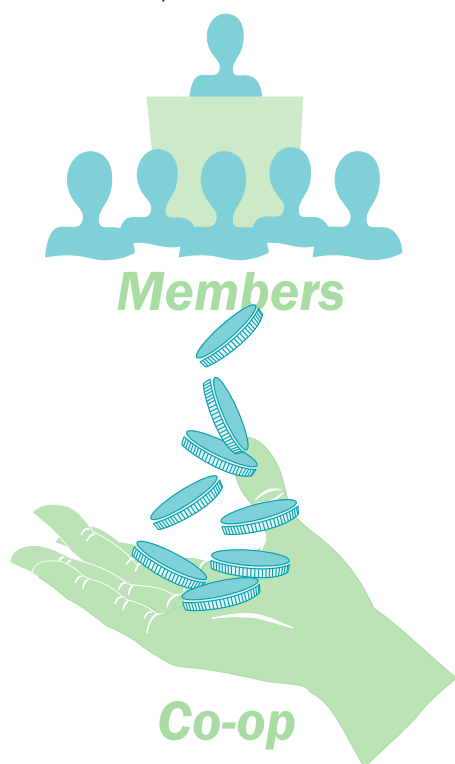
Other types of direct investment are membership fees, membership certificates, and capital certificates. These represent forms of direct investments by members in nonstock types of cooperatives.

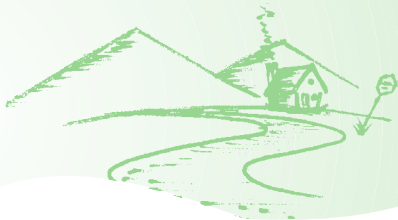
Retained Net Income represents proceeds from net earnings (net margins) retained in the business to provide equity capital. Part of a cooperative's net income, usually at least 20 percent, is customarily paid to members in cash, with the remainder held as retained patronage refunds. These refunds are accumulated until sufficient capital is available to finance facilities and operations. When that level is reached, the cooperative's board of directors may decide to redeem or repay a portion of equity capital to members.

Some cooperatives retain a portion of their income as unallocated reserves to serve as a cushion for allocated equity if there is an operating loss. Unallocated equity is usually paid to members only in cases where the cooperative is being dissolved.

Per-unit capital retains are used primarily by marketing cooperatives. They are obtained through deductions from sales proceeds. Deductions are calculated on a physical unit basis or as a percentage of sales value. As with retained patronage dividends, when sufficient equity capital has been accumulated, the board may consider returning a portion of allocated equity capital to members.

Revolving fund financing is what the return of capital is called in a cooperative. The oldest equity capital is repaid first to ensure that current users provide the





majority of needed equity financing. The cooperative's board of directors is responsible for approving any return of member capital. Its fiduciary responsibility requires that the cooperative be adequately capitalized before any equity is paid or "redeemed" to members.

A modification of the revolving fund is the base capital plan method of equity financing. Annually, members are required to invest capital in proportion to their use of the cooperative over a "base" period of years. This is the most equitable way for members to provide equity capital, and it always maintains the investment in proportion to use. Cooperatives may use retained patronage refunds, per-unit capital retains, or a combination of both to obtain the required amount of investment from their members. Members who are overinvested in relation to their level of patronage would receive a refund of a portion of their investment. The board of directors determines the needed level of equity capitalization for the cooperative and must approve any return of equity to overinvested members.

Debt Capital

Cooperatives use two types of debt capital to finance operations.

Short-term loans are obtained to finance day-to-day operating expenses. The lender expects that funds borrowed on a short-term loan will be repaid in less than a year. These funds supplement the cooperative's own working capital and may be used to pay for raw product delivered by members in a marketing cooperative, or to purchase goods for resale in a supply cooperative. These loans are usually repaid from sales proceeds.

Long-term debt is obtained to finance the purchase of fixed assets such as property, plant, and equipment. Long-term loans are

scheduled for repayment in annual installments over the useful life of the asset being acquired. Long-term loans are repaid from net income.

Sources of Borrowed Funds

Cooperatives may borrow from traditional and nontraditional financing sources. Commercial banks are the traditional source for short-term loans. Banks and insurance companies are typical sources of long-term loans.

Cooperatives have the added advantage of obtaining loan funds from specialized banks and other lending institutions established to serve only cooperatives. These specialized or nontraditional sources include CoBank, public and private agencies that lend to rural electric and telephone utilities, and the National Cooperative Bank.

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The cooperative's board of directors may decide to redeem or repay a portion of equity capital to members.
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Cooperatives may borrow from traditional and nontraditional financing sources. Non-traditional sources include CoBank and the National Cooperative Bank, who provide both short and long-term loans.

Some large cooperatives may also use the services of brokerage firms to obtain borrowed capital through private debt placement or the sale of commercial paper and other financing instruments.

Leasing is another debt financing option available to cooperatives. This method allows a cooperative the use of an asset without tying up its own capital in the acquisition. In addition to leasing companies and commercial banks, cooperatives have access to companies and banks that provide leasing services to cooperatives. These include the Farm Credit Leasing Service Corporation and the National Cooperative Bank.

Conclusion

Cooperatives finance themselves much like other businesses, through the use of equity and debt capital. The features of cooperative equity capital, however, make cooperative equity financing methods different from those used by noncooperatives. Cooperative users provide equity capital to finance the cooperative in proportion to their use of it. Most cooperatives also provide a way to return equity to members after a period of time.

These characteristics of cooperative equity capital make it more complex to understand by those not familiar with how cooperatives operate. These features, however, are what make cooperatives the unique, self-help organizations they are, operating for the benefit of their member-owners. ■

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This circular is one of a continuing series that provides training information and presentations for education resource persons who may or may not be familiar with the cooperative form of business. This series provides the basic background material they need and in a form that can be readily adapted, with limited preparation time, to a lecture or other presentation.

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