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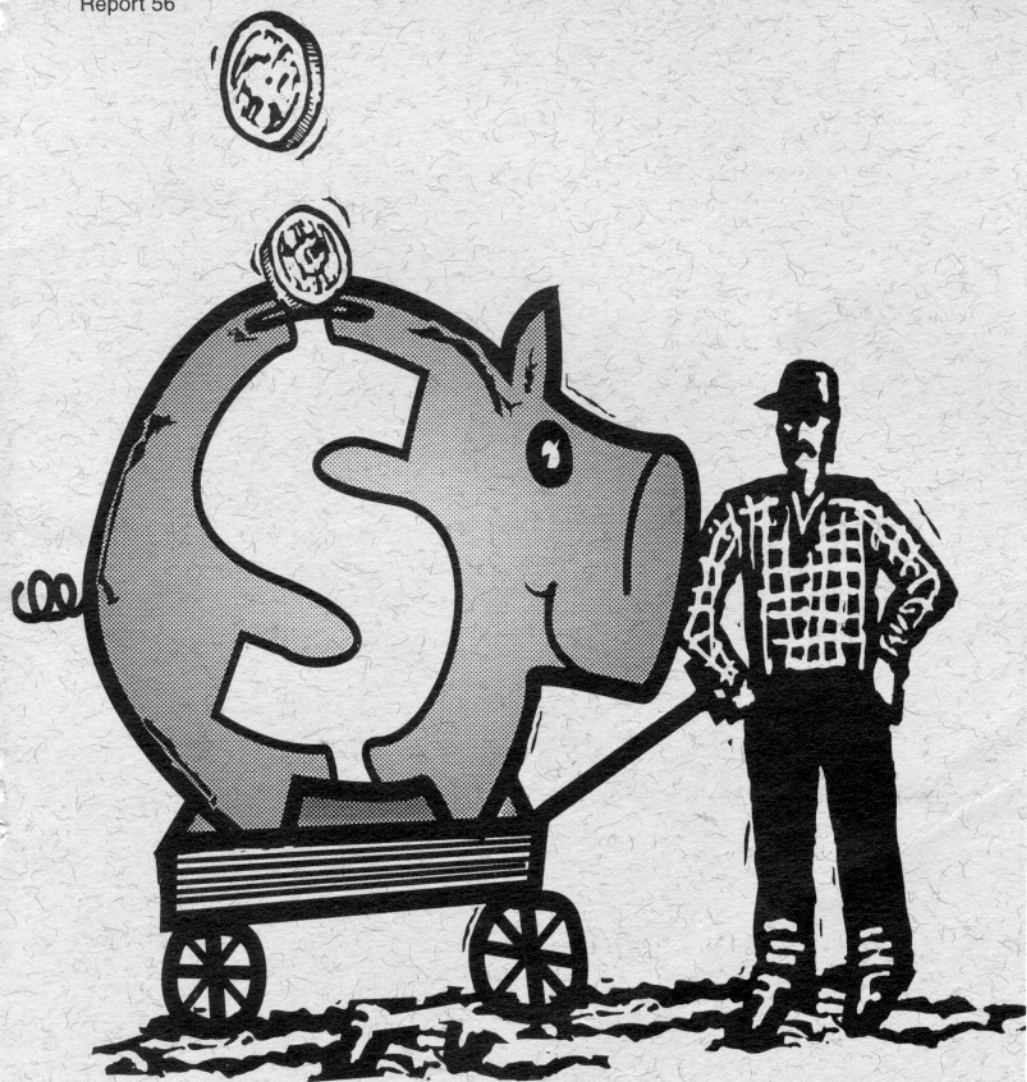


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# Managing Your Cooperative's Equity



# Abstract

This report provides information on the ways a cooperative can manage its equity capital to achieve and maintain proportionality of investment, regardless of the type of capital plan used. It discusses the different methods of accumulating and redeeming equity and methods of managing the processes. The report stresses the importance of financial planning and describes the difference between the board of director's role and that of management in managing the cooperative's equity.

**Key words:** Cooperative, Equity, Management, Proportionality

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## Managing Your Cooperative's Equity

Cooperative Information Report 56

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# Preface

Do you manage your cooperative's equity or does it manage the cooperative? All too often, equity is not managed in such a way that a member's investment is maintained in proportion to use, and ownership and control are kept in the hands of current users. The purpose of this publication is to provide a guide for cooperative management teams so that they can do a more effective job of managing equity capital. Regardless of the type of capital program used, there are pointers provided to help achieve and then maintain the type of balance in the equity accounts that allow adherence to cooperative principles. For some cooperatives, achieving this result may seem daunting, but ignoring the problem now will make it even more difficult to address down the road.

# Contents

What Is Equity in a Cooperative? .....	1
What Is the Purpose of Equity? .....	1
What Does Managing Equity Mean? .....	2
Handle or Direct with a Degree of Skill .....	2
Treat with Care .....	3
Exercise Executive, Administrative, and Supervisory Direction .....	3
Achieve One's Purpose .....	4
Effective Equity Management .....	4
Equity Management and Cooperative Principles .....	4
The Importance of Financial Planning .....	4
What Is Financial Planning? .....	5
<b>Equity Types</b> .....	<b>.</b>
Types and Uses of Allocated Equity .....	6
Direct Investment .....	6
Retained Patronage Refunds .....	7
Per-Unit Capital Retains .....	8
Unallocated Equity .....	8
Base Capital Plans .....	9
Equity Redemption Programs .....	10
Types of Equity Redemption Programs .....	10
Revolving Fund Programs .....	10
Percent-of-all-Equities Program .....	11
Special Redemption Programs .....	12
Equity Management Considerations .....	12
Managing Proportionality .....	13
Closing the Gap .....	13
Changing Cash Patronage Percentages .....	14

# Contents

Using Per-Unit Capital Retains . . . . .	14
Managing the Revolving <b>Cycle</b> . . . . .	15
Changing To a Base Capital Plan . . . . .	15
Use of Unallocated Equity . . . . .	16
Advance Capital . . . . .	16
Managing Equity Accumulation . . . . .	17
Retained Patronage . . . . .	17
Per-Unit Capital Retains . . . . .	17
Direct Investments in Value-Added Cooperatives . . . . .	18
Managing Base Capital Programs . . . . .	20
Choosing a Base Period . . . . .	20
Selecting a Measurement Unit . . . . .	21
Determining Proportionality . . . . .	22
Managing Equity Redemption . . . . .	22
Regular Redemption Programs . . . . .	22
Revolving Fund . . . . .	23
Percent-of-all-Equities . . . . .	24
Special Redemption Programs . . . . .	25
Estates . . . . .	25
<b>Age of Patron</b> . . . . .	26
Retirement . . . . .	26
Moveaways . . . . .	27
Hardships . . . . .	27
Summary and Conclusions . . . . .	28

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# Managing Your Cooperative's Equity

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## What Is Equity in a Cooperative?

Equity is the net worth, or risk capital, of the organization and represents the members' ownership interest in the total assets of the company. In balance sheet terms, equity is total assets less total liabilities.

Cooperative equity comes in two forms, allocated and unallocated. Allocated equity is the amount assigned, on a proportional basis, to each member. Unallocated equity is not designated to specific member accounts.

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## What Is the Purpose of Equity?

Because it is the risk capital invested in the business by its owners, equity serves to protect the interests of the liability holders—the entities to which the cooperative owes money. In a cooperative, just like other forms of business, it is desirable for the members to have a larger ownership stake in the organization than the creditors or liability holders. This gives the owners more control and flexibility in determining how the business is operated and financed.

Equity in a cooperative should be at least 50 percent of total assets. In many cooperatives, equity far exceeds this amount, but in 1994, based on the latest survey by USDA's Rural Business-Cooperative Service (RBS), the average equity level for all agricultural cooperatives was only 43 percent.

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## What Does Managing Equity Mean?

Webster's dictionary offers several insights into what it means to manage. For example, managing is the ability to:

1. Handle or direct with a degree of skill;
2. Treat with care;
3. Exercise executive, administrative, and supervisory direction;

and

4. Achieve one's purpose.

All four of these definitions apply directly to the management team's responsibility in managing the cooperative's equity. The cooperative's management team consists of the board of directors and the professional management staff.

The board's role differs from that of the management staff. The board establishes policy on how to manage equity and monitors how these policies are carried out. Management's role carries out the board's policies and keeps it informed of the results. Although the roles are different, the objective of effectively managing equity is the same—to ensure the cooperative is properly capitalized at all times to achieve its purpose of serving the members' needs effectively and efficiently.

Each definition of “managing” can be used to illustrate the difference between board and management roles in fulfilling the responsibility of properly managing the cooperative's equity.

### **1. Handle or Direct with a Degree of Skill**

**Board of Director's Role**— The board has a fiduciary responsibility to safeguard the assets of the cooperative and preserve the members' investment. To carry out this responsibility, board members should have at least a basic knowledge and understanding of cooperative finance. They must also insist on receiving periodic reports from management on the cooperative's financial condition and progress toward achieving its capital goals. **Board** members use their knowledge of finance and the information from financial reports to satisfy themselves that the cooperative is in sound financial condition and has sufficient equity invested in the business to operate profitably.

**Management's Role**— The cooperative's management should possess a thorough knowledge and understanding of cooperative finance to accurately monitor, report, and forecast the cooperative's financial results



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and equity capital requirements. Management must also have the ability to develop and operate the cooperative's equity programs to guarantee sufficient equity capital is acquired and retained in the business.

## 2. Treat with Care

**Board of Director's Role-** Treating with care deals with the board's fiduciary responsibility and means to manage sensibly and conservatively. This would apply to policy decisions involving both equity capital accumulation and distribution. The need for care in equity management should be clearly communicated to the membership so they fully understand the important role of equity capital in cooperative operations. Without this understanding, members may have unrealistic expectations on their required level of investment and when and how much of their equity may be redeemed. Members must understand the need for retaining sufficient equity in the cooperative to operate the business profitably, finance growth, and provide a cushion against financial difficulty.

**Management's Role-** There is a close parallel between the board's and management's role in exercising care, but management is more concerned with day-to-day operating performance. Management should continually evaluate the cooperative's competitiveness in obtaining maximum returns from the assets in which the members have their equity invested.

## 3. Exercise Executive, Administrative, and Supervisory Direction

**Board of Director's Role-** Setting equity management policy is how a board of directors exercises its executive direction. Written policies should be adopted that address all aspects of the capital program, including long-range financial planning, fixed asset expenditures, capital retention methods and guidelines, borrowing sources and limits, and equity redemption practices. The board also needs to monitor adherence to these policies as part of its supervisory responsibility.

**Management's Role—**In carrying out the board's capital program policies, management provides all three types of direction. Executive direction is given by establishing the procedures needed to carry out the board's policies. Management also supervises the work performed to carry out the procedures and has the administrative responsibility to report ongoing results to the board.

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## **4. Achieve One's Purpose**

With this definition, the roles of the board of directors and management become the same. The purpose achieved by effective equity management is a well-capitalized, competitive business in which each member's investment in the cooperative is maintained in proportion to use.

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## **Effective Equity Management**

Before addressing the strategic and operational considerations of effective equity management practices, it is important to review some basic tenets as well as characteristics of equity accumulation and redemption methods.

### **Equity Management and Cooperative Principles**

Adhering to cooperative principles is a critical aspect of effective equity management. At the heart of equity management are: (1) the owner-user principle; (2) the user-control principle; and (3) the user-benefit principle.

The key element of the owner-user principle is that equity (ownership financing) is supplied by the current users of the cooperative in proportion to use. If the owner-user principle is followed, then the user-control principle is usually being followed. This principle means that voting control in the cooperative is maintained in the hands of current users. The user-benefit principle means that net income should be distributed or allocated to members on the basis of current use.

### **The Importance of Financial Planning**

Managing cooperative equity effectively highly depends on sound financial planning. The complete management team, both the board of directors and the professional management staff, should participate fully in this planning effort. The board's role is to set longer term (3 to 5 years) financial goals for the organization that are consistent with the overall strategic plan. Management staff develops shorter term (1 to 3 years), detailed financial plans for achieving the long-term goals established by the board. The financial plan will identify the equity levels necessary to achieve the short- and long-term goals. Achieving these goals is where effective equity management comes into play.

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## What Is Financial Planning?

It is the identification, analysis, and evaluation of the capital sources and requirements of the business. Financial planning identifies all the sources and uses of capital involved in the successful operation of the cooperative. Typical sources include net income to be retained (whether allocated or unallocated), capital retains, sale of assets, investments by members, and various types of debt. Capital uses include fixed asset expenditures, debt servicing, investment in other cooperatives, and equity redemption. The specific types or sources of equity capital available to a cooperative normally are determined by the type of capital **program(s) being used**. These relationships will be discussed later in the report.

Debt is used to supplement equity used in helping the cooperative meet its capital needs. Determinations involving the use of debt capital include decisions regarding the correct mix of short- and long-term debt, interest rates, repayment terms, and loan restrictions or covenants. Debt capital is an integral part of the overall equity management strategy.

Financial planning is a year-round activity, but takes on greater importance in the second half of the organization's fiscal year. Specific planning for the new fiscal year can begin because preliminary results for the current year can be reasonably estimated and expectations for the coming year can be identified.

## Equity Types

How equity is managed depends largely on what types of equity a cooperative has, how and when it was acquired, and how it is redeemed. In its broadest sense, equity is divided into two categories—allocated and unallocated. Allocated equity is capital recorded on the cooperative's books which is assigned, or allocated, to each member on a proportional basis according to use. It is acquired in three different ways. Allocated equity may come from a direct investment by the member, through patronage refunds, and/or from per-unit capital retains.

Unallocated equity is capital not assigned or designated to specific member accounts. It may originate from net income earned on nonmember or nonpatronage business, patronage income the board of directors decides not to allocate, or capital obtained from a special event like the profit from the sale of an asset. The mix between allocated and unallocated equity capital in one cooperative compared with another may present a significantly different equity management situation.

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## ***Types and Uses of Allocated Equity***

### **• *Direct Investment***

A direct investment in cooperative equity can be made through the purchase of common or preferred stock, membership certificates, or other means that evidence the investment. It is most often used to record the initial purchase of equity a member makes when joining the cooperative and usually carries a voting right. A direct investment can also serve other important purposes. It also can be used to acquire additional member investment, related or unrelated, to patronage of the cooperative. The purpose may be to further strengthen the equity position, fund expansion or an acquisition, or shore up a weakened financial condition. Direct investments can also be made by nonmembers as a way to supplement member equity. These investments, usually in the form of preferred stock, often pay a dividend, but do not usually provide a voting right.

Recently, with the increased formation of new, value-added, processing and marketing cooperatives, direct investments have taken on more significance as a source of equity. These types of cooperatives often require a large, up-front investment of capital as a condition of membership. The capital is used to help finance the construction and initial operation of the value-added processing facilities. This investment generally gives the member the right and obligation to deliver a prescribed amount of product to the cooperative for the value-added processing and marketing activity.

Effectively managing the equity acquired by direct investment can either be an easy task, such as with a membership share, or a complex undertaking in the case of a value-added cooperative. The membership share is usually a nominal amount compared with the total equity amount and is often repaid when membership ceases.

Managing direct investment capital acquired from members or nonmembers as preferred stock can be more complicated. If the stock pays a dividend, the rate of dividend and whether it is cumulative or noncumulative presents different management situations. Cumulative dividends put more pressure on earnings to meet the cooperative's capital needs and still keep dividend payments current. Another management consideration with preferred stock is the manner in which it can be redeemed, if at all, in situations other than the liquidation of the coopera-

tive. Regardless of the situation, the board of directors must have the approval authority over the redemption event to protect the financial integrity of the cooperative.

Direct investments made by members in a value-added cooperative provides the greatest equity management challenge. Much depends on the type of capital plan adopted by the cooperative. Does it permit, with board approval, trading equity among members along with the attendant delivery rights? Is the capital program operated as a base capital plan where members must maintain a proportional share of the required equity needed by the cooperative? Or, are retained patronage refunds, with their potential variability, the only new equity source after the initial investment? Do the marketing agreement or bylaws permit the cooperative to call for additional direct investment as capital requirements increase? These provisions need to be adequately addressed in designing a capital program in a value-added cooperative.

#### • ***Retained Patronage Refunds***

Patronage refunds are amounts allocated to members, in proportion to use, from the net income of the cooperative. In most instances, a portion of the patronage refund is paid in cash and the rest is retained as allocated equity. Retained patronage refunds are most commonly used to acquire equity capital. Managing the accumulation of equity using this method can be demanding because the amount of capital available depends on the level of net income achieved. A shortfall in net income or a net loss can leave the cooperative in a difficult situation in meeting capital outflow requirements such as fixed asset purchases or equity redemption. Supply and service cooperatives that normally have more stable earnings are better suited to use patronage refunds, but many marketing cooperatives also use them.

Paying out a smaller percentage of the patronage refund in cash and/or postponing equity redemption are methods used to provide some flexibility in managing the amount of equity available if net income falls short of expectations. Options available to the cooperative when faced with a net loss will be addressed later.

The cooperative also has other options available in handling patronage refunds. They can be allocated either in qualified or **nonqualified** form. The cooperative can deduct a qualified allocation from net income in determining its tax liability. To qualify for the tax deduction, the cooperative must provide a written notice of allocation within 8<sup>1</sup>/<sub>2</sub>

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months of the cooperative's fiscal year end, a minimum of 20 percent must be paid in cash, and the member must have given prior consent to pay income tax on the entire allocation in the year it is received.

With a nonqualified patronage refund, the cooperative is not required to make a minimum cash payment. The cooperative pays income tax on the full amount of the patronage allocation and the member has no tax liability until that nonqualified allocation is redeemed. At that point, the cooperative qualifies for a tax credit. Nonqualified allocations can serve as an equity management tool in several ways. If the cooperative's income tax rate is a lower percentage than the cash payment it would have paid members, a nonqualified allocation will permit more equity to remain in the cooperative. In other instances, a tax credit may be available to offset the tax liability arising from issuing nonqualifieds, also allowing more equity to stay in the cooperative.

#### ***. Per-Unit Capital Retains***

Per-unit capital retains are investments made by a member based either on a physical unit of product delivered or on a percentage of the sales value of that commodity. In a marketing cooperative, the retain is withheld from the sales proceeds due the members on the raw product delivered for processing and marketing. The advantage of this type of retain is its stability because equity accumulation is not dependent on the net income of the cooperative. It is also more flexible because the amount deducted can be increased or decreased to compensate for fluctuations in volume or price of the commodity being handled. Marketing cooperatives are the predominant users of per-unit capital retains, often in combination with retained patronage refunds. Per-unit capital retains are taxable income to the member in the year in which they are withheld.

#### ***Unallocated Equity***

Unallocated equity is not assigned to a member's account, but usually redeemed only upon liquidation of the cooperative. While it is primarily retained as the after-tax portion of nonpatronage net income, some cooperatives specifically designate a portion of patronage income as unallocated. This requirement is usually outlined in the bylaws and may be specified in State statutes. The purpose for the cooperative is to build a tax-paid reserve to cushion allocated equity from operating losses. Unallocated equity also serves as a "permanent" capital base.

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The unallocated equity accounts should be administered cautiously, however, because there is a danger of members losing control if the unallocated equity portion becomes too large a percentage of total equity. When members' allocated ownership interest diminishes as a proportion of total equity, loyalty to the cooperative may also weaken. If member control is diluted, there is a danger that management, rather than the board of directors, will begin making more decisions affecting the cooperative's capital. If too much of the cooperative's net income is designated as nonpatronage, the benefits of "operating at cost" are also lost to the member. In other words, patronage refunds are not being distributed according to use.

## **Base Capital Plans**

The base capital method of capitalization functions as a complete equity management tool because it serves as both an equity accumulation and an equity redemption technique. When operated as designed, it keeps member investment proportional to use on a continuing basis. The 1991 study showed only about 1 percent of all agricultural cooperatives use this type of capital plan—primarily cooperatives marketing dairy products and fruits and vegetables. Also, some of the value-added cooperatives organized in recent years have selected this method.

Operating a base capital plan involves periodic adjustments to a member's required investment to keep it aligned with the proportional use of the cooperative. Proportional use is determined by measuring each member's average patronage over a base period that may range from 1 to 10 years depending on the type of cooperative. At least annually, equity capital requirements for the business are projected and each member's proportional share is calculated. Based on this calculation, the member will be either under-invested, over-invested, or at the required investment level. The under-invested member will be required to invest sufficient capital to become fully invested, while the over-invested member will be due a refund or redemption of equity.

The advantages and disadvantages of base capital plans are:

Advantages

- Links member investment directly to use
- Keeps ownership and control in hands of current users
- Allows for systematically adjusting capital requirements

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Disadvantages

- Does not work well if there is constant and large member turnover
- May require large initial investment by new member
- Difficult to understand and complex to administer

## **Equity Redemption Programs**

Just as important as equity accumulation are the types of equity redemption programs a cooperative uses to maintain and control the level of equity. Combined, these two activities constitute the primary tools available to the management team in carrying out its equity management responsibilities. In its simplest term, equity redemption is the payment to members, in cash or other property, of previously issued equities. The decision to redeem equities is made by the board of directors after determining that the cooperative's financial condition warrants the action.

### ***Types of Equity Redemption Programs***

Equity redemption programs are divided into two categories-systematic and special. A systematic program periodically redeems equities, subject to financial ability and approval by the board of directors. Systematic programs include the revolving fund method, and **percent-of-all-equities**. In a special program, redemption is triggered by an event that happens to individual members such as death, retiring from farming, or reaching a prescribed age. How these programs are used, if at all, individually or in combination, is fundamental to any equity management consideration.

#### ***• Revolving Fund Programs***

Equity redemption using the revolving fund method consists of paying out equity on a first-in, first-out basis. The oldest year of equity is repaid before equities issued in subsequent years are redeemed. The board may adopt a policy that sets a target revolving fund period, for example 10 years, and attempts to adhere to it as long as financial conditions allow. Revolving funds are the most common type of systematic redemption program used. A study conducted by RBS based on 1991 financial data showed that 92 percent of cooperatives with systematic redemption programs used the revolving fund method. The study also



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showed the average revolving period for all cooperatives was 16 years, but varied from 2 years to more than 25 years. Fruit, vegetable and nut marketing cooperatives had the shortest average revolving period at 10 years, while grain marketing and farm supply had the longest average period at 19 years each. More than half of the cooperatives with revolving fund programs used them in combination with one or more special redemption programs. Cooperatives primarily use retained patronage refunds and per-unit capital retains as the methods for accumulating allocated equity that is redeemed on a revolving fund basis.

The revolving fund method has advantages and disadvantages as a tool in managing a cooperative's equity:

Advantages

- Easy to understand
- Keeps investment proportional when revolving period is short
- Requires no cash outlay by member

Disadvantages

- Easily manipulated
- Disparities occur when earnings vary or revolving period is extended
- Unrealistic member expectations revolving cycle will be maintained

#### • **Percent-of-all-Equities Program**

Compared with the revolving fund method, the percent-of-all-equities program is used by only a limited number of cooperatives. The board of directors establishes a percentage of all allocated equities to be redeemed regardless of the year they were issued. Based on RBS data, the average percentage redeemed annually was 10 percent. This would be similar to a 10-year revolving fund. Percentages redeemed ranged from 2 to 15 percent. The 1991 study results indicated that cooperatives paying a lower percentage usually combined this program with one or more special programs. The primary benefit is, regardless of how long members have patronized the cooperative, they get an equity redemption amount. This is particularly beneficial to younger members because it returns capital to their farming operations more rapidly. This feature could serve as an important membership recruitment and retention tool.

Advantages and disadvantages of this method are:

Advantages

- Easily understood and administered
- Attractive to new members

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Disadvantages

- Well-suited to cooperatives relying on retained patronage refunds
- Proportionality takes longer to achieve
- Contributions unresponsive to changes in patronage
- Plan must be combined with special programs for inactive members to receive equity on a timely basis

• ***Special Redemption Programs***

The use of special equity redemption programs is quite prevalent among agricultural cooperatives. The 1991 study data indicated that 72 percent of all cooperatives whose equity was subject to redemption used one or more types of special programs, often in combination with regular redemption programs. The most common method, used by 95 percent of cooperatives with special programs, was payment to estates. **Age-of-patron** was the second most common, followed by redemption upon retirement from farming. Other types of special programs included redeeming to members moving out of the cooperative's trade territory and to members suffering some type of hardship such as foreclosure.

Although the basic use of these special programs was the same among cooperatives, the manner in which they are administered varies greatly. This variability provides some good examples of different equity management techniques, which will be discussed in more detail later in the report.

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## **Equity Management Considerations**

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This section will discuss, analyze, and evaluate the considerations the board of directors and management must address in making the decisions involved in managing the cooperative's equity.

The key objective of managing equity effectively is to keep members' investment proportional to use of the cooperative. In most instances, achieving and maintaining proportionality is easier to talk about than to accomplish because of the uncertainty of financial outcomes. But, it should still be the underlying goal of equity management. How it is accomplished will depend on many factors. A cooperative that has been in business for many years and has accumulated equity with no

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regard to proportionality will have a difficult task achieving this objective. A new or relatively young cooperative will have a much easier job in achieving, and then maintaining, members' investments in proportion to use. Likewise, a cooperative that has been operating with an active equity redemption program may only need to fine tune its capital program to achieve proportionality.

## **Managing Proportionality**

Where should a cooperative begin in its efforts to achieve a closer relationship between a member's investment and use of the cooperative? Start by identifying the difference between each member's investment and use level. Depending on the number of active and inactive members and the length of time the cooperative has been in business, this may be a daunting task. The project will be even more difficult if the membership records have not been kept current. Regardless of the obstacles, however, this exercise must be performed to provide a starting point to begin managing the cooperative's equity.

The greatest amount of disproportionality usually occurs in a cooperative that does not redeem equities, or only redeems using special programs such as estates or age-of-patron. This situation can only be corrected by adopting an aggressive capital program such as a revolving fund or base capital plan. Such a program must have the capability to acquire sufficient equity from current users of the cooperative (on a proportional basis) to redeem the equity of former and retired members who are no longer patrons. The cooperative should prepare a long-term financial plan that provides a road map as to how the objective will be achieved. The plan should set a goal to achieve proportionality in a specified number of years. The plan should be reviewed at least annually and changed to incorporate actual results from the past year and changes in assumptions and expectations for future years.

## ***Closing the Gap***

Achieving proportionality among members' equity investments is accomplished by using a combination of equity accumulation and equity redemption techniques. Regardless of the ways used to achieve proportionality, the overriding consideration is the need to accumulate sufficient equity capital to make it possible.

Asking current users to bear the additional investment burden to achieve the objective may meet with resistance. Therefore, it is extremely

important to continually educate members on their obligation to provide equity capital according to use. This is in keeping with the equitable treatment principle on which cooperatives are organized and should be operated. If current members are under-invested in proportion to their use of the cooperative, they are being subsidized by retired members and/or other members whose use of the cooperative has declined. Likewise, it is unfair to inactive members to be providing a majority of the equity capital to finance the organization.

It will take, at the very least, several years before cooperatives that have significant disparity between members' investment and use to make noticeable progress towards "closing the gap." Progress against the financial plan should be continually monitored with the results communicated to the membership on a regular basis. Here are some tips.

#### **• *Changing Cash Patronage Percentages***

The cooperative has a number of tools at its disposal to assist in making members' equity investments more proportional. One way is to control the percentage of the patronage refund paid in cash. For example, if only the minimum amount of 20 percent is paid in cash (to qualify the distribution for tax purposes), current users will be adding to their investment at a more rapid pace than if a higher percentage is paid. This may make more equity capital available, sooner, for redemption to inactive members, either through regular or special programs. For instance, the objective might be to reduce the number of years in the revolving fund by a specified amount (from 15 to 10 years), or if a cooperative is redeeming to members at age 72 under an age-of-patron program, the goal could be to lower the age to 65.

Another method is to vary the cash patronage percentage paid to different members. Those who are under-invested would receive only the minimum amount, usually the 20 percent. On a graduated scale, members who are fully invested or over-invested would receive a higher percentage of the patronage refund in cash. A member that is significantly over-invested may even receive 100 percent of the patronage refund in cash to prevent more disproportionality from occurring.

#### **• *Using Per-hit Capital Retains***

Another way to increase the amount of equity accumulated is to use a per-unit capital retain, either in lieu of retained patronage refunds, or in addition to them. Because per-unit capital retains are a more stable

source of equity than retained patronage, equity has the potential of accumulating at a faster rate. Although a per-unit capital retain is used primarily by marketing cooperatives, others have successfully adopted this method.

The amount of the retain can also be varied. An under-invested member can be required to invest at a higher per-unit capital retain rate than one who is fully invested. An over-invested member may not even have a per-unit retain deducted from sales proceeds.

#### **• *Managing the Revolving Cycle***

The amount of retained patronage refunds and/or per-unit capital retains added to the revolving fund each year will vary depending on earnings levels, the amount paid in cash, and the volume and value of the commodities handled. This results in some years' revolving funds being large and others containing lesser amounts. These differing amounts may provide the opportunity to combine two or more full and/or partial years of retained equity into one redemption. This will speed the return of equity to inactive or less active members and achieve proportionality more rapidly.

As with other methods available for reducing disparities, shortening the revolving cycle requires current users to provide sufficient capital to achieve this result and still maintain the cooperative's financial soundness. In any given year, the ability to shorten the revolving cycle will also be governed by other factors such as out-of-the ordinary capital expenditures and the demands of any special redemption programs.

Shortening the revolving cycle when financial conditions permit also gives the cooperative more flexibility in future years. If available capital in a specific year falls short of expectations, the revolving fund can be lengthened by a partial or full year with less impact on proportionality. In addition, members should be more willing to accept a lengthening of the cycle if it has been shortened in previous years. Once again, member communications is the key to more ready acceptance of this situation.

#### **• *Changing To a Base Capital Plan***

Another approach would be to convert the current equity program to a base capital plan. One of the first steps is to calculate the relationship between each member's investment in, and use of, the cooperative. Even if a base capital plan is not adopted, the cooperative will have done the

calculations to determine how disproportional member's investments are compared to use and will have taken an important equity management step.

• ***Use of Unallocated Equity***

Cooperatives can designate a certain portion of each year's net income as unallocated equity. The primary purpose, in most instances, is to cushion allocated equity from losses, but other benefits may be realized. If a certain amount of the equity pool is unallocated, allocated equity becomes a smaller percentage of total equity. The smaller allocated equity pool can often be redeemed more rapidly than if the whole equity amount was subject to redemption. This helps to keep equity more in the hands of current users. Caution needs to be exercised, however, to prevent the unallocated equity level from becoming the dominant form of equity because members may risk losing control of the cooperative. Unallocated equity should be maintained in a range of no more than 15 to 25 percent.

• ***Advance Capital***

A form of advance capital payment may be used to require under-invested members to more quickly bring their investment in line. The most common time for its use would be when a new member joins the cooperative. An advance capital payment might be used to set the initial investment at a prescribed minimum so the new member can help provide the capital necessary to support the additional business volume being contributed. Another situation occurs when an existing member's volume increases significantly in a short time and the cooperative needs additional capital to finance it. In each instance, the regular methods such as retained patronage refunds or per-unit capital retains may not be sufficient to adequately capitalize the additional volume. The existing member could be required, on a basis similar to the new member, to make a direct payment to bring the investment up to a prescribed minimum.

The advance capital payment requirement may be too costly for the member to contribute all at once. In these instances, installment payments can be used to allow the member to fulfill the obligation within a prescribed period. The intent is still the same, to have the member's investment approach a proportional level on an accelerated basis. Authority to assess an advance capital payment can be placed in the

organization's bylaws or membership agreement with parameters established as to when and how the advance capital requirement will be triggered.

## **Managing Equity Accumulation**

In the section "Managing Proportionality," some aspects of equity accumulation were touched on, but there are many other considerations involved in raising equity that are important to an effective equity management strategy. Equity accumulation is the most important aspect of a cooperative's equity program. Without new equity being provided in some manner, the business can neither grow nor be proportionally maintained through the redemption of equity to less active members. All other equity management considerations depend on results of the equity accumulation efforts, i.e., equity redemption, capital asset purchases, obtaining and repaying debt capital.

### ***Retained Patronage***

How equity accumulation is managed largely depends on the methods used for retaining equity in the cooperative. For example, if retained patronage refunds are used, one technique is to delay making the cash patronage payment until the full 8<sup>1</sup>/<sub>2</sub> months after the end of the fiscal year, as permitted under the tax laws. In this way, the cooperative has full use of the entire patronage allocation for that period, instead of paying the cash portion immediately. The cooperative saves by reducing borrowed operating capital and accompanying interest costs.

### ***Per-Unit Capital Retains***

If per-unit capital retains are used, how and when the retain is deducted from sales can have a significant capital impact. This is particularly true in marketing cooperatives that use the pooling method of accounting for sales and returns to members. By deducting the per-unit retain from the initial payment made to members, the cooperative has use of that capital much sooner than if it waits to deduct the retain from the final payment when the pool is closed. A dairy marketing cooperative has a built-in advantage in this respect, because per-unit retains are usually deducted from each month's milk check, providing an ongoing source of equity capital throughout the year.

The pooling method also offers another capital management advantage. In most pooling operations, members receive an initial payment on

their product shortly after it is delivered. Throughout the rest of the pooling period (the fiscal year, or longer, depending on the marketing cycle of **the** commodity), progress payments are made to members as sales results justify. Delaying, or reducing the level of **progress payments** from the maximum amount that could be paid based on sales allows the cooperative to operate for short periods of time on the members' capital. Members, in essence, provide short-term operating capital. Less debt **capital is** borrowed and interest expense is reduced. This strategy should be **used** carefully, however, or the cooperative may risk losing members if it **does** not stay competitive.

The type of per-unit capital retain used provides another equity management consideration. A cooperative may choose to set the retain on the basis of physical volume of product delivered or purchased or a percentage of the item's dollar value. The physical volume method is the most straight forward, but has some weaknesses. A shortfall in the needed amount of equity may occur in a year in which the physical volume **of the** product is less than projected. This may hamper the cooperative's ability **to** make needed capital purchases or may curtail equity **redemption** plans. If lower volume is anticipated, the option exists to raise the monetary amount of the retain, per unit of physical volume, to regain the potential loss of capital.

A better tool for managing equity accumulation is to base the retain **on a** percentage of the product's sales value. In years when physical **volume is** lower, the value of the product normally increases. Using a retain **based** on a percentage of product value could result in the same, or more, equity being raised by the cooperative compared with a normal volume year. This would not hold true if the lower volume occurs as an isolated incident for the cooperative, while the rest of the industry has normal volume.

### ***Direct Investments in Value-Added Cooperatives***

With the proliferation of value-added cooperatives in recent years, a **new** set of equity management challenges is emerging. Most of these cooperatives need a large, up-front capital investment by members to provide the equity necessary to construct expensive, value-added, processing facilities. Raising this capital is often a lengthy and difficult process, requiring the dedicated efforts of producers and professional advisors who believe **in the project**. The effort usually begins with a grassroots' campaign to generate interest in the project and to solicit seed



capital from potential members. This initial drive for capital is a means to gauge interest and to fund feasibility studies and hire consultants and interim management.

When this effort is successful, the studies have been performed, and project feasibility confirmed, the real task of raising capital begins. In most instances, lenders expect equity capital to represent at least 50 percent of the required investment for these value-added facilities and the operating capital needed to get the project under way.

The organizational and operational characteristics of capital raised by these “new generation” cooperatives provide unique equity management situations. First of all, membership is usually closed—the number of members is fixed. The capital invested entitles, and obligates, each member to deliver a prescribed amount of product to the cooperative for processing. For example, for every \$1,000 invested, the member may be purchasing the right to deliver 1,000 bushels of wheat. The investment is therefore said to carry a delivery right. In most of these cooperatives, delivery rights may be traded among members. This enables a member wanting to get out of production to sell the delivery rights for the commodity to another member wanting to increase production, or to a new member wishing to join the cooperative.

These transactions, including setting the sales price per unit, are conducted between members, but the transfer, exclusive of the sales price, is subject to board of directors approval. The cooperative’s only other role in the purchase and sale of delivery rights may be to serve as an information clearinghouse for potential buyers and sellers.

If the cooperative is successful, the value of the delivery right may appreciate, permitting the member to realize a gain on the original investment that granted the delivery right. If unsuccessful, the delivery right may sell below the original cost of the investment, or may be unsalable, resulting in the member losing all or part of the investment. This reinforces the point made earlier that equity capital is risk capital.

Appreciation of the delivery right over time can present a challenge for both the cooperative and its members. It is a matter on which recently or newly organized value-added cooperatives need to be aware and address in their organizational structure. It involves a situation in which, after years of successful operation, the value of the delivery right becomes so high new members can not afford to buy. Likewise, long-time members are reluctant to sell their rights because the capital gains tax on the original investment would be very costly.

A cooperative can address this possibility early in its organizational efforts by including provisions in the corporate documents requiring members to sell their rights when they are no longer delivering product. Another approach would be to set a high nondelivery penalty to act as a disincentive for continuing to hold the delivery right if there is no bylaw provision requiring the **sale** of the delivery right when product is no longer being delivered. A third possibility would be to suggest that the long-term member sell the right on an installment contract to defer some of the gain, although it is recommended that a professional tax advisor be consulted before any transaction is carried out.

Provisions should be made for allowing new members to purchase the delivery right on a time payment plan of some kind, or make the purchase on an installment contract.

After obtaining the initial investment, the cooperative must decide how it is going to retain additional capital from operations; through patronage retains, per-unit capital retains, additional direct investment, or a combination of methods.

## **Managing Base Capital Programs**

The equity management considerations with a base capital plan are quite varied. The options a cooperative chooses may depend largely on the capital investment requirements of the commodities being marketed, **as well** as the marketing cycle of the products produced. These characteristics affect the length of the base period, what type of measurement period is used to determine each member's patronage level over the base period, and the type of equity accumulation method(s) to be used.

### ***Choosing a Base Period***

Products marketed in fresh form such as milk, fruits, or vegetables usually involve a relatively short base period (1 to 5 years). The purpose of a shorter base period for fresh products is to provide the flexibility to adjust more rapidly to seasonal or year-to-year fluctuations in volume and/or price in setting the required investment level for members. A short period may be preferred by a cooperative handling a commodity that is subject to large swings in production levels, even though it is marketed in processed form. Examples would include certain tree crops that have alternate-year bearing characteristics. A shorter period also permits under invested members—those who have recently joined the **coopera-**

**tive**—to build up their proportionate share of equity more rapidly. Conversely, members who are decreasing volume or quitting production completely can expect to have their equity investment returned sooner.

In contrast, products with an extended marketing cycle, such as in a winery cooperative, may want to consider a longer base period (5 to 10 years). Winery products are normally stored for several years before being marketed. A longer base period will help smooth out fluctuations in capital and provide the stable equity base needed to finance the storage activity, including the multiple-year cost of carrying the inventory and the capital needed for the investment in the storage facilities themselves.

Plans with shorter base periods (1 to 5 years) may not need to be combined with some type of special program, such as payments to estates or upon retirement, because the return of a member's investment occurs fairly rapidly. Cooperatives with longer base periods (more than 5 years), however, may want to consider the use of one or more special programs to expedite the return of equity to members who die or retire from farming.

### ***Selecting a Measurement Unit***

Another important management consideration is selecting the measurement unit used to calculate each member's equity requirement based on the member's proportional use of the cooperative during the selected base period. This will vary among cooperatives, particularly between different commodity types. A cooperative first must decide between either a physical unit of measurement or one based on a percentage of the commodity's value. A physical unit could be a bushel or hundredweight for grain cooperatives, or a ton of product delivered to a fruit and vegetable processing and marketing cooperative. A unit based on value could be calculated as a percentage of the dollar value of the raw product delivered. The advantages and disadvantages of these methods were discussed earlier.

The physical measurement unit should be a common denominator that applies equally to all members under the plan. If several commodities are involved, different measurement units may be needed for each, such as bushels or hundredweights.

### ***Determining Proportionality***

With the base period and measurement unit(s) selected, management has the tools to calculate the proportionality of each member's investment. At this point, the real management activities of a base capital plan begin by determining a member's investment compared with use of the cooperative over the prescribed base period and how to correct any disparities. Depending on whether a member is fully invested, over invested, or under invested, a program must be developed to bring each member close to being fully invested in a practical time period.

A program for the under invested member may be used to accelerate equity contributions-higher per-unit capital retain or smaller cash patronage payment. For the over invested member, it would be a plan to redeem the over invested portion in a reasonable time period without undermining the capital strength of the cooperative.

In administering the base capital program, it is important to monitor the proportionality of each member's investment on a regular basis. At least annually, members should be provided with an individualized statement showing their investment in relationship to a fully invested position. Issuing this statement should coincide with the time of the year when the board of directors establishes the desired level of equity for the cooperative for the coming year. The statement should show the cooperative's overall equity capital needs and each member's required investment level. The statement should include a message explaining capital expenditure plans for the coming fiscal year. This message should also explain what method will be used to bring members to a fully invested position if they are either under or over invested.

### ***Managing Equity Redemption***

This section will discuss strategies and other considerations for regular and special equity redemption programs. Regular redemption programs include revolving funds and percent-of-all equities. Special programs to be covered are estates, retirements, age-of-patron, moveaways, and hardships.

#### ***Regular Redemption Programs***

In regular equity redemption programs, equity is redeemed by orderly methods, often called systematic programs. Each type of program

has advantages and disadvantages as discussed earlier. In this section, **two regular** types—the revolving fund and percent-of-all equities—will be examined along with approaches used to manage them.

### **. Revolving Fund**

The revolving fund method offers an array of possibilities for redeeming equities, even though the basic concept is always the same. The oldest equities are redeemed first. Specific aspects of one cooperative's revolving fund plan compared with another will often differ widely. Variations exist not only between cooperatives handling different commodities, but also among those of the same type. Practices may also differ greatly from one part of the country to another. A cooperative's current and historical financial condition also influences the way a revolving fund is administered. How equity is acquired—either retained patronage refunds or by per-unit capital retains, or both—will also impact the revolving fund operation. Operations may also be affected if other regular or special redemption programs are used. For example, special program redemptions usually have priority over regular redemptions and may reduce the amount of capital available to redeem under a revolving fund program. That is why cooperatives with a combination of regular and special programs may have longer revolving fund cycles.

The most common measure of a revolving fund program's effectiveness is the length of the revolving cycle. From a member's viewpoint, the shorter the revolving cycle the better because it returns capital faster for reinvestment in the member's production operation. However, a shorter cycle may not always be the best from the business' standpoint. The pressure to maintain a short revolving cycle may strain the cooperative's resources and undermine opportunities for worthwhile projects. Therefore, the cooperative must balance the members' expectations against the capital requirements of the organization. This may not be an easy task, particularly from a member relations perspective. Regular communication with the membership will help.

A shorter revolving cycle also has some other benefits by keeping members' investment more proportional to use and therefore addresses one of the key aspects of effective equity management.

The key to operating an effective revolving fund is to actively manage it, instead of letting the revolving fund control the actions of the cooperative. Active management means a target is established for the length of the revolving cycle. This is accomplished by the board of **direc-**

tors establishing the goal and directing management to develop a financial plan to achieve it. This plan should incorporate planned capital outlays, including equity redemption amounts required to achieve and/or maintain the target revolving fund cycle, and expected sources of capital, both equity and debt. Too often, financial planning only identifies capital expenditures for such items as the purchase of fixed assets and the servicing of long-term debt. Equity redemption amounts (regardless of the type of plan used) are derived from any capital remaining after all sources and other uses are accounted for. In this case, the revolving fund is doing the managing.

A cooperative can operate two or more revolving funds simultaneously. Generally, the purpose for these funds is to keep track of equity obtained from multiple sources. Examples are having separate revolving funds for equity retained as patronage refunds and per-unit capital retains. Other cooperatives may choose to put equity retained from local operations on a different basis than that received from patronizing a regional cooperative. This has an advantage when the regional's redemption cycle is significantly longer than the local cooperative's. By revolving only local equity, the cooperative relieves itself of the cash flow burden of repaying regional equity before it is received.

Multiple revolving funds could also be established for each commodity handled by a marketing cooperative. For example, it might be appropriate to have a longer revolving fund for a commodity with an extended processing and marketing cycle.

### • ***Percent-of-all-Equities***

This program has many of the same equity management aspects as a revolving fund because the percentage of equity redeemed in a given year approximates a revolving fund cycle. For example, a 10 percent redemption of all equities is roughly equivalent to a 10-year cycle. The higher the percentage redeemed, the better the performance is judged, at least by the member. The cooperative has the same challenge of balancing the needs of the cooperative against the expectations of the member.

One advantage the percent-of-all-equities program has over a revolving fund is that newer members have some equity redeemed sooner than under a revolving fund. This feature, however, works against achieving proportionality of investment as quickly as with a revolving fund. Also, the plan provides the cooperative more flexibility in redeeming equity on an annual basis because the percentage-of-all-equity

redeemed can be adjusted up or down depending on operating results for the year. A smaller percentage could be paid in years when earnings are below average, but at least some equity is redeemed.

This program, however, encourages having some other program in combination, so when a member quits patronizing the cooperative, a system is in place for returning equity on a more timely basis than paying out a percentage of an ever decreasing equity amount. A **percent-of-all-equity** plan could be combined with a special program such as estates or age-of-patron.

### ***Special Redemption Programs***

There are management considerations for five special equity redemption programs—estates, retirements, patron's age, moveaways, and hardship. Each involves a different situation related to the member, but equity management considerations are quite similar. The similarity exists because the time when the special event will occur is not known in advance, except for the patron's age program, and therefore more difficult to predict when and in what amount requests for equity redemption will be made. Given this uncertainty, planning and budgeting for a special program redemption is more difficult, although the board of directors decides when the equity is actually paid. There are a number of ways that cooperatives can deal with this uncertainty. First, develop a good membership profile that provides the birth date of each member, amount of equity investment, and other personal data that will give management a better feel for the exposure under each program. Even with this information, some uncertainty will still exist.

- ***Estates***

When the cooperative's average membership age is rising, frequently the case with the farm population, so does the exposure for redeeming to estates. A cooperative can manage that exposure by limiting the maximum amount of equity to be redeemed to estates during a fiscal year. This amount can be arbitrary, represent a set percentage of total equity, or a percentage of the patronage allocation for that year. If no limit is established, a decision must be made whether to redeem to estates when the claim is made, or hold all claims until the fiscal year ends. Holding off gives management and the board the opportunity to determine if the amounts requested exceed what can reasonably be redeemed without undermining the cooperative's equity base. If the

claim amounts are too high, payments may be prorated among all estates filing claims during the fiscal year or made on a first-come, first-served basis determined by when the claim was filed. By delaying the decision to redeem to estates until fiscal year end, the cooperative has longer use of the capital. This could reduce the amount needed to be borrowed during the year which could lower interest expense and increase net income.

Another equity management decision with estates involves the redemption approval process. The policy may be that the board must approve all claims regardless of the amount, or it can delegate this authority to management within prescribed parameters. Which option the board chooses may depend on the estimated exposure to claims in a given year and the estimated amount of equity per claim. In either case, the board of directors must retain the fiduciary responsibility for the financial integrity of the cooperative.

### • ***Age of Patron***

Although estates are the most common form of special programs, they are often combined with other special redemption programs. One standard combination is with an age of patron program which is a more predictable factor. Using both reduces the ultimate exposure for estate redemptions if the age of patron level is set low enough. If the program is going to work as a retirement plan, the age level should be in the 62 to 65 year range. When a member reaches the prescribed age, but continues to be active, existing equity would be redeemed and all subsequent patronage dividends paid 100 percent in cash. The total amount of equity in the member's account does not necessarily need to be redeemed when the prescribed age is reached. Instead, a percentage may be paid each year over a prescribed period in equal percentages or weighted more heavily in the earlier years. Delaying redemption keeps more capital invested in the business and allows time for the cooperative to accumulated replacement equity.

### • ***Retirement***

Redeeming equity when a member retires from farming is also a common special redemption program in agricultural cooperatives. Equity can be paid in a lump sum when the member retires or redeemed over a period of time. Redemption of equity under this program may include the condition that the retiring member no longer owns or controls the land on which the farming operation was located. This program has the



**same** uncertainty as estates in **that the cooperative does not necessarily have advance knowledge** of when the member will retire. The uncertainty as to when redemption will occur makes the equity management function more difficult, particularly if regular redemption programs **are also** operating.

- **Moveaways**

Programs that redeem equity to members who move out of the cooperative's trade area are less common than other special programs, but still have equity management considerations. Uncertainty also becomes a factor with this program if the event is unplanned. As with redemption based on age of patron, "moveaways" do not necessarily receive immediate payment. Waiting periods, perhaps as long as 5 years, may be imposed before the former member is paid. This differs from the normal practice with age of patron programs where payments are usually made in installments.

- **Hardships**

Another special program deals with redeeming equity in hardship situations to facilitate the timely settlement of legal matters such as bankruptcy, foreclosure, or divorce, or if the member suffers a disability. The type of hardship involved will usually determine how the program is managed from an equity standpoint. For instance, one hardship might be a member's bankruptcy or foreclosure of the farming operation. Where financial difficulty is the cause, the member may be unable to repay debts, including amounts owed the cooperative. Under these circumstances, the cooperative must have the right to offset the member's equity investment against the debt. The authorization for a right of offset should be contained in every cooperative's bylaws and/or membership agreement.

In hardship cases, the board's decision to redeem equities early should be considered on a case-by-case basis with no precedent **established** from one situation to the next. This distinguishes it from other special programs where, subject to board approval and the availability of funds, equity is redeemed as a matter of normal policy.

For hardship redemptions, as well as other unforeseen early redemption situations such as "moveaways," consideration should be given to discounting the amount redeemed to its present value. Discounting the equity provides fairer treatment for all members who

have to wait the normal time period for the return of their equity. It also lessens the cooperative's financial burden on the amount it has to pay. The cooperative's right to redeem out of sequence equities at a discounted value should be clearly stated in the bylaws and/or membership agreement. The rate at which equities are discounted for early redemptions is a matter for the board to decide, but a discount rate comparable to prevailing interest rates such as the prime rate should be used. This rate is applied to the equities to be redeemed for the time period involved between when payment is made and the estimated time for normal redemption. Discount factors to be applied to the equity can be obtained from a standard present value table. Before discounting equities, however, a tax adviser should be consulted to determine the tax consequences for both the cooperative and its members.

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## **Summary and Conclusions**

Every cooperative needs to devote the necessary time and resources to manage its equity in a manner that will benefit both the organization and its member/users. Depending on the type of equity structure, how equity is accumulated, and what redemption programs are used, the task of managing equity can range from straightforward to extremely complex.

The board has the ultimate responsibility for managing the cooperative's equity with guidance from management. It is essential for the board, in carrying out this responsibility, to have a good understanding of the unique features of cooperative finance and the importance of adhering to cooperative principles.

The primary objective of equity management is to ensure the cooperative has adequate equity capital invested in it to serve the members in an efficient and effective manner. The greatest challenge is to manage the accumulation and redemption of equity capital in a manner that achieves and then maintains the member's investment in proportion to use. The RBS study on equity redemption showed that U.S. cooperatives have a long way to go in meeting this challenge. No planned method for accumulating equity, lengthy revolving fund cycles, using only special programs to redeem equity, and the limited use of base capital plans are only a few examples that show there is much more cooperative boards and managers could be doing to "manage" their cooperatives' equity.

At the heart of effective equity management is a sound financial plan that serves as the primary equity management tool. Equity management doesn't end with the development of a financial plan. A financial plan should be a dynamic tool, referred to often and updated as necessary. The plan should serve as the focal point for all decisions concerning both equity and debt capital.

An active approach to managing equity is more important than the methods used to accumulate and/or redeem equity. The key to active management of equity is knowing the relationship between each member's use of the cooperative compared with the level of equity investment. Measuring this relationship and then adjusting the program to reduce any disparity is the key to an active versus passive approach.

An important aspect of any equity management effort is ongoing, consistent, and forthright communications with members on the capital needs of the cooperative. This information should come from both the board and management. Members must understand why the cooperative needs their equity investment and how it is applied in operating the business.

If a cooperative is going to operate according to the cooperative principles on which it was founded, the board of directors and management need to manage equity on a continuing basis. To not do so violates the board's fiduciary responsibility and is a disservice to the entire membership.