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Who owns the cooperative?

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Who owns the cooperative? The question of ownership is, in theory, easy to answer. Cooperative corporations, like other corporations, are owned by those who contribute equity to the firm. Yet an individual's investment in a cooperative – equity contribution – is tied directly to his or her use of the cooperative. This is perhaps the primary characteristic that distinguishes the cooperative business form from other organization structures. For example, one need not invest in Apple, Inc., to buy an iPad and, similarly, could invest in the company by purchasing stock without ever buying a single product or service from Apple. Not so with a cooperative; it is owned by those who use it currently or have used it in the past. In the case of the agricultural grain and supply cooperatives in Iowa, the producers who sell grain to and buy inputs from the cooperative own it. Or do they?

Today, Iowa is home to approximately 58 grain and farm supply cooperatives, less than 10 percent of the 710 cooperatives that existed in 1951. While some of the reduction in numbers is attributable to cooperative failures or sales, much is the result of co-ops merging with other co-ops. In 1951, a majority of the cooperatives were single location; today, very few single-location cooperatives exist.

Instead, cooperatives have grown into multiple-location firms spanning several counties. Cooperatives needed to grow to keep pace with and be able to service the growth in farm size and complexity of operations. As cooperatives have grown in size – and as they have experienced recent record-profitability years – the producers who do business with them (their owners) have, not surprisingly, begun to question whether they own the cooperative or whether the cooperative owns itself.

To understand ownership in a cooperative, its equity composition needs to be examined. In the simplest sense, a cooperative can build equity in two ways: by direct initial investments from the producers who use it and by earning profits. The initial investment piece is small. In most cases, producers in Iowa become a member of a cooperative by purchasing a single voting share for a relatively modest sum, perhaps \$25 to \$1,500. The majority of equity then is accumulated when the cooperative earns a net income, typically called “savings” or “local savings” in co-op jargon. With each year of positive savings, a cooperative allocates a portion to its members in the form of patronage based on an individual's proportional “use” of the cooperative – his or her share of the total business conducted. Often 20–30 percent of

this allocated equity is paid out as cash to the members who used the cooperative. The rest of the allocated

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Handbook updates
 For those of you subscribing to the handbook, the following new updates are included.

- Historical Costs of Crop Production** – A1-21 (2 pages)
- Lean Hog Basis** – B2-41 (1 page)
- Live Cattle Basis** – B2-42 (1 page)
- Feeder Cattle Basis** – B2-43 (1 page)
- Feeder Steer-Heifer Price Spread** – B2-45 (1 page)
- Computing a Cropland Cash Rental Rate** – C2-20 (4 pages)
- Flexible Farm Lease Agreements** – C2-21 (4 pages)

Please add these files to your handbook and remove the out-of-date material. *continued on page 6*

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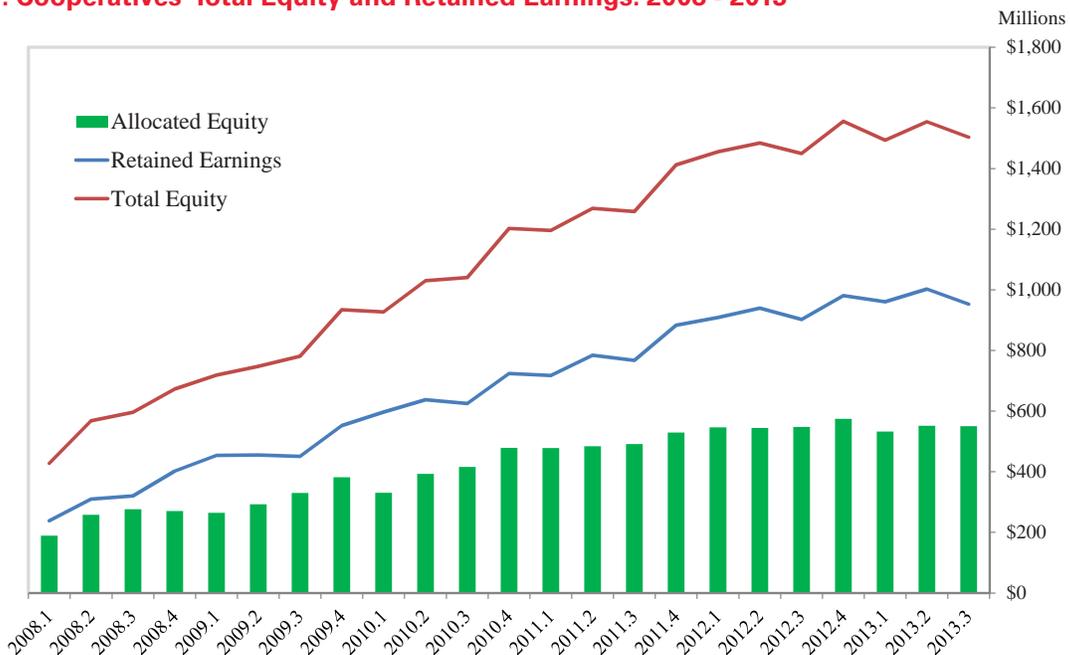
equity stays on the cooperative's balance sheet as equity in the member's name. This is retained patronage or retained allocated equity, and it will eventually be redeemed or paid out to the members over the normal course of business. In Iowa, many cooperatives are redeeming allocated equity 7–12 years after it was allocated to the members. The rest of a year's savings – that which is not paid out as cash to members or placed into members' retained allocated equity – is designated as retained earnings: equity in the cooperative with no one's name on it. This is where the issue of ownership gets blurred: whose equity is that? Importantly, equity that has not been allocated to a member is members' equity because members control and own the cooperative. However, it is not designated to be redeemed to members as retained patronage is. Practically speaking, it is only accessible to the members if the cooperative is sold or dissolved.

Recent record profitability years coupled with tax deductions – like Sec. 199 (the domestic production activity deduction) – have led to significant increases in cooperatives' retained earnings. Adding to retained earnings benefits the cooperative in a number of ways. The most often cited benefit given by cooperative managers and directors is that it is permanent equity. Conversely, retained patronage is not viewed as permanent equity because of the expectation that it be redeemed to members at some point in the future. A cooperative board ultimately has control over whether and how much of that is redeemed, but the expectation of redemption exists. Having a significant share of the co-op's equity as permanent equity is favorable to the cooperative when working with lenders who evaluate the risk profile of a cooperative on their permanent equity. Another benefit of retained earnings is

that it acts as a cushion to absorb losses (negative savings) when they occur. Without retained earnings to absorb the loss, the co-op would be required to reduce members' equity or "bill" members for their share of the loss in that year. Even though reducing retained earnings does reduce members' equity, most members do not perceive it as a direct loss because the equity against which it is charged was not allocated to them initially. Finally, retained earnings provide a readily available pot of equity to use for investments (asset acquisitions, replacements, etc.) without taking directly from the members' allocated equity, which, as a reminder, is expected to be redeemed to them. This gives the board and management more flexibility in the timing of the investment activities and often permits them to make decisions more quickly.

Just as there are benefits to retained earnings, there are drawbacks. Perhaps the greatest of those is the question at hand. A large share of equity as retained earnings creates uncertainty about the cooperatives ownership and the reason for its existence. Members incorrectly perceive that they do not own the cooperative because the share of equity with members' names on it is relatively small in comparison. A potentially negative disincentive exists because members understand that the only way to "get" that equity is to sell or dissolve the cooperative. Consider a cooperative that has 75 percent of its equity as retained earnings and 25 percent as retained patronage and membership certificates. If a private firm were to approach the board of the cooperative and make an offer to buy the cooperative for "balance sheet" value, the members in aggregate would stand to earn four times their retained equity. When members do not perceive the retained earnings as "members' equity," then the threat of

Figure 1. Cooperatives' Total Equity and Retained Earnings: 2008 - 2013



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an outside firm buying the cooperative becomes very real. Further, because members' equity accumulates over time, this situation is made more likely because the members with the largest equity share are the older members who are perhaps no longer farming or are contemplating retirement. Do they have the same incentives as the beginning or younger farmers to ensure that the cooperative is around for the next 10–40 years? Generally speaking, older members prefer to get the equity out of the cooperative; younger members want the permanent equity left intact because it supports capital investments, which benefit their own farming operations.

How real is this situation? Does it exist locally? Firm-level equity data from 33 cooperatives in Iowa and surrounding states indicates that it may. Figure 1 shows the aggregate quarterly value of these cooperatives' total equity and retained earnings since 2008. Allocated equity has increased even as cooperatives have paid out older equity to members and retained earnings has also increased over this time period; however, the largest increase has been in retained earnings. On average, these cooperatives have approximately 65 percent of their equity as retained earnings.

Farmers anecdotally perceive that as the co-op has grown in size, farmers actually own less of the cooperative. Interestingly, the largest cooperatives are not necessarily the ones with the highest proportion of retained earnings. The disaggregated data for these same individual cooperatives during 2013 is illustrated in Figure 2. The cooperatives here are arranged smallest to largest in asset value, given by the total height of the vertical bars. The

colored portions of those bars indicate the amount of retained earnings and allocated equity in each. Green markers (top portion of bar) identify the percentage of these cooperatives' total equity that is in retained earnings. While some of these cooperatives are operating with approximately 40–50 percent of their equity in retained, most have retained earnings at 55–75 percent of total equity, with a few as high as 90 percent. The perception of members of larger cooperatives is often that they feel the members no longer own the cooperative, but as this shows, cooperative size has little to do with its equity mix.

The equity mix of cooperatives results directly from board decisions. A cooperative's board decides how its income will be allocated to meet its members' needs and the cooperatives' future strategic plans. The board, which is elected by the membership and who are also producers with production at risk, has a responsibility to direct the cooperative in a manner that is consistent with the best interests of the members and to ensure the continued operation of the cooperative for the benefit of its members. Whether a board targets a relatively high proportion of retained earnings or a high proportion of retained allocated equity, it is all members' equity, and it exists to benefit the members either through eventual equity redemption or through investment in the assets, technology, and services that benefit its members. As a co-op's retained earnings grow relative to allocated equity, it becomes increasingly important that the cooperative board and management communicate with members the value proposition of this permanent equity so that members correctly perceive its value to their own continued use of the cooperative.

Figure 2. Cooperative Equity Composition by Asset Size, 2013

