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AGRIBUSINESS MANAGEMENT

EQUITY RAMIFICATIONS TO THE ALLOCATION OF COOPERATIVE OPERATING LOSSES

A survey of agricultural cooperatives operating in Washington State in 1968 suggested that equity capital was used in support of sixty percent of the total assets employed[1]. By 1977 a similar survey suggested a dramatic shift in financial structure; i.e., debt capital was being used to support sixty percent of total assets. What had occurred during the nine-year interim between surveys? Actually, a broad array of items that impacted the industry. The economic vitality of our agricultural economy during 1973-74 had prompted many cooperatives to expand their scope of operations, both vertically and horizontally. Much of this expansion had been funded through the use of debt capital. Other firms had acquired new, expensive, technological innovations which also accelerated their debt load. With the advent of the 1980's, our cooperatives had become heavily reliant on debt, were experiencing rising interest payments, and had extended their leverage to a questionable point. This, alone, would be reason for concern. Yet another more recent phenomena seems equally troublesome to me; i.e., the lessening of the "protected status" of that cooperative equity which remains.

While equity has always existed to serve as a buffer during periods of economic misfortune, its true status has always been determined and governed by the cooperative Board of Directors. Whether generated through retained earnings (unallocated), retained patronage (allocated), direct patron assessments, or voluntary patron investment, the resultant "pool" of equity capital is normally impacted if, and only if, by action of the Board. Most typically the Board will decide at each year's end how much to assess, how much to retain (allocated or unallocated), and/or how much to redeem (revolve) of equity certificates issued earlier in the firm's history. The Board, therefore, was able to respond to good times and bad by supplementing, sustaining, or reducing the pool of equity as conditions warranted. As such, the pool of equity was protected by virtue of Board prerogatives. More recently, however, this protected status has been threatened and the impact may be just as traumatic as that created by recent shifts in the financial structure of our cooperative organizations.

Cooperatives may expand their bases of investment capital in manners analogous to those employed by investor-owned corporations. Legal limits, however, preclude cooperatives from paying dividends on common stocks and bonds at levels sufficient to attract credible sums of private investment capital. To protect and/or supplement their bases of equity capital, therefore, cooperatives must impose investment-assessment requirements on their member-patrons and/or retain such funds from annual earnings. In fact, it is this unique dependency which creates an environment of potential equity diminution for cooperatives. Questions have risen recently which may substantially alter the status of equity capital generated in the above-mentioned manners. First, there is some discussion, at the national level, that cooperatives be required (legislatively) to redeem equity capital within some prescribed period of time[2]. Second, cooperatives are being subjected to claims from member-patrons that their investment capital in the cooperative be used as an "offset" against their accounts (debts) payable with that cooperative[3]. Third, local cooperatives have grown more dependent on large federated regional cooperatives. As a result, pyramiding of equity capital (where equity of a local or regional cooperative is comprised, in part, of equity held in a regional or super regional, respectively) results and losses sustained at the regional may be large enough to totally offset the sum of local member-injected capital (excluding that capital being held in the regional). A further review of these three factors follows.

In recent years, several federal government reports have expressed concern over findings which suggest that a growing number of agricultural cooperatives are failing to retain a "current" capital revolving program. In fact, those same data indicated that a significant number of operating cooperatives had never, in their history, elected to redeem member equity certificates. At least in this case, some concern is legitimate in that any cooperative not revolving equities fails to adhere to the principle that control of the firm should rest largely with those member-patrons who currently utilize its services. The proposed solution that cooperatives be required to redeem equity within a specified period of time is, in my opinion, not a desirable one. The proposed solution, itself, is in violation of a basic principle which states that Boards of Directors, representing the general membership, must retain the prerogative of establishing levels of capitalization. In addition, a mandated maximum revolve period would cast some accounting doubts as to the "permanency" of the pool of equity capital. Equity capital certificates (retains) with a required date of redemption maturity would cause some accountants and financiers to question whether such certificates are to be carried on the asset or liability side of the cooperative's balance sheet.

Many cooperatives have elected to implement a credit policy wherein members' unpaid accounts receivable are, at some point prior to a full write-off as bad credit losses, used to "offset" the defaulting member's current equity balance. It should be noted that this increasingly common and understandable practice can be initiated only by action of the cooperative. The act is not reciprocal; i.e., the defaulting member cannot elect to use his current investment in the cooperative as a vehicle for paying his outstanding balance for products or services utilized. Yet this fact has not deterred cooperative members from attempting to gain this prerogative. In some rare cases, the situation has been worsened by a Board of Directors offering to negotiate a settlement (equity reduction vs. accounts receivable) with individual members. Such acts expose the entire pool of equity capital to claims by other members (class action suits) seeking a way to quickly convert their equity certificates to cash. Should members gain this prerogative, the "protected status" of all cooperative equity would be lost and many cooperatives would collapse financially.

The pyramiding of local cooperative equity through regional and so-called super-regional cooperatives has long been of concern to cooperative lenders. If allowed to reach an extreme point, one can easily envision the classic "house of cards" wherein a single failure within the federated structure causes a collapse of the entire system. Some lenders, therefore, elect to discount the value of equities held in other cooperatives.

The wisdom of this act, of course, rests on the relative magnitudes of local member-injected capital vs. those held in regionals. When equity held in the regional begins to comprise a dominant portion of the local cooperative's total equity, there is reason for concern. Operating losses sustained at the regional, lying well beyond the direct control of the local, can thereby impose a traumatic burden on the local. In a similar sense, some locals have historically generated little net savings on their own operations, relying instead on the patronage earnings declared by their regional. When such earnings disappear, the local receives a rude awakening to the operational inefficiencies of their own facilities. Fifteen years ago, four different regional supply cooperatives operated in Washington State. Linkages and communications with locals were close. At the present time, only a single regional supply cooperative operates in this state, with its headquarters elsewhere. Even in a healthy economic environment, it is very difficult to maintain close linkages. Within this context, some locals have defaulted in their practice of good management, depending, instead, on the wisdom and guidance from a distant regional to cover such local deficiencies. Local member-injected capital is thereby exposed to the fortunes of a more distant cooperative entity.

Cooperative Article and Bylaw Deficiencies

Cooperative By-laws and Articles of Incorporation often pose additional problems when cooperatives confront the unpleasant task of allocating an operational loss. In principle a cooperative is to operate "at cost" for its members. In principle, therefore, an operation's loss should never occur.

Unfortunately the "real world" rarely adheres to established principles and losses are incurred, sometimes with large and devastating results. Articles and Bylaws provide the operational guidelines for cooperatives, but too often they are ignored, if not forgotten. Only in times of stress are Boards of Directors inclined to pull these documents from their little-used files. And then they are apt to be surprised and/or disappointed with what is found. As often as not, these documents will contain little, if any, mention of procedures for allocating losses[4]. A subsequent reference to state statutes will likely show that they are equally deficient.

A brief review of our regions (Pacific Northwest) cooperative bylaws, articles, and statutes suggests that provisions for the allocation of operating losses are nonexistent, written in nebulous form or so stated as to reduce the cooperative's ability to best protect its equity base in times of economic reversals. In theory, an operational loss can be charged against allocated or unallocated equity as it was, is, or will be patronage-base-created in the past, present, or future[5]. While investor owned corporations are allowed to carry losses into previous or succeeding tax years under the Internal Revenue Code Section 172, cooperatives are discouraged from doing so. Seemingly, the cooperative would seek to allocate its loss in such a manner as to least diminish its equity base, and in a manner that is fair to its membership. Yet, the IRS has informally indicated that bylaw provisions allowing cooperative Boards of Directors total discretion regarding the allocation of losses are not favored. To make matters more interesting and confusing, when challenged, the U.S. Tax Court has rejected the IRS's arguments, at least when asserted against the ability of cooperatives to carry over net operating losses pursuant to Section 172[6]. The cooperative seeking to protect its equity capital base when confronting an operational loss is clearly in a dilemma.

A Question of Equity

To best protect its base of equity capital, a cooperative must have available to it alternative means for allocating losses when they occur. As described above, the attitude of the IRS may restrict those options. In yet other cases where articles, statutes, and bylaws do address the issue, other constraints may be evident. Where mentioned, bylaws most commonly call for the distribution of operating losses in a manner such as, "Whenever a net loss occurs, said loss shall be borne, insofar as possible, by patrons in the year of said loss, distributed in accordance with their respective patronage with the cooperative during the year of said loss."

Quite simply, losses are treated as the inverse of a net savings. Intuitively, this treatment has some appeal and is linked to basic cooperative operating practices. Problems do arise, however.

First, one must wonder what can be done when the magnitude of the loss exceeds the amount of total equity owned by those members actively patronizing the cooperative during the year in which the loss was sustained. While occurring only rarely, it is not an impossible situation. This is particularly true in the Pacific Northwest where many cooperatives have operated only a few years. Such organizations and their members have simply not had the time to generate large reserves and equity balances. Second, one must wonder about questions of equity; e.g., why must current year patrons be penalized for a current year loss when it can clearly be shown that the loss resulted from a major decision made by the cooperative two or more years earlier. Again I must reference a Pacific Northwest example. In the early and mid-1970's, many of our cooperatives expanded their operations in light of expected increases in producing acres, new irrigation development, and a rapidly growing economy. By the early 1980's, all expectations were proven to be overly optimistic and the cooperatives were left with costly capacity in excess of current needs. Resulting losses would, under the above provision, be born by current year patrons, while those patronizing the cooperative during the period of growth decisions are clear and free to receive their equity revolves undiminished by the current consequences.

Similar questions of equity in the allocation of losses arise under conditions wherein the cooperative elects to offset those losses against future year's earnings. Is it fair and equitable to burden future patrons with the errors of their predecessors? Is it fair for a cooperative to offset losses in one of its divisions with savings generated in another division, assuming some division of patrons between them?

Another problem plaguing our Northwest cooperatives is that relating to so-called "floating tonnage;" i.e., characterized by a grower who chooses to take his produce from one cooperative to another in near successive years. As the grower withdraws his volume from one cooperative, the unused capacity thereby created may contribute to an operating loss. Yet the burden of the loss, if allocated to current patrons, is born by those who remain loyal to the cooperative and not by the grower who contributed to the loss but conveniently took his business elsewhere during the year of the loss. Where cooperatives are confronted with a high proportion of floating tonnage, real chaos results and serious questions of what is fair and equitable arise.

Finally, we have not yet even dealt with the personal income tax implication of loss allocation. In a well-established and economically vibrant region, the allocation of losses direct to the member-patron may, for at least a brief period, provide some personal income tax relief. In other regions where the agricultural population is young and largely undercapitalized, the allocation of a loss is less well received by the membership. When applied over a large area such as that served by a regional cooperative, one can easily see how tax advantages and disadvantages would not be uniform throughout.

Summary

Despite an attempt to operate "at cost" for its member-patrons, cooperatives can, and do, incur operating losses. As the viability of our agricultural economy has declined since the early and mid-1970's, the number and size of cooperative losses has risen to reflect this adjustment. As a result of this and other factors, the protected status of cooperative equity has suffered. At the federal level there are threats to force cooperatives to revolve old equity certificates. The pyramiding of equity through large regional federated affiliations exposes the pool of local member-injected capital to absorption beyond their direct control. Finally, cooperative members, themselves, have attempted to cash out their investment via offsets against their unpaid cooperative accounts. Bylaws, articles of incorporation and state statutes do little to guide the allocation of losses, or otherwise restrict the options available to a cooperative Board of Directors. Finally, questions of IRS treatment and a fair and equitable means for distribution losses arise. There are many questions and few answers; much fire, but little light. Cooperative researchers have little time and even fewer funds to search for answers. Yet search we must if our nation's cooperatives are going to cope with the environment of the 1980's and serve their membership well.

References

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Sincerely,

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