Equity Management

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The objective of equity management is to attract members, while keeping current members' needs satisfied. Equity management also has the daunting task of trying to maintain cooperative profitability while allowing for growth, all while adhering to the cooperative principles. Sound complicated? It certainly is!

What is Equity?

Equity is the net worth of the cooperative and it represents the members' ownership interest in the total assets of the cooperative. On the balance sheet, equity is the following:

Equity = Total Assets – Total Liabilities

Equity is the "cushion" fund that increases or decreases with the profitability of the cooperative. Due to the defining characteristics of the cooperative, this equity is held by its member users. It allows the membership to have more control and flexibility in determining how the cooperative is operated and financed.

Sources of Cooperative Equity

Cooperative equity can come from several different sources. The following are some common ways equity is acquired:

Retained Patronage

At the end of each year, a portion of a specific member's patronage to the cooperative is allocated to their account to be later redeemed, however, a portion of the patronage is retained. This is the basic way most cooperatives acquire equity.

Direct Investment

Many cooperatives require a membership fee to be paid by patrons. Another way this may be achieved is by requiring the purchase of one share of common stock in the cooperative; therefore a voting right is gained. Usually, this amount is a relatively small sum, making direct investment capital a small proportion of equity. Some value added cooperatives, however, depend upon a larger initial investment by members, in proportion to the amount of their cooperative use.

Profits Made From Non-Member Business

Cooperatives often do business with non-members, in addition to doing business with members. Profits made from business done with such non-members are retained as equity.

Per-Unit Capital Retains

Equity is gained in this way by deducting a small amount from the price paid for some thing or some service. The small amount is then retained as cooperative equity. This is most commonly used by marketing cooperatives where a small charge may be retained from the marketing of a unit of a certain commodity.

Role of Equity

Generally speaking, equity in a cooperative should account for about half of the cooperative's total assets. This amount varies, depending on the cooperative. A USDA survey of cooperatives shows, however, that the average percentage of assets accounted for by equity came to 43 percent.

Why is Equity Important?

Equity Maintaining Cooperative Principles

One major reason cooperative equity is important is that it maintains the key principle of member-ownership. It represents the members' investments in the cooperative and serves to protect that investment. If equity is managed effectively, the amount of equity a particular member has in the cooperative is directly proportional to their use of the cooperative. Because those who use the cooperative reap more of its benefits, it corresponds that they should contribute more equity. On the other hand, those who use the cooperative minimally should only be required to make a minimal investment.

Equity and Financing Debt

Another important role of equity is to improve financing debt. A cooperative's ratio of equity relative to its liability level affects their ability to obtain credit and the terms and condition of additional debt financing. An adequate amount of equity allows the cooperative to obtain lower interest rates and avoid restrictive loan covenants. In a broader sense, equity reduces the risk of the cooperative. A decision to finance additional assets with debt generates additional interest payments. If weather or other unforeseen events reduce the cooperative's income, the firm faces the risk of being unable to meet its fixed payments.

Equity Leads to Involved Members

Cooperative performance is strongly influenced by the activity and dedication of the membership. By contributing equity to the cooperative, a patron becomes a member, and with membership comes responsibilities. These responsibilities are taken more seriously if members are confident that their investment, or equity, is managed effectively. Some of the crucial control tasks members must perform with diligence are: electing a board of directors and approving by-laws. By maintaining equity, members will respond with a greater interest and stronger sense of purpose when convening on such decisions.

Types of Equity

There are two types of equity in cooperatives that must be managed; allocated and unallocated. Understanding the importance of each type to the working of the cooperative and finding the correct balance between the two is a key responsibility of equity management.

Allocated Equity

Allocated equity is equity that is recorded in the books that is allocated to a specific member in proportion to their cooperative use. A cooperative could have several categories of allocated member equity including membership stock, common stock, and equity credits. Membership stock corresponds to the initial investment that was required to join the cooperative. Membership stock is generally only redeemable for estates. Most cooperatives have transitioned away from stock certificates to a stock credit system where the balanced are tracked on the cooperative's books. This avoids lost stock certificates and other issues relating to physical stock certificates. A cooperative may also have more than one class of stock. Cooperatives involved in mergers often use stock classes to create separate redemption programs.

Unallocated Equity

Unallocated equity, also called unallocated reserves or permanent equity is capital that is not assigned to a specific member's account. It may come from many sources including earned net income, income from non-member business, subsidiaries organized as LLC's (Limited Liability Companies), or capital from random events such as the sale of assets. Most boards also allocate a portion of profits from member operations to unallocated equity.

The board must determine the amount of unallocated equity in the equity structure. Unallocated equity serves an important function as a "cushion" fund. If a cooperative had no unallocated equity it would be forced to write down the value of member stock in any year in which the firm showed a loss. Unallocated equity is also sometimes referred to as permanent capital since it does not have to be redeemed. One advantage of retaining profits in the form of unallocated equity is that it does not create additional pressures for equity redemption in future years. The disadvantage of channeling funds to unallocated equity is that members do not see an increase in their individual ownership. Unallocated equity is only distributed to members if a cooperative is dissolved. Channeling too large a portion of funds to unallocated equity reduces the member's sense of ownership in the cooperative. Extreme levels of unallocated equity may encourage members to dissolve the cooperative since their share of the cooperative's total equity far exceeds their allocated stock value.

Preferred Stock

Most cooperative by-laws allow for preferred stock. Preferred stock ownership is not limited to members and it does not convey voting privileges. Because of legal restrictions on cooperative dividends (8 percent in Oklahoma) there is typically little interest among investors in cooperative preferred stock. Some cooperatives have converted the equity of inactive members into preferred stock. In this case, the preferred stock does not pay dividends, but is redeemed under the same timing as the equity that was converted. The rationale for this conversion is to remove inactive members from the voting roles of the cooperative without impacting their financial position.

Developing an Equity Program

The equity program the board of directors decides to implement must have certain characteristics:

- o Create sufficient amount of equity for their cooperative.
- o Keep member equity investment as closely proportionate to use as possible.
- o Provide adequate cash returns to allow members the ability to handle the taxes on their allocated patronage.
- o Allow for sufficient returns on equity.

The Equity Management Process

Because of their unique structure, cooperatives face unique challenges in managing their equity structure. Unlike investor owned firms, the majority of cooperative equity comes from retained profits. Cooperative equity is also unique because it generally is not bought or sold, but rather it is redeemed at face value by the association. Because of this structure, a cooperative board must manage the cooperative's equity structure through decisions to return profits to members in the form of equity (creating additional equity) and decisions to redeem outstanding equity. An effective equity management process should involve the following steps:

1. Determine income generation.
2. Determine the proportion of income that will be retained as unallocated equity or distributed in the form of stock or equity credits.
3. Determine additional assets required.
4. Determine desired financial structure by computing the following:
   a. Debt/equity
   b. Working Capital
      (current assets – current liabilities)
5. Determine equity redemption budget.
6. Determine equity redemption program.

The critical point of this process is that the board of directors should actively manage their equity structure rather than let equity be the residual effect of decisions on asset purchases or a predetermined redemption process.

The Importance of Strategic Financial Planning

Strategic financial planning plays a key role in the effective equity management of a cooperative. There are two main goals of financial planning; identifying sources of capital and identifying uses of capital. This inflow and outflow of capital must be analyzed in order to determine the strategy for managing cooperative equity. Deciding the desired debt/equity ratio and the desired amount of working capital is an important step in determining the financial structure the cooperative will have.

Who Carries Out the Process?

Responsibilities of the Board of Directors

Because the board has the responsible for protecting the investment of the members, they have the great responsibility of establishing a policy on how to manage equity and keep watch over how the cooperative's management team is carrying out the accepted policies. In order to fulfill this task, they need at least a basic understanding of cooperative finance. Requesting and receiving periodic reports from the management team on the financial standing of the cooperative and the progress they are making toward achieving board-set goals is imperative. They must determine if the cooperative has sufficient equity funds invested in order to operative efficiently and develop a written policy that addresses all aspects of the equity management program, including equity retention as well as equity redemption guidelines.

Responsibilities of the Management Team

The management team carries out the equity retention and redemption decisions the board sets. The manager's ability to generate profits has an obvious impact on future equity management options. The management team also has important perspectives concerning the need to replace assets and the ability to service additional debt. The cooperative board and management team should work together to analyze the interrelated decisions involved in equity management.

Summary

The main objective of equity is to attract members while keeping current members' needs satisfied. Cooperative equity is important since it represents the members' investments in the cooperative. Of course, the cooperative performance is strongly influenced by the activity and dedication of the members. There must be enough equity to be used as a cushion for the cooperative, but not too much.

The Oklahoma Cooperative Extension Service
Bringing the University to You!

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; family and consumer sciences; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and research-based information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

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