Mis-describing Cooperative Equity

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I may call a meal dinner and you call it supper. We can say that is just semantics and its not important. However, if I fix a sandwich when you were expected a four course meal our terminology starts to become important. Descriptions of cooperative equity are full of semantic issues. We often label cooperative equity as "permanent" and "revolving". Permanent equity would include membership stock, preferred stock and unallocated equity. The first two categories are really "semi-permanent" since they are owned by an individual who must eventually convert it to cash. If the cooperative has a mechanism for selling preferred stock among members, then it could be truly permanent.

The term permanent equity becomes important when it starts effecting how we distribute profits. Some boards and managers express the concept about creating allocated equity because it is not "permanent". Instead, they advocate retaining profits as unallocated equity. There are two problems with that equation. First, the profits going into unallocated reserves are never distributed to the individual members. That profit allocation choice clearly reduces the members return from the cooperative. If the EPA passes a rule that was to reduce farmers' income by $1M most cooperatives would join in the fight to oppose it. A cooperative that has, over time, retained $1M of member profits as retained earnings has had the same impact on their farmers. Not only did the cooperative not oppose that impact, they created it!

The other issue is that all cooperative equity can be as permanent as we need it to be. Equity redemption is at the discretion of the board of directors. Ideally, they should practice balance sheet management and set the equity redemption budget consistent with their goals for working capital and leverage. A board that avoids creating allocated equity because they don't think they will have the discipline to manage it is acknowledging a deficiency in their processes. The terms "permanent" and "revolving" equity can be very useful in describing balance sheet structures. It's certainly true that the balance sheet of cooperative with a higher portion of "permanent" equity can more easily get away with poorly managed equity redemption process. Perhaps we should just put an asterisk beside the word "permanent" to remind ourselves that the revolving equity can be as permanent as we need it to be if we have disciplined equity redemption process.

Next week I will discuss another term that mis-describes equity.