MIs-describing Revolving Equity

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I discussed in my last newsletter that the words we use to describe cooperative equity matter when they begin to subtlety influence our decisions. The most blatant case is when we refer to revolving equity as “debt” or as a “liability”. That is obviously incorrect from an accounting standpoint. If revolving equity were debt most cooperatives would be highly leveraged. In extreme cases cooperatives can unilaterally write down the value of their allocated equity. A firm does not have that option with debt. The system of distributing a portion in the form of revolving equity is how members build ownership in the cooperative and how the cooperative creates equity.

In a general sense, issuing revolving equity does imply an eventually cash redemption. It is important to recognize the unique nature of our revolving equity. But when a cooperative creates unallocated equity solely because they want to avoid creating revolving equity they are doing the members a disservice. Equity redemption is at the discretion of the board, just like the setting the cash patronage rate for current earnings. The cash patronage distributed from current profits and the redemption of previously retained patronage are the vehicles by which members receive value from the cooperative. As owners, members are the residual claimant. They get the funds remaining after the expenses and the fixed commitments to the holders of the cooperative’s debt have been satisfied. Revolving equity is eventually redeemed for cash but the timing of that redemption, that is, the equity redemption budget, should reflect the cooperative financial position. The board should manage the balance sheet to maintain the desired level of working capital and leverage. All funds in excess of those needed to project the cooperative’s balance sheet should be distributed to members. When profits are high the cooperative should increase cash patronage and accelerate equity retirement. In unprofitable years there is obviously no cash patronage and the equity redemption cycle may have to be extended.

Cooperatives retain equity in order to generate the funds to invest in productive assets. Those assets create the future cash flows that should be available to redeem the equity. The only time a cooperative should be concerned about creating additional revolving equity is if it investing in nonproductive assets. The board is not creating “debt” when they create revolving equity. They are perpetuating a cycle where the members that use the cooperative contribute capital which is eventually returned. It is this system of revolving equity which helps to ensure that the members that are using the cooperative are helping to finance it, and that those who are transitioning out of farming (and cooperative use) have their equity returned.

Cooperatives don’t create debt when they create equity. They create equity when they create equity. Let’s not call revolving equity debt. Perhaps we should call it our revolving value package!

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