Equity Management
Inter-Cooperative Investments

NSAC TACC 2014
Pre-meeting Basic Accounting Seminar
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Learning Objectives
- Equity Management
  - Types of Cooperative Equity
  - Equity Redemption
- Inter-Cooperative Investments
  - Components
  - Balance Sheet Presentation
  - Timing and Recognition Issues
  - Income Statement Presentation
  - Footnote Disclosures
  - Impairment Questions
Equity Management

User Ownership & Control

- Cooperatives are owned and controlled by the people who use their services, not outside investors.
- This limits the attractiveness of co-op to outside investors, who can usually purchase only nonvoting interests (or loan money to).
- Equity accumulation is one of the major challenges facing cooperatives.

Stock Certificate, Aurora Elevator Company, Aurora, NE, 1908
Types of Cooperative Equity

Cooperatives accumulate equity from four sources:
1. Direct Investment
2. Retained Patronage Refunds
3. Per-unit Retains
4. Non-patronage Earnings

Direct Investment

- Cash purchase of membership certificate, common or preferred stock
- Necessary to capitalize new cooperative
- Nonmember investment in nonvoting stock
- When adding new members

Retained Patronage Refunds

- Earnings allocations to patrons, retained to capitalize the cooperative
- Primary method of building equity capital in most established, profitable cooperatives
### Patronage Refund Example

- If ABC Co-op earned $500 last year, and
- ABC Co-op did 8 percent of its business with Ms. Smith, then
- Ms. Smith is entitled to a patronage refund of $40 ($500 x .08)
- If ABC Co-op retains 70 percent of its patronage refunds, Ms. Smith receives $12 cash and $28 in equity in the co-op

### Per-Unit Capital Retains

- A portion of sales proceeds due patrons for product sold through the cooperative, retained to capitalize the cooperative
- Used by some marketing co-ops

### Per-Unit Retain Example

- If Mr. Jones is due $10,000 for product delivered this year, and
- ABC Co-op collects a per-unit retain of 3 percent of the sales proceeds, then
- Mr. Jones receives $9,700 cash and a per-unit retain allocation of $300 ($10,000 x .03)
Nonpatronage Income

- Incidental earnings from activities not directly related to business with or for patrons
- Usually placed in a tax-paid reserve

“Qualified” & “Nonqualified” Retains

- Retained patronage refunds and per-unit retains can be allocated to patrons in either “qualified” or “nonqualified” form
  - Qualified allocations transfer the Federal income tax liability for the value of the retain through to the patron when the allocation is distributed

- Non-qualified allocations are taxable to the cooperative until redeemed with a cash payment to the patron
Cooperatives regularly redeem for cash their retained patronage refunds and per-unit retains. This keeps the burden of financing the co-op on those currently using its services. The practice also further complicates the challenge of accumulating sufficient equity.

Cooperatives normally use one of three methods of managing their equity redemption program:

1. Systematic Revolving Cycle (oldest first)
2. Special Situations
3. Base Capital Plan

Most cooperatives using a revolving fund plan redeem the oldest retained equity first. Many cooperatives strive to redeem old equity on an annual basis. Equity accounts of established members are adjusted each year for additions of retained allocations and subtractions for old equity that is redeemed. Equity of former members is all redeemed over the life of the revolving cycle.
### Revolving Fund Calculation Example

<table>
<thead>
<tr>
<th>Year</th>
<th>Units Delivered</th>
<th>Refund Rate</th>
<th>Amount</th>
<th>Accumulative Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>4,000</td>
<td>0.06</td>
<td>$240</td>
<td>$240</td>
</tr>
<tr>
<td>2005</td>
<td>5,000</td>
<td>0.04</td>
<td>$200</td>
<td>$440</td>
</tr>
<tr>
<td>2006</td>
<td>6,000</td>
<td>0.05</td>
<td>$300</td>
<td>$740</td>
</tr>
<tr>
<td>2007</td>
<td>8,000</td>
<td>0.06</td>
<td>$480</td>
<td>$1,220</td>
</tr>
</tbody>
</table>

2007 Redemption 2004 Layer $(240) $980

### Equity Redemption: Special Plans

- A special plan is one in which a specific event or condition triggers equity redemption.
- The most common events are death, retirement, or reaching a certain age.
- Once the condition is verified, the member’s equity is returned at once or over a period of years.
- Under a special plan, the cooperative will add all retained equity to member accounts and then pay out whatever obligations are triggered by the occurrence of the event specified in the plan.

### Equity Redemption: Base Capital Plans

- Each year the Co-op board determines its total equity need.
- Each patron is assigned an equity contribution level based on that patron’s pro rata share of the total patronage business conducted by the co-op over a set number of the most recent years (the base period).
- Each year each patron’s contribution level is recomputed to reflect changes in the co-op’s equity needs and the patron’s share of patronage over the new base period.
Equity Redemption: Base Capital Plans

For example, a co-op board might determine:

- How much equity is needed: $1,000,000
- Base period: 5 years
- Unit for measuring patronage: tons delivered

- Assume patrons delivered 500,000 tons over the 5-year base period

To determine each patron's equity obligation:

- First calculate the equity share for each ton delivered:
  
  \[
  \frac{\text{Equity needed}}{\text{units delivered}} = \frac{1,000,000}{500,000} = \$2 \text{ / ton delivered}
  \]

- Then multiply the tons each patron delivered over the 5-year base period by $2.00

Under-invested patrons receive only a minimum cash patronage refund each year.

Patrons who have met or exceeded their investment obligation receive most, if not all, of their patronage refund in cash.

Former patrons' equity is returned over the length of the base period.
Introduction

- Background and Characteristics of Inter-Cooperative Investments
- Accounting and Disclosure Issues Related to Inter-Cooperative Investments
- Valuation Considerations of Inter-Cooperative Investments; Impairments
- Case Studies

Why Needed

- To Enhance Operations
  - As sources of supply
  - To provide markets for output
Why Needed

- To Enhance Operations
  - As sources of supply
  - To provide markets for output

- To Expand Scope
  - Vertical integration
  - Enter new lines of business

Components

- Direct Investment
- Retained Patronage Allocations

Balance Sheet Presentation

- Carrying Value
  - At Cost
Balance Sheet Presentation

- Carrying Value
  - At Cost
  - The Equity Method

Asset Classification
- Long-term
- Short-term

Timing & Recognition Issues

- Timing of recognizing patronage refunds
  - When notification is received?
  - When patronage occurs?
  - When refund is received?
Timing & Recognition Issues
- When to recognize non-qualified allocations

Income Statement Presentation
- Patronage refunds from other cooperatives
  - Netted to source?
  - Separate entry?

Footnote Disclosures
- Basis
  - At cost or equity method
  - Allocations received policy statement
  - Practicability exception
  - Table of material investments
Footnote Disclosures

- Ownership Percentage
  - Statement of underlying value
  - Statement of any impairments
  - Refunds received
  - Purchases of goods from

Footnote Disclosures

- SFAS 107 Disclosures
  - Fair value of financial instruments
  - Repeat of practicability exception

Impairment Questions

- Can the investor demonstrate that it is probable that the carrying amount of the investment is fully recoverable?
- Does the investee have unallocated losses that exceed unallocated equities?
Inter-Cooperative Investments

Case Study #1

A. Local Cooperative invests $1,000 in common stock of Regional Co-op
   ▶ Prepare Journal Entry on books of Local

B. Local Cooperative accrues $3,600 patronage estimate in Regional Cooperative at 12/31
   ▶ Prepare Journal Entry on books of Local

C. What is total Local investment in Regional at 12/31?

Suggested Solution

Case Study #1

A. Investment in Regional $1,000
   Cash - Local $1,000
   [To record initial investment of Local in Regional]

B. Investment in Regional $3,600
   Revenues - Local $3,600
   [To record accrual of estimated patronage dividend at Dec. 31, 2010]

C. Local Investment Account at December 31: $4,600

Inter-Cooperative Investments

Case Study #1

D. On or before 9/15 of the following year, Regional issues to local patronage income as follows
   Cash $ 750
   Qualified Written Notice 3,000
   Total Patronage $3,750
   ▶ Prepare Journal Entry on books of Local

E. What is the total Local Investment in Regional at 9/15?
Suggested Solution

Case Study #1

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Regional</td>
<td>$600</td>
</tr>
<tr>
<td>Revenues – Local</td>
<td>$150</td>
</tr>
</tbody>
</table>

To record patronage distributed by Regional in cash and adjust investment/revenue accounts for actual amounts.

E. Local Investment Account at September 15: $4,000

Inter-Cooperative Investments

Case Study #2

At December 31, MidState Milking Cooperative had an investment in Class “E” Stock, at cost, in CoBank totaling $5,340,000. In the following year, MidState completed the following transactions with CoBank:

A. Purchased Class “E” Stock quarterly equal to 10% of interest paid of $5,480,000.  
   ▶ Prepare Journal Entry on books of MidState

B. In January, MidState received notice of qualified patronage allocation of $390,000 from CoBank, which included the minimum qualifying amount in cash and the remainder in allocated equities.  
   ▶ Prepare Journal Entry on books of MidState

C. Calculate MidState investment in CoBank after above entries.

D. Determine interest expense to be reported in MidState’s reports.

Suggested Solution

Case Study #2

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in CoBank</td>
<td>$548,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$548,000</td>
</tr>
</tbody>
</table>

[To record quarterly purchase of Class “E” stock, 10% override]

B. Investment in CoBank  | $312,000    |
| Cash         | $ 78,000    |
| Interest Expense | $390,000    |

[To record patronage allocation: 20% cash / 80% qualified notices of allocation]
### Case Study #2

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>C. 20xx Balance</strong></td>
<td>$5,340,000</td>
</tr>
<tr>
<td>Purchase, at cost</td>
<td>548,000</td>
</tr>
<tr>
<td>Equities Received</td>
<td>312,000</td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
<td>$6,200,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>C. 20xx Interest Paid</strong></td>
<td>$5,480,000</td>
</tr>
<tr>
<td>20xx Patronage Received</td>
<td>390,000</td>
</tr>
<tr>
<td>20xx Interest Expense</td>
<td>$5,090,000</td>
</tr>
</tbody>
</table>

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**Equity Management Inter-Cooperative Investments**

**QUESTIONS**

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**NSAC Basic Co-op Accounting Course**

**END HOUR 2**

Enjoy a **10 minute** Break
Thank You for Participating

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