Understanding Cooperatives:

Base Capital Financing of Cooperatives

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Cooperatively owned and operated businesses face the constant challenge of obtaining sufficient equity capital to properly finance their organizations.

A responsive and impartial equity accumulation and redemption program is an important tool for helping cooperatives become and remain adequately capitalized. A well designed and operated base capital equity plan serves as just that kind of equity management tool.

What Is a Base Capital Plan?

A base capital plan is an effective financial management tool for cooperatives to use in achieving the appropriate level of equity, not only to capitalize the business, but also to balance member investment to make it proportional to use.

Through the systematic collection and repayment of member investment, a base capital plan provides a method for managing a cooperative's equity capital levels. By doing so, a member's investment in the cooperative is maintained in proportion to use, supporting the user-financed principle in the cooperative. Another principle, user-control, is also fulfilled.

Why a Base Capital Plan Is Different

In many cooperatives, the method used for getting equity capital doesn't necessarily relate directly to current capital needs. For example, if the primary source of equity is from retained patronage refunds, operating results decide the amount of capital available for the business to use in financing capital needs. Very little capital planning can take place until operating results are known at the end of the year.

Uncertainty can also occur if the cooperative is using a per-unit capital retain. The amount of capital generated can vary because the retain unit, usually based on physical volume of the product handled, can fluctuate widely.

With a base capital plan, however, the amount of equity capital needed is decided in advance by the board of directors based on careful financial planning. Then, the method for getting the needed capital is established, whether from direct member investment, per-unit capital retains, retained patronage refunds, or some combination of methods.

Equity redemption decisions are often just as inconsistent as in the capital-gathering phase because the amount approved for redemption is based on what is left over after other capital needs are met. This allows little flexibility in trying to fulfill the cooperative principles of user-controlled and user-financed.

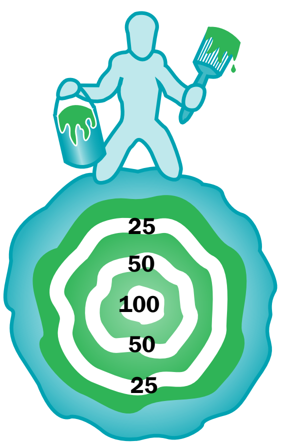
A base capital plan also brings better control to the equity redemption process. The redemption amount is included as part of the capital requirements identified in next year's financial plan. It is set up as a capital need right along with fixed asset purchases, long-term debt repayment, etc.

The financial planning required to make a base capital plan operate correctly is more involved than with other programs of equity accumulation and redemption. The result, however, is a better capitalized cooperative that has control of its financial future and can adjust its capital require-ments in a planned and logical fashion to meet changing needs.

How a Base Capital Plan Operates

Three elements are required for setting up and operating a base capital plan: (1) the base period, (2) the measurement unit, and (3) the current investment level.

The cooperative has set a financial target to meet its capital needs for the year and developed a program to achieve the desired results.



1. Base Period

An initial requirement is to establish a base period—the length of time over which a member's patronage or use of the cooperative is measured in relation to all other members. This provides the measurement base for finding out proportional owner-ship, financing, and control.

Base periods vary among cooperatives, but generally range from 1 to 10 years. A short base period (from 1 to 3 years) is effective in adjusting for rapid changes in levels of patronage. A longer period (from 8 to 10 years) can help smooth out year-to-year swings in patronage levels. A 1991 survey showed the average base period for agricultural cooperatives with base capital plans was 7 years.

2. Measurement Unit

Another tool in determining proportional membership investment levels is the measurement unit. It is used with the base period to quantify the patronage level of each member in relation to all others. Measurement units, like base periods, will vary with the type of cooperative and commodities handled or services offered.

The measurement unit can be a physical unit of product supplied or marketed, or it can be a percentage of the value of the product. The important factor for a measurement unit is that it represents a common denominator that applies to each member's use of the cooperative.

For example, in a fruit and vegetable processing operation, the measurement unit maybe a ton of product delivered, such as with tomatoes or peaches. In a dairy cooperative, the measurement unit is generally a hundredweight (cwt.) of milk. If a product is fresh-marketed, the physical unit is often the packed carton, as with oranges. A physical unit is easy to use and understand.

Supply and service cooperatives can also use a per-unit capital retain based on a physical unit of product sold to its members, such as a ton of feed or fertilizer.

The percentage of value method is a little more complicated, but has an advantage over the physical unit of measurement. A set percentage is applied to the price of the product for each year in the base period to find out the proportional value of a member's use of the cooperative during the base period. This method takes into account the possibility that higher commodity values require more equity to support them.

3. Current Investment Level

Once the measurement unit and the base period are decided, the cooperative has the means to calculate the equity investment level that each member must have to satisfy the proportional ownership (financing obligation) requirement. This is compared to the member's current capital investment in the cooperative. This identifies which members are over-invested and which ones are under-invested in terms of capitalizing the cooperative according to use. From this information, a program can be developed to equalize each member's investment according to use. These adjustments, depending on how large the disparity is between members, may take several years to accomplish. This length of time may be necessary to avoid placing too large a financial burden on any single member at any one point in time.

Table 1 shows possible disparities and what adjustments in capital levels must be made to correct them. A 5-year base period is used for the example and shows that three members are under-invested (A, D, and E) and two members are over-invested (B and C). If members A, D, and E contribute the amount of capital they are under-invested, this provides the funds needed to repay the over-invested members who would then be brought down to a fully invested level. At that point, equity capital is equalized and each member is capitalizing the cooperative in proportion to use.

Implementing a Base Capital Plan

With the base period established, the measurement unit identified, and proportionality of investment decided, the cooperative now has the fundamental tools to set up and operate a base capital plan.

Determining Equity Capital Needs

As part of its annual financial plan, a cooperative should identify its capital requirements for the coming operating year. Begin by projecting the ending net worth level for the current fiscal year. Next, estimate the capital resources to be generated in the coming year. This includes estimates of patronage and nonpatronage income to be retained, per-unit capital retain amounts, and/or other miscellaneous sources of equity capital. Capital outlays should be identified next, including fixed asset purchases, long-term debt payments, and any special circumstances under which equity is redeemed separate from the base capital plan. When this information is known, the amount of additional capital needed for the coming year is established.

Required Levels of Investment

Next, recalculate each member's required investment level based on the coming fiscal year's capital needs. Each member is notified of this obligation and the method for making the adjustment. If a member is already over-invested, no additional equity investment may be required for the coming year, or the member may be entitled to a repayment of capital.

For the under-invested member, the situation is quite different. If the required investment shortfall is small, the cooperative's planned patronage retain or per-unit capital retain for the coming year may be sufficient to satisfy the new requirement. If not, the member may have capital retained at a higher rate than the member who is closer to being fully invested, or be asked to make a direct cash investment to achieve parity.

The different methods used by cooperatives to adjust capital levels for over- and under-invested members are quite diverse and beyond the scope of this publication. Each base capital plan, while containing the elements discussed, becomes a customized capital plan for the cooperative. Most base capital plans get modified from time to time to fine-tune the plan for the benefit of the membership and the cooperative. Dramatic changes in capital needs may also require significant modifications.

Advantages and Disadvantages

As with any capital program, base capital plans have advantages and disadvantages. Most often, the advantages outweigh the disadvantages compared with using other types of capitalization programs.

Advantages

- Links a member's investment in the cooperative directly to use, and provides a mechanism for maintaining that relationship.
- Keeps ownership and control of the cooperative in the hands of current users, and in proportion to that use.
- Permits the cooperative to systematically adjust capital up or down to meet changing equity capital needs.
- Members view their investment as a true

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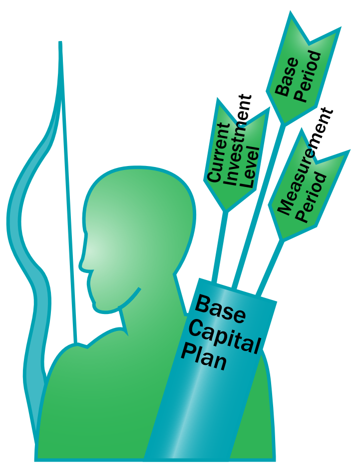
Table 1 - Example of current equity investment level compared with base period usage of cooperative, 5-year patronage base period

	Allocated equity investment level		Average 5-year base period patronage	Amount over (+) or under (-) invested	
Member	**Total dollars**	**Percent of total**	**Percent of total patronage**	**Percent**	**Dollars**
A	10,000	10	15	-5	-5,000
B	30,000	30	25	+5	+5,000
C	35,000	35	20	+15	+15,000
D	20,000	20	30	-10	-10,000
E	5,000	5	10	-5	-5,000
Total	100,000	100	100	0	0



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investment compared with money withheld from sales proceeds or from patronage refunds that may or may not be redeemed on a timely basis.

◆ Requires the board and management to do a careful job of budgeting and financial planning at least annually. Although smaller cooperatives may not have the expertise or resources to develop detailed financial plans, some effort is necessary to decide capital needs and set investment levels for the coming fiscal period.

◆ Permits the board and management to proactively manage the cooperative's capital.

◆ Permits a member who is phasing down operations or withdrawing from membership to have equity returned over a reasonable period.

Disadvantages

◆ Initial capital investment requirements can financially burden new members. This may act as a barrier to membership, but programs can be designed to allow new members to achieve required investment levels on an installment basis over a multiple-year period.

◆ The plan does not work well if there is a constant and large membership turnover because it strains the cooperative's ability to accumulate sufficient capital reasonably and dependably.

◆ A base capital plan can be harder to understand when compared with more traditional capital programs such as the revolving fund method. This complexity should not be viewed as an obstacle to adopting a base capital plan, because it can be overcome with effective and ongoing education and communication programs.

Conclusion

Base capital financing provides cooperatives with a flexible and effective financial management tool. Members provide capital according to use to ensure that ownership and control are kept in the hands of current users.

Base capital plans are more complex to administer than more common equity programs, but their advantages as a complete equity management program far outweigh the disadvantages.

More cooperatives should seriously consider adopting a base capital plan. An in-depth study should be conducted to decide how a base capital plan might operate and what benefits it would provide in financing and capitalizing the cooperative.

Cooperatives interested in exploring the possibility of using a base capital plan can obtain assistance from several sources: the cooperative's accounting firm, financial consultants specializing in cooperatives, and university extension specialists. The Cooperative Services program, of USDA's Rural Business-Cooperative Service, has publications available on the subject, and can provide technical assistance on the many considerations that go into developing a base capital plan. ■

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