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# FINANCING COOPERATIVES WITH REVOLVING FUNDS



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# Financing Cooperatives With Revolving Funds

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## Introduction

**W**HY ARE revolving funds to be preferred to the more usual business methods of borrowing or of selling stock certificates? This publication tries to answer this question by discussing the nature of capitalization of cooperatives, describing how revolving funds work, and pointing out some of the advantages and disadvantages of this method of financing.

A cooperative differs from other businesses in the purpose of the organization and in the way it keeps its books of record and distributes the patron's savings. In the usual types of business we find the organization is operated for the profit of owners, who are not important patrons of the business. The cooperative on the other hand, is operated to increase the profit of the patrons of the business, who are also its owners.

### Principles of Cooperation

The principles of formal cooperation may be broadly stated as democratic control by the patron-owners, limited returns to capital, and savings to the individual de-

termined by the volume of his patronage of the business. Patrons must own and control the organization if they are to get the savings. The usual method of gaining and maintaining control is to allow one vote per member regardless of the size of his investment or the number of shares of stock he owns and by limiting the returns on stock to a nominal amount. The limitation on the returns to invested capital is recognized by both state and federal laws.

### Cooperative Savings

Since savings are normally distributed on the basis of patronage, they are commonly called patronage refunds. The term patronage dividends, as sometimes used, is misleading, because it is not a true dividend (return to capital). Nor is it in a strict sense a "refund" but this term is in common usage and we will use it here.

There are innumerable methods of settling with patrons, depending upon many things. Some cooperatives operate on an outright pur-

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chase basis, buying the produce from the farmer and adjusting the price later. Others operate on a pooling arrangement as agent for the farmer, giving him a partial payment at the time of delivery and the rest of the proceeds-minus-expenses when the product is sold or at the end of the year. They may pay (or charge) just enough to cover costs of operations, or charge (or pay) the going price and return any savings. In a few cases they may undercharge (or overpay) and make assessments for shortages. The normal method appears to be to operate at competitive prices. This has the additional advantage over the others of giving the firm some operating capital during peak periods.

### **Members Share In Earnings**

Members of the cooperative usually share in the earnings in proportion to the volume of business they do with it. It is only reasonable that a farmer who markets 10,000 bushels of grain with his cooperative should expect to get back ten times as much in patronage refunds as his neighbor who sells only 1,000 bushels through it. Since, in many cases, the amount of capital stock that each holds is the same, the only way the difference in refunds can show up is for refunds to be based on this difference in trading volume.

### **Cooperative Financing and Members Savings**

The limited dividends on capital stock have another effect which is not intended—they make it hard for the cooperative to secure equity

capital to finance business operations and to expand. Most farmers do not have money to put into another business. The voting stock cannot usually be sold to nonfarmers and the sale of preferred, non-voting stock is often rather limited. Few nonfarmers are willing to invest money on which the maximum return is limited and with no "say" in the operations of the business.

The sale of bonds is also disadvantageous at times, and in many instances, an unreliable source of operating capital. Even if the money obtained is invested productively, nonmembers may be reluctant to purchase the bonds because of the unusual capital structure of the cooperative. The equity portions of the balance sheet are often quite different from those of the usual business corporation and may cause outsiders to consider the organization financially unsound.

But money they must have if cooperatives are to operate effectively. It is a big job to educate the patrons as to the necessity for it. An even greater task involves the question of how to obtain the money from the owner-patrons and at the same time to retain the basic principles of cooperation. The most common method of financing has been by withholding part of the members' savings.

### **Retaining Funds**

How best can a cooperative retain the funds required for operations and treat the individual members equitably? The conditions required might be stated as: (1.) The amount that is withheld from the member should bear a relation

to the use he makes of the cooperative, (2) it should eventually be returned to him, (3) control of the association should remain in the hands of the active members, (4) the funds should not be kept without allocation to the patrons, (5) the funds available to the organization should bear some relation to its volume of business, (6) the funds should be relatively stable and dependable.

Savings are retained by several methods. Many cooperatives withhold some or all of the refunds of the farmer, giving him some type of credit for this amount retained in the business; some cooperatives keep back a portion of total earnings without allocating them to the patrons. A common method has been to use "product retains" in which a given amount per item is "charged" each patron when he

buys or sells through the cooperative. This is an advantage in impressing on the patron his responsibility in financing his association.

### **The Problem**

"It takes money to make money."

This oft-made remark seems to be an appropriate one with which to begin a discussion of financing. It has a great amount of truth to it, but many farmers do not seem to grasp its significance when it is applied to middlemen's fields of operations.

Cooperatives, as already mentioned, have some unusual problems in obtaining increased funds as the business expands. Many cooperatives have turned to the "revolving fund" method of providing assets for use in performing their functions.

## **Revolving Funds—What They Are**

### **Keeps Turning Over**

As its name implies, a revolving fund is one that keeps turning over. It picks up new funds each year and pays out retiring ones. Perhaps a more accurate way to look at it would be that the owners of the funds are being revolved. If the funds were always of the same amounts from the same patrons year after year, there would be little need for the fund to revolve. It is needed because some patrons leave and others join, while still others change their volume of transactions from year to year.

The rotating or revolving fund system makes new members and nonmembers who are using the cooperative (but have not contributed much in the past) bear a share of the burden of financing. If the investment is proportionate for all patrons no interest or dividends need to be paid, while the association gets working capital on an installment basis. The system is flexible and well suited to the cooperative method of doing business. Investments are in proportion to the use made of the organization. Active patrons carry most of

**Table 1. How Revolving Funds Work**

Year	Amount retained	Amount returned	Amount in fund
1	\$1,000	\$	\$1,000
2	1,000	\$	2,000
3	1,000	\$	3,000
4	1,000	\$1,000 for year 1	3,000
5	1,000	1,000 for year 2	3,000
6	1,100	1,000 for year 3	3,100
7	1,100	1,000 for year 4	3,200
8	1,100	1,000 for year 5	3,300
9	1,100	1,100 for year 6	3,300
10	1,100	1,100 for year 7	3,300
11	1,200	1,100 for year 8	3,400
12	1,300	1,100 for year 9	3,600
13	1,400	1,100 for year 10	3,900
14	1,500	1,200 for year 11	4,200
15	1,400	1,300 for year 12	4,300
16	1,300	1,400 for year 13	4,200

the load and voting control is facilitated.

**Concern of Management**

The management must be concerned with two things in the use of revolving funds—the rate of withholdings and the length of time withheld. The rate of withholdings must be limited to not more than 100% of the patron’s savings and, to be competitive with other businesses and to hold patrons, probably should be somewhat less than 100%, at least in the early years. The length of time involved should not be too long or the farmer will begin to feel that he will “never get the money anyway.”

Table 1. illustrates how these funds work.

Of the amount withheld in year 1, nothing is returned that year. This continues each year until the fund builds up to desired size. In the fund as illustrated in table 1, the “retains” of year 1 are paid back at the end of the fourth year.

In year 6 in the illustration, the size of the fund was increased. Over the next 3 years the fund was built up to the desired level. In year 11 the fund was increased, possibly to go along with rising earnings and rising volume and the need for more working capital. If the \$1,300 rate of retains is maintained in the next few years, the fund will decline by \$200 in the 17th year, \$100 in the 18th year, and in the 19th year stabilize, at \$3,900.

# Revolving Funds—What They Are Not

## Shorter Time Period

It might be best to start the fund with a shorter time period and then increase it in later years when some refunds can be paid. This was also illustrated in table 1. In this instance the size of the fund was enlarged by increasing retains after repayments were being made. Another method might have been to put the fund on a longer basis by retaining \$1,000 in the 4th year and paying out nothing. Or, by increasing the retains earlier, some refunds could be made while still increasing the size of the fund.

On the other hand there are some things that management must watch for if the plan is to succeed. The members must be kept fully informed as to how the system operates and the need for it. If investments are not in line with the use made of the facilities, interest should be paid on them.

## Interest Reduces Savings

However, interest cost reduces the savings available for the use of the cooperative and thereby weakens the loyalty of the members. If the total yearly savings of the business are retained, the fund may vary considerably from year to year, working somewhat counter to

requirements. During periods of inflation or deflation the system may not operate perfectly. When prices are rising the management finds itself in need of expanded outlays for inventory and this will likely cut into the amounts that can be repaid. Here the management should see that the patrons are well informed as to the necessity of the increased funds. If prices are falling, the cooperative may find itself with excess working capital.

## Other Disadvantages

Other disadvantages of a revolving fund system sometimes noted are: (1) it may lead to undue expansion of the cooperative because of the relative ease of getting the money, (2) it adds to the accounting tasks of the association, (3) farmers may have to pay tax on such "refunds" but get no money, (4) farmers want due dates on them, a requirement which the association may find difficult in meeting, (5) new patrons get no refunds for a number of years, quite often when they need them most. These are not insurmountable difficulties but do indicate that revolving funds are not a full solution to the problem of equity financing.

# Revolving Funds and Income Taxes

It appears that in the normal operation of a true cooperative, the organization has no income or profits in the usual sense of the words. They have only "savings" to the patrons.

It is important, however, to keep in mind the difference in the methods of capitalization and operation of cooperatives when considering the tax treatment. A cooperative may be thought of as a part of the investment a farmer has in his farm—a sort of department of his operations.

## Must Meet Conditions

Taxwise, any business may exclude from its gross income for tax purposes patronage refunds paid to patrons if they meet these conditions—the distribution must be legally binding on the business and in existence before the transaction took place; and if paid only to members, only that portion can be excluded which does not represent profits from transactions with non-members.

This has been a Treasury policy since 1914 and in 1954 was written into the Internal Revenue Code. In order to constitute a patronage refund, the payment must be made from the patronage of the individual to whom it is being made; it is immaterial whether the refund is in cash, credit notices, certificates of indebtedness, letters of advice, or stock.

## Tax Exclusions

Section 522 (b) of the 1954 Code allows these exclusions from gross income specifically if paid or allocated and disclosed to each patron within 8½ months after the close of the tax year. But it adds that these must be included in the farmer's income at face value (because they represent a reduction of his actual expense or an increase in the selling price of his produce). Those amounts that are retained and not allocated to patrons on the basis of their patronage are taxed to the cooperative.

# Conclusions

It appears that the cooperative should make very clear in its by-laws how the revolving fund is to function, the interest, if any, that is to be paid on it, the part the directors are to play in determining its length, and under what condi-

tions payments should be skipped or delayed.

## Capital Investment

Further care should be taken to see that the fund is considered as capital investment. While the fund

is in the form of "near-debt," putting a due date on retains apparently makes them a legal debt of the corporation to the holders of the certificates and the cooperative can be sued for nonpayment as with any other debt.

Since these funds are retained from the members of the organization and the members should expect to finance their own organization, other creditors should not be placed in jeopardy by allowing such funds to compete with them in case of bankruptcy or just because one of the owner-patrons

wants his money and forces the company to pay off at an inopportune time.

#### **Members Should Know Facts**

Above all, members should be kept fully informed as to how the fund operates and the necessity for it.

In conclusion, the revolving fund appears to be the best means yet devised to obtain needed operating capital for cooperatives. If it is carefully planned and operated there need be only a minimum of friction, misunderstanding, and inequitable treatment.

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**For a more complete discussion of Cooperative Financing, see South Dakota State College Agricultural Experiment Station Bulletin 434, February 1954.**

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