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The Increasing Use of Unallocated Retained Earnings by Farmer Cooperatives

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Market Report	Yr Ago	4 Wks Ago	3/9/12
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	$119.00	$123.09	$129.25
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.. . . .	152.46	187.92	184.17
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	130.05	155.95	155.93
Choice Boxed Beef, 600-750 lb. Carcass.	177.34	185.98	196.65
Western Corn Belt Base Hog Price Carcass, Negotiated.	79.98	84.93	84.98
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean..	91.06	85.12	84.55
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct..	180.50	147.13	145.00
National Carcass Lamb Cutout, FOB.	377.76	383.21	377.61
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu..	6.69	6.10	6.07
Corn, No. 2, Yellow Nebraska City, bu.	6.29	*	6.38
Soybeans, No. 1, Yellow Nebraska City, bu.	13.09	*	12.92
Grain Sorghum, No. 2, Yellow Dorchester, cwt..	10.52	10.89	11.00
Oats, No. 2, Heavy Minneapolis, MN , bu.	3.41	3.43	3.15
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton..	140.00	250.00	225.00
Alfalfa, Large Rounds, Good Platte Valley, ton..	72.50	145.00	145.00
Grass Hay, Large Rounds, Good Nebraska, ton..	*	100.00	100.00
Dried Distillers Grains, 10% Moisture, Nebraska Average.	191.00	201.00	220.00
Wet Distillers Grains, 65-70% Moisture, Nebraska Average.	70.50	74.63	76.00
***No Market**			

In the past, the primary source of equity capital in U.S. farmer cooperatives has been retained patronage refunds. Typically, a cooperative would allocate its net earnings to individual members on the basis of patronage and retain a share of those allocations to provide equity until eventually redeeming it in cash. Over time, however, unallocated retained earnings have become an increasingly important source of equity. In fact, in 2008, cooperatives kept a greater proportion of their net earnings as unallocated retained earnings than as retained patronage refunds, according to the most recent U.S. Department of Agriculture (USDA) financial profile of farmer cooperatives.[1]

Unallocated retained earnings are earnings that a cooperative retains but does not allocate to individual members. A major source of unallocated retained earnings is nonpatronage-source income, which is incidental income not directly related to the marketing, supply, or service activities of a cooperative. It can include rents received, investment revenues, gains on the sale or exchange of depreciable property and capital assets, and amounts from business done with the federal government. Another

[1] All data cited in this article are contained in the three most recent USDA financial profile studies: E. Eldon Eversull, *Cooperative Financial Profile, 2008,* Research Report 222, Rural Development, U.S. Department of Agriculture, Washington, D.C., June 2011; Robert C. Rathbone and Roger A. Wissman, *Farmer Cooperatives' Financial Profile, 1997,* Research Report 178, Rural Business-Cooperative Service, U.S. Department of Agriculture, Washington, D.C., April 2000; and Jeffrey S. Royer, Roger A. Wissman, and Charles A. Kraenzle, *Farmer Cooperatives' Financial Profile, 1987,* Research Report 91, Agricultural Cooperative Service, U.S. Department of Agriculture, Washington, D.C., September 1990. See: http://www.rurdev.usda.gov/rbs/pub/research.htm

important source of unallocated retained earnings is earnings from business done with or for nonmembers but not distributed to them. A cooperative also may retain earnings from member business in unallocated form.

How a cooperative handles nonpatronage-source income and earnings from nonmember business depends on its tax status. A cooperative that qualifies for tax treatment under section 521 of the Internal Revenue Code can exclude nonpatronage income distributed to patrons on a patronage basis from its taxable income. However, to qualify for section 521 tax status, the cooperative must treat nonmembers in the same manner as members with respect to all business transactions, including the allocation of patronage refunds. It also faces restrictions on the volume of its nonmember business and the size of its unallocated reserves. Because cooperatives without section 521 tax status cannot distribute nonpatronage-source income as deductible patronage refunds, many retain nonpatronage income remaining after tax as unallocated equity.

As shown in Figure 1, the proportion of cooperative equity held in unallocated form increased steadily from 1962 to 2008, the year of the most recent USDA financial profile study. In 2008, 36.2 percent of cooperative equity was held in unallocated form, more than three times the 11.8 percent held as unallocated equity in 1962. During the same period, the proportion of cooperative net earnings retained as unallocated earnings also increased substantially. In 2008, cooperatives retained 31.8 percent of their net earnings as unallocated earnings, more than eight times as much as in 1962, when they retained only 3.8 percent of their earnings in unallocated form.

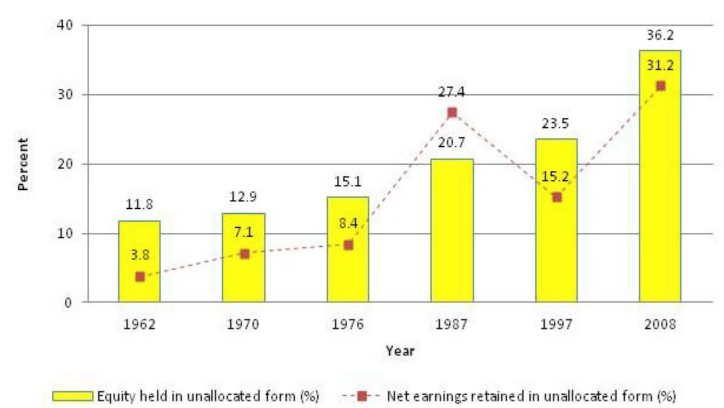

Figure 1. The Increasing Importance of Unallocated Retained Earnings

The increasing use of unallocated retained earnings is attributable in part to rising nonpatronage and nonmember income. For instance, cooperatives operating convenience stores or selling lawn and garden supplies near suburban communities have experienced considerable growth in nonmember business in recent years. In addition to providing an increased source of unallocated equity, the rise in nonmember business has led many of those cooperatives to abandon their section 521 tax status to avoid the restrictions on nonmember business and unallocated reserves.

The share of net earnings retained in unallocated form was especially large in 1987 and 2008. The size of those retentions can be understood in the context of significant operating losses incurred in the early 1980s and 2000s. Many cooperatives with losses wrote them off against unallocated equity reserves because of a reluctance to burden members directly with the losses when they also were facing financial difficulties. The higher level of net earnings retained as unallocated earnings in 1987 and 2008 reflects an effort by cooperatives to rebuild those reserves. However, the continued increase in the proportion of equity capital held in unallocated form suggests that cooperatives may have built up unallocated reserves beyond previous levels in anticipation of future losses.

Some cooperative experts have argued that cooperatives should consider replacing revolving funds consisting of retained patronage refunds with permanent unallocated equity. They maintain that the obligation of cooperatives to redeem allocated equity disadvantages them relative to corporations that can accumulate retained earnings without such an obligation. For example, because there is no expressed or implied call on unallocated equity, it can be used to acquire more leverage than allocated patronage refunds.

Other experts contend that the assignment of substantial amounts of net earnings to unallocated reserves represents a divergence from operating on a cooperative basis and a violation of the cooperative principle of operation at cost. To the extent that allocated equity is replaced by unallocated reserves, members no longer have a financial interest in the cooperative as an ongoing business concern, thus threatening member loyalty and control. Members may become less interested in decision making, leaving management too much discretion in making key decisions.

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