Center for Cooperatives
Working Paper Series No. 11

Ownership, Financial Instruments, and Control of U.S. and Selected European Cooperatives

Mahlon Lang
Independent Research and Consulting
Davis, CA
Former Director
Center for Cooperatives

Rick Castanias
Associate Professor
Graduate School of Management
University of California, Davis

Mike Cook
Professor
Department of Agricultural Economics
University of Missouri, Columbia

University of California Center for Cooperatives

March 2001

This report was prepared under terms of a contract between the Center for Cooperatives and the Accounting and Auditing Committee of the National Society of Accountants for Cooperatives (NSAC). NSAC was supported by the following organizations: Blue Diamond Growers, Cooperative Resources International, Farmland Industries, GROWMARK Inc., Southern States Cooperative, Sunkist Growers, Sun-Maid Growers, Sunsweet Growers, and Welch's.

Printed in the United States of America

Center for Cooperatives

One Shields Avenue

University of California

Davis, California 95616

Web site: http://cooperatives.ucdavis.edu

E-mail: centerforcoops@ucdavis.edu

Contents

Ownership, Financial Instruments, and Control of U.S. and Selected European Cooperatives

Introduction

Recently, there has been increased interest among U.S. agricultural cooperatives in comparing their characteristics with those of other countries, particularly European countries. This interest is readily explained by the opening of markets and increased global competition. While sharing root principles, cooperatives in major industrial countries had little else in common until the last decade. Previously, European cooperatives were the beneficiaries of favorable institutional treatment and, to some degree, the tools of national food and rural social policies. During the same period many U.S. cooperatives lagged in institutional support and market share.

But that is changing. Cooperative experts in the European Union (EU) now speak of the need for permanent, long-term at-risk capital to support value-adding investment, horizontal expansion of distribution systems, and size-driven economies of scale — all in the name of making a market for the members' production. The realization in the early '90s that the Common Market would lower long-cherished and still popular national agricultural trade barriers has led to frenzied mergers and restructuring among European cooperatives.

Most recently, this restructuring movement led to the planned merger of two of the world's largest dairy cooperatives, MD Foods (Denmark) and Arla (Sweden). This would be one of the largest agricultural cooperatives outside of North America. It would constitute a well-financed, internationally experienced cooperative capable of extending its marketing and joint-venture efforts to virtually any market in the world — and making a market for members' products as it does so.

Background and Objectives

In response to globalization affecting virtually all industries, accounting professionals have begun to compare international accounting standards. In particular, they are interested in the possible convergence of accounting standards in Europe (IASC), Canada (AcSB) and the United States (FASB).

The interest of the National Society of Accountants for Cooperatives in the subject is clear. Its members wish to evaluate the impact of proposed changes in accounting standards and to stimulate new relationships among cooperatives in different countries. If they are to do so, accounting professionals in the United States need to understand how cooperatives are financed and controlled in the EU. Indeed, the cooperatives for and with which these professionals work have increasingly close working relationships with cooperatives in the EU. As they explore those relationships, they ask:

- How do cooperatives in the United States and Europe differ in sources of long-term capital, especially equity?
- How do those cooperatives compare in control and governance?
- How do financial specialists and lenders, tax specialists, economists and financial standards setters perceive these differences?
- How do these differences affect their competitiveness in international markets?

With these questions in mind, the following specific objectives were adopted and pursued in this research. The objectives were:

- to identify and compare the principal sources of long-term capital for agricultural cooperatives in the United States and the EU;
- to identify trends associated with alternative approaches to cooperative finance;
- to compare governance structures and trends for cooperatives on both continents;
- to assess the implications of these differences as viewed by financial specialists and lenders, tax specialists, economists, and financial standard setters;
- to identify research needed to fully respond to questions raised in this project.

As regards the final objective, we recognized from the outset that the subject matter of this research is far more expansive than the scope of the supporting grant. Therefore, the identification of additional needed research is also a principal objective.

Approach

To achieve these objectives, we have drawn upon financial statements of the larger cooperatives in the EU and the United States, upon web sites supported by those cooperatives, and upon published literature cited below. An important source of early guidance was Dr. Onno-Frank Van Bekkum of the Netherlands Institute of Cooperative Entrepreneurship. Dr. Van Bekkum, who has written extensively on European agricultural cooperatives, was in the midst of completing research on adjustments by cooperatives to a changing EU. He was helpful in identifying issues and approaches to finance by European cooperatives.

While studying the capital sourcing and control issues listed above, we also examined the policy and competitive environments in which EU and U.S. cooperatives operate. Clearly, the policy environments as defined by the legal, tax and other public policy variables, along with economic, institutional, and historical differences, shape the differences among cooperatives. As we will see, the backgrounds against which EU and U.S. cooperatives evolved differed significantly throughout most of the past century. Today, however, cooperatives on both continents face similar competitive environments. The same forces of competition and internationalization shape the future of both the EU and the United States. Increasingly, they test the original and intended impacts of individual national policies.

In this research report, we describe and compare the approaches to finance and governance of cooperatives in the EU and the United States. We first examine European cooperatives, followed by U.S. cooperatives. We then make explicit comparisons between cooperatives on each continent.

While there is some basis for generalizing about how cooperatives in each area operate, we have more information about some countries and their cooperatives than about others. As a result, our commentary on European cooperatives is a list of tentative findings that might be characterized as informed hypotheses about cooperatives in the EU. In brief, we found evidence to support generalizations, but did not, given the scope of this research, find sufficient information to describe these tentative findings as conclusions. Hence, we have classified this document as a working paper.

European Cooperatives

Overview

European cooperatives were founded on similar principles and for similar purposes as U.S. cooperatives. Like U.S. cooperatives, those in the EU are currently evolving in ways that alter the historical application of those principles. Horizontal growth to achieve economies and vertical integration to add value are fast-paced in Europe and in the United States. Aggressive efforts to penetrate non-traditional markets and to conduct more nonmember business are more common than in the past. And many cooperatives are experimenting with nontraditional sources of long-term financing, including both member and nonmember stock issued solely for investment (rather than patronage) purposes. As cooperatives do so, the organizational distance of their members from operations changes, as do the incentives to draw risk capital to support growth.

This study did not identify all institutional and policy variables affecting cooperative control and finance. It did, however, produce sufficient information to generalize about the institutional and policy environments in which European cooperatives operate. By definition, the generalizations are broadly applicable, but don't necessarily apply to individual countries.

Institutional and Legal Environment: Financial management and governance practices of cooperatives are shaped in part by cooperative bylaws. These, in turn, are shaped by national cooperative and corporate laws that may establish guidelines on voting, transfer of ownership, the distribution of earnings and other cooperative practices.

Policy Environment: The structure and financial practices of cooperatives in the EU also have been shaped by public policy toward agriculture in general and cooperatives in particular. Price supports, protective trade policies, favorable tax treatment and policies generally supportive of cooperatives are principal components of the policy environment in Europe.

Similarities among public policies toward cooperatives are common throughout Europe and justify some generalizations, but an exhaustive study of tax, price and trade policies is not a part of this work. Further research to detail relevant policies on a country-by-country basis would be required to explain in detail how cooperatives in each country evolved.

But historical public policies toward cooperatives and agriculture can be expected to change. The emergence of the European Union (EU) as a "level playing field" for all EU businesses makes some changes inevitable. Previously protected national "monopolies" have given way to competition among EU cooperatives. These changes, along with new public policies and the globalization of markets in general, have led European cooperatives to seek and find profitable markets for direct sales and for marketing joint ventures with cooperatives and for-profit companies outside of the EU. Against this background, we examine the emergence of new organizational and financial structures of European cooperatives.

Organizational and Legal Structure

Agricultural marketing and supply cooperatives in Europe are more than 100 years old. Before World War II most agricultural markets in Europe were highly localized.[1] Public policies toward these cooperatives have been based on a general concern that corporate or extra-regional interests should not exploit farmers and agricultural markets. Price supports and marketing boards reflective of the interests of farmers were common.

The "Ordinary" Cooperative

The building block of the historic European cooperative is a local, highly- specialized cooperative. Founded according to the principles of member ownership, benefit, and control, they conduct little or no nonmember business, and readily return untaxed patronage-based earnings to members. In some countries (e.g. France, Germany and the Netherlands), ordinary cooperatives are chartered under special cooperative laws. In others, like Denmark, they have no legal distinction from other business enterprises.

A widely applied variation of the "ordinary" cooperative is the "Raiffeisen" cooperative named for Friedrich Wilhelm Raiffeisen, who founded a cooperative banking system in 1886. The Raiffeisen principles called for member control and benefit, with one vote per member, open entry conditions (often with restrictive limits for location and crop), a one-time membership fee, and return of capital upon exit from the cooperative. This is the model for "ordinary" cooperatives in Germany, Austria, Switzerland, and other European countries.

Cooperatives founded on Raiffeisen and similar principles tend to retain strong local affiliations even when combined into larger regional organizations.

Following this model, and before World War II, farmers typically belonged to several small, specialized cooperatives. As recently as 1962, for example, 1,100 dairy marketing cooperatives (with very limited processing capacities) were operating in Denmark alone. [2] Similarly, members of marketing cooperatives were often members of specialized agricultural machinery, seed, and other supply cooperatives as well.

Important sources of long-term financing were nonallocated patronage equity and bank debt — often from cooperative lending organizations. In some countries, ordinary cooperatives received special status for tax purposes.

The Federated Cooperative Structure

As economies of size created incentives to do so, the local cooperatives formed regional associations, generally along single crop or service lines. Eventually, regional cooperative organizations with similar market objectives (e.g., the same or related crops and products) became national "federated" organizations serving national (pre-EU) markets.

---

[1] Van Bekkum and Van Dijk, 'Agricultural Co-operatives in the European Union', Van Gorcum, Assen, 1997, a study carried out by the Netherlands Institute for Cooperative Entrpreneurship (NICE).

[2] Van Bekkum and Van Dijk, P 32.

In the early years of the "national" cooperatives, actual operations (harvesting, processing and shipping) were conducted at the local levels, and marketing was handled at the highest level. As cooperatives modernized with larger, more efficient, value-added facilities (in the '60s and '70s), the need for more centralized management led to the creation of still larger, national "shell" corporations to conduct the actual operations and marketing functions of the cooperative. While centralized for operations, the cooperatives remained multi-tier organizations for governance purposes. Members of the original local cooperatives elected district, regional, and national governing bodies.

Legal Structure of Modern European Cooperatives

Today, the largest European cooperatives tend to be cooperative associations that own investor-oriented corporate (investor-oriented, limited liability company — PLC) shells through which most of the cooperatives' value-added business takes place.[3] The PLCs are owned by cooperative association(s), and not directly by the associations' members.[4] The multi-layered local and regional governance structures retain control of the PLC through an association-dominated supervisory board. The corporations either retain or pay out profits to the cooperative associations (and other investors) with supervision from the supervisory board. The cooperative associations tend to retain their historical local-regional-national multi-layered structures. Rules governing membership, delivery rights, and allocation of profits to members are the domain of the cooperative association(s) and not the PLC.

PLCs

The PLCs tend to be owned exclusively by the cooperative associations and their individual members, although increasing numbers of cooperative-owned PLCs have issued stock to nonmember investors.[5] Indeed, reference to outside investment in cooperatives really refers to minority ownership in PLCs in which the cooperative is a majority investor-owner.

Few legal constraints or advantages are associated with the "cooperative's company." The PLC is governed by a board of directors, generally including all the members of the cooperative association's board of directors along with outside directors required by law. The PLC supervisory board hires management and oversees the activities of the PLC much in the manner of the board of a U.S. corporation. The PLCs produce annual reports like those of other corporations, with the exception that accounting for the breakdown of equity investment is generally relaxed (that being the concern of the cooperative association that owns the corporation).[6]

---

[3]The PLC is legally equivalent to a U.S. corporation in the sense that the owners of the entity are afforded limited liability.

[4]In fact, ownership is occasionally split, with some shares owned directly by members and others held by cooperative entitites.

[5]Most European countries today (e.g., Germany and France) do not prohibit ownership by nonparticipating investors in PLCs that are owned by cooperative associations.

[6]Typically, the PLC annual report will have appended to it (or included as a note) a separate set of financial statements for the underlying coopertive association. In some instances, the cooperative association will conduct other business or own investments outside the PLC, and this will appear in the appended statements.

The Cooperative Association

The PLC is owned by the Cooperative Association, which tends to be a governance unit rather than a business unit. The association is organized under a set of bylaws and charter that is separate from the PLC. The laws that govern the cooperative organization vary by country, but tend to protect the rights of individual farmer members, maintaining organizational divisions that sustain the layering of historical local and regional geographical and product lines. At the lowest level, individual cooperative members belong to local departments, and the departments are grouped into regions. A number of regions make up the (usually) national cooperative. In some cases, the national cooperative is not one but several legally separate cooperatives with regional roots (Cebeco-Haandelsraad) that make up the cooperative association and own the PLC.

Governance

For many larger cooperatives, individual members elect a large representative body—the members' union. This body elects a "cooperative council" which, in turn, elects the board of directors for the association. This structure, although typical, may vary across cooperatives. Each governance body is described in more detail below.

The Members' Union

Governance begins at the departmental level, at which members from each department elect representatives to the members' union. The basis for voting varies; some coopertives use a one-vote-per-member standard, others use a patronage-based method and some use a combination. Membership in the union often numbers in the hundreds. The members' union represents association members on matters that ordinarily require a membership-wide vote, such as approval of an annual report. The members' union must approve some organizational business of the cooperative, but decision authority on other governance issues is the jurisdiction of the cooperative association's board or "cooperative council."

The Cooperative Council

The members' union for each department elects (usually three) members to the cooperative council. The cooperative council serves two important functions: It has the final say on issues pertaining to the internal organization of the cooperative association, and it composes the majority of the supervisory board, which oversees the operation of the PLC.

The cooperative council also directs the search for outside members of the PLC supervisory board, and acts in an advisory role to the cooperative association board of directors. In some larger cooperatives, the cooperative council frequently elects yet another board, the farmers' council, voting on a regional basis. The cooperative council under these circumstances would assume some of the responsibilities ordinarily performed by the cooperative council.

None of these representative cooperative association bodies, once elected, are directly responsible to the general membership of the cooperative.

The Association Board of Directors

The association board of directors is equivalent to the same-named body in a U.S. cooperative. It is the product of two successive elections: the first in which members elect their union representatives, the second in which the members' union selects the council, and the third in which the council selects the directors.

The PLC Board

The PLC board is typically composed of the association's board and of three public directors required by law. As long as the business of the corporation/cooperative association(s) described above follows the general principles of Raiffeisen, this structure might be called a joint corporate/Raiffeisen Federated cooperative. However, cooperatives in most European countries have considerable latitude to alter their guiding principles by revising their by-laws. And modern cooperatives may vary considerably from the original Raiffeisen model, allowing for proportionate voting, closed membership, increasing outside ownership (in the PLCs), and alternative forms of securitization of member "equity" investment.

Institutional Factors Affecting European Cooperative Organization

Do institutional subsidies explain the prevalence of cooperatives in various countries? Hackman and Cook (1997) argue that institutional factors including legal organization, antitrust policy, taxation, access to credit, and interpretation of cooperative principles vary from country to country, affecting the ability of producer-owned and -controlled companies to compete internationally. However, most European Union member nations are in the process of revising rules under which their cooperatives operate. The trend is for the institutional factors noted above to be less constraining. This is discussed further below.

Legal Issues Governing Cooperative Structure

No EU regulations govern cooperative business organization or operation. Few European Union laws directly affect businesses operating as cooperatives. The current trend at the EU level is to treat cooperatives like other business organizations. Thus, a business entity defines itself as a cooperative in accordance with its national laws. The legal definition of a cooperative varies by country, and some countries do not have a separate legal definition of a cooperative. In most countries, cooperatives are subject to the regulations and laws governing other business enterprises. This is especially relevant today as commercial law in the EU evolves away from exemptions that are perceived to inhibit competition and entry. By-laws typically define the relationship between cooperatives and their members, whereas corporate law defines the relationship between cooperatives and other businesses and investors. [7]

---

[7]In some countries (Germany, for example), cooperatives must submit to supervising (or administrative) agencies their by-laws, when these are altered, and must report any changes in their boards of directors and management.

TABLE I: Legal Structure of Cooperatives of Selected Eurpean Union Countries

Legal Structure	
European Union	Aside from the national stipulations indicated below, the EU currently recognizes no legal definition of a cooperative. A cooperative must satisfy constraints placed on business enterprises by the European Commission. In particular, the EU awards no antitrust advantages to cooperatives.
Denmark	The cooperative is not a separate legal form. Commercial enterprises organized as cooperatives are subject to the same laws and regulations as other enterprises. Thus, bylaws define the constraints within which individual cooperatives operate.
Germany	Germany has extensive legislation related to cooperatives. Bylaws for individual cooperatives must be written according to guidelines that generally align with classic cooperative principles. Legislative emphasis is placed on member rights. Cooperatives in selected activities (farming and timber operations in which members jointly own land and/or production equipment, for example), enjoy some special rights. However, most other agricultural and supply cooperatives are subject to the same laws and regulations as other enterprises. In general, few constraints are placed on mergers with and acquisitions of other business enterprises by cooperatives. Cooperatives may issue dividend-paying investment stock to members and nonmembers.
Netherlands	With few exceptions, cooperatives are treated legally the same as other business associations. Cooperative enterprises may be of limited or unlimited member liability, and may own stock in other enterprises. Before the '90s major Dutch cooperatives were provided with "individual tax agreements" allowing them favorable tax treatment. These were eliminated in the early '90s.

Tax Issues

Tax law varies considerably from one European country to the next, but the following generalization is appropriate. Most European countries allow "ordinary" cooperatives that conduct little or no non-member business (and satisfy other constraints listed below) to operate for tax purposes as an extension of the business of the members. As in the United States, profits passed back to the members are not taxed at the cooperative level.

However, value-added businesses are not always exempt from taxes at the level of the cooperative-owned PLC. Thus, as cooperatives (through the PLCs) pursue more non-member business and more value-added business, their tax status is more like that of a typical PLC. Such income is treated as non-patronage-based income would be treated in the United States.

As already noted, however, tax policy varies considerably by country and by year. In Denmark, cooperatives pay no taxes on net income (retained or paid out; allocated or not), but pay a modest tax rate per year on retained equity capital. In the Netherlands, however, most cooperatives are treated as for-profit corporations with respect to the tax on net income (net of what is paid members for their product).[8] The Netherlands also has a severe tax on equity funds later returned to members. The consequence for both countries is a greater incentive for funds to be retained in the cooperative, perhaps in unallocated form, than one might find for a comparable U.S. cooperative. (See Appendix I: Cooperative Taxation Policy in European Countries, page 35.)

Price Supports and National Self-sufficiency

Before 1990, price supports and marketing boards supporting farmers' interests were common. Partly, these were used to help farmers to "countervail" in markets with few buyers. Also a factor in Europe was the concern with agricultural self-sufficiency. Cooperatives were useful in furthering such governmental policies.

The influence of commodity price and other policies upon cooperative success is clearly important to some cooperatives. Production quotas and prices set by the government clearly facilitate the management of dairy cooperatives. But more research is required before generalizations about the effect of commodity policies on other cooperatives can be useful.

Long-Term Financing

The sources and classes of equity capital for European cooperatives vary by commodity and by country. Again, therefore, generalizations about how European cooperatives are financed, while possible, must be interpreted with caution for any single cooperative.

Further, most of the research for this paper has focused on the larger, rapidly growing cooperatives in a few western European countries. As a result, the generalizations we develop will apply mainly to those cooperatives and to the ways in which they have evolved.

The Importance of PLCs

A principal finding about cooperative finance in the EU is that the largest EU cooperatives differ structurally from those with which we are familiar in the United States. The ownership by cooperative associations of investor-owned holding companies (PLCs) creates a range of possibilities for equity investment in cooperatively owned operations. As an investor-owned

---

[8]Both the Denmark and Netherlands laws are subject to specific circumstances. In Germany, larger corporations are taxed the same as for-profit businesses.

entity, non-member investors can invest in and take investment returns from the PLC without violating the cooperative character of the association, which is the PLC's majority stockholder.

Thus, while the PLC may be called a cooperative, it is really an investor-oriented entity owned by a cooperative. As such, its subsidiaries may or may not be partially owned by outside investors that are not cooperative members.

The Financial Relationship of the PLC to the Cooperative

The nature of the financial relationship between the cooperative association and the PLC varies as well. In some cases, the balance sheets of the cooperative association and the PLC are identical. Member equities in the association appear under the same name and in the same amount on the balance sheet of the PLC. In other cases, the relationship between the balance sheets is much less apparent.

In part, these differences arise from different financial reporting requirements. In others, particularly when the PLCs are highly diversified, earnings are retained and unallocated. In the latter case, establishment of a clear patronage income stream from the diversified PLC to the ultimate member-owner may be difficult.

For this reason, we strongly recommend further research to investigate the flows of funds between cooperative associations and their PLCs.

The Cooperative *Per Se*

Separation of the cooperative itself from its investor-based holding companies enables easier analysis of how cooperatives themselves have been financed in Europe. Like their U.S. counterparts, European cooperatives have both allocated and unallocated member equity. These are accumulated in many of the same ways as equity in U.S. cooperatives. However, some variations present for each are not found in the United States. As we shall see, the relative importance of each source may vary by continent as well.

As in the United States, *allocated equity* typically comes from one of three sources. These are:

1) Direct investment by members
2) Patronage refunds issued as stock
3) Per-unit capital retains

In the United States, direct investment may appear in the form of membership/voting shares, and in some cases as marketing rights. A portion of patronage refunds may come in the form of member equity shares. Per-unit retains as part of a revolving capital fund represent an important source of allocated equity to many U.S. marketing cooperatives.

Many of the same sources of allocated equity are used in Europe (see Appendix II: Financing Policies of Selected European Cooperatives). However, the following are variations

on allocated equity and debt by EU cooperatives.

1) Investment shares

Increasingly, large cooperatives issue securitized financial instruments to members. In one cooperative (Friesland Coberco), members have three shares for which earnings are based on patronage for every single share to which earnings are based on cooperative earnings. This means that three of every four dollars in refunds are based on patronage, whereas one of every four dollars is based on investment. In concept, the latter share could be sold to non-member investors. These may be issued as allocated retained earnings, but in some cases, members pay for the new securities directly.

2) Appreciating participation rights (certificates; shares)

Members are often required to purchase "participation" shares in proportion to deliveries upon entry into the cooperative. The nature of these shares varies considerably, but some cooperatives "allow" the participation shares to appreciate with time (based on unallocated reserves), to be transferred to other members, or to be redeemed. Other shares can be purchased to enhance the price received for milk.

3) Dividend-bearing common stock certificates and interest-bearing debt instruments sold to members for investment purposes

Members may buy, from allocated refunds or from their own moneys, common shares, preferred shares, or debt claims against the cooperative. The common shares may be a separate, new class created for this purpose, without voting or other rights.

4) Stock and debt instruments based on allocated patronage

Members are allocated a portion of earnings in the form of either a stock or debt instrument. Patronage refunds may be paid in the form of the dividend-bearing certificates or interest-bearing debt instruments like those described above. Revolving funds based on per-unit retains are also used as debt instruments. They appear in every way like per-unit retains issued by U.S. marketing cooperatives but are treated like debt in the sense that they receive interest payments on such retains.

Unallocated equity in the EU also comes from the same general sources as in the United States. These are retained earnings from:

1) Nonmember business
2) Unallocated patronage business
3) Proceeds from asset sales, etc.

Economists have become increasingly involved in analyzing the role of unallocated equity in European cooperatives. Many analysts claim that European cooperatives rely very heavily upon unallocated retained earnings. Some people worry that if such reliance is true, the futue of the coopertive is jeopardized because the market value of the cooperative to members might greatly exceed the book value of their equities and therefore would create an incentive for members to "sell" the cooperative.

Our research has identified evidence both to support and to refute the claim of heavy reliance on unallocated retained earnings. As our data (Appendix II) show, European cooperatives tend to have *more unallocated equity relative to allocated equity* than U.S. cooperatives. As those data also show, significant exceptions to this generalization exist.

When we found supporting evidence for that claim, we were led to ask what, in fact, might prevent members from selling their cooperative to investor-owned firms. This possibiilty suggests a need for research on the rights of growers to transfer their ownership in the cooperative.

Our focus here, however, is on the reasons for which cooperatives have accumulated unallocated equity and on those forces leading them to seek more allocated equity.

How European Cooperatives Accumulate Unallocated Equity

Unallocated equity is the net worth of the cooperative after all debts are paid and after retains held in the name of specific members is reconciled. Generally, this equity is accumulated through the value-added operations of the cooperative and through earnings from non-member business. Why might European cooperatives accumulate more unallocated equity than their U.S. counterparts?

In particular:

1) In some commodities, members have been accustomed to receiving a government-supported commodity price. Farmers don't necessarily expect the cooperative or the PLC to return all of its net income. In some cases, the grower price is enhanced with cooperative earnings, but the net income of the PLC from member and non-patronage business may be retained permanently in unallocated form.
2) Profits from non-member business can be retained and not allocated to members, just as in he United States.
3) European cooperatives were able to build up unallocated equity balances because of their generally profitable history since WWII. This allowed the cooperatives to pay what members perceived as fair (or better) prices for their products. This was in part possible because of the national and "cooperative" nature of product pricing—cooperatives dominated most national agricultural product markets.
4) The organizational "distance" between farmer members (who were generally happy with the home and price for their product) and the PLCs, which since WWII have been growing both horizontally and vertically contributed to growth of unallocated equity.
5) Tax laws in some countries encouraged the retention of net income. In Austria, Denmark, France, Germany and Sweden, the incidence of taxation appears higher on members than on the cooperative, thereby creating an incentive to retain unallocated earnings in the cooperative. Members still take financial benefits in the form of price enhancements. (See Appendix I.)
6) The U.S. concept of the qualified patronage refund has no direct equivalent in most European countries, although some countries have similar tax provisions applicable to ordinary cooperatives that do limited or no nonpatronage business.

These observations should be viewed as researchable hypotheses that could be tested through direct discussions with members, directors and managers as well as examination of tax laws affecting cooperatives and farmers themselves.

Long-Term Debt Financing

European cooperatives, like U.S. cooperatives, obtain most non-equity financing by borrowing primarily from cooperative banks (Rabobank Nederland is a global lender to cooperatives).

Nonmember Stock, Preferred Stock, Quasi-Stock, and Securitized Debt Investors

Some EU cooperatives issue shares and other financial instruments to non-member investors. As indicated above, the stock issued is not in the cooperative itself, but rather in the investor-owned holding company (PLC) which is owned by the cooperative in which investors share ownership.

The primary motivation for seeking non-member equity is the need to fund vertical, value-added, and horizontal expansion deemed necessary to remain competitive. In the EU, as in the U.S., traditional (member) financing sources (retained equity and bank debt) are inadequate to meet the capital requirements of vertical and horizontal expansion in a global market. In fact, the use of holding companies in which cooperatives are majority owners appears to serve purposes similar to the common use of joint ventures by U.S. cooperatives with non-cooperative partners to establish an extended presence in new markets or products.

Current Issues Affecting European Cooperatives

Pending Legislation

Rules affecting cooperatives currently vary by country and, in the absence of statutes that supercede them, these rules will be followed. However, the potential for contradictory policies is great. As cooperatives cross national boundaries, the need for uniform commercial codes will probably become apparent. Therefore, the codes most relevant to the future of cooperatives are probably those of the EU.

Competition and Antitrust

Prior to the '90s, most European countries were extremely tolerant of market power in the hands of agricultural cooperatives. Generally, this tolorance was motivated by the desire for national self-sufficiency and by acceptance of the idea that agricultural market power is generally "balancing," given that wholesale buyers of agricultural products tend to be few in number. Under

EU commerce treaties, mergers and acquisitions that potentially affect competition in a product market are subject to approval by the European Union Competition committee.[9]

Cooperative Form of Business

Some European countries (Denmark and Germany) are considering revising laws governing the cooperative form of business. Germany is also discussing whether the European Commission should enact legislation governing the cooperative form.[10]

Taxation

Many countries in Europe have recently revised or are currently revising their business enterprise tax codes in order to better conform to EU guidelines.[11] It remains to be seen what impact these national revisions and EU guidelines will have on cooperative taxation.

Financial Reporting Standardization

Presently, European Union companies are under pressure to conform to the generally accepted accounting procedures of the International Accounting Standards Committee. The latest EU law of business enterprises, which took effect in 1995, requires most medium and large cooperatives to register and comply with the law of accounts. However, cooperatives in some countries are not required to include a breakdown of their equity accounts at the corporate level. This is the concern of the cooperative associations, which are often legally separate entities. In these cases, the annual reports of the cooperative-owned PLCs need not and frequently do not provide specific information concerning cooperative equity financing from retained earnings or member investments. The International Accounting Standards Committee "Standard 39: Financial Instruments: Recognition and Measurement," now under revision, does not clarify cooperative specific issues regarding retained equity funds. This EU-national contradiction remains to be resolved.

Internationalization

Until 1990, most European cooperatives were national, at best, in scope of markets and membership. But that trend is changing. Most major European cooperatives now market their products aggressively throughout Western Europe, Eastern Europe, Africa, North and South America, Australia, and even Asia. Others have set up wholly owned subsidiaries and joint ventures in other countries, including the United States.

---

[9]The recent cooperative mergers of Arla and MD Foods and of Danish Crown and Vestjyske Slagterier were subject to EU competititon committee approval.

[10]Recent revisions of German business law allow coooperative mergers as well as joint ventures with and acquisition for for-profit businesses.

[11]In December 1999 the German Ministry of Finance announced plans for substantial tax law revisions, which are expected to remove any remaining differences in cooperative and non-coooperative tax treatment.

Membership patterns have also changed, particularly in Northern Europe where previously national cooperatives now commonly have members (perhaps as part of a federated cooperative) in adjoining countries.[12]

International memberships notwithstanding, cooperatives have until recently retained their national identities. But the prospective merger of Arla, the largest Swedish milk cooperative third largest in Europe) with MD Foods, the largest Danish cooperative (largest dairy cooperative in Europe) represents a dramatic departure from this history. The new cooperative will be the largest in Europe and will rival the largest U.S. dairy cooperatives. Similarly, mergers in meat processing (Danish Crown with Vestjyske Slagterier), and the German supply cooperative merger with Raiffeisen Ware Austria) have produced Europe's largest firms in their respective businesses.

Conversion to PLCs

In other parts of Europe, notably the U.K., Ireland, and Italy, cooperative internationalization proceeds more slowly. In those countries, conversions of cooperatives to PLCs during the past decade have been more common than consolidations of cooperatives.

Summary—Overview of European Cooperatives

European cooperatives are founded on principles much like those of U.S. cooperatives. The typical large cooperative in Denmark, France, Germany, Sweden, or the Netherlands is a PLC owed by one or more cooperative associations. These have separate by-laws from the PLCs and are controlled by a board of directors, elected indirectly by the members of the cooperative associations. The cooperative association board composes the majority of the PLC supervisory board of directors. Producer members of the cooperative are represented in their associations by a representative body, or "union," which elects a "council" that nominates and advises the supervisory board. These structures have resulted in considerable "distance" between the producing members and the management of a typical European cooperative.

Variations on organizational structure occur by country, by product market and over time. Smaller and less vertically integrated cooperatives tend to be less "layered" in their structures. Institutional factors that were prominent during the consolidation phase (1960s through '80s) is fading with the liberalization of markets in the European Union. EU cooperatives now compete directly with each other and with for-profit firms from Europe and elsewhere.

European cooperatives have depended more heavily than their U.S. counterparts on unallocated equity financing. Increasingly, however, large cooperatives use securitized financial instruments, including appreciating delivery rights, member-owned investment (not related to participation) shares and debt instruments, and nonmember financial instruments. The economic environment in which European cooperatives operate, is in a state of flux, and potentially significant legal, tax, competition and antitrust, and financial reporting changes

---

[12]The Dutch dairy co-op Campina Melkunie has members in the Netherlands, Belgium, and Germany.

are possible. Internationalization is beginning to have continent-wide implications, and cooperative-to-PLC conversions are influential in some countries. Many variations on the details of agricultural marketing cooperative finance are evident in the United States. These arise from different practices with respect to the acquisition, accumulation, redemption, transferability, and allocation of equity, as well as from residual claims at dissolution, control of the cooperative and others. A list of the variables that shape equity finance programs is attached as Appendix III.

U.S. Cooperatives

In the United States as in the EU, the efforts of cooperatives to adjust to a changing competitive environment have led them to seek new equity management plans, issue preferred stock, subordinate debt and form joint ventures with other cooperatives. Increasingly, they create partnerships with investor-oriented firms. As they do so, they multiply the variations on their financial structures.

In spite of the many ways in which these financing tools and approaches are used, nearly all approaches to cooperative finance emerge and are derived from three basic models. These are stock, nonstock, and the so-called "new generation cooperatives"—also a form of stock cooperative. We separate the latter because it was identified by at least one European cooperative expert as a model for "enlightened" European cooperatives.

Stock Cooperatives

"Traditional" stock cooperatives are most common in the Central United States. While this model has many minor variations, more than 2000 agricultural supply and grain marketing cooperatives in the Great Plains and the Corn Belt are organized as stock cooperatives. Dairy cooperatives are commonly organized as stock cooperatives as well.

Organized mainly in the early part of the 20th century, cooperatives were financed with minimal stock purchases by their members. These farmer-owned cooperatives typically provided agricultural supplies (e.g. feed, seed, fertilizer, agricultural chemicals, petroleum) to their members and provided storage and marketing services for their wheat, soybeans and corn.

While members created these local cooperatives with some direct equity purchases (the purchase of a single voting share is typical), they relied heavily and increasingly on retained earnings and "passive" investment in equity shares by members to accumulate risk capital. In such cooperatives, equity is accumulated in three ways.

1) Non-member business. When corporate taxes are paid on earnings from non-member business, those earnings can be retained as permanent capital. These retained earnings are "unallocated."

2) Member business (allocated). Earnings from member business may be retained and equity shares distributed to members who pay taxes on those earnings. Up to 80 percent of patronage earnings may be returned to members as equities. These earnings are "allocated" or identified with a specific member who has rights to those equities when redeemed. Re-

demption practices vary greatly among cooperatives. These equities are issued with the expectation of redemption at par. Barton has catalogued the many programs under which they are redeemed.[13]

3) Member business (unallocated). Earnings from member business may become part of permanent capital if the cooperative pays corporate taxes on those earnings. They are typically unallocated retained earnings.

Variations on Traditional Stock Cooperatives

1) Local Cooperatives Federate to Create Regional Cooperatives

Changing technology (mechanization, chemical fertilizer, animal nutrition, unit trains to ship grain) created potentials for production agriculture that could not be satisfied by the locals. The locals joined together to create regional cooperatives with greater financial resources and the ability to perform functions beyond the means of the locals. The locals owned and controlled the regionals and continued to perform the direct, retail service functions just as they had before. The regionals performed wholesaling and manufacturing functions in farm supplies and regional grain marketing (storage and merchandising functions).

2) Base Capital Plans

As members of local or regional cooperatives, owners may accumulate equity in volumes far out of proportion to their patronage of the cooperative. Long-time members, for example, may have accumulated a great deal of equity, whereas relatively new members have accumulated very little. This differential creates great inequities when earnings are distributed in proportion to purchases or sales (patronage), thereby rewarding new members far more than old members whose equities are principally responsible for financing the cooperative and its ability to deliver benefits to members.

To address these inequities, cooperatives like CoBank, Farmers' Rice, Farmland, Land O' Lakes and others developed "base capital plans." Under such plans, a base capital requirement calculated from members' patronage histories are established for each member. The earnings retained for each member and issued as equity then vary based on each member's base capital requirement.

3) Conversion of Equities and Permanent Capital

A continuing challenge for cooperative management is that of replacing retired capital as members' equities are redeemed. This issue becomes especially important as large numbers of growers retire or as downturns in earnings reduce the equity retained and available for capital projects.

Alternative approaches to dealing with this challenge include:

1. Tri-Valley Growers' conversion of retains to "permanent" transferable, appreciable stock. Under this program, TVG members were expected to sell their shares to other growers rather than to retire it.

---

[13]David Barton of Kansas State University has long conducted extension programs that define and quantify the range of equity redemption programs used by stock cooperatives.

2. Agri-Link Foods' exchange of publicly traded preferred stock for inactive equities as members retire. Retiring members receive tradable stock that they can keep or sell.
3. Calavo Growers exchange of inactive equities for dividend-bearing stock. Inactive members can exchange their equities for shares of stock that return dividends based on the earnings of non-member business.

Non-stock Cooperatives

"Traditional" non-stock organization is typical of California's marketing cooperatives. Membership fees provided the original risk capital in some of these cooperatives (see Appendix III). However, current bylaws commonly state that no fees will be charged for membership.

Per-unit retains are the primary source of member capital in non-stock cooperatives. Bylaws provide for a variety of different revolving funds, which have different names and can be activated for different purposes.

Per-unit retains are most commonly a percentage of the expected value of a crop delivered by members. This amount may be retained by the cooperative for a specified period. Typical, for example, is the program of Blue Diamond Growers, which currently retains 5 percent of the value of members' deliveries each year and keeps it in the cooperative for four years.

At the direction of the board of directors, the percentage retained and the number of years that a retain is held may vary. Once in place, however, a formula it is not casually changed by the cooperative's board.

Variations on Traditional Non-Stock Cooperatives

In non-stock cooperatives, just as in stock cooperatives, management continually faces the challenge of dealing with redemption of equity. The board can raise retains or delay redemption to deal with capital shortages. However, members frequently and understandably object when the board takes such action.

The Tri-Valley Growers' case mentioned above represented the conversion of a non-stock cooperative to a stock cooperative with permanent, tradable capital.

More recently, Diamond (walnut) of California began to eliminate its retain program. It did so to make its returns to members more attractive. It took advantage of an opportunity to tap preferred stock from outside investors to replace member capital, and to do so at a cost of funds that was lower to Diamond than to members.

"New Generation" Cooperatives

"New generation" refers to a group of cooperatives organized largely during the last decade, and largely in the North Central United States. Compared to "traditional" cooperatives, they are among the newest agricultural cooperatives in the United States. They have

drawn international attention. A principal European contact for this work described many European cooperatives as trying to become like "new generation" cooperatives. This is not because they are the largest cooperatives or because they necessarily represent substantial shares of the products they market. It is due to interest by those cooperatives in developing allocated member equity.

Primary features of the "new generation" cooperatives are:

1. They require direct, "up-front" member investment
2. They hold the expectation of appreciation in stock value arising from an expectation of increasing returns to marketings.

"New generation" cooperatives also have drawn interest because they directly respond to the alleged weaknesses of traditional cooperatives. These alleged weaknesses tend to be 1) they are underfinanced, 2) members have no sense of ownership, 3) they lack start-up capital, 4) they lack clear terms of exit, and 5) they lack proportional (equitable) terms of capital provision and clear definition of ownership.

While some financial analysts dispute the appropriateness of the "new generation" name or whether they are truly unique, this much is true: New generation cooperatives require active (as opposed to passive) direct investment from their members. The purchase of shares in the cooperative is by definition, proportional to marketing rights. The cooperatives are closed to those who do not have marketing rights. Because of limited processing or because marketing capacity is limited, the value of transferable members' equities may appreciate as the earnings of the cooperative, and therefore the value of marketing rights, increase.

The focus of "new generation" cooperatives on proportionality and the potential of appreciation in stock value is relatively new to U.S. agricultural cooperatives. However, the idea that growers must provide capital to create the cooperative or that the cooperative may be closed because of limited capacity is not new. Indeed, most U.S. agricultural cooperatives began with some member investments[14] and California's marketing cooperatives[15] recognized early the need to match their commitment to growers with the financial capacity of the cooperative to process and market its crops.

The "new generation" title is most appropriate if claims by Mike Cook are true that their relative uniqueness derives from the fact that they tend to be formed to take advantage of marketing opportunities as opposed to being formed for defensive purposes.[16] Historically, cooperatives may have been created because members had little choice. If they wanted an assured market or assured supplies, they had to create their own cooperative.

In Cook's words however, the new generation cooperatives are formed for "offensive" purposes. Their founders were the first to say "of the potential uses of my investment capital, I choose to put money in my cooperative because it will generate returns to my farm marketing that exceed alternatives." This differs greatly from the decision to invest in a cooperative because it is essential to survival of the farm enterprise.

---

[14]Fite, *Beyond the Fencerows*
[15]The *Sunsweet Story*
[16]Mike Cook, personal interview

Other Approaches to U.S. Cooperative Finance

Globalization, close coordination, concentration of competitors, product development and, most recently, the increasingly rapid concentration of global retail chains, food service companies and ingredient buyers continue to create demands for capital by cooperatives. Meanwhile, cooperatives face special challenges because (as cooperatives alone) they cannot obtain true risk capital from other than their members. They have limited sources of risk capital.

Some would argue that the recent and heavy use of preferred stock as a source of finance suggests otherwise. However, as a form of quasi-risk capital, not necessarily provided by members, preferred stock will not be provided by outside investors unless their members provide a minimum level of true risk capital.

Historically single-commodity, production-driven firms, cooperatives have been vulnerable to the increasing demands for full-line distribution from fewer and larger firms. These firms exercise substantial market power and are able to define terms of trade to their suppliers.

Therefore, cooperatives have sought alternative means of financing their efforts to compete. They have done so by growing horizontally and vertically to add value through relationships with other cooperatives and investor-owned firms—consolidation with cooperatives, federation, agencies in common, joint ventures, e-commerce alliances and other acquisition of investor-oriented firms. In doing so, they have benefited from shared risk/equity finance approaches and levered their own scarce capital by attracting Quasi-risk capital such as preferred stock and subordinated debt.

Comparing Cooperatives in the United States and the EU

Risks accompany generalizations about cooperative finance in the EU. This is especially true with respect to this document, which is based on review of a handful of large cooperatives in each of four countries.

The same caution applies to generalizations about U.S. cooperatives. Certain broad classes of cooperatives have similar financial structures. But recent change in the competitive environment is sufficiently rapid to create many exceptions to every generalization.

Nevertheless, we can state several generalizations with which we are comfortable in comparing cooperative finance and control in the United States and the EU. These relate to

1) Cooperative Organization and Structure
2) The Cooperative Business Environment
3) The Effects of Globalization
4) Sources of Risk Capital

Cooperative Organization and Structure

In the EU, the larger cooperative is frequently a joint structure — a holding company organized as a limited-liability corporation (PLC) owned by a cooperative or group of cooperatives. The cooperative itself, over which the members have direct control, is a governance association. The business operations of the cooperative are mostly conducted by the holding company (with the primary exception of some of the larger supply cooperatives). In the United States, governance and operations are controlled within the same cooperative corporation.

The holding company may be a full or part owner of a variety of other food or agricultural supply companies with which the member does business. Some larger EU cooperatives have dozens or even hundreds of subsidiary business units.

While the authors of this paper are not prepared to draw conclusions about the implications of separate governance and business units, several hypotheses are suggested by this development.

1) The relatively small members of large governance organizations are sensitive to price. They prefer favorable prices to patronage refunds composed of equity.
2) Cooperative management seeks more risk capital, and tax policies did not discourage them from keeping it.
3) The process of tracking patronage for and allocation of equity to very large numbers of relatively small member became prohibitively cumbersome for centralized cooperatives. This was especially true if the members separately patronized the many subsidiaries of a holding company.
4) Nevertheless, competitive conditions now require more member capital if a cooperative structure is to prevail. Therefore cooperatives in the EU increasingly seek to accumulate allocated equity through innovative finance programs.

The relative importance of allocated equities to selected U.S. and EU cooperatives is seen in Table II.

TABLE II: Statistics and Equity Policies of Selected EU and U.S. Cooperatives

Cooperative	Net Sales	Total Assets	Operating Income/Net Sales	Member Capital /Total Assets: Allocated	Member Capital /Total Assets: Un-allocated	Retained /Net Income
European Cooperatives*						
Arla (Swedish)	1,578	736	1.10%	24%	17%	100%
BayWa AG (Germ.)	3,386	1,098	1.00%	11%	10%	55%
Campina Melkunie (1998)	3,498	1,474	1.40%	8%	17%	91%
Cebeco Group (1998)	2,715	898	1.50%	nc	22%**	62%
Danish Crown	4,896	1,837	3.65%	4%	7%	19%
Friesland Coberco	4,026	1,713	2.40%	32%	0%	61%
Vilmoran, Clause & Cie (Limagrain)	358	424	11.10%	32%	19%	76%
MD Foods (Dan.)	3,402	1,920	3.55%	5%	18%	35%
Greenery Intern'l (1998)	1,245	882	0.6%	4%	(5%)	100%

Groups of U.S. Cooperatives—CoBank Customers 1999	Net Sales***	Total*** Assets	Operating Income/Net Sales	Allocated	Un-allocated	Retained /Net Income
Farm Supply/Grain	397	189	0.82%	26%	6%	68%
Farm Supply	330	176	0.83%	11%	13%	15%
Fresh Fruit & Veg.	36	24	11.27%	5%	9%	76%
Dairy	420	88	1.52%	17%	16%	17%
Sugar	94	133	19.43%	3%	35%	6%
Cotton			11.31%	38%	5%	10%

Selected U.S. Cooperatives	Net Sales***	Total*** Assets	Operating Income/Net Sales	Allocated	Un-allocated	Retained /Net Income
Farmland	9,148	2,875	2.43%	nc	nc	nc
LOL (1998)	5,174	2,292	1.32%	31%	3%	(8.3%)
Cenex/Harvest States	6,435	2,788	1.35%	35%	7%	33%
Blue Diamond	404	173	nc	61%	19%	100
Sunkist (1998)	1,069	189	0.5%	5%	25%	100%
Naturipe	70	20	6.04%	21%	4%	6.5%
Diamond Cal (1998)	205	117	nc	28%	8%	nc

nc = not calculable from available info

* Sales and Assets in Millions of Euros (1999) except as indicated
** Total members' capital / TA
*** Sales and Assets in Millions of U.S. Dollars (1999) except as indicated

Note: Euro/U.S. Dollar exchange rate in 1999 approximately 1.035

Cooperative Business Environment

During the past decade, European cooperatives, like many U.S. cooperatives, have found institutional support falling and market competition rising. Cooperatives on both continents require more long-term at-risk capital with which to pursue value-adding investment, horizontal expansion of distribution systems, and size-driven economies of scale.

Changes in the policy environment have contributed to this development. For EU cooperatives, the implementation of the EU itself has lowered and, in many cases, eliminated price supports and price stabilization. Many of the "rules" under which EU agricultural cooperatives operate have changed or are changing. We expect new legislation will be forthcoming from the European Commission and its member nations that will continue to alter the economic environment faced by EU cooperatives.

These changes explain in part the high level of merger and restructuring activity (as a means of avoiding destructive competition) among European cooperatives. This is a departure from the past in which EU cooperatives dominated national markets for their products whereas U.S. cooperatives faced stiffer competition from investor-oriented firms in their industries.

Internationalization of Cooperatives

In addition to the policy changes encouraging consolidation, globalization itself constitutes an important part of the competitive business environment. Merger activity in Europe has reached the international level. The recent and proposed mergers and acquisitions of large cooperatives by other cooperatives includes the following:

- Dutch Campina-Melkunie's acquisition of Comelco in Belgium and Sudmilch in Germany, along with the Swedish grain cooperative federation's acquisition of Weibulls
- a merger with Svaloef by the Swedish grain cooperative federation, and
- a merger of Danish cooperative MD Foods and Swedish Arla.

Many EU cooperatives have subsidiaries and joint ventures operating outside of Europe, including the United States and Canada (Dutch cooperative Cebeco and the French cooperative Limagraine, are examples).

Long-Term Financing

Most of the same instruments used to finance cooperatives in the United States can be found in the EU. This is reflected in summary Table III. These sources include but are not limited to:

Member investments

1) unallocated retained earnings from member and nonmember business
2) direct purchases of stock as delivery rights
3) shares of stock or interest-bearing debt in lieu of cash as a portion of the patronage refund
4) per-unit retains and associated revolving funds

5) transferable and appreciable investment shares

Outside financing

1) bank debt
2) dividend-bearing shares that can be held by outside investors

Trends

1) the larger cooperatives in the EU have begun to favor
   - allocated equities, marketing rights
   - allocated, securitized, appreciable, and/or tradable participation certificates (shares), as well as allocated interest-bearing debt certificates with fixed maturity dates
2) cooperatives in the EU have been reluctant (with some notable exceptions) to pursue non-member equity financing; pursuit of outside investor equity is strongest for those cooperatives with less equity than they need to pursue vertical and horizontal growth
3) primary source of debt financing for most EU cooperatives, as in the U.S., is bank debt, including primarily debt from cooperative lending associations

TABLE III: Sources of Equity Capital for Selected Firms in the European Union and the U.S.

Sources of capital to entities owned in whole or in part by cooperatives	**European Union**	**United States**
1. Cooperative "shell" (ownership of investor-owned holding companies and subsidiaries)	Typical of EU cooperatives*	
2. "True" outside investors		
In subsidiary companies	Very common	Possible
Joint ventures (other cooperatives & IOFs)	Growing	Very frequent
3. Consolidation by cooperatives	Rapid	Rapid
Capital provided to cooperative by members as members		
4. Patronage shares	Common	Typical of stock cooperatives
5. Investment shares	Emerging*	
6. Per-unit retains		Typical of non-stock marketing
7. Dividend-bearing retains (obligatory debt)	Common*	
8. Dividend-bearing shares held by inactive/retired members		Two known cases
Equity Participation Units		
9. Delivery (& earnings) rights	Emerging	Increasing
10. Earning augmentation	Common*	
Unallocated		
11. Retained earnings/non-member business	Major source	Frequent source
12. Retained earnings/ member business	Very common	Frequent

Cooperatives in the United States and the EU share many of the same sources of capital. The above table offers qualitative comments on the relative frequency with which each is used on each continent.

Sources thought to be unique to cooperatives in the EU are identified by asterisk (*). Other sources of equity used by cooperatives on both continents are preferred stocks and subordinated debt.

The first broad category of capital sources refers to sources of capital for entities that are not typically cooperatives, but in which cooperatives have a substantial financial interest. Most of the investor-oriented capital associated with cooperatives in the EU is capital provided by cooperatives or by outsiders to investor-oriented subsidiaries of or joint ventures with those cooperatives.

The following are notes describing each of these capital sources.

1. Cooperative entities in the EU commonly own investor-oriented holding companies with many subsidiaries. Returns to the cooperative "shell" are based on investment and not on patronage.
2. Outside investors may be part owners of investor-oriented subsidiaries or joint venture partners.
3. Consolidation or other cooperative unifications are means of dealing with lack of capital by cooperatives.

The second broad category of capital sources refers to the capital provided directly to the cooperative.

4. Voting shares or equities are accumulated by members of stock cooperatives as a patronage refund. These are not dividend bearing but are typically revolved to members at par.
5. Actual investment shares are emerging in some EU cooperatives that issue them in fixed proportion to patronage shares and on which an investment return is paid. Until now these have been owned by members who could sell them to other investors.
6. Per-unit retains are a percentage of the amount due members for deliveries. They are revolved on a relatively predictable basis.
7. Dividend-bearing, per-unit retains in the EU appear identical to per-unit retains in the U.S. with the exception that they are dividend bearing and look very much like debt.
8. The United States has two cases (Agri-link and Calavo) in which equities held by retired or inactive members can be converted to publicly traded shares (Agri-link) or shares that receive earnings from non-member business (Calavo).

Equity Participation Units

9. Increasingly common among the so-called new generation cooperatives and cooperatives wishing to capitalize new ventures with limited capacities are "equity participation units," shares of stock that entitle the buyer to deliver a specified unit or units of a commodity. The buyer benefits on the basis of earnings per bushel, per hundredweight, per ton or other unit delivered.
10. In some EU cooperatives, the purchase of an equity participation unit entitles the member to a higher payment (e.g. 2 kronen per hundredweight) for milk.

Unallocated retained earnings

11. Earnings from non-member business are a common source of permanent unallocated capital for cooperatives in the EU and the United States.
12. Earnings from member business that are not allocated are sometimes a source of capital for cooperatives in the United States and frequently a source for cooperatives in the EU.

Conclusions

1) The evolution of markets in the EU has led to the development of separate governance and operating structures in the larger cooperatives. The cooperatives themselves are often largely governance associations that own holding companies (PLCs). The latter are often composed of many subsidiary, investor-oriented entities, owned in whole or in part by the cooperative association. This evolving structure is shaped by many of the same

forces that have led to the proliferation of joint ventures and partnerships used by some of the largest U.S. cooperatives.

2) Over time, EU cooperatives have relied more on unallocated than on allocated retained earnings. In part, this appears to be a result of the organizational distance between the original local cooperative owners and national cooperatives that evolved to manage large operations. Examination of financial data for individual cooperatives shows that one should be cautious in applying this generalization, however, due to many significant exceptions.
3) Some differences exist between the financial instruments used by U.S. cooperatives and those in the EU. However, most EU instruments would be readily recognized by accounting specialists from U.S. cooperatives. Some variations in European cooperatives include allocated debt (retains or certificates as opposed to equities) and the sale of equities as participation rights that increase the unit price paid to growers for their crops.
4) Because both U.S. and EU cooperatives face the same global competitive environment, cooperatives on both continents look toward allocated equities and rewarding the contribution of capital to the cooperative enterprise so that they can be more competitive.
5) International marketing and alliances signal the value in conforming national and international accounting standards. Unification of Europe puts pressure on the IASC to achieve conforming standards among European nations. However, the Canadian board is inclined to wait for and conform to adjustments by FASB.

Needed Research

- Cooperative Statutes and Bylaws in the EU

Throughout this study, the researchers had difficulty locating bylaws and other documents needed to explain clearly the rules within which cooperative ownership, control and distribution of benefits are carried out. Research designed specifically to assemble statutes to incorporate, tax, facilitate or regulate the development of cooperatives in each country would strengthen our understanding of European cooperatives. As such efforts are pursued, however, some judgement must be made about the circumstances under which national or EU statutes are relevant to their study.

- Transfer of Ownership in Cooperatives

While cooperatives in the EU have historically carried relatively large shares of unallocated equity and appear to have performed relatively well financially, no well-publicized efforts by investor-owned firms to "buy out" cooperatives have occurred. It appears as if some statute may ultimately prevent such transfers. If so, we have not found it as a part of this research. It is a worthy research effort to determine whether statutory obstacles prevent such transfers, if superior performance by cooperatives from the member perspective has assured their continued success, or if some form of market failure prevents the sale of cooperative equities.

- Price, Trade and Marketing Policies

Food and agricultural policy in European countries is also relevant to the question of how cooperatives perform in the EU. For example, pricing policies for dairy cooperatives to members are clearly affected by dairy policies in general. This raises the question of how and to what extent the performance of the cooperative is dependent upon the food and agricultural policy for each

commodity.

- Flow of funds and decision-making in European Cooperatives

The authors of this report were not always able to track the flow of revenues for cooperatives through the operating business, through the cooperative and to its members. Direct interviews with cooperative directors, managers and members are critical to understanding the incidence of benefits from cooperative earnings and decision control affecting the distribution of benefit, allocation of earnings and investment in other cooperatives.

- Implications for U.S. cooperatives

In discussing the findings of this research with officers of the National Society of Accountants for Cooperatives, the researchers were informed about a need to develop models of ways in which U.S. cooperatives could combine, create alliances, create joint ventures with or consolidate with cooperatives in European countries. The development of a range of possibilities is feasible, and the development of a guide to such options would be of interest to U.S. cooperatives.

References

Van Bekkum, Onno-Frank, interviewed by the authors. This research benefited greatly from extensive conversations with and assistance from Onno-Frank Van Bekkum of the Netherlands Institute for Cooperative Entrepreneurship

Cook, M.L., "The Future of U.S. Agricultural Cooperatives: A Neo-Institutional Approach." In: *American Journal of Agricultural Economics*, vol. 77, December 1995, pp. 1153-1159

Stefanson, Brenda, Murray Fulton, and Andrea Harris, "New Generation Cooperatives: Rebuilding Rural Economies," Center for the Study of Cooperatives, University of Saskatchewan, Canada, September 1995

Couchman, Robert. *The Sunsweet Story*. San Jose, Calif.: Sunsweet Growers, 1967

Fite, Gilbert. *Beyond the Fence Rows*, an Authorized History of Farmland Industries. Kansas City, MO

Gentzoglanis, A. "Economic and Financial Performance of Cooperatives and Investor-Owned Firms: An Empirical Study," in J. Nilsson and G. Van Dijk (Eds.): *Strategies and Structures in the Agro-Food Industries*. Van Gorcum: Assen, 1997, pp.171-182.

Hackman, Deanne L. and Michael L. Cook, "Producers as Agrichain Leaders: The Importance of the Institutional Environment," 1997. Third International Conference on Chain Management in Agribusiness and the Food Industry, eds. G.W. Ziggers, JH Trienekens, PJPZuurbrier-Wageningen: Management Studies Group, Wageningen Agricultural University, Netherlands

Van Bekkum & Van Dijk, "Agricultural Co-operatives in the European Union," Van Gorcum, Assen, 1997, a study carried out by the Netherlands Institute for Cooperative Entrepreneurship (NICE)

Zwanenberg, A. "European Dairy Cooperatives—Developing New Strategies." Dissertation, University of Cork, Ireland,1997

United Nations General Assembly Document dated 23 Dec.1998. Report of the Secretary-General: "Status and Role of Cooperatives in the Light of the New Economic and Social Trends"

Annual Reports of numerous U.S. and European cooperatives

Interviews with accounting professionals in the U.S. and other countries

Audit and Accounting Guide: Audits of Agricultural Producers and Agricultural Cooperatives, AICPA, May 1, 1994

Appendices

Appendix I - COOPERATIVE TAXATION POLICY IN EUROPEAN COUNTRIES

	Taxation at Cooperative Level	Taxation at Member Level	Implications for Financing
Austria	Cooperatives "profits" taxed as ordinary corporations.	"Double taxation" for most investors. Members pay taxes on receipt of cash distributions. Retained surplus (allocated and nonallocated) of cooperatives not taxed at member level until paid out. Austrian farmers are taxed as business enterprises, although extensive tax subsidies exist in Austria at the farm level.	Cooperatives are not particularly tax favored, althoug farmers receive more generous deductions than othe enterprises. Tax shelter status of retained surplus provides incentive to keep equity in cooperative.
Denmark	Cooperatives doing more than 25% business with nonmembers taxed as corporations. "Double taxation" with lower rate on cash distributions. Ordinary cooperatives are not taxed on profits (but members are). Instead, ordinary cooperatives' equity capital is taxed. Shares held for more than three years are exempt from capital gains tax.	Denmark farmers taxed as business enterprises. Extensive tax subsidies for farmers' enterprises.	Encourages retention of equity
Germany	Some ordinary cooperatives are exempt from profit tax (but members are taxed). However, most German agricultural cooperatives have difficulty meeting stringent criteria and are taxed as corporations. German corporate tax system has a mechanism to lower effects of double taxation on distributed profits. Retained profits are taxed at a higher rate.	German farmers taxed as business enterprises. Mechanisms exist for investors in corporations to minimize impact of double taxation.	Not clear.
Netherlands	Retained profits (net profits less distributions to members) are taxed at corporate rates. There may also be a lower, flat rate for businesses 95% or more owned by cooperatives.	Dutch farmers taxed as business enterprises. Extensive tax subsidies for farmers' enterprises. Members pay taxes on distributed profits.	Negative? May unduly punish members who are willi to leave equity in cooperative (as shares or debt).
France	Agricultural marketing and supply cooperatives exempt from corporate tax on member but not nonmember business, which is taxed at regular corporate rate.	Farmers taxed as business enterprises. Double taxation on nonmember business. Substantial tax subsidies for farmers.	Positive for the retention of and raising of permanent equity funding.
Sweden	Taxed same as corporations, except that member related income is taxed only at member level, whether it is retained or not.	Members seem not to have to pay tax on retained equity. Member equity share retained by cooperative is calculated by a formula that seems to imply full allocation of member-related business profits.	Positive for retention of allocated member capital.

Appendix II – FINANCING POLICIES OF SELECTED EUROPEAN COOPERATIVES

Company	Co-op Owners		Member Investment/Financing Policy	Tradable Shares	Legal Subs.	Outside Funding (other than bank debt).
Arla (Dairy)	Coop Association	Swed.	Performance price; capital contributions similar to base capital plan	Limited		
Avebe (Flour; potato)		Neth.	Share-based delivery rights			
BayWa Ag (Supply)	Bayerische Raiffeisen-Beteiligungs-Ag	Ger.	Participation shares (purchased once) and investment shares. Spits profits by investment share. Some equity allocated to members permanently.	Yes	Yes	Outside shareholders Kredit-Genossenschaften also has some ownership.
Campina Melkunie (Dairy)	Co-op Association	Neth.	Performance price. Members get "part" of performance price, and the rest is added permanently to capital base. The coop allows the members' participation units appreciate some to reflect the investment in capital base. Member's allocated share in forms of Participation Shares and Tradable bonds. Permanent/Base Capital Plan	Yes	Yes	
Cebeco Group (Mixed; supply)	27 Cooperatives	Neth.	Participation Shares in two classes, A and K.	Yes	Yes	
Centralmarkt Bonn-Roisdorf (Fruit; Veg)	Coop Association	Ger.	Significant nonmember business (800 of 2800 suppliers are members). Splits profits among members by shares			
Dumeco B.V. (Meat)	Coöperatie Dumeco	Neth.	Participation Shares			Convertible debt certificates
Friesland Coberco Dairy Foods	Friesland International B.V. Friesland Coberco	Neth.	Portion of surplus allocated through price, or allocated equity in form of A Shares Members may also purchase traded, dividend-yielding B	Yes	Yes	

Company	Co-op Owners		Member Investment/Financing Policy	Tradable Shares	Legal Subs.	Outside Funding (other than bank debt).
	Dairy Foods B.V.		Shares			
Vilmoran, Clause & Cie (Stock Subsidiary of Groupe Limagrain)	Limagrain Cooperative	France	Investment shares. Dividends to owners.	Yes	Yes	Some corporate investors/JVs
Landsforeningen Den Lokale Andel A.M.B.A.	Coop Association	Den.	Surplus allocated through price Rest retained permanently			
MD Foods (Dairy)	Coop Association	Den.	Guarantee certificates? (are these just nonappreciating participation shares?) Permanent Equity Plan - transfers (from capital account) to personal account occurs at discretion of Board, based on participation. Board may decide to pay interest on personal accounts not to exceed the official Danish discount rate. (have more)	Limited		
Raiffeisen Hauptgenossenschaft Nord Ag Hannover		Ger.	Members have participation shares	Limited	Yes	Have limited ownership by non coop corporation (<3%)
Danish Crown (Meat)	Cooperative Association	Den.	Participation Shares Permanent Capital Plan; Allocated to permanent equity member accounts at discretion of board each period. Allocations per patronage; Allocation rates vary per product group. Board may occasionally pay interest on member allocations.	Yes	Yes	
Südfleisch GMBH (Meat)	Südfleisch Holding Aktiengesellschaft Muenchen	Ger.	Participation shares	Yes	Yes	
Vestjyske Slagterier A.M.B.A.	Co-op Association				yes	private shareholders
The Greenery International	Voedingstuinbouw	Neth.	Surplus returned as cash payment. Balance retained.	Yes		

Appendix III: Variables in U.S. Cooperative Capital Formation

Initial Risk Capital

Historically, members of U.S. cooperatives have not made major contributions to their capitalization when they join. However, initial capital contributions were surely essential to the creation of the many well-known U.S. cooperatives. The cooperative now known as Farmland Industries was started in1929 by contributions of $1,000 each from five local cooperatives that saw a need to federate. A predecessor organization of what is now Sunsweet Growers was capitalized in 1917 with $750,000 in contributions from growers representing 75 percent of California's apricot and prune acreage.

However, new members now make minimal or no contribution to capital as a condition of membership in most agricultural cooperatives. New generation cooperatives represent a major change, and well-publicized exceptions are the recent "new generation" cooperatives in the northern plains of the United States. There, capital drives with members have produced sufficient equity capital to justify bank loans for multi-million-dollar processing facilities. For example, North Dakota growers, as part of an equity drive, contributed $12 million in equity to finance the construction of a $40 million grain processing facility. The Southwest Minnesota Beet Sugar Growers provided $200 per acre in 1975 to finance the acquisition of their processing facility.

The cases mentioned above describe the origins of U.S. agricultural cooperatives at the beginning and the end of the 20th century. During the interim, however memberships in existing cooperatives were characterized by little *active* capital contribution.

Membership in stock cooperatives may require the purchase of one voting share of common stock. This requirement is common to the bulk of stock cooperatives throughout the United States. The purchase requirement is less common among the marketing cooperatives of California than among the local and regional cooperatives from the U.S. Great Plains and the Corn Belt. The latter started out as agricultural supply and grain marketing cooperatives. The cost of a share of common stock is typically a minimal expense and does not represent a significant source of equity for the cooperative.

With the exception of the "new generation" cooperatives, virtually all of the stock cooperatives in the Great Plains and the Corn Belt have similar requirements for initial membership commitments.

Most non-stock cooperatives, impose no membership fee. Indeed, almost all of California's marketing cooperatives are non-stock cooperatives and specifically state that they charge no membership fee. The membership agreement normally brings with it a commitment by the producer to deliver and a commitment by the association to accept the production from specified acreage.

How U.S. Cooperatives Accumulate Risk Capital

The formulas for calculating members' contributions of risk capital to their cooperatives vary widely. These, too, may be broadly classified under the same "new generation," stock and non-stock categories used above.

"New generation" cooperatives are characterized in part by the members' commitment to purchase delivery rights (dollars per ton) for the production that growers provide. This amount may be due at the time of membership, it may be a debt to the association, or it may be withheld in lieu of full payment to growers over a specified period of time. The concept underlying new generation cooperatives is that they are capitalized by their users clearly and directly in proportion to use.

Stock cooperatives have many potential variations on how to accumulate equity. However, three broad classifications are useful. In general, stock cooperatives accumulate equity by retaining earnings. They do this in three ways. They may

- Retain part of patronage refunds and issue equity shares to members in lieu of cash. In fact, federal tax treatment of cooperatives permits them to return as much as 80 percent of earnings from member business in the form of equity. These are *allocated* retained earnings.
- Retain earnings from *member* business, pay corporate taxes on them and make them part of permanent *unallocated* capital.
- Retain earnings from *non-member business*, pay corporate taxes on them and make them part of permanent *unallocated* capital.

The board authorizes the exact terms of retention, distribution, and allocation annually.

Fairness in the accumulation of equity is increasingly defined as a proportional relationship between business conducted by members and the equity they hold. A relatively popular and increasingly common means of moving toward proportionality is through *base capital plans* under which a certain capital requirement per unit of patronage is established and multiplied by the units of business conducted by each member. This defines each member's *base capital (allocated equity) requirement.* In stock cooperatives, allocated retained earnings are used to meet each member's base capital requirement. Greater shares of earnings may be retained and allocated as a member is meeting the requirement. Increasing shares of earnings are distributed in cash when the member has met the requirement.

Non-stock cooperatives accumulate capital through a system of *per-unit retains.* Under these systems, the cooperative retains a specified portion of the value of each *member's* deliveries with an expectation of returning that retain in a few years. (For example, the cooperative may *retain* 5 percent of the value of the grower's deliveries and revolve them after five years. The board of directors may alter either the retain rate or the revolvement period depending on the financial needs of the cooperative.)

How (and When) Risk Capital is Redeemed

Cooperatives vary greatly in terms of their commitments to redeem risk capital contributed by members. At the extremes, these range from those with no specific commitment to redeem capital, to those that describe the per-unit retains as a debt of the cooperative to its members.

Permanent capital: When equity shares are issued as a delivery right and obligation, they are a form of permanent capital that carries no promise of redemption and can be sold only to other members or back to the cooperative. The "new generation" cooperatives and Tri-Valley Growers have this structure. In concept, the value of such equities may appreciate based on the value of delivery rights to the cooperative.

Revolving shares: Allocated equities in stock cooperatives are issued with the expectation that they will eventually be revolved. David Barton has studied the terms of revolvement in great detail. Barton has examined the equity retirement practices of stock cooperatives, identifying those that commit to redeem equities through

- estate settlements
- retirements
- age of patron
- percentage pool and
- others.

As the names of these programs suggest, these equities may remain with the cooperative for a long while. Rarely do cooperatives redeem equities such as these on say, a five-year basis. Indeed, members often view these equities as a retirement fund.

Cooperatives with base capital plans may accelerate the redemption of equities to members that have met their base capital requirements.

A variation on these retirement programs is in use by Agri-Link Foods, for example, which permits retiring members to exchange their stocks for shares of publicly traded preferred stock. Another variation is that of Calavo Growers of California, whose retired members may exchange their inactive equities for a form of stock that returns dividends from funds earned through non-member business.

In brief, issuance of shares of stock as a portion of patronage refunds, is not accompanied by a general expectation of rapid redemption. The decision to redeem is always in the hands of the board of directors.

Revolving retains: The per-unit retains method is used in relatively brief (three-to seven-year) revolvement periods. When issued, they tend to carry with them the expectation of a predictable revolvement period based on past practices of the cooperative and current revolvement policies. While the board may extend the revolvement period on the retain, it does not do so casually. The retain may be worth three to seven percent of a member's annual crop.

This is in contrast to revolvement practices in stock cooperatives upon which cooperatives don't carry an expectation of rapid redemption. The relatively rapid revolvement practices of non-stock cooperatives may explain, in part, the fact that many growers view retains as debts and ask why dividends are not paid on those funds.

In fact, however, the bylaws of non-stock cooperatives describe these funds differently, sometimes labeling them as equities and sometimes as debt, but virtually always indicating that redemption is at the discretion of the board of directors and generally indicating that they are subordinate to all other obligations of the cooperative.

Transferability of Equity Shares

The transfer of shares is not typical, but is seen with increasing frequency among stock cooperatives. First, bylaws typically state that the board of directors must approve the exchange of equity in their cooperative. Second, the earnings of a cooperative belong only to its member owners and then in proportion to use. Therefore, no investor would have a rational interest in the acquisi-

tion of cooperative equity as an investment. However, when cooperatives require members to hold equity in proportion to patronage, and when the cooperative is profitable and its capacity fully utilized, the value of membership and therefore the equity of the share may increase to the point that they are willing to pay other members for their shares.

This phenomenon has been most common among the closed "new generation" cooperatives and others (Agri-Link) with innovative financial approaches. Members of stock cooperatives with base capital plans have bought and sold equities to meet base capital requirements, but the extent of such transactions is not recorded and is reportedly low.

Per-unit retains in non-stock cooperatives are not known to be transferable.

Ownership Rights on Dissolution of the U.S. Cooperative

The question that prompted this study—specifically, which financial instruments will be viewed as liabilities and which will be viewed as equities led us to look for tests of ownership which, in the authors' views, are most directly aligned with equity in the cooperative.

One such "test" is that of how the cooperative's net worth would be divided in the case of its dissolution. For any cooperative, this question is somewhat easily researched by examining the bylaws of the cooperative.

Investigators in this study, did not examine all cooperative bylaws. However, based on the bylaws that have been examined, the following appear to be reasonable generalizations:

Stock cooperatives: Bylaws typically indicate that allocated equities are the last criterion for residual claims on the net worth of a cooperative. While, as a practical matter, this may be the case, it could be argued based on Subchapter T that once equities are redeemed, any residual would have to be distributed on the basis of patronage history.

Non-stock cooperatives: As the last criterion for distribution of residual claims, non-stock cooperatives use the patronage histories of their members. This criterion follows all other obligations of the cooperative to which the per-unit retains of the cooperative are subordinated. For example, one cooperative indicates that the patronages histories of the last three years will be considered, another indicates that patronage histories of the last six years will be considered, and still another claims that it would attempt to estimate the entire patronage histories of all members.

Subordination of equity shares and retains: The equity shares in stock cooperatives and the per-unit retains in non-stocks tend, in bylaws, to be subordinated to all other financial obligations of the cooperative. Thus, while some bylaws define equity shares as all-encompassing, including everything from debt to equity, the board declares that it has discretion abou the time of redemption and specifies that retains bear no dividends.

Dividends on Shares

In U.S. cooperatives, dividends on shares per se are relatively rare. Patronage dividends are earnings of the cooperative that are returned to members in proportion to their use for patron-

age of the cooperatives. These may appear as cash (at least 20 percent must be in cash) or as new equities in stock cooperatives.

A limited return on equities as equities is paid by some cooperatives. This amount is limited to meet the requirements of tax and anti-trust treatment, both of which state that single-tax treatment or qualification under Capper-Volstead are conditional on limited dividends, or on one member-one vote rules within the cooperative.

Control

Democratic control of cooperatives is also a condition of tax treatment under Subchapter T of the IRC. Democratic control does not necessarily mean one member, one vote. While most cooperatives probably still operate on a one member, one vote basis, proportional voting arrangements are tied increasingly to patronage (tons of walnuts) or weighted combinations of patronage and equity holdings. Proportional voting schemes typically limit the percentage of the total votes that can be held by any single member.

Pressure to change from a one-member, one vote control system to a proportional voting system occurs simultaneously with a substantial change in the financial stake held by one group of members compared relative to another. For example, when Farmland Industries, historically a purely federated cooperative, chose to allow individual memberships for pork producers, they voted as well to accept a proportional voting structure.

Technical Footnotes

Various forms of allocated equities arising from patronage are used by cooperatives. A brief description of those commonly used follows:

Audit and Accounting Guide

Retained patronage allocations. Retaining patronage earnings through methods such as the issuance of qualified or non-qualified written notices of allocation is a major form of financing by cooperatives.

Per-unit retains. Are used in marketing cooperatives in accordance with debt agreements, bylaws or board of directors' authorizations. These amounts are determined without regard to earnings and may be based on a rate per ton, on a percentage of earnings, or on a percentage of the dollar amount of raw product delivered. Amounts are withheld from payments to patrons for deliveries of raw products and are credited to the account of each patron.

If the retained patronage allocations and per-unit retains have no fixed maturity dates and are subordinated to all debt instruments, they should be treated as equity with appropriate disclosure of face value, dividend rate, negotiability, subordination agreements and any revolving or retirement plan.

In 1999 The Canadian Accounting Standards Board (AcSB) issued the following statement: The AcSB has agreed to commence a project to require that liabilities and equity be presented on an entity's balance sheet according to clear, conceptually sound, practical criteria for distinguishing one type of item from the other. Most if not all of the items to which the standard would be directly applicable would be financial instruments or components of financial instruments. The project is expected to follow closely the FASB project on Liabilities & Equity and to result in amendments to CICA Handbook - Accounting Section 3860, Financial Instruments - Disclosure and Presentation.

Thus, it seems that the Canadian regulators are paralleling the U.S. FASB efforts.

Most recent status: At the March 29, 2000, board meeting, board members raised no objections to moving forward to the preballot draft and expected no dissentions.

Perspectives on the Definitions of Equity and Debt

As part of the research conducted for the NSAC, the authors were asked to comment on the implications of alternative definitions of equity and debt from different professional perspectives.

1) From the perspective of the tax accountant:
Tax aspects of the classification of member investment as debt versus equity may be inconsequential, since the tax classification of patronage (dividend) payments to growers is now generally well understood and independent of classification. That is, no matter how a cooperative classifies member retains or base capital investments in its books, the tax law still treats returns to members as a patronage refund (with proper advance tax planning).

Example: A cooperative in the Midwest classifies member-retained funds as a "subordinated

debenture" both in its books and its bylaws. It still treats returns to members as an equity dividend for tax purposes. The cooperative's bylaws contain liquidation features that are also very equity-like.

2) From the perspective of the banker:
The biggest issue is likely to be the potential effect on the balance sheet if member equity is classified as debt—creating the perception of even more debt, discouraging lenders who are hesitant about cooperatives in the first place. That would be the reason the Midwest cooperative called the member funds "subordinated" debt, as in subordinated to any other debt the cooperative might raise from outside lenders.

3) From the perspective of an attorney:
Legally, well-documented ways now exists to organize a cooperative around a separate joint venture or subsidiary so as to retain cooperative status.

Attorneys seem to be residually concerned about the following issues that might potentially result in the loss of cooperative status:

Voting rights – restructuring (or reinterpretations of member equity positions) should not give nonmember holders of securities voting rights in the coop or the ability to obtain voting rights. In fact, this restriction might extend to member voting rights if extended based on ownership rather than patronage.

Dissolution issues; basis for sharing net worth on dissolution-patronage history or equity.

4) From the perspective of the economist:
Classification of member investment as debt or equity shouldn't matter as long as tax (see Tax Specialist perspective) or cooperative status effects (see legal perspective) are not present.

A relatively simple interpretation is to describe the range of financial instruments as a continuum defined by two extremes. At one extreme is pure debt. At the opposite extreme is pure ownership.
Pure debt is senior to all other financial instruments and has clearly specified terms of repayment such as a rate of interest, time of repayment, guarantee of repayment, and no expectation of profit sharing. Pure ownership "equity" has: rights to all revenue net of all expense, the highest possible risk of loss, the highest possible expectation of gain, the right to net worth in case of dissolution and no guaranteed time of redemption.

Between these two extremes are financial instruments that reflect continuums of subordination and risk. The label used for a financial instrument is less significant from a financial point of view than is its seniority and associated risk. For example, one might, as some California cooperatives do, label a retain as a debt of the association to its members. However, this does not change the fact that in some bylaws, it is clearly defined as junior to all other financial obligations in dissolution. (Some bylaws take greater pains than others to point out that their members' retains are junior to all other debt.)

5) From the perspective of the European cooperative:
As far as European cooperatives are concerned, classification of allocated member-retained funds does not appear to be an issue of concern. Those few cooperatives that issue debt-type instruments to members appear to include the amounts in the equity account.

6) From the perspective of the IASC:

The IASC position on liabilities and equity is very similar to the revised FASB position. Clearly, this is a timely question. As global food trade expands, as international joint ventures and acquisitions of food companies accelerate, competitive pressures will lead cooperatives as well to consider mergers, consolidations and even international memberships. Cooperative leaders and their financial officers will ask, "How do cooperatives in other countries differ from our own? What special challenges might we encounter as we consider mergers or consolidations with cooperatives in other countries?"

U.S. cooperatives meeting FASB standards will wish to understand how their European counterparts define equities and liabilities. They will ask as well, "How would a merger, acquisition or consolidation affect our balance sheet?" In addition, they will want to know how lenders, tax specialists and allied professionals view their financial statements if definitions of equity and liability change.

As we respond, the following questions also seem appropriate.

Under what circumstances are FASB standards binding or influential? What cooperatives would be affected by changing standards?

Any cooperative with registered securities must comply with FASB standards. As a practical matter, any cooperative that receives credit from commercial banks would also be expected to do so as well. Therefore, definitions of equity and liabilities — the focus of this study, potentially affect the balance sheets of many U.S. cooperatives.

These are sure to include, but not be limited to the largest U.S. cooperatives with the greatest presence in their industries and those that export U.S. products or import others. To the extent that U.S. cooperatives establish close financial relationships with European cooperatives or other firms, those too will be affected by FASB rules.

The European firms with which U.S. cooperatives deal may be among the largest, and most progressive. However, as U.S. firms consider acquisition, consolidation or merger partners, this will not necessarily be true. U.S. cooperatives may find it easier to achieve their purposes by seeking out smaller firms. To the extent that such relationships are pursued by U.S. cooperatives, the European firms' definitions of liabilities and equities will be of great interest as U.S. cooperatives seek to evaluate decisions relative to merger, acquisition or consolidation.

Because our resources are limited, this study focuses on comparisons of the most common U.S. finance models with the financial practices of the largest European cooperatives with the largest market presence. This does not mean that FASB standards may not ultimately affect smaller cooperatives. But the latter are likely to follow standards set by the larger firms.