Effectively Managing Capital Credits

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They are known by a variety of names – capital credits, patronage dividends, patronage refunds, equity allocations, and the like – but they all serve the same purpose: to return equity in the cooperative to members and patrons. They are the defining attribute of cooperatives. So why are they generating so much controversy over recent years? Why should cooperative accountants, in particular, be concerned about effectively managing them?

I) Why Do Capital Credits Matter?

Federal law and the law of most states provide cooperatives with various benefits, such as favorable regulatory treatment, tax exclusions and deductions for patronage dividends, and exemption from income taxes, property taxes, and sales taxes. These advantages come with rules and restrictions – the most obvious of which is that a cooperative must, in fact, be a cooperative.

Cooperative laws generally define “cooperative” with reference to the three Puget Sound principles, named after the seminal federal tax case. The last of the three principles states that a cooperative must operate at cost by returning excess margins to patrons on the basis of patronage. Capital credits are the basic mechanism by which cooperatives accomplish the third principle. Accordingly, to qualify as a cooperative under most cooperative laws, the cooperative must properly allocate and retire capital credits.

The failure to properly manage capital credits may cause all sorts of problems. It could result in the loss of benefits provided to cooperatives, such as tax exemption or deductions for patronage dividends. It may also result in lawsuits by members or patrons against the cooperative, its board, or upper-management. Lawsuits involving capital credit management have become more common in the past few years. They have been filed in Arizona, Georgia, Missouri, New Mexico, North Carolina, South Carolina, and Texas. Some of the plaintiffs have sought class status, seeking to sue the cooperative on behalf of all members or all similarly situated members.

The most common allegations of the lawsuits center around cooperatives’ alleged failure to timely and properly allocate and retire capital credits. The following are specific allegations made against cooperatives:

- A cooperative failed to retire capital credits despite having the financial wherewithal to do so;
- A cooperative violated its own capital credit retirement policy;
- A cooperative violated the state electric cooperative statute concerning retirement of capital credits;
- A cooperative’s bylaws violated public policy because they effectively resulted in forfeiture of members’ patronage capital
- A cooperative had no system in place to routinely retire capital credits

- A cooperative did not notify its members and patrons of their capital credit allocations

- A cooperative's retirement practices discriminated against classes of members (e.g., former members) in favor of other members

- A cooperative maintained an excessive amount of patronage capital or unusually high equity-to-asset ratio, indicating that it was not properly retiring capital credits

- A cooperative improperly discounted capital credits and retained the discount as permanent (non-member) equity

- A cooperative's board of directors had concealed the amount of members' patronage capital by preventing access to the cooperative's books and records and denying members access to board meetings.

Lawsuits involving capital credits can be costly and pose enormous risk to cooperatives. Cooperatives may even be faced with litigating insurance coverage for the claim. Furthermore, cooperatives make long-term strategic plans based on the assumption that a set amount of patronage capital will be available for future capital needs. When this assumption is jeopardized by a class-action lawsuit, cooperatives' strategic plans are put at risk.

Besides legal compulsion and the threat of lawsuits, there are other reasons to effectively manage capital credits. Cooperatives can use capital credit retirement as a tool to generate goodwill among members and patrons. Receiving a check from a cooperative reminds patrons of "one more" reason they should appreciate their cooperative. It also might alleviate tensions with membership or quell any discontent among patrons. It is perhaps the most effective marketing tool of cooperatives.

A) Why Should Accountants Care? It All Starts (and Ends) With Accounting

Effective capital credit maintenance is clearly a sensible goal. So what role do accountants play? Cooperative accountants are on the frontlines of capital credit management. They record patronage-sourced and non-patronage-sourced income, expenses, gains, and losses; they log patronage units attributable to each patron; they advise upper management and the board concerning the feasibility and effect of capital credit retirement; and they oversee the retirement process. Simply stated, accountants have direct responsibility over effective management of capital credits.

Cooperative accountants provide their board members with timely and accurate information that is relevant to capital credit retirement decisions. Accountants possess intimate familiarity with the most critical factor of capital credit retirement decisions: the cooperative's current and prospective financial condition. In other words, directors and trustees heavily rely on accountants to tell them whether, and to what extent, the cooperative can retire capital credits without harming the cooperative's current and future financial health. Occasionally, directors and trustees, and even upper management, need to be reminded that this essential function of capital credit management would not be possible without the service of cooperative accountants.

II) Effective Capital Credit Maintenance

Cooperative accountants should take an active role in effectively managing capital credits. There are a number of tools and strategies to reduce the risk associated with capital credits, and accountants play a vital role in each.

A) Assess Current Capital Credit Policies and Practices

Step one involves an assessment of current policies and practices governing capital credits. Every system needs improvement – especially systems that can threaten a business's smooth operation and financial stability. Capital credit policies and procedures are certainly no exception.

Cooperatives should first determine whether their bylaws and policies comply with applicable state and federal laws. State enabling acts typically set specific rules and limitations for handling patronage capital and retirement of capital credits. State laws may also address classification of members and patrons for the purpose of capital credits and director election.

Depending on the type of cooperative, federal tax laws impose requirements for retirement and notification of members and patrons. For instance, a substantial body of federal tax law governs capital credit retirement for Subchapter T cooperatives, agricultural cooperatives, and rural electric and telephone cooperatives. Applicable Treasury regulations and Internal Revenue Service rulings and pronouncements should be reviewed with reference to each cooperative's capital credit policies and procedures.

In addition to applicable laws, contracts with individual members and patrons may set parameters regarding capital credits. Contracts may contain provisions that address the calculation of patronage capital and the timing of capital credit retirement. Contracts with such provisions can present thorny problems, especially when the contract is not consistent with applicable cooperative laws. Cooperatives do not want to be forced to choose between breaching a patron's contract and complying with state or federal law.

In assessing capital credit practices, accountants have their own additional set of issues. Some of the key accounting considerations would include:

- adequate accounting of patronage transactions
- proper calculation of patronage units for each individual member and patron (e.g., gross billings, units purchased or sold, or kWh)
- controls to distinguish patronage transactions from non-patronage transactions, member transactions from non-member transactions, operating versus non-operating transactions, exempt function versus non-exempt function transactions, transactions among various classes of membership, and transactions among lines of business
- maintaining records to identify each member's and patron's patronage for each year
- whether capital credit accounting is consistent with the customer's contract or rate schedule
- timely notification of members

- compliance with applicable deadlines for payment of capital credits

It should be clear by now that accountants play a fundamentally important role in cooperatives' capital credits system and risk mitigation. Cooperative accountants should therefore take a leadership role in the second step to effective capital credit maintenance – risk assessment and mitigation.

B) Capital Credit Risk Assessment and Mitigation

After examining current practices and policies, cooperatives should take measures to minimize risk associated with capital credits. In a cooperative's risk matrix, risk associated with capital credits deserves special attention. Again, accountants should play a front-and-center role in mitigating such risk.

Those cooperatives that do not have written policies concerning capital credits should strongly consider drafting one. Written policies set a cooperative-wide standard for the effective management of capital credits. They provide guidance to board members, some of which are not familiar with the importance of capital credit retirement decisions.

Capital credit policies can provide evidence of the cooperative's commitment to rational and regular return of patronage capital. Such policies – if properly drafted and consistently followed – would assist the cooperative and its attorneys in the event of litigation or regulatory inquiry.

Another approach to minimizing risk involves a targeted assessment of risk associated with capital credits. As risk levels increase, cooperatives might more intently consider retirement of capital credits, as long as retirement does not negatively impact the cooperative's finances.

Like any risk assessment, cooperatives must compile and rank risk components associated with capital credits. Components may include the following:

- Magnitude of Patronage Capital: a higher balance of patronage capital vis à vis debt indicates higher risk

- Age of Capital Credits and Length of Rotation Periods: older capital credits and longer rotation periods indicate greater risk

- Board Turnover and Contested Elections: higher turnover of board members and intense election contests are generally negative risk factor

- Member or Patron Satisfaction: risk decreases as members and patrons feel satisfied with their cooperative

- Cost/Benefit Comparison: risk is greater when customers perceive the cooperative's fees as higher in comparison to its benefits

- Competitor Pricing Comparison: risk is higher when customers perceive the cooperative's fees as greater than the fees of local competitors

- Economic Conditions of the Community: when the economy of the cooperative's community declines, risk increases

- Media Exposure: media exposure can positively or negatively impact risk

By evaluating risk components, board members can make more informed decisions about capital credit retirement. And they can more effectively balance important factors, such as member satisfaction and goodwill as well as financial stability and long-term equity goals.

C) The Cooperative Accountant's Role in Capital Credit Retirement Decisions

Cooperative accountants fulfill an important function in capital credit retirement decisions. They assist the board in making an informed decision about whether to retire capital credits and in what amount. Accountants not only record and maintain data pertaining to capital credits, they format and present the data in a clear and comprehensible form. For instance, accountants can provide the board with such data as:

- capital credit account balances
- key financial ratios
- projected capital needs
- reserve fund balances
- equity and debt level goals
- pro forma models showing the effect of alternative capital credit retirement options

While data should be presented in the best format, board members will probably ask questions that only the cooperative accountant can answer. For this reason, accountants should be invited to board meetings in which capital credit retirement is on the agenda.

III) Conclusion

As capital credits mismanagement becomes a greater source of liability, cooperatives must actively work to assess and control the associated risk. Likewise, the role played by cooperative accountants will become increasingly important. Accountants can bring vital skills to reduce the risk associated with capital credits for the cooperative and for individual board members and management.

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David primarily practices in the firm's energy, tax, and construction law groups. His energy law practice involves advising utilities and electric cooperatives on their regulatory, transactional, and organizational questions. For example, David has prepared powerpurchase agreements for several utilities' wholesale power needs. He has advised electric cooperatives on the scope and impact of rules promulgated by the state public utility commission and the Federal Energy Regulatory Commission. He has also advised cooperatives on the tax benefits and burdens of operating on a cooperative basis, including advising several electric cooperatives on the requirements of tax exemption under I.R.C. § 501(c)(12).

His construction law practice includes complex litigation matters for clients that range from large owners, such as state and county governments, to smaller builders. He assists construction companies in avoiding and minimizing claims, resolving disputes, and closing out problem projects. He minimizes risk by strategically negotiating and drafting construction contracts and related agreements, structuring transactions, and organizing construction companies. Combining his energy, construction, and tax expertise, he helps energy developers and owners to implement their energy development and energy efficiency goals. He has advised clients in connection with the financing and development of renewable energy generation projects, focusing on financing, tax, power contracting, and construction issues. He has also advised owners, including state agencies, with regard to energy savings performance projects.

David is a member of the American Association of Attorney-Certified Public Accountants, American Institute of Certified Public Accountants, American Bar Association, State Bar of Georgia, Atlanta Bar Association, the Construction Financial Management Association, and the Electric Cooperative Bar Association. He is involved with the Georgia Electric Membership Corporation Counsel Association and Georgia Electric Membership Corporation Accountants Association.