The Story of Capital Credits

By Adam Schwartz, founder of The Cooperative Way

Capital credits, patronage dividends, patronage refunds—these are all familiar terms with similar meanings: the allocation of operating margins as equity and, when appropriate, retiring them to the members of the co-op in the form of money or credit on the bill.

The retirement of capital credits is one of the most important things we do as co-ops. It's unique to the cooperative business model, and as such, it can present tremendous competitive advantage for us, particularly if executed fairly and communicated well.

If we do it poorly, it can be a public relations disaster.

In my many visits to co-ops, I am often asked to discuss this topic. I typically approach my answer the same way: What are capital credits? Why do we have them? What are the benefits? What are the risks?

Why do co-ops allocate capital credits?

Federal law provides cooperatives with certain preferences and exemptions, such as federal tax-exempt status. Many state laws provide additional benefits. To retain this tax exemption, co-ops are required to operate on an at-cost basis. Capital credits facilitate operating at cost.

Whose job is it?

Ultimately, it is the board's responsibility to ensure that capital credits are handled—ideally pursuant to a board-adopted policy—in a manner that is consistent with federal and state laws while also ensuring the process complies with the co-op's articles of incorporation and the bylaws. Management can assist the board in shaping the policy, and it is management's job to implement it. Importantly, the board of directors has sole discretion in determining when to retire capital credits.

What happens if co-ops fail to do this properly?

Co-ops can experience problems, both legal and to their reputation, if they fail to handle capital credits properly. Like all governance problems, these issues can be limited if the appropriate procedures are put in place and executed.

What are some of the risks?

In *The Cooperative Accountant*, David Cook lists several factors co-ops should consider in implementing a   capital credits policy. Some of those factors are:

Amount of capital credits retired—Co-ops can incur risk to their financial position if they retire capital credits needed to build or retain co-op financial strength.

Age of capital credits—Co-ops can balance the desire to retire old capital credits with the desire to include current members by selecting a hybrid approach.

Member satisfaction—The timing of capital credit retirement, the amount retired, and how it is communicated are key to member satisfaction.

Rates—If members feel they are paying high rates, your co-op may need to carefully consider the balance between rate levels, equity level, capital needs, and capital credit retirements among other things.

Local and national economy—If economic conditions are poor, a co-op will need to carefully balance retiring capital credits to members, meeting capital needs, and retaining equity at the co-op.

Retiring capital credits to members can be a cause for celebration. Capital credits are not a pain to be endured but a crucial part of what makes co-ops special. With a good policy and proper execution, it is a great benefit for the members and the co-op they own.