INTERNAL CAPITAL ACCOUNTS:

Theory and Practice

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INTERNAL CAPITAL ACCOUNTS IN COOPERATIVE THEORY

The internal capital accounts are central to the worker cooperative legal structure recommended by the Industrial Cooperative Association and embodied in the ICA Model By-laws for a Worker Cooperative. There is an individual account for each member (recording the capital eventually due back to the member) and a collective account. The sum of the individual capital accounts and the collective account is the net worth or net book value of the corporation. Since this account structure is rather novel, this paper will examine the internal capital accounts from a variety of viewpoints such as cooperative theory, accounting, the treatment of profits and losses, tax policies and procedures, and corporate law [see An Introduction to the ICA Model By-laws for a Worker Cooperative for a section-by-section treatment of the By-laws].

The legal structure recommended by the ICA is of the same general type as the legal structure of the Mondragon cooperatives [see Thomas and Logan 1982; Ellerman 1982c]. While one can hardly attribute the phenomenal success of the Mondragon cooperatives to their legal structure, the structure has complemented and reinforced, rather than hindered, a number of other positive factors. There is such a multiplicity of factors affecting cooperatives that it is always difficult to single out any particular elements as being responsible for a given success or failure. Indeed, any attempt to design a proper legal structure solely by extrapolating from past successes would be quite underdetermined. Facts are always viewed in the light of theory. The question of legal structure is no exception. In particular, the model legal structure considered here is based on theory and is derived, in its broad contours, from first principles [Ellerman 1982a, 1982b]. The application of the legal structure has been much refined in practice and will continue to be honed as more experience accumulates.

To understand cooperative legal structure, we first consider the legal structure of a conventional corporation. The shareholders in a conventional corporation have a certain bundle of rights attached to their corporate shares. These rights consist essentially of the right to control the corporation by voting to elect the board of directors and the right to receive value from the corporation in the form of dividends while the stock is held and in the form of capital gains when the stock is sold at a higher

price. The total value that accrues to the shareholders can be analyzed as the sum of the net book value or net worth (= Assets minus Liabilities) of the corporate assets plus the value of the present and future economic profits [see the Book plus Profits Formula in Chapter 12 of Ellerman 1982]. Hence the bundle of rights attached to conventional shares is:

VOTING RIGHTS + ECONOMIC PROFIT RIGHTS + NET BOOK VALUE.

If we define

MEMBERSHIP RIGHTS = VOTING RIGHTS + ECONOMIC PROFIT RIGHTS, and

CAPITAL RIGHTS = RIGHTS TO THE NET BOOK VALUE,

then we have the following equation:

CONVENTIONAL SHARE RIGHTS = MEMBERSHIP RIGHTS + CAPITAL RIGHTS.

Enough concepts have now been developed so that we may properly characterize both a conventional corporation and a worker cooperative corporation.

> A corporation is <u>investor-owned</u> or <u>capitalist</u> if the membership rights (defined above) are property rights, i.e., rights that are transferable and marketable.
>
> A corporation is a <u>workers' cooperative</u> (or "self-managed firm") if the membership rights are personal rights attached to the functional role of working in the company — while the capital rights remain property rights.

The new Massachusetts worker cooperative statute, M.G.L. Ch. 157A [see Pitegoff 1982] was designed to provide a legal framework for a worker cooperative (in the sense just defined). Essentially the same statute has also been passed in Maine (13 MRSA Ch. 85, subchapter III). Aside from similar legislation being introduced in several other states, there are no U.S. statutes at present, cooperative or otherwise, which are designed to implement this definition of a workers' cooperative. In particular, the old

cooperative statutes are rather archaic and poorly designed. Without an appropriate statute, a cooperative as defined herein can still be organized within the legal framework of a stock business corporation or a statutory cooperative corporation. By appropriately drafting the articles of incorporation and by-laws, one can internally structure the company so that it will function as a Mondragon-type worker cooperative, e.g., the Industrial Cooperative Association Model By-laws for a Worker Cooperative.

The basic idea of the restructuring is to split apart the conventional bundle of rights attached to corporate shares so that the membership rights can then be treated as personal rights assigned to the functional role of working in the corporation. The conventional bundle of rights attached to corporate shares was analyzed (see above) in two parts: (1) the membership rights (voting rights plus net income or "labor-patronage" rights), and (2) the capital rights to the net book value or net worth of the corporate assets. The strategy is to have the membership rights attached to the shares and to create a new capital structure - the system of internal capital accounts -- to take over the function of carrying the net worth. With that net worth value removed from the shares, the shares can be treated just as carriers of the membership rights, i.e., as membership certificates, attached to the functional role of being a worker in the firm.

One of the flaws in traditional workers' cooperatives (e.g., the plywood co-ops in the northwest U. S.) is that the co-op shares continue to carry the net book value, so they can't be used as membership certificates. To give each newly qualified and accepted member a traditional co-op share as a membership certificate would be to make an unwarranted gift of a proportionate part of the net worth to each new member. Thus a new worker is required to buy at least one share to become a member, and this can be prohibitively expensive (e.g., $20,000 - $60,000 or more in some profitable plywood cooperatives). Moreover, membership should be designed in such a way that the person qualifies for membership by working in the firm and doesn't have to buy membership (even though, as specified below, there are financial obligations of membership).

The solution is to split off the net worth or net book value from the shares using a system of internal capital accounts, one account for each

member recording that member's share of the net worth. When a person leaves the firm or retires, the balance in his or her account is paid out by the firm over a period of years. A new worker does not have to individually pay off a retiring worker — as would be the case if a new worker had to buy a share with the accumulated value from a retiring member. With the rights to the portions of net worth recorded in internal capital accounts, the shares can then be treated as non-transferable membership certificates issued to new members and collected from exiting members. The new member would not be getting a portion of net worth, since the balance in the new member's account would start at zero.

Rights usually come together with obligations. For example, one does not have to 'buy' the rights of union membership or the rights of political citizenship, but there nevertheless are union dues and government taxes. In a workers' cooperative, one similarly does not 'buy' membership but there would be a fixed membership investment required of each new member as a financial obligation of membership. Most of that paid-in membership fee would be recorded in the new member's account. At the end of each fiscal year, interest is added to the account and the member's share of the retained positive or negative residual (computed after interest on the accounts) would be added to or subtracted from the account's balance. Each member's share of the residual is proportional to their labor as measured by their hours of work or by their pay.

There usually would also be a collective account that is unindividuated in the sense that it never has to be paid back to anyone during the lifetime of the corporation. By having a certain portion of the net worth that never has to be turned over or revolved as the membership turns over, the cooperative is helping to insure that it could eventually pay off the individual accounts. Hence the allocation to the collective account is a form of self-insurance.

The insurance rationalization for the collective account can be better understood by considering an alternative payout arrangement for the individual capital accounts. Suppose that all retained earnings were credited to the individual accounts. Since it would be rather difficult for the cooperative to payout such accounts, suppose that each terminating or retiring member were issued a negotiable perpetual bond for the full balance

in the account. Then the member would try to sell the bond on a bond market. Since the bond would be perpetual, the co-op would only have to service the bond (pay interest) and would not have to pay out the principal. In that manner, could the member reap the full value of the retained earnings (without having a portion collectivized)? The answer is unfortunately "No" because such bonds would sell at far below their face value due to the ever-present uncertainty about the future of the co-op (which must service the bonds). That discount on the face value of the bond would be the price of uncertainty.

Due to the absence of any reasonable external market for negotiable debt instruments issue by worker cooperatives, we assume that the co-op will itself try to "provide the market" by paying off the individual accounts, partly while an individual is a member with the remainder after termination or retirement. Uncertainty is still present, and it will exact its price. At the least, the co-op can try to self-insure by only promising to pay back a portion (called the "individual portion") of the retained earnings. The remaining portion of the retained earnings is credited to the collective account, and is called the "self-insurance allocation".

A cooperative might also have a <u>startup losses account</u>. There are usually sizable one-time losses incurred in starting up business. It would be unfair to the founding members to bear all these losses and not to have them shared by the members who arrive after the company finally turns a profit. The startup losses account is a means of spreading those losses over a multi-year period. It is what accountants would call a "contra-account" or an "offset account" to the collective account. Its balance subtracts from the balance in the collective account, and, over the years, those losses 'seep' out of the startup losses account into the individual capital accounts of the future members.

The individual, collective, and startup losses accounts are adjusted each year to reflect the retained net income, paid-in membership fees, and paid-off accounts so that the sum of the individual and collective account balances minus the startup losses account balance always equals the net worth.

OTHER LEGAL STRUCTURES FOR WORKER OWNERSHIP

With the internal restructuring based on the internal capital accounts and the share membership certificates, a corporation would legally function as a Mondragon-type worker cooperative. This worker cooperative structure might be compared to three other legal structures used for worker ownership:

(1) employee-owned corporations,
(2) traditional worker cooperatives, and
(3) Yugoslav-type self-managed firm.

An employee-owned corporation might have direct ownership of the shares by the employees or indirect ownership through a trust such as an Employee Stock Ownership Plan (ESOP). Without additional restructuring, an employee-owned corporation is an investor-owned company where the investors are the employees. Companies which are directly employee-owned tend to degenerate quickly into conventional management or absentee ownership (e.g., the Vermont Asbestos Group or the Mohawk Valley Community Corporation). The life-cycle of an ESOP depends, in part, on the structure of the trust arrangement, e.g., on whether the ESOP will buy back the shares issued to departing employees. In any case, there is no separation of the membership and capital rights; both rights are directly or indirectly owned as property rights by the employees. The membership rights are not personal rights attached to the functional role of working in the firm, the net income is not allocated according to labor, and the voting is ordinarily not on a one-person/one-vote basis.

The traditional workers' cooperatives in the U.S. (e.g., the plywood co-ops) do not detach the net book value from the co-op's shares (i.e., no internal capital accounts, no separation of personal and property rights). Each member typically owns one share. A member gets one vote even if he or she owns more than one share. The new workers often cannot afford to buy the shares of retiring members, so in order to fill the jobs, new workers tend to be hired as non-member employees. Sometimes, as the founding members approach retirement with no prospective market for their individual shares, they band together and sell control of the company to a conventional firm in order to capitalize their shares. Indeed, some of the plywood co-ops were sold, while most of those that remain as cooperatives have a

significant number of non-member employees.

The common ownership firms of Great Britain and the Yugoslavian self-managed firms do, in effect, treat the membership rights as personal rights assigned to the functional role of working in the firm. But they do so at the price of eliminating the members' property rights to the net worth, the reinvested fruits of their past labor. It is as if a cooperative was incorporated as a non-profit corporation with no individual internal accounts and only the collective account. Thus the net income or profit rights assigned to the workers are incomplete, since the workers lose any claim on the retained net income. It becomes "common property" or "social property." Misplaced idealism and Marxist ideology notwithstanding, there really is no good reason why the workers should be forced to forfeit the value of the fruits of their labor simply because they reinvest it in the company. This destroys the incentive to invest by retention of earnings as opposed to borrowing.

Instead of retaining earnings, it would be rational for the workers to distribute all earnings, deposit a portion in a savings account, and then have the bank loan the money back to the firm. In that manner, the company could (indirectly) self-finance its investment without the workers being forced to give up any recoupable claim on the reinvested earnings. That is impractical, but the practical solution is to move the savings accounts into the firm itself. That is the conceptual origin of the idea of the internal capital accounts. Moreover, that is the solution worked out and field-tested by the Mondragon cooperatives over the last two decades.

In this model legal structure for a worker cooperative, the two parts of the traditional bundle of ownership rights, the membership rights and the capital rights are treated quite differently. The membership rights are personal rights attached to the role of working in the firm, while the capital rights are property rights owed to the worker-members. In the past, legal structures for worker ownership have usually floundered on either the Scylla of the "worker-capitalist" structure or the Charybdis of the "non-profit" structure. In the worker-capitalist structure (used in employee-owned corporations and to some extent in the traditional statutory worker co-ops) the membership rights are treated as property rights combined with the capital rights, and in the non-profit structure (used in the

Common Ownership firms or the Yugoslav firms) the membership rights are treated as personal rights but only at the cost of eliminating the workers' capital rights.

The system of Mondragon-type internal accounts takes the function of carrying the net worth away from the shares so that the membership rights, evidenced by the shares, can be fully transformed into personal rights assigned to the workers' functional role. The net worth due to each worker-member, representing the reinvested fruits of their labor, is not thereby sacrificed since it remains a property right evidenced by the balance in the member's internal account. In this manner, a proper legal structure will transform a company from a piece of property into a social institution wherein people will receive the fruits of their labor and have democratic control over their worklives.

SOME ACCOUNTING BACKGROUND FOR INTERNAL CAPITAL ACCOUNTS

"Money in an internal account?" What does that mean? There is often confusion about what it means to have money or value in a worker-member's account, so we must delve into the nature of these accounts.

First we must review the basic form of a balance sheet in a conventional corporation.

B A L A N C E S H E E T

	ASSETS:		LIABILITIES:	
CAPITAL ASSETS (Capital owned)	Cash Accounts Receivable Inventories Plant and Equipment Land		Accounts Payable Wages Payable Current Notes Payable Other Current Liab. Long Term Debt EQUITY: Paid-in Capital Retained Earnings	CLAIMS ON CAPITAL (Capital owed)

The important point is that one can consider left-hand side (LHS) and the right-hand side (RHS) as representing, respectively, the value of the capital assets and the claims against the corporation for that capital. The claims on capital value can be divided into two parts, "debt capital" and "equity capital". Debt capital represents the claims against the

corporation on the part of external creditors. The equity capital represents the residual claim of the owners or members of the corporation. The equity capital is conventionally divided into the "Paid-in Capital", representing the capital paid in or contributed by the external owners, and the "Retained Earnings", representing the capital value internally generated and retained in the corporation.

Is a given machine debt capital? The answer is not yes or no. The answer is that it is an ill-posed question because a machine is a capital asset (LHS of balance sheet) while debt is a claim on capital (RHS of balance sheet). A given machine might have been financed with capital raised from debt or equity sources, but the machine itself is neither debt nor equity capital.

In a cooperative corporation with internal capital accounts, the equity capital can also be expressed as the sum of the individual accounts and the collective account (we temporarily ignore the startup losses account).

C O O P E R A T I V E B A L A N C E S H E E T

ASSETS:	LIABILITIES:
Same	Same
	EQUITY: Individual Capital Accounts Collective Account

Thus the same total EQUITY in a cooperative can be expressed in two ways:

(1) according to the source in Paid-in Capital (e.g., membership fees) and Retained Earnings (e.g., retained patronage dividends), or
(2) according to the ultimate claimants (the individual worker-members or the 'collectivity' in the case of the collective account).

This double aspect is not new. Debt capital, for example, has the two faces: (1) it is a source of capital, but (2) it also represents a claim against the firm for the value of the debt. The money is from someone and must be paid back to someone.

The individual/collective account split and the paid-in capital/ retained earnings split are similarly two ways of cutting up the same equity

pie:

EQUITY = Paid-in Capital + Retained Earnings
= Individual Capital Accounts + Collective Account.

And the two classifications overlap or cut across each other in the sense that an individual account, for example, will contain elements of both paid-in capital (e.g., membership fees) and retained earnings (e.g., retained patronage dividends).

We are finally in a position to explain the idea of "money being in an internal account." That is only a figure of speech. Money is not "in an internal account" because money, in the form of cash, is a capital asset (LHS of balance sheet) whereas the internal accounts, representing equity capital, are residual claims on capital value (RHS). The balance represented in an internal capital account might be embodied in cash, inventories, plant and equipment, or in any other assets. That is the meaning of the language in the ICA Model By-laws which states that amounts credited to the individual capital accounts "may be used for any and all corporate purposes."

This "money-in-an-account" figure of speech is also used for savings accounts in a bank, and, here again, it is only a figure of speech. If one put money in a safe deposit box (as opposed to a savings account), then indeed the money would literally be in the box. But when one puts money in a bank savings account, then such an account is a liability, a claim on capital on the RHS of the bank's balance sheet. Some is held in cash reserves, some is loaned out as notes receivable, and the remainder is invested in other assets such as marketable securities (all on the LHS of the bank's balance sheet).

The word reserves is sometimes used to describe two totally different types of accounts: (1) a subaccount of Retained Earnings (a claim, RHS) and (2) a sinking fund of set-aside cash or other liquid assets (an asset, LHS). For example, a portion of retained earnings (RHS) might be designated as a "Reserve for the Retirement of Debt." This name conjures the image of a fund of cash set aside to pay off a debt, but it is nothing of the sort. A company could have a large reserved portion of retained earnings and yet

have hardly any cash or liquid assets. A reserved portion of retained earnings boils down to being only a restriction on dividends. Cash dividends reduce retained earnings. But if a portion of retained earnings is "reserved," then no dividends may be declared which would eat into those reserves. It is quite different for a company to have a sinking fund or reserve fund for the retirement of debt as an asset (LHS). That is a specific use of capital. Current usage in Accounting recommends that reserved portions of retained earnings be called "Appropriated Retained Earnings," and that the word "reserves" be reserved for sinking funds of assets.

These points about reserves are relevant to understanding the collective account. The ICA Model By-laws state that the collective account is not to be appropriated by the individual members during the lifetime of the corporation. The confusion over "reserves" crops up when the collective account is referred to as the "collective reserve." Sometimes one finds the interpretation that "the money in the collective reserve" is reserved for use by the cooperative while "the money in the individual accounts" is somehow available to be used or drawn out by the individual members. But there is no money "in the internal accounts" in the first place, and the balances represented by both the individual and collective accounts are embodied in any and all of the corporate assets (and cannot be drawn out on demand). The collective account is only a "reserve" in the sense that cash dividends may not be declared and subtracted from the balance in the collective account. In that sense, the collective account is not to be appropriated by any members as individuals during the lifetime of the corporation.

THE INTERNAL CAPITAL ACCOUNT ROLLOVER OF RETAINED PROFITS

When the ICA Model By-laws state that retained patronage dividends (evidenced by written notices of allocation and credited to the individual accounts) "may be used for any and all corporate purposes," that includes the payment of debts (as well as the financing of assets). In that regard, retained patronage dividends are quite different from cash (capital or patronage) dividends. The payment of debt and the payment of cash dividends are alternative competing uses of earnings. The same earnings cannot be used for both.

A retained patronage dividend is the name given to a certain portion of the retained net income that is allocated to the members in accordance with their labor patronage. It is a source of capital, whereas a cash patronage dividend (or a payout of previous retained patronage dividends) is the opposite, a use of capital. Hence a retained patronage dividend is perfectly compatible with a debt payment. The same earnings could be treated as retained patronage dividends and <u>also</u> be used to pay off debts.

Debt retirement with retained patronage dividends is one of the main ways workers build up their capital accounts in a cooperative. Conventional corporate lawyers sometimes do not realize that retained patronage dividends and debt retirement are mutually compatible. Hence there have been some (non-ICA) by-laws drafted for cooperatives which only allowed patronage dividends to be declared out of "net savings," where the latter was net of principal payments on debt (e.g., the Denver Yellow Cab Co-op by-laws).

Yet another use of earnings is to pay off the old written notices of allocation which evidence past retained patronage dividends. This is the process of <u>rolling-over the internal capital accounts</u>. Earnings are first retained in the company and credited to all the current members' accounts in accordance with their patronage. Then the earnings are used to pay out entries in the members' account which are a certain number of years old. This procedure of systematically paying out the retained patronage dividends after a fixed time period is recommended for a variety of pragmatic reasons.

Other arrangements are possible. For example, farmer co-ops sometimes

use a procedure which leaves it at the discretion of the board of directors to pay off the written notices whenever there is a sufficient surplus of funds. But this usually doesn't work. Small businesses 'never' have a sufficient surplus of funds. Hence it is best to have a payout that is 'mandatory' — unless adverse circumstances or subordination agreements force the Board of Directors to delay the payout.

It is possible to have a mandatory payout geared to retirement or termination rather than geared to a fixed time period. This would allow for maximal capital retention during the first generation of members, but it involves several difficulties. It seems to reward those who leave the cooperative and to penalize those who stay. This could, to some extent, be compensated for by only paying out a smaller portion of a member's account if the member left voluntarily, before retirement age, to work in another company.

In the longer run, another problem with the retirement payout plan is the bunching of retirees. Often new companies go through a period of rapid growth. Like a baby-boom, this 'member-boom' will have later repercussions. It will impose unacceptable decapitalization demands on the company when the large wave of members reach retirement age. This is one of the major future problems facing the Mondragon cooperatives. The Mondragon co-ops only pay out interest on an internal account during a member's tenure, and there is a penalty imposed for voluntarily leaving before retirement to work outside the Mondragon complex. The full balance is paid out if the member remains until retirement. The member-boom in the Mondragon cooperatives, from the golden years of growth in the sixties and early seventies, will tend to decapitalize the co-ops around the turn of the century — unless some countermeasures are taken.

Another problem arises from the marked inequality of accounts under the wait-until-retirement plan. The alternative fixed-rollover plan has the effect of equalizing the accounts (as will be explained below). But if the co-op waits until retirement, then the accounts of the older members will loom large in comparison with the newer accounts. The ICA model cooperative structure is specifically designed so that the membership rights (voting and patronage dividend rights) are personal rights based on labor and are thus independent of the capital account balances. But if there are huge

inequalities in the financial risk borne by the members (due to large inequalities in account balances), then, even with the best of intentions, this will unnecessarily distort the democratic process within the cooperative.

The ICA Model By-laws, for the reasons suggested above, use a fixed-rollover payout plan rather than a retirement payout plan. The rollover method does not penalize those who stay with the cooperative since the payout of retained patronage dividends is then independent of retirement. The rollover method avoids the problem of the bunching of retirees by smoothing the payout stream and by making it more independent of demographics (although it introduces the problems of financing the pre-retirement payouts). And the rollover method tends to equalize the account balances so it mitigates the tensions created by large inequalities of financial risk.

An example will help illustrate two of the attributes of the rollover method, the smoothing of the payout stream and the equalization of the account balances. Consider a simple example with three representative members: member L with a Large account balance of $10,000, member M with a Medium balance of $6,000, and member S with a Small balance of $2,000.

Member:	L	M	S
Account Balance:	$10,000	$6,000	$2,000

Without a fixed rollover plan, the demands on the company's financial resources would be unpredictable and widely varying. There might be a large, medium, small, or no demand depending on which member, if any, terminated. The rollover plan smoothes the stream and makes it predictable.

Assume a fixed rollover period (e.g., five years) where, at year's end, the previously retained patronage dividends due to be paid out are $2,000 for L and $1,000 for M. Member S, being newer to the co-op, does not yet have any written notices old enough to be paid off. These patronage dividend payouts are quite predictable (e.g., known five years ahead of time) and are independent of whether the worker has terminated in the meantime. Suppose that the retained patronage dividends for the current year are $4,200 and that all members have equal current labor patronage.

Hence each member gets a $4,200/3 = $1,400 credit to their account, and L and M get the cash payouts and the corresponding debits to their accounts.

Member:	L	M	S
Old Account Balance:	$10,000	$6,000	$2,000
Current Patr. Div.:	1,400	1,400	1,400
Payouts:	-2,000	-1,000	0
New Account Balance:	$9,400	$6,400	$3,400.

The equalizing tendency is already evident; the difference between accounts has been reduced from $4,000 to $3,000. This process of putting in the new, and paying out the old, retained patronage dividends is the process of rolling over the internal accounts. It will tend to equalize the balances in the accounts because (a) the inflows or credits will add more or less equally to the accounts since the credits are based on current patronage, while (b) the debits or payouts will tend to subtract from the larger accounts for the members who have been there the longest and have the oldest written notices of retained patronage dividends. The amount of the payout ($3,000 in the example) adds a little to all the accounts more or less equally while it is subtracted from the balances of the larger accounts. Hence the smaller accounts go up and the big accounts come down. That is the leveling or equalizing tendency of the rollover plan.

A retained (positive) patronage dividend is credited to a member's internal capital account and is externally evidenced by a written notice of allocation of patronage dividends. In order for these patronage dividends to be paid out under a five year rollover plan, they must first run a five year gauntlet. That is, any retained losses (i.e., "negative patronage dividends") are debited first against the membership fee and any accumulated interest and then against the oldest and, thus the next to be paid off, written notices of allocation. Hence any written notice which does finally 'mature' after five years will have run the gauntlet of potential debits. It is then to be 'rewarded' by being paid off. The fixed rollover plan thus tends to equalize the risks borne by the members. With a termination payout plan, the long-term members would carry the lion's share of the risk and this would tend to have an insidious effect on the internal democratic processes. With the fixed rollover plan, everyone's retained patronage

dividends will be exposed to the same gauntlet and then paid off.

The benefits of the rollover plan have their price. Obviously, it will impose greater cash flow demands on a cooperative during its first generation than would a termination plan which postponed most payouts until the first generation of members started to retire. Financial planning is required to meet these cash flow demands. In the absence of intervening losses, the cooperative knows five years ahead of time about the payouts -- so it has the opportunity for advance planning.

The crux of the matter is that the co-op must schedule the wages and salaries paid out during the year at a level that will leave enough at year end to finance the payouts. This is less of a burden on the senior members who will be getting the double income of both salaries and account payouts. It is more of a burden on the newer members who don't yet have the second income of five-year-old account payouts. But that does not seem unfair because the newer members have not yet borne the risk of having their patronage dividends retained in the co-op for the five year period.

To undertake the rollover plan in a serious manner, the co-op must not adopt the naive attitude of setting current wages and salaries as high as possible and then hoping for enough year-end profits to finance the scheduled payouts. The co-op should provide, with reasonable assurance, for the year-end surplus to finance the payouts by setting an appropriate level of wages and salaries in the projected cash budget or cashflow statement to be approved by the Board of Directors and/or the members.

The senior creditors may well have concerns about a rollover plan, or about any payout from the capital accounts. Most financing agreements with banks or public financing agencies would require prior consent for any payout of old or current patronage dividends to the members. However, the financiers will tend to be guided by their experience with conventional companies. Co-ops have some significant differences with regard to dividend payouts. Financiers would tend to question dividend payouts more than wages and salaries. Yet in a worker co-op, the members control within limits the decision about whether labor income is treated as wages or patronage dividends. The most 'responsible' action for a young co-op would be to maximize retained patronage dividends consistent with reasonable wages.

However, it is difficult to maintain a maximal retention policy without some reasonably assured payout after a number of years. If financiers would block any payout of five-year-old patronage dividends, but would not block 'equivalent' higher wages ('equivalent' in the sense of total cash outflow), then they would be forcing the members into the 'irresponsible' practice of maximizing wages with little or no reinvestment. Hence a rollover plan may also require education work with financiers if the loan agreements require prior consent for any patronage dividend payouts.

THE TREATMENT OF NET INCOME: AN OUTLINE

There is a federal tax break for worker cooperatives so that ultimately the member pays only the personal income tax on income from the cooperative which is declared as "patronage dividends" (PDs). The cooperative eventually avoids the corporate income tax of patronage dividends, although it may have to first pay the tax and then get it later refunded or credited against future taxes (see the procedure for 'non-qualified' patronage dividends below). If the PDs are immediately paid out in cash, they are deducted from taxable corporate income, and the individual member pays the personal tax. However, the ICA recommends that PDs for a given year always be retained in the cooperative for a time period (the "rollover period"), and then paid out in cash.

There are two methods of treating the retained patronage dividends, i.e., by evidencing them with NON-QUALIFIED or QUALIFIED written notices of allocation of patronage dividends. The relevant federal tax law is Subchapter T, sections 1381-1388 of the Internal Revenue Code of 1954.

If the NON-QUALIFIED written notices of allocation are used, only the cash redemptions of the non-qualified notices which can be deducted from taxable corporate net income. Thus when patronage dividends are originally declared and 'paid' in non-qualified written notices of allocation, the corporate income tax is paid. When the allocation notices are eventually redeemed in cash, the redeemed amount is deductible from the taxable income in that year. The non-qualified written notices of allocation do not

constitute taxable personal income to the members — until redeemed. Hence the member's personal income tax is postponed until the allocation notice is redeemed in cash.

One complication in the calculation of the corporate tax in any company is the possible difference between tax-basis net income (net income allowed by tax laws and regulations for tax computation) and accounting net income in accordance with the Generally Accepted Accounting Principles (GAAP). For example, tax laws might permit special forms of accelerated depreciation (e.g., Accelerated Cost Recovery System depreciation) which were not in accordance with GAAP. The general rule is that patronage dividends and the internal capital accounts should be based on accounting net income, but that a cooperative might use a different tax-basis net income for tax computations. The only legal requirement is that the co-op cannot declare patronage dividends in excess of the tax-basis net income for the fiscal year. In the examples developed below, we shall ignore the possible differences between tax-basis and accounting net income.

The following symbolism will help to concisely describe the calculations with the net income when non-qualified PDs are used (qualified PDs are treated later).

ANI = accounting net income
REDMPD = redeemed value of non-qualified written notices of allocation
TNI = taxable net income
MISCD = miscellaneous deductions not related to PDs (e.g., loss carryovers)
TAX = federal corporate income tax
INT = interest on individual capital accounts
PD = patronage dividends
CPD = cash PD
RPD = retained PD evidenced with written notices of allocation
SIA = self-insurance allocation to the collective account
RNI = retained net income.

When the non-qualified written notices of allocation are used, then the net income computations can be made as follows. The computation is simpler if we assume, unless otherwise specified, that the cash patronage dividend is zero, i.e., CPD = 0. This is quite reasonable, since in the early years,

lenders would frown on cash dividends, and after several years, cash pay-outs should go to redeem the senior non-qualified written notices of allocation representing past retained patronage dividends - instead of being used to pay out current patronage dividends. Under the assumption that CPD = 0 and that the accounting net income is the tax-basis net income, the taxable net income is:

$$TNI = ANI - MISCD - REDMPD, \text{ or}$$

Taxable Net Income = Net Income - Misc. Deductions - Redeemed PDs.

The tax on TNI is computed as usual. For example, if the rate for TNI less than $25,000 is 15%, then TAX = .15 TNI. That is, the tax is 15% of the taxable net income.

The accounting net income ANI is assumed to be split 50-50 between the individual and collective parts. The corporate taxes TAX are subtracted from the collective part to yield the self-insurance allocation SIA (which is allocated to the collective account):

$$SIA = (.50\ ANI) - TAX.$$

The other 50% of the accounting net income is the individual part. The interest on the individual capital accounts is subtracted from that individual part and the remainder is the (positive or negative) patronage dividend or allocation to the individual members:

$$PD = (.50\ ANI) - INT.$$

The interest is divided between the individual capital accounts in proportion to the capital in the accounts (since interest is computed as a percent of the balance in each account). The patronage dividend or patronage allocation is divided between the accounts in proportion to the labor patronage of the individual members during the fiscal year.

Since we have assumed no cash patronage dividends, PDs are retained, i.e., RPD = PD, and all the dividends would be paid in non-qualified written notices of allocation. The retained net income is

$$RNI = ANI - TAX - CPD = INT + PD + SIA.$$

The retained net income can be used for any and all corporate purposes, such as redeeming old non-qualified allocation notices, i.e., financing the REDMPD payments.

For a numerical example, suppose that the before-tax accounting (and tax-basis) net income is $10,000, and that the loss carryovers are $4,000 with no patronage dividend redemptions. Hence the taxable net income is

$$TNI = ANI - MISCD - CPD = \$10,000 - \$4,000 = \$6,000,$$

and the corporate taxes at a 15% rate are

$$TAX = .15\ TNI = .15 \times 6,000 = \$900.$$

Hence the self-insurance allocation to the collective account is

$$SIA = (.50 \times 10,000) - 900 = \$4,100.$$

Suppose that there is a balance of $20,000 in the individual capital accounts and that interest accrues on these accounts at the rate of 6%. Then the interest is

$$INT = .06 \times 20,000 = \$1,200,$$

so the patronage dividend is

$$PD = (.50 \times 10,000) - 1,200 = \$3,800.$$

The retained net income is

$$RNI = ANI - TAX - CPD = INT + RPD + SIA = 10,000 - 900 = \$9,100.$$

An extended multi-year example of the tax and internal account calculations is given in a later section. It also involves the amortization of start-up losses and the five-year patronage dividend rollover.

Appropriate language is used in the Model By-laws to allow a cooperative to use QUALIFIED written notices of allocation to evidence retained patronage dividends. Moreover, the membership agreement signed by the members should include a clause explicitly stating that they agree to include the face value of any qualified written notices of allocation they receive in their reported taxable personal income. The By-law language and the written agreement insure that the allocation notices are "qualified" in the sense of section 1388(c) of the IRC. A sample membership agreement, with an appropriate tax clause, is included in the By-laws package.

The entire amount of the patronage dividend can be deducted from taxable corporate income if the dividend is paid in qualified written notices of allocation (or cash). In contrast, the amount of a non-qualified allocation notice is only deductible when the notice is finally redeemed in cash. However, the qualified written notices must be included in the member's personal income so the member must pay personal income tax on them in the year they are received — even though the members might not receive the cash until five years or more later. The company is required by law to pay at least 20% of the patronage dividend in cash to cover those personal income tax payments.

If the qualified notices are used, then the net income calculations can be made as follows. As above, the patronage dividend is

$$PD = (.50\ ANI) - INT = (.50 \times 10{,}000) - 1{,}200 = \$3{,}800.$$

The 20% cash dividend is $CPD = .20 \times 3{,}800 = \$760$, so the retained patronage dividend is $RPD = PD - CPD = 3{,}800 - 760 = \$3{,}040$. The retained patronage dividend is evidenced to the members with qualified written notices of allocation. The entire patronage dividend of $3,800 is qualified to be deducted from taxable corporate income, so the taxable net income is

$$TNI = ANI - PD - MISCD = 10{,}000 - 3{,}800 - 4{,}000 = \$2{,}200,$$

and the corporate tax is

$$TAX = .15 \times 2{,}200 = \$330.$$

The tax is subtracted from the collective half of the accounting net income to yield the self-insurance allocation:

$$SIA = (.50 \times 10{,}000) - 330 = \$4{,}670.$$

The retained net income is

$$RNI = ANI - TAX - CPD = INT + RPD + SIA = 10{,}000 - 330 - 760 = \$8{,}910.$$

The use of the cooperative tax break, with either non-qualified or qualified allocation notices, means that sooner or later the personal income tax must be paid but that the corporate tax is ultimately avoided. The difference between the non-qualified and qualified notices lies mainly in the timing of the payments. With the qualified notices, the personal income taxes are paid upfront and the corporate tax is altogether avoided. With the non-qualified notices, the corporate tax is paid upfront but the company gets a deduction from taxable net income when any non-qualified notices are redeemed in cash. Then the corporate tax is, as it were, refunded and the members pay personal income tax on the cash redemptions.

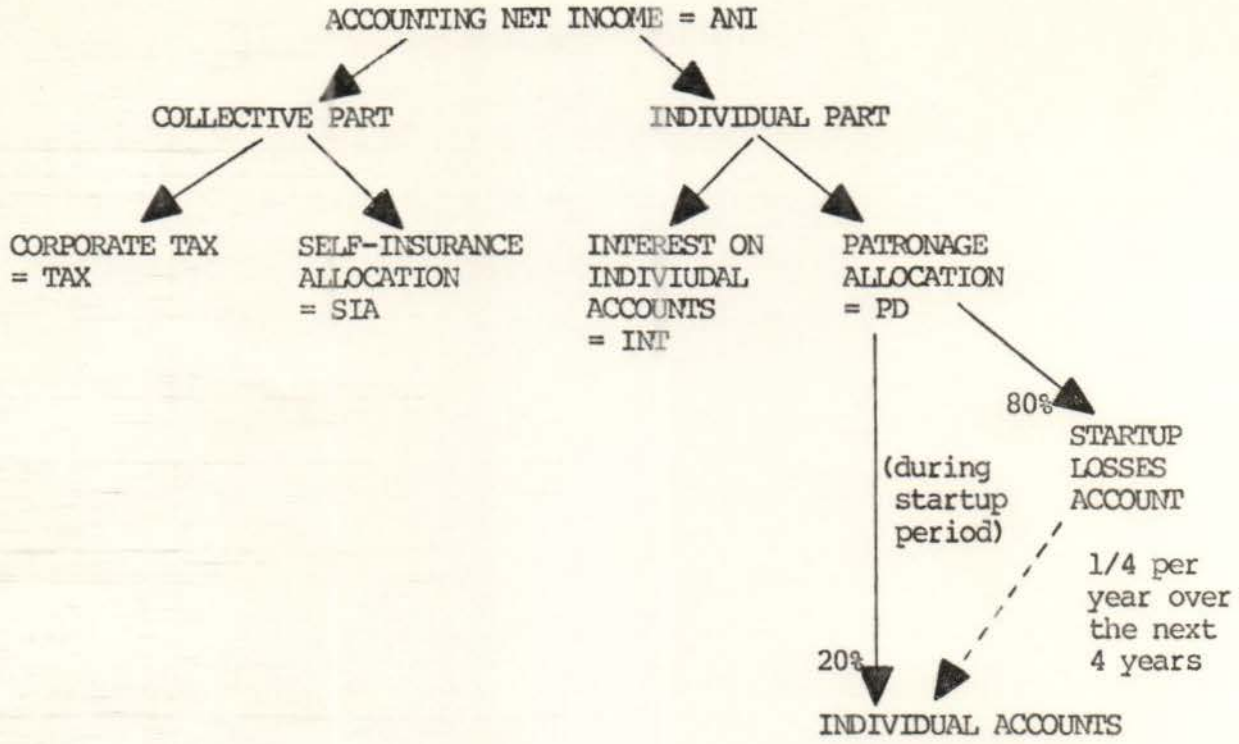
If the qualified notices are used, the co-op is required to pay at least 20% of the patronage dividend in cash, presumably to cover the personal income tax payments. When the lowest corporate tax rate was 22%, there was some cash-flow advantage — a cash break — in using the qualified notices. However, the lowest corporate tax bracket is now 15%, so there is a cash break in using the non-qualified written notices of allocation, at least for companies in that tax bracket. Moreover, there are some other advantages to using non-qualified notices. In the first years with positive net income, there are often startup loss carry-overs which can be a shelter from the corporate income tax. If the By-laws required the use of qualified notices, then the co-op would still have to pay out 20% in cash upfront. The same holds if the corporate tax can be reduced or avoided using the Investment Tax Credit. For such reasons, the ICA recommends the use of the NON-QUALIFIED written notices of allocation for cooperatives in the lower tax brackets.

There are two possible definitions of PATRONAGE in a workers' cooper-

ative: the hours worked or the labor compensation (e.g., as shown on the W2 form) for the hours worked. It is a choice of whether the patronage allocation, be it positive or negative, should be distributed equally per hour of work or equally per dollar pay.

The 50-50 split of the accounting net income into the individual part and the collective part could be a different numerical split. If the percentage of non-members' patronage in any given year exceeds the by-law-stipulated percentage for the collective part, then the collective part should be increased to that larger percentage for that year, so that members will not receive patronage dividends from the patronage of non-members in their probationary period.

TREATMENT OF THE NET INCOME:
(during startup period)



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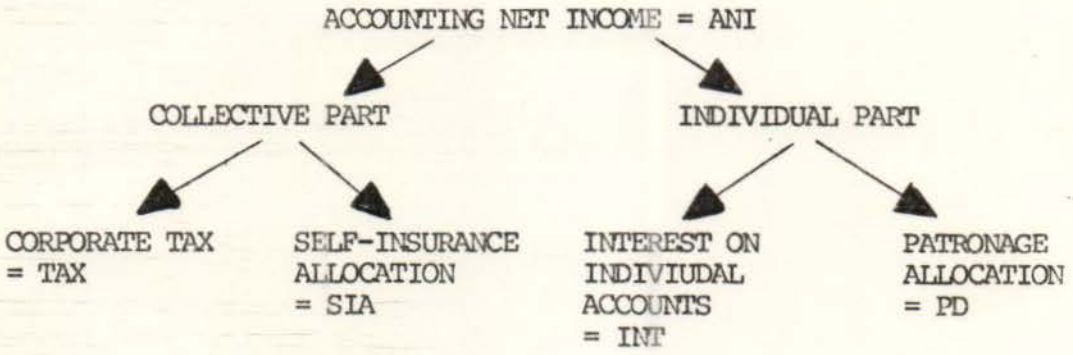
TREATMENT OF THE NET INCOME:
(after startup period)



ACCOUNTING FOR LOSSES: GOING CONCERN LOSSES

In the early years of a cooperative, there are usually going to be more retained losses than retained profits. It is necessary to have some rational pre-determined policy for the allocation of losses. No one likes to have their account debited so, in the absence of a fixed policy, the tendency would be to leave the individual accounts intact and to let the collective account absorb the debits. When the co-op makes a profit, the tendency is, of course, the reverse.

It is useful to distinguish between two different situations;

1) loss allocations in a going concern, and
2) loss allocations in the first years of a new startup.

To consider the first situation, there should be a standardized and fixed procedure to allocate any losses occurring in a normal going concern (not one-time startup losses). The accounting net income is split into equal individual and collective parts. It seems reasonable and fair to use the same procedure for both retained losses and profits. In times of profit, no less than 50% is collective and, in times of loss, no more than 50% of the loss is collective. After interest, the remaining amount of the individual part is allocated, positive or negative, to the individual accounts in proportion to each member's patronage for the year. If positive, it is credited to the individual accounts, and if negative, it is debited.

To understand the details of the debiting, let us first review the internal structure of an individual account. Each individual capital account can be broken down into two parts; 1) the short-term part externally evidenced by written notices of allocation of patronage dividends due to be rolled over, and 2) the remaining long-term balance due to the paid-in membership fees and accumulated interest on the acount. The two parts are treated differently for tax purposes. That is the reason for rolling over the patronage dividends (after the fixed period) instead of the interest allocations.

With the <u>"non-qualified" written notices of allocation</u>, the co-op

pays the corporate tax when the patronage dividends are first declared and retained. When they are later paid out, the non-qualified patronage dividend redemptions are deductible from taxable corporate income, and then the individual pays the personal income taxes on the payouts.

"Qualified" written notices of patronage allocations give the opposite tax break. The individual pays the personal tax when the qualified patronage dividend is declared and retained in the company. This personal tax is being paid on a 'paper' dividend. The company is required by law to distribute at least 20% of qualified patronage dividends in cash (as opposed to written notices) to cover those tax payments. The positive aspect of the qualified written notices is that they are deductible from taxable income when originally declared -- not when paid out (as with the non-qualified written notices). They are 'qualified' for that tax deduction. And when they are finally paid out, there is no further personal tax liability.

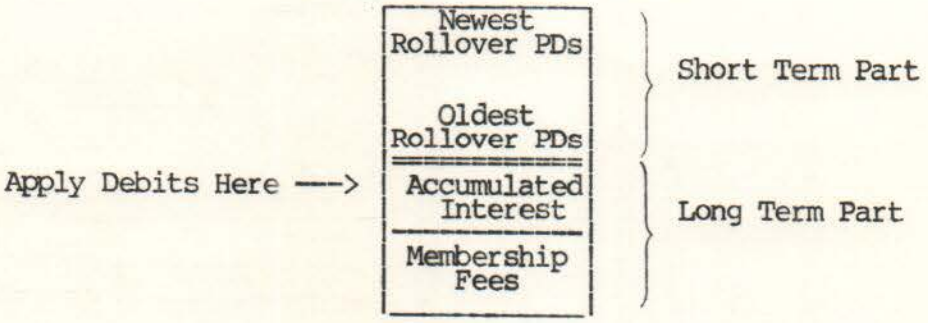
There is thus, a tax break associated with the payout of either the non-qualified or qualified notices. With the non-qualified notices, the payout or redemption is deductible from taxable corporate income, and with the qualified notices, there is no personal tax liability on the payout (since the personal taxes were paid when the PDs were originally declared). In contrast, a payout of accumulated interest has no tax break associated with it. Due to one among many archaic irrationalities in GAAP (the Generally Accepted Accounting Principles) and the tax codes, accrued interest on capital financed from equity sources (as opposed to debt sources) may not be treated as a deductible corporate expense. Hence there is no tax break when interest is accrued or paid out. Moreover the interest is taxable personal income when paid out.

The 'top' part of an individual account (see next diagram) might be called short term because it represents the written notices due to be rolled over after the fixed rollover period (e.g., 5 years). The remaining balance could be called long term in that it is only paid out after termination or retirement and even then over a period of years. By leaving the accumulated interest in the long-term part of the account, the intent is to obtain long term capital gains personal tax rates on the ultimate payout.

Which part of an account should be debited for retained losses

("negative patronage dividends")? If the losses are debited against previously retained PDs, then when cash is eventually paid out, that much less of the payout will be treated as a PD redemption. If say $100 of 'erased' PDs were non-qualified, then a later payout of $100 of accumulated interest or membership fees (after termination) would not be tax deductible at the corporate level (whereas a non-qualified PD redemption is deductible). If the $100 erased PD was qualified, then the personal income taxes on the PDs have already been paid. Thus a later $100 payout of accumulated interest or membership fees would be taxable at the personal level (whereas the same $100 payout labeled as a "qualified PD redemption" would be tax-free). Hence for tax purposes it is desirable to apply the debits first to the accumulated interest and membership fee — not to the PDs (unless there is nothing else left). For these tax reasons, the ICA recommends first debiting losses against the interest and membership fees. Only after the accumulated interest and membership fees are exhausted should the debits be applied to the written notices of allocation of patronage dividends.

Method of Handling Losses



An Individual Internal Account

It might be noted that it is possible to have positive profits (i.e., positive accounting net income) but a negative patronage allocation to the individual accounts. This will occur when the interest on the individual accounts exceeds half the positive accounting net income. Then all individual accounts will increase proportionally due to the interest allocation, but the patronage allocation will be negative.

For tax purposes, the written notices of allocation are preserved as long as possible from being debited. However, it should not be inferred that the written notices can always be redeemed on schedule. If a co-op is

not making enough accounting profit to cover interest on the accounts, or is making losses, then it will not be in a good position to redeem the oldest written notices. The Board of Directors may choose or be forced by creditors to postpone the scheduled redemptions of written notices.

ACCOUNTING FOR STARTUP LOSSES

In most any startup, there are sizable initial one-time losses due to product development, organization, and market penetration costs. If these losses were debited to the members' accounts, it would wipe out the membership fees of the founders and pioneers. Anyone entering the co-op after it had struggled to achieve breakeven would share in the later profits without having to share in the startup losses. Hence a special procedure is necessary to provide a fair allocation of the startup losses.

In the Mondragon cooperatives, the startup losses (the losses up to the time of the first profit) are 30% currently expensed and 70% capitalized as an 'asset.' This 'asset' is then depreciated over a period of seven years — so most of the startups losses are spread over that time period.

This approach involves at least two problems, one practical and one theoretical. The practical problem is that in the American context, the Internal Revenue Service will not in general allow the capitalization of the bulk of the startup losses. Usually product development and market penetration costs cannot be capitalized and must be expensed. The theoretical problem is that the capitalization approach contributes to the irresponsible practice of putting imaginary 'assets' on the balance sheet when there is no identifiable and transferable property right involved. For example, it can be plausibly argued that the founders of a cooperative business will always make some mistakes, and that later members should equitably share in the cost of these mistakes. But it is quite another thing to treat these mistakes as creating 'assets' which later members must, in effect, buy from the founders.

There is a way to equitably share the startup losses without capitalizing them as assets. In double entry bookkeeping, assets are debit balance accounts while liabilities and equity accounts are credit balance

accounts. A contra-equity account is a debit balance account which offsets or subtracts from the balance in an equity account. The startup losses, which are not to be currently individuated, can be debited to a contra-equity account called Startup Losses, instead of debiting them to an asset. This will avoid the IRS objections to capitalizing the startup losses as assets and it would not involve imaginary assets. This contra-equity account can be considered as an offset to the collective account. Then instead of depreciating an asset, the contra-equity account is amortized over the years to equitably share out the startup losses. Hence the startup losses are all expensed as current losses, but they are, for the most part, 'suspended' in the contra-equity account. Over a period of years, they will 'seep out' of the contra-equity account into the individual capital accounts.

The startup loss allocation procedure is used until the cooperative reaches the breakeven point, i.e., has a positive accounting net income. Then for that year and each subsequent year, the normal procedure for the allocation of profits and losses is used. The time from the start of operations up to but not including the first profitable year is called the startup period. For startup losses, the suggested method is to spread the startup losses over a five year period. During the startup period, it is the after-interest portion of the individual half of the loss (the negative patronage allocation) which is amortized over five years. Hence one-fifth or 20% of the patronage allocation is currently debited to the individual accounts according to patronage, and the remaining four-fifths or 80% is debited to the debit-balance account of Startup Losses. Then one-fourth or 25% of that four-fifths is debited to the individual accounts according to patronage at the end of each of the next four years. Thus the negative patronage allocation is spread over a five year period. For a seven year spreadout, one seventh of the negative patronage allocation would be taken as a current negative patronage allocation. The remaining six-sevenths would be debited to the startup losses account and then amortized over the next six years.

APPENDIX

A MULTI-YEAR EXAMPLE OF ALLOCATION OF LOSSES AND PROFITS

The following example of accounting for profits and losses is only intended to be illustrative of the accounting calculations. It is not intended to be a normative model of business or financial planning. It might also be noted that some of the sums may be off a dollar or two due to accumulated rounding error.

Suppose that the cooperative splits the accounting net income half-and-half between the individual part and the collective part. Ten (10) workers each pay in an initial membership fee of $5,000 (borrowed from the ICA Revolving Loan Fund) which is credited to their individual capital accounts. Hence the equity section of the initial balance sheet is:

EQUITY AT BEGINNING FIRST YEAR:	
Individual Accounts	$50,000
Collective Account	0
Total Equity	$50,000

At the end of the first year of operations, the accounting (and tax-basis) net income is -6,000 dollars. The collective part is 50% or $-3,000. The individual accounts accrue interest at the rate (say) of 6% so $3,000 of interest accrues to the individual accounts. Hence the negative patronage allocation is $6,000 (= .50 x -6,000 - 3,000). Twenty percent (20%) or $1,200 is taken as a current negative patronage allocation, and the remaining 80% or $4,800 is put into the startup losses account to be amortized over the next four years. Hence the new equity portion of the year-end balance sheet is:

EQUITY AT END FIRST YEAR:		
Individual Accounts	$51,800	[= 50,000 + 3,000 - 1,200]
Collective Account	(3,000)	[= 0 - 3,000]
Less: Startup Losses	(4,800)	
Total Equity	$44,000	[= 50,000 - 6,000]

At the end of the second year, suppose that the accounting net income is -2,000 dollars of which $-1,000 is the collective portion. The interest on the individual accounts is 6% of $51,800 or $3,108, so the negative patronage allocation is -1,000 - 3,108 = $-4,108. Twenty percent (20%) is $-822, the current patronage allocation, and the remaining 80% or $3,286 is allocated to the startup losses account. Since the startup losses account is to be amortized over a four year period (25% a year in straight-line fashion), 25% of its old balance of $4,800 or $1,200 'seeps out' and is debited to the individual accounts. At the end of the second year, two new members are admitted. They pay in $10,000 of membership fees ($5,000 each). Hence at the end of the second year the equity portion of the balance sheet is:

EQUITY AT END SECOND YEAR:		
Individual Accounts	$62,886	[= 51,800 + 3,108 - 822 - 1,200 + 10,000]
Collective Account	(4,000)	[= -3,000 - 1,000]
Less: Startup Losses	(6,886)	[= 4,800 - 1,200 + 3,286]
Total Equity	$52,000	[= 44,000 - 2,000 + 10,000]

At the end of the third year, suppose that the accounting net income is +1,000 dollars so breakeven has been obtained. This terminates the special startup loss allocations so the net income is to be treated in the normal fashion. The collective part of the accounting net income is $500. The interest on the individual accounts is 6% of $62,886 or $3,773 so the patronage allocation is $500 - 3,773 = -3,273 (note the positive net income and the negative patronage allocation). All of the patronage allocation is current since the startup period is finished. The seepage from the startup losses account is another 25% of the first year losses of $4,800 or $1,200 plus 25% of the second year losses of $3,286 or $822, for a total of $2,022 to be debited to the individual accounts from the old startup losses. These losses allocated amongst the accounts, including the accounts of the new members in the third year, according to labor patronage. There is no corporate income tax due to the loss carry-forwards. Two of the founding members leave the cooperative at the end of the third year, but before that is recorded the new equity portion is:

EQUITY AT END THIRD YEAR:

Individual Accounts	$61,364	[= 62,884 + 3,773 - 3,273 - 2,022]
Collective Account	(3,500)	[= -4,000 + 500]
Less: Startup Losses	(4,865)	[= 6,886 - 1,200 - 822]
Total Equity	$53,000	[= 52,000 + 1,000]

Let us suppose that the termination procedure is to close the internal account at the end-of-the-year balance, and, conditions permitting, to pay out 20% at that time and then 20% at the end of the next four years. To see the balance in a founder's account, we assume that each worker had the same labor patronage each year (the individuated normal and startup losses were allocated amongst the accounts according to labor patronage). The activity in a founder's account through three years is as follows:

Initial Balance	$5,000
First Year's Interest	300
Member's Portion of Individuated Startup Loss	(120)
Balance End First Year	$5,180
Second Year's Interest	311
Member's Portion of Individuated Startup Loss	(82)
Member's Portion of Amortized Yr1 Startup Loss ('seepage')	(120)
Balance End Second Year	$5,289
Third Year's Interest	317
Member's Portion of Amortized Yr1 Startup Loss (1200/12)	(100)
Member's Portion of Amortized Yr2 Startup Loss (822/12)	(68)
Member's Portion of Current Loss (3,273/12)	(273)
Balance End Third Year - Founder's Account	$5,165

The closing balance in a Founder's account at the end of year 3 is $5,165. Twenty percent or $1,033 is paid out to each of the terminating founders, and the remainder of their accounts is reclassified as a subordinate debt evidenced by a subordinate note. The effect on the equity at the end of year 3 is to subtract 2 x 5,165 = $10,329 from the Individual Accounts total.

EQUITY AT END THIRD YEAR (after terminations):

Individual Accounts	$51,035	[= 62,884 + 3,773 - 3,273 - 2,022 - 10,329]
Collective Account	(3,500)	[= -4,000 + 500]
Less: Startup Losses	(4,865)	[= 6,886 - 1,200 - 822]
Total Equity	$42,671	[= 52,000 + 1,000 - 10,329]

At the end of the fourth year, there is an accounting net income of $8,000 of which $4,000 is the collective part. The interest on the individual accounts is $3,062, so the patronage allocation is 4,000 - 3,062 = $938 which is declared as a non-qualified patronage dividend and evidenced with non-qualified written notices issued to the members. The seepage from the startup losses account is 1,200 + 822 = 2,022 subtracted from the individual capital accounts on a patronage basis (note the positive patronage allocation from current operations and the negative patronage allocation from the startup losses account).

There were a total of $8,000 = $6,000 + $2,000 of losses in the first two years, and $1,000 of these loss carry forwards were used last year to protect the $1,000 third year profit from tax liability. Hence the remaining $7,000 of loss carry-forwards can be used against this year's $8,000 profit. With non-qualified patronage dividends to be declared (and no non-qualified PD redemptions), the taxable income is $1,000. At a 15% corporate tax rate, the corporate income tax is $150 — which is subtracted from the collective portion, so the net credit to the collective account is the self-insurance allocation of $4,000 - 150 = $3,850.

The equity at the end of the fourth year is:

EQUITY AT END FOURTH YEAR:		
Individual Accounts	$53,014	[= 51,035 + 3.062 + 938 - 2,022]
Collective Account	350	[= -3,500 + 4,000 - 150]
Less: Startup Losses	(2,843)	[= 4,865 - 1,200 - 822]
Total Equity	$50,521	[= 42,671 + 8,000 - 150]

Six more years of the example are contained in the following computer printout. For simplicity, it is assumed that there is no further change in membership. At the end of years 9 and 10, the patronage dividends declared at the end of years 4 and 5 are paid out in cash ("rolled over"), and the taxable income in year 9 is accordingly reduced by that redemption of non-qualified patronage dividends.

As emphasized initially, these calculations are only intended to be

illustrative, and should not be taken as a normative model of financial planning. One obviously unsatisfactory aspect of the model as a financial plan is the low cash payout to the members who do not terminate, e.g., $94 after 9 years is the first rollover payout with the modest profit assumptions of the model. With such a small expected payout, there would be much pressure for increased cash bonuses — which in turn may endanger reinvestment in the firm's assets. Unless the firm plans to go out of business in the near future, saving and reinvestment in the firm should be encouraged over current consumption of the firm's revenues. Hence any cash payout over and above the usual wages and salaries should be structured as a reward for saving and reinvesting in the firm.

The five-year-delayed cash payout of the patronage dividends is one example of such a reward. One way to increase the patronage dividends, and thus the amount of the rollover, is to lower the interest rate paid into the individual capital accounts. But 6% is hardly a high interest rate.

Another method (which is neither forbidden nor forced by the By-laws) is an early cash payout of some of the interest accumulating in the individual capital accounts. Such a cash payout would be construed as a capital dividend as opposed to a patronage dividend. Since each member holds an identical share, the capital dividend should be equal for each member. Hence it might be structured as a delayed payout of the interest on the membership fee -- since everyone presumably paid in the same membership fee. In the above example, 6% of the $5,000 membership fee is $300 a year. Hence with (say) a three year delay, each member would start receiving a cash payout of $300 a year starting at the end of the third year.

A Multi-year Example of Accounting for Profits and Losses

Ind. Acct. Int 6 %
Spread Yrs = 4 for Startup Losses
Rollover Yrs = 5 for Patronage Dividends

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Yr 1
Accounting New Income (according to GAAP)	-6000	-2000	1000	8000	7000	6000	7000	10000	10000	800
- Coll. Part (50%)	3000	1000	-500	-4000	-3500	-3000	-3500	-5000	-5000	-400
Individual Part (50%)	-3000	-1000	500	4000	3500	3000	3500	5000	5000	400
- Interest Int. Accts	-3000	-3108	-3773	-3062	-3181	-3270	-3400	-3610	-3910	-415
- Add to Startup Loss Spread yrs = 4	4800	3286	0	0	0	0	0	0	0	
Curr Patronage Alloc.	-1200	-822	-3273	938	319	-270	100	1390	1090	-15

TOTAL EQUITY ACCOUNTS

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Yr 1
Total Begin. Equity	50000	44000	52000	42671	50521	56471	61571	67521	76021	8372
+ Accting Net Income	-6000	-2000	1000	8000	7000	6000	7000	10000	10000	800
- Corporate Taxes	0	0	0	-150	-1050	-900	-1050	-1500	-1359	-115
- PD Rollover PMTs	0	0	0	0	0	0	0	0	-938	-31
- Terminated Accts	0	0	-10329	0	0	0	0	0	0	
+ Membership Fee 100%	0	10000	0	0	0	0	0	0	0	
Total Ending Equity	44000	52000	42671	50521	56471	61571	67521	76021	83723	9025
Sum Equity Accounts (from below)	44000	52000	42671	50521	56471	61571	67521	76021	83723	9025

A FOUNDER'S ACCOUNT

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Yr 1
Beginning Balance:	5000	5180	5289	5165	5366	5518	5740	6094	6599	701
+ Interest Int. Acct.	300	311	317	310	322	331	344	366	396	42
+ Curr Patr. Alloc.	-120	-82	-273	94	32	-27	10	139	109	-1
- Amort Startup Loss	0	-120	-168	-202	-202	-82	0	0	0	
- PD Rollover PMTs	0	0	0	0	0	0	0	0	-94	-3
Ending Balance:	5180	5289	5165	5366	5518	5740	6094	6599	7010	738

ANALYSIS OF EQUITY ACCOUNTS

INDIVIDUAL CAPITAL ACCOUNTS (Credit Balance)

Years:	1	2	3	4	5	6	7	8	9	10
Beginning Balance:	50000	51800	62886	51035	53014	54492	56671	60171	65171	69233
+ Interest Int. Accts	3000	3108	3773	3062	3181	3270	3400	3610	3910	4154
+ Curr Patr. Alloc.	-1200	-822	-3273	938	319	-270	100	1390	1090	-154
- Amort Yr 1 Startup	0	-1200	-1200	-1200	-1200	0	0	0	0	0
- Amort Yr 2 Startup	0	0	-822	-822	-822	-822	0	0	0	0
- Amort Yr 3 Startup	0	0	0	0	0	0	0	0	0	0
- Amort Yr 4 Startup	0	0	0	0	0	0	0	0	0	0
- PD Rollover PMTs	0	0	0	0	0	0	0	0	-938	-319
- Terminated Accts	0	0	-10329	0	0	0	0	0	0	0
+ Membership Fee	0	10000	0	0	0	0	0	0	0	0
Ending Balance:	51800	62886	51035	53014	54492	56671	60171	65171	69233	72913

COLLECTIVE ACCOUNT (Credit Balance)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Yr 10
Beginning Balance:	0	-3000	-4000	-3500	350	2800	4900	7350	10850	14491
+ Collective Part	-3000	-1000	500	4000	3500	3000	3500	5000	5000	4000
- Corporate Taxes	0	0	0	-150	-1050	-900	-1050	-1500	-1359	-1152
Self-Insurance Alloc.	-3000	-1000	500	3850	2450	2100	2450	3500	3641	2848
Ending Balance:	-3000	-4000	-3500	350	2800	4900	7350	10850	14491	17339

STARTUP LOSSES ACCOUNT (Debit Balance)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Yr 10
Beginning Balance:	0	4800	6886	4865	2843	822	0	0	0	0
+ Add to Startup Loss	4800	3286	0	0	0	0	0	0	0	0
- Amort Startup Loss	0	-1200	-2022	-2022	-2022	-822	0	0	0	0
Ending Balance:	4800	6886	4865	2843	822	0	0	0	0	0

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