Cooperative Finance

Developed by Tim O'Connell

Key Terms

- PATRONAGE: Use of a cooperative by its members.
- EQUITY: Money directly invested in a cooperative.
- NET RETURNS OR NET SAVINGS (PROFIT):The amount remaining after a cooperative subtracts it costs from its income.
- PATRONAGE DIVIDENDS: Distribution of net returns to members based on how much each member uses (patronizes) the cooperative.

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How Cooperatives Are Financed

- Equity capital is money the cooperative obtains from its members without assuming a legal obligation to pay it back at a stated time.
- Debt capital is money that is borrowed either short-term or long- term.

Cooperatives and Equity

- What is Equity?
  - Equity is member funds that buy ownership in a cooperative. Equity funds have two major purposes. They serve as a buffer when losses occur, and they finance growth.

Three Ways to Obtain Equity

- Direct investment (stock/membership fees)
- Retaining a portion of net income. (patronage)
- Retaining a portion of proceeds from sale of the members products. (Retains)

Types of Equity Capital

Member equity is recorded on the cooperative's books in two different ways.

- Allocated equity is designated (or allocated) to individual member accounts in proportion to their use of the co-op.
- Unallocated equity is not assigned to each member's account, but is left in a general fund. Most co-ops use unallocated equity to build a capital base and to use as a cushion from operating losses.

Cooperatives and Equity

- How are members (investors) paid back?
  - Funds can be returned after a set time period (revolving fund plan).
  - Members can be paid back based on how much they have invested used the cooperative (base capital plan).
  - A percentage of each member's equity can be paid back (percentage-of-all-equities plan).

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What is the Purpose of Equity?

- Protect the bank to which the co-op owes money.
- Gives the members a higher ownership than creditors.
- Gives owners more control and flexibility in how the business is operated and financed.
- Equity in a co-op should be at least 50% of assets.

Why is Co-op Equity Unique?

- Only from qualified members.
- Equity is redeemed at par-value.
- Equity is often raised through retains.
- Equity is considered a temporary investment.

Example

Capital Required		**$10,000**
Membership Fees		
50 members @ $100/per membership		**$5,000**
Total Equity:	**$5,000**	
Debt Capital Required	**$5,000**	
Total Capital Obtained		**$10,000**

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Example

Per-Unit Retains

Member A

Sells 500 lbs. of lettuce to the Cooperative @ $1.00/lb.	**$500**
Cooperative retains 10% for equity capital.	**$50**
Producer is paid balance.	**$450**

Retains of $50 are *allocated equity* to the member.

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Guiding Beliefs in Determining Capital Policy

- Each cooperative must determine its adequate level, but a rule of thumb is to have at least $1 of equity capital for every $2 of assets.
- The membership must have control over the cooperative's future.
- Equity ownership should be held by the current membership of the cooperative, namely those who patronize it within the past 3 years.

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Ways to Reduce Capital Needs

"Who controls the capital controls the business."

- Consolidation
  - Pooling to reduce costs
  - Influences efficiencies
- Joint Ventures
  - Between co-ops and other partners
- Partner with firms with superior market strength
  - Gain access to markets rather than control the markets

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Financial Statements

<u>3 Basic Financial Statements:</u>

- Balance Sheet
- Statement of Operations
  (profit and loss, operating statement)
- Statement of Cash Flows

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Balance Sheet

- A balance sheet is a statement of what you owe and what you own as of a specific date.
- It is called a balance sheet because the right column must equal the left column: they must "balance".
- The equation to balance is:

TOTAL ASSETS = TOTAL LIABILITIES + MEMBER EQUITY

(What is owned = What is owed to others + What is "owed" to Member's)

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Assets

Assets are classified by the amount of time it takes to convert into cash. Assets are shown on the left hand side of the balance sheet.

- *Current Assets*
  - can be turned into cash with in one year. They are listed at their expected reasonable value.
- *Fixed Assets*
  - are used repeatedly in the cooperative and are not intended for sale.
  - The net value of fixed assets listed on a balance sheet do not reflect the current market value or any future replacement cost.

Assets

Current Asset Examples

- *Cash:* money you have in a checking or savings account.
- *Accounts Receivable:* money that people owe that will be paid within 12 months.
- *Inventory:* stuff you have on hand that you plan on selling within 12 months.

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Assets

- Fixed Asset Examples
  - *Equipment:* how much was paid for tools and equipment.
  - *Buildings:* how much was paid for all buildings owned.
  - *Land:* how much was paid for all fee-simple land.
  - *Depreciation:* depreciation is a deduction from income tax the IRS allows on certain fixed assets. It is an "expense" but not a cash transaction. Depreciation is deducted from the value of certain fixed assets to get the "book value".

Liabilities

Liabilities are classified by when they are due.

- *Current Liabilities:* "bills" that you owe that have to be paid within 12 months:
  - Accounts payable
  - Patrons payable
  - Loan payments due within one year.
  - Line of credit
- *Long-Term Liabilities:* "bills" you owe that are due after 12 months:
  - Loans for equipment, land, etc.

Member Equity

- What you "own" or what is left over if you sold all the assets and paid all of the bills.
- Represents a members investment into the cooperative. Dollar amounts are "invested" in the assets of the business, therefore this amount is not cash dollars or a checking account.
- As risk capital, it is subject to loss.

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Operating Statement

An operating statement is a financial record of a cooperative's business activities during an accounting period (the fiscal year). The statement is important because it details income and expense information for use in reaching decisions about internal operations.

Operating Statement

An operating statement is usually divided into three sections:

- Income
- Expenses
- Net income

Operating Statement

The following equations are used in preparing the statement:

1. Sales - Cost of Sales = Gross Margins
2. Beginning Inventory + Purchases - Ending Inventory = Cost of Sales
3. Gross Margins + Other Income = Gross Income
4. Gross Income - Operating Expenses = Net Income

Operating Statement

- The income portion summarizes all revenues received by the cooperative during the accounting period (month, year).
- The expense portion summarizes those items the cooperative paid to do business. Expense items are divided into two classifications, fixed and variable.
- Net margins. Subtracting expenses from income results in net margins. It reflects the earnings or loss of the cooperative on the products and services provided for the patrons.

Statement of Cashflows

The statement of cash flow categorizes gross cash receipts and payments during a period into one of three categories –

- cash flow from Operations,
- cash flow from Investing,
- cash flow from Financing.

Statement of Cashflows

Included in the Operations category are:

- net income
- changes (decrease or increases) in current assets and liabilities:
- changes in non-cash items included in the net earnings

Statement of Cashflows

Included in the Investing category are:

- proceeds from the sale of plant, property, and equipment
- purchase of plant, property and equipment
- equity in other organization purchased
- equity in other organizations redeemed

Statement of Cashflows

Included in the Financing category are:

- capital stock or membership fees issued
- equity revolved/capital stock retired
- patronage dividends paid
- long-term money borrowed or repaid
- short-term money borrowed or repaid
- allocated patronage paid in cash
- per unit retains

Statement of Cashflows

The statement is intended to help members assess:

- the cooperative's ability to generate positive future net cash flow.
- the cooperative's ability to meet its obligations, its ability to pay patronage, revolve equity, pay dividends, and its need for external financing.
- the reasons for differences between net income and cash flow.
- the effects on a cooperative's financial position of both it cash and noncash investing and financing during the period.

Ratios

Logical Structure of Analysis

- Use of ratios to analyze financial statements
- Searching for problem resolution
- Need logical organized structure

Limitations of Ratios

- Get a limited picture
  - may miss important dimensions
- Results are static rather than dynamic
  - generally use “point in time” data
- Subject to manipulation
- There is no uniform theory of ratios

Usefulness of Ratios

- Improve competitiveness
- Identify problems/predict distress
- Understand interactions
- Simplify data
  - able to focus on specific items
  - ignores confounding information
- Compare similar variables
  - uses relative sizes
  - uses important relationships
- Observe trends

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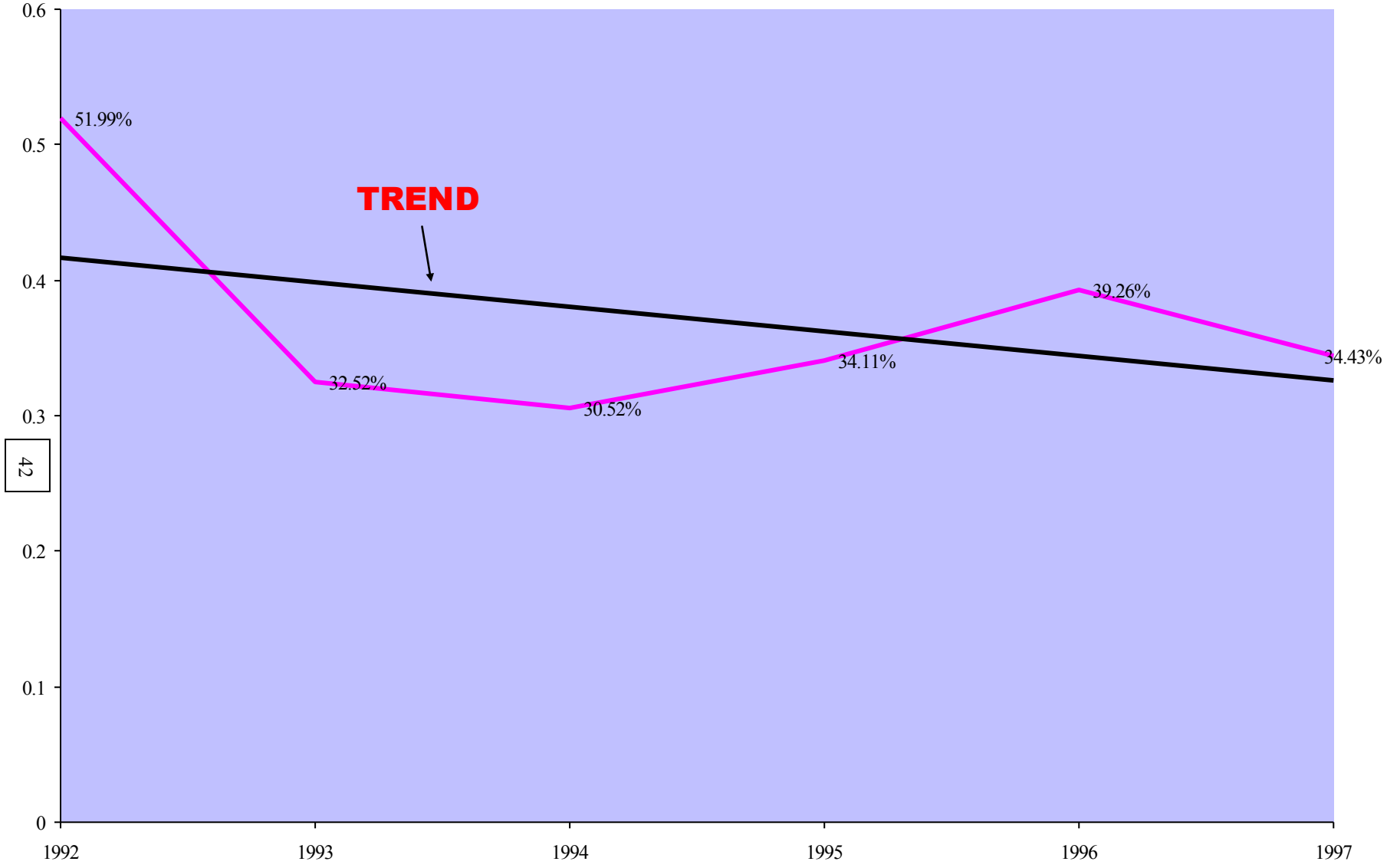
LABOR EXPENSE RATIOS



Common Size Statements

- Balance Sheet
  - Total Assets Set to 100%
- Income Statement
  - Total Sales Set to 100%
- Individual elements expressed as the percent they represent of the full 100%
- Can compare different size firms

Operating Statement		Common Sized--%		Common Sized--%
	Year 1		Year 2	
Sales	1,690,338	100.0%	1,806,921	100.0%
COGS	1,069,577	63.3%	1,082,283	59.9%
Gross Profit	620,761	36.7%	724,638	40.1%
Operating Expenses				
Wages	282,015	16.7%	351,998	19.5%
Supplies	40,042	2.4%	45,647	2.5%
Depreciation/Amortization	98,862	5.8%	85,399	4.7%
All Other Expenses	312,513	18.5%	312,354	17.3%
Total Operating Expenses	733,432	43.4%	795,398	44.0%
Processing Income	79,689	4.7%	11,406	0.6%
Other Income	57,780	3.4%	54,872	3.0%
Net Operating Income	24,798	1.5%	(4,482)	-0.2%
Other Income (Expense)				
Other Income	137,974	8.2%	33,308	1.8%
EBIT	162,772	9.6%	28,826	1.6%

Balance Sheet	Year 1	Common Sized--%	Year 2	Common Sized--%
ASSETS	$$		$$	
Cash	246,973	21.8%	363,763	30.9%
Accounts Receivable	274,260	24.2%	234,033	19.9%
Inventory	89,111	7.9%	125,189	10.6%
Other	0	0.0%	1,205	0.1%
TOTAL CURRENT ASSETS	610,344	53.8%	724,190	61.5%
Fixed Assets	523,702	46.2%	453,760	38.5%
TOTAL ASSETS	1,134,046	100.0%	1,177,950	100.0%
LIABILITIES				
Accounts Payable	49,720	4.4%	49,304	4.2%
Payable to Growers	213,568	18.8%	456,334	38.7%
Line of Credit/Notes Payable	107,200	9.5%	76,800	6.5%
Accrued Expenses	0	0.0%	0	0.0%
Other	52,147	4.6%	52,147	4.4%
TOTAL CURRENT LIABILITIES	422,635	37.3%	634,585	53.9%
TOTAL LONG TERM LIABILITIES	499,801	44.1%	918,804	78.0%
TOTAL LIABILITIES	922,436	81.3%	1,553,389	131.9%
Dues	20,220	1.8%	20,095	1.7%
Retained Earnings	191,390	16.9%	(395,534)	-33.6%
TOTAL MEMBER'S EQUITY	211,610	18.7%	(375,439)	-31.9%
TOTAL LIABILITIES AND MEMBER'S EQUITY	1,134,046	100.0%	1,177,950	100.0%

What is Working Capital?

1. Amount of money available to finance the day-to-day operations.
2. Why does it become so important?
   - As an indicator of financial problems
   - Can maximize growth
   - Can help minimize future financial shortcomings

What is Working Capital?

3. Determining the amount of working capital needs.
   - Current assets minus the current liabilities.
   - The more that assets are in the form of cash, the lower the amount of “liquid” working capital needed

Working Capital Guidelines

Management of the cooperative can impact on the amount of working capital needed.

1. Management's ability to convert current assets to cash in time to pay liabilities.
2. The total sales volume of the association, and the seasonality of sales.
3. The age of the association's accounts receivable.
4. The turnover of inventories.

Working Capital Guidelines

A common guideline for measuring this working capital ration is $1.50 of current assets for each dollar of current liabilities. The need for working capital will be affected by:

1. Permanent inventory levels
2. Number of locations or branches
3. Type of Cooperative