

## COOPERATIVES – ACCOUNTING FOR SUCCESS

### 1. The functions of the accounting system

The accounting<sup>1</sup> system, within any form enterprise, has three essential functions:

- The preparation of periodic financial statements
- The preparation of management information, which directly assists in decision-making
- Facilitating the auditing process which is one part of the 'oversight'<sup>2</sup> system of the enterprise.

### 2. Financial accounting

All enterprises need to prepare financial accounts in accordance with the accounting standards<sup>3</sup> required for their specific form and type of organization, these will be published at least annually. They will be presented in the form of a set of financial statements, which will allow those reading them to arrive at an informed opinion as to the financial health of the enterprise.

A standard set of accounts will comprise a Trading Account, a Balance Sheet and a Fund Flow Statement, along with Notes to the Accounts, the Auditors Report and a Directors Report. However, not all of these items will be legally required in the case of smaller enterprises. Financial statements are similar for all models of enterprise

The published accounts are intended to provide information to the owners of the enterprise and in the case of member-controlled enterprises (MCEs), the owners are the members. The published accounts will also inform the directors and managers of the enterprise. In addition, this information will be required by: HM Revenue & Customs, banks, trade creditors and credit providing businesses (such as mortgage companies or sale & leaseback providers), any external investors, any grant giving bodies that may have supported the enterprise, prospective members, current and prospective employees (and any trade union representing employees); and any relevant regulatory authorities (such as the Registrar of Industrial & Provident Societies or the Registrar of Companies).

The financial accounts should tell the reader whether or not the enterprise is:

- Running with a surplus or a loss - viable or not (self-sustaining)
- Liquid<sup>4</sup> or not
- Solvent<sup>5</sup> or not
- Too dependent upon external finance (highly geared)

It is important to understand that the financial statements alone will only inform readers about the financial health of the enterprise, **and especially in the case of coops, very little about the success or otherwise of the enterprise in terms of their fulfilling their true purposes.** It is also interesting to note that there is no budget information provided in the legally required accounts.

### 3. Management accounting

In the case of coops, management accounting is concerned with the use and provisions of accounting information to directors, managers and members within enterprises so as better equip them to undertake their respective control and management functions, and to provide them with the basis to make informed decisions.

It should be understood that in a shareholder company the investor benefits<sup>7</sup> from the financial performance of their company, therefore its owners will find most of the things that they wish to know within the financial statements. Whereas in coops the owner/members receives the primary benefit from the results of the market interventions that their enterprise undertakes on their behalf, therefore, most of the important things that they wish to know can only be provided by the management accounts.

A major element of the management accounting system, in all forms of enterprise, will be the planning, budgeting<sup>8</sup> and reporting system, which is considered in more detail later in this document.

### 4. Auditing

The process of auditing provides the verification of accounts and identifying errors within a given period of time, auditing can also enhance the degree of confidence of intended users in the financial statements.

Financial audits are typically performed by firms of practicing accountants who are experts in financial reporting (external auditors). External auditors are required to express a view about the validity of the

financial statements and may issue a certificate subject to qualification when they are not fully satisfied. The financial audit is one of many assurance functions provided by accounting firms. Many organizations separately employ or hire internal auditors, who do not attest to financial reports but focus mainly on the internal controls of the organization.

In the case of coops, auditors must report to members any significant items which do not comply with the legislation. Directors and members need to read their auditors report, then decide if it raises important issues that must be addressed.

The directors must arrange for the selection and appointment of external auditors, which must be confirmed by the members, in such a manner that ensures their independence and competence. The directors must also ensure that all necessary procedures and systems of internal audit are in operation, which are sufficient to protect the assets of the enterprise. The code of corporate governance should provide guidance as to the procedures to be followed.

## 5. The role and responsibilities of directors

The directors should ensure that the books and accounting records are:

- Adequate to meet statutory requirements
- Kept up to date
- Designed so as to facilitate:
  - Safeguarding the company's assets and
  - The prompt preparation of accounting and management information, adequate for the proper control of the particular business

Directors also need to be aware that in the event that they permit the enterprise to continue trading when it is insolvent they may be held to personally liable for the financial consequences. Such a situation may occur due to overtrading which leads to cash flow problems, most often because of a lack of working capital. A typical scenario is that cash inflows from sales (especially sales on credit) come in too late to pay suppliers for the increase in stocks required. Another common scenario is when wages may have to be paid, and equipment and material obtained, long before a customer pays for work completed. Enterprises can avoid overtrading through: good planning, so that they can ensure that resources are available when required, before problems occur; and being well financed so, for example, funds are available to increase working capital if required.

## 6. Key points in Financial and Management Accounting

It is important to remember that all accounting needs to be undertaken:

- On a continuing basis – this impacts upon the valuation of buildings, machinery, redundancy costs etc.
- With consistency – so as to prevent manipulation by selective changes in approach, which may involve placing a monetary value upon research and development, stock valuations, debtor provision, for example.
- On a prudent basis – income and surpluses may be taken into account before they have in reality come in; which would be imprudent. However, it is prudent to take into account losses which have arisen, or are likely to arise, after the year end but based on knowledge that is available to board up to date of signing-off the accounts need to be taken into the accounts.
- An accruals basis - includes all transactions that relate to the actual accounting period, as distinct for the transactions accounted for on a 'cash basis'.
- By separate valuation of assets and liabilities – it is important to discourage offsetting. e.g. Where good and bad investments are put into one group to 'disguise' the fact that some are non-performing.

## 7. What directors and active members need to know

If control is to be retained by members and exercised on their behalf by their elected directors they, at a minimum, need to fully understand:

- The difference between capital expenditure<sup>10</sup> and revenue items, also the methods of calculating

depreciation.

- The differences between fixed and variable costs<sup>11</sup>.
- How to use a series of financial statements to assess the financial position of a relevant enterprise.
- The concepts of liquidity and solvency, also the function of cash flow management.
- The concept of financial gearing and its impact upon coops.
- How to calculate the capital employed and identify the value of the assets employed in a coop.

In addition, they need to understand what kind of information they need and the key management ratios appertaining to the trades, industries or services in which their enterprise is involved.

## **8. Mutual trading**

Lord Wilberforce (a Lord of Appeal in Ordinary in the House of Lords from 1964 to 1982) said: "A person cannot make a profit out of themselves". A solicitor who draws up his own will cannot invoice himself and make a profit for himself from the transaction. Likewise a group of persons, in this example farmers, who agree to market their produce through a joint effort can propose that they are not at arms-length from their own group. For example, the farmers set the fees unit and can adjust them up or down at will to produce any result they wish relative to the costs of running the enterprise.

The tax authorities (the Inspector) may accept, after checking, that the business results are within the direct control of the farmers and award the group mutual tax status. The Inspector then ignores the results from the marketing activities and only taxes bank interest and similar profit not derived from the members. If the Inspector is to accept the view that a group is not "Trading" and award mutual tax status, it clearly makes sense for the group to use the appropriate terminology.

HM Revenue and Customs (the UK taxation authority) accepts that no profit arises from genuine mutual trading and that tax should not be levied upon a mutual enterprise, provided that strict conditions are met. These include that: the contributors to and the participators in a surplus must be identical; the surplus must be returned to the contributors in proportion to the contribution they made to the surplus; and the members must control any common fund (undistributed surplus).

Where coops are claiming mutual tax status then the enterprise must ensure that its accounts are prepared to meet the required criteria.

## **9. Barriers to understanding**

When it comes to understanding both financial and management accounting within coops, considerable barriers are created by the use of words that have more than one meaning. For example: the word 'profit' the first and most commonly used meaning of the word is that it is 'money gained in a business transaction' but because coops are 'not for profit' enterprises it is absurd to use this word. All too often the word 'profit' is used when what is meant is 'margin'. All enterprises need to operate with sufficient 'margin' between costs and income so as to remain viable.

Similarly, there are many other words when used in accountancy, that need to be properly understood if we are to communicate in a way that leads to a correct understanding of the topic, this is infinitely more important within coops than it is in commercial businesses.

## **10. The process of enterprise planning and setting objectives**

Member-controlled enterprises have to concentrate upon establishing and then delivering those outcomes agreed by the membership. The planning and control system needs to be member-focused, and the methods deployed have to be both inclusive and democratic.

Clear objectives, based upon the agreed planned outcomes, along with specific measurement criteria, should be set by the board. In the absence of such clear objectives the enterprise will simply drift along. In these circumstances the enterprise is most unlikely to deliver what the members need, instead its managers usually end up setting their own objectives, which are typically designed to ensure their own survival in post. And, as a result, the enterprise shifts away from providing benefits for members to preserving jobs for the management and workforce, and perhaps also benefiting a clique of members clinging onto their elected positions.

The first point to understand about setting objectives is that they must be ranked in order of priority,

with the prime (purpose-related) objectives placed ahead of those that are essential but only supporting purpose related objectives. The second point is that objectives need to be established first at a strategic level and then at an operational level. Strategic objectives (planned outcomes) should be agreed in broad terms with the members and set out in more detail by the board of directors. The management team usually propose operational budgets, which will be agreed with the board of directors and set out in quantifiable terms within the framework of a strategic enterprise plan. Annual operating plans will be set out to cover each section of the enterprise. The operational objectives for each manager will be the specific goals against which the performance of individuals needs to be measured; and to which the reward system should be linked.

### **11. Budgeting and control**

The annual operating plan is expressed in the form of a budget for each part of the enterprise. Budgets offer the main means of control by directors, that is to say control in the sense of having sufficient information to ask appropriate questions and be in a position to judge if the answers are at least reasonable, even if not totally satisfactory.

The budgeting process ought to require management to:

- Think about the purpose of the enterprise and to discover those outcomes that are most important to members
- Work out how those outcomes can be best achieved and to set and quantify the actions required in physical and financial terms
- Establish the financial implications of following the actions planned
- Identify the key performance areas in respect of progress toward those outcomes

The reporting system will compare performance against the budget and should:

- Measures results against plans.
- Prompt timely action if performance varies from the results planned.

It is important when setting out realistic plans and securing ownership/commitment to the planned outcomes, that the component figures of the budget are initially prepared at the lowest possible level in the decision-making chain. It should also mean that the probability of being successful is greatly enhanced.

### **12. Measuring results and performance**

Where managers fail to deliver the required results, the root of the problem often lies with the absence of clear-cut objectives and associated measures of performance. Often managers are allowed set their own performance criteria, usually borrowed from commercial businesses and not tailored specifically to the coop concerned. The absence of performance indicators related directly to the purpose and objectives of the enterprise can become a serious problem, which is often compounded by the existence of salary and reward systems geared towards achieving objectives that are contrary to the outcomes required by the membership. For example, sales staff may be rewarded for selling specific products to their members when, in fact, this may not be in their members' best interest.

It is essential that the managers are given performance criteria and are set performance indicators directly related to the coop's prime objectives. It is also essential that the salaries and other reward systems are geared towards achieving these objectives. Defining objectives and measuring attainment must be a priority for all coops, for without this framework nothing else makes much sense.

It is sometimes difficult to measure performance in coops because many of the benefits are passed directly back to the members and thus the usual profit measures used in commercial businesses do not work. The more that is passed directly back members, in the form of lower prices of other benefits, then the lower will be the resultant surplus. Often directors and managers resort to using profit as the measure of performance simply because they have failed to develop the correct forms of measuring results and performance; using the wrong form of measurement invariably leads achieving the wrong results<sup>13</sup>.

The results required in coops need to be expressed in terms of specific outcomes and the level of productivity of the resources used in the process of achieving these outcomes (resource optimization). It is fully appreciated that in many established organizations, where there is frequently the need to change the basis of setting objectives and measuring results this will be a significant challenge requiring a paradigm shift throughout the organization.

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**End notes:**

1. 'Accounting' is the process of communicating financial information about an enterprise to its owners, users and other stakeholders. The communication is generally in the form of financial statements and management accounting reports that show, in money terms, the economic resources under the control of the management and how/where these are deployed.
2. 'Oversight' is a system of structural checks and balances, which is crucial for ensuring that the enterprise achieves its purpose. Whenever those running an enterprise are not the same people who own it, a vigorous system of oversight becomes essential; otherwise the owners are likely to find the main benefits end up accruing to those running the enterprise. In this context 'owners' refers to the shareholders in the case of a company, the trustees in the case of a charity, and the members in the case of a member-controlled enterprise.
3. 'Accounting standards', are rules according to which accounts have to be drawn up. They demand minimum levels of disclosure, lay down fundamental principles, define the meanings of terms and specify how numbers should be calculated. The sources of accounting standards will include those set out by international accounting bodies, national standards bodies (in the case of EU countries, both EU and national legislation set standards), the requirements of legislation, the requirements of regulators of particular industries or types of organisation. It is also common for many aspects of accounting standards to vary with the size of the enterprise: for example the UK has separate standards for smaller companies and other entities.
4. 'Liquidity'- The ability to meet bills payable as they become due. A serious example of lack of liquidity is not being able to meet a loan repayment on the due date because a major customer fails to pay you on time.
5. 'Solvency' - A more demanding approach than liquidity. To be solvent requires the enterprise to have sufficient assets to meet its liabilities, including contingent liabilities (which are possible future liabilities that will only become certain on the occurrence of some future event). A contingent liability is less certain than a provision made in the accounts for an expense that is expected to occur, for example a contingent liability might be a pending claim for damages against the enterprise. In the case of coops the members' funds should represent the margin of solvency, since the members only collect after third parties are paid out.
7. An investor in a shareholder company receives their rewards in the form of dividends and/or capital growth in relation to the money they have invested in shares.
8. A 'budget' is simply a plan expressed in terms of money and numbers.
10. 'Capital expenditure' may be defined as expenditure incurred in the acquisition of assets required for use in the business and not for resale, or in the alteration or improvements of assets for increasing their revenue earning capacity in the enterprise.
11. When we refer to fixed revenue costs and variable revenue costs it is nothing to do with capital items. We are dealing with items that will all be recorded within the Trading Account. Fixed costs do not vary with output (until there is a need to invest in further capacity), variable costs vary closely with output.
13. An example is the 'leakage control system' that was used in most co-op food shops, and which played a significant role in the decline co-op retailing in the UK from its pre-eminence in about 1960. The system, which was the main measure of performance, involved charging all stock in to the store at retail prices and measuring the difference between opening stock plus goods-in minus sales plus stock to-end; this difference was known as 'leakage'. As a result, managers focused upon loss prevention rather than developing the expanding the range of products, and their quality and freshness – which was what their members wanted.