Challenges to the Cooperative Board of Directors

Recognizing Key Responsibilities	**Governing by Policy**
Meeting Legal Duties	**Critiquing Business Plans**
Planning Recruitment and Nominations	**Evaluating Management**
Analyzing Financial Statements	**Assessing Board Performance**

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For information on authors and ordering, see the last page.

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The International Cooperative Alliance Statement of Cooperative Identity

Adopted September 1995

DEFINITION:
A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.

VALUES:
Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, cooperative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.

PRINCIPLES:
The cooperative principles are guidelines by which cooperatives put their values into practice.

FIRST PRINCIPLE: VOLUNTARY AND OPEN MEMBERSHIP
Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibility of membership, without gender, social, racial, political, or religious discrimination.

SECOND PRINCIPLE: DEMOCRATIC MEMBER CONTROL
Cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary cooperatives members have equal voting rights (one member, one vote) and cooperatives at other levels are organized in a democratic manner.

THIRD PRINCIPLE: MEMBER ECONOMIC PARTICIPATION
Members contribute equitably to, and democratically control, the capital of the cooperative. At least part of that capital is usually the common property of the cooperative. They usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing the cooperative, possibly by setting up reserves, part of which at least would be indivisible, benefiting members in proportion to their transactions with the cooperative, and supporting other activities approved by the membership.

FOURTH PRINCIPLE: AUTONOMY AND INDEPENDENCE
Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy.

FIFTH PRINCIPLE: EDUCATION, TRAINING, AND INFORMATION
Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of cooperation.

SIXTH PRINCIPLE: COOPERATION AMONG COOPERATIVES
Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.

SEVENTH PRINCIPLE: CONCERN FOR THE COMMUNITY
While focusing on member needs, cooperatives work for the sustainable development of their communities through policies accepted by their members.

Challenges to the Cooperative Board

By David Gutknecht

Is the board of directors a weak link in your cooperative — or a key strength? To be the strength that it can be, the board's role must be well defined and clear to all directors and management, even to staff and members. Consider the following description of the role of a board of directors — one that applies as much to cooperatives as to private corporations:

The board of directors is an elected body responsible for overseeing the affairs of the corporation on behalf of its owners. The board is legally accountable for the actions of the corporation. The board is responsible for ensuring the long-range security and viability of the corporation and for making decisions in the best interests of all owners.

For the co-op board, though, this definition doesn't describe the full breadth of board responsibilities. Cooperatives are governed by broad purposes that extend beyond financial goals and incorporate social aims. They adhere to a set of international principles followed by co-ops around the world. A successful cooperative requires a board responsible for and responsive to all the leadership needs of the organization — those related to the co-op as a business, and those related to the co-op as a member-owned organization. The co-op board's role is crucial to ensuring that the business fulfills its mission as a member-owned, democratically-controlled *and* financially viable (profitable) enterprise.

"But," some readers may object, "we're not a 'for profit' business." While that may be true of your co-op's incorporation status, it is also true that your co-op is a *business*. In order to fulfill its purpose of serving members, your co-op, like all businesses, must achieve a profit on operations — that is, income must exceed expenses. (Most co-ops prefer the term "net earnings" or "net savings" to the term "profit.") Without some net earnings, it will be difficult, if not impossible, for your co-op to stay alive as well as to grow, to serve more people, or to make any improvements or changes in its operations.

While a co-op's purpose is not to generate profit, every co-op needs such earnings. What is most distinct about co-ops is who *owns and controls* these earnings. In a cooperative, it is the members (owners) who are entitled to (own) the earnings and who control the corporation. In a consumer cooperative, the co-op's member/owners are also the co-op's customers: a business owned and controlled by the people who use its services.

This is a unique business form; how *does* it shape the board of directors' functions?

COOPERATIVE PRINCIPLES: A QUICK GLANCE

In order to better understand the board's role, co-op directors must be familiar with the overriding philosophy and principles that govern co-ops. This philosophy is endorsed and promoted by the International Co-operative Alliance, which most recently revised its "Statement of Cooperative Identity" *(shown on the previous page).*

This creed, shared by all co-ops worldwide, is based on a fundamental respect for all human beings and a belief in their capacity to improve themselves economically and mutually by working together. This statement includes a "values" statement that describes the beliefs common to all cooperatives:

> ***Statement of cooperative values:*** *Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, cooperative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.*

In addition to their common values, all co-ops adhere to seven basic principles. These co-op principles are guidelines for how co-ops will put their ideals and values into practice. They help all co-ops maintain both the spirit and the structure of cooperation and distinguish co-ops from other types of organizations and businesses.

These principles are significant because they outline a democratic structure that can be adapted to businesses providing many different kinds of services and products. Every director should be familiar with these seven internationally accepted co-op principles and with the board's role in putting these principles into practice. Two of the seven principles describe who owns a co-op, two describe how decisions are made, and three list specific ways that co-ops put their beliefs into action.

OWNERSHIP

1. Open and voluntary membership. Co-ops do not restrict membership for any social, political, or religious reasons. They are open to all who can make use of the co-op's services and are willing to accept the responsibilities involved. In a co-op, members may join or withdraw whenever they wish, and cooperatives cannot coerce members to join or to be members against their will.

Nonetheless, co-ops can and should have membership *requirements* — e.g., a fee, an investment requirement, maybe an orientation — and these should be approved by the board. The requirements of each co-op, and the way membership is marketed, should make it easy and attractive to join. Overall, co-ops will want to do a high or increasing proportion of their business with members — reaching more and more people with the benefits of member ownership. Co-ops that sell only to members will need especially strong membership marketing programs and a favorable market position. In examining and strengthening membership sales and benefits, the board is upholding this first co-op principle.

2. Member economic participation. This principle has many distinct aspects, all based on the core idea that co-ops — and their money — are owned and controlled by their members.

- Members, as the owners, provide the money needed to start and operate the co-op. But, regardless of the amount invested by a member, decisions are made democratically.
- To encourage members to invest in the co-op and to compensate them for the use of their money, co-ops can pay dividends (like interest) to their members. However, when co-ops do so, the dividend rate must be limited. This prevents people from investing in co-ops solely for the speculative purpose of earning a financial return — keeping the co-op in the hands of those who really want to use its services. This makes it clear that a co-op is more interested in gains to the whole than gains according to the level of investment.
- Any earnings (or profit) resulting from the operations of the co-op belongs to the members. They control how it will be distributed and may allocate earnings to reserves, use it to support other activities, or may allocate it to themselves.
- If earnings are to be allocated to members, it will be distributed in proportion to the amount of business each member has conducted with the co-op. This essentially results in a rebate to all members on their purchases. In this way, any return of surplus is handled equitably — to avoid one member gaining at the expense of others. These distributions are called "patronage refunds."

Again, rather than favoring the investor, the cooperative system distributes business earnings in proportion to use.

DECISION MAKING

3. Democratic member control. In contrast to the more traditional corporate structure of one share, one vote (where the number of votes depends on the amount of investment), co-ops prefer a democratic system for owner decision making: one member, one vote. At the primary co-op level (where members are individuals), this principle commonly is interpreted as one vote for each membership, whether the membership is held by one or a number of people. At the secondary co-op level (where the members are organizations), the principle allow more votes for members whose own membership numbers or purchasing volume is several times that of smaller members. In supervising the co-op's governance systems and procedures (such as annual elections), the board monitors the co-op's compliance with this profound and definitive tenet.

4. Autonomy and independence. Cooperatives are independent, self-help organizations controlled by their members. If they enter into agreements with other organizations (such as government or development agencies) or raise money from outside sources (such as banks), they do so only on terms that ensure democratic control by their members. This protects co-ops from being controlled by outside interests — however well-intentioned these outsiders may be. Members must clearly retain decision making control, so that their co-ops can follow their wishes and serve their needs.

BOARD CHALLENGES

SPECIAL PRACTICES

5. Education, training, and information. The role of a co-op member is quite different from the role of a customer at a traditional business. A co-op member is simultaneously the co-op's customer, owner, and decision maker. Educating members and leaders about the principles, practices, and structure of the co-op business is vital. There can be no cooperation without cooperators, and cooperators need to know how to use and lead cooperatives effectively.

Co-op education programs provide members with information about co-ops and being a co-op member (such as voting, membership rights, governance system, etc.) as well as about the products and services of the co-op (nutrition, food production, consumer value, etc.). Similarly, co-ops must teach the general public, young people, and opinion leaders to understand the nature and benefits of cooperation. The cooperative enterprise eventually will fail unless the board sees to it that the members, employees, management and directors themselves benefit from a continuing program of education and enhanced awareness.

6. Cooperation among cooperatives: The power of working together grows exponentially as efforts are combined. This principle affirms the need of co-ops to pool resources beyond their own, individual operations, to avoid isolation or struggling through bad times. By working with other groups, co-ops can help each other strengthen their economic positions and contribute to the broader aims of the co-op movement. Co-ops in other sectors such as credit unions or rural electrics have realized many benefits and many fewer failures through standardized procedures, technical assistance, and trade relations. Other important examples of cooperation among co-ops include management contracts, federations, mergers, and franchises. For co-ops of all types and sizes, association with co-op distributors and with regional and national financial and trade cooperatives are all examples of key opportunities for mutually beneficial activities promoting cooperative development, education, and success. The board has a key role in providing the leadership for co-ops to look beyond their own operations and to expand the benefits of working together.

7. Concern for community. Every co-op operates in a community that extends beyond its own sphere of operation and in which members live. Its actions affect that larger community. While member needs are their primary concern, co-ops also work for the sustainable development of their communities in positive ways. This means more than providing donations to non-profit organizations and community service agencies in an area. This principle requires that co-ops participate in the development of strong, sustainable economic solutions that can address the full range of needs in its community.

BOARD FUNCTIONS

How do these principles affect the role of the board? How do they affect the way the board does business? Whether in a private corporation or a cooperative, the board is the body ultimately accountable for the actions of the group. But a successful cooperative needs a board that can do more than be on the line for the co-op. A successful co-op needs a board that can oversee and provide constructive guidance to management, supervise governance events, and provide direction for the co-op — that is, a board that can provide effective leadership.

Traditional descriptions of the board's role in a corporation distinguish five key functions. All arise from the board's primary focus on overall corporate performance. Even legal codes make it clear that it is the board's job to "... direct the management of the business," not to manage it.

1. Decision making: Three key decision making areas are hiring and supervising management; overseeing financial matters, especially approving financial projections (budgets) and capitalization structure; and clarification of strategic direction and corporate identity (long-range planning as well as corporate policy and guidelines). The board's decision making function also will extend to legal questions, but this should require far less time and be only a minor area of the board's focus. While management can and should play a big role in formulating recommendations and providing background for board consideration, the board itself is the ultimate decision making authority. However, by keeping focused on those decision making areas that are clearly the board's responsibility, directors will avoid meddling in other, more operational areas.

2. Advisory: Directors can bring many areas of expertise and experience to the co-op. While this experience may extend to areas beyond the board's involvement, directors help strengthen the co-op if they are willing to provide advice to management. For management, directors' advice and assistance can be invaluable provided that directors recognize the difference between giving advice to management and getting involved with management responsibilities. Interference in operations by the board can handicap management's ability to run the business and always handicaps the board's ability to oversee and evaluate management. The board's leadership of the cooperative must also include a conscientious advisory relationship to the members, informing and advising them on matters affecting the co-op, from ways to best use and support the co-op to guidance on larger, strategic issues.

3. Trustee: This refers to the board's fundamental "fiduciary" responsibility on behalf of the cooperative's member/owners: safeguarding the owners' assets with the overall good health and name of the business. Ultimately, the law regards this function as the definitive context for all board decision making and action. Understanding this function of the board is critical to good business decision making as well as good member relations.

4. Perpetuating: Beyond simply meeting formal requirements, a crucial but often neglected board function is to ensure continuing, effective board leadership through proper nominations, elections, and training of directors. In the co-op system, where corporate governance is a pluralistic, democratic process, the board's role in this area is all the more critical and heightened. The board is legally required to ensure that elections meet both the letter (the bylaws) and the spirit (the principles and values) of the cooperative.

5. Symbolic: This function includes demonstrating formal leadership to the co-op's members and employees as well as maintaining responsible and beneficial relations with all parts of the general and institutional public. In leading a community-based and community-oriented business, the co-op board's symbolic function can be much more public and vital than for other boards.

By fulfilling the basic functions and principles outlined here, yours can be a strong board in a healthy cooperative. Obviously, this is no easy assignment. But it can't be skipped! Can your board meet all of these challenges? Can it be something much more than the weak link that it is in many co-ops? Can you do this while maintaining your sense of humor as well as your budget?

Usually not well paid for their efforts, and often not well recognized for their dedication and services, co-op directors nevertheless must accept responsibility for ensuring the long term health and growth of the cooperative. Assistance is available and most certainly should be sought, from management, from the members, from other cooperatives and from trainers. Such help can only clarify that ultimate board role: the opportunity and challenge of putting cooperative ideals into practice at the governance level.

Legal Duties and Responsibilities of Co-op Board Members

By Kathryn Sedo

Members of the board of directors of a cooperative have the same duties and responsibilities as do directors of any other business. In addition, they have a few other responsibilities that are unique to cooperative board members.

Cooperatives are member organizations, unlike most other businesses. This places a unique responsibility on cooperative directors to be sensitive to the needs of members and balance their conflicting interests. Therefore, director decisions are based not only on what is most profitable, but also on what the needs of the members are.

One important function of the cooperative board is to educate members about their organization. Effective member control is impossible without information. It is the duty of the directors to provide the membership with that information.

GENERAL DUTIES AND RESPONSIBILITIES

The legal standard of conduct required of directors of any business is found in state statutes and court decisions. An ongoing attempt to codify the standard has been made by the American Bar Association, and is named the Model Business Corporation Act (1994). Chapter 8 of the Model Act is entitled "Directors and Officers." Subchapter C of this chapter contains the general standards of conduct that are required of directors. That Subchapter reads in part as follows:

SECTION 8.30. GENERAL STANDARDS FOR DIRECTORS

(a) A director shall discharge his *(sic)* duties as a director, including his *(sic)* duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances;

(3) in a manner he *(sic)* reasonably believes to be in the best interests of the corporation.

(b) In discharging his *(sic)* duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of directors of which he *(sic)* is not a member if the director reasonably believes the committee merits confidence;

(c) A director is not acting in good faith if he *(sic)* has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he *(sic)* performed the duties of his *(sic)* office in compliance with this section.

Subchapter F goes on to define director "conflict of interest," discussed below.

How does a director make sure that his or her conduct complies with the standard in the Model Act or of his or her state? Three main areas can be singled out for action. If a director is

- attentive and diligent
- loyal, and
- acts with the care of a prudent person

then his or her actions cannot be successfully challenged. These three areas are sometimes referred to as duty of *attention* or *diligence*, a duty of *loyalty*, and a duty of *care*. Each will be discussed in turn.

DUTY OF ATTENTION/DILIGENCE

Directors must participate actively in the affairs of the cooperative. Active participation includes regular attendance at meetings, review of information and data provided by employees and experts, and monitoring employee activities.

A director is entitled to rely on information, reports, opinions or statements, including financial statements and other data prepared by an officer, employee or committee of the cooperative when the director reasonably believes that the source of the information is reliable and competent in that area. This includes attorneys, consultants, and accountants hired by the cooperative to provide information, data, or opinions. In order for a director to be entitled to rely on such reports, the director must have read it or be at a meeting where a verbal presentation was made. The general standards contained in Subsection (a) above – good faith, ordinary care, and best interests – apply when judging whether reliance on a report was reasonable.

Close monitoring of employees and committee work is also required. It is important that directors act responsibly in delegating tasks to responsible individuals. It is the responsibility of the board to make sure that any task delegated to any responsible officer, employee, or committee is being properly performed.

DUTY OF LOYALTY

Directors are in a position of trust with the cooperative and must not abuse this relationship to enrich themselves. Two main areas of concern of self-dealing and dealing with someone who otherwise would have dealt with the cooperative.

The law with regard to self-dealing has undergone changes over the years. In the past, any type of contract between a director and the cooperative would have been subject to cancellation at any time. At the present time, if proper disclosure of all other options has been made and the contract is fair and reasonable, it is possible for a director to contract with the cooperative. Of course, the director involved should not participate in the discussion about or vote on the contract.

The question of fairness is normally determined by the range of terms that might have been entered into at arm's length by disinterested persons. Therefore, if the contract or agreement is within a fair range, it will be valid.

Since directors of a cooperative are also presumably members and patrons of the cooperative, some dealing with the cooperative is inevitable. Directors should make sure that they are treated just like other members. Special discounts for directors, or special treatment of any kind, are to be avoided.

Dealing with those who might otherwise have dealt with the cooperative is sometimes called usurping "corporate opportunity." It is not appropriate for a director to deal with anyone who otherwise would have dealt with the cooperative, thus depriving the cooperative of a business opportunity. If the cooperative, after carefully considering the opportunity, decides against pursuing, it then is proper for a director to take advantage of the opportunity. The director who is interested in the opportunity should not participate in the discussion about or vote on the opportunity.

Part of the duty of loyalty also includes keeping confidential the affairs of the cooperative until such time as they are released to the members and the public in general.

DUTY OF CARE

The duty of care that is required of directors is found in Section 8.30(a) of the Model Act (which is set forth fully above). A director must act in good faith and in the best interests of the cooperative. In so doing, the director must act as a prudent person would under similar circumstances. This standard allows for the taking of risks as long as they are reasonable under the circumstances. The results of directors' decisions need not always be positive in hindsight, but decisions must be arrived at honestly and prudently.

Hindsight is a wonderful teacher. It allows one to learn from previous actions. Directors are protected from attacks on their decision based on hindsight by a legal doctrine developed by the courts and known as the Business Judgment Rule.

BUSINESS JUDGMENT RULE

The Business Judgment Rule is another doctrine that has undergone a gradual change over the years. Broadly stated, the rule is that if the directors of a business acted on an informed basis and in good faith while making a decision, then the decision will be upheld despite any adverse consequences that resulted from the decision. In the past, the rule shielded just about all director decisions from attack. Absent bad faith, fraud, or self-dealing on the part of a director, courts routinely refused to question the propriety of a board decision.

However, a trend has emerged whereby courts will look more closely at the decision making process itself to determine if the directors acted reasonably. In Delaware, where the Business Judgment Rule was raised, three decisions have attracted much attention, in large part because of the results. The attention is also the result of the fact that many companies are incorporated in Delaware because of its favorable corporate and tax laws, and therefore decisions in that state affect many corporations and are often considered carefully by courts in other states. The decisions signaled that a closer review of director actions and decisions had emerged.

The three cases are *Zapata Corp. v. Maryland*, 430 A.2d 779 (Del.Sup.Ct. 1981), *Smith v. VanGorkum*, 488 A.2d 858 (Del.Sup.Ct. 1985), and *Moran v. Household International*, 490 A2d 1059 (Del.Sup.Ct. 1985). While the facts of these cases are not especially relevant to a cooperative, the careful and close scrutiny of the board's decision making process which the Delaware Supreme Court engaged in, despite the Business Judgment Rule, *is* relevant. The court carefully looked at the following:

- the time devoted to decisions,
- the complexity of decisions,
- the decision process itself,
- the amount of notice provided before meetings,
- the availability of written information and data, and
- the financial interests of the directors involved in the decision.

The court reviewed much more carefully and completely the actions of the board than has usually been done in the past.

INSURANCE AND INDEMNIFICATION

Because of increased exposure to risk of lawsuit, which is expensive even if directors prevail, many persons are hesitant to serve on a board of directors. Two ways that a cooperative can offer protection to directors are indemnification and insurance. In addition, some states (e.g., Minnesota) allow cooperatives to limit the liability of their board members in their Articles of Incorporation. Each of these is discussed in turn.

Indemnification is the reimbursement of payments made by a director as a result of having been a director or officer of the business. The payments may be in the form of expenses, attorney fees, or reimbursement to the business, shareholders or others. Some state cooperative incorporation statutes permit such reimbursement to directors in appropriate circumstances. If the state cooperative incorporation statute does not specifically mention indemnification, then it may be possible to use the general business incorporation statute provision. In either case, the bylaws of the cooperative should contain a provision allowing such reimbursement in appropriate circumstances.

The question of what circumstances are appropriate ones for indemnification is not always an easy one to determine. Generally, it is required that a director acted in good faith and believed his or her conduct was in the best interests of the cooperative (or not unlawful, in the case of a criminal proceeding).

In many instances, a clear decision about a director's culpability is not made. More commonly, a claim is settled and no determination is made about the director's good faith and/or acting in the best interests of the cooperative. In this situation, indemnification may be allowed.

The question of who makes the determination to indemnify or not to indemnify is thus raised. Similar questions about the amount to be paid or to whom it is paid may be at issue. Depending on circumstances, these decisions may be made by the remainder of the board, a committee of the board, a disinterested outside legal advisor, the shareholders, or a judge.

Although generally indemnification is a good idea, like any good idea it can be abused. Reimbursement for a director who was careless may encourage such behavior. Therefore, any indemnification bylaw provision should be very carefully drafted.

It is possible for a cooperative to obtain insurance to cover any payments that a director might be required to make. The provision of insurance coverage is somewhat controversial. Providing too broad insurance coverage may encourage directors to be lax in the performance of their duties and is to be avoided. The terms of various policies may differ, and the cooperative should determine which types of director behavior it wishes to protect. Careful consideration by the directors while purchasing the insurance is required.

Minnesota's cooperative incorporation statute allows cooperatives to eliminate or limit the liability of its board members in the cooperative's Articles of Incorporation (Minn. Stat. 308A.325). The cooperative may not limit or eliminate liability for:

• breach of the duty of loyalty;

• acts or omissions not in good faith or that involve intentional misconduct or knowing violation of a law;

• or a transaction from which the director derived improper personal benefit. Cooperatives that incorporated in states whose statutes contain similar provisions should consider amending their governing documents.

CONCLUSION

Members of the cooperative who serve as directors have the important function of overseeing the management of the cooperative. The directors must keep themselves informed and act prudently while making decisions. If a director acts in good faith, is careful and deliberate in his or her actions, and avoids financial self-dealing or special treatment, he or she will encounter no difficulties in fulfilling his or her legal duties to the cooperative.

In addition, the special characteristics of a cooperative business require that the directors be sensitive to the needs of the members and make sure the members are educated so that they can exercise their rights.

Careful concern for and compliance with the duties and responsibilities imposed by law on directors will prevent problems. In addition, indemnification, insurance, or provisions in the Articles of Incorporation limiting liability (where permitted) can further protect directors from burdensome financial liability.

Serving as a director is a responsible position, but it need not be a burdensome one if the director carefully observes the legal requirements of the job.

SAMPLE CODE OF ETHICS

FOR DIRECTORS OF COOPERATIVES

The board of directors believes it to be appropriate and useful to adopt a Code of Ethics to clarify any uncertainty which may exist now or in the future. This Code of Ethics will address two issues:

- the authority of the board or of individual directors, and
- general rules applicable to directors' conduct of co-op business.

The bounds of authority as outlined in this code serve as a medium by which greater unanimity and closer coordination can be effected between directors, and among directors, management and co-op employees.

AUTHORITY: The board recognizes its authority as being limited to overseeing the affairs of the cooperative in a manner deemed beneficial to the cooperative as a whole; to employing a manager to be responsible for the overall and day-to-day management of the business under the direction of the board; and to effecting other duties as provided by the bylaws or by general or specific corporate laws.

LIMITS TO AUTHORITY: Each director recognizes that, except when the board is in formal meeting, his/her authority is equal only to the rights and authority of any individual member of the cooperative and that no individual director may take action on behalf of the cooperative alone unless explicitly delegated that authority by action of the board.

MANAGERIAL AUTHORITY: The board recognizes the authority of the manager, as provided in the bylaws or as established by general corporate practice, to manage the affairs of the cooperative. The manager shall employ, supervise, and discharge all employees, agents and laborers and engage in all negotiations and discussions on behalf of the cooperative as necessary and/or directed by the board.

DISAGREEMENT: The board agrees that while an individual director may disagree with a policy or action adopted by the majority of the board, s/he should support said policy or action as being the considered judgment of the board. Such an individual director shall have the right and duty to present further evidence and argument to the board for further consideration in a manner consistent with the board's practices, and the board shall have the duty of reconsidering its actions appropriately.

CONFIDENTIALITY: The board and each individual director agree that all directors shall use the utmost of professional judgment and discretion in discussing disputed or confidential corporate actions, policies, or issues with co-op members, employees or the general public. All personnel, real estate, marketing, legal, strategic planning, and financial matters will be considered sensitive issues subject to director's good faith and discretion unless or until made specifically clear by action of the board as a whole.

PROFESSIONAL CONDUCT: At all times directors shall recognize that they project an image as a representative of the cooperative and shall conduct themselves in a professional manner which fosters confidence and reflects positively on the cooperative, its members, and its staff. All directors will respect the rights of others — directors, staff and members — to communicate their ideas free from interruption and without intimidation. All directors shall affirmatively and, at any times, disclose any/all economic conflicts of interest.

By Karen Zimbelman

Board Recruitment and Nominations

By Karen Zimbelman

It's true. The responsibilities of being a director are often so consuming that not much time ends up being devoted to upcoming elections. For many co-ops, the "recruitment and nominations process" begins a month or so before elections when a departing board member points out that there aren't enough candidates to fill all vacancies. Nominations are hastily collected, even made from the floor of the annual meeting. Any individual indicating even a vague interest in the position is warmly welcomed, and retiring board members breathe a sigh of relief at having passed on the baton.

However, this situation represents a very serious abdication of one of the most important functions of the board of directors — that of perpetuation of a strong and effective board. This job is one that simply cannot be overlooked — it's too important. It is one that cannot be delegated to staff, no matter how the co-op is structured. This responsibility is even more important for a co-op board, given the commitment (by law and by philosophy) to being a democratically controlled business. Legally and ethically a co-op board must devote considerable attention to the process by which new directors are selected — to perpetuating a strong and effective board of directors.

RECRUITMENT: THE NAME OF THE GAME

Standing by and waiting for candidates for the board of directors to emerge from among the co-op's membership is not a responsible way of doing this important board job. It certainly does not ensure that qualified candidates will come forward. Qualified members are much more likely to volunteer if someone approaches them and asks them to contribute their time and skills. Potential candidates will be honored to have been asked, and they will more seriously consider this significant position of responsibility in the cooperative business.

The approach of simply calling for candidates and then taking whoever comes forward condemns the co-op and board to reinvention of the wheel. While it's true that cooperatives hold a tremendous potential to develop skills and familiarity with business among those who would not typically have the chance to learn such things, the board room is simply not the place for providing such an educational experience. Committees or other special project groups can better serve as such a leadership training ground. The stakes are too high.

Your co-op's survival, let alone the livelihood of its staff, is too important to be placed in the hands of people seeking a "learning experience." And what position do we put co-op managers in when we give no thought to who will join the board as their supervisor? Who among us would accept a job under these terms — knowing that your supervisor will be selected with no regard for experience or skill? Additionally, the position of director of a cooperative corporation incurs serious enough legal liabilities for the corporation and for the individual (the director) that it merits the requirement of certain skills and prerequisites. At the very least, a board training session should be held to ensure that everyone elected to the co-op board understands such basics as the board's role, directors' legal responsibilities, how to read financial statements, and basic business practices.

Recruitment of qualified and appropriate candidates for your board is not a one-month or even a three-month process. It is a *year-round* responsibility which requires that *each board member* constantly keep an eye out for potential candidates. Directors should keep the co-op's need for directors (especially in particular skills areas) in mind, identifying potential candidates from the co-op's membership and community. Directors can then approach potential candidates, point out their qualifications, and ask them to consider running for the board when the next elections cycle comes around. The best candidates will want to think about this and spend some time getting to know more about the co-op and the issues it faces before agreeing to take on such a position of responsibility. Additionally, some candidates may need to clear their crowded schedules of other commitments.

THE NOMINATING COMMITTEE

It's vital that a small Nominating Committee be responsible for overseeing the recruitment and nominations process. It's the committee's responsibility to formally approach candidates, to make nominations, to accept petitions, and to ensure presentation of candidates' qualifications to the members for an election. Although the committee will nominate a group of candidates, nomination does not constitute endorsement of those candidates; the nominating process should be kept as clear as possible of campaigning or advocacy of particular individuals. Indeed, the Nominating Committee should nominate more candidates than there are vacancies on the board. After all, an uncontested election does not allow for members to effectively participate in selecting the board of their

Director Recruitment: Step By Step

1. As part of any new director orientation program, the co-op's commitment to continuous recruitment of new potential directors should be emphasized.
2. Immediately after a new board convenes, when committee assignments are made, name the chair, and if possible other members, of the co-op's Nominating Committee is formed. If the co-op has never had such a committee, guidelines for the committee's operations should be established, such as: reporting requirements, timeline for completion of key tasks, committee composition, budget, etc.
3. The Nominating Committee begins by establishing when directors' terms expire and if any vacancies need to be filled in the next election. From here goals can be established regarding particular skills desired and a minimum number of candidates to ensure a contested election.
4. The committee should prepare a background packet for potential candidates, including: background on the co-op and the board, a description of board responsibilities and expectations, an overview of the elections schedule, application and petition forms, etc. Make sure that, in reviewing the packet potential candidates will know: how often the board meets, what qualifications are required to be a director, what kind of compensation is provided, what kind of training the co-op will provide, what committees the board has, and what particular expectations the co-op has of directors.
5. At least five months prior to the annual meeting (i.e. at least four months prior to the mailing of the ballot) announce the opening of nominations. Make available background packets for interested individuals. Send out announcements calling for nominees to community groups, newspapers and radios, as well as through the co-op's communications – bulletin boards, newsletters, minutes, etc.
6. At the same time, begin formally contacting candidates recommended by staff and board members. Ask interested candidates to complete a short application form which outlines formal training and education, employment and skills, and informal experiences appropriate to being a director.
7. At least three months before the annual meeting, announce the nomination (the committee's selection) of enough candidates to provide at least the minimum number of candidates targeted by the board. Notify all individuals by mail that they have either been selected and have a deadline for submitting candidates' statements and photos, or that they have not been nominated by the committee and may become a candidate by petition. Be sure there are clear instructions (including a deadline) for being nominated by petition.
8. Two months before the annual meeting, the nominations process closes. All petitions are due along with statements and photos from all candidates. This should allow plenty of time for production of election materials, and possibly for an in-store display featuring the candidates. Election materials — background information on the candidates and a ballot — should be sent out at least one month before the annual membership meeting.
9. (optional) The Nominating Committee oversees the collection and counting of all ballots and makes its final report to the board of directors and, if required or desired, to the annual membership meeting.
10. The Nominating Committee wraps up the year by passing along its notes, including names of potential candidates and recommendations for changes (to the process, to the timeline, to forms) for future committee's use.

co-op. Being a democratically run organization means presenting members with a choice of candidates.

While the major responsiblities of a Nominating Committee can be accomplished if the committee is formed four months prior to the beginning of the elections process, this is far from optimal. It's preferable to have a small standing committee who make it their year-long responsibility to recruit and nominate candidates and who are prepared to recommend a candidate for appointment in the event of a vacancy. The Nominating Committee should be chaired by a board member who is not up for election (or not seeking re-election) that year, and may also include other board members, former board members, staff members, and members at large.

The establishment of a Nominating Committee does not release each individual director from his/her "perpetuating" responsibility. All directors should assist the Nominating Committee by providing names of qualified potential candidates to be contacted and setting a target number (minimum and maximum) of candidates. In this way, the board can ensure that there will be a contested election between *excellent* candidates and that the co-op will benefit no matter how the voting turns out.

THE NOMINATIONS PROCESS

In a nutshell, the annual responsibility of the Nominating Committee is a four-step process:
1) publicize the need for candidates and recruit individuals;
2) collect background on all interested members;
3) nominate enough candidates to have (at least) a contested election;
4) allow additional candidates to be nominated by petition.

In this way, the co-op isn't caught in the position of having no good candidates or only enough candidates to fill vacancies. This process also allows candidates to be nominated even if they are not selected by the committee.

In seeking qualified and skilled candidates, the committee will want to promote its search broadly throughout the community. Information should be sent via public service announcements to local newspapers, community newsletters and radio stations, as well as to local small business associations or industry groups. However, calling for candidates is not active recuitment; this is just the first step in the committee's job.

The committee should prepare a packet of materials for interested members. This packet should include:

- background on the board — time commitment required, length of terms, qualifications for directors, meeting frequency and schedule, compensation provided to directors (e.g., a purchase discount or stipend), and any relevant board policies (e.g., whether expenses are reimbursed);
- some background on the co-op — mission statement, membership demographics, sales and trade area, physical locations, number of employees, growth trends, etc.;
- a description of the responsibilities and expectations of a director;
- a timeline for the nominations and elections process — when applications, petitions, statements, and photos will be due, when ballots will go out, and when the election results will be announced;
- a copy of any application to be submitted by interested members or petition materials, along with clear instructions on how to pursue nomination (e.g., where to mail or turn in materials).

A list of specific skills or training requirements should also be made clear, including what type of orientation and training the co-op will provide its directors. Committee members should make sure the candidates know what they are getting into, and make it clear that selection by the Nominating Committee does not ensure election as a director.

Finally, after all nominations have been made (by the committee and by petition), a report should be made to the full board descriving the committee's work, any unusual events, and recommendations for changes. In most organizations, the committee's job doesn't stop there. Other functions for the Nominating Committee commonly include: overseeing the elections process, enforcing corporate policy regarding removal of directors, making committee assignments, training and orientation of directors, overseeing cases potentially involving conflict of interest, making any recommendations regarding compensation of directors, and conducting an annual evaluation of board performance.

The process of recruiting and electing new board members is a key to the survival of a strong and successful cooperative. How a board manages the nominations process reflects the co-op's commitment to economic democracy. This is important — if you do nothing else, make sure that the board that follows you will be a better one!

Reading and Utilizing Financial Statements

By Fred Stapenhorst

As a group, the directors of cooperatives are responsible not only for understanding their cooperative's financial statements, but for using that understanding to make important financial decisions. Such decisions may include the approval of loans, acquisition of assets (equipment, land and building), evaluation of management performance, disbursement of rebates, dividends, discounts or other benefits to the members, the maintenance of adequate member investment, and long range planning. The understanding and effective utilization of financial information is a skill usually developed over a period of time and with experience. The intent of this article, which focuses on financial analysis for a retail food co-op, is not to circumvent the necessity of experience, but rather to provide a basic introduction to financial statements, their interpretation, and their use for co-op directors in decision making.

STATEMENTS AND REPORTING

Every retail cooperative should routinely produce at least two financial statements: a balance sheet and an income statement (also known as a "statement of operations" or "profit and loss" statement). More sophisticated operations may also generate a sources and uses (of capital) statement. Periodically cooperatives may have need for cash flow projections, funds flow projections, or other more sophisticated and detailed financial analyses. The standard reporting period should be monthly or every 4-week period (in actual practice, the 52-week year is often divided into eight 4-week and four 5-week periods).

Given the great number of statements produced each year (twelve monthly, four quarterly, and one annual), it's not practical or particularly useful for directors to receive all of them. It is advisable, however, that directors receive a complete set of statements (income statement and balance sheet) for each quarter and for the complete year. With each of these sets of statements, directors should expect a thorough review and analysis by management. During interim months, directors can expect a summary of the most recent month's sales, key indicators, and major expenses as a part of the manager's routine report.

In addition, it's advisable that the income statement show the financial results for not only the particular period (quarter or year), but for the "year to date" as well. In other words, directors should receive an income statement which shows the following:

- comparison of actual to budgeted results for the period
- current year to date (YTD) results compared to last year's YTD results, and
- current YTD results compared to budgeted YTD results

In this way directors can measure performance against historical performance and projected financial goals.

THE INCOME STATEMENT

The income statement answers the question, "Did we make or lose money?" and shows the financial performance of the cooperative over a period of time (month, quarter, year). The income statement format for a retail food cooperative is:

SALES
- less COST OF GOODS SOLD
= GROSS MARGIN
- less EXPENSES
= NET INCOME OR LOSS

Under this format the costs (cost of goods sold) have been separated from expenses, leaving two levels of profit: gross profit or gross margin (profit before expenses) and net profit or net income (after expenses).

Before examining the income statement more closely, it should be noted that it's advisable that the income statement show not only the dollar amounts of each category or "line item," but also the "common sized" amounts as well. What this means is that each line is expressed as a percentage of total sales.

As a final point, note that an income statement is accurately stated only if a physical inventory has been taken at the end of the period which that statement represents. Without an actual inventory the amount of the "ending inventory" in the cost of goods sold section must be estimated.

When that happens, cost of goods sold, gross margin, and net income may all be correspondingly inaccurate. Directors need to be aware of whether a particular income statement reflects an actual physical inventory or an estimate. Customarily, food stores take a complete physical inventory quarterly, resulting in four complete and accurate statements each year.

Sales: This section simply states the total revenues the cooperative collected through the operation of its normal business activities: the retail sale of merchandise. Note that since sales is used as the basis of the common sized numbers, the sales percentage will be 100%.

Cost of Goods Sold: This section expresses the amount of money the cooperative had to pay its suppliers or vendors to purchase the merchandise that it sold during that period. In order to accurately state the cost of goods sold, the purchases for the period have to be adjusted by the difference between inventory levels at the beginning and end of the period. The cost of goods sold section is then calculated as follows:

beginning inventory	$ 160,000
+ plus purchases	140,000
cost of goods available for sales	300,000
- less ending inventory	150,000
= COST OF GOODS SOLD	$ 150,000

Gross Margin: The gross margin is simply derived by subtracting the cost of goods sold from the sales. The gross margin represents the amount or money left over that will be available to pay for the expenses of the business.

For most natural foods cooperatives, the gross margin represents 28-33 percent of sales. If cash register discounts are offered to particular groups of shoppers (e.g. working members), or surcharges are imposed on a category of shoppers (e.g. non-members), these are often shown as an adjustment to gross margin, as follows:

gross margin	$ 56,000	
- less discounts		6,000
+ plus surcharges		2,000
= GROSS MARGIN		$ 52,000

Although simple in concept, the gross margin is the most difficult aspect of a retail food business to manage and control. It involves accurate and careful purchasing, receiving, payment, pricing, and inventory control of thousands of different items. As a percentage of sales, the gross margin is one of the most important pieces of financial data the board of directors should monitor. A gross margin that is a few percentage points off its projected goal can have ruinous effects on overall profitability.

Expenses: The expense category is simply the total amount the co-op paid out during the period to cover the expenses of operating the business: employee wages, rent, utilities, insurance, store supplies, etc.

Because there are so many different types of expenses, they're typically divided into three main categories:

- <u>Personnel:</u> (also called labor) includes all expenses related to the employees, i.e., gross wages and salaries, payroll taxes, health benefits, vacation benefits, etc.
- <u>Occupancy:</u> includes all expenses related to the physical plant, i.e., rent, utilities, maintenance, etc.
- <u>Operating:</u> includes all other expenses necessary to operate the business, i.e., insurance, store supplies, advertising, office supplies, etc.

Interest and depreciation expense are handled in a variety of ways by different accountants. It's important to note where these two expenses show up on your particular statement.

Depreciation is a special type of expense known as a "non-cash" expense. Quite simply it is listed as an expense and "booked" against the net income, but no cash is actually disbursed. Due to the scope of this article, depreciation will not be explored further. Nevertheless, it's important that directors have a conceptual understanding of depreciation and its impact on the income statement and cash.

It's with expenses that the common sized percentages have the greatest application and use. For example, the percentage of personnel costs, rent, advertising, etc. should be monitored from period to period. Likewise, the percentages for these particular line items can be compared to industry standards — the ratio in those categories for businesses in the same industry.

Net Income: Subtracting total expenses from the gross margin results in the net income or loss. It's reasonable to expect a 1-3% net income for a typical food cooperative. The basis of federal and state corporate taxes is the net income (although other credits may apply).

THE BALANCE SHEET

The balance sheet answers the question, "How much are we worth?" The balance sheet is a financial inventory or "picture" of the business at a given point in time (usually the end of an accounting period.)

In its simplest form the balance sheet categorizes all of the items the cooperative has — its assets. Then, the balance sheet presents a categorization of its debts to outside parties (liabilities) and its capital — the capital contributioned by owners and any capital earned from operations. The totals of these two lists (assets, and liabilities plus capital) are always equal — hence the name balance sheet. A simple balance sheet might appear as follows:

ASSETS		
Cash	$ 20,000	
Inventory	100,000	
Equipment	80,000	
TOTAL ASSETS		$ 200,000
LIABILITIES & CAPITAL		
Loan payable to bank	$ 80,000	
TOTAL LIABILITIES		$ 80,000
Capital contr. by members	$ 80,000	
Capital contr. by operations	$ 40,000	
TOTAL CAPITAL		$120,000
TOTAL LIABILITIES & CAPITAL		$ 200,000

In this simple balance sheet the cooperative has $200,000 in assets. The $200,000 in assets has been "paid for" by an $80,000 loan from a bank (liability), $80,000 in shares purchased by members (capital), and $40,000 retained by the cooperative from profitable operations (capital).

From this example the concept of net worth can be easily understood. Net worth is defined as the value of the assets (what the co-op has) minus how much is owed to outside parties (liabilities). In this case, the co-op's net worth is $120,000 — that it, it owns $120,000 worth of its assets. Of the $120,000 in net worth, $80,000 arose from member capital contributions; the remainder represents earnings from operations. It can be said that the $80,000 member investment is now worth $120,000 — or, every $1.00 invested is now worth $1.50.

Of course, the assets, liabilities and capital sections of a balance sheet usually show more detailed categories than in the above example.

Current Assets: All of those assets which, in the ordinary operation of the business, could be converted to cash in the next 12 months are listed separately as current assets. They include such assets as cash, accounts receivable, inventory, and marketable securities. The current assets are totaled. This total provides an indicator of how liquid the assets of the business are, i.e., in the event of a fiscal emergency, how many of the assets are convertible to cash in a relatively short period of time.

Fixed Assets: All of those assets which are generally not convertible to cash in the normal operation of the business (fixed) are listed and totaled. Fixed assets include equipment and fixtures, land and buildings, vehicles, and leasehold improvements (improvements to leased facilities). Fixed assets are depreciated over several years. This means that the values stated on the balance sheet will be the purchase price of the fixed assets less any accumulated depreciation, resulting in the net value. Note that the numbers on the "less accumulated depreciation" line are subtracted, even though they aren't commonly written with any negative symbols.

Other Assets: Usually a small category in a retail food cooperative, other assets includes deposits (leases, utilities, etc.) and investments in other corporations or companies (e.g., a wholesaler).

Current Liabilities: All debts to outside parties which are due in 12 months or less are listed and totaled. These include bills to merchandise vendors, taxes, contracts payable in less than 12 months, and that portion of any long-term debt which comes due in the next 12 months.

Long-term Liabilities: All debts which are due in more than 12 months are listed and totaled. Long-term liabilities include the long-term portion of promissory notes, installment contracts, and other instruments of indebtedness.

Member Investment: (capital contributed by members) The total amount of shares in the cooperative that have been purchased by members is usually listed as the first item under the capital (also called "equity") section of the balance sheet. If the cooperative issues different classes of shares, those sub-totals will usually be shown.

Retained Earnings: (capital earned from operations) The retained earnings figures represents the amount of net income (profit) the cooperative has retained in the business. Retained earnings are a result of profitable operations and are typically divided into two lines: cumulative earnings and net income year to date (YTD). The first reflects all earnings which have been retained by the co-op from the opening of business through the end of the last fiscal year. Net income year to date, reflects all earnings during the current fiscal year. Note that this figure will correspond with the net income year to date figure on the income statement for the same time period.

Armed with a basic understanding of the contents of these two financial statements, directors can analyze their own statements and utilize their analysis to guide decision-making.

A TEN-POINT FINANCIAL ANALYSIS

To facilitate an understanding of financial analysis, I have created an income statement and balance sheet for a fictional co-op, Rochdale Food Co-op (RFC). I will use these statements to illustrate a 10-point analysis. *(See next page.)*

Note: The RFC statements are dated June 30, 1999. RFC's fiscal year is January 1 to December 31, so the year to date (YTD) figures reflect the first six months of the fiscal year. The physical inventory at that time was $150,000. Although not included with the income statement, supplemental schedules are usually provided for expense categories: personnel, occupancy and operating. These schedules show the detailed line items within each main expense category.

1. Sales: Has the historic level of business activity changed? Sales will tell us that. Sales are up 8.1 percent for the most recent quarter (to $800,000 from $740,000). The spring quarter is typically a higher sales period in this particular market area. I conclude that business is normal, adjusted to seasonal fluctuations. I can verify this by looking at past years' statements or by asking management.

2. Net Income: Given normal levels of business activity, are we making money? Unprofitable businesses don't stay around long, or, if they do, they aren't much fun!

I note that year to date, net income is OK at 1.1 percent. For this quarter, however, it has increased to 2.0 percent. Good! To get some perspective on past profitability, I flip to the balance sheet and note retained earnings at $51,500. I know RFC has been in business for 10 years, so over that period (10 years), earnings have been scant. In the first six months of this year, RFC has earned one-third of what it did in the previous 10 years! I conclude that current profitability is OK, and there is some hint it may be improving. Why?

3. Gross Margin: The quickest way to increase net income is to increase gross margin. Gross margin can be increased in a number of ways — price increases are only one way. I immediately look at gross margin: 29.0 percent YTD; 30.0 percent in the second quarter. I'm pleased. The increase in net income is almost entirely a result of the increase in gross margin. How did RFC do it? I have two clues from the income statement. First, surcharges increased from 1.0 percent YTD to 1.5 percent in the second quarter. That 0.5 percent increase in surcharges flows directly into gross margin. About half of the gross margin increase can be attributed to an increase in surcharges. I will question management on how that occurred. Second, I notice that personnel expenses are up slightly: the percentage has gone from 17.5 percent YTD to 18.0 in the second quarter. Did management (wisely) invest a little more in staff time to improve gross margin through better pricing, buying, promotions, etc.? I will question management about this possibility.

4. Expenses: The first thing to look for in expenses is the personnel percentage. I see that total personnel costs are running 17.5 percent YTD and 18.0 percent for the second quarter. That is about average, even slightly low, for this type of store. My questions for management are very incidental: 1) Why the slight increase in the second quarter? 2) How much of total personnel cost is payroll, health benefits, etc.?

Occupancy expense is good compared to national averages. My only questions: 1) How much is annual lease cost? 2) Operating expenses came down noticeably in the second quarter. Why? Otherwise I notice nothing startling. As a total, expenses look good: 27.9 percent YTD.

At this point, we can summize a few things about the co-op's operating performance from the income statement. Overall, operations appear steady — profits are OK, nothing really stands out. Gross margin could possibly be increased; it's a little low compared to industry standards. Otherwise, A-OK.

5. Cash: Moving to the balance sheet, the first thing to look at is cash. Businesses need cash to allow for mistakes, unforeseen slumps or emergencies, special projects, etc. Without cash and the corresponding maneuverability, a business is always running to stay ahead of the bank — an inefficient way to operate!

With $30,000 RFC has a little more than three days' worth of cash for merchandise purchases and operating expenses. (I calculate this by taking the second quarter's cost of goods sold [$540,000] plus total expenses [$224,000], and divide the total [$764,000] by 90 days, since this is a quarterly statement.) I would like to see a week's worth of cash. More than two weeks would be a misuse of cash. More than two weeks would be a misuse of assets – too much cash! With three days' worth, RFC's cash position is fair. I will question management further regarding extraordinary payments coming up, etc.

6. Inventory: Next, look at the inventory. Is the amount of inventory appropriate for the sales volume? Do the inventory levels fluctuate with the sales levels? Unwarranted inventory increases can tie up huge amounts of cash and credit. Directors need to watch the use of this asset. In general, large inventory is a quick way to put yourself into a cash crisis.

To answer the first question, I calculate the inventory turnover rate as follows:

Rochdale Food Co-op
INCOME STATEMENT
for quarter ending June 30, 1999

	Current Quarter		Year to Date	
	$	%	$	%
Sales	800,000	100.0	1,540,000	100.0
beginning inventory	160,000		140,000	
purchases		530,000		1,057,500
cost of goods available	690,000		1,197,200	
ending inventory	150,000		150,000	
Cost of goods sold	540,000	67.5	1,047,200	68.0
Gross margin		260,000		492,800
less discounts	32,000	4.0	61,600	4.0
plus surcharges	12,000	1.5	15,400	1.0
Total gross margin	240,000	30.0	446,600	29.0
Expenses:				
Personnel	144,000	18.0	269,500	17.5
Occupancy	36,000	4.5	67,760	4.4
Operating	44,000	5.5	92,840	6.0
Total expenses	224,000	28.0	430,100	27.9
Net income	16,000	2.0	16,500	1.1

Rochdale Food Co-op
BALANCE SHEET
as of June 30, 1999

ASSETS

Current Assets:		
Cash	$ 30,000	
Inventory	150,000	
Accounts receivable	4,000	
Total Current Assets		$ 184,000
Fixed Assets:		
Equipment	160,000	
Leasehold improvements	80,000	
less accumulated depreciation	90,000	
Total Fixed Assets		150,000
Other Assets:		
Deposits	4,000	
Investments	10,000	
Total Other Assets		14,000
TOTAL ASSETS		$ 348,000

LIABILITIES AND CAPITAL

Current Liabilities:			
Accounts payable - trade	$ 80,000		
Payroll payable	16,000		
Payroll taxes payable	8,000		
Notes payable, current portion	16,000		
Total Current Liabilities		$ 120,000	
Long-Term Liabilities:			
Notes payable, long-term portion	80,000		
Total Long-Term Liabilities		80,000	
Total Liabilities			$ 200,000
Member Investment			
Joining shares	20,000		
Fair shares	60,000		
Total Member Investment		80,000	
Retained Earnings			
Retained earnings	51,500		
Net income, year to date	16,500		
Total Retained Earnings		68,000	
Total Capital			$ 148,000
TOTAL LIABILITIES AND CAPITAL			$ 348,000

COST OF GOODS SOLD
AVERAGE INVENTORY

Using YTD figures, I arrive at an annual turnover rate of 14.4:

$$\frac{\text{CoGS: } 1{,}047{,}200}{\text{AVG. INV.: } 145{,}000} = 7.22 \times 2 = 14.4$$

The entire inventory is sold and replaced 14.4 times per year. Obviously, the faster the inventory is sold the more efficient and profitable the store. For a natural foods store of this type, I would expect a turnover of 12.0 to 18.0 annually. The higher the percentage of sales from perishable items (e.g., meat, deli, produce, or dairy), the higher the turnover rate should be. Since RFC's product line doesn't include many perishable items, its turnover rate of 14.4 is acceptable.

Next I check the levels of inventory (in the cost of goods sold section of the income statement). I note that it was $140,000 at the beginning of the fiscal year (January 1), $160,000 on March 31, and is now down to $150,000 (June 30). It appears stable, and given that sales are relatively stable, it should be. RFC seems to be under control here.

7. Accounts Payable: Accounts payable represents the amount of credit currently outstanding with merchandise suppliers or vendors. As of June 30, RFC was running a credit balance of $80,000 with its vendors; however, this number has little meaning unless it's related to the inventory. In a traditional grocery business the goal is to have as much vendor credit (accounts payable) as inventory. In that way the store doesn't have to pay its vendors until after it has sold the merchandise. This means that the store "works on vendors' money" — i.e., the inventory is "financed" by the vendors and not the store. Of course, that goal is rarely realized, and I have never seen it happen in a natural foods store (inventory turnover is too slow). A reasonable goal seems to be a .5:1 accounts payable/inventory ratio — half of the inventory is financed by the vendors and half by the store. With a little prodding additional vendor credit is often available. Any increase in the accounts payable balance will flow directly into the checkbook in the form of cash.

RFC has about 53 percent of its inventory financed by vendors as of June 30 ($80,000 of $150,000). This is good. However, I'll double check with management to see if the accounts payable balance can be increased.

8. Current Ratio: The current ratio is calculated by dividing the current assets by the current liabilities. The resulting ratio gives an indication of short-term (current) cash resources as compared with short-term cash requirements.

RFC's current ratio is 1.53:1. What this means is that for every $1.00 that RFC has to pay in short-term debts, the co-op has $1.53 available in cash or things that can be readily converted to cash. Obviously this is a good position. A ratio of less than 1:1 can be trouble. A safe range for retail food co-ops is a ratio of 1.25 to 1.5:1. A ratio higher than 2:1 probably indicates "idle assets" (too much cash).

Note, however, that a "comfortable" current ratio is largely dependent on the skill and experience level of the management. The greater the competency of the management the more realistic it is to operate with a current ratio closer to 1.25:1. With less experienced management the directors may be prudent to require a current ratio closer to 2:1.

9. Member Shares: Next, look at the amount of member capital invested and relate it to the total value of the assets. This exercise helps answer the question, "How much of the cooperative has been financed by the members?" Member investment should be a significant amount for the balance sheet to be considered healthy and the cooperative owned by its members.

For RFC, members have contributed 23 percent of the value of the assets ($80,000 of $348,000). It's difficult to say what the right percentage is; the right percentage varies with every situation according to the market strength, management experience, level of retained earnings, etc. Less than 20 percent of the assets contributed by members does not seem adequate. In my experience, a co-op with 20 to 30 percent member investment, good management, and good profitability, will be "bankable".

10. Debt to Equity Ratio: Finally, look at the debt/equity ratio to further determine how "leveraged" or "bankable" the cooperative is. The debt/equity ratio is determined by dividing the total liabilities by the total equity or capital.

For RFC, debt/equity is 1.35:1 ($200,000 divided by $148,000). What this means is that for every $1.00 in equity or capital (remember, capital consists of both member investments and earnings), RFC has $1.35 in debts.

Acceptable debt/equity ratios vary greatly with the situation — the management, the market, the confidence of the banker, etc. In my experience a debt/equity ratio exceeding 2:1 for a food cooperative is usually not prudent. If a cooperative is experiencing instability in terms of management, sales, or other factors, then a ratio closer to 1:1 is advisable. Establishing a debt/equity ratio goal for any particular cooperative will need consideration of all the factors. However, a range of 1:1 to 2:1 appears most realistic for most food cooperatives.

You have reached the end of Challenges to the Board of Directors ***part one***.

Please continue reading ***part two*** by downloading the file at: http://www.cgin.coop/node/6159

Thank you.