OCFAID - a simple tool to take the financial pulse of your cooperative

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ABSTRACT: When private sector firms fail, few question capitalism. But when co-ops fail, some are quick to suspect the model. In fact, cooperatives have a much higher success rate (60 percent) than private sector firms; and when they do fail, it is often due to high-risk, high-debt management strategies inappropriate for a co-operative. How can we equip members with better tools to diagnose the financial health of their co-op? This paper demonstrates how Operating Cash Flow After Interest and Distribution (OCFAID) Analysis, developed by Professor Alan Robb, Saint Mary's University, Halifax and the University of Canterbury, New Zealand, could have saved Dairyland – one of Canada's oldest dairy cooperatives – from forced demutualization on the eve of its centenary.

Keywords: OCFAID, financial analysis, diagnostic tools, cooperative health, Dairyland

SUMMARY

OCFAID Analysis is a system developed by Professor Alan Robb, co-op forensic accountant based at the University of Canterbury in New Zealand and Adjunct Professor of Accounting, St Mary's University, Halifax.

In this analysis, which provides a clear window of transparency into the financial workings of an organization, Operating Cash Flow After Interest and Disbursements (OCFAID) is plotted graphically against Retained Earnings (RE), both on a cumulative basis. A major change in governance, management or operations triggers a new cumulative graph (Robb, 2008).

When plotted on a single graph over time, these two lines reveal, with devilish simplicity, five CLEAR SCENARIOS to take the financial pulse of an organization. When both lines are rising it's a STAR. When OCFAID is falling and RE rising, it's a PROBLEM CHILD. The reverse is a CASH COW. When both are falling it is A DOG. There is also a fifth scenario relating to mergers and transition.

OCFAID Analysis works equally well for co-operatives and private sector businesses.

INTRODUCTION

This case study discusses how OCFAID Analysis, if used as an ongoing diagnostic tool by the members of Dairyland Co-op, would have provided fully 4 years advance notice of the impending fiscal cliff, arming members with the facts they needed to save this century co-op from demutualization in 2001. The benefits of OCFAID analysis apply equally well to private sector firms. This text describes its importance as a tool to facilitate meaningful engagement by members in the financial oversight of their co-op.

The information presented in this analysis was obtained by the author from Dairyland/Dairyworld/Agrifood International Annual Reports (1980-2001) as well as personal discussions with numerous farmers who were either former directors and/or shippers. Alan Robb undertook the OCFAID analysis.

OCFAID: WHY THIS TOOL IS NEEDED

To achieve the ICA Vision of co-ops becoming the first and most compelling organization choice by 2020, we need to provide members with tools to more effectively monitor financial health. OCFAID is a necessary tool in the Co-op Toolbox because nothing else provides members with such a simple, accessible and irrefutable assessment of the financial health of their co-op.

As co-ops move to triple bottom line accounting to demonstrate to members all the good things they are doing for community and the environment and

as balance sheets become more complex and financial instruments more arcane, member "evaluation" of co-op performance at each year's annual meeting increasingly reflects the "warm fuzzies" left by the stories of social and environmental payback that pepper the Annual Report and not the financial health and well being of the balance sheet.

A stool with one weak leg is dangerous, more so when it "appears" normal. Members instinctively know when something is "right" socially or environmentally. Living wage employer? Great! Supported social housing? Great! Winning Recycling Awards? Great! But members lack the same intuitive response to balance sheets and income statements. And therein lies the vulnerability of the co-op and its members.

If your doctor told you at your annual checkup "…Well, you have a foot on the left and one on the right… Each side has a hand. Ears and eyes balance. Nothing is too large or too small. You must be in good health…" you would quickly find yourself a new doctor! Yet this is pretty close to what happens when members approve the annual financial statements of their co-ops.

Ideally, the first responsibility for fiscal oversight lies with the elected Board of Directors, who are the members' representatives. But boards can be bullied and snowed by management, and when failure of agency occurs (inability of directors, the members' agents, to perform), the responsibility for fiscal oversight falls right back onto the shoulders of members.

If, as ICA Blueprint says, member participation is the most important priority in this Co-op Decade, the right co-op tool has to give members some way to

allow them to participate more meaningfully in the financial oversight of their co-operative.

To accomplish this, we need to render balance sheets, income statements and related financial statements more transparent (what's really going on?), accessible (everyone understands), useful (irrefutable; gives the Board hollow-point ammo) and compelling (spurs members to action) in a straightforward (one simple graphic to diagnose fiscal health) way.

To measure human health, your doctor uses a stethoscope, a blood pressure cuff and a thermometer. The equivalent tool for members who need a better measure of the financial health of their co-op is OCFAID analysis.

DAIRYLAND – ALMOST A CENTURY OF CO-OPERATION

In the mid 1980's, the marriage of timing (fall of global tariffs) and technology (capable of separating bulky and perishable fluid milk into dehydrated constituents) created an opportunity for profitable new trade and investment in "modified milk ingredients". The "super dairy" was born. (Holm, 2010, 2009, 2008.)

As cheap imports displaced domestic product in local markets, smaller dairies – mostly co-operatives - tried to keep pace by modernizing plants and evolving product lines. But demutualization pressure was strong. There was a good buck to be made from dominating the Canadian dairy processing market, and global giants like Saputo and Parmalat were sniffing 'round the property line, ready to make their move.

BC’s Dairyland Milk Producers’ Co-operative, which would have been one hundred years old today, fell prey to this wave of predation-demutualization.

Dairy farmers, so good at carefully monitoring the health of their cows - feed uptake, milk production, stool quality, somatic cell count, hoof condition – are no better than any other member at monitoring the financial health of their co-operative. They elect Directors for that. It’s up to the Directors to take action on behalf of the members. If Directors have problems doing that, it’s their job to bring their concerns to the attention of the members at the AGM (or before, if serious).

But it is often hard even for directors to detect poor financial performance. And this problem is certainly not limited to co-ops. Senior managers acting to maximize individual performance bonuses can often mask financial risk and economic vulnerability, making income statements and balance sheets “hard to figure”. Staff comes to the meeting armed with bafflegab, and board politics often constrain the ability of Directors to mount an effective challenge. The global financial collapse of 2008 was moot evidence to this phenomenon.

Some industry insiders interviewed for this paper say the problem lie in the fact that Dairyland’s management took members on a very pricey ride, funding expansion across Canada and exposing the co-op to highly leveraged financial risk that ultimately proved to be its downfall. Others say the Board was at fault - where were they when all this was happening? Many claim management snowed the Board, making effective challenge of the CEO’s practices impossible. Others point to similar dairy co-op failures (e.g. Australia’s Warnambool Cheese and Butter) and say it was inevitable.

At the final AGM, members were taken by surprise. The Board presented members with a resolution: bankruptcy or sell the co-op to Montreal-based global dairy giant Saputo at fifty cents on the dollar.   Blindsided and seeing no option, they voted to demutualize.   As one Alberta delegate to the fateful final meeting told me: "No-one knew what was going on... Delegates were not kept up-to-date by the Board; there was no transparency. Basically, they destroyed the co-op and Saputo picked it up for a song…"

How did it happen? Unsustainable debt. Why did it happen? Lack of transparency and loss of member control. Like mushrooms, farmers and Board members felt they had been kept in the dark and fed agricultural byproducts. Corrective actions were impossible. And when the chickens came home to roost, their co-op was gone

Could farmers have saved their co-op? Is there a tool out there that could have forewarned co-operative members– in a simple and straightforward manner – that they were heading for financial disaster? Is there a tool that could have forearmed members at the AGM with the transparent information needed to convince management to change course or resign?

Using Alan Robb's OCFAID Analysis, the answer is yes. OCFAID stands for Operating Cash Flow After Interest and Disbursements. Had Dairyland members used OCFAID's one simple chart as the cover page of their Annual Report, they would have known 4 years in advance that they the run they were having was straight for the cliff.

This case study explains how – with the proper tools - this story might have ended differently for Dairyland and its members.

THE STORY OF DAIRYLAND

Like many co-operatives, chaotic marketing conditions were behind the formation of the Fraser Valley Milk Producers Association.

By 1917, the new co-op represented 90 percent of lower mainland diary farmers. Within three years, it operated two processing plants and a condensing plant. In 1925, it added a butter, powdered milk and cottage cheese plant to process milk surplus to fluid requirements. Ice cream was soon added to the product line. For some 70 years, Dairyland was a healthy and vibrant co-operative.

All that changed in July 1992, when Fraser Valley Milk Producers Co-operative merged with Northern Alberta Dairy Pool (Nu-maid Dairies) and Central Alberta Dairy Pool (Alpha Milk) to create a new entity: Dairyworld.

According to a dairy farmer on the board at the time, the 1980's was a period of positive board/management dynamics. "We had a CEO who was good - just needed someone to stand on his head occasionally." Allegedly, the CEO had two weaknesses: "he was not enough adverse to debt and was soft on clients - really scared of losing an account; if we managed to save 1¢ on a litre of milk, he would give 2¢ away to keep a client… Our Chair at the time was strong and could do it. And at the time, the Dairyland board didn't have the authority to spend money or go into debt without authorization from the members, so things were kept pretty well in check."

The catalyst, according to many, was cheese. In the 80's, Macdonald's Restaurants sourced cheese slices locally. When Macdonalds announced it wanted to buy from only one Western Canada supplier, dairy co-ops in BC,

Alberta, Saskatchewan and Manitoba decided they should find a way to collaborate to keep the Macdonald's market, opening the door to merger.

Even with apparently common goals, predictable challenges arise when co-operatives merge membership. Geographic separation adds complexity. As do changes to governance structure.

As part of the BC-Alberta mergers, the new Dairyworld co-operative kept Dairyland's Head Office and CEO, but BC's (strong and respected) Chair had to step down in favour of a (less experienced and weaker) Chair from Alberta. According to a director at the time: "this new Chair had a very different governance style; he was not prepared to lean on the CEO like his predecessor. And so the CEO basically ran the board, directors were kept in the dark and the membership did what the Board told them to do."

But the real challenge in this merger lay curled in the weeds of the new bylaws. And like a snake poised to strike, it took aim at the co-operative heart of the organization.

Alberta's two co-ops didn't operate under the same rules as Dairyland in BC. On merger, BC's requirement that members be consulted before spending large sums of money was dropped. As one former director on the Board at the time told me "….the board knew this was not helpful, but the Chair wasn't prepared to challenge the CEO, and it went through."

Also dropped in the merger was a revolving check-off loan (1% from milk cheques) that provided the co-op with low cost equity from its members

(patient capital, the loans earned modest interest and were repaid in 15 years). Paying out the loan drew down $7-12 million in co-op capital.

According to industry insiders and former directors at the time, removing member authority over spending approval removed the last obstacle in the path of an expansionary, CEO-led Board.

The spending spree accelerated. In 1993, Dairyworld was again restructured and Dufferin Employment Co-op Ltd (Manco) became Dairyworld's Manitoba plant, with 3,000 employees.

But storm clouds were gathering… At the 1993 AGM, Director and former Vice Chair John Van Dongen publicly resigned, telling delegates that he had many concerns for which he could not get board support. In his remarks, he recommended to members several case studies of US co-op failures at the hands of overly aggressive CEOs.

In June 1996, Dairy Producers Co-operative Ltd. (DPCL) of Saskatchewan was brought in by merger and the new company's name changed to Agrifoods International Co-operative Ltd., the new parent company of Dairyworld.

The reorganization resulted in a co-operative with 2100 milk shippers (dairy farmers) in western Canada, the largest dairy co-operative in the country. In 1996, sales reached $1.13 billion. Further expansion throughout Eastern Canada pushed this to $1.5 billion/year in 2001.

The income statement looked sunny, but the real story was in the balance sheet: debt was growing faster than income. And it was this debt, in the end, that brought this proud farmer co-op down.

In 1997, the co-op's ice cream division was sold to Nestle. Sometime that year, Cliff Denny stepped down as Chief Financial Officer. A board member at the time suggests he was pushed.

Problems came to a rolling boil in 1998, when accelerated steps to position the co-op as a national supplier included expansion to Eastern Canada through purchase of plants in Ontario, Baxter Dairies in the Maritime, McCain Refrigerated Foods, a joint interest in Pascobel cheese and a partnership agreement with Nurtinor and Agrodor. Merger talks with Agropur were also initiated at this time; they failed on two issues: governance (Agropur wanted 14/10 board split, a four seat majority; Agrifoods wanted 12/12) and management (each co-op wanted its own CEO to take the helm).

In its 1998 acquisitions, the enterprise paid heavily for intangibles: goodwill represented 50% ($43.8m of the $84.2m) of net assets acquired from McCains and 79% ($22.5m of the $28.5m) of net assets of other acquisitions. All acquisitions were dependent on borrowed finance. And a rapid depreciation of this good will tanked profitability, leaving no surplus for distribution to members.

As a result of the 1998 acquisitions, long-term debt rose by 68% ($73 million), and current liabilities rose 55% ($75 million). The cash paid for intangibles caused a sharp drop in operating cash flows.

At the 1998 AGM CEO David Coe, brandishing a balance sheet showing assets of $513 million and sales of $1.2 billion, told delegates how "immensely proud" he was of this "substantial increase in sales and net earnings" that positioned the enterprise for a bright future. The budget was approved by the Delegates.

By 1999, the ratio of external debt to members' equity had risen to almost three to one (2.9:1), double the debt to equity level in 1982 (1.5:1). Similarly, the ratio of intangibles to members' equity and members loans had risen to a whopping 66.4 percent, up from only 0.6 percent in 1997 and a mere 3.3 percent in 1982.

At the 1999 AGM, delegates were told of a $6 million loss (25% of member equity) from Ontario processing operations. When members criticized the board for operating outside their mandate ("to process members milk"), members in attendance told me the CEO justified the Ontario acquisitions as a "pre-emptive strike" to "stop processors from coming west".

In a meeting in Calgary in January 2001, with financial statements reporting sales of $1.5 billion, 120 farmer delegates were given the grim news by the Agrifoods Board: the Royal Bank had turned the co-op down for an operating loan, other banks were running scared, and bankruptcy was imminent.

Delegates were told there was only one offer on the table – 50¢ on the dollar from Montreal-based dairy giant Saputo. They were "advised to take it" by the Board.

According to my conversations with farmers who attended that fateful meeting, "a few people knew a lot and many knew nothing. There had been no transparency. Company insiders were the only ones who had the full story. The board knew only what senior management told them and the delegates knew virtually nothing of what was going on…."

A core of delegates argued passionately from the floor to preserve the co-op by seeking bankruptcy protection. This would have allowed the co-op to restructure debt, develop a strategy to reorganize assets and would have saved the cost of substantial severance packages for senior executives.

In the end, only 10 of the 120 delegates voted with them. The majority were, according to one farmer in attendance, "scared into accepting." Between a rock and a hard place, 110 farmers voted to sell the co-op's assets and brand to Saputo. The co-op Agrifoods International retained the raw milk transport business and a yoghurt plant. Reportedly, senior staff got healthy termination bonuses.

"No-one knew what was going on," reports an Alberta delegate at that meeting. "Delegates were not kept up to date; there was no transparency… Basically, management[i] destroyed the co-op and Saputo stole it for 50 cents on the dollar…"

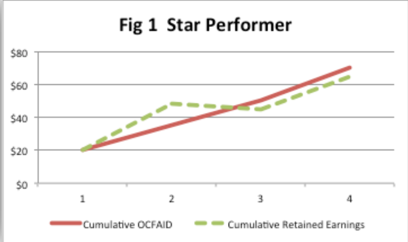
COULD OCFAID ANALYSIS HAVE SAVED THIS CO-OP?

Absolutely says Alan Robb, co-op forensic accountant based at the University of Canterbury in New Zealand and Adjunct Professor of Accounting, St Mary's University, Halifax who developed OCFAID Analysis[ii].

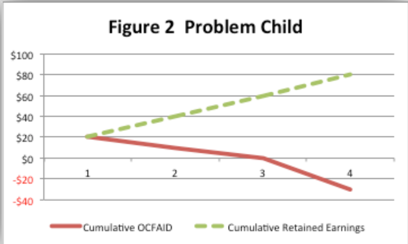
According to Robb, profit (or share value) is a completely unreliable measure of business performance; enterprise survival depends on two factors - profitability and liquidity. OCFAID would have predicted their problems years in advance, giving them both the time and the ammunition to put management on a different course.

OCFAID stands for Operating Cash Flow After Interest and Distribution (mainly dividends). It is plotted graphically against Retained Earnings, both on a cumulative basis. A major change in governance, management or operations triggers a new cumulative graph. When plotted on a single graph over time, these two lines reveal, with devilish simplicity, 5 CLEAR SCENARIOS that take the financial pulse of an organization:

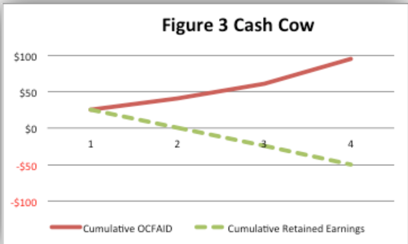
1. When operating cash flow after interest and distribution and retained earnings are both rising, it's a STAR.



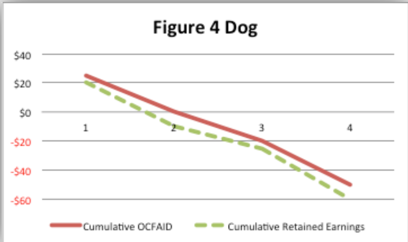
2. When operating cash flow after interest and distribution is falling but retained earnings are rising, it's a PROBLEM CHILD.



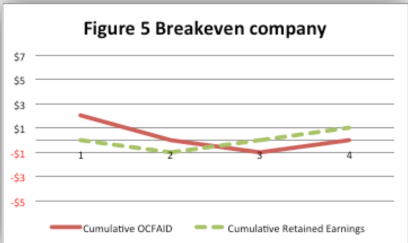
3. When the reverse is happening (operating cash flow after interest and distribution is rising but retained earnings are falling, it's a CASH COW.



4. When both are falling, it's a DOG.



5. A TURNAROUND (usually under a receiver or a change manager) is when both are neutral as the nature of the entity is reconfigured.



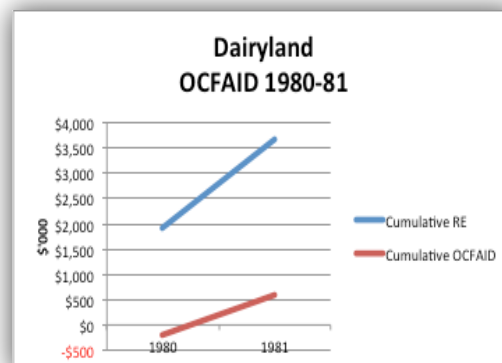
Robb's analysis has been applied successfully by investor-owned companies, co-operatives and not-for-profits in New Zealand, Australia, the UK and the USA, is monitored as a Key Performance Indicator by many boards and is in use by a national firm of chartered accountants to help decide whether a client is a 'going concern' or not (Robb, 2008).

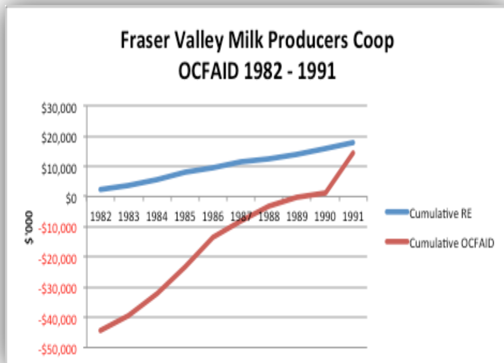
To test the effectiveness of Robb's OCFAID Analysis in the Dairyland case, I compiled a complete set of Dairyland/Dairyworld financials from 1980-2001 and sent them off to Alan Robb for analysis. The results are fascinating…

APPLYING OCFAID ANALYSIS TO DAIRYLAND

Had OFCAID analysis been used in the boardroom and featured on the cover of annual reports, the changing fiscal health of this co-operative would have been fully transparent to both directors and delegates FOUR YEARS BEFORE the co-op collapsed. This would have done two things: a) it would have provided irrefutable evidence of the deteriorating fiscal health of the co-op that management would have been powerless to deny, and b) it would have provided this information in time for farmers to take action to save their co-op.

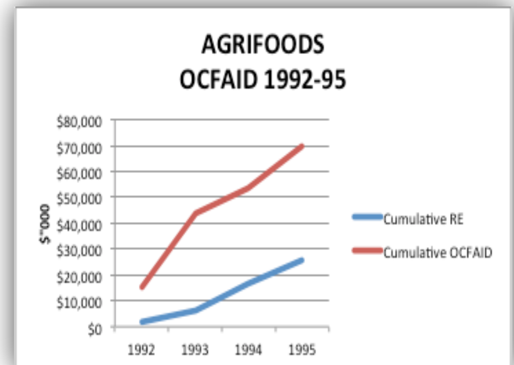
Opening OCFAID analysis for 1980-81 depicts a healthy co-op. Both retained earnings and OCFAID are rising steadily.

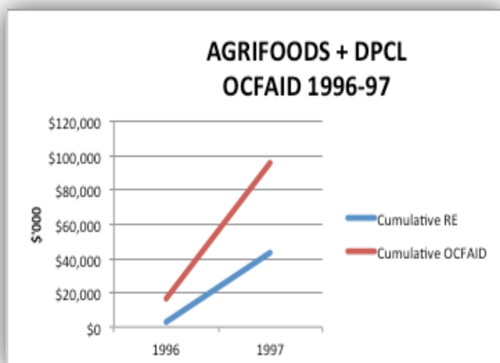




OCFAID analysis (1982-91) following the merger of Fraser Valley Milk Producers Co-op and Shushwap-Okanagan Dairy Co-op to create FVMPCA continues to show a *"very good trend after an initially poor year of amalgamation…"* (Robb, prs. com.)

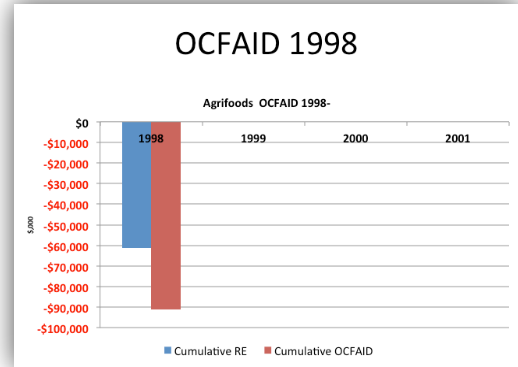
OCFAID analysis for 1991-1995 following the merger of Fraser Valley Milk Producers Co-op Association, Northern Alberta Dairy Producers and Central Alberta Dairy Pool to form DAIRYWORLD FOODS continues to show *"…a healthy trajectory, even better than the previous period."* (Robb, prs com.)

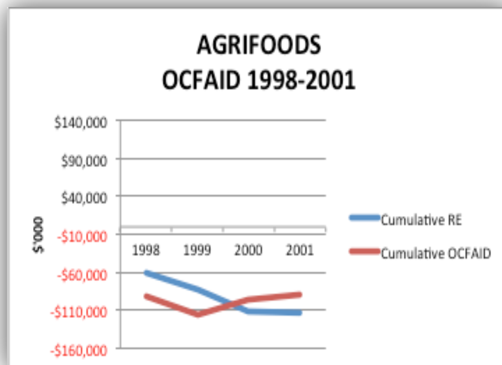




OCFAID analysis for 1996 and 1997 following Dairyworld Foods 1996 merger with Dairy Producers Co-op Ltd Saskatchewan to form Agrifoods International was again positive: " *a successful merger for the members…"* (Robb, prs. com.)

But in 1998, OCFAID analysis reflects a sharp drop in operating cash flows following acquisition of close to $70 million in intangibles following purchase of Eastern Canada plants. Funded with borrowed capital, long-term debt rose by 68% and current liabilities by 55%. Had members known this in '98, it would have been obvious the co-op was in serious financial trouble and steps could have been taken to reduce vulnerability.





OCFAID analysis from 1998 onward tells the sad story. By 1999, debt to equity ratio had become 2.9:1 and intangibles represented 66.4% of members' equity.

Over the ensuing two years, unmanageable debt brought this fine, close to century old co-operative to its knees. It toppled by vote of the members in 2001.

In the decade or so since then, Saputo has grown into a behemoth that, like the beast described in Job, "…drinketh up a river, and hasteth not: he trusteth that he can draw up Jordan into his mouth…" (Job, 40:15-24).

Since 2001, a number of small dairies across Canada were acquired and shut down by Saputo; two Alberta plant closures were announced just this

month. Today, Saputo is the third largest cheese maker in the US and one of the top 10 dairy processors in the world, generating about $9.3 billion of annual sales and employing 13,000 people.   With plants in Canada, the US, and Argentina, Saputo just acquired Australian giant Warnambool Cheese and Butter after fierce and costly takeover battle with Australia's largest processor, dairy co-operative Murray Goulburn. Saputo is now eyeing acquisitions in Brazil and New Zealand.

SUMMARY

As this case study shows, Dairyland didn't fail because it was a co-operative trying to make its way in a sector dominated by global players. There are a number of highly successful, international dairy co-operatives, including Australia's Murray Goulburn, New Zealand's Fonterra, The Netherland's Friesland Campina, Denmark's Arla Foods and Canada's Agropur.

But Dairyland never got the chance to spread its wings on the global stage. Its potential to follow in the steps of Goulburn et al was nipped in the bud by unacceptable levels of financial risk that delivered this once-strong co-op to the private sector.

If dairy farmers in western Canada had been able to exercise effective fiscal oversight, Dairyland would today remain in member hands and be planning for its centenary. OCFAID Analysis would have given them that clear and crisp ability: an irrefutably transparent diagnostic that like the iconic smiley face (happy-bored-sad-dead) gives a clear reading of financial health.

[i] The CEO who drove the expansion plans and attendant debt retired when Saputo took over and went on to become a leadership coach with US-based TEC. His management record at Dairyland is described on the TEC Canada website as follows:

> *During that time, [he] drove the business from a two-plant operation…to a national company with plants operating from coast to coast and selling its own national brands. During this period of unprecedented expansion, company revenues grew from $180 million to more than $1.7 billion, and productivity of the company's 3,400 employees increased five-fold on a per-worker basis.*

[ii] It is based on the Tom Lee dictum: "*The ultimate bottom line in business is not profit, it is the ability to earn a profit on a transaction and turn it into cash and do this repeatedly…*" (Lee is a well known financial author and Director of Accounting and Auditing Research, Institute of Chartered Accountants of Scotland. More information on OCFAID analysis can be found at www.alanrobb.coop)