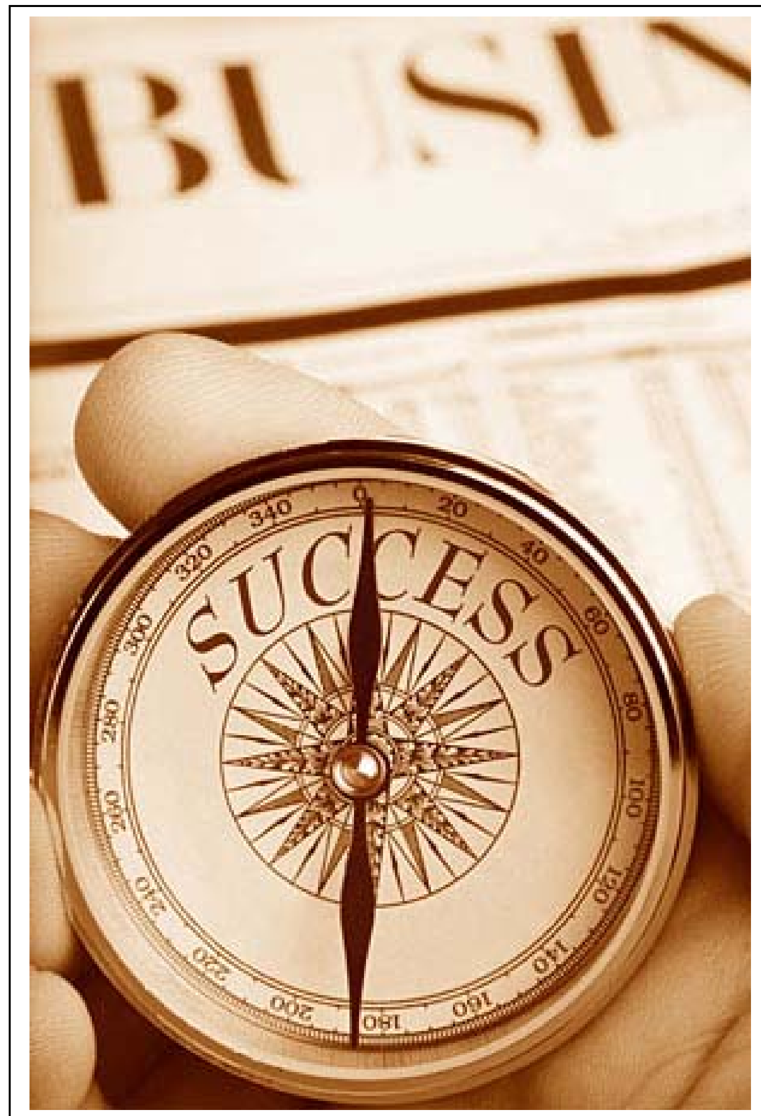
Phase 4 - Business Planning



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Overview of the Basics of Business Development

A business plan is critical for business start up, and this section describes the components of a business plan.

The feasibility study is intended to help the owner(s) understand the viability of the proposed venture, what it would take to get started, whether there is a viable market, and where the risks lie,. It is meant to help potential owners and investors to decide whether to move forward at all.

The business plan, however, assumes that the venture is potentially viable. It assumes a decision to go ahead, and outlines how that will happen, and how the business will be developed in the short and medium term.

What is a business plan and why do we need one?

A business plan lays out the guiding statements, goals, objectives and what will be done to achieve them over a stated period of time. It describes the cooperative as to, who it is, what it will sell and to whom, where the cooperative will be located, when is it expected to get under way, how it will overcome the risks involved and provide the returns anticipated.

A business plan will provide information on your proposed venture to lenders, investors, and suppliers to demonstrate how you plan to use their money, and to establish a basis for credibility of the project. The Business plan gives the cooperative's financial institution insight into your business opportunity so that they can consider your financing application with enough information.

Business plans typically have detailed information about the organization, cooperative steering committee or team attempting to reach the goals. With for-profit entities, external stakeholders include investors and customers. For non-profits, external stakeholders may include donors, granting agencies or clients/ beneficiaries of the services.

Developing a Realistic Business Plan

Many investors and financial institutions review the financial section of the business plan first. It is critical that the assumptions and projections in this section be realistic. Plans that show operating margin and revenues that are poorly reasoned; internally inconsistent or simply unrealistic greatly damage the credibility of the entire business plan. In contrast, well-reasoned financial assumptions and projections are perceived as signs of capable and critical thinking.

As much as possible, the financial assumptions should be based on actual results from other firms in the same business.

Writing a Business Plan

The following sections first give a summarized overview of the components of the business plan, for quick reference, and follows with more detailed descriptions of the components.

The overall concepts that should be included in the business plan include:

- **People:** The biographies and experience of the people involved in starting and running the enterprise, including outside parties (suppliers) and professionals (consultants)
- **Opportunity:** A description of the opportunity, including a profile of the business and the potential of the business
- **Environment:** An understanding of the environment the business will operate in, including regulatory, technology, competition, market and demographic trends and interest rates
- **Financial Projections:** A frank assessment of the risk and reward of the venture, including financial projections

A detailed outline of the components of the business plan follows and includes the concepts mentioned above.

- **Title page**
  - Company name, address, phone/fax number, website
  - Names and contact information for owners/executives
  - Date of business plan issue
- **Table of contents for business plan sections and headings**
- **Executive summary and fact sheet**
  - Summarized highlights of the business plan in the executive summary
  - Facts about the business, such as name, location, type of business and industry, organization structure, principal product/service, registered patents or trademarks, number and name of founders or shareholders, length of time in business, current/projected market share, funds and source of funds invested in business to date, additional required financing, proposed terms and payback period, net worth of business, names of professional business advisors.
- **Guiding statements**
  - Vision, mission, values statements
  - Goals of the company
- **Company overview**
  - Background of the company
  - Current situation, including a description of the market opportunity and your competitive advantage
  - Industry overview, including industry trends and characteristics as well as major competitors
- **Products/Services**
  - Description of what you are selling, including any unique features or advantages over competitors' products/ services. Includes information on why people would buy your product/service
  - Patents or trademarks that are proprietary to your company.

- Regulatory standards that your product/service may be required to meet
- Outline of market potential and any key success factors

- **Market Analysis**
  - Assumptions and information sources on which your analysis of the market is based
  - Description of who you expect to be buying your products (your target market) and market segments, Market segments may include individual people, companies, institutions, professional groups, governments, or others.
  - Characteristics of the target market
  - The number of customers there are in the market; the frequency with which they will buy your product/service; the seasonal purchase patterns, if any apply
  - Description of recent demand for your product/service in the marketplace and projected market demand based on facts, trends and anticipated changes in the world
  - Main competitors and a comparison of their products/ services to yours, in terms of price, quality, performance, warranty and any other relevant points of comparison.
  - Comparison of your business against your competitors' businesses in terms of sales/marketing efforts, relative profitability, distribution, production capabilities, and other relevant factors.
  - Estimates of your sales and market share for the next three to five years
- **Marketing Plan**
  - The pricing structure for your product/service, including expected gross and net margins. Terms of sale (i.e. credit terms, volume or cash discounts).
  - Identification of your breakeven point.
  - Description of sales and distribution methods.
  - Your plan to promote your product/service, that is, to create awareness of your product/service within your market.
  - Description of your service and/or warranty program and whether it will be handled through dealers or your company
- **Development Plan**
  - Description of the stages of development for your product/ service, including costs
  - Description of any proprietary issues.
- **Operations Plan**
  - The location, facilities and equipment, including their costs, that are need to provide the product or service

- The Labour, skilled or unskilled, required to provide the provide the product or service
    - The environmental approvals that are required to be met. Any required licensing.
    - Activities that need to occur to be in operation and to meet your goals, including quality control process, inventory monitoring and control and procurement
- **Management Plan**
    - The key players and their qualifications and contributions, whether active investors, consulting professionals, management team or directors
    - Compensation for key players
    - Employee recruitment and retention plan
- **Implementation Plan**
    - Significant implementation goals and timelines expected to meet those goals
    - A schedule of significant events and their priority for completion.
    - Summary of risks of delayed implementation or problems arising during the course of implementing the business plan
- **Financial Plan**
    - Current financial statements (if your venture is already in operation)
    - The amount and type (i.e. debt or equity) of funding you require and the purpose of those funds
    - Investment requirements, and funding sources for any investments already made
    - Proposed terms of funding requests, including repayment or ownership structure
    - Existing financial projections, The effect of additional investment on financial projections for the following:
        - Profit/loss forecasts (Income statement)
        - Pro forma balance sheet
        - Projected cash flow statements
        - Break even analysis
- **Appendices**
    - Product or service specifications
    - Management team resumes
    - Management team job descriptions
    - Potential customer listing
    - Potential supplier listing

    - Market surveys
    - Legal documents
        - Leases
        - Contracts
        - Environmental permits
        - Patents
        - Trademark registration
        - Articles of incorporation
        - Cooperative articles
    - Any Consultants' reports

Keep in mind that, even though a business plan is used as a guide for the owners, it may have to be changed from time to time as a result of changes in the environment or changes in circumstances.

Guiding Statements

One of the critical first steps in creating the business plan is to agree upon appropriate guiding statements for the cooperative. These may include a vision statement, a mission statement, and guiding principles or values. It is important that these guiding statements are agreed by the founding organizers, because actions planned or taken need to flow from a shared set of assumptions about how to approach the business.

Vision Statement

A vision statement should be a clear, motivating message about what your organization wants the future to look like. When the guiding statements are shared with members, customers or suppliers, it can help them understand the organization's motivations, and why they should be members of the cooperative. What is the difference your cooperative exists to create? For whom? What does it look like?

Vision statements often meet three key criteria:

- Timelessness – the ideal conditions in the future
- Inspirational – Inspires employees or members to embrace the vision and act accordingly
- Clear – provides clear and flexible decision making criteria

Mission Statement

A mission statement is focused on the present rather than the future. It defines what the organization does or intends to do, on a regular basis (product, service) and for whom. In the case of a member cooperative, beneficiaries may be members, customers, both at once, or even other parties. Again, a mission statement may say something about *how* the organization does things.

The prime function of a mission statement is internal; it provides a compass bearing for the leadership team, the cooperative board and the employees. The mission statement describes those things on which the organization concentrates on a daily basis.

Values

Values or principles are the set of beliefs people share about how to operate in conducting business. Values play a critical role in guiding, aligning, and galvanizing an organization. Values serve to maintain organizational integrity by providing a context for consistency and accountability in decision making. Values lead the cooperative to regard some goals as more desirable than others.

Strategic Goals

The next step in the visioning process is to determine the overarching or major strategic goals for fulfilling the vision. A strategic goal is a broad statement of a desired and measurable result, in support of the organizational vision. The key in creating goals is thinking strategically about the gap between where the organization is today, and where it needs to be after a defined planning period. In considering goals, the challenge is to address. "What are the top two or three priorities on which the business must focus attention in order in order to achieve the vision?"

Objectives

Objectives are the next level of detail from a set of overarching strategic goals. They provide the cooperative with the means to measure the performance of the cooperative directly. Objectives give the cooperative a set of clearly defined targets.

The most effective business objectives meet the following criteria:

S – Specific – objectives are aimed at what the business does,

M - Measurable – the business can put a value to the objective (e.g. $100,000 in sales),

A - Agreed by all those concerned in trying to achieve the objective.

R - Realistic – the objective should be challenging, but it should also be considered achievable by the resources available.

T- Time specific – there is specificity as to when the objective should be achieved (e.g. 500 new members by the end of the second quarter).

Defining the Nature of the Business

When preparing this section of the business plan, you want to provide information to ensure certain questions that investors have are answered. The section allows you to describe your strategic understanding of your own company, its products/services and how the company will compete and thrive within the existing industry. Investors/financers need to know that the owners understand the nature of the business and its drivers of success. Owners and managers/ employees need a common understanding of the same issues.

The company and product/service sections of the business plan should answer the following questions:

- What is the basic nature and activity of the business?
- What are your company's objectives?
- When and where was the business started?
- What has been achieved to date?
- What changes have been made in the structure and/or ownership lately?
- What stage of development is your company? In seed stage or full product line?

- What is the primary product/service (i.e. what is the primary focus of the business)?
- What customers will be served?
- What is your company's distinctive competence?
- What is your company's organization structure (proprietorship, partnership, corporation, and cooperative)?
- What are the current and projected situation/trends of the industry?
- What other industry participants are there (suppliers, distribution chain and competitors), and what is their role relative to your business?
- How do other industry participants perform?
- What is your product/service uniqueness?
- Why would people buy your product/service?
- Does your product/service have to be developed and in what stage of development is the product/service?
- What regulations and standards apply to your industry and product/service?
- How will you address the regulatory requirements, if any?
- Do you have patents or trademarks that are proprietary to your company?
- What is the market potential of your product/service?
- What are the key success factors of your product/service?

Marketing

If you have completed phase three of the work book, you have seen how a market assessment and analysis has been completed. If you have not prepared a feasibility study, refer to Module 3 for guidance in preparing a market assessment and analysis. This section is to serve as a refresher for phase three.

The fundamentals of marketing can be summarized in the four P's, which are: Product, Price, Place, and Promotion.

Product means 'the thing you are selling' and can be either a product or a service. It may be a series, collection or category of items (e.g. Hardware stores are a category within the retail market and sell all kinds of hardware).

Understanding product includes analyzing the market for opportunities in terms of product need and demand of the buying segment. The product component of marketing also includes differentiating products (or services) you have as well as developing new products (or services) based on market needs. It includes product support management, including quality control of the product/service. It includes ongoing measurement of product performance (or service results) in terms of quality, customer satisfaction and ongoing demand for the product/service.

Products/services are chosen by a venture based on a business analysis which includes market demand and estimates of product costs and revenues.

Price means identifying the price at which the business can cover its costs and get a return on investment while customers see value for their dollar and buy the product/service.

The price component of marketing includes developing pricing strategies and programs, for new products and existing products. There has to be a balance between profitability and customer satisfaction with product support and value for money.

Place means where the product/service is available and how it is distributed. This area of marketing considers marketing channels, distribution logistics and, local vs. global availability

Promotion means making customers aware of your product/service through a sales force, advertising, and public relations, as well as understanding if your product/service promotion efforts are effective.

Overall, the marketing effort is about organizing, implementing, evaluating and controlling marketing activities. Marketing is also about the 4-Ps as they relate to what the competitors are doing.

Marketing does go into great depth beyond these fundamental points and can be very complex. When your venture advances in complexity, you should hire marketing professionals, either on staff or as consultants.

Developing a Corporate Image and Marketing Plans

To start up your business, you have to let potential customers know that you exist. You also need to make them aware of the advantages of your product/service. Many companies, especially cooperatives, may also want to let potential customers know who they are, in terms of mission and values.

Often, a corporate image is driven by the values of the cooperative. You may want to emphasize whether your business is focused on keeping prices low, providing

premium quality products/services, being community-focused, seeking fair trading practices, being environmentally sustainable, or some combination.

You should keep your values and image in mind as you develop a marketing plan. Many organizations want their corporate image to become part of the 'brand'.

In your business plan, you should include a section describing to potential members how your sales projections will be achieved. The marketing plan should describe what will be done to achieve sales, when and how it will be done, and by whom. The plans do not need to be elaborate. Marketing activities and spending should be sustainable (affordable and realistic) for your business. Answer the following questions as you write your business plan:

- What is the pricing structure of your product/service and how does that compare to competitors? That is, what are the typical gross and net margins?
- Does your gross margin cover cost of transportation, selling, rent, depreciation, etc? What profit remains?
- If there is distribution required in your business model, does the mark up allow for others in the distribution chain to make money? Is the profit for distributors and retailers comparable to what the competition offers?
- Do the terms of sale compare with those of others in the industry?
- When will you break even?
- How will you distribute the product/service?
- How will you use sales people?
- What are the parameters and targets for sales people?
- How will the sales people be paid and how much can they make in a year? How does this compare with those of competitors?
- How will you use distributors?
- How will distributors be compensated?
- What will the credit and collection policies with distributors be?
- Will they have territories and distribution rights?
- Where are you distributing? Locally or internationally?
- How will you make customers aware of your product/service?
- What media will you use?
- How much do you plan to spend on advertising? How will you find out whether it is working?
- What are your service arrangements for handling customer complaints and warranty issues?
- What are you competitors doing about service and warranty?

Market Analysis

The purpose of the market analysis in a business plan shows your investors that you know who your customers are and that you can provide them with something that they need. You should demonstrate that you will be able to sell enough of your product/service to be sustainable and that you have examined the competition, knowing fully where you can take advantage of their weakness and get some of their market share.

In your business plan, you should answer the following questions:

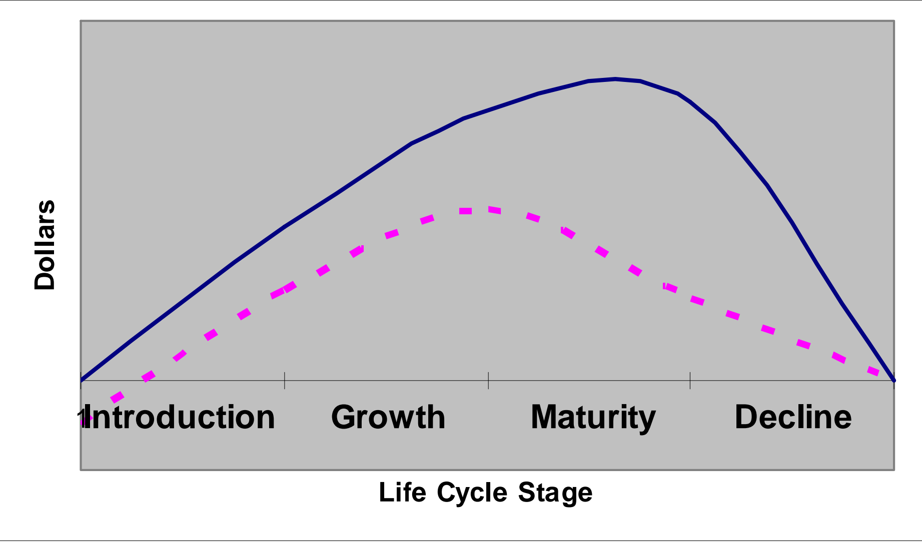
- Who is your primary (or target) market?
- What are the segments of that market?
- What is the profile of each target market segment?
- How do they make purchase decisions?
- How/why would they use your product/service?
- What benefit would your product/service bring to your target market segment? (Benefits need to be considered from the customer's perspective, not the seller's.)
- Do you already have any purchase orders for your product/ service?
- How many purchasers are in your target market segment? What amount of product/service would they buy?
- What are the recent purchase trends of the product/service?
- What are the projected purchase trends?
- What are the recent demographic changes/trends of the people in your target market segment and what are the projected trends?
- What is a reasonable estimate of demand over time for your product/ service?
- How would you justify that estimate?
- What are the sales projections for your product/service?
- Who are your competitors?
- How does your product/ service compare to that of the competition in terms of price, quality, service support, performance, warranties, or other factors that matter to buyers?
- How does your business compare with your competitors' businesses in terms of profitability, sales, marketing, distribution, production capabilities, or other factors?

Marketing Strategy

1) Product Strategy

Understanding product life stages helps entrepreneurs understand when to make adjustments in promotion, pricing and distribution policies and practices. The life cycle chart below depicts that during the introductory stage of the product life, sales are low and profits are negative. During the growth stage, sales and profits increase quire quickly. At the maturity stage, sales start to level off and so do profits. During the decline stage, product sales drop quite significantly, and profits also decline.

The table below further shows how products/services exist in the market place. Most products and services have a certain life expectancy in the market. In the early, introductory stages, the curious, innovator customers will be the first ones to 'try out' the product/service. In the growth stages, early adopters start buying after they have observed the innovators. The middle majority start purchasing the product at the maturity stage in larger volumes and the 'laggards' buy long after most people are using the product/service.


Dollars
Introduction
Growth
Maturity
Decline
Life Cycle Stage

Product Life Cycle Stage:	Introduction of Product/Service to the Market	Growth Stage of Product/Service Market	Maturity Stage of Product/Service Market	Decline of Product/Service Market
Market Characteristics				
Sales	Low	Rapidly rising	Peak	Declining
Costs	High cost per customer	Average cost per customer	Low cost per customer	Low cost per customer
Profits	Negative	Rising	High	Declining
Customers	Innovators buy the product/service	Early product/service adopters	Middle majority of market segment	Late purchasers of product/service (Laggards)
Competitors	Few	Growing	Stable, but beginning to decline	Declining
Marketing Objectives				
	Create product/service awareness and trial	Maximize market share as competition increases	Maximize profit while defending market share	Reduce expenditures and make the most of the brand
Marketing Strategies				
Product	Offer a basic product	Offer product extension, service and warranty	Diversify brands or models	Phase out weak performing items
Price	Charge cost, plus	Price to penetrate market	Price to match or beat competitors	Cut price
Distribution (Place)	Build selective distribution	Build intensive distribution	Build more intensive distribution	Go selective. Phase out unprofitable outlets
Advertising	Build product awareness amongst early adopters and dealers	Build awareness and interest in the broadest definition of your target market	Stress brand differences and benefits	Reduce advertising to retain hard-core loyals
Sales Promotion	Use heavy sales promotion to entice trial	Reduce promotion tactics to take advantage of heavy customer demand	Increase promotion to encourage brand switching	Reduce to minimal level

Source: Kotler & Turner

2) Description of Target Market (Market Segmentation)

Define the group of people (or businesses) that you will sell your product/service to by choosing a market segment for your product/service. The group you describe in your marketing plan can be based on a mass market, segmented market, niche market, or marketing efforts can be directed at individuals or a local market.

Mass Marketing: The product is produced, distributed and promoted on a mass level. One product is intended for all buyers. For many years, Ford epitomized mass marketing whereby they manufactured one model of car, which was available in one color.

The result of mass marketing is the largest potential market, which leads to lower costs and cheaper products for consumers with higher margins for manufacturers.

The down side to mass marketing is that people look for more options to the "one-size-fits-all" approach, which results in a splintered market with a multitude of options.

Segment Marketing: The product is produced for a large identifiable group within a market. The business recognizes that customers are individuals with different wants and needs. The market segment has differing attitudes, buying habits, levels of purchasing power, and is in certain, defined geographic locations (urban/rural/remote, certain city/province/country, etc.)

The benefits of segment marketing is that it allows the enterprise to create a more fine tuned product that meets a specific groups' need and price point. For example automobile manufacturers may segment car buyers broadly by 1) those seeking basic transportation 2) those seeking high performance vehicles 3) those seeking luxury autos and 4) those seeking safety. Understanding who is buying and defining their habits and attitudes allows the enterprise to select distribution and communication channels that meet the needs of that defined buying group.

Niche Marketing: The product is produced for a buying group that is more finely tuned than the market segment, defined above. The niche buying group is usually much smaller sub-segment of a market segment and is a group whose needs are not being served with mainstream products/service offered by competitors. Usually, niche markets have few competitors and businesses operating in a niche market can usually charge a price premium to the niche group (assuming the business actually meets or exceeds the expectations of the niche buyers). Serving this market allows the enterprise to specialize, allowing for some gains in economies.

Individual Marketing: The product is created for a market of one. The business provides unique, custom products or services to meet the needs of the individual.

Local Marketing: The product and marketing program takes on the needs and wants of local customer groups. That is, larger organizations with multiple product lines identify the product needs of low, middle, high income, or ethnic neighbourhoods and offer products in those locations that are suited to those neighbourhood characteristics.

3) Evaluation of the Competitive Market

It is very important to consider that there is probably some form of competition for your product/service. It may be direct competition, or it may be indirect competition (e.g. if your product/service can be substituted with something similar).

Sources to find information about your competitors include Statistics Canada, Industry Canada, media ads, competitor web sites, Dun & Bradstreet Industry Reports, trade shows, trade associations, and other industry specific sources.

Understanding what your competitors offer as well as understanding success factors in the industry will help you understand how to position your product in the market place. (To position your product in the market place is to present a distinct advantage or benefit or to design an image that brings the buyer to the point of purchasing your product/service and not the competitor's product/service.)

4) Building the Total Product Offering

Your venture has gathered and analyzed extensive amounts of information to understand the market demand and competitive environment around our product/service offering. However, to provide the package that ultimately makes your product/service successful in the market includes:

- Branding
  - Selecting a name that is descriptive, and easy to remember
  - Select a name that is not legally questionable (avoid copying other names)
  - Select a name with promotional possibilities
  - Select a name that can be trademarked and associated with an image
  - Select labelling and packaging that attracts the target market
- Follow through with customer service
  - Provide value for money products/services
  - Provide after-sales service
  - Provide warranties for innovative, relatively expensive, purchased infrequently products

5) Define Pricing Strategy

There are a number of factors that should be considered as you choose a price for your product service. Some pricing objectives you learned in the in the Phase Two and are reviewed here:

- Increase market share
- Increase sales volume (quantity)
- Increase dollar sales
- Increase store traffic
- maximize long-run profit
- Maximize short-run profit
- Match competitors' prices
- Obtain a target rate of return on investment (ROI)
- Obtain a target rate of return on sales
- Company growth
- Maintain price leadership
- Discourage new business entering the industry
- Encourage marginal firms to leave the industry
- Survival
- Obtain or maintain loyalty
- Increase distributors' marketing of product or service
- Enhance the image of the firm, brand, or product
- Create interest in a product/service
- Discourage competitors from cutting prices
- Enhance viability of the product or service
- Social, ethical, or ideological objectives

From a revenue standpoint, the price of the product or service should be the maximum consumers are willing to pay.

In reality, a good pricing strategy would be the price of the product or service would balance between the price floor (the price below which the organization ends up in losses) and the price ceiling (the price beyond which the organization experiences a no-demand situation).

Penetration Pricing

A business that uses penetration pricing prices a product or service at less than market price in order to gain market share. The business sacrifices profit for market share. Large companies often to use this pricing strategy to discourage new companies from entering a market.

Skimming Pricing

A skimming price strategy raises prices for the product or service for a short period before reducing them back to more normal levels. This strategy assumes that some consumers will pay a higher price as they view the product or service as a status item. Business use skimming price only when there is little or no competition for their product or service or when start-up costs must be covered quickly.

Follow-the-Leader Pricing

A follow-the-leader strategy uses the competition as a model when setting he price of the product or service. The reaction of the competition is a critical factor in deciding to decrease pricing below the competition's price. Small firms have to be careful that larger firms do not see the price decrease as a direct threat as small firms seldom have the ability to sustain a price war.

Prestige Pricing

Prestige pricing sets a high price on the product to communicate to the consumer the image of high quality or exclusivity. High income consumers are less sensitive to price variations, thus prestige pricing works better in these markets.

Variable Pricing

Variable pricing strategy adjusts prices to different customers, depending on their relative purchasing power or bargaining ability. Business utilizing this strategy may have a two-part price. A standard list price and offer a range of price concessions.

Flexible Pricing

Flexible pricing takes into consideration special market conditions and pricing of competitors and then sets the price based on different prices to different customers.

Price Lining

Price lining is the offering of merchandise at a number of specific but predetermined prices. Once set, the prices may be held constant over a period of time, and changes

in market conditions are adapted to by changing the quality of the merchandise. A limited number of predetermined price points at which merchandise will be offered for sale are established (e.g., $7.95, $10.95, $14.95, etc.).

6) Setting Price

Prices should be set by calculating break even points for the product/service in addition to considering demand for your product/service balanced with the prices that competitors are charging for similar or substitute products.

You learned about break even calculations in the Feasibility Study Module. Here is a review of those calculations:

$$\text{Breakeven Point (in units)} = \frac{\text{Total Fixed Costs}}{\text{Per Unit Contribution to Fixed Costs}}$$

$$= \frac{\text{Total Fixed Costs}}{\text{Price Per Unit} - \text{Variable Costs Per Unit}}$$

And

$$\text{Breakeven Point (in dollars)} = \frac{\text{Total Fixed Costs}}{\left[1 - \frac{\text{Variable Costs Per Unit}}{\text{Selling Price Per Unit}}\right]}$$

Example

A company produces widgets from a rented retail store. The annual fixed costs are $80,000. The company sells each the widget for $0.75 and the variable cost of each widget is $0.50. The breakeven point in sales and dollars is:

$$\text{BP units} = \frac{TFC}{P - VC} = \frac{\$80{,}000}{0.75 - 0.50} = \frac{80{,}000}{.25} = 320{,}000$$

$$\text{BP \$} = \frac{TFC}{\left[1 - \frac{VC}{P}\right]} = \frac{\$80{,}000}{\left[1 - \frac{.50}{.75}\right]} = \frac{80{,}000}{1 - .67} = \frac{\$80{,}000}{.33}$$

= $242,424 of revenue for the company to break even.

Remember that demand for your products/service is not limitless. There are competitors that also have some of the market share. There are certain price levels where customers won't buy the product/service. Sometimes the market can become saturated with the product or the product becomes obsolete. When calculating breakeven points and long term profitability, you should probably consider the product life cycle and what the potential sales are for your product/service.

When determining a price, you should calculate margin for your business that allows you to cover operating expenses as well as earning a profit. If your product/service originates at your enterprise, you may want to consider what the final selling price will be, to ensure that the end price is something that the customer will pay and that the price is competitive with comparable products, and that the price allows others in your distribution chain to earn some profit.

Calculating Mark-up:

Choose a percent mark up that will allow your product pricing to be competitive as well as allowing you to earn profits. You may have to do several sample calculations (trial and error) to determine where your starting point should be. You may also be able to find some standard industry mark-ups that are relevant to your enterprise.

To calculate mark up on the cost of the goods being sold (COGS):

$$\frac{\text{Mark up (\$)}}{\text{Cost of Goods Sold}} \times 100 = \text{Mark up as \% of COGS}$$

So, if your product costs $15 to produce (materials and labour), and you are selling the product for $22, the mark up is $7 and expressed as a percent in the following example:

$$\frac{\$7}{\$15} \times 100 = 47\% \text{ (Mark up as a percent of COGS)}$$

Calculating margin:

To understand the percent of your revenues that will be available to pay for operating expenses, you can calculate Gross Profit Margin.

Using the example above, where the selling price, or revenue is $22 the Gross Profit Margin is calculated below:

$$\frac{\text{Mark up (\$)}}{\text{Selling Price}} \times 100 = \text{Gross Profit Margin}$$

$$\frac{\$7}{\$22} \times 100 = 32\% \text{ (Gross Profit Margin)}$$

32% Gross Profit margin means that 32% of the revenue for your product/service is available to pay operating expenses. That is, for every dollar of revenue you earn, $0.32 is available to pay for expenses. However, in your calculations, you want to ensure that you have more than enough margin not only to cover operating expenses, but also to earn a profit for the enterprise. You may require some trial and error calculations to ensure you can meet your operating expenses while generating some profit for your enterprise.

You may choose to use the following formula as an alternative for using the mark p formula to set a price for your product/service:

$$\text{Selling Price} = \frac{\text{Cost}}{1 - \text{Gross Margin \%}}$$

Example:

$$\text{Selling Price} = \frac{\$15}{1 - 32\ \%}$$

$$\text{Selling Price} = \frac{\$15}{0.68}$$

$$\text{Selling Price} = \$22$$

7) Define Distribution Strategy

Distribution of your product/service is defined as the actual movement of your enterprises product/service as well as the wholesalers and retailers involved in bringing your product/service to the marketplace.

There are direct distribution channels, which forego middlemen. These can include catalogue sales (paper-based or web-based), product/service retail locations (e.g. some bakeries produce and retail their own products), professional offices (e.g. consultants, lawyers, accountants often 'distribute' their services directly to clients) or direct sales to industrial users of your product.

There are also indirect distribution channels, where there are one or more middlemen between the product/service and customer. For example, many processed goods (e.g. food or textiles) go through many levels of distribution.

There are a number of purposes to having middlemen in your distribution channel:

- Breaking bulk
    - Wholesalers/agents/brokers and retailers buy large quantities of a product from manufacturers and sell the product in smaller quantities to customers
- Assorting
    - Wholesalers/agents/brokers distribute into groups of like kind, which make it easier for retailers to buy an assortment of like goods from one supplier, rather than to buy items from multiple suppliers
- Providing information
    - Wholesalers/agents/brokers can provide information to their suppliers about certain market realities, such as size and appropriate pricing
- Shifting risks
    - Some middlemen offer credit to final purchasers, taking accounts receivable risks away from the primary producer
    - Some middlemen, called merchant middlemen. take title on the goods they distribute

Components of distribution channels can include the following:

- Transportation
    - Modes include rail, truck, air, ship
    - Common carriers are available for general hire; Contract carriers work for individual shippers; Private carriers own their means of transportation
    - Choose transportation based on your preference for cost vs. transit time, reliability, traceability as well as convenience to use and capacity
- Storing inventory
    - Warehouse your products in your own facilities
    - Rent space in public warehouses

    - Utilize a merchant middleman or wholesaler, where title and storage of the product is transferred to the middleman
- Safe materials handling
    - Establish methods of safe handling for your product to avoid damage
- Terms of delivery
    - Identify which party is responsible for paying for transportation, selecting the carrier and modes of transport and accepting the risk of damage

Often, a distribution channel you choose is directed by others in your industry. It is wise to conduct some research to understand how competitors distribute their products/services. However, your venture need not be tied to the distribution plan set out by others. Your venture could consider developing a unique distribution channel.

When considering distribution channels, consider the following:

- Cost
    - Depending on what your venture is selling, sometimes direct distribution is more cost effective, and other times, using middlemen can be more cost effective. For example, it may not be beneficial to invest in a trucking fleet to deliver your product to your target market. Sometimes, it is more cost effective to use an established trucking network.
- Broader exposure
    - Distributors can make more contacts with end users because they represent multiple suppliers and have a bigger sales force than your venture, often with a smaller sales force
- Control
    - The more steps involved in your distribution channel, the less control you have. However, if there is opportunity for cost savings or increased sales, your venture will have to consider whether it needs more or less control over distribution

8) Define Promotional Strategies

Developing promotional strategies includes setting goals for the product, communication & sales effort to create awareness of product/service, budgeting and evaluation of market success.

Promotion Strategy Outline

- Establish goals for the business
    - Decide upon sales targets, target market share, and the target number of customers. This will give your business something specific to strive for and will help establish a baseline to measure your success
- Establish a promotional budget
    - Use industry standards to begin (breakdown to monthly values)
    - You will be able to monitor your spending and relate them to the goals established for sales
- Select a promotion mix

- The promotion mix is the combined effort to promote your product/service and includes personal sales, advertising, internet, promotions, public relations
    - Choose the combination that you believe will help you work within your budget as well as help you achieve your goals. The mix or combination of activities may need to be adjusted, depending on your results
- Evaluate Promotional effectiveness
    - Adjust budget or promotional mix to achieve your target results defined under goals

Budgeting promotions

Budgeting promotions is dependent on individual preference and available funds. In fact, promotions can be the first area that is cut when an enterprise is short of funds. However, if you have a good product, you want to continue promoting it, so that sales continue and funds increase.

There are some philosophies for establishing a budget for promotional spending:

- Allocate a percentage of sales
    - The percent can be determined by the company (often, 2% is used)
    - To assess industry practices for allocating percent of sales, review the Financial Performance Indicators published by Statistics Canada
    - The downfall is that promotional spending decreases as sales decrease
- Spend as much as the competition spends
    - Enables a firm to remain competitive
    - May be infeasible if the competitor is large, with more available resources
- Determine what it will take to achieve the goals
    - Require comprehensive analysis and include a variety of promotional options to evaluate
- Deciding how much can be spared
- Combination of the above
    - Start with an estimate of what it will take to achieve the goals
    - Compare to the industry standard for the percentage of sales
    - Estimate what can be spared from the business (especially in a start-up situation when sales are low)
    - Examine what the competition is doing
    - Use your best judgment in deciding how much to budget

Communication, Sales Effort & Advertising (Promotional Mix)

Identify the message you want to communicate. Ensure that the message is 'salient' to the target market. Having a 'salient' message means portraying a message that is relevant and important to the target market. Salience means fully understanding who is buying your product/service and filling their need in a meaningful, beneficial way with your product/service. A salient message is memorable to the targeted customer and contributes to brand loyalty. You may choose to hire professionals to assist with developing an appropriate message to attract your target market.

When you understand your target market and the benefit your product/service provides, your message should penetrate everything you do, including sales. To provide the sales people in your organization with optimal selling experiences:

- Ensure they have product knowledge
  - Product knowledge helps educate customers and allows sales staff to answer questions
- Ensure they have appropriate, professional attire and appropriate etiquette
- Teach them to search for new customers through referrals, directories, public announcements, telephone or mail surveys
- Have them prepare sales presentations
  - Practice sales presentations by understanding the product uses, limitations, and benefits. Prepare for customer objections; use testimonials; use comparisons
  - Adapt sales presentations to the customer needs and situation (avoid using a uniform, one-size-fits-all approach). That is, ensure you understand your customer's situation.
- Allow opportunities for relationship selling; recurring customers are loyal and profitable
- Compensate sales people appropriately
  - Recognizing achievement of targets is an effective non-financial reward
  - Commission, for sales people, is directly related to productivity (However, do not make the mistake of assuming that all people will be motivated by money. Also, do not assume that salesmanship can be learned by everyone)
  - Straight salary is less motivational for sales people, however, it is more secure
  - Often, a combination of a small base salary is provided in addition to paying the sales person a percentage of sales

An alternative to personal selling, as described above, is advertising. Utilizing personal selling techniques may be more expensive than using other promotional tools, such as internet communications, media messages, and trade show exhibits. However usually personal selling and advertising complement each other. Your enterprise will have to determine the combination of promotional techniques that work the best to achieve your goals.

Operations Plans:

Start-up

The strategic planning process moves through a series of stages, from long-range decisions, through tactical planning or medium-range decisions, to operational planning or short-range decisions. Long-range strategic decisions identify what will be provided or made, where it will be made or provided, how it will be generated (in broad terms) and what kind of capacity will be required to meet anticipated demand.

All cooperatives must make the long term decisions regardless of the purpose of the enterprise. These materials have provided a variety of planning exercises that led up to the business plan. This section is designed to provide insights into putting the plans into operation. Operating decisions must reflect and represent strategic plans, business plans, market research, marketing direction; they must apply the logistics for the vision to become a reality.

Many great entrepreneurial ideas have failed as a result of failed operational implementation. Poor location, inadequate facilities, improper equipment, poor process, lack of quality control and unskilled or poorly structured labour and management could contribute to the failure of a great concept.

It is also important here to consider the market discipline selected by the business (operational excellence, product excellence or relationship intimacy), when making operational decisions.

The nature and complexity of how much value is actually added, along with the competitive advantage required to meet or beat the competition, both have a bearing on the operational decisions.

Location, Facilities & Equipment

Location

For location decisions, the first key item to consider is the location of the customers. Some forms of value added enterprise need to have close geographic proximity to their market, while others may not. Considerations of transportation and communication infrastructure can have a major impact. For example, if either the cost of acquiring materials to be processed or the cost of product delivery is too high, the venture could fail. Location is often driven by sipping and receiving costs and or logistics.

Two other components that must be considered are availability of local infrastructure and an appropriately sized and skilled labour force. Most manufacturing processes require local service capacity that can be defined and measured. More importantly, the availability of specific labour skills is likely to be a challenge. Labour skills, needs in this technological age, including in manufacturing businesses, are vastly more complex and mission critical than in the past. In addition to availability of skills, decision makers also need to consider the costs of such labour.

Many municipal development projects offer significant advantages to attract various kinds of business activity. These may have conditions attached that would need to be examined.

It also is important to ensure that the decision-makers evaluate location options with regard to the criteria that are good for the business. Well-intentioned loyalties to communities have resulted in placing great ideas in self-defeating locations. The old saying, "If you build it they will come," is not always true.

The factors surrounding location are sufficiently complex that decision-makers should seek expert advice, and even obtain second opinions.

Capacity, Facilities & Equipment

The type of facilities and equipment needed depend on the nature of the venture being proposed, as well as the optimum size needed for efficient operation. This is also affected by decisions on what production process is to be used. Different processes require facility and equipment choices based on the initial capacity requirements, and anticipated future markets.

Strategic decisions (based on research) may require long-term choices about future production capacity. Market research will identify market potential and projections will show the share of that market expected to buy products or services in the future. Does the plant need the ability to expand or should the facilities or equipment for future demand be built or acquired at the outset?

Location, facilities and equipment are highly significant from a capital perspective; they are also complex decisions. Given all of the variables, cooperatives should consider professional project help to manage these aspects. Where possible, the decision makers should visit sites similar to the proposed venture to gain insights. Furthermore, the design engineers must be completely connected to the production process decisions, so they can design the appropriate facilities.

Production Process

While the plant (facility and equipment) often determine the nature of the production process, a new venture is often able to develop creative processes that provide significant competitive advantages. Properly captured, these advantages can provide a clear path to success. On the other hand, poorly designed processes can result in failure.

Ventures that require processing and manufacturing require very specialized design, because the technology advances so quickly. Decision options will be dictated by the type of activity being undertaken. For example, an operation that makes french fries is likely to have a continuous process that produces large volumes of standardized products. As a result, the plant does not require an ability to change production

frequently. If the objective is to produce products in smaller quantities, that ability to retool production needs to be taken into account. Organizations like Toyota have revolutionized the concepts of quick change.

The production process also requires some inventory management decisions. For example if the venture is using grains or oilseeds, who will store the supplies? Processors and manufacturers are very aware of the cost of material inventories, and most prefer to have the materials supplied as needed. Having producers store the materials until processing should be considered. This is also very dependent on the types of materials being processed, how perishable they are, how costly they are to store, whether availability seasonal or year round, just to name a few factors. Process design is part of a much larger picture that is integrated. The following are some of the big picture components to be considered:

- Location
- Layout
- The type and design of the products/services i.e. need for quick change etc.
- Capacity required (scheduling and production planning) based on markets
- Minimum levels of acceptable production
- Employee skill requirements
- Time and quality standards required
- Availability and affordability of technology
- Finally, production process design

Production process plans should also look into potential uses of by-products which can in some cases provide the profit margins and at the very least provide supplemental income. These functions often require process production plans of their own.

Production design requires process engineering that is in tune with the goals and objectives of the organization. These skills are highly specialized and the decision makers will need to acquire outside assistance.

Labour and Management Requirements

Whether the organization is large or small will have an impact on the numbers of staff at various levels, but all ventures will require key tasks to be performed. The size of the organization required to deliver expectations is based on location, facility, equipment, production processes and capacity required. Organizational size will also dictate the level of skills required for each position. In smaller organizations, some of these functions may be outsourced or combined. For example, the production process design coupled with the specialized and technical expertise required, will determine the production job requirements.

As soon as possible, the organization should size the labour force and develop position job descriptions that include qualification requirements. In many cases some of the key positions are put into place early in the start-up process, so that these individuals can make decisions that will affect them in their organizational roles.

Input Suppliers

Producer cooperatives are generally designed around group marketing and value-added processing. The normal pattern is for the producers to provide materials to the cooperative, either by way of contracts or proportional to their capital investment in the operation. The production process will determine what and when deliveries can be made.

It is very common for this type of cooperative to require the producer to store crops or other commodities, so that inventory levels can be controlled through an orderly delivery program. It is important for investors /producers to understand exactly how these events will occur. They need to know how much they can produce, when they can deliver and when they can expect payment for their individual planning.

Where suppliers outside of the cooperative are required, the details of the organization's needs must be clearly laid out and negotiated in advance. The start-up program needs to be clear about when material supplies are needed to meet production requirements. Most often these are determine and contractually acquired (guaranteed) before construction of production facilities is begun.

Identify the Start-up Goals of the Organization

Start-up goals need to be identified and organized into an overall project plan. The master project plan will likely have many components, but it is important to ensure that all of the components work together to deliver the desired outcomes. These goals must include the following:

- How long will it take to begin production? This includes everything from the generation of capacity (physical needs) to securing staff and materials.
- When can the first goods sold be delivered?
- How much product can be reasonably expected and by when?

There is a need for high level project management skills to put the start-up plan together and to ensure that the components are moving ahead as required. Cooperative leaders should consider hiring a professional project manager to oversee the full range of start-up requirements from planning to opening for business. A large-scale project will likely require a team of project managers.

Start-up goals for the organization need to outline:

1. What is to be achieved
2. At what cost
3. By when, and
4. By whom – who is accountable.

These goals are measurable. These goals should be set overall and structured around each phase. The timelines will dictate "by when", and each goal should be evaluated against the outcomes.

Identify the Start-up Challenges/Opportunities for the Organization

Delays

Delays may affect sales or result in penalties. Delays also affect suppliers and/or producers. This affects cash-flows for all concerned.

In particular, where significant investments are required for facilities and equipment, the business case was built around income being generated from a certain point forward. Many projects have failed because of delays.

In addition to cash-flow issues, the enterprise-in-progress will be less likely to make adjustments to changing market conditions, so marketplace changes that occurred during start up are more difficult to overcome than if it the business were in operation.

Cost overruns

Delays can cause cost changes for items such as building materials, labour and equipment; it needs to be clearly understood that any delay will add risk. Aside from delay risks, changes in design or production processes may change costs significantly.

While a change in a particular piece of equipment may improve efficiency and profitability in the long run, it may cost the start up much more than was included in the original plans. Even though a strong business case can be made, such changes require corresponding increases in capital.

Opportunities to Manage Start-Up Risk

Strong start-up plan

Having a strong start-up plan that addresses the risks is the first step. The stronger the plans, and more secure the costs, the greater the opportunity of success. Insist on construction and equipment delivery delay penalties where appropriate.

Contingency funds

Having a contingency fund for cost overruns and delays is also sound business. When the business plan is put together, investors should insist that there is a contingency fund sufficient to offset the risks, based on the experience and abilities of the individuals managing the project and based on the risk nature of the venture.

It is normal to consider contingency funds of 15 to 20 percent. and for some ventures it could be even higher.

It is prudent to check the guidelines for the industry selected. It is also beneficial to gain insights from others who have experience in this area – i.e. similar ventures.

Identify the Start-up Steps, Timelines & Resources

This section has outlined a series of start-up steps from location, facilities, equipment, to labour and management as well as production processes. All of these need to be put together in a master plan that includes not only the production aspects (suppliers and processing) but also marketing and delivery. Aside from the business plan and the strategic plan, start-up is concerned with two main areas:

- **People** – those needed to get production or delivery started and those who will remain after the start-up phase as well as being required for start-up.
- **Development** – ensuring that the business gets to the point where it has the capacity to deliver as soon as possible (in a timely and cost effective manner). This means bringing facilities, equipment and production processes into "delivery mode" (up and running).

The timelines will vary: for example, initial recruitment and marketing activity may begin well in advance for some industries. Clear timelines are a necessity, not an option. They are mission critical for start-up because they form critical assumptions for the business plan. Achieving start-up goals is vital to maintain the viability of the venture.

The more complex the proposal, the more reliant the leaders must be on professional project planning and project management assistance. The project manager (or project management team) will need to identify the desired sequence of events. As facilities and equipment come together and the production process is designed, various levels of skills will be required. The project plan needs to include employment plans outlining which positions are required and at what point.

Measure the Results of the Start-up Steps

The establishment of measurable start-up goals is critical to being able to measure results later. Results for each of the goals should be evaluated as soon as possible after completion. The goals included: what is to be achieved, at what cost, by when, and by whom. This assessment will provide accountability and provide opportunities for learning and improvement.

After each segment of the start-up plan key players should review any "lessons learned". Doing these evaluations on a regular basis will help to reduce potential errors in the future.

A good project manager will build these into the project plans. The leaders should be informed (or should insist on being informed) of the evaluation results for the key areas that they are responsible for. Likewise, the project manager should be able to bring any issues related to leadership decisions, or lack thereof, to those in charge, i.e. the Board of Directors or their committee. Not all of the delays are caused by those involved with start-up work. Many issues can arise from the decision-making group, and these can result in costs, delays or even project failure.

Hire Management and Staff

An organization distinguishes itself by the quality, desire, ability, creativity and loyalty of its people. The best businesses tend to attract and keep the best people. The ability to hire the right staff and put them in the right jobs is a key to building a successful business.

Hiring managers is among first activities in starting a business and, if hired earlier in the business start-up process, they may help you prepare some of the information required for the feasibility study and business plan.

For business plan purposes, you should profile the owners and your key manager(s) and provide brief highlights education and/or experience. (Detailed resumes should be included in the appendices.) You should also describe the authority assigned to each person as well as the functional area for which they are responsible.

The General Manager

The board's most important job is to choose the right general manager. Progressive boards seek to ensure that the cooperative's success outlasts the general manager and current market opportunities. The board defines manager selection criteria so that skills required are matched by the candidate's strengths. For example, with a new store planned, criteria might include experience operating a business with multiple locations.

The board must thoroughly assess both inside and outside candidates. Search firms, consultants, and a board search committee have all proven beneficial in this assessment.

Director support helps the new general manager succeed. The board chair may coach the general manager in working with the board and encourage her/him to use directors with expertise, such as in market research, as a resource. Participation in the cooperative community helps the general manager learn about the industry.

Ongoing feedback and coaching are very important in the startup phase to help the general manager succeed and to clarify expectations. Periodic scheduled performance reviews are critical for both the board and the general manager, they help the general manager to understand whether s/he is meeting the board's expectations, and they help the board to clarify any concerns. Human Resources consulting firms can be contracted to help boards do effective performance reviews for a general manager.

A written succession plan gives the board and management a resource both for emergencies, such as death or serious illness, and for planned changes, such as retirement. Annual updates keep the succession plan and strategic plan aligned.

Business Opening

Planning and preparing for your business requires effort, and you have prepared much information already. You know that the business venture is feasible. You have hired some consultants and/or managers to help you plan and implement. You have considered your market and planned to inform them of your new product/service.

Now, it is time to review where you are with product/ service development, as well as what is needed to operate. At this point you can create an implementation schedule. Your investors are interested in your development plans, operations plans as well as the timing of your start-up.

You should answer the following questions in your business plan:

Product Development

- Does your product/service require development work to make it saleable?
- What stage of development are you in? (i.e. concept, prototype, or finished)
- What is required to finish or refine the product/service to a marketable state?
- How much has development cost to date?
- How much more funding is required to finish development?
- Are there any proprietary issues with the product/service?
- Have you market tested the product/service?

Location and facilities

- Where is your business located?
- What are the advantages and disadvantages of the location?
- What kind of facilities are you using and what is the cost?
- What are the advantages and disadvantages of the facilities?
- What type of equipment do you need and what is the cost?

Manufacturing considerations

- If manufacturing:
  - what is your raw materials purchasing policy?
  - what is your quality control program?
  - what is your inventory control mechanism?
  - what is the cost breakdown of each operational area?

Suppliers

- What will be supplied from external suppliers?
- Who are the planned suppliers?

Other

- What is your production capacity?
- Are you required to obtain any permits or licenses?
- What is the schedule for start-up activities? Which start-up activities are inter-related and occurring simultaneously? Provide milestone activities and their priority for completion.
- What are the risks of delayed implementation?

Monitor Business Results

Planning activities described above must be followed up to determine whether the enterprise is successful, in terms of how the plan defined success. To determine whether you are meeting your goals, strategies and objectives, you should consider some ways of measuring your performance against those goals. It is best to measure results over a period of time.

There are many measurement styles and programs. Some are linked to bonus programs and incentive pay programs. There are benefits to these, and they can be complex to administer. When incentive pay is linked to corporate performance, effective measurement is essential. It will also be necessary to communicate target outcomes in important areas, or there will be nothing against which to measure results.

Your organization will have to identify its own appropriate measures to determine success. Ideally, the outcomes you set for the business are inherently measurable. Each requires a target for a specific time frame. Be careful that the targets you use support your business's goals and that they do not hinder your success.. For

example, pure sales targets can hinder success if there is not also a focus on after-sales service or customer satisfaction.

Some common measures are included below, as a sample starting point. Remember that is important to use measures that actually measure the corporate goals or priority areas.

Monitor Business Activities

Your cooperative may want to consider benchmarking its business activities and performance against those of its competitors. You prepared competitive analyses for the market research component of your feasibility study and business plan that may provide you wish some information. Your cooperative may want to continue monitoring your performance, relative to others in the industry. Benchmarking yourself against other organizations helps your organization understand where it fits in the industry.

Benchmarking also gives you some perspectives about the marketplace. For example, if sales are declining at your company, you could see if competitor sales are continuing to grow, or also declining. If sales are declining across the industry, products may be becoming obsolete, demand drying up or customers may be finding substitute products. If your products' sales are the only ones declining, try to determine why. In either case, your organization will have to make some strategic decisions to respond to the changing environment.

Ongoing Planning Activities

There are a number of planning activities that should occur regularly. Sometimes the planning includes the board of directors and owners/managers. Sometimes the planning occurs at the management level. Some organizations find ways of involving the whole system in their planning. One thing is universal: the highlights of any planning, including any recommendations, should get shared with everyone to ensure consistent thinking within the organization. Everyone should understand the big picture goals and challenges, and their own part in it.

1. The first type of planning, which should occur early in the life of the enterprise, is **directional planning**. The people who have early involvement in the business, the founders and partners, should identify a direction or future state for the organization. As discussed in previous segments, the future state is also called the **vision** and describes what the organization is to become or what future state it is trying to create. The founders should also identify the purpose of the organization. The purpose is also called the **mission** and describes what you do every day, and for whom. Directional planning should also include the **values** of the organization, because, as discussed earlier, it helps drive your decisions through a behavioural compass. It helps you define the types of people you want to hire as well and ensure they fit with corporate values. Clarifying agreed values also allows you to define a corporate image.

   Directional planning occurs at the onset of the business and then every 4-7 years thereafter. The board of directors and sometimes the most senior staff conduct this type of planning on an ongoing basis.

2. **Strategic planning** defines the top areas in which work needs to happen to close the gap between "now" and "then", as defined in the guiding

Strategic planning involves an assessment of the business environment, including the economic situation, regulatory changes, changes in technology, changes in the industry including suppliers and competitors. Strategic planning not only looks at what is going on externally, it also considers how the organization functions in the current environment, assessing strength and weaknesses in all areas of the enterprise.

Strategic planning takes the top issues and priorities facing the organization and identifies means of addressing those issues, within the parameters of the **vision**, **mission**, and **values**. The means of addressing the issues are often called the goals, strategies or objectives,, which require further operational plans to achieve. Strategic planning occurs annually for most organizations, and often considers a three to five year period. This type of plan is called a 'rolling' plan, because it continually rolls the three to five year period out as it is updated.

3. **Operational planning** is conducted by managers and their departments. Operational planning allows managers and staff to identify activities that will achieve the goals and objectives outlined in the strategic plan. The activities, some recurring each year and some new initiatives or unique projects, need to have budgets assigned to them. So, organizational activities and budgets are created from the results of the strategic plan. This type of planning occurs annually and includes activity schedules and budgets. Senior managers may have input into the operations planning process. Operations plans are usually presented to the board in a summarized view, not in great detail. Complex new ventures or projects may require more detail for the board.

Consider Succession

Management succession is a critical role of the board of directors. The board of directors has the responsibility to hire, direct, evaluate and compensate or release the general manager of the cooperative. is the general manager reports to the board and is responsible for carrying out the directives of the board.

Without strong leadership at the executive level, the cooperative can languish with no clear direction. Establishing a clear succession plan, including all the key leadership positions, is a key element to the cooperative business plan. When a key person leaves, a successful transition that continues a tradition of success is not important only to the employees and customers but to the community that needs the goods or services.

Succession Planning Guidelines

1.) Succession Planning should be based on the strategic plan. The strategic plan dictates what the cooperative wants to accomplish and how it will be completed. This helps define what characteristics and skills sets will be required of the general manager to accomplish the plan. The general manager position requires vision, personal insight, resourcefulness and courage. Thus boards should be encouraged to identify potential successors early and provide assignments meant to develop these skills.

2.) Succession planning includes the management team as individuals and as a whole. Organizations that can generate various generations of leadership within their own organization will continually be able to refresh their organization with fresh ideas and approaches.

3.) In the succession plan, positions or titles should be used to describe the position, rather than using incumbents' names. The succession plan must encompass sufficient staff to enable the company to operate effectively in the event of multiple resignations.

Some organizations use a career path or progression plan, clearly communicated, as an important contributor to success. Such a plan can help ensure all employees are well trained, equipped, and adaptable to a changing environment. A career path system outlines potential career progression from entry to executive level. A typical, professional career path includes five levels: entry; Junior; senior; managerial; and executive.

Employees become qualified for higher level positions through a combination of education, training, and experience. Advancement is accomplished through a competitive selection process.

Career ladder positions are a defined progression of positions within the type of work being performed. They typically include a formal development track that includes training courses and on-the-job training that lead to increasingly more responsible work experiences.

Although variations on this approach exist in many organizations, it is a challenge to stay relevant in these matters, as generations start to differ in what they want to get from their working lives. Today's employees are unlikely to remain in one organization for their entire career.

However, there is certainly value in planned, ongoing programs to help move valued employees from one level of responsibility to the next.

Business Plan Fundamentals

FINANCIAL STATEMENTS INTRODUCTION

A company's financial statements tell us what has happened in the company's past. They reflect the company's successes and failures, the capabilities of the company's owners, and the circumstances under which the company has operated. An understanding of the company's past performance, as reflected in its financial statements, is important in assessing the capabilities of its management and determining the company's chances for future success.

Financial statements are a combination of:
- recorded facts
- accounting conventions
- personal judgments.

Personal judgments and accounting conventions can often have a significant impact on the facts presented in the financial statements. The soundness of the judgments made in preparing the statements depends on the competence and integrity of those who made them, and on their adherence to generally accepted accounting principles and (GAAP).

GAAP is the set of recommendations contained in the *CPA Canada Handbook: Standards and Guidance Collection*, published by Chartered Professional Accountants (CPA) Canada. *The Canadian Business Corporations Act* requires that financial statements referred to in the Act will be prepared in accordance with the standards set out in the CPA Canada Handbook.

This section explains explain financial statements and their importance. We will begin by discussing the three approaches taken by accountants when preparing financial statements.

Standards of Financial Statements

In 1989, the Canadian Institute of Chartered Accountants developed and instituted guidelines for the three types of financial statements that Chartered Accountants (and in some jurisdictions, Certified General Accountants and Certified Management Accountants) may prepare for businesses. In descending order of reliability, these financial statements carry the following qualifiers from the accountant:

- Audited Financial Statements
- Review Engagement
- Notice to Reader.

Audited Financial Statements

Audited financial statements with an **unqualified opinion** provide the highest level of credibility of the three types of financial statements. On behalf of the shareholders of a company, the auditor will examine a company's financial records and operations to determine whether the information reported in the financial statements is presented fairly. Refer to the sample unqualified auditor's report in Appendix 1.

Review Engagement Financial Statements

A review engagement is not as extensive as an audit. It consists primarily of enquiry, an assessment of analytical procedures, and discussion with management and owners. If the Chartered Accountant (CA) discovers that the financial statements are not in accordance with generally accepted accounting principles, this fact would be

disclosed in the review engagement report. A sample review engagement report is contained in Appendix II.

Notice to Reader Financial Statements

In some cases the CA may prepare financial statements from information provided by the client, but the client does not require the CA to provide any assurances regarding such statements. This type of service is referred to as a notice to reader or a compilation engagement.

In this case, the CA's responsibility is to prepare financial statements from information provided by management. They do not attempt to test the accuracy or completeness of the information provided, or to determine whether there are departures from the generally accepted accounting principles. No expression of assurance is intended. A sample notice to reader report is contained in Appendix III.

Balance Sheet Analysis

The balance sheet is a picture of a business's financial affairs at a particular point in time. The assets side of the balance sheet consists of what the business owns and what is owing to the business.

The liabilities and owners' equity side of the balance sheet shows what the business owes, to its creditors, owners or shareholders. Equity also represents how much money the owners have invested in the business's assets (the excess of the business's assets over its liabilities).

Accordingly, the business's total assets is the sum of its liabilities and the owners' equity.

This equation: "Assets = Liabilities + Equity" is the underlying concept of a balance sheet.

Figure 2.1 lists some of the items commonly found in balance sheets. These items are defined and discussed in the following pages. Each listed item is followed by its definition as outlined in *Terminology for Accountants (TFA), Fourth Edition*, published by the Canadian Institute of Chartered Accountants. Where appropriate, discussion of the item follows the definition.

Assets

1. Generally, the assets of a business represent the properties or economic resources used by the business. This section covers current assets, long-term assets, fixed assets, deferred assets and other assets.

Current Assets

Unrestricted cash or other asset that, in the normal course of operations, is expected to be converted into cash, or consumed in the production of income within one year or within the normal operating cycle, when that is longer than a year.

Figure 2.1 - Common Balance Sheet Items

Balance Sheet December 31, 20XX ABC Limited.			
Assets		**Liabilities**	
Current Assets		**Current Liabilities**	
Cash	$	Operating Loans	$
Accounts Receivable	$	Trade Payables	$
Inventory	$	Accounts Payables	$
Marketable Securities	$	Accrued Liabilities	$
Prepaid Expenses	$	Income Tax Payable	$
		Current Portion of Long Term Debt	$
Total Current Assets	$	*Total Liabilities*	$
Long Term Assets		**Long Term Liabilities**	
Patronage Capital	$	Promissory Note Payable	$
Other Equities	$	Patronage Refund	$
Fixed Assets		***Total Long Term Liabilities***	$
Land & Building	$		
Machinery & Equipment	$	**Members Equity**	
		Unallocated Retained Earnings	$
Total Long Term Assets	$	*Members Equity*	$

In terms of a business's day-to-day operations, current assets are the most important group of assets. They largely determine a firm's ability to pay its ongoing operating expenses. On the balance sheet, current assets are usually listed in declining order of their liquidity, with cash as the first-listed item, as in the listing of balance sheet items shown in Figure 2.1. Liquidity is a measure of how easy it is to turn the asset into cash.

Coin, bank notes, money orders, cheques and accepted sight drafts, and (by extension) the balances in respect of demand and savings deposits at banks or other financial institutions.

Cash, of course, is the most liquid of any asset. It is cash that repays a lender's loan, pays the business's operating costs and its other cash needs.

Accounts receivable is an amount claimed against a debtor, usually arising from the sale of goods or services. We would expect these receivables to be converted into cash in the next operating cycle (usually one year). It may be the case, however, that not all of the outstanding receivables can realistically be expected to be collected in cash. An "allowance for doubtful accounts" is used to reduce total accounts receivable outstanding by the amount that management has reason to believe may not be collectible.

Inventory includes items of tangible property which are held for sale in the ordinary course of business, or are being produced for sale, or are to be consumed, directly or indirectly, in the production of goods or services to be available for sale.

If the business is involved in manufacturing and/or processing, inventory can be in three forms. Other types of businesses, such as retail businesses, usually have inventories containing finished products only. For a manufacturing company, the three types of inventories are:

- Finished product – goods which are ready for sale.
- Work-in-progress – partly-finished goods or goods which are in the process of manufacture or completion.
- Raw material – material which has not been changed or used through the production process.

Marketable securities are those securities which are readily convertible into cash. Typically, these will consist of publicly traded securities (stocks, bonds, etc.).

Prepaid expenses –is expected to yield its benefits in the near future and meanwhile is carried forward to be charged to expenses in the near future. Prepaid expenses may normally include items such as insurance premiums, property taxes and, possibly, supplies.

Deposits –a lodgement of cash, securities, etc., with others."

Long-term Assets - are assets which would not normally be converted to cash in the next 12 months (or operating cycle). When assessing a business's financial position, it is important to determine the underlying value of such an asset.

Notes receivable - may occasionally consist of trade receivables for which specific extended repayment terms have had to be arranged.

Fixed Assets are tangible, non-current assets, such as land, building, equipment, etc., held for use rather than for sale. These assets are used by a business over a long term. Their primary value to the business lies in their use in generating income for the business. Fixed assets are shown on the balance sheet at their original (historical) cost, including installation and other acquisition cost, less accumulated depreciation.

The current market value of land and buildings may be considerably higher than their book value (cost less accumulated depreciation), especially if they have been owned for a lengthy period. Of course, the reverse is also true in some cases.

Fixed assets generally consist of one or more of the following:

- land
- buildings
- machinery and equipment
- furniture and fixtures
- vehicles

Depreciation refers to:

1. The continual reduction in the service capacity of fixed assets arising from normal wear and tear that cannot be prevented by maintenance practices and, in some cases, from anticipated obsolescence.

2. The expense in an accounting period arising from the application of depreciation accounting.

Accumulated depreciation is the total, to date, of the periodic depreciation charges related to fixed assets since the assets were placed in use.

Liabilities

Liabilities refers to:

1. Debt - amounts that likely will require settlement in the future as a result of events and transactions that occurred prior to the accounting date, or obligations for future delivery of goods or services for which payment has already been received.
2. Liabilities represent claims on the assets of a business. While assets, on a balance sheet, are generally listed in descending order of liquidity, liabilities are generally listed in terms of descending order of payment priority.

Current Liabilities are those whose regular and ordinary liquidation is expected to occur within one year or within the normal operating cycle when that is longer than a year. They **exclude** a liability, otherwise classified as current that will be settled from other than current assets.

Loans payable: usually the first listed liability will be the outstanding balance of the line of credit or operating loan, owed by the business to the lender providing operating funding. Such lines of credit provide support for assets such as receivables and inventory.

Accounts payable means an amount owing to a creditor, usually arising from the purchase of goods or services. Generally, accounts payable represent amounts due to suppliers for purchase of inventory, as well as utilities, supplies, advertising, etc.

Accrued liability refers to a claim by another party, that is increasing with the passage of time, or the ongoing receipt of service, but is not yet enforceable. It arises from the purchase of services (including the use of money) that at the date of accounting have been only partly performed, are not yet billable and have not been paid for.

Income taxes payable: unusually represents the remaining amount payable in the current year's income taxes, but may include arrears from past years.

Current portion of long-term debt: refers to current maturities. That is, the portion of long-term obligations to be retired during the ensuing twelve months.

Bear in mind that the current portion of long-term debt (or current maturities, which means the same thing) is the amount of principal (not both principal and interest) payment due on the company's debt over the ensuing twelve months. Where appropriate, balance sheets may also show a current portion of capital leases.

Long-term Liabilities: These are any liabilities that are not current liabilities.

Long-term liabilities are generally related to the financing of fixed assets, with the security for the loan being fixed assets (either those purchased with the funding or providing collateral for the funding if the term loan was for a purpose such as providing working capital).

Promissory notes payable: refers to an unconditional promise in writing made by one person to another, signed by the maker, promising to pay on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer.

Deferred income taxes: consist of the accumulated difference between income taxes charged in the accounts, and income taxes paid or currently payable. Under *The Income Tax Act*, income tax can be deferred to later years. The amount of deferred income tax is determined by the method of calculating depreciation.

Capital cost allowance (CCA) method:

This method depreciates the asset on a percentage basis. These percentages are set by Canada Revenue Agency for the various types of assets eligible for depreciation. This is similar to a declining balance method of depreciation.

Example: A company in a 50% tax bracket has $100,000 income before depreciation and income tax. Using both methods of depreciation, Table 2.1 illustrates the depreciation amounts after the first year of an asset's life.

The deferred income tax is added to a reserve for deferred income tax on the liability side of the balance sheet. Use of the deferred tax method enables the company to have use of the funds for a longer period; however, the eventual payment obligation still remains.

Table 2.1 – Straight-Line Depreciation Vs. Capital Cost Allowance

Salvage Value	Per Company's Accounts Straight-Line Method	Per Income Tax Return Capital Cost Allowance (CCA) (20% rate)
Income before depreciation and income tax	$100,000	$100,000
Less: Depreciation $\frac{\$110,000 - 10,000}{10}$ = $10,000 CCA (20% x $110,000) = $22,000	$10,000	$22,000
Taxable income	$90,000	$78,000
Less: income tax (50%)	$45,000	$39,000
Net Profit (straight-line method)	$45,000	
Income Tax (capital cost allowance)	$39,000	
Tax Savings	$6,000	

Equity

Equity is the residual interest in assets after deducting related liabilities.
The investment in a cooperative that represents member ownership, usually expressed in common shares owned by members.

Share capital – The "authorized capital" of a company refers to the number and par value, if any, of shares of each class of capital stock that a company may issue in accordance with its instrument of incorporation. "Issued capital" refers to the portion of authorized capital stock for which shares have been subscribed, allotted and entered in the share register whether or not fully paid. "Paid up capital" refers to that part of the issued capital for which settlement has been received.

Generally, the share structure should be clear in the financial statements – if necessary, clarified in the notes to the financial statements.

Patronage Refund - Net savings are reinvested in a cooperative or are returned to members as patronage dividends, which may be in the form of cash and/or additional shares in the cooperative.

Retained Earnings is the accumulated balance of income, less losses, of a limited company, after taking into account dividends and other appropriate charges or credits. It is what is left over for the business to work with. Increasing retained earnings are a key ingredient in building up a business's equity base and its financial strength, which can enable it to withstand losses incurred in unprofitable times. If accumulated losses are greater than accumulated earnings, a deficit retained earnings position results.

THE INCOME AND EXPENSE STATEMENT

The income and expense statement, on the other hand, describes a business's performance *over a period of time*. It shows how much revenue a business has generated from sale of its products or services, and how much was spent on purchases of inventory, raw material, wages, salaries, utilities, taxes and other expenses incurred during the period. The amount left over, after recognition of all sources of income and costs, is net income.

The income and expense statement reveals:

- where revenue comes from and how it is spent,
- the size of the earnings generated by the business, which are necessary to provide for its successful operation and to provide income for the owners,
- the success (or failure) of management in generating profit from the resources available to the business.

Adequate earnings, together with the effective management of those earnings to meet present and future needs, are an essential ingredient in success.

Cash Vs Accrual Accounting

The cash method and the accrual method (sometimes called cash basis and accrual basis) are the two principal methods of keeping track of a business's income and expenses.

The main difference between accrual basis and cash basis accounting is when they recognize and record income and expenses. The cash basis method generally recognizes income when cash is received and expenses when cash is paid.

The accrual method recognizes income when it is earned (the creation of assets such as accounts receivable) and expenses when they are incurred (the creation of liabilities such as accounts payable).

Under the cash method, income is not counted until cash (or a cheque) is actually received, and expenses are not counted until they are actually paid. Most people use the cash method for their personal finances, because it's simpler and less time-consuming. However, this method can distort a business's stated income and expenses, especially if the business extends credit to customers, if the business purchases inventory on credit from suppliers, or it keeps an inventory of the products it sells.

Structure of the Income and Expense Statement

The structure of the income and expense statement could generally be described as follows:

1. The statement starts by recording the business's revenues from its normal operations, sometimes adjusted for product returns and discounts to arrive at a net sales amount.
2. The statement then focuses on the direct costs of the product sold, by recording the opening inventory for the period, the purchases of products for use in manufacturing, processing or for sale, recording the closing inventory values, recognizing the direct costs associated with producing products for sale (if appropriate), and arriving at a cost of goods sold. The resulting number, after deducting cost of goods sold from revenues, is the business's gross profit.

3. Next, the statement will typically record the expenses associated with the other activities normally carried out in the business's operations (general operating expenses not directly related to a production process, selling salaries, office expenses, insurance costs, interest costs, etc.). Deduction of these expenses from gross profit produces the business's net operating income – in other words, the net income generated through the business's normal operations.
4. In some income and expense statements, expenses associated with financing (interest costs) and items not associated with normal or usual activities (the gain or loss on sale of assets, for example) will be recorded separately from the group of operating (or SG&A) expenses. Income not directly associated with sales activity (interest income, for example) may also be recorded separately with other miscellaneous income items. Once these expense/revenue items are recognized, the business will have demonstrated its profit before income taxes and extraordinary items.
5. Extraordinary gains or losses are just that – one-time events which are not in the "normal course of business" and are not expected to recur. In general, these extraordinary transactions are recognized after all revenues and expenses associated with the business's normal (and near-normal) activities have been recognized.
6. After recognition of extraordinary items and income taxes, the business records its net income. This is the end result, in terms of profit, of the business's operation over the period covered and the "report card" on management's ability to operate the business profitably.

The Statement of Retained Earnings (Incorporated Companies) or Proprietor's/Partners' Capital (Proprietorship and Partnership)

Appendix IV to this Module contains a sample financial statement (excluding accountant's report and notes to the statements) for a limited company; Downtown Printing Services Ltd. Included with this information is a Statement of Retained Earnings. This statement is the fundamental link between the income statement and the balance sheet. You will observe that:

In summarizing the retained earnings for Fiscal 20XX, the "beginning of the year" figure is the "end of year" figure from the previous fiscal year, and the "end of year" figure for 20XX is also the retained earnings figure on the December 31, 20XX balance sheet.

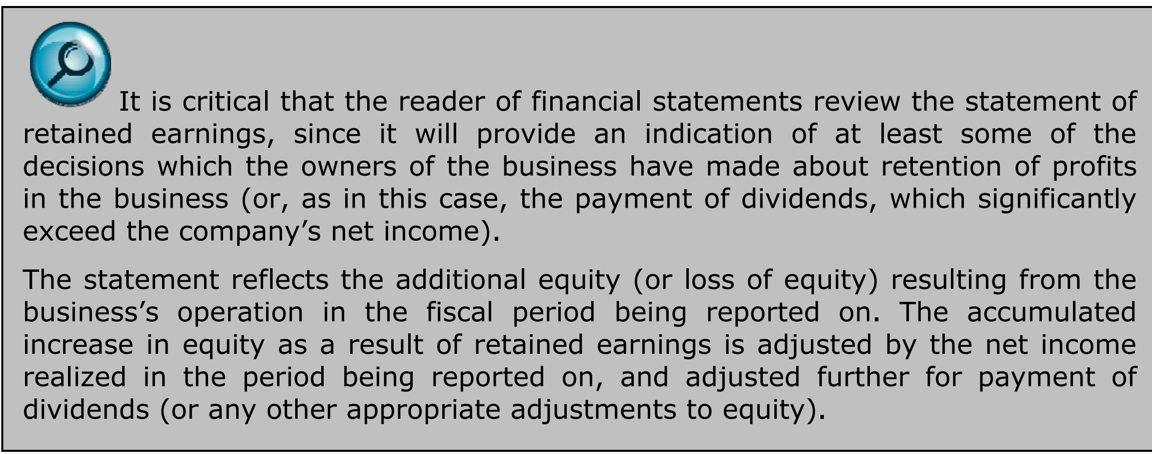
Sample Income and Expense Statement Format

XYZ Company Ltd.
Income and Expense Statement
For the 12 months ending March 31, 20XX

Revenues (net of return and allowances)				$5,000,000
Cost of Goods				
	Opening Inventory	$1,000,000		
Plus	Purchases	$2,000,000		
(less)	Closing Inventory	$1,000,000		
			$2,000,000	
Plus	Direct Labour		$500,000	
Plus	Plant Overheads		$400,000	
	Cost of Goods Sold			$2,900,000
Gross Profit				**$2,100,000**
(Less)	Operating Expenses	$200,000		
	Selling Expense	$700,000		
	Administration	$400,000		
	Financial Expenses	$200,000		
Total Operating (or SG&A) Expenses				($1,500,000)
(Equals)	**Net Operating Income**			**$600,000**
Plus	Other Income			$50,000
				$650,000
(Less)	Loss on Sale of Fixed Assets			($250,000)
Profit before Income Taxes & Extraordinary Items				$400,000
Plus	Extraordinary Gain			$200,000
				$600,000
(Less)	Income Taxes			($100,000)
Net Income				**$500,000**

To the "beginning of the year" figure in 20XX is added the company's net income from the previous year, as recorded in the company's income statement for the year ended December 31, of the previous year.

The company paid dividends of $41,500 during fiscal 20XX. Dividends represent a form of compensation to the shareholder and, effectively, a withdrawal of company earnings. After recognizing the declaration of dividends – a reduction in the company's retained earnings – the balance of the retained earnings account ($10,093) is the amount carried to that account in the balance sheet.



It is critical that the reader of financial statements review the statement of retained earnings, since it will provide an indication of at least some of the decisions which the owners of the business have made about retention of profits in the business (or, as in this case, the payment of dividends, which significantly exceed the company's net income).

The statement reflects the additional equity (or loss of equity) resulting from the business's operation in the fiscal period being reported on. The accumulated increase in equity as a result of retained earnings is adjusted by the net income realized in the period being reported on, and adjusted further for payment of dividends (or any other appropriate adjustments to equity).

The Statement of Changes in Financial Position

This statement (sometimes described as a "cash flow statement", "statement of operating, financing and investing activities", or "statement of changes in cash resources") is intended to provide information about the operating, financing and investing activities of a business and the effect of these activities on cash resources.

The sample financial statements for Downtown Printing Services, and Anytown Convenience Store, in Appendices IV and V, contain examples of such statements. We will deal more extensively with the cash impact of transactions in the following module.

The statement of changes in financial position helps the reader of financial statements answer questions such as:

- Where did the earnings go?
- Why is working capital down when earnings are up?
- How was the expansion of plant and equipment financed?
- How was the retirement of debt accomplished?

Business Operational Cycle

All business operations have financial cycles, during which they experience cash inflow and outflows. The cycle that covers the day to day operations of the cooperative is referred to as the operating cycle. The operating cycle typically begins with the disbursement of cash, and ends with the collection of cash from customers. It also includes other cash inflows and outflows primarily related to current assets and current liabilities.

Raw materials are purchased and stored in inventory. During the manufacturing process, the value of the raw materials increases by adding the costs of manufacturing and overhead. To the finished goods, we add the sales and administration expenses. When the product is sold, it becomes a receivable. Included in the profit margin, the collection of receivables represents a net inflow of cash for the company.

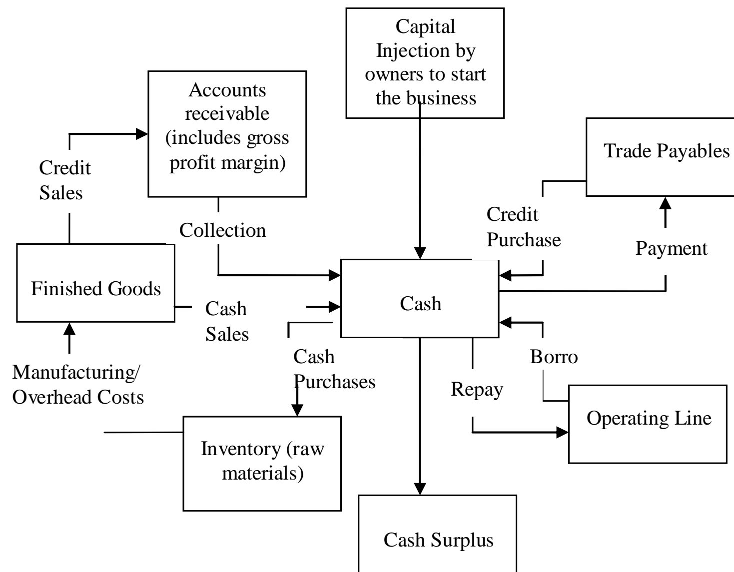
The purchase of raw materials in the asset conversion component begins the funding cycle. The cycle is financed by trade payables, and an operating line of credit from a financing source.

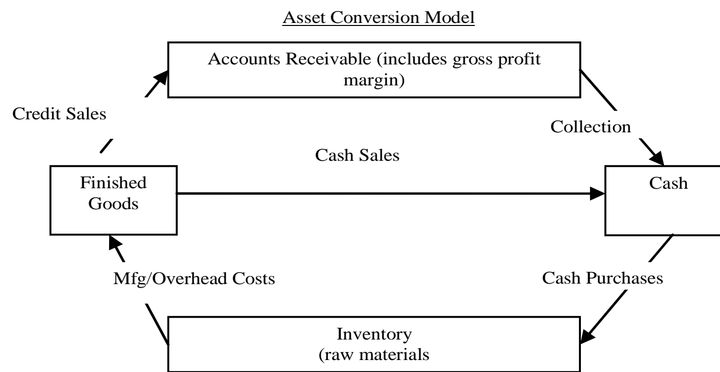
As stated above, the cycle begins with the purchase of raw materials. When purchases are made on credit, the company experiences no immediate outflow of cash. In all likelihood, payment will be necessary prior to the product being sold. This outflow of cash will be funded by borrowing through an operating line of credit. When the product is sold and the resulting receivable collected, repayment of the operating credit can be made. Because this repayment includes interest on the original amount, it represents a net outflow of cash for the company.

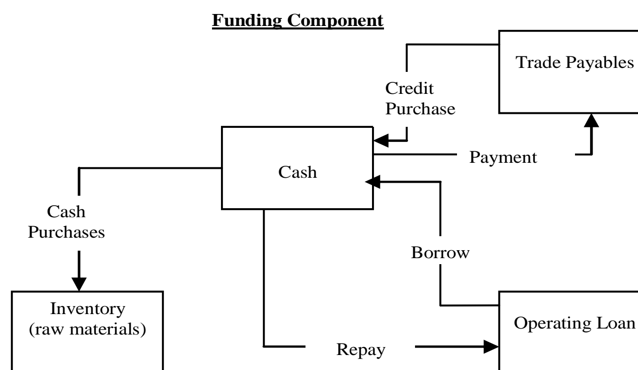
The desired result is for net inflow of cash from the asset conversion component to cover the net outflow of cash from the funding component, resulting in a cash surplus or profit.

This resulting cash surplus can be used to repay debt, finance future growth or divide the profit between cooperative members.

Business Cash Cycles/ The Operating Cycle







Notes to Financial Statements

Notes to financial statements form an integral part of the statements. Notes have been used extensively over the years to provide information which is otherwise difficult to incorporate into the main body of the statements. They are intended to provide further explanation and clarification of the financial information.

RATIO ANALYSIS

Ratio analysis is a major tool in the evaluation of financial performance. Ratios express the relationship between various financial statement data, pointing out patterns that reflect risk, opportunities and efficiencies.

Most ratios fall into the following categories:

- liquidity ratios
- efficiency ratios
- leverage ratios
- profitability ratios.

Balance Sheet Ratios

A cooperative will perform ratio analysis on a balance sheet in three main areas: *The business's current position:* the relationship between current assets, current liabilities, and the business's ability to meet its current liabilities as they mature.

Operating efficiency: the efficiency with which the business uses its assets to produce goods or services.

Liquidity Ratios

These ratios can be used to determine the liquidity position (the ability to convert assets into cash).

Current Ratio: The *current ratio* measures the relationship between current assets and current liabilities. Essentially, the margin of current assets over current liabilities represents the cushion of protection for current creditors. Theoretically, the larger the margin, the stronger the financial position of the company. A generally accepted *ideal* standard for the current ratio is 2:1 (i.e., current assets have twice the value of current liabilities), although this depends a great deal on the nature of the business and the strength of other factors.

Once these limitations are recognized, the current ratio can be a useful tool for measuring the ability of the present current assets to pay current liabilities. This ability will depend on:

- how quickly the receivables and inventories are converted to cash
- the quality of the receivables and inventories
- how quickly the current liabilities have to be paid.

The current ratio of Downtown Printing Services Ltd. In fiscal 2000 was:

Current Assets or $212,535 or 1.29:1
Current Liabilities $165,149

In fiscal 2001 the company's current ratio was:

$301,964 or .90:1
$335,381

Quick (Acid-Test) Ratio

For the purpose of assessing liquidity, current assets should be divided into two categories:

- Liquid assets such as cash or assets that can be converted into cash without further sales effort, such as receivables and most marketable securities.

- Assets that must be sold before they can be converted into receivables or cash. In this category are the various classifications of inventory.

Liquid assets usually provide much greater protection for the short-term than does inventory. Sales are required before inventory can be converted into cash. Additionally, inventories are difficult to evaluate accurately and are frequently subject to shrinkage in value.

The quick ratio (or acid test, as it is sometimes called) measures the coverage of the more liquid current assets versus current liabilities. Two formulas have been used to calculate the quick ratio:

1. $\frac{\text{Current assets less inventory}}{\text{Current Liabilities}}$ or

2. $\frac{\text{Cash plus marketable securities plus receivables}}{\text{Current Liabilities}}$

The second formula is preferred because it specifically identifies the more liquid current assets—those that are cash or can be more readily converted to cash, regardless of sales efforts.

Consider the following example of the current portion of a balance sheet:

Balance Sheet

Assets		*Liabilities*	
Cash	$10,000	Bank loan	$10,000
Receivables	20,000	Payables	15,000
Inventories	5,000	Accruals	5,000
Current Assets	$35,000	Current Liabilities	$30,000

The quick ratio is:

$\frac{\text{Cash plus Receivables}}{\text{Current Liabilities}}$ or $\frac{\$10,000 + 20,000}{\$30,000}$ or

$\frac{\$30,000}{\$30,000}$ or 1:1

A quick ratio of 1:1 means that for every dollar of current liabilities there is a dollar of liquid assets, and that the business should have little difficulty meeting its current obligations very promptly. The larger this ratio, the greater the protection for short-term lenders/creditors, and the more liquid is the financial position of the business. Assessment of this ratio’s trend over time is an important part of the analytical process.

Interpretation and assessment of these ratios requires a knowledge of the business, the characteristics of its industry, the seasonal/cyclical nature of the business, the quality of the business’s assets, and the composition and terms of its liabilities.

Efficiency Ratios

Operating efficiency is a measurement of how well a business manages its assets. An efficient company is one that optimizes the use of assets in supporting its sales volume, and maximizing its profit. One of the first signs that a business may be facing some difficulty is a declining trend in the efficiency of how it uses its assets (asset utilization). A number of ratios may be used to measure efficiency, including *turnover ratios*.

A variety of the ratios may be used to gauge efficiency, including:

- *Sales/Receivables Ratio:* measures the turnover of receivables into cash. Theoretically, the numerator (sales) should include only credit sales, but this information is rarely available. The formula used in calculating this ratio is generally written as:

  net sales = "X" times average trade receivables

where:

(a) net sales represents annual sales after provision for returns and discounts (in some cases, only a "sales" or "revenue" figure may be shown in the income and expense statement),

(b) average trade receivables means the average of accounts receivable (after deduction of allowance for bad debts) at the beginning and end of the fiscal period.

The ratio gives some indication of the quality of receivables and how successful the business is in converting its receivables into cash.

In the case of Downtown Printing, its sales/receivable ratio in 2001 was:

$$\frac{\text{Net sales (2001)}}{(\text{Receivables (2001)} + \text{Receivables (2000)})/2}$$

$$\frac{\$1,287,857}{(\$222,742 + \$175,701)/2} = \frac{\$1,287,857}{\$199,221} = 6.46 \text{ times}$$

The financial information we have for Downtown Printing does not include a financial statement for 1999. Assume that these financial statements record receivables of $163,848.

Using this assumption, the receivables turnover ratio in 2000 was:

$$\frac{\$1,239,297}{(\$175,701 + \$163,848)/2} = \frac{\$1,239,297}{\$169,774} = 7.29 \text{ times}$$

Comparison of 2000 and 2001 results suggests the receivables turnover is slowing, meaning that receivables, in 2001, were being converted to cash less rapidly than in 2000. This could reflect Downtown's difficulty in collecting their customers' accounts.

Whatever the ratios selected for comparison may be, it is most important that you are consistent in the selection of the information used in their construction. While the use of average receivables is the standard and recommended form of the denominators in this equation, there may be occasions when you wish to make some comparative assessments, notwithstanding the lack of sufficient historical data to calculate averages over a meaningful period of time.

The higher the turnover rate, the shorter the average collection period, and, accordingly, from the point of view of conversion of sales to cash, a business should aim to have this ratio as high as possible.

The reverse of the sales/receivable ratio is the *receivables aging/collection period*, which attempts to quantify the overall quality of receivables by measuring their average age. It is based on the assumption that the older the receivable, the greater the possibility it will become uncollectible. The average age of receivables will depend on a variety of factors, including general trade terms in the industry, and the business's own credit granting and collection practices. The ratio is useful in measuring not only the apparent quality of a business's receivables, but also how well management sticks to its stated credit policies.

If the average collection period has been decreasing, a strengthening of management control is often assumed. However, depending on other factors, a shortened collection period can also indicate a strong (and perhaps even desperate) focus on cash generation. An exceptional concern about cash generation may result in lost sales because of a business's inability to extend credit terms to customers. Generally speaking, a pattern of lengthening age of receivables may suggest:

- poor credit granting and collection policies and procedures
- customers who are experiencing financial difficulty.

A most useful tool for analyzing the quality of receivables is an up-to-date and aged list of receivables. From this you can determine:

- which amounts are past due
- how the accounts are distributed among time (i.e., aging) periods of 30, 60, 90 days, etc.
- which accounts are slow in making payment the adequacy of reserves for doubtful accounts which accounts are likely to be uncollectible.

As was indicated above, the *receivables aging/collection period* calculation is simply the reverse of the sales/receivables ratio. The receivables aging/collection period formula is as follows:

$$\frac{\text{Average receivables}}{\text{Net sales}} \times 365 \text{ days} = \text{“X” days}$$

For 2001, the collection period for Downtown Printing was:

$$\frac{(\$222{,}742 + \$175{,}701)/2 \quad \times 365 \text{ days}}{\$1{,}287{,}857}$$

$$= \frac{\$199{,}221}{\$1{,}287{,}857} \times 365 \text{ days} = 56.5 \text{ days}$$

The calculation indicates that, in fiscal 2001, the company's receivables were equivalent to 56.5 days' sales and therefore, representing, on average, a 56.5-day period for conversion to cash. The 56.5 days collection period is equivalent to the annual turnover of 6.46 times calculated earlier:

365 days = collection period x turnover frequency
= 56.5 days x 6.46 times = 365 days

Let's compare the turnover and aging results revealed by using the "average receivables"
and year-end receivables amounts as calculated earlier:

		Average Receivables	Year-End Receivables
Receivables turnover	2000	7.29 times	7.05 times
	2001	6.46 times	5.78 times
Collection period	2000	50 days	52 days
	2001	56.5 days	63 days

In this particular case, the use of year-end receivables in the denominator tends to emphasize (and may well over-emphasize) the deterioration in receivables turnover/collection period which has transpired over the two fiscal periods.

The collection period calculation can have particular relevance when compared with a business's selling terms. Ordinarily we should not necessarily expect the collection period calculated from the financial statement information to precisely match the business' trade terms (e.g., payment in 30, 60, 90 days) – you might expect the collection period, on average, to be several days longer than the collection period. In the table above, for example, if Downtown's terms were net 45 days, 2000 performance could possibly be considered quite good. If repayment terms were net 30 days, performance in 2000 and 2001 could be reason for real concern about the quality of the business' receivables.

Sales to Fixed Assets or Sales to Total Assets

The first of these ratios measures the efficiency of fixed asset utilization in generating sales volume, and the second measures the efficiency of the utilization of all assets in generating sales volume. The numerator is annual net sales, and the denominator is the average of the yearend balances of fixed assets (in the first case), or total assets (in the second case).

The 2001 sales/total assets ratio for Downtown Printing Ltd. is:

$$\frac{\text{Sales}}{(\text{Total Assets (2001} + \text{Total Assets (2000))}/2}$$

$$= \frac{\$1,287,857}{(\$981,602 + \$990,088)/2} = \frac{\$1,287,857}{\$985,845}$$

$$= 1.31 \text{ times}$$

This ratio may occasionally be meaningful in comparing a business with others in its industry *but* it can be affected significantly by a business's accounting policies (as applied to depreciation of fixed assets) and the age of its physical assets—a lower book value of fixed assets, all other things being equal, would tend to raise this ratio, yet perhaps have little real significance in measuring management's effectiveness in using the assets at its disposal.

However, the ratio can sometimes provide a clue to an issue needing clarification. For example, if the sales/total assets ratio of business comparable to Downtown Printing was four times, a accountant might wonder, for example:

a) about the company's overall effectiveness in marketing
b) if it was simply over invested in fixed assets given the size of its market.

Inventory Turnover Ratios

These are ratios which provide an indication of the rapidity with which inventories are converted into sales. It is calculated by dividing average inventory into cost of goods sold (which latter, of course, is sales volume less the profit margin).

In the case of Downtown Printing Services Ltd., the inventory turnover ratio is:

$$\frac{\text{Cost of goods sold (2001)}}{\text{(Inventory (2001) + inventory (2000))/2}}$$

$$= \frac{\$803,584}{(\$39,768 + \$24,442)/2}$$

$$= \frac{\$803,584}{\$32,105}$$

$$= 25.03 \text{ times}$$

While we do not have a balance sheet for 1999, and could not accordingly get a 1999 receivables figure from a company balance sheet in calculating receivables turnover or collection period, the income statement for 2000 records "inventory beginning of year" of $27,150 – this is the inventory figure that would have been provided on the December 31, 1999 balance sheet.

Accordingly, the 2000 inventory turnover ratio of Downtown Printing Services can be calculated as follows:

$$\frac{\text{Cost of goods sold (2000)}}{\text{(Inventory (2000) + inventory (1999))/2}}$$

$$= \frac{\$796,154}{(\$27,150 + \$24,442)/2}$$

$$= \frac{\$796,153}{\$25,796}$$

$$= 30.86 \text{ times}$$

Relatively speaking, Downtown Printing is in a "high inventory turnover" business and, as in other areas of its operation, performance in 2001 deteriorated from that of 2000. Here again, a accountant may want to compare the performance of this business with that of its counterparts in the industry (based on lending experience).

A cooperative board member's objectives for analyzing inventory include:

- determining how accurately it is presented on the balance sheet
- estimating the liquidity of the inventory
- obtaining an indication of management's philosophy, style, merchandising approach and overall management ability.

Average Payables Aging

This ratio provides a general indication of whether or not a business is adhering to its suppliers' trade terms (once these are known) and whether or not the business is making the most effective use of its cash. While a business most efficiently averaging its cash will maximize support from its suppliers, an increased aging of payables can also be a signal of business in financial difficulty. Delay in paying its trade creditors is one of the more common tactics followed by a business having cash flow problems. The formula generally used to calculate payables aging is:

$$\frac{\text{Average Accounts Payable} \times 365}{\text{Cost of Goods Sold}} = \text{average payables in days}$$

In the case of Downtown Printing Services Ltd., the balance sheet information indicates that accounts payable also include accrued liabilities. Assuming that accrued liabilities are minimal in amount, the payables aging for Downtown Printing Services Ltd. In 2001 was:

$$\frac{(\text{Accounts Payable (2001)} + \text{Accounts Payable (2000)})/2 \times 365 \text{ days}}{\text{Cost of Goods Sold (2001)}}$$

$$= \frac{(\$109,800 + \$87,305)/2 \times 365}{\$803,584}$$

$$= \frac{\$98,552 \times 365}{\$803,584}$$

$$= 44.7 \text{ days}$$

A calculation using the cost of goods sold as the numerator could possibly have pointed to the need for further examination of the support available to the business from its creditors.

CAPITAL STRUCTURE

Assessing the long-term solvency of a business is quite different from evaluating its short-term liquidity. The key elements in evaluating long-term solvency are an analysis of the business' capital structure, and its earning capacity (the capacity to build up equity through profitable operations).

Leverage Ratios

A number of ratios have been developed to assess a business's capital structure; two of the key ones are the total debt/equity ratio and the current debt/equity ratio. The total debt/equity ratio has been defined differently by different practitioners; as is the case with ratios generally, consistency of application is the important thing.

The numerator in the total debt/equity equation is defined by some practitioners and analysts as "all liabilities owed by a business" – defining debt as "all liabilities". Other analysts define debt as "borrowings" (e.g., specific, formalized borrowings through financial institutions or others) and would not include trade payables or other indebtedness as part of the borrower's debt. In formula presentation, therefore, one debt/equity relationship could be:

Formula 'A'

Total debt/equity ratio = total liabilities

net worth (equity minus intangibles)

The debt/equity ratio, tells us the relative degree of participation in the business's financing by creditors, compared to investment in the business by its owners.

Formula 'A' indicates the participation in the business's financing by *all* creditors (lenders, trade suppliers, etc.) compared with the owner's equity.

The higher the ratio (i.e., the higher the participation of creditors vs. the owners), then the less protection there is for the creditors. As the ratio decreases, creditor protection increases.

Typically, the debt/equity relationship is measured against the previous historical performance of the business and its situation relative to other firms in its industry.

For purposes of the debt/equity calculations which follow, relative to *Downtown Printing Services Ltd.*, we will include, as equity, only the capital stock and retained earnings. We will assume that the notes to the financial statement make no reference to assignment of the shareholders' loans to the lender. Since deferred income taxes represent a debt to be paid at some future time, we'll include deferred taxes as debt. The company's debt/equity ratio at December 31, 2001 is therefore:

Total debt/equity ratio = $\dfrac{\text{total liabilities}}{\text{net worth (equity minus intangibles)}}$

Formula 'A'

Total debt/equity ratio = $\dfrac{\text{total liabilities}}{\text{net worth}}$

$= \dfrac{\$971{,}409}{10{,}193}$

= 95.3:1

Three factors can lead to an unacceptably high debt/equity ratio:

- lower profits, resulting in slower accumulation of equity, or losses, which erode equity
- excessive capital withdrawals (dividends, reduction of shareholders' loans)
- increased debt.

In the Canadian securities industry, a number of *rules of thumb* have been developed over the years for publicly-traded companies to measure their financial strength. Generally, these rules of thumb for the debt/equity ratio are no more than 1.5:1 for utilities, and no more than .5:1 for industrial companies.

Excessive debt can create several problems. One reason is that heavy interest charges can reduce profits. This deterioration in earnings can result in a loss of flexibility and become a competitive disadvantage. Another possible problem is that principal payments on the debt (paid out of after-tax cash flow) can require such a large proportion of cash flow, that other needs, such as working capital

improvement, are not met. Finally, the business can become extremely dependent on the attitude of its creditors.

Utilities generally have a more consistent pattern of earnings and debt-service capacity than industrial companies and accordingly, a more consistent ability to service debt. This consistency has led to the acceptance of a higher debt/equity ratio for utilities than for companies in other industries.

RATIOS AND THE INCOME STATEMENT

The most common sources for loan repayment are cash flow and the conversion of an asset through the sales cycle. A critical aspect of loan evaluation is the analysis of the operating results, which are reported on the income statement. The main objective of a cooperative's analysis here is to obtain reasonable satisfaction that the business will maintain (or improve) its profitability in the future.

There are essentially two key questions that cooperative's have in analyzing the income statement:

- Are earnings sufficient to meet all obligations and generate the funds necessary for growth and other needs?
- How effective is management?

Sales (or Revenues)

An analysis of sales is based on three basic questions:

- What are the major sources of revenue?
- How stable are these sources, and what is their trend?
- When is revenue considered earned, and how is it measured?

Knowledge of the major sources of sales revenue is important as each major product or service line may have its own growth pattern, profitability and future potential.

Cost of Goods Sold

The cost of goods sold (or direct costs) includes the cost of inventory that has been sold or used in the production process; freight, transportation, customs duties, direct labor and factory overhead. Discounts on purchases are deducted from these costs to arrive at the cost of goods sold. This measurement, as a percentage of sales, is an indication of how efficiently the business controls its costs and sets its prices.

Gross Profit Margin

This is calculated as follows:

$$\frac{\text{Net sales} - \text{cost of goods sold} \times 100\%}{\text{net sales}}$$

This ratio is important because all other expenses, the principal component of debt repayment, dividends, and future equity needs must come from this source.

This ratio is an indicator of whether the markup on cost is sufficient to yield a profit to the business. You should pay particular attention to:

- the factors which account for variation in sales and cost of sales.
- the relationship between sales and costs, and the business's ability to control this relationship.

Changes in the gross margin can be brought about by the following events:

- an increase or decrease in the unit selling price
- an increase or decrease in the cost per unit

- changes in the methods of accounting for inventory valuation
- changes in the product sales or production mix (since different products may have different pricing structures).

Net Profit Percentage

The net profit (or net income) percentage measures the performance of the business – management's ability to use the resources available to generate profits. It is often regarded as the key indication of the strength and ability of a business's management. The percentage is calculated as follows:

Net profit (net income) x 100 = "x" %

Sales

The net profit (net income) figure generally used is the figure transferred to the statement of retained earnings (net profit/net income after payment of all costs and expenses including income taxes). In assessing the performance revealed by this calculation, a cooperative will consider the impact of non-recurring extraordinary gains or losses.

The net profit percentage would generally be compared with previous performance of the business being reviewed and with its industry – note that the net profit percentage will differ from one industry to the next – with, for example, the retail grocery industry having a very low – in the 1-2% range – net profit/sales percentage in comparison with some other industries.

Interest Coverage and Debt Service Ratios

Two of the coverage ratios used in assessing business loans are the:

- interest coverage ratio
- debt service coverage ratio.

The interest coverage ratio (sometimes referred to as a "times interest earned" ratio) measures a business's ability to meet its interest charges. It is typically of interest to providers of long-term debt. The formula can be shown as:

$$\frac{\text{Income before interest and income taxes}}{\text{annual interest expense}} = \text{"x" times}$$

A formula which precisely defines the numbers used in this equation (and which is often preferred because of this clarity) is the following:

$$\frac{\text{Net income + interest expense + income taxes}}{\text{Annual interest expense}} = \text{"x" times}$$

The debt service coverage ratio incorporates the principal payments on the business's term debt. A variety of formulas have been used in calculating the ratio. One such formula has been expressed as:

$$\frac{\text{earnings before interest and taxes}}{\text{annual principal and interest payments}} = \text{"x" times}$$

This formula is flawed to the extent that it does not recognize that loan principal payments are made from after-income-tax profits. While consistent income tax

obligations would not necessarily preclude meaningful year-to-year comparison of a business's debt service coverage performance, this consistency is often lacking.

Accordingly, the funds assumed available for debt service requirements are considered to consist of:

Net income (after income taxes)
+ Interest expense
+ Depreciation and amortization

Funds available for debt service, commonly described as "cash flow".

This denominator is then divided by principal and interest payments to arrive at a debt service coverage ratio. The formula can be presented as: net income after taxes + interest expense + depreciation and amortization expenses annual principal and interest payments

This formula recognizes the impact of income taxes by using net income after income taxes and deals more effectively with the deficiency in the formula discussed earlier. Typically, the debt service coverage ratio expected in commercial property loans will be in the range of 1.25 to 1.5 times coverage.

Ratios—A Comment

Ratios are (or should be) seldom used as *absolute* measures of good or bad performance. However, a accountant will form judgments about a business's strengths and weaknesses by using ratio analysis to detect trends, or compare a business with its competitors and its own past (and projected) performance.

Appendix I -Unqualified Report

(1) We have audited the balance sheet of XYZ Company Limited as at December 31, 20XX along with the statement of income, retained earnings and changes in financial position for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
(2) We conducted our audit in accordance with generally accepted auditing standards.
(3) Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis,
(4) Evidence supporting the amounts and disclosure in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.
(5) In our opinion, these financial statements present fairly, in all material respects,
(6) The financial position of the company as at December 31, 20XX and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles.
(8) Signed
Smith & Co.
Chartered Accountants
Sunnyside, Anywhere
February 28th, 20__

Explanation of the above numbered items follows:
(1) *Introductory paragraph* – the financial statements being reported on are identified. The respective responsibilities of management and the auditor regarding the financial statements are explicitly stated.
(2) *Scope paragraph* – describes the audit examination.
(3) *Generally accepted auditing standards* – these standards require that those performing the audit have adequate technical training and proficiency in auditing. The examination should be planned and performed with due care and with an objective state of mind. The standards also require that sufficient evidence is obtained during the audit by inspection, observation, enquiry, confirmation, computation and analysis to support the content of the financial statements. These standards are developed and published in the *CPA Canada Handbook: Standards and Guidance Collection*.
(4) *On a test basis* – the auditors perform tests only and do not undertake a total verification of all transactions. The nature, extent and timing of these tests was determined by independent professional judgment.
(5) *Assessing and evaluating* – the auditor makes judgments in applying generally accepted auditing standards regarding management's application of accounting principles and financial statement presentation.
(6) *Opinion paragraph* – in this paragraph, the auditors do not present a statement of facts. The result of the audit consists of an informed professional opinion based on an assessment of internal control and an examination of the enterprise's accounting records and other supporting evidence.

(7) *Present fairly in all material respects* – the information in the financial statements is not exact, but it is fairly presented. In the auditor's opinion, estimation errors and disclosure deficiencies are not sufficiently material to mislead informed readers.
(8) *Generally accepted accounting principles* – the manner of recording and measuring transactions and the methods of classification and presentation are based on basic concepts of accounting as developed and published by Chartered Professional Accountants (CPA). Any significant item that has not been properly treated or disclosed on a consistent basis must be mentioned in the audit report as a qualification of the opinion.
(9) *Date* – indicates the date up to which the auditor sought evidence to support the opinion expressed in the auditor's report.

Appendix II-*Review Engagement* Report

(1) I have reviewed the balance sheet of Bertha Ltd. As at June 30th, 20XX and the statements of income, retained earnings and changes in financial position for the year then ended.
(2) My review was made in accordance with generally accepted standards for review engagements and, accordingly, consisted primarily of enquiry, analytical procedures and discussions related to information
(3) supplied to me by the company.
(4) A review does not constitute an audit and consequently I do not express an audit opinion on these financial statements.
(5) Based on my review, nothing has come to my attention that causes me to believe that these financial statements are not, in all material respects, in accordance with generally accepted accounting principles.

Signed
T. Brown
Chartered Accountant
Rainyville, Anywhere
September 20th, 20XX

Explanation of the above numbered items follows:
(1) *Identify statements* – only the statements reviewed by the CA will be listed.
(2) *Nature of review* – the scope of the CA's review is described.
(3) *Identify source of information* – the source of the information used in the preparation of the financial statements, and on which the financial statements are based, is identified.
(4) *State no audit performed/disclaim opinion* – the CA clearly states that no audit has been conducted to test the accuracy of the information and no audit opinion is being expressed.
(5) *Negative assurance* – this form of reporting informs the reader that, although sufficient evidence has not been obtained to enable the CA to express an audit opinion, a review has been completed in accordance with the standards established by the CPA. Nothing has come to the attention of the auditors that causes them to believe that the information being reported on is not, in all material respects, in accordance with generally accepted accounting principles.

Appendix III-*Notice to Reader* Report

(1) I have compiled the balance sheet of Joe's Ltd. As at August 31st, 20XX, and the statements of income, retained earnings and changes in financial position for the six months then ended, from information provided by management.
(2) I have not audited, reviewed or otherwise attempted to verify the accuracy or completeness of such information.
(3) Readers are cautioned that these statements may not be appropriate for their purposes.

Signed
H.L. Black
Chartered Accountant
Hopeville, Anywhere
October 10th, 20XX

Explanation of the numbered items above follows:
(1) *Nature of Assignment* – explicit reference is made as to what the CA did (i.e., compiled the statements from information supplied by management).
(2) *Scope Limitations* – it is clearly stated that the CA's work is limited and has not included an audit or review to verify the accuracy or completeness of the financial information. There is no form of assurance implied or intended.
(3) *Caution to Readers* – since it is management or the proprietor, not the CA, who determines the distribution of the statements, it is necessary that a caution to readers be provided to inform others who may use the statements that the statements may not be appropriate for their purposes.

Appendix IV-Income Statement, Retained Earnings, Changes in Cash Report,

Appendix IV (continued)
Limited Company Financial Statements
Downtown Printing Services Ltd.
Income Statement
Year Ended December 31, 2001
(prepared without audit)

	2001	2000
Sales	$1,287,857	$1,239,297
Cost of Sales:		
Inventory, Beginning of Year	$24,442	$27,150
Purchases	$485,585	$452,995
Direct Labour	$333,325	$340,451
	$843,352	$820,596
Inventory, End of Year	$39,768	$24,442
Cost of Goods Sold	$803,584	$796,154
Gross Profit	$484,273	$443,143
Expenses:		
Advertising and promotion	$13,683	$13,223
Depreciation	$107,867	$138,850
Automobile and travel	$19,873	$17,541
Bad debts	$7,907	$6,124
Business tax	$2,017	1,584
Delivery and freight	$10,460	$10,614
Insurance	$2,382	$2,201
Miscellaneous expenses	$570	$419
Interest expense	$75,940	$47,349
Office supplies	$9,600	$6,906
Professional fees	$2,200	$4,685
Rent	$42,000	$42,000
Repairs and supplies	$39,737	$44,183
Salaries and commissions	$113,591	$139,301
Telephone	$7,165	$7,441
Utilities	$10,268	$9,365
Total Expenses	$465,260	$491,786
Income (Loss) Before Other Items	$19,013	$(48,643)

Appendix IV (continued)
Limited Company Financial Statements
Downtown Printing Services Ltd.
Statement of Retained Earnings
Year Ended December 31, 2001
(prepared without audit)

	2001	*2000*
Other Items:		
Miscellaneous	$923	$941
Interest	$4,874	$3,413
Gain (loss) on sale of fixed assets	$(1,629)	$38,095
Total Other Items	$4,168	$42,449
Income (Loss) before income taxes	$23,181	$(6,194)
Income Taxes:		
Deferred (Reduction)	$5,864	$(875)
Net Income (Loss) for the Year	$17,317	$(5,319)

Downtown Printing Services Ltd.
Statement of Retained Earnings
Year Ended December 31, 2001
(prepared without audit)

	2001	2002
Retained Earnings, (beginning of the year)	$34,276	$75,995
Net income (loss) for the year	$17,317	$(5,319)
Subtotal	$51,593	$70,676
Less: dividends paid	$41,500	$36,400
Retained Earnings, (end of year)	$10,093	$34,276

Statement of Changes in Cash Resources

Downtown Printing Services Ltd.

For the Year Ended December 31, 2001

(prepared without audit)

Year Ended December 31st

	2001	2000
Operating Activities:		
Net Income (Loss) for the Year	$17,317	$(5,319)
Items Not Affecting Cash -		
Deferred Income Taxes	$5,864	$(875)
Amortization	$107,867	$138,850
(Gain) Loss on Sale of Fixed Assets	$1,629	$(38,095)
Net Change in Non-cash		
Working Capital Balances	$(33,883)	$(23,083)
	$98,794	$71,478
Financing Activities:		
Dividends	$(41,500)	$(36,400)
Advances from Shareholders	$201	$ —
(Decrease) Increase in Long-Term Debt	$(73,703)	$245,872
	$(115,002)	$209,472
Investing Activities:		
Purchase of Fixed Assets	$(12,294)	$(733,871)
Proceeds on Disposal of Fixed Assets	$713	$399,477
	$(11,581)	$(334,394)
Decrease in Cash Resources	$(27,789)	$(53,444)
Cash Resources, Beginning of Year	$(32,911)	$20,533
Cash Resources, End of Year	$(60,700)	$(32,911)
Cash Resources Consist of:		
Term Deposit	$39,163	$12,113
Bank Indebtedness	$(99,863)	$(45,024)
	$ (60,700)	$(32,911)

Appendix V-Partnership Financial Statements, Statement of Changes in Financial Position,

Appendix V

Partnership Financial Statements

Anytown Convenience Store

Balance Sheet as at December 31, 2001

Unaudited

	2001	*2000*
Assets		
Current Assets		
Cash	$ 300	$ 300
Bank account	$45,807	$18,356
Accounts receivable	$492	$312
Inventory	$53,418	$60,378
Prepaid expenses	$1,168	$752
Total Current Assets	**$101,185**	**$80,098**
Fixed Assets (at cost)		
Land	$3,000	$3,000
Store	$37,936	$37,936
Automotive equipment	$17,663	$19,474
Fixtures and equipment	$20,448	$20,448
Total Fixed Assets (at cost)	**$79,047**	**$80,858**
Less: Accumulated Depreciation	$24,653	$28,604
Total Fixed Assets (net)	$54,394	$52,254
Total Assets	**$155,579**	**$132,352**

Appendix V (continued)

Partnership Financial Statements

Anytown Convenience Store

Balance Sheet (continued)

	2001	*2000*
Liabilities		
Current Liabilities		
Accounts payable	$3,564	$2,514
Employee deductions	$270	$437
Sales tax payable	$3,940	$784
Current portion of long-term debt	$6,216	$6,257
Total Current Liabilities	**$13,990**	**$9,992**
Long-term debt		
Loan No.2 -- Entwine Credit Union	$6,216	$12,781
Less: current portion of long-term debt	$(6,216)	$6,257
Total long-term debt	**0**	**6,524**
Partners' Equity		
Opening balance	$115,836	$108,947
Net earnings subtotal	$46,394	$33,401
	$162,230	$142,348
Drawings	$(20,641)	$(26,512)
Ending balance	$141,589	$115,836
Total Liabilities and Partners' Equity	**$155,579**	**$132,352**

Appendix V (continued)

Partnership Financial Statements

Anytown Convenience Store

Income Statement

For the Year Ended December 31, 2001

Unaudited

	2001	*2000*
Sales	$ 439,649	$ 495,292
Cost of Sales		
Opening inventory	$60,378	$51,825
Purchases	$362,157	$440,633
Subtotal	$422,535	$492,458
Less: Ending inventory	$53,418	$60,378
Total Cost of Sales	$369,117	$432,080
Gross Profit	$70,532	$63,212
Other Income		
Gain on the sale of fixed assets	$5,435	
Interest income	$2,106	
Commission income	$21,786	$23,134
Other income	$1,000	0
Gross Income	$100,859	$86,346

Appendix V (continued)

Partnership Financial Statements

Anytown Convenience Store

Income Statement (continued)

	2001	*2000*
Operating Expenses		
Accounting	$800	$800
Advertising	$1,053	$1,861
Automotive and travel	$3,524	$4,143
Bad Debts	$407	0
Depreciation	$9,345	$8,912
Insurance	$1,208	$1,196
Interest and service charges	$1,212	$1,730
Miscellaneous	$1,105	$674
Office and postage	$388	$127
Repairs and maintenance	$5,403	$2,944
Supplies	$2,645	$2,984
Taxes	$1,671	$1,584
Telephone	$1,160	$1,197
Utilities	$2,364	$2,013
Wages	$21,912	$22,507
Workers compensation	$268	$273
Total Operating Expenses	$54,465	$52,945
Net Earnings	$46,394	$33,401

Appendix V (continued)

Anytown Convenience Store

Statement of Changes in Financial Position

For the Year Ended December 31

Unaudited

	2001	2000
Cash Provided (Used) By:		
Operating Activities		
Net earnings for the year	$46,394	$33,401
Depreciation	$9,345	$8,912
Gain on sale of fixed assets	$(5,435)	$ --
Other working capital components	$10,361	$(4,039)
Drawings	$(20,641)	$(26,512)
Cash provided by operating activities	$40,024	$11,762
Financing activities		
Reduction of long-term debt	$(6,524)	$(11,487)
Cash provided by financing activities	$(6,524)	$(11,487)
Increase (Decrease) in cash position	$27,451	$(1,800)
Cash position -- beginning of year	$18,656	$20,456
Cash position -- end of year	$46,107	$18,656

Keys to Obtaining Financing - Understanding the Process

To a cooperative seeking capital financing for the first time, an understanding of the financing process is essential. The capital financing industry includes many firms with substantial funds to invest in cooperatives; however, it is often a challenge to a new cooperative to tap into this vital source of financing. For the cooperative' to maximize the opportunity for a positive response from its their financial institution, it must be informed and well prepared.

Financial institutions carefully assess the strength and weaknesses of each business financing proposal, including the soundness of the loan proposal, the capacity of the borrower to generate adequate profits and cash flow, the adequacy of collateral security, the strength of the company's financial position, and the integrity and ability of management.

In the discussion below we will identify the steps that should be taken into consideration when applying for financing.

Step 1

Prior to visiting a financial institution, the cooperative should answer the following questions:

What is the specific purpose of the loan?

A financial institution considers the cooperative's financing need based on two types of loans:

Operating Loans

I. Purpose

An operating loan is considered to be a loan for 12 months or less, dependent on the industry's normal production, servicing or sales cycles. It is made to the enterprise to cover normal operating expenses and/or to acquire current assets. An operating line of credit is the most prevalent operating loan. Operating lines of credit are used to provide financing of current assets, which will soon be converted into the most liquid of all current assets, cash. A line of credit will, in the majority of cases, be confined to loans for one of the following three purposes:

a) To finance accounts receivable.
b) To finance inventory (purchase or production of).
c) To finance current operating expenditures (i.e. crop inputs, start-up costs, etc.)

II. Source of Repayment

Since the main purpose of operating loans is to finance current assets, it is only fitting that the source of repayment is from liquidation of current assets. The primary source of repayment is therefore from the sale of inventory and collection of accounts receivable resulting from credit sales.

For example, a retailer purchases merchandise on normal trade terms for the industry. On due date, accounts payable are reduced by a cash payment, resulting in

the cash being reduced. If insufficient cash is available, a short-term operating loan is required. Additional sales will result in an inventory reduction and an increase in accounts receivable for all non cash sales. Collection of the account receivable will bring in cash, which will then reduce the operating loan/line of credit. The process may vary somewhat between the different industries, but nevertheless, it remains a circulation of cash through the business.

An operating line of credit is written on demand and revolves constantly within the operating cycle. The faster the inventory turns over, and the quicker the receivables are collected, the more the operating line will fluctuate.

The interest is payable monthly based on the principal portion being used during that specific month. There is no orderly scheduled principal repayment as such, because the balance fluctuates with the changes in the current assets of the business.

Operating loans, if properly administered, are self-liquidating and revolving.

III. Collateral

Collateral for an operating loan should be directly related to the purpose of the loan, although where considered necessary, other collateral can be taken.

Most types of inventory are not considered to be good collateral due to the following concerns:

a) Inability to adequately describe the collateral.
b) Ability to disappear quickly due to fast turnover.
c) Inventory may become obsolete for one reason or another, thus reducing its saleability and value.
d) Trade creditors can register a purchase money security interest in the inventory they have sold on credit and take priority over a financial institution.

Operating loans are not provided for capital expenditures, withdrawal of shareholders' loans or similar transactions which impair the working capital.

Term Loans - Mortgages/Equipment/Land/Buildings

I. Purpose

A term loan is defined as a loan with an originally agreed upon repayment term over a period in excess of 12 months, measured from the date of initial disbursement of any portion to the date of final repayment. Term loans are normally made for the following purposes:

a) For the purchase of an established business.
b) For the purchase of land to be used for business purposes.
c) For the purchase, construction, renovation or improvement of premises.
d) For the purchase, installation, renovation or improvement of equipment affixed to the property.
e) For the purchase, renovation or improvement of equipment not affixed to the property, which would include furniture and fixtures, machinery and vehicles used for business or farm purposes.
f) To refinance existing debt which could include other loans at the business's financial institution, as well as loans at other financial institutions.
g) For the purpose of providing additional working capital.

II. Source of Repayment

In the normal course of events, term loans are to be repaid only out of after-tax profits. The longer the amortization period on the loan, the easier it will be for the borrower to make the prescribed payments from cash flow generated by the business.

III. Collateral

Similar to the operating loans, term loans are to be secured by the assets acquired from the proceeds of same. Again, they will want to ensure that the repayment of the term loan is in line with the life expectancy of the fixed asset(s) being used as collateral.

How Much Financing Capital Is Required Based On The Business Plan?

The question is not "How much can I borrow?" but, "What is the amount of capital financing required based on the business plan requirements?" In other words, how much total capital will be required to operate the business successfully through the first three years of operations?

It is important to remember that the business will require sufficient resources to withstand start-up expenses and the initial operating phase during which losses are likely to occur.

Generally speaking, the business will be required to inject between one-third and one-half of the total capital required. In addition, contingency funds of an additional one- quarter should be in place to compensate for any losses in the first 1 to 2 years.

How long does the cooperative require the capital financing?

The length of the capital financing is determined by the type of asset being financed. For example, capital required to purchase land and buildings generally have a 2-15 year repayment, whereas equipment and machinery generally have a 2-7 year repayment. It is important to remember that the longer the capital asset is financed, the more interest will be paid to the financial institution, increasing the overall cost of the project.

How will the business generate sufficient cash flow to repay the loan?

A clearly defined business plan which is based on documented statistical information that shows when, where and how much the business will generate to pay debt is one of the most important aspects of a business plan to take to a lender. Financial institutions are not willing to invest considerable amounts of time considering financing proposals where there is not a clear source of cash flow to repay debt.

What are the collateral security requirements?

There are several types of security which may be required by the financial institution:

- Land mortgage – a specific charge on land and buildings.
- Chattel Mortgage – a specific claim on equipment, machinery, vehicles and other items that are not attached to the land. *The Personal Property Security Act* provides an interest in personal property which secures

payment or performance of an obligation. Types of security agreement under *The Personal Property Security Act* is as follows:

I. Specific Security Agreements: allow the financial institution to take security
where specific items are being acquired and or to secure a line of credit.

II. General Security Agreements: allow the lender to take a charge in all present and future acquired property of the borrower.

The cooperative will need to know the value of the assets which may be taken and may require value of the land and buildings to be supported by an appraisal. Other assets may be required to have their value substantiated by an third party who is considered to be an expert in the required field.

Will the cooperative be required to provide personal guarantees?

Personal guarantees require the guarantor to be held liable for the debt if the principal borrower defaults on the debt. Guarantees may take the following forms:

- Limited guarantee: limits the amount for which the individual could be held liable.
- Unlimited Guarantee: provides the financial institution with a guarantee of payment of the full amount of the debt plus any legal costs, recovery costs, overdrafts, credit renewals, etc.
- Sole Guarantee: is a guarantee from an individual
- Joint & Several Guarantees: in the case of multiple business owners, joint and several guarantees hold liable any and all of the business owners (individually or in combination) for the *full* amount of the default.

Funding Gap

The funding gap is the amount of money needed to fund the ongoing operations or future development of a business or project that is not currently provided by cash, equity or debt.

Funding gaps can be covered by member investment, share offering, or through debt offerings and bank loans. Most often used in context with early-stage companies during the initial stages of research, product development and marketing.

The ease with which a very young cooperative receives funding depends on many factors including the viability of the business model, barriers to entry for that particular industry, and overall economic and market conditions.

Funding gaps are also more likely at these early stages because a cooperative won't know what its full operating expenses will be until it reaches a more mature stage and, at first, there aren't likely to be any meaningful revenues coming in.

Working with Lenders

1.) Selecting the right financial institution

Selecting the right financial institutions at the start of the financing process can speed the process, reduce frustration and make the start up process much smoother. It is important to know that each financial institution prefers different types of

It is important to determine the experience of the commercial lender within the institution and his/her experience within the industry. The average size of the transaction that the financial institution usually finances is also important. Some financial institutions prefer financing cooperatives that are very large while others like to finance cooperatives that are small to medium size.

financing. Some prefer to focus on traditional real estate loans, term loans or leases within standard industries. Others may emphasize equipment loans or ongoing lines of credit. And still others will specialized in knowledge based financing, or specific industries or industry segment such as financing drilling companies within the oil and gas industry.

In addition, each individual financial institution and commercial lender within the financial institution may have a different attitude towards risk. Some financial institutions have a mandate to assume more risk; an example is certain government lending institutions. Determining the industry, industry segment and amount of risk the project will entail and matching it up with the right financial institution is a key to finding the right financial institution for your needs.

2.) Preparing for the financing interview
Getting your loan request approved depends on how well the management of the cooperative present themselves, their business plan and their financial requirements. It is important, in presenting a financing proposal, to know every aspect of the business plan, be able to articulate the key aspects of it concisely and be able to answer any questions that the financial institution presents. Avoid statements that are not substantiated within the business plan.

3.) Financial Institution Approval Time
Knowing how long it will take to get for the financial institution to analyze the business plan and provide an approval is critical. However, the process is not always completed quickly; it can take several months for the security documentation to be prepared, signed and registered. Knowing the time it will take to complete the process will allow the cooperative to apply early and ensure that the funds are available when they are needed. This also demonstrates to the financial institution the cooperative's ability to plan.

4.) Informed the financial institution of changes to business
It is important to communicate with the financial institution any changes to the business that may affect its ability to repay Financial institutions do not like surprises, and expect you to anticipate any problems before they occur. Lenders are highly regulated, and their procedures may not allow instant response to "emergency" situations. Have the financial institution visit the business and explain any unique processes or procedures or expansion plans. The better they understand your goals and the unique circumstances of your business and your location, the more likely they are to want to do business with you.

5.) A Lender's Perspective on Making a Loan
The discussion below examines the lender's perspective of the borrower, the business, the loan itself and the circumstances surrounding the loan and the business.

1. **Management**: Years of experience are not necessarily indicative of good management ability. Ability is reflected in the business's accomplishments over a period in which experience is gained. Managing a business requires the proper use of human, physical and financial resources available, planning for the future, and responding and adapting to change. Does the cooperative have a thorough understanding of the market and industry in which they will be competing? Does the borrower have industry contacts and know the industry players? Does the individual have experience in starting and running a business?

2. **Character**: Does the cooperative management team display characteristics of honesty, fortitude and integrity? Is it willing to provide accurate information, cooperate on an ongoing basis and be transparent about problem areas? Does the management team convey information clearly and will they create harmonious relations with lenders, clients, supplier and staff?

3. **Capacity**: Is the cooperative committed to the business venture and willing to do what is necessary to make it successful and repay the loan? Can the management tam generate the cash flow and profits that are stated on the cash flow projection?

4. **Economic & Business Conditions:** Economic conditions both general and those specific to the business's market, will have an impact on a cooperative's ability to repay debt. Financial institutions consider the following questions when assessing a cooperative as a potential borrower: What are the present general economic conditions, and what will they be like in the near future? What are the local, regional, national and international economic conditions now and what will they be like in the near future? What impact, if any, will these factors, and their anticipated changes have on the business now and in the future?

5. **Financial History:** Does the cooperative have a track record of successfully starting new businesses? Does the cooperative have a track record of loan repayment?

6. **Unforeseen Circumstances:** The key questions that financial institutions ask regarding unforeseen circumstances are:

   - Is the business sufficiently capitalized to withstand a short- to long-term problem?
   - To what additional resources does the cooperative have access?
   - What risk management strategies are in place to help mitigate the risk?
   - Are there contingency plans in place to mitigate risk?
   - Can the business take on additional debt and maintain a reasonable debt-to-asset ratio?
   - Is the business positioned to adequately meet its loan repayment requirements along with covering the other financial demands of the business?

DISCLOSURE AND FINANCING – LEGAL REQUIREMENTS

As with all business entities, cooperatives require financing of some nature to launch their endeavours. The financial requirements of cooperatives in Manitoba are governed primarily by *The Cooperatives Act*, Cooperatives Regulation, *The Securities Act* and the Securities Regulation.

Exemption Order:

In 1999, Manitoba Securities Commission issued a blanket exemption order from *The Securities Act* that allows the offering of securities pursuant to *The Cooperatives Act.*

Offering Statement:

The cooperative will be required to prepare and deliver an Offering Statement for the sale of a security. A security cannot be issued for sale to the public in Manitoba unless an Offering Statement has been approved, by the Financial Institutions Regulation Branch (FIRB), to authorize the sale of that security.

The Offering Statement provides a potential investor with information on the cooperative issuing the security, the details of the investment and the purpose for which the funds are being raised.

Sale of securities cannot begin until the Offering Statement is approved by the Director of the Securities Commission and a receipt is issued to the cooperative.

Contents of the Offering Statement:

The Offering Statement must include the information listed below. Specific details and requirements are found in the *Manitoba Securities Commission MSC Rule 2007-15F1: Form 41-101F1 Information Required in an Offering Statement*, and the Manitoba Securities Regulations.

1. Cover Page Disclosure
2. Table of Contents
3. Summary of Offering Statement
4. Corporate Structure
5. Describe the Business
6. Use of Proceeds
7. Dividends or Distributions
8. Management's Discussion and Analysis
9. Earnings Coverage Ratios
10. Description of the Securities Distributed
11. Consolidated Capitalization

12. Options to Purchase Securities
13. Prior Sales
14. Escrowed Securities and Securities Subject to Contractual Restriction on Transfer
15. Principal Security Holders and Selling Security Holders
16. Directors and Executive Officers
17. Executive Compensation
18. Indebtedness of Directors and Executive Officers
19. Audit Committees and Corporate Governance
20. Plan of Distribution
21. Risk Factors
22. Promoters
23. Legal Proceedings and Regulatory Actions
24. Interests of Management and Others in Material Transactions
25. Relationship Between Issuer or Selling Security Holder and Underwriter
26. Auditor, Transfer Agents and Registrars
27. Material Contracts
28. Experts
29. Other Material Facts
30. Rights of Withdrawal and Rescission
31. List of Exemptions from Instrument
32. Financial Statement Disclosure for Issuers
33. Credit Supporter Disclosure, Including Financial Statements
34. Exemptions for Certain Issues of Guaranteed Securities
35. Significant Acquisitions
36. Probable Reverse Takeovers
37. Certificates

Fees:

The fees for filing an Offering Statement, or further Offering Statement is $200.

Disclosure and Financing – Legal Requirements

Common shares are shares issued by the cooperative that have no special preferences, rights, conditions, restrictions, limitations or prohibitions affixed to them as prescribed in the cooperative's Articles of Incorporation and By-laws. The Articles will establish the number of common shares that can be issued and their fixed price or "par value".

1) Common shares may only be sold to members of the cooperative.
2) Members can only resell common shares back to the cooperative.
3) A membership will provide the shareholder with the right to one vote, regardless of the number of common shares that may be held, at a meeting of members, to elect directors or vote on cooperative business.
4) Holders of common shares also have the right to receive interest or dividends declared by the cooperative and, in the event of dissolution of the cooperative, a share in the remaining property of the cooperative.

5) Patronage dividends may be paid to members holding common shares of a cooperative as determined by the Board of Directors.

6) A by-law may be created to stipulate that, rather than a patronage dividend payment made in cash, the dividend, in whole or in part, may be used to purchase additional common shares for that member.

7) A bylaw may be created to require that, if the cooperative's surplus for the year results in a patronage dividend for each common share holder that is below a certain dollar amount, then the patronage dividend would not be paid to the member, but rather retained by the cooperative and used as the board of directors sees fit.

8) The cooperative may enact a by-law that would require its common shareholder members to lend to the cooperative, in whole or in part, the patronage dividend payable to the member. A provision in the by-laws would also have to be made for repayment of that loan back to the member.

9) If a member terminates membership in the cooperative, any shares purchased for the member through the application of patronage dividends will be purchased back from the member by the cooperative.

10) If any patronage dividends were set up as a loan to the cooperative, all such loans would be repaid to the member by the cooperative.

11) Because a cooperative is incorporated, the directors, officers and shareholders of the cooperative are protected from the obligations and debts of the cooperative.

Director Liability:

Shares:

- With regards to the issuance of the cooperative's shares, the directors have the authority to approve a resolution to issue shares of the cooperative in exchange for goods or services rather than cash.

Wages:
If a cooperative has not paid the wages or salary of an employee of the cooperative for a period not exceeding six (6) months, the directors of the cooperative during that period may be held jointly and severally responsible for payment of those wages or salary.

Director's Conduct:
A cooperative may indemnify a director or officer of the cooperative who, while acting on behalf of the cooperative as a director or officer of another organization of which the cooperative is a member, shareholder or creditor, results in a civil, criminal or administrative action or proceeding against that individual.

Insider Trading:
Directors and officers of the cooperative may also encounter liability for insider trading of securities of the cooperative.

Reporting Inaccuracies:
Where a report, return, notice or other document required by *The Cooperatives Act* contains untrue statements, or omits information of a material nature, the person preparing the report, or assisting in it is guilty of an offence and liable, upon conviction, to a fine up to $5,000, imprisonment for a term up to six (6) months or both.

Misrepresentation of Information:

Directors or officers of the cooperative may also incur liability, where a misrepresentation is contained in any of the following documents, and a purchaser of the item in the document was influenced by the misrepresentation to purchase the item:

- Offering statement for a security.
- Offering memorandum for a security.
- Take over bid circular.
- Director's circular.
- Issuer bid circular.

Director's Insurance:

The cooperative may choose to provide protection for such situations, for their directors and officers, by maintaining Directors' and Officers' Liability Insurance against any liability incurred by their directors and officers while acting on behalf of the cooperative.

Annual Reporting:

- The cooperative is required to prepare an annual return in a format approved by the Registrar by a date specified by the Registrar.

Annual Financial Statements:

The Registrar:

The following documentation must be prepared by the cooperative:

- Comparative financial statements for the relative financial period
- The report of the auditor of the cooperative*
- Any other pertinent information on the financial position of the cooperative
- Details of the results of operations required to be reported by the cooperative's articles, by-laws or a unanimous agreement of the cooperative

* The Act section 264 allows non-distributing cooperatives to resolve not to appoint an auditor.

This documentation must be made available to its members at the annual general meeting.

The financial statements cannot be published or circulated until:

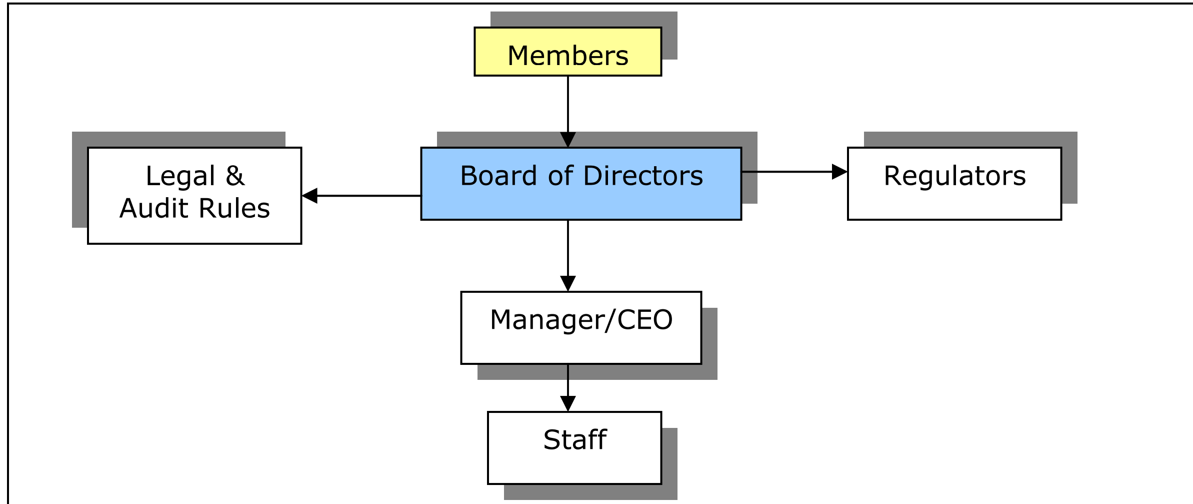
- Approved and signed by the directors of the cooperative, and
- Accompanied by the report of the auditor.

The Superintendent of Cooperatives (FIRB):

Where a security issue of a distributing cooperative under the Offering Statement remains outstanding, the financial statements and auditor's report must be sent to FIRB on the same date they are issued to the shareholders, and not less than twenty-one (21) days before each annual meeting of shareholders.

Responsibility, Accountabilities & Liabilities

Like all corporations, cooperative Boards of Directors are considered to be the "supreme decision centre". All organizations must have one body responsible for direction, decisions and policy. In a cooperative, that body is the Board of Directors. The following diagram outlines the responsibility and accountability of the board of directors:



The board is responsible and accountable for everything that happens in the organization. Hence, the board and its directors can be liable in cases where they act or fail to act (in good faith) in the best interest of the members (shareholders). Common law dictates that directors of corporations are required to exercise the degree of care and skill that may reasonably be expected from persons of their knowledge and experience. Of course in practical terms for reasons of efficiency and logistics, management and staff make day to day operational decisions. The board controls these decisions by controlling the *policies that govern* such decisions.

The manager or CEO is the sole employee of the Board of Directors, and the board hires the manager or CEO to deal with day to day operational decisions required to operate the business of the co-operative. The manager, in turn, hires staff to assist with functions that contribute to the organizational delivery of the outcomes desired by the Board of Directors. The board does have the power to over-rule management decisions, but this generally comes at a cost to board-CEO relationships.

Perhaps the most critical responsibility of a board is to establish long-tem direction. The board establishes the vision, mission, values, and desired outcomes for the organization.

The board also has a responsibility to ensure not only that the organization's policies are legally compliant, but also that the policies enable the vision, mission and desired results to be achieved.

Boards have legal authority under corporate rules to act in accordance with the bylaws approved by the members who elected them.

The Board as an Advisor

The board should and often does act in an advisory capacity to management. Cooperative directors are elected from the cooperative consumer base, so they have collective and individual insights that are valuable in planning and decision making. Theoretically at least, the directors should provide a close link to the membership and be a great sounding board for management when it comes to products, services, facilities and change initiatives.

The board sets out a policy framework within which the management and staff are required to generate the desired results. The General Manager/CEO is generally given freedom to manage activities within the framework and held accountable for the results.

The Board as Trustee

A cooperative can have many stakeholders, including its members, creditors, employees, suppliers, trade associations, communities, industries and other cooperatives.

The Board of Directors must safeguard the organization's assets on behalf of the owners and sometimes for other stakeholders. The board must ensure that the cooperative operates in accordance with "sound business practices", consistent with the type of business being conducted. The board must ensure that operations are compliant with GAAP (Generally Acceptable Accounting Procedures). The board is also morally and ethically required to ensure that the organization is operating in a manner that will achieve the ends desired by its members, adhering to sound financial management practices and operating within the policies set out by the board.

To achieve this trustee function, the board relies on annual audits, internal audits, external reports, internal reports, questions and queries for reasonable assurance. The board also has the right to follow up any concerns in a manner sufficient to determine compliance. Most boards have audit committees, and more and more cooperatives are using internal audit programs to assist them in this area of responsibility. To achieve independence, the internal auditor must report to the Board Audit Committee, not the CEO or manager.

The Board as Caretaker

On behalf of the members (and other stakeholders) the board is charged with the responsibility of ensuring the long-term success and sustainability of the organization. The board hires and manages one employee, the CEO/general manager. Aside from ensuring that the selection process is effective, efficient and conducted properly, the board must also ensure that there is a succession plan in the event of sudden or planned departure of the CEO/general manager. The board must also satisfy themselves that similar succession plans are in place for other key positions required to ensure the safety and soundness of the operation.

Governance

Co-operative governance is about defining (on behalf of the member/owners) what is to be achieved, for whom and at what cost. Once that is defined, the board's

attention shifts to enabling the results and monitoring progress. It is critical that the board speaks with one voice when it comes to direction. Where this is not the case, the results can be chaos or even failure.

As obvious and simple as this sounds, achievement is difficult. It has been said that "If you don't know where you are going, you'll probably end up somewhere else"

Boards need to be aware that "What gets measured (or paid attention to) gets done," so boards need to be careful what they choose to measure and scrutinize. More importantly, the board must agree on what will be measured.

The CEO/general manager is accountable only for that which the board can agree upon. The board must put its expectations and the key targets against which the expectations will be measured in writing.

(attributed to Yogi Berra).

The CEO/general manager cannot be held accountable where there is a lack of consensus. That collective direction forms the basis against which performance (including CEO and organizational performance) will be measured; consensus is essential. Boards can debate all of the issues during the planning process, but in the end, the Board of Directors must speak with one voice.

Director Education

It is clear that all directors need an understanding of cooperative values and principles as well as training in governance. Co-operatives should have a formal orientation program that graduates into ongoing training.

- Orientation for new boards and incoming board members should include cooperative principles, values and an understanding of cooperative philosophy. The exposure needs to include the history, vision, mission, values, goals and objectives of the particular cooperative being served. From this backdrop, a new director would move into governance training, including the governance techniques and reports used to fulfill that responsibility. Orientation may take several sessions, but in the end it should provide a fully competent director for the board.
- Governance training should be ongoing, both in the boardroom and externally. Externally, governance conferences, related trade conferences, trade association involvement and governance model training are worthy director pursuits, as are personal development opportunities.

  Board functions and meetings should include regular updates of governance policies, which include policies that outline how the board will function and how it will manage its relationship with the CEO/general manager.

  Directors come from varied backgrounds and have varied experience. Much of what is required of them by way of monitoring and decision making can be overwhelming. Best practice boards regularly provide training specific to the meaningful interpretation of complex reports such as financials, benchmarking and trending. They also provide training on special items or concepts on which they will be asked for decisions.

- Often overlooked in cooperatives is the need to provide director training on the *actual products and services provided by the cooperative*. This may sound obvious, but it needs to be addressed, not only for existing directors, but also to orient new directors. Periodic updates on industry issues are also important. A board member may have significant experience in management, but none in your actual business line. It is difficult to manage a business that you know little about.

Most trade associations and National co-operative associations offer significant director training opportunities. Training opportunities covering governance in general are also applicable and widely available at various sites such as the Manitoba Quality Network (QNET), universities or colleges throughout Manitoba.

Roles & Responsibilities Board & Management

Although the board is responsible and has full authority, it can delegate some of its authority to the CEO/general manager, as an employee of the board. The board must still assume ultimate responsibility for the actions of a CEO. The board and management must function as a team for maximum results. The following table seeks to show some of the common role differences between boards and management:

Roles & Responsibilities Board & Management		
Item	**Board**	**CEO/General Manager**
Accountability	- To Members	- To Board
Decisions	- Long Term Decisions Ideas Affecting Direction	- Short Term - Operational and Action
Policies	- Create Governance Policies - Create Board/CEO Policies - Approves Operational Policies	- Provides Policy Advice - Prepares Draft Policies for Board Review - Operates within Polices
Direction	- Vision	- Provides resource and Advice
Planning	- Strategic Planning - Reviews & Approves Management Plans	- Provides Advice and Information - Short- term Plans, Strategies, operational and Tactical
Budgets	- Reviews & Approves	- Prepares Budgets
Goals	- Approves	- Proposes Goals
Succession Plans	- For the Board - Of the CEO/General Manager	- For Management and Staff
Job Description	- For the Board & its Directors - Of Committees - Of the CEO/General Manager	- Of Employed Personnel
Performance Standards	- For the Board & its Directors - Of the CEO/General Manager	- Of Employed Personnel
Authority	- Over the CEO/General Manager	- Of Employed Personnel

As you can see, to manage a successful cooperative, teamwork is necessary and desirable. The relationship between the board and management will vary with size, complexity and maturity. It can also vary from one governance model to another.

What does not vary, however, is the ultimate responsibility and accountability of the board.

Fiduciary Responsibility

Directors of all corporations, including cooperatives, are charged with investing in calculated risks and doing all in their power to protect the interests of investors. The difference for most cooperative directors is that they usually live in the communities affected. Fiduciary responsibility in essence means that a director will act for the benefit of the cooperative, even when the right decision could affect him or her personally in a negative way. It is a responsibility to act honestly, fairly and loyally by putting the needs of the cooperative first.

In addition, the actions or comments of any director may reflect on the board as well as the cooperative. Reputation risk is real and needs to be managed. Directors must keep board information confidential as well as any member information they receive in the course of their duties.

The power directors have is given in the legislation governing cooperatives, by corporate legislation and by the bylaws approved by the membership. Any powers exercised must fall within such limits and decisions must be consistent with the purposes for which such power was granted. A director must not place himself or herself in a position that gives rise to a conflict of interest. (Nor should the board allow any activity that could be remotely interpreted as such by a member or other individual outside of the board.) This would apply to material contracts of any kind where the co-operative is acquiring goods or services from an individual or organization with ties to a director. A board should have policies outlining conflict of interest guidelines including transaction descriptions types of disclosure required and remedies. Most of these policies will not allow a director to participate in any discussion, debate or decision in such instances.

Regulatory Responsibilities

Most cooperatives are regulated in some form. This varies depending on the type of cooperative. For example, a financial cooperative, such as a credit union, will have a differently regulatory regime than a co-operative grocery store, and for obvious reasons. For most cooperatives, there are at least three regulatory areas that require attention:

- Cooperative legislation – annual returns, bylaw approval etc.
- Corporate legislation – annual filing of audited statements
- Other regulatory bodies related to the actual business of the co-operative

The board is responsible to ensure that its actions and policies are legal in every way, and that the business conducted within the cooperative is beyond reproach. Beyond outside regulatory responsibilities, the board must also comply with the bylaws approved by the members. These bylaws outline the timing and nature of meetings (annual or special), the nature of business to be conducted, time frames for board reports to members and so on. The board must comply and operate within these bylaws. The board must also structure itself in accordance with the bylaws that outline executive board positions, mandatory board committees and much more.

Board Development & Performance

A number of ideas were presented above on the topic of director education. These included orientation, on-the-job training on reports and specialized information and providing the board with product and service training. Boards and directors should have job descriptions that outline the responsibilities, accountabilities in a manner

similar to that of employees, and the job descriptions should also outline qualifications required as well as skills and knowledge preferred.

Each director should have a personal development plan that is consistent with the job description. The board should encourage and support such personal development, insofar as it is able. The board should also consider group development such as team-building, planning skills, communication skills; the possibilities are endless. Boards should have a discretionary budget for development purposes. Development may include courses, conferences, retreats (facilitated or otherwise), classes or home study.

Boards and directors (collectively and individually) need to evaluate their performance against the job descriptions and against the objectives set by the board for itself as well as for the organization.

Sound cooperative boards ensure that performance targets are clear, and they evaluate board performance regularly.

The board must act as one, providing direction as one to the CEO/general manager; how well it does that needs to be evaluated. Many boards also ask for an evaluation of the board from the CEO, and some go so far as to ask a team of members to contribute to their evaluation as well. Once the group evaluation is done, boards generally progress to individual evaluation where the questions relate to how well each individual director contributed. For some boards, individual results are collectively reviewed, and for others this is left to self-evaluation. All of these methods can be beneficial.

Introduction to Strategic Planning

Strategic planning

Strategic planning is vital to the success of any business and even more critical for a cooperative, because it involves so many stakeholders. In addition, cooperatives are democratically controlled, so the process needs to bring diverse opinions together in a unified effort to achieve the collective goals and objectives.

Strategic planning is about articulating what the cooperative is to become – in the big picture. Such overriding statements are meant to clarify a number of areas:

- What benefit is to be achieved
- For whom, and
- At what cost

For example: "XYZ Cooperative exists to provide superior _____ products and services for the benefit of _______, in a manner that provides significant benefits and cost advantages."

There are many planning methodologies, but the following example outlines how the concept of strategic planning flows through an entire organization. Whichever methodology a cooperative chooses should follow similar guidelines to ensure alignment throughout the organization

The first step in this approach is to choose a market discipline. This is important because the discipline defines what the co-operative wants to become (be famous for).

Does the organization want to be famous for its operational excellence, its product excellence or its ability to create relationships with its customers?

Selecting any one of the disciplines does not mean abandonment of the others. It simply focuses all of the organization's attention on excelling in that dimension. For example, an organization that selects "Product Excellence" still needs to be operationally competent and customer responsive to remain competitive.

The problem with *not choosing* is that the organization may try to be "all things to all people", and continually shift from one focus to another. The other important factor is that the operating models for each of the disciplines work in opposition to each

other. They conflict. Think of Operational Excellence: in a fast food outlet, the food is quick, inexpensive and you carry it yourself. Can such a business afford to let its operational excellence slide? Product Excellence, on the other hand, would be exemplified by a delicatessen with superb meat and cheese products that people are willing to drive miles to buy. An "Intimate Relationship" focus would be demonstrated in a fancy establishment with a dedicated waiter. Customers have different expectations from the different disciplines.

These expectations are rooted in the dimensions of customer value. A good place to start is to review these dimensions and define what your cooperative wants to be famous for.

Strategic planning can take many forms and have any number of models. The point is that, without vision, the cooperative will fail, and without clear direction and discipline, results will likely be mediocre.

Co-operatives should create a policy that outlines strategic planning activity. The following is a guideline created for credit unions by the Credit Union Deposit Guarantee Corporation (CUDGC). CUDGC is the body that insures deposits at credit unions and regulates them in Manitoba. It has established and communicated Standards of Sound Business practices as a yardstick by which credit unions need to operate.

These guidelines are applicable to and useful for any cooperative venture. Where you see 'credit union', read 'cooperative':

Standards of Sound Business Practices – Link to Strategic Planning

Standard Understand and Fulfill Directors Responsibilities

- Does the Board have a written strategic Business Plan?
- Does the Board approve an annual budget?

Standard Conduct Strategic Business Planning

- Does the cooperative have a written strategic business plan?
- Does the Board have an annual strategic business planning session?
- Has the Board used an external consultant in the last 5 years?
- Does the Board follow up to make sure the CEO develops the operational plans, marketing initiatives, budgets and human resources to meet the strategic plan?
- Does the Board receive reports from the CEO (at least semi-annually) in the credit union's progress toward meeting its business objectives?
- Has the Board defined a mission statement?

Corporate Governance Elements – Strategic Business Plan

- Does the cooperative have a written strategic business plan developed or revised less than two years ago?

Does the strategic business plan identify:

- Areas of risk for the credit union
- Areas of opportunity for the credit union
  a. Business objectives to achieve?
  b. Target dates for each objective?
  c. Capital requirements if objectives are met?

d. Follow-up dates for progress reports?

Performance Planning & Evaluation

Once the overall direction is set (the discipline selected), then appropriate performance objectives and benchmarks that are consistent with the long term vision can be established. Measurement needs to be consistent with the long term vision and goals.

For example, the Relationship discipline might measure flexibility and creativity in solving customer problems, whereas an Operational discipline might measure simplicity and delivery costs. Strategic plans need to result in performance targets that measure progress toward the desired end state.

Management is charged with tactical and operational plans that bring the cooperative to the desired state. The board can measure organizational progress by evaluating such progress, and by evaluating its contribution to such progress.

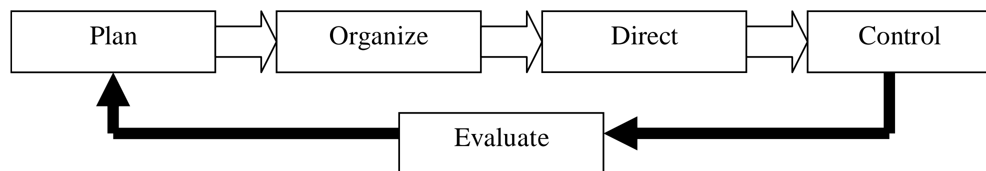
The board and management should be ever vigilant in ensuring that the policies, practices and even the measurements are consistent with what needs to be achieved. In fact, *the entire organization needs to be aware of and aligned with what is to be achieved.* Whether you are a director or a manager, the process or cycle is the same:

Leadership Understanding & Leading Change

Change is not an option; it is necessary and essential for survival. Evolutionary change will occur in any business, and cooperatives are not exempt. Environmental changes, economic conditions, regulatory changes and changes in technology are but a few examples of ongoing adaptation; all organizations are routinely engaged in responding to these changes and creating their own change as a result.

More evolutionary changes come slowly, although less slowly than in the past. They require less active change management than major shifts. Major changes, such as a decision to intentionally change a cooperative's whole culture or market discipline, take years and require significant ongoing change management.

Some significant tools have been developed on the experience and management of change at the Rotman School of Business at the University of Toronto. The following findings are designed to prompt prospective cooperative businesses to seek support from this or other change programs.



The "Experience Change" program contains seven stages:

1. Understand the need to change.
2. Enlist a core change team.
3. Develop vision and strategy.
4. Motivate – Create a sense of urgency.
5. Communicate the vision.
6. Take action.

7. Consolidate the gains.

In a change, participants move through various stages of commitment before a change becomes embedded. These stages include awareness, acceptance, adoption and advocacy. Stakeholders of the change fall into four groups, namely: resisters, bystanders, helpers and champions. It is important to understand where participants and stakeholders are in the cycle.

Personal & Professional Sustainability

Boards, individual directors and managers of cooperatives should strive to keep abreast of changes, best practice and personal development opportunities and should participate wherever possible. Learning is a life-long process, and those who have gained wisdom need to mentor individuals who may someday be called upon to replace them. Engaged boards and management teams are exponentially more successful.

Planning & Project Management

Project management is covered in another section, but from a broad perspective, projects are generally the result of planning. Complex projects should be assigned to individuals who have sufficient project management training and skills for the task at hand. It is important to point out that many cooperatives take on too many projects at once, resulting in delivery failures or partial completion. Stay focused, limit projects to what is achievable and make sure that the project sponsor has a span of control that covers the entire scope of the project.

Cooperation among Co-operatives

One of the key cooperative principles is cooperation among cooperatives. Just as individual cooperatives exist to serve their respective members and communities, the principles of mutual self-help apply to cooperative organizations equally. Cooperatives around the world form a community and have many opportunities to interact and share expertise as well as experience. Most cooperatives have ties to local, national, regional and international associations.

Related Organization Resources

There are countless cooperative organizations around the world. Most types of cooperatives, groups of similar cooperatives and geographic areas have a series of trade and supportive associations. This segment provides some local contacts as well as some national and international contacts specifically tied to the cooperative movement. The Manitoba Cooperative Association (MCA) Inc. provides resources, links and opportunities for cooperation among cooperatives to approximately 150 cooperatives in Manitoba. It in turn belongs to CCA, the Canadian Co-operative Association.

Manitoba Cooperative Association Inc.
Unit C, 3059 Portage Avenue
Winnipeg, Manitoba
R3K OW4
http://www.manitoba.coop

Canadian Co-operative Association
400-275 Bank St.
Ottawa, Ontario
K2P 2I6

http://www.coopscanada.coop

International Co-operative Alliance (ICA)
15, route des Morillons
Grand-Saconnex
Geneva, Switzerland
http://www.ica.coop.html

Conflict Resolution

Cooperatives are by their nature a people business, because they are built on the assumption of cooperation among individuals for the benefit of all involved. A cooperative is made up of individuals and their personalities. While policies, such as conflict of interest guidelines, cover actions both inside and outside of the board, personality conflicts can develop on a board. Cooperative directors are asked to put the organization and the needs of the membership first, rising above personal differences. When a director acts or speaks in a manner that is considered inappropriate, the board Chair, together with the other directors needs to address the situation directly. This is why a set of organizational values is useful. All directors can intentionally hold themselves and each other to behaviours that reflect the values.

Conflict may arise when there is poor direction (incomplete strategic plans, poorly communicated changes and/or a lack of proper policy development).

Where the co-operative has clear direction based on consensus conflict is less likely to occur. Boards must decide what the expectations are and develop appropriate policies that clearly reflect these expectations.

The Role of Policies in Conflict Resolution

Board policies and/or director orientation need to reflect items such as attendance, preparation for meetings, individual use of authority, conflict of interest and how the relationship between the board and the CEO/general manager will be conducted.

Board policy manuals should include the following:

- The governance process, including strategic planning cycles, policy review cycles and the role of governance.
- Roles and responsibilities of board positions (i.e. Board Chair), job descriptions for directors and all board positions including committee positions.
- Terms of reference for all board committees
- Directors' Code of Conduct – including a section declaring that only the Board Chair may speak on behalf of the board.
- A job description for the board's employee – the CEO/general manager
- Policies outlining the Board's relationship with the CEO/general manager, including authority, accountability and performance expectations.

While even the best intentions of individual directors can lead to conflicts, most of the conflicts can be managed with sound policies and a clear sense of what is to be achieved.

Governance Policy Development & Maintenance

The governance policies of a board need to be outlined in a board policy manual under the topic of "The Role of Policies in Conflict Resolution". The governance policies should include requirements for regular review of all policies including those related to governance. It is recommended that a clear policy review schedule be prepared and followed (for example, each meeting can consider one of the policies, whether it is still applicable and whether it is being followed, and what action may be required). It is common for a board to use ad-hoc committees for the development of new policies.

Operational Policy Development & Maintenance

Operational policies direct how to carry out the desired outcomes of the cooperative in practical terms. They govern (practically and operationally) areas such as financial management, human resources, business activities and so on. Development of operational policies is the responsibility of the CEO/general manager, even when such policies require board approval.

Operational policies dictate how day to day business decisions will be made, and must be consistent with the general direction set by the board. They must also enable management to achieve the desired results, so they need to align with (rather than work against) the desired results.

Maintenance activities are important for the business to be able to retain the value of its investments (building, technology and other assets). Management should provide a schedule of maintenance activities to be undertaken as part of operational policy.