

## Financing and Financial Management for Co-operatives

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When individuals join a cooperative, they become joint owners of a democratically-controlled organization established to meet members' shared economic and social needs.

The business structure and operation of a cooperative and a traditional business have many similarities, and both must have a sound financial structure and adequate finances for successful operation. However, they also have three important differences: purpose, the way financial surplus or profit is used or distributed, and the ownership and control structure.

This fact sheet provides an introductory explanation of the basic financial structure and operation of a cooperative. We recommend that you obtain additional information from other sources, and consult the **Canada Cooperatives Act** for all purposes of interpretation and application of the law.

### Cooperative Principles

Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. The *Statement on the Cooperative Identity*, which sets out the seven core cooperative principles, was adopted by the International Cooperative Alliance and is widely accepted by the cooperative movement throughout the world. These principles are the guidelines by which members put their cooperative values into practice. The seven principles are: voluntary and open membership; democratic member control; member economic participation; autonomy and independence; education, training and information; cooperation among cooperatives; and concern for community.

### Benefits for Members

The basic objectives of cooperatives revolve around mutual self-help to benefit members and the community, while the primary goals of privately-owned businesses is profit. As co-owners of a cooperative, members are involved in the enterprise and they control its activities. Their investment in a cooperative can yield both economic and social returns and benefits.

Members may receive a reasonable return on their financial investment, plus other benefits which vary according to the type of cooperative but may include access to goods and services that might not otherwise be available, markets for their products, jobs, and improvements to their social and economic well-being.

Return on investment extends beyond the members. Communities, through local residents, businesses and organizations, invest in their cooperatives and the cooperatives, in return, make

substantial contributions within their communities through local employment, business activity, economic development, and participation in community affairs.

Concern for communities is the seventh cooperative principle, which states "cooperatives work for the sustainable development of communities through policies approved by their members".

## **Start-up Costs**

To start a cooperative, individuals must have clear goals and objectives. Development of a successful cooperative will require both a strong organization and business plan.

Members must have the capacity to finance the start-up costs for the organization's development, feasibility studies and business plans. Money will be needed to cover the costs of the initial planning and development, incorporation, start-up, and ongoing operation of a cooperative.

When the decision is made to establish a cooperative, initial development costs will be incurred even before the cooperative is incorporated. These costs will be incurred as a group examines and assesses its ability to develop, finance and operate the proposed cooperative. Such costs can include fees for legal and financial advice, and consultants' services.

Additional costs may occur if a decision is made to promote a proposed cooperative through methods such as advertising, printed material and public meetings.

Developing cooperatives may choose to hire someone to conduct an independent **feasibility study**, which can give an objective assessment of a project's viability.

The factors studied will vary, depending on the type of cooperative being considered, but can include market opportunities, competition, start-up costs, capital costs, production costs, investment requirements, potential return on investment, personnel requirements, and management requirements and availability. A feasibility study should state whether the project is feasible and, if so, recommend how to proceed and describe the organizational steps needed to establish a successful cooperative business or service.

Having determined that a project is feasible, the decision may be made to hire a consultant to prepare a comprehensive **business plan**, which should clearly identify the purpose, organizational structure and financial structure of the cooperative. The business plan should include a capital financing plan and a marketing plan.

A **capital financing plan** identifies the amount of money needed to finance a project as described in the feasibility study, and potential sources of the necessary capital. A **marketing plan** analyzes the potential market for the cooperative's goods and services.

Financial costs will also be incurred when the cooperative is incorporated. Fees must be included when the incorporation package is submitted. The incorporation package includes the *Articles of Incorporation*, a *Notice of Registered Office* and a proposed set of by-laws. When a cooperative has been incorporated, money will be needed to start operations. Start-up capital expenses will vary, depending on the type of cooperative, but can include the costs of building rental or renovation, office furniture and supplies, tools and equipment, machinery and vehicles, insurance, and initial stock. When the cooperative is operating, working capital will be needed to conduct its day-to-day business. Ongoing costs can include the mortgage or lease, utilities and building maintenance, taxes, insurance, stock and equipment, product packaging and transportation, equipment maintenance, and wages.

A **first-year operating plan** is essential for a new cooperative, and should include a cash flow projection detailing the amount and timing of all anticipated expenses and revenue (income) for that year. Within the first year of operation, it should be possible to identify a general pattern of cash flow and surpluses generated in a given period after all income is accounted for and all cash expenses (after taxes and before depreciation) are paid. The decision may be made to develop a **capital reserve** (a financial cushion) to help cover costs during periods when expenses are expected to be high. A three- to five-year operating plan should be developed, reviewed annually, and revised as needed.

## How Cooperatives are Financed

Cooperatives need money to start operations, to expand and diversify, and to modernize facilities. When the amount of money needed for the project has been determined, the cooperative should identify the best sources of capital and the desired amount from each source.

These sources include common and preferred shares, other types of securities, member loans, and loans from financial institutions.

A **prospectus** is necessary before a cooperative may sell securities unless an exemption is granted. The purpose and intent of a prospectus is to provide potential investors with sufficient information which, on reading, will permit them to make informed decisions on the securities being offered by a cooperative. When the prospectus has been approved, it must be given to all prospective buyers of the cooperative's securities.

**Common shares** include any share issued by the cooperative to which the Articles and by-laws attach no special preferences. They are sold only to members, and usually a member must purchase a defined number as a condition of membership as stated in the by-laws. Membership gives the person the right to one vote regardless of the number of shares held.

The number of common shares that a cooperative may issue, and their par value (fixed price), is stated in its Articles. Members may resell their common shares only to the cooperative, and at a price not greater than the par value, unless the cooperative's by-laws provide otherwise.

Historically, the amount of equity raised by cooperatives through shares sold as a condition of membership has been minimal, usually less than \$1 000 per member. Today, cooperatives emerging in sectors such as agricultural value-added processing are raising substantial proportions of their total capital requirements in the form of equity linked to membership.

These cooperatives generally require members to purchase common shares that provide rights and obligations to deliver a prescribed amount of produce, livestock, etceteras to the cooperative for processing. Membership is limited to the availability of delivery rights/obligations. More information is provided in the *New Generation Cooperatives for Agricultural Processing and Value-Added Projects* fact sheet and development guide produced by the Saskatchewan Cooperatives Directorate.

As members, common shareholders are entitled to receive **patronage dividends** that may be allocated by the Board of Directors. The amount of this dividend is in proportion to the amount of business the member does with the cooperative. Patronage dividends can be paid in cash or in the form of additional shares. In a worker cooperative, patronage dividends are normally based on hours worked and, in effect, increase the members' wages.

Dividends or interest may also be paid on common shares but at a rate not higher than the rate prescribed. Earnings are distributed to members who are common shareholders.

The Act also provides for cooperatives to issue **preferred shares**. These shares normally have special preferences, rights, conditions and restrictions. They generally have a defined rate of interest and receive dividends in preference over common shares. Preferred shares normally provide members with no additional voting rights. However, the by-laws of a cooperative may provide for preferred shareholders to elect a defined number of directors in the event that the cooperative is in default of any term or condition of the share issue.

Preferred shareholders are entitled to vote separately as a class with respect to the sale, lease or exchange of all or substantially all of the property of a cooperative other than in the ordinary course of business where preferred shareholders are affected in a way that is different from ordinary shareholders. In such cases, preferred shareholders may vote on the basis of the number of shares they hold.

Other securities, including bonds and debentures, may also be issued by a cooperative and sold to members and non-members. They provide holders with no voting rights or special privileges.

**Debt capital** includes lines of credit, loans and mortgages from financial institutions. This financing method provides necessary capital at defined rates of interest and terms for repayment. Interest rates and payments are generally fixed and do not relate to the cooperative's economic performance.

The cooperative may have to offer security of real property (such as the mortgage on land or equipment) to obtain the loan, and the cost of borrowing may reduce earnings and patronage dividends to members.

Members may be required, or volunteer, to lend money to the cooperative to help finance capital purchases or operation. The terms of these loans are set by the Board or Directors. Compulsory loans must be approved by members.

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