Financing of Co-operative Societies

THE EXPERIENCE OF LEICESTERSHIRE

by

J. M. DALE
(Financial Controller,
Leicestershire Society)

Adequate funds are required to finance the development of our business both in terms of capital expenditure and 'working capital'. The term 'working capital', in this context, is intended to embrace stocks plus debts due from credit customers offset by credit extracted from suppliers. In this short article, I shall attempt to -

1. describe our main sources of finance and indicate how they have changed over the ten years ended January 1979

2. compare Leicestershire's profile with that of retail Societies as a whole, as published by the Co-operative Union in their booklet "Co-operative Statistics"

3. review the sources of capital employed by some of our major competitors, viz. Tesco, Sainsbury and Marks & Spencers

4. highlight other methods which can be used to raise additional funds should the need arise.

1. Our Sources of Finance

The main sources of our funds, in decreasing order of magnitude, as at January 1979 are: (a) Reserves, (b) Share capital, (c) Loans.

It is interesting to compare the profile at January 1979 with the profile at January 1969. The amounts transferred in from Other Societies on merger are shown separately in order to highlight the true net movements within the Leicestershire Society during that ten-year period.

£'000	Share Capital	Reserves	Super. Fund	Loans	Total
As at Jan.69	1958	601	1503	159	4221
	46.4%	14.2%	35.6%	3.8%	100%
Ex other Soc. on merger	1579	525	696	516	3316
Movement in the 10 years 69/79	(781)	4586	(1030)	292	3067
	2756	5712	1169	967	10604
	26.0%	53.9%	11.0%	9.1%	100%

Back in January 1969, share capital represented the source of no less than 46% of the Society's funds but ten years later that percentage had dropped to 26%.

A very significant net outflow of share capital took place during the early seventies, an experience suffered by many Societies. This withdrawal of share capital was, no doubt, in part influenced by the adverse publicity associated with the "MILLOM" affair.

£'000	Year £	Cumulative £
1969/70	(428)	(428)
1970/71	(817)	(1245)
1971/72	(180)	(1425)
1972/73	(38)	(1463)
1973/74	71	(1392)
1974/75	134	(1258)
1975/76	190	(1068)
1976/77	93	(975)
1977/78	80	(895)
1978/79	114	(781)

The main source of additional funds during this ten-year period has been retained profits. Funds generated from this source are interest free. The creation and retention of profits in this ten-year period has added more than £4½ millions to our funds. In January 1979 they represented almost 54% of our total funds compared with only 14% in 1969. A table is given below which indicates how much has been added to reserves each year. It also indicates the extent to which these additions to reserves have been derived from revenue sources:-

MOVEMENT IN RESERVES OVER 10 YEARS

£'000	Total	After crediting profits on sale of fixed assets & investments	After charging special depreciation	Hence net addition to reserves from revenue sources
1969/70	(5)	40	(43)	(2)
1970/71	131	150	(30)	11
1971/72	112	160	(60)	12
1972/73	227	254	(175)	148
1973/74	152	129	(19)	42
1974/75	176	23	(2)	155
1975/76	272	114	(2)	160
1976/77	249	81	(1)	169
1977/78	869	78	(14)	805
1978/79	764	94	-	670
Prior Years Adjustments				
Deferred Tax	1310			1310
Dividend stamps	314			314
Subsidiaries' profits	15			15
	4586	1123	(346)	3809

In the year 1978/79, certain prior year adjustments were made adding to general reserves significant sums in respect of 'deferred tax' and 'dividend stamps'. In accordance with Statement of Standard Accounting Practice No. 15, issued by the professional accountancy bodies, our Balance Sheet provision for deferred tax was significantly reduced and the stock appreciation relief content was transferred to general reserve, and noted on the accounts as a contingent liability. Moreover, part of the provision for dividend stamps which had been built up over a number of years was assessed to exceed our potential maximum liability and hence the excess was transferred to general reserve. In addition to these two items, the accounts to January 1979 were the first ones to be made up on a Group Accounts basis, with the consequence that the profits retained of the subsidiary companies were added into the profits retained of the Group.

It is quite legitimate to add in these adjustments to the increase in profits retained over the ten-year period 1969 to 1979 because the build up of both the deferred tax provision and the dividend stamps provision took place during this ten-year period.

The right hand side of the above chart analyses the profits retained by source into those emanating from revenue profits and those from capital profits and of the capital profits how much has been used specially to depreciate fixed assets.

It is of interest to note that in the early years capital profits were the main source of profits retained. In those early years, the Society was obliged to rationalise after a series of mergers and needed to dispose of some properties to raise finance to help offset the outflow of share capital and to enable the business to embark on a meaningful re-development programme.

The proportion of revenue profits retained to total profits retained has increased considerably over the ten-year period:-

£'000	Total profits retained	Revenue profits retained	Proportion of revenue profits to total profits
	£	£	%
5 years 1969/74	617	211	34
7 years 1969/76	1065	526	49
10 years 1969/79	2947	2170	74
3 years 1976/79	1882	1644	87

A factor which can be deceptive in reviewing levels of profits retained as a source of funds is the depreciation policy adopted. It is worthwhile therefore, to take the same ten-year period under review and set out 'net liquidity cost of developments' comparing capital expenditure with depreciation and comparing the difference with the increase in balance sheet reserves:-

£'000	Capital Expenditure	Depreciation Normal	Depreciation Special	Net Liquidity Cost of Developments	Increase in Balance Sheet Reserves	Net gain or (erosion)
1969/70	(276)	238	43	5	(5)	-
1970/71	(468)	242	30	(196)	131	(65)
1971/72	(631)	236	60	(335)	112	(223)
1972/73	(691)	240	175	(276)	227	(49)
1973/74	(534)	314	19	(201)	152	(49)
1974/75	(702)	315	2	(385)	176	(209)
1975/76	(632)	300	2	(330)	272	(58)
						(653)
1976/77	(509)	397	1	(111)	249	138
1977/78	(1151)	497	14	(640)	869	229
1978/79	(1834)	802	-	(1032)	764	(268)
	(7428)	3581	346	(3501)	2947	(554)
Plus prior years adjustments referred to previously					1639	1639
					4586	1085

Leicestershire Society's depreciation rates have been increased twice in recent years:-

	In 1976		In 1977	
	From	To	From	To
Fixtures, Fittings & Machinery	10%	15%	15%	20%
Transport - Elec. vehicles			12½%	20%
Others	20%	25%	25%	33⅓%
TV sets on rental			16.7%	20%

Depreciation of freehold land & buildings has remained unchanged at 2½%.

It will be seen that these increased rates, together with the impact of additional capital expenditure, has increased the depreciation charge from £300,000 in 1975/76 to £802,000 in 1978/79.

Right up to January 1976, the trend revealed in the above table was an excess of capital expenditure over the sum of depreciation and increases in balance sheet reserves. Two years then followed with the trend reversed, showing a much healthier picture. Regrettably the year to January 1979 produced an erosion again. This erosion in no small measure reflects significant capital expenditure in the Kettering region which has not been translated into additional profits and retentions in the short term.

The overall position can be summarised as follows:-

£'000			Ten years to January 1979
Capital expenditure			7428
Less: Depreciation	: Normal	3581	
"	: Special	346	
			3927
Net liquidity cost of developments			3501
Increase in balance sheet reserves over this ten years period excluding any transfers in from merged Societies			4586

Thus the cost of Leicestershire's capital developments has been more than met by retention of profits.

2. Comparison of Leicestershire profile with that of the Co-operative Movement

The latest figures in circulation at the time of writing this paper are those contained in the Co-operative Union's booklet 'Co-operative Statistics 1977'. The Movement's ten-year record therefore covers the period January 1969 (1968) to January 1978 (1977).

£ millions	Shares	Reserves	Loans	Total
1968	203.9	49.0	151.1	404.0
	50.5%	12.1%	37.4%	
1977	151.4	224.9	183.6	559.9
	27.0%	40.2%	32.8%	
Movement in the ten years	(52.5)	175.9	32.5	155.9

The trend in share capital is very similar to Leicestershire's. Share capital accounted for half the funds ten years ago and now accounts for just over one quarter of the funds.

Reserves have contributed significantly and now represent over 40% of funds in the Movement. (Over 50% in Leicestershire).

Loans accounted for just under 40% of funds ten years ago. Now down to around 30%. In Leicestershire's case, the proportion is down to 20% after ten years. The Movement still relies heavily on Loans. One of the main reasons for this is that most other Societies have not reduced the level of internally invested superannuation funds on the same scale that Leicestershire has done in recent years. Approximately 20% of the superannuation moneys continue to be invested in the Society.

Leicestershire Society does attract moneys on two-year development bonds on which interest rates are fixed for the two-year term. Interest rates are modified from time to time according to

(a) the level of interest rates in the market place and

(b) the Society's desire to attract cash at particular interest levels.

Some £760,000 is currently invested in the Society development bonds at various rates of interest. The latest series have had to respond to the high interest rates available to investors in the market place and offer 12% per annum paid gross twice per year.

3. The Sources of Finance of Some of our Competitors

£'000	Share Capital	Reserves	Debentures & Loan stock	Total
Tesco 24-2-79	16213	164215	368	180736
	9.0%	90.8%	0.2%	100%
Sainsbury 3-3-79	20744	182958	6011	209713
	9.9%	87.2%	2.9%	100%
Marks & Spencers 31-3-79	326264 *	175075	51621	552960
	59.0%	31.7%	9.3%	100%

* includes £162457 capitalised out of reserves in the year to 31-3-79 by way of a scrip issue - no doubt a number of scrip issues have been capitalised out of reserves over the years.

Suffice to say that these Companies:-

(a) are able to raise finance through the issuing of more shares;

(b) have accrued very significant profits retained as reserves, and

(c) raise some cash by way of debentures and loan stock.

These organisations also extract the maximum credit from their suppliers. A review of their balance sheets indicate that amounts due to creditors and accrued charges roughly equate to the value of stocks on hand. To take the first two for their closer comparability with Leicestershire Society particularly in the extent of their food trade:-

TESCO					
£'000	Stocks	Creditors & Accrued charges	Net	Debtors	Total Working Capital
24-2-79	£136601	(152633)	(16032)	3752	(12280)
Feb.78	121076	(108730)	12346	3410	15756
SAINSBURY					
3-3-79	79101	(76759)	2342	7170	9512
Mar.78	58579	(55528)	3051	5420	8471
LEICESTERSHIRE CO-OP					
27-1-79 (incl. KICS)	6427	(6788)	(361)	2960	2599
Jan.78 (excl. KICS)	4687	(4231)	456	2352	2808

4. **Other Methods to Raise Finance or Ease the Financial Burden**

A number of possibilities exist:-

(a) pass on the financing of our credit trade to a bank or finance house.

(b) sell and, as necessary, lease back property.

(c) join a CWS regional distribution centre for groceries and thereby free the moneys tied up in stocks in our distribution warehouse and release the warehouse itself for other use or for sale.

(d) revert to leasing fixtures, fittings, plant & equipment and thereby spread some of the burden of the finance of new projects over approximately five years instead of incurring a larger initial outlay.

(e) bank overdraft facilities or term loans.

(f) adopt a much more aggressive marketing approach to the selling to the public of a whole series of unit loans, income loans, share saver stamps, etc. along similar lines to that followed successfully by CRS Ltd.

General

There is no better alternative to making sure that

(a) sufficient profits are made and retained.

(b) depreciation provisions are adequate.

It is imperative that these two items together, in the medium term at least, equate to the cost of the net liquidity cost of capital developments. Hopefully one's affairs can be arranged in such a way that one's suppliers virtually finance the Society's stocks. There is merit in financing one's own credit sales to customers only if one can generate enough interest to pay for the true cost of the credit sales operation.