Journal of Co-Operative
Accounting and Reporting

OCFAID analysis of the demise of Canada's Dairyland Co-operative

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Abstract

This case study discusses how Operating Cash Flow After Interest and Disbursements (OCFAID) Analysis, if used as an ongoing diagnostic tool by the members of Canada's Dairyland Co-operative, would have provided fully four years advance notice of the impending fiscal cliff, arming members with the facts they needed to save this century co-operative from demutualization in 2001. The benefits of OCFAID analysis apply equally well to private sector firms. This paper describes its importance, as a tool to facilitate meaningful engage-

Introduction

The purpose of this paper is to examine how board members, who are not financially sophisticated, can utilize a financial analysis tool to evaluate the financial health of a co-operative. The financial tool examined in this study is a technique known as "Operating Cash Flow After Interest and Distributions (OCFAID).

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

Methodology

The methodology for this research is comprised of a documentary review of Dairyland/ Dairyworld/Agrifood International Annual Reports (1980-2001) and interviews farmers who were either former directors and/or shippers.

OCFAID: Why This Tool is Needed

To achieve the International Co-operative Alliance (ICA) Vision of co-operatives becoming the first and most compelling organizational choice by 2020, we need to provide members with tools to more effectively monitor financial performance. OCFAID is a useful tool since it provides members with a simple, accessible, and understandable assessment of the financial health of their co-operative.

As co-operatives move to triple bottom line accounting to demonstrate to members their contributions to the community and the environment, and as balance sheets and financial instruments become more complex, member "evaluation" of co-operative performance at each year's annual meeting increasingly reflects the "warm fuzzies" left by the stories of social and environmental payback that appear in Annual Reports and not the financial health of the co-operative.

Ideally, and legally, the first responsibility for fiscal oversight lies with the elected Board of Directors, who are the members' representatives. However, when failure of agency occurs (inability of directors, who are the members' agents, to perform) can bully boards, the members become responsible for fiscal oversight.

If, as ICA Blueprint (ICA. 2014) says, member participation is the most important priority in this Co-operative Decade, the right tool is needed to enable members to participate more meaningfully in the financial oversight

Dairyland – Almost a Century of Co-operation

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

As cheap imports displaced domestic products in local markets, smaller dairies – mostly co-operatives - tried to keep pace by modernizing plants and evolving product lines. Nevertheless, demutualization pressure was strong. There were excellent profits to be made from dominating the Canadian dairy processing market, and global giants like Saputo and Parmalat were looking for dairies for potential mergers. British Columbia's (BC's) Dairyland Milk Producers' Co-operative, which had been in operation for 100 years, fell prey to this wave of predation-demutualization.

Dairy farmers, so good at carefully monitoring the health of their cows - feed uptake, milk production, stool quality, somatic cell count, hoof condition – are no better than any other members in monitoring the financial health of their co-operative. They believe it is the responsibility of the directors to take action on behalf of the members. If directors have problems doing that, it is their job to bring their concerns to the attention of the members at the annual general meeting (AGM) (or before, if serious).

Unfortunately, it is often challenging for directors to detect poor financial performance. Moreover, this problem is certainly not limited to co-operatives. Senior managers acting to maximize individual performance bonuses can often mask financial risk and economic vulnerability, making income statements and balance sheets challenging to understand. Staff come to the meeting armed with technical jargon, and board politics often constrain the ability of directors to mount an effective challenge. The global financial collapse of 2008 is an example of this phenomenon.

Some industry insiders interviewed for this paper argue that the problem emanated from Dairyland's management recommended costly expansion across Canada thereby exposing the co-operative to a highly leveraged financial risk that ultimately proved to be its downfall. Others say the board was at fault - where were they when all this was happening? Many farmers involved at the time claim management did not provide sufficient disclosure to the board, thus making effective challenge of the CEO's practices impossible. Others point to similar dairy co-operative failures (e.g. Australia's Warnambool Cheese and Butter) and say it was inevitable.

At their final January 2001 AGM, members were taken by surprise. The board presented members with a resolution: bankruptcy or sell the co-operative to Montreal-based global dairy giant Saputo at fifty cents on the dollar. Blindsided and seeing no option, they voted to demutualize. As one Alberta delegate to the fateful final meeting explained: "no-one knew what was going on...the board did not keep delegates up-to-date, there was no transparency. Basically, they destroyed the co-operative and Saputo picked it up for a song…"

How did it happen? Unsustainable debt. Why did it happen? Lack of transparency and loss of member control. Farmers and Board members felt they had been kept in the dark and by the time they discovered what was happening, it was too late to take corrective action. Could farmers have saved their co-operative? Is there a tool out there that could have forewarned co-operative members– in a simple and straightforward manner – that they were heading for financial disaster? Is there a tool a very different governance style; he was not prepared to lean on the CEO like his predecessor. And so the CEO basically ran the board, directors were kept in the dark and the membership did what the board told them to do."

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

Also included in the merger was a revolving check-off loan (1% from milk cheques) that provided the co-operative with low cost equity from its members (patient capital, the loans earned modest interest and were repaid in 15 years. Paying out the loan drew down $7-12 million in co-operative capital.

According to industry insiders and former directors at the time, removing member authority over spending approval removed the last obstacle in the path of an expansionary, CEO-led board. Consequently, expenditures continued to climb as additional mergers were pursued. In 1993, Dairyworld was again restructured and Dufferin Employment Co-operative Ltd (Manco) became Dairyworld's Manitoba plant, with 3,000 employees. However, not all board members were in agreement with the merger.

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

In June 1996, merger brought in Dairy Producers Co-operative Ltd. (DPCL) of Saskatchewan and the new company's name changed to Agrifoods International Co-operative Ltd., the new parent company of Dairyworld. The reorganization resulted in a co-operative with 2100 milk shippers (dairy farmers) in western Canada, the largest dairy co-operative in the country. In 1996, sales reached $1.13 billion. In 1997, the co-operative's ice cream division was sold to Nestle.

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

In its 1998 acquisitions, the enterprise paid heavily for intangibles: goodwill represented 50% ($43.8m of the $84.2m) of net assets acquired from McCain's and 79% ($22.5 million of the $28.5 million) of net assets of other acquisitions. All acquisitions were dependent on borrowed finance and the amortization of this goodwill had a significant negative impact on profitability, leaving no surplus for distribution to members.

While the income statement appeared favourable, a different story was in the balance sheet: debt was growing faster than income. Ultimately, it was this debt, and its servicing costs, which resulted in the co-operative's demise. As a result of the 1998 acquisitions, long-term debt rose by 68% ($73 million), and current liabilities rose 55% ($75 million). The cash paid for intangibles caused a sharp drop in net cash flows.

At the January 1999 AGM the CEO — emphasizing the co-operative's assets of $513 million and 1998 sales of $1.2 billion — told delegates how "immensely proud" he was of this "substantial increase in sales and net earnings" that positioned the enterprise for a bright future. The budget was approved by the delegates.

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

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

In a meeting in Calgary in January 2001, with financial statements reporting sales of $1.5 billion, 120 farmer delegates were given the grim news by the Agrifoods Board: the Royal Bank had turned the co-operative down for an operating loan, other banks were refusing to issue loans, and bankruptcy was imminent. Delegates were told there was only one offer on the table – 50¢ on the dollar from Montreal-based dairy giant Saputo. They were "advised to take it" by the Board. According to the interview respondents (farmers who attended that fateful meeting), "a few people knew a lot and many knew nothing. There had been no transparency. Company insiders were the only ones who had the full story. The board knew only what senior management told them and the delegates knew virtually nothing of what was going on…."

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

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

"No-one knew what was going on," reports an Alberta delegate at that meeting. "Delegates

Figure 4: When both are falling, it is a DOG.

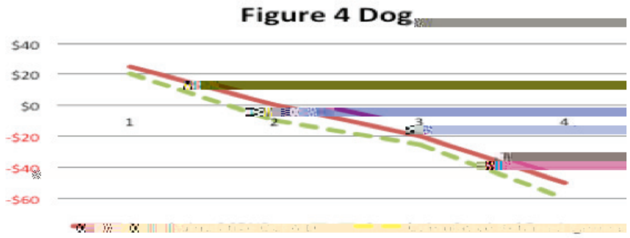
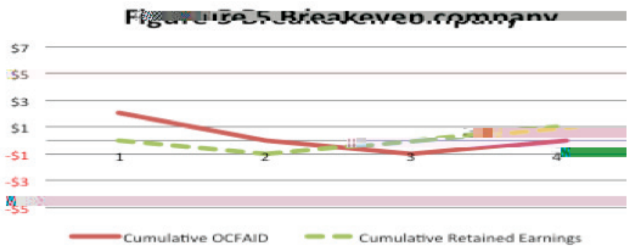


Figure 5: A TURNAROUND (usually under a receiver or a change manager) is when both are neutral as the nature of the entity is reconfigured.



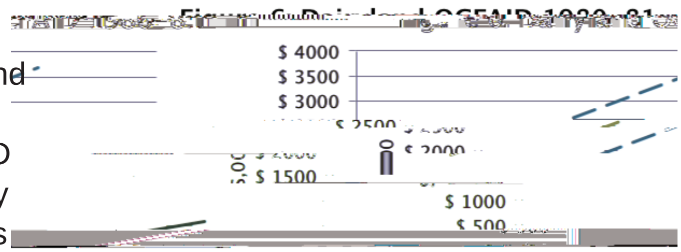
Investor-owned companies, co-operatives, and not-for-profits in New Zealand, Australia, the UK, and the US have applied Robb's OCFAID analysis successfully. It is monitored as a Key Performance Indicator by many boards and is in use by a national firm of chartered accountants to help decide whether a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

To test the effectiveness of Robb's OCFAID model in the Dairyland case, a complete set of Dairyland/Dairyworld financials from 1980-2001 were compiled and analyzed through the model.

Applying OCFAID Analysis to Dairyland

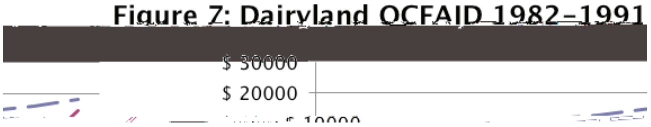
Had OCFAID analysis been used in the boardroom and featured on the cover of annual reports, the changing fiscal health of this co-operative would have been fully transparent to both directors and delegates four years before the co-operative collapsed. This would have had two important benefits: a) it would have provided irrefutable evidence of the deteriorating fiscal health of the co-operative that management would have been powerless to deny, and b) it would have provided this information in time for farmers to take action to save their co-operative.

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

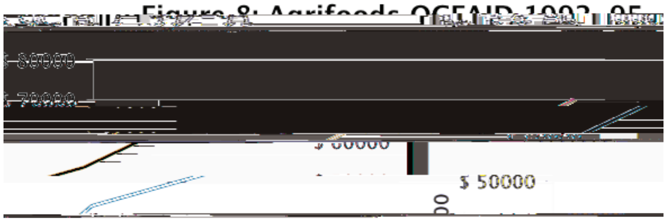


OCFAID analysis (1982-91) following the merger of Fraser Valley Milk Producers Co-operative and Shushwap-Okanagan Dairy Co-operative to create FVMPCA continues to show a "very good trend after an initially poor year of amalgamation…" (Robb, prs. com.)

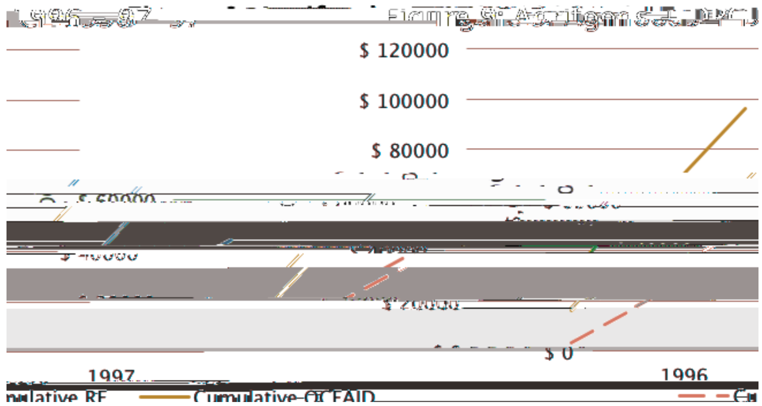
Figure 7: Dairyland OCFAID 1982–1991



OCFAID analysis for 1992-1995 following the merger of Fraser Valley Milk Producers Co-operative Association, Northern Alberta Dairy Producers and Central Alberta Dairy Pool to form Dairyworld Foods continues to show "…a healthy trajectory, even better than the previous period." (Robb, prs com.)



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



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

OCFAID analysis from 1998 onward tells the sad story. By 1999, debt to equity ratio had become 2.9:1 and intangibles represented 66.4% of members' equity. Over the ensuing two years, unmanageable debt brought this fine, close to century old co-operative to its knees. It was toppled by a vote of the members in 2001.

Since 2001, a number of small dairies across Canada were acquired and shut down by Saputo; two Alberta plants in Wetaskiwin and Glenwood were closed in 2014. In 2014, Saputo is the third largest cheese maker in the US and one of the top 10 dairy processors in the world, generating about $9.3 billion of annual sales and employing 13,000 people. With plants in Canada, the US, and Argentina, Saputo has acquired Australian giant Warnambool Cheese and Butter after fierce and costly takeover battle with Australia's largest processor, dairy co-operative Murray Goulburn.

Conclusions

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

Ultimately, Dairyland did not have the opportunity to expand globally. Its potential to follow in the steps of Goulburn and others was curtailed by unacceptable levels of financial risk that delivered this once-strong co-operative to the private sector.

If dairy farmers in western Canada had been able to exercise effective fiscal oversight, Dairyland would today remain in member hands and be planning for its centenary. OCFAID analysis would have given them that clear and crisp ability: an irrefutably transparent diagnostic that gives a clear reading of financial health.

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