

- BASIC ECONOMICS OF A CONSUMER CO-OPERATIVE
a learning element for staff of consumer cooperatives

international labour office, geneva

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by Urban Strand



MATCOM
Material and techniques for cooperatives management training

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In collaboration with cooperative organizations and training institutes in all regions of the world, MATCOM designs and produces material for the training of managers of cooperatives and assists in the preparation of adapted versions for use in various countries. MATCOM also provides support for improving the methodology of cooperative training and for the training of trainers.

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BASIC ECONOMICS OF A CONSUMER CO-OPERATIVE

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HOW TO LEARN

- Study the Element carefully.
- Write down answers to all the questions in the Element. This will help you not only to learn, but also to apply the knowledge in your work at a later stage.
- After studying the Element on your own, discuss it with your instructor and colleagues, then take part in practical exercises organised by your instructor.

PREREQUISITES

- To benefit from this Element you should be able to perform simple percentage calculations.

TRAINER'S NOTES

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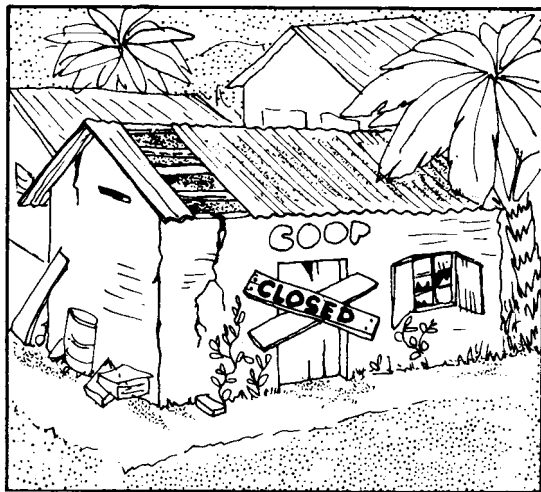
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INTRODUCTION

How is it that co-operative shops, which start under more or less the same conditions, develop differently?



Some shops immediately become very popular and their members are very happy with them. They often start out in small buildings, selling only a few items, but steadily improve and develop into larger shops where the members can buy almost everything they need.



Other shops may do well at first, but soon get into trouble. The members, who had hoped that the variety of goods in the shop would increase, find instead that there are fewer and fewer goods on the shelves. In the end there is very little to be bought in the shop, the money runs out and the shop goes out of business.

In this Learning Element you will study the work of some co-operative shops. From their success or failure you will learn:

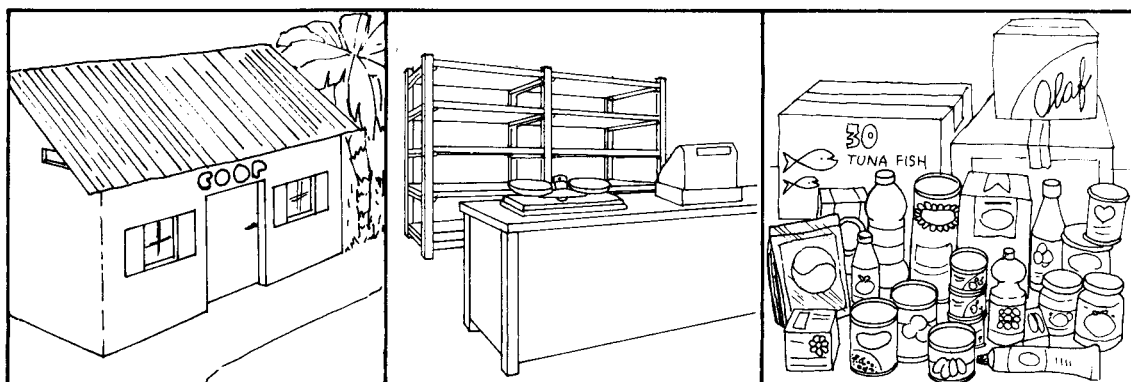
- How money is raised and used in a co-operative.
- Why a surplus is necessary and how it is created and used.
- How to increase the surplus.

Compare with the list of contents on page 1.

MONEY TO START THE SHOP

A lot of money is needed before the first customer even enters the shop. What is it needed for and where does it come from?

- The shop premises themselves, whether bought or rented, are expensive.
- Money has to be spent on equipping the shop with shelves, a counter, a set of scales and all the other necessary equipment.
- Finally, a stock of goods has to be bought.



When people decide to start a co-operative shop, they may collect the necessary capital or money to start and run the shop in several ways.

- All those who want to become members have to let the co-operative use some of their money as capital. Usually most of the money the members put in is called SHARES or SHARE CAPITAL.
- The co-operative may apply for a loan from a bank.
- The co-operative may ask for loans or contributions from various development funds or similar sources.



Where did you collect the money from to start your co-operative? How much did the members contribute?

Benev is the name of a small village, where the people formed a co-operative society in order to run a shop. This is how they collected capital:

Contributions from a Development Fund	T\$ 5,000*
Share capital, contributed by the members	10,000
Loan from the bank	15,000
	<hr/>
Total	T\$30,000

This amount was sufficient to start a small shop, because the members did a lot of work themselves without payment. They built the shop and made the furniture, paying only for the material. This is how they used the money:

Materials for the shop building	T\$ 3,000
Equipment for the shop	6,000
Goods	15,400
Cash remaining	600
	<hr/>
Total	T\$ 30,000

* We use an imaginary currency here, because this booklet is used in many countries. We call it "Training dollars and cents" (T\$ and c).

WORKING CAPITAL

The Benev Co-operative Society started with a capital of T\$30,000.

T\$14,000 were spent on a shop building and its equipment. These **FIXED ASSETS** were expected to last for a long time. They represent the society's **FIXED CAPITAL**.

Of the remaining T\$16,000, most were used to buy a stock of goods for the shop.



They sold goods to the members and received payment. In this way they got some money back.



When the stock of goods became low, they bought new goods, and used the money again.



Trading continued. They collected money for the goods they sold, used it to buy new goods to refill the shelves, and so on.....

The capital which is not used for the fixed assets is called the **WORKING CAPITAL**. It consists of the money which is available plus the stock of goods.

Therefore, there should be more money available when the stock is low, and less when it is high. It is the working capital that makes the trading possible.

All successful businessmen are careful not to waste their working capital, or spend it unwisely. This sad little story from Akiba will show you why this is necessary.

● The Akiba Co-operative made a very good start. In a few days they had sold goods for T\$8,000. The committee members were very excited to see all this money in the cash box. Someone suggested they use some of it to buy a freezer. So T\$2,000 was used for this purpose.

● That left T\$6,000 to buy new goods. It was not quite enough to refill the shelves completely. The stock was now a little bit smaller.

● Nevertheless, trading continued and they got some more cash for the goods they sold. Unfortunately, the committee members knew nothing about shop management and could not resist taking money from the shop and spending it on buying more equipment. This time they bought a modern weighing machine.

● So the working capital was reduced even more and turned into fixed capital. It was not possible to refill the shop with as many goods as in the beginning, because of lack of capital. The members found a lot of empty shelves, lost interest, went elsewhere and eventually the shop had to close.

● And the reason for this sad state of affairs was, of course, that the working capital had been used for other purposes than buying goods. It is true that it was a good idea to have the shop better equipped, but when they took the money from the shop's working capital they made a serious mistake, and they ruined their co-operative.



From this we can see that it is extremely important not to let the working capital decrease. It must be there all the time, not only in the beginning, but for as long as we want the business to continue.

MARGIN

The Benev Co-operative used their working capital to buy goods for the shop.

For instance, they bought tea from a wholesaler. The cost for each packet was T\$3.15, freight cost included. This is what we call the COST PRICE.

Suppose now that the Benev Co-operative sells the tea to the members at the same price. In this way the co-operative gets back its working capital and can buy more tea. We know that the working capital must be used to refill the shelves.

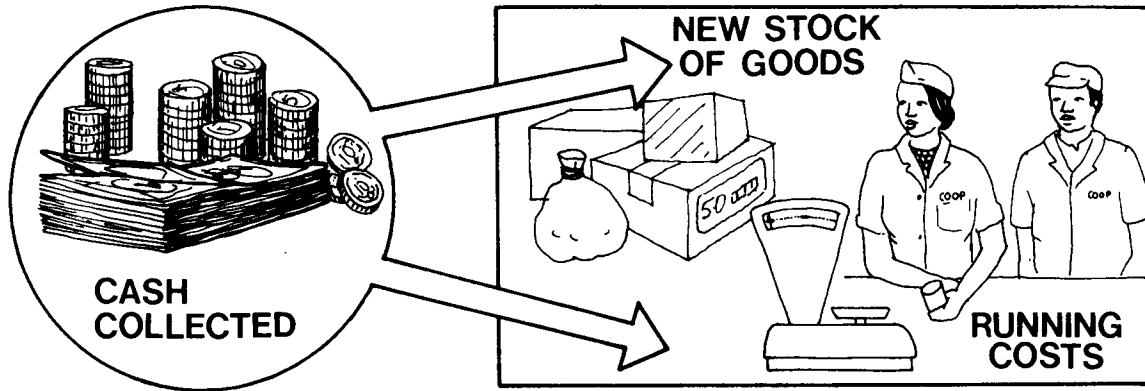
But business is a bit more complicated than that: Benev has employed a shop manager who must be paid a wage; the shop also has to pay for some other things, such as paper bags, cleaning material and an insurance premium.

The Benev Co-operative must take the money for these costs from the working capital, because they have no other source of money.

By doing so they will reduce the money which was intended for new goods. We know the risks and possible consequences of this - remember what happened in Akiba.....

But the management of Benev Co-operative is aware of this problem. They know very well that the money they collect from the members when they sell the goods in the shop must be sufficient to do two things:

1. to buy new goods
2. to cover the costs of running the shop (wages, etc.)



So, if the Benev Co-operative buys a packet of tea for T\$3.15 and sells it at the same price, they may collect enough money to buy a new packet of tea, but will not have any money to cover the other costs of running the shop.

So they have to increase the prices a little before selling the goods to the members. For instance, they have a T\$0.35 MARK-UP on a packet of tea and the SELLING PRICE will then be T\$3.50. In this way they will also collect some money for their other costs.

$$\begin{array}{ccc} \boxed{3.15} & + & \boxed{0.35} & = & \boxed{3.50} \\ \text{COST PRICE} & & \text{MARK-UP} & & \text{SELLING PRICE} \end{array}$$

Every business must do this. We say that we need a MARGIN to cover our costs.

The MARGIN is usually stated as a percentage of the SELLING PRICE. In the Benev Co-operative they wanted a margin of 10% on the tea, as you can see from this calculation:

$$\frac{\text{T\$0.35}}{\text{T\$3.50}} \times 100 = 10\%$$

Usually, a shop aims at a certain average margin. The Benev Co-operative was aiming at an average margin on sales of 10%. They expected the sales to be T\$260,000 in one year. The margin would then be:

$$\frac{10}{100} \times \text{T\$260,000} = \text{T\$26,000}$$

The margin was lower on some goods, especially food (5 to 12%). For other items, like clothes and tools, they used a higher margin (10 to 20%). But on average, the margin was 10%, enough to cover their running costs.

This calculation shows how the Benev Co-operative planned their business:

$$\begin{array}{ccc} \boxed{260,000} & - & \boxed{234,000} & = & \boxed{26,000} \\ \text{EXPECTED SALES} & & \text{COST FOR GOODS} & & \text{MARGIN} \end{array}$$

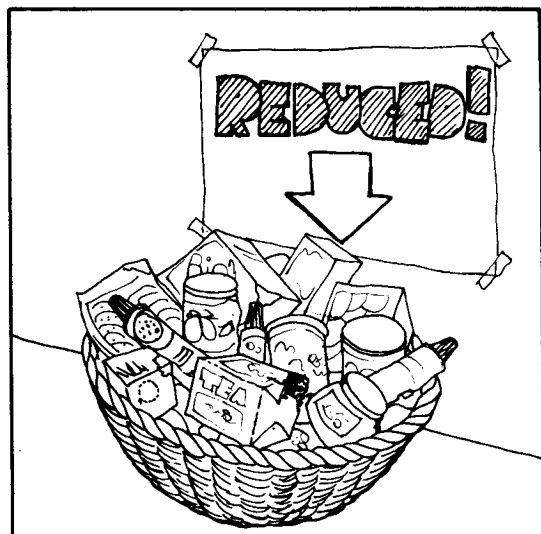
They expected the sales to be T\$260,000. After paying the suppliers for all those goods, they expected to have T\$26,000 left to cover running costs. That was their margin, 10% of the sales.

Unfortunately, something nearly always happens to reduce the expected margin. Let us take one example.

The Benev Co-operative had bought 20 packets of tea. The cost price was T\$3.15 each, that is a total of $20 \times \text{T\$}3.15 = \text{T\$}63.00$.

The mark-up was T\$0.35 on each packet, that is $20 \times \text{T\$}0.35 = \text{T\$}7.00$ for the lot.

But one packet was torn in the shop. The selling price of that packet had to be reduced by T\$2.00. This means that instead of T\$70.00 they collected only T\$68.00 for the tea. We can say they had T\$2.00 of LEAKAGE.



This is what they expected:

$$\begin{array}{ccccc} \boxed{63.00} & + & \boxed{7.00} & = & \boxed{70.00} \\ \text{COST PRICE} & & \text{MARK-UP} & & \text{EXPECTED} \\ & & & & \text{SELLING PRICE} \end{array}$$

This is what they got:

$$\begin{array}{ccccc} \boxed{68.00} & - & \boxed{63.00} & = & \boxed{5.00} \\ \text{ACTUAL} & & \text{COST PRICE} & & \text{MARGIN} \\ \text{SELLING PRICE} & & & & \end{array}$$

As you can see, the MARGIN was actually less than the MARK-UP.

Very often, because of leakage and price reduction, the total margin will be reduced.

You can learn more about these matters in three other MATCOM Elements called Leakage, Pricing, and Planning and Controlling the Business.



How much is the margin in your co-operative shop? Find out the cost prices and the selling prices of the following items and calculate the margins.

	Selling price		Cost price		Margin	%
1 kg sugar	-	=
1 kg rice	-	=
Soap	-	=
Cigarettes	-	=

Remember that the margin percentage is calculated on the selling price, see page 9.

GROSS SURPLUS AND NET SURPLUS



One week the Benev Co-operative sold goods for T\$5,000. We know that their margin was 10% on average. What was the cost price of these goods? Show your calculations here.

Selling price	T\$
- Margin	-
<hr/>	
= Cost price	T\$

(Look at page 8 again, if you have any difficulty remembering what cost price is.)

In the exercise above, your calculation should show that the Benev Co-operative spent T\$4,500 on goods and had T\$500 left over because of the margin.

Co-operatives use the word SURPLUS to describe this "left-over" money. We can say that the Benev Co-operative had a surplus of T\$500 this week. The word PROFIT is often used instead of SURPLUS.

Sales	T\$5,000
- Cost for goods	-4,500
<hr/>	
= Gross surplus	T\$ 500

We know what the surplus should be used for: wages and other costs for running the shop. The Benev Co-operative used T\$450 for this purpose. They then still had a small surplus of T\$50.

Gross surplus	T\$ 500
- Running costs	- 450
<hr/>	
= Net surplus	T\$ 50

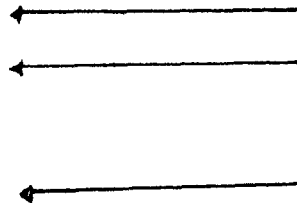
The first, bigger surplus, which is equal to the margin, is called GROSS SURPLUS.

The smaller surplus, which is left over when all costs have been paid, is called NET SURPLUS.

We have now examined some very basic principles. Everyone should understand this much about business operations, not only the shop staff, but also the members of the co-operative.

As a professional shop assistant or manager you need to be sure of the meaning of all these commercial words and to know the relationships between them. You can use the summary on the following pages whenever you want to refresh your memory.

COST PRICE	3.15
+ MARK-UP	+ 0.35
<hr/>	
= SELLING PRICE	= 3.50

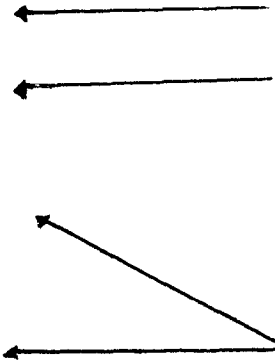


When we buy goods from the wholesaler we pay the COST PRICE.

To that price we add the MARK-UP.....

.... so that we get a SELLING PRICE for all goods, the price we expect the customers to pay for the goods.

SALES	5,000
- COST OF GOODS	-4,500
<hr/>	
= GROSS SURPLUS	= 500



SALES will bring money into the shop. This is our income.

We must keep enough of this income to replace the goods with new stock.

note!

If we do not follow this principle, the WORKING CAPITAL will decrease and the stock of goods will decrease more and more. Eventually the shop will be left with just a few goods which nobody wants.

GROSS SURPLUS	500
- RUNNING COSTS	- 450
<hr/>	
= NET SURPLUS	= 50



The remaining amount is our GROSS SURPLUS, or MARGIN.

This should cover the COST OF RUNNING THE SHOP.

note!

If we do not earn a gross surplus, we will not be able to pay wages, rent and other costs unless we spend the money which should be used to buy goods. This would ruin the co-operative.

Having paid the running costs there should still be a small amount left over, the NET SURPLUS.

HOW TO USE THE NET SURPLUS

You might think that co-operatives should not make a net surplus (a net profit). If so, you would be very wrong. It is true that co-operatives exist to give service to their members rather than to make profits but net surplus is needed in order to give service.

The following paragraphs will show you why net surplus is needed and how to use it.

Allow for the unexpected

In business it is unusual to get exactly the result you planned for. If you aim to make costs and sales exactly equal to each other (which would give neither a surplus nor a loss), you will often end up with a loss.

Gross surplus T\$	500
- Running costs	- 580
<hr/>	
= Net surplus ^{loss!}	T\$ 80

It is better to aim for a small net surplus which will allow for unexpected events leading to a drop in sales or extra costs. For example, the rent of the shop may be raised or the members may have less to spend following a poor harvest. Aiming at a net surplus helps to avoid a loss.

Improve the co-operative

A net surplus can also be used to expand the business. If we put some of the net surplus in the society's RESERVE FUND we make it available for the co-operative as its own capital. It can be used as working capital to increase the range of stock. It can also be used as fixed capital to improve the building or equipment. So, a net surplus can be used to improve the service to the members.

Replace borrowed capital with the Society's own capital

Loans have to be repaid. Suppose a co-operative pays back T\$1,000 to the bank each year. What happens to the total capital used by the shop? It goes down unless it is replaced by new capital. Some of the net surplus can be used to provide this "new capital". So we put some of the net surplus into the society's reserves, to replace the borrowed capital with capital owned by the society.

Thus, the net surplus can be used to maintain the capital available to the co-operative.

Maintain stock levels

Extra working capital is needed to replace stock when cost prices are rising. Suppose a shop has been buying 200 kg of sugar every week at a price of T\$2.00 per kg. They need T\$400 for sugar every week. If the price goes up to T\$3.00 per kg, they will need T\$600 to buy the same quantity. The working capital must go up by T\$200 just to maintain the same stock level. This is possible if a net surplus is available. So, a net surplus can be used to maintain stock levels when cost prices are rising.

Pay interest on shares

It is common to pay members INTEREST on the shares they contributed. For example, members might be paid T\$0.05 each year for every T\$1.00 of share capital they contributed. The intention is not to distribute most of the net surplus in proportion to contribution - that would be against co-operative principles. But members should get about the same interest as if they had put the money in a savings account at a bank. This interest should come from the net surplus, and it can only be paid if there is enough surplus.

So, a net surplus is needed to pay interest to the members on the money they put into the co-operative.

An example

one year the shop in Benev produced a net surplus of T\$12,000. The members decided to use it in the following way:

According to the Co-operative Law of the country, 25% had to be placed in the Reserve Fund. That is T\$3,000.

The policy was to give the members 3% interest on their shares. As the total number of shares amounted to T\$10,000, the amount to be paid out was T\$300.

After that, T\$8,700 of the surplus remained. The members wanted to build up the society's own capital even more, so they agreed to put another T\$3,500 in the Reserve Fund. This amount was chosen so that

.... the remaining T\$5,200 were just enough to give every member a 2% bonus or patronage refund on purchases. A member who had bought goods for T\$500 received T\$10 as a bonus, and one who had bought goods for T\$1,000 received T\$20. In this way, the part of the net surplus which was not needed for developing the shop was returned to the members.

<i>Reserve Fund (Statutory)</i>	3,000
<i>Interest</i>	300
<i>Reserve Fund (extra)</i>	3,500
<i>Patronage Refund</i>	5,200
<i>Total</i>	12,000

Instead of paying a bonus to every member, which involves quite a lot of recording work, the money can be given to an institution which benefits the members. For example, it can be used to improve the local school or health centre.

In some countries there is also a tax on surplus, which has to be paid before it is distributed.

This is what happened to the capital of the society:

Before the surplus was distributed, the Benev Co-operative had the following capital:

<u>Own Capital</u>	
Reserve Funds	T\$ 5,000
<u>Members' Capital</u>	
Shares	10,000
<u>Borrowed Capital</u>	
Bank loan	<u>15,000</u>
Total	T\$ 30,000

Because so much of the surplus was invested in the society (placed in the Reserve Funds), the society's own capital grew, while the borrowed capital was reduced by a repayment of T\$1,000.

<u>Own Capital</u>		
Reserve Funds	T\$ 11,500	← 5,000 + 3,000 + 3,500
<u>Members' Capital</u>		
Shares	10,000	
<u>Borrowed Capital</u>		
Bank Loan	<u>14,000</u>	← 15,000 - 1,000
Total	T\$ 35,500	

Although some money was returned to the bank, the total capital went up by T\$5,500. That amount was used to develop the shop and increase the stock range.

We saw on page 18 that the Benev Society made a net surplus of T\$12,000 in one year. The members had paid that much more than was necessary to cover the cost of the goods and the costs of running the shop. The money would have come in handy if something unexpected had happened. But this year everything went well for the Benev Co-operative. Even after payments to reserves and interest on share capital T\$5,200 were left over to distribute to members as bonus. Some people might say that the prices of goods in the shop had been too high. However, the committee of the co-operative were pleased. They could improve services to members and pay a bonus at the end of the year.



What would you prefer, - to pay a fair price for the goods when you buy them and maybe receive some bonus later, or pay a very low price when you buy the goods knowing that there will be no bonus? Give reasons for your answer.



How was the net surplus in your co-operative used last year? If there was no net surplus, state the reason.

INCREASING THE NET SURPLUS

Here is a monthly report of the Elima Co-operative Society:

Sales	T\$	32,000
- Cost of goods		-28,800
<hr/>		
= Gross surplus		3,200
- Cost of running the shop		- 3,450
<hr/>		
= Net surplus <i>loss!</i>	T\$	250

As you can see, they earned a gross surplus of T\$3,200 in El ima. But this was not enough, because their costs for operating the shop were T\$3,450.



The Elima Co-operative still managed to pay costs of T\$3,450. Explain where they got the money from.



What will happen to the Elima Co-operative if they continue to make a net loss for several months?

You will agree that the management of the Elima Co-operative must turn the net loss into a net surplus. We shall see how this could be done.

You can see the monthly report on the following page.

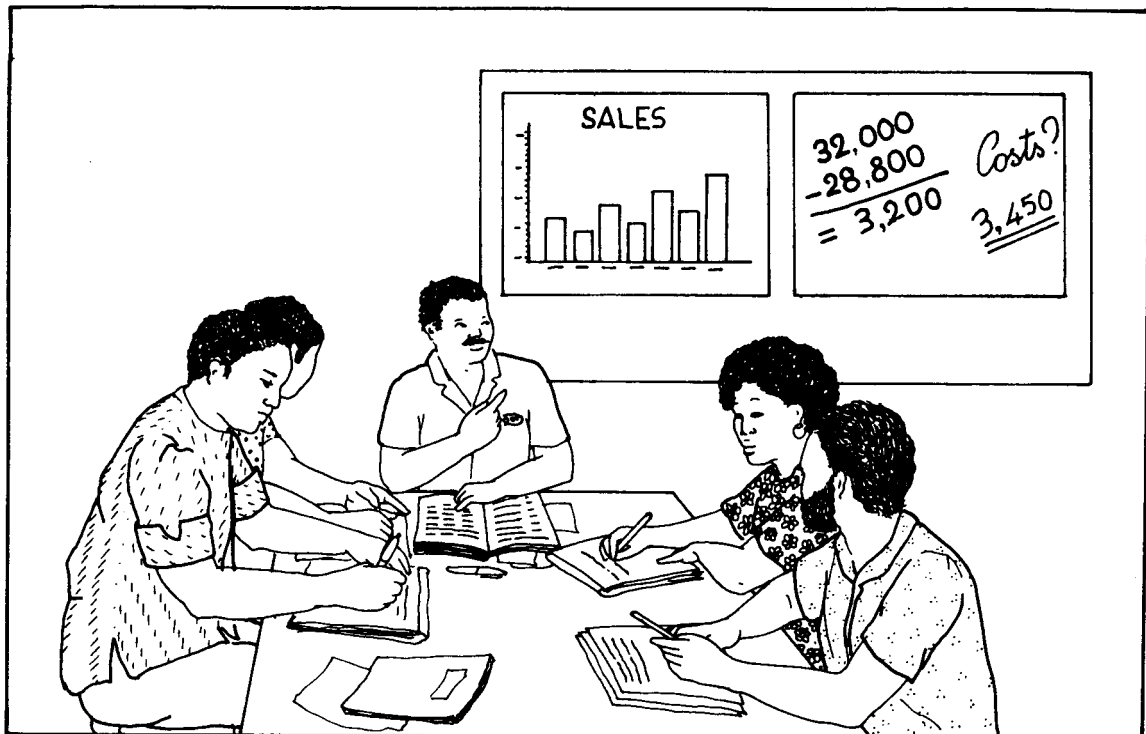
One way to improve the result would be to increase the gross surplus. If this can be done without increasing the running costs, the net surplus will be increased too. Basically, there are three ways to increase the gross surplus:

- 1 Increase the income from sales
- 2 Buy goods more cheaply
- 3 Reduce the leakage

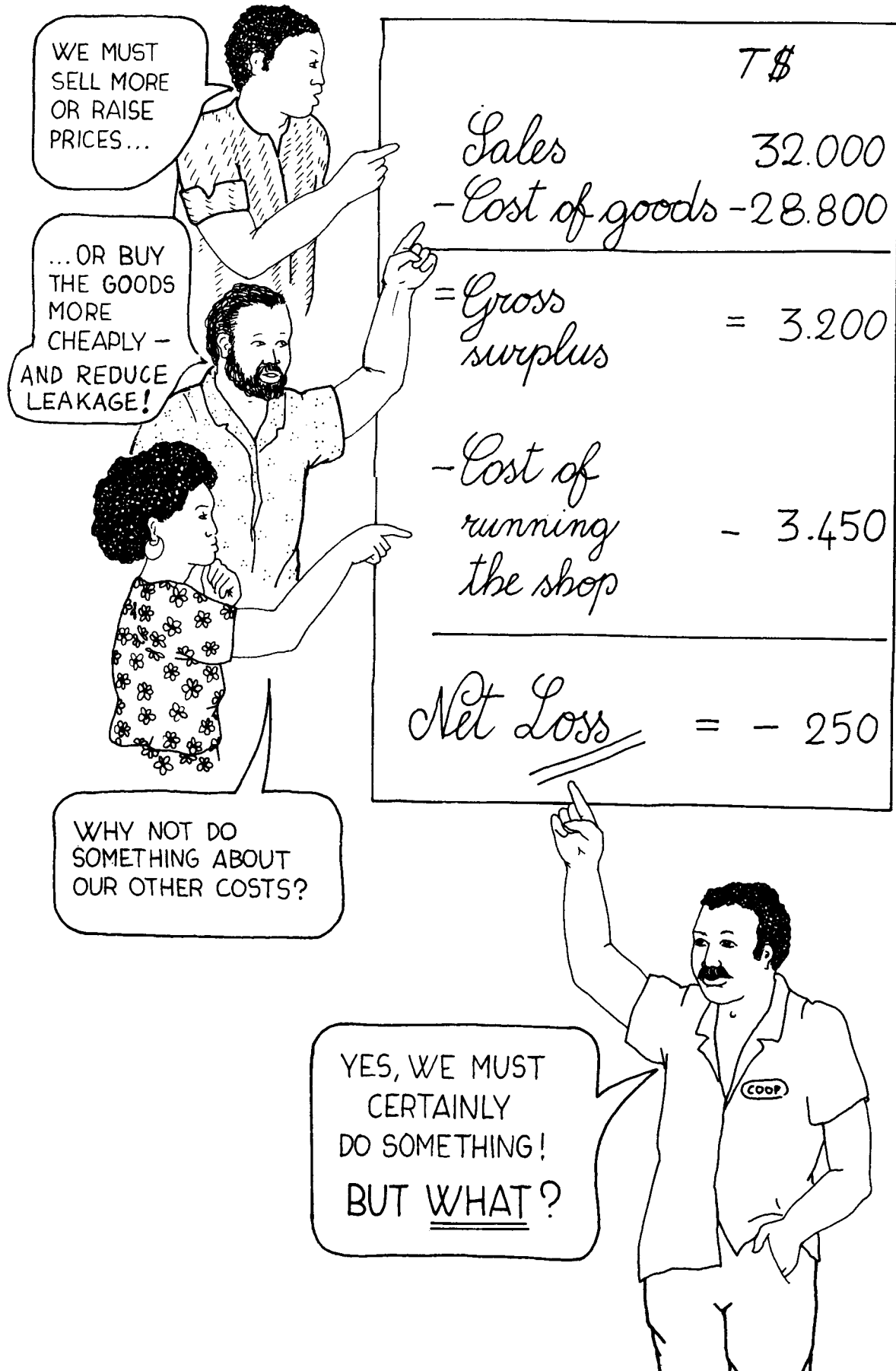
There is also a fourth way to improve the net surplus while the gross surplus may remain the same:

- 4 Lower the running costs of the shop

The management committee in Elima discussed all the possibilities with the manager. So will we, as you will see on the following pages.



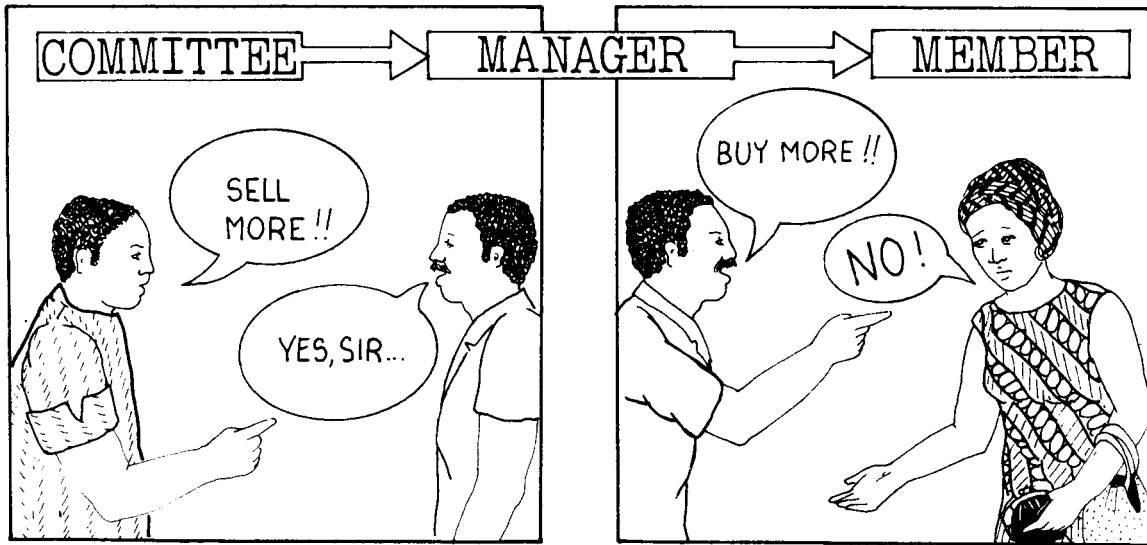
Elima's problem



INCREASING THE INCOME FROM SALES

Selling more

It is very easy to tell the manager of Elima Co-operative that he should sell more in order to increase the surplus. It is rather more difficult to tell him how to go about it.



First he has to find out if it is possible to sell more.

- Do the people of Elima have more money to spend?
- If so, do they need to spend it on more goods?
- Are they spending their money in other shops?

Once he is sure that it is possible to sell more, he must ask himself why he is not doing so.

- Are we not selling the kind of goods our members most want or are these things often out of stock?
- Are our members not satisfied with our services?
- Are the opening hours not convenient to our members?
- Do people know what they can buy in the shop and at what price?
- Do the members fully understand the importance of "member loyalty" in a co-operative?

If the manager does not know the answers to these questions he should ask his customers, the members. From their answers he should be able to decide what he should do in order to increase the sales.



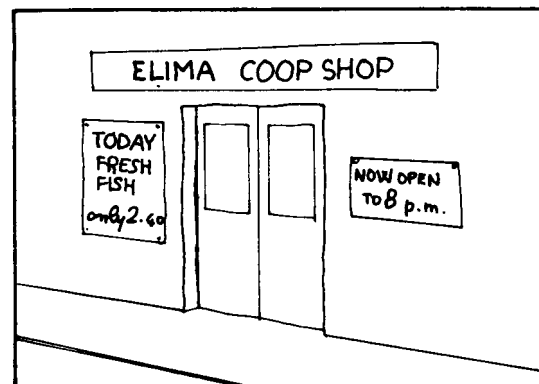
Examine your own shop. Try to find some reasons why you are not selling more, and write them down here. Compare with the questions on the previous page.

In Elima they found that some members, who were employed at a factory quite a distance away from the shop, were buying from other shops, which they passed on their way from the factory. When they were asked why they did not shop in their own co-operative, they gave two reasons:

- They did not know that the same goods were available in their co-operative.
- Because of the distance, they were not always able to reach the shop before it closed.

The committee discussed the problem and decided on the following action:

- The display of goods was improved so that everybody entering the shop could get a good view of the range of goods.
- A notice-board was put up outside the shop, in order to advertise new goods, special offers, etc.
- The closing time was changed from 6 p.m. to 8 p.m.



By so doing they managed to increase the sales to T\$36,000 the following month.

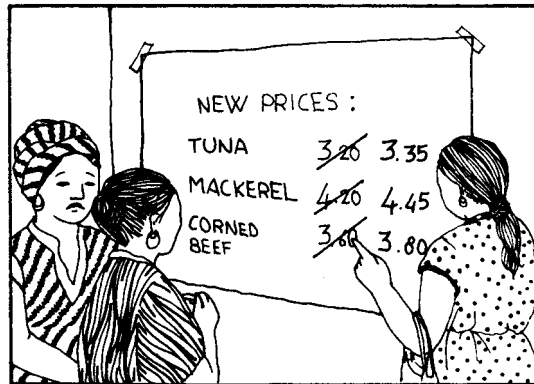
Raising prices

In the remote village of Kaitum, there was a co-operative with a special problem. It was making a loss and the committee knew why: they were not selling enough, due to a shortage of goods. How could they increase the sales without a sufficient supply of goods?



Of course they could not sell more than they received from the suppliers, but they could still increase the income from the sales: they simply increased the prices of the available goods. People would have to pay more for the same goods.

They increased the prices by 5% on average. By so doing, income from sales increased from T\$20,000 to T\$21,000 per month.



Sell more or raise the prices - which method is better?

As you can see, there are basically two ways of increasing the income from sales:

- selling more goods
- raising prices

Which method is better? It is impossible to say, since the answer depends on the local conditions, but the following example may be of help to you.

The co-operatives in Elima and Kaitum both sold tins of Pax Cooking Oil. The cost price of a tin was T\$7.20. Each shop sold about 40 tins a month. The gross surplus earned on this sale was T\$32.00.

Sales	40 at T\$8.00	T\$ 320.00
- Cost of goods sold	40 at T\$7.20	- 288.00
<hr/>		
= Gross surplus		T\$ 32.00

Elima managed to increase the gross surplus by selling five more tins a month without changing the price.

Sales	45 at T\$8.00	T\$ 360.00
- Cost of goods sold	45 at T\$7.20	- 324.00
<hr/>		
= Gross surplus		T\$ 36.00

Kaitum increased the price to T\$8.40 and sold the same quantity.

Sales	40 at T\$8.40	T\$ 336.00
- Cost of goods sold	40 at T\$7.20	- 288.00
<hr/>		
= Gross surplus		T\$ 48.00

In this example, by selling the same quantity at a higher price, Kaitum increased their gross surplus to T\$48. By selling 45 tins at the old price, Elima raised their gross surplus to T\$36. To reach a gross surplus of T\$48, Elima would have had to sell 60 tins. Raising prices can be the easiest way to increase the gross surplus.

However, raising prices is certainly not always the answer. It may be forbidden by price control regulations. Even where raising prices is permitted, it often causes people to buy less. This is more than likely if they can use less of the product or if they can buy it more cheaply elsewhere. One reason why Kaitum could increase their gross surplus by raising prices was that there were no other shops there!



What would be the effect on the gross surplus if your co-operative raised the price of cooking oil by about 5%? Would people use less cooking oil or buy it elsewhere? Give the reasons for your answer.

(If you do not sell cooking oil, choose another item for this exercise.)

Reducing prices


It is sometimes possible to sell more and increase your gross surplus by reducing prices. If there are several shops competing in the same area, people often buy where the prices are lowest. From page 27 you will remember that Elima started with a gross surplus of T\$32.00 on sales of cooking oil.

Sales	40 at T\$8.00	T\$ 320.00
- Cost of goods sold	40 at T\$7.20	- 288.00
<hr/>		
= Gross surplus		T\$ 32.00

If, by reducing the price to T\$7.80, they had managed to sell 60 tins instead of 40, their gross surplus would have been T\$36.00.

Sales	60 at T\$7.80	T\$ 468.00
- Cost of goods sold	60 at T\$7.20	- 432.00
<hr/>		
= Gross surplus		T\$ 36.00

You can see that they needed to sell a lot of extra tins to earn even a small increase in surplus.

	What would the gross surplus be if they sold 50 tins at T\$7.80?
---	--

Unless they sell more than 53 tins, they will actually reduce the gross surplus, so this method must only be used if you are sure that the price reduction will greatly increase the amount you sell.

So far we have considered the following basic ways of increasing the income, and therefore the gross surplus:

- selling more
- raising prices

We also mentioned the effect of reducing prices.

Whichever of these methods we use, we should also try to reduce costs. From page 23 you remember that one committee member in the Elima Co-operative suggested that the cost of goods should be reduced. If they manage to buy the goods more cheaply without decreasing the sales, they will, of course, earn a bigger gross surplus.

$$\begin{array}{r} \text{SALES} \\ - \text{COST OF GOODS} \\ \hline = \text{GROSS SURPLUS} \end{array}$$

This possibility is discussed on the following pages.

BUYING GOODS MORE CHEAPLY

Suppose the cost price to Elima for a 10 kg bag of flour is T\$150. This price covers the costs which have built up so far, including:

- payment to the grower for grain
- transport to the mill
- milling
- packing
- transport to the wholesaler
- storage and handling by the wholesaler
- transport to the shop
- tax (if any)
- profit for the wholesaler or anyone else who handles the grain or flour.

Many of these costs are quite outside the control of a shop manager, but we may be able to influence some of them, especially if we work together with other co-operatives.



Write down any ideas you already have on how your co-operative could buy goods more cheaply.

Some of the costs may be Government-controlled or you may have an efficient co-operative wholesale society which supplies goods to you. If so, your job is easier. However, it is usually possible to make further reductions in the cost of goods and the information on the next few pages should help you to do so.

Let us take another look at the Elima Co-operative. By selling more goods they improved their gross surplus

from this:

Sales	T\$ 32,000 (100%)
- Cost of goods	- 28,800 (90%)
<hr/>	
= Gross surplus	T\$ 3,200 (10%)

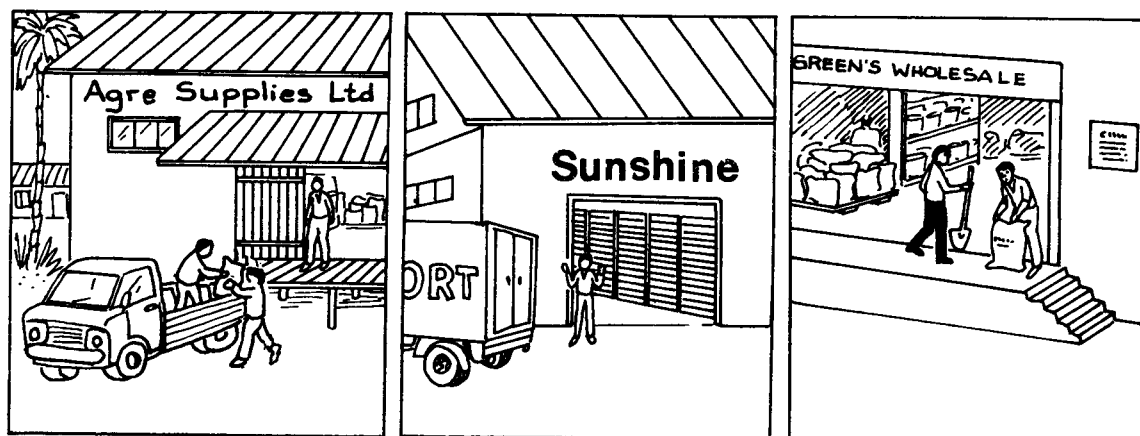
to this:

Sales	T\$ 36,000 (100%)
- Cost of goods	- 32,400 (90%)
<hr/>	
= Gross surplus	T\$ 3,600 (10%)

Since they sold more goods the cost of goods also increased. In both cases the margin was 10%. They hoped that by cutting the cost of the goods they could now increase the margin and the gross surplus even more.

The Elima Co-operative found they could try to obtain goods more cheaply as follows:

- They asked for price-lists from all the wholesalers in the area, compared the prices and found that the Sunshine Trading Company offered the lowest prices.



- They could get tea at T\$3.25 a packet, instead of T\$3.70, if they purchased directly from a tea factory 50 km away.

- They were promised a 2% saving by the Sunshine Trading Company, if they paid cash for the goods rather than buying on credit. A deduction from the ordinary price is called a DISCOUNT. In this case it is a CASH DISCOUNT.
- The company also offered a 3% discount if more than five bulk packages of the same commodity were bought at a time. Unfortunately, if Elima bought large quantities they could not afford to have many different types of goods in stock.

However, when trying to reduce costs, you must check whether the lower wholesale price may cause other costs to increase or sales to decrease.



Elima found that two of the possible methods for buying goods more cheaply, which we have just listed, were of no help because they could actually reduce the surplus. Which were they? Give reasons for your answer.

This is what the Elima Co-operative did:

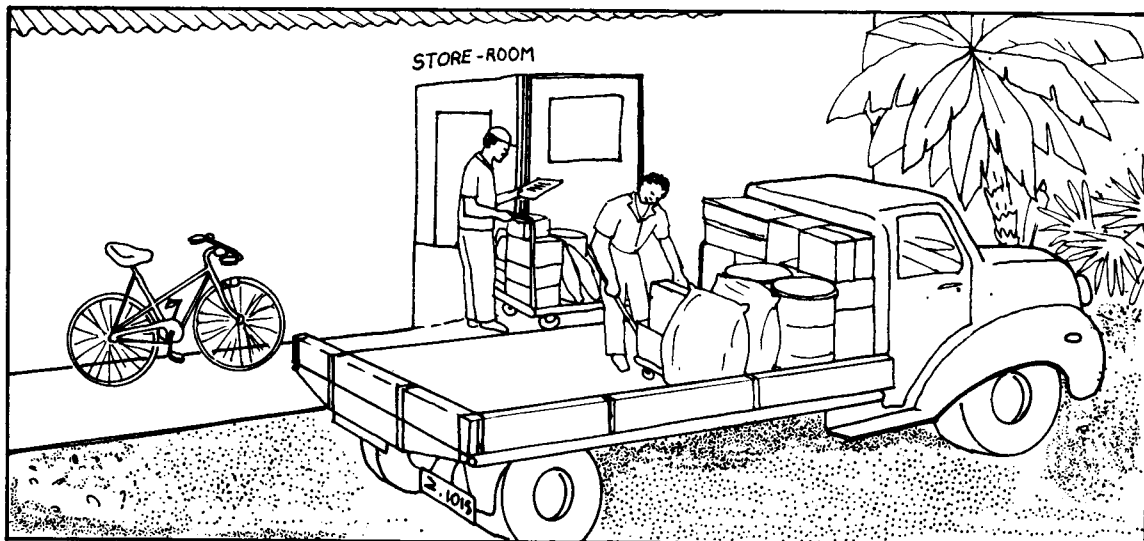
- By changing from their previous supplier to the Sunshine Trading Company, they obtained their goods 1% cheaper on average. On goods worth T\$20,000 this was a saving of T\$200 per month.
- They looked at the possibility of saving T\$0.45 per packet by fetching tea from the factory. Since they sold about 100 packets per month this would save T\$45. Unfortunately the extra transport from the factory would cost T\$60, so they rejected this idea. (This was part of the answer to the last question. Did you think of it?)
- They also considered the possibility of buying in large quantities to claim 3% discount. At first they rejected

this too because, if they bought large quantities of certain goods, they would not have enough money left to buy any others. They would sell less, and even lose customers who could not find what they wanted in the shop. (This is the other part of the answer to the previous question. Did you think of this too?)

Luckily, the chairman of Elima had a good idea. He and the manager visited two neighbouring co-operatives and persuaded them to order goods together with Elima.

Through this "Co-operation between Co-operatives" they were able to order sufficient quantities to claim the discount on many types of goods. They were able to claim the discount for quantity on goods worth a total of T\$8,000 and this saved them T\$240.

- Elima claimed a cash discount of 2%. This was worth T\$390.
- They also saved on transport costs which, before, were at least T\$550 every month. Again they made a friendly agreement with two nearby co-operatives. A lorry picked up goods for all three of them on the same journey, every Thursday. The lorry owner charged T\$900 per month, but Elima's share of this was only T\$300. This meant that Elima saved T\$250 on transport each month.



The Elima Co-operative managed to reduce their monthly costs for goods by a total of T\$1,080:

Lower cost prices (new supplier) T\$	200
Quantity discount	240
Cash payment discount	390
Reduced transport costs	<u>250</u>
Total	T\$ 1,080

This lower cost of goods improved their margin to 13%, which meant a larger gross surplus:

Sales	T\$ 36,000	(100%)
- Cost of goods	-31,320	(87%)
<hr/>		
= Gross surplus	T\$ 4,680	(13%)



Write down all the ideas you now have on how your co-operative could obtain goods more cheaply. The list will probably be longer than the one you prepared on page 30.

REDUCING THE LEAKAGE

When we talked about the "cost of goods" in the previous chapter, we meant the costs of all the goods that left the shop.

Sales	T\$ 36,000 (100%)
- Cost of goods	- 31,320 (87%)
<hr/>	
= Gross surplus	T\$ 4,68 (13%)

This made the calculation simple. However, not all the goods that left the shop were sold and properly paid for, some were lost. There was a leakage. If we separate the cost for the lost goods (the leakage), we get the following:

Sales	T\$ 36,000 (100%)
- Cost of goods sold	- 30,600 (85%)
- Leakage (cost of goods lost)	- 720 (2%)
<hr/>	
= Gross surplus	T\$ 4,680 (13%)

As you can see, the leakage in Elima amounted to 2% of the sales. It is hardly possible to avoid leakage completely in a retail shop where they may handle thousands of items every day. Some goods will be damaged or too old and lose in value, some might even be stolen. All kinds of leakage will affect the gross surplus, since the co-operative already has paid the cost of the goods but will earn little or no income on the sale of them. Elima Co-operative had a very high leakage.

There are many reasons for leakage which you can learn more about through the MATCOM Element "Leakage". Generally, if the staff know their jobs well and handle the goods carefully, there will be a minimum of leakage.



a) By taking better care of the goods, the staff of Elima Co-operative managed to reduce the leakage from 2% to 1% of the sales. Calculate the new gross surplus.

b) Compare the new gross surplus with the figures on page 21 to see the improvement. Work out the new net surplus or loss, assuming that running costs are still the same. Show how to calculate it.

LOWERING RUNNING COSTS

If you did the exercises on the previous page correctly, you will have discovered that, instead of a net loss of T\$250, Elima now has a net surplus of T\$1,590. The complete calculation looks like this:

Sales	T\$ 36,000	(100%)
- Cost of goods sold	- 30,600	(85%)
- Leakage	- 360	(1%)
= Gross surplus	5,040	(14%)
- Cost of running the shop	- 3,450	(9.6%)
= Net surplus	T\$ 1,590	(4.4%)

By selling more, buying goods more cheaply and reducing the leakage the Elima Co-operative managed to increase the monthly gross surplus from T\$3,200 to T\$5,040 or to 14% of the sales.



There is another method of increasing the gross surplus, which Elima did not have to use. Check your memory! Which method is that?

(See page 26 if you do not remember.)

Elima's new gross surplus of T\$5,040 is enough to cover the costs of running the shop and still leave a net surplus of about 4.4% of the sales. But Elima were still not satisfied. They wanted to increase their net surplus even more.

On page 22 you saw that the way to do this is to make the running costs lower.



Make a list of the different costs involved in running your co-operative shop. You need not state the amounts, just headings like "wages", etc.

You should have a long list. Such costs are often grouped together to make them easier to handle. For example, these were the monthly costs for running the Elima shop:

Wages and other staff costs	T\$ 2,500 (6.9%)
Costs for the shop building and equipment	325 (0.9%)
Interest	125 (0.4%)
Other costs	500 (1.4%)
	<hr/>
Total cost of running the shop	T\$ 3,450 (9.6%)

For easy comparison with other shops, the various costs are often expressed in percentage of the sales, as above.

Wages and other staff costs

In Elima the shop was staffed by a shop manager and two assistants. They were paid quite normal salaries; the manager got T\$800 a month and the assistants T\$600 each. The monthly cost for wages was T\$2,000.



Wages were not the only staff costs. The society also made payments towards retirement benefits and the workers' compensation fund. The shop had to pay a total of 10% on the wages for various social costs. This came to about T\$200 a month.

T\$300 a month was reserved for the Society's education and training programme. It was to cover training for both staff and committee members and a programme for members' education.

Wages	T\$	2,000
Social costs		200
Training		300
<hr/>		
Total wages and staff costs	T\$	2,500 (6.9%)

The wages and other staff costs are 6.9% of the sales. Note that they are bigger than all the other costs of operating the shop. This is usual for most shops.

Therefore, wages are the most important costs to look at. The committee must carefully consider questions like:

- How many employees are really needed?
- Do we need full-time employees or could we use some part-time workers?
- How much in wages will the income from the shop allow us to pay?

In Elima there was a proposal that one more assistant should be employed because the shop now stayed open longer in the evening. Before they took a decision the treasurer made the following calculations:

Monthly cost of one shop assistant :

Wages	T\$	600
Social costs		60
<hr/>		
Total cost	T\$	660

Thanks to the extended opening hours, the improved display and the notice board, the sales went up from T\$32,000 to T\$36,000 per month, an increase of T\$4,000. Half of that amount, T\$2,000, was probably due to the extended opening hours.

We can now calculate by how much the gross surplus increased as a result of the extended opening hours. We know that the margin is now 14%.

$$\frac{14x}{100} \quad T\$2,000 = T\$280$$

And the extra cost of a new shop assistant would be T\$660! It would be stupid to pay T\$660 to earn only T\$280. So the committee agreed that they should try to run the shop in the evenings without employing any new staff. Instead they would ask the staff to agree to work longer in the evenings in return for reduced working hours earlier in the day. If that did not work out well, they would close the shop in the evenings.



Would it be sensible to employ another shop assistant if the sales had increased by T\$5,000 just because of the extended working hours? Show your calculations.

You will now understand that fairly high sales are needed to justify employing staff to run a shop.

This was the problem they were facing in the very small village of Cemal. Their sales were only T\$6,000 a month. With a margin of 10% they earned a gross surplus of T\$600 a month. This was not enough to employ even one shop assistant after they had paid the other costs of running the shop. They only managed to have a co-operative because the committee members worked voluntarily in the shop and had no paid staff at all.



How high are the staff costs in your shop? Calculate the percentage of the sales and compare with the gross surplus.

Staff costs last year: _____ %

Gross surplus last year: _____ %

If the staff costs are more than half of the gross surplus, you will most likely face some problems in the future.

Costs of the shop premises and equipment

Because the Elima Co-operative owned the shop building, they paid no rent. This does not mean that the building was free. What were the costs each year?

Well, the shop cost T\$18,000 to build. The annual costs depend on the number of years the building will be used. We could say that the building would cost them T\$9,000 a year if used for only two years, and T\$1,000 a year if used for 18 years.

It is difficult to know in advance how long a building will be used. Therefore, it is a common practice to spread out the actual cost over a period of 20 years. The annual cost for Elima would then be

$$\frac{\text{T\$18,000}}{20} = \text{T\$900}$$

and the monthly costs would be

$$\frac{\text{T\$900}}{12} = \text{T\$75}$$

It does not mean that the co-operative actually pays out this amount every month. It is the calculated monthly cost of a building, and it is included among the other running costs for the shop. This one is called DEPRECIATION.

Shop equipment and furniture are treated in the same way. But the "lifetime" of these things is usually much shorter, so their cost is depreciated over a 5-year period.

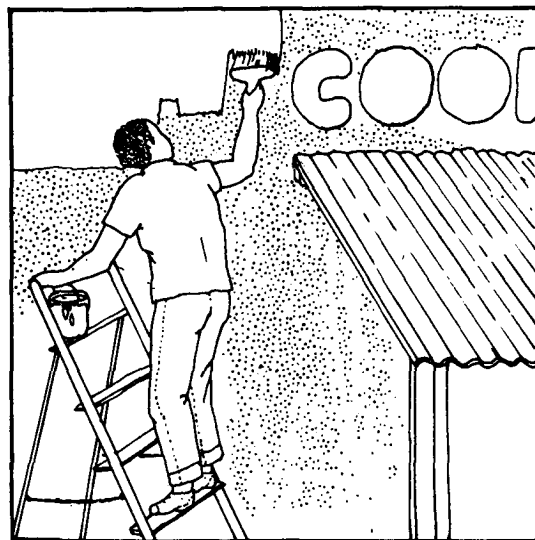
? Calculate the depreciation of the shop equipment owned by the Elima Co-operative. They originally paid T\$6,000 for the equipment.

Annual depreciation =

Monthly depreciation =

Costs for furniture and equipment which are expected to last for less than five years are not depreciated. Instead, the entire cost is included among the other running costs for the month in which the equipment is purchased.

In the Elima Co-operative there were other costs in connection with the building and the equipment. They were very anxious to keep the building in good condition. The maintenance cost them T\$1,800 a year, that is, an average of T\$150 a month. (The purchase of equipment lasting less than five years is also included in this amount.)



The monthly costs for the building and its equipment in Elima were therefore:

Depreciation of building	T\$	75	
Depreciation of equipment		100	
Maintenance		<u>150</u>	
Total	T\$	325	(0.9%)

Is it possible to reduce these costs?

Maintenance and repairs can usually be postponed. If other costs are unusually high one month it may be a good idea to wait until the next month before having a wall repainted, for instance. But it is not advisable to put off maintenance or repairs for too long. You will either shorten the life of the building or make more costly repairs necessary later.

Once calculated, the depreciation costs cannot normally be changed. But a well maintained building could last much longer than the depreciation period. After that there will only be the maintenance cost without the cost of depreciation, so the total cost for the building will be low.

Interest

In Elima the members did not contribute all the capital needed to start the shop themselves. Part of it was borrowed from a bank, for which the bank charges them 6% interest a year. They borrowed T\$25,000, so the yearly interest amounts to T\$1,500.

$$\frac{6}{100} \times \text{T\$}25,000 = \text{T\$}1,500$$

This is equal to T\$125 a month or about 0.4% of the sales.

Unless the Elima Co-operative can repay the loan, they can do nothing about these costs. In fact, if they failed to pay the interest, the whole amount of T\$25,000 would be due for repayment immediately.

A bank loan is usually the cheapest way of borrowing money. As an alternative the Elima Co-operative could have taken three months' credit offered by the grocery supplier, the Sunshine Trading Company.

The Sunshine Trading Company charged a monthly interest rate of 2%, except on the first month's credit which was interest free.

2% may not sound much, but if charged monthly, it is. Suppose Elima owes T\$25,000 to the trading company instead of the bank. They would have to pay:

$$\frac{2}{100} \times \text{T\$}25,000 = \text{T\$}500$$

This T\$500 per month is the same as T\$6,000 per year! They would also lose their cash discount. (Look back at pages 31-33 if you have forgotten about the cash discount.)

A bank not only charges interest, it also pays interest on money deposited there. Sometimes the money paid to a shop is not spent immediately, but put aside for payments which are due later. Elima put amounts such as these in a savings account they had opened at the bank. In this way they earned a yearly interest of T\$120. That is T\$10 a month.

So the monthly interest charges were reduced a little, and the committee agreed that it would be too expensive to run the shop on credit given by the suppliers.

Interest paid to the bank	T\$	125
- Interest received	-	10
<hr/>		
= Net cost of interest	T\$	115



How much did your society pay in interest last year?

- a) to banks?
- b) to suppliers?

How can you reduce interest costs in your society?

Did you claim a cash discount from any supplier last year? If so, how much?

Other costs

There are a lot of other costs involved in running a shop.



Here are the costs of the Elima shop. Write down the costs for your co-operative for last year to see if you have similarly high costs for certain items and low costs for others.

	<u>Elima</u>	<u>Your shop</u>
Business licence	T\$ 700	
Stationery	600	
Wrapping materials	800	
Price labels, tags	600	
Telephone	250	
Postage	50	
Water supply	650	
Lighting	250	
Cleaning materials	300	
Insurance premium	500	
Entertainment	700	
Bank charges	60	
Posters	0	
Sundries	<u>540</u>	
Total per year	T\$ 6,000	
Total per month	T\$ 500	

If a shop is running at a loss, every single cost must be carefully examined to see if it can be reduced or avoided altogether.



Before looking into what the Elima people did, make your own suggestions. Which of the costs mentioned on page 45 would be the easiest to reduce?

This is what the Elima Co-operative actually did:

Stationery	They had been using cash tickets, which had been specially printed for the Elima Society. By changing to a type which did not have to be specially printed they saved T\$120 a year.
Wrapping materials	Paper bags had been given to the customers free of charge. The committee decided that this should stop. Those who wanted bags should pay for them. T\$600 were saved.
Telephone	They saved T\$60 by making no long-distance telephone calls.
Postage	This increased by T\$20 because they sent more letters instead of making phone calls.
Water supply and Cleaning materials	Could not be reduced. The shop must be kept clean.
Lighting	Increased to T\$390 due to the extended opening hours in the evenings.
Entertainment	It was agreed that all kinds of entertainment should stop. T\$700 was saved.
Poster	To keep the members better informed about news and special offers, it was agreed to use T\$120 for posters.

Other costs remained the same.

Summary of changes:

"Other costs" (as they were)			T\$ 6,000
Changes:			
Stationery	less	-	120
Wrapping material	less	-	600
Telephone	less	-	60
Postage	add	+	20
Lighting	add	+	140
Entertainment	less	-	700
Posters	add	+	<u>120</u>
"Other costs" (as they now stand)			T\$ 4,800

The yearly costs were reduced from T\$6,000 to T\$4,800 and the monthly costs from an average of T\$500 to T\$400.

Note that some costs increased due to the measures taken to increase sales. Before any such action is taken, its effect on the net surplus must be considered.

For example, the lighting costs increased by T\$140 a year due to the extended evening opening hours. Just to cover this extra cost, the gross surplus must increase by the same amount. With a margin of 14%, the sales must increase by T\$1,000. Calculation:

14% of the extra sales = T\$140

$$\text{the extra sales} = \text{T\$140} \times \frac{100}{14} = \text{T\$1,000}$$

If you do not expect the sales to increase more than that, the net result will most likely be worse.



What is the minimum increase of sales needed to pay for the posters if the margin is 14%.

SUMMARY

Elima's success

The Elima Co-operative turned a net loss into a net surplus. Here is a summary of how they did it:

Monthly (average)	Before		After		Ref. pages
	T\$	% of sales	T\$	% of sales	
Sales	32,000	100%	36,000	100%	24-25
- Cost of goods sold	-28,160	88%	-30,600	85%	30-34
- Leakage	- 640	2%	- 360	1%	35-36
= Gross surplus	3,200	10%	5,040	14%	
- Wages, staff costs	- 2,500	7.8%	- 2,500	6.9%	38-41
- Buildings, equipment	- 325	1.0%	- 325	0.9%	41-43
- Interest	- 125	0.4%	- 115	0.3%	43-45
- Other costs	- 500	1.6%	- 400	1.1%	45-47
= Net surplus or loss	- 250	- 0.8%	+ 1,700	4.7%	

If a co-operative is so successful that the net surplus is bigger than they need, they can decide whether to lower selling prices or return some of the money to the members, either as a patronage refund or by spending it on something which benefits them all.

IF IT EARNS A NET SURPLUS

* a co-operative can really benefit its members. *

! Write down five reasons why a co-operative needs a net surplus. If you find this difficult, read pages 16 and 17 again.

Planning for the success of your co-operative

You will now want to improve the net surplus of your own co-operative, so as to serve your members better.

Analyse the need for improvement by preparing a statement like the one for the Elima Co-operative on the previous page. Sales and costs might be much different in your shop, but the percentage figures could be compared. They would give you some ideas on what to improve.

You have studied the basic ways of improving the economy and, to help them stay firmly fixed in your memory, they are listed together on the next page.

You have learned also that each problem must not be considered separately - you must check how your plans and actions affect the overall result of the business.

For example:

- your plan to sell more may increase your running costs,
- your plan to raise prices may reduce the amount you sell.

This Element has only taught you certain basic principles. To put them into practice you need to learn more.

There is another MATCOM Element to help you master the details. It is called "Planning and Controlling the Business".

we need a NET SURPLUS

LOOK FOR IMPROVEMENTS :

- INCREASE SALES
- BUY GOODS MORE CHEAPLY
- LOWER RUNNING COSTS
- REDUCE LEAKAGE



WHY?

TO SERVE THE MEMBERS BETTER

"CHECK-OUT"

To prove to yourself that you have fully understood this Element, you should now go through the following questions. Mark what you think is the right answer to each question. The first question is answered as an example. If you have problems with a particular question, go back and read the corresponding chapter again. Your teacher will check your answers later.



- 1 Which of the following statements is correct?
 - a A margin is needed to purchase new goods.
 - b A margin is needed to pay staff wages.
 - c A margin is not needed in a co-operative shop.

- 2 The cost price should include:
 - a only the amount paid to the wholesaler;
 - b all the costs involving the goods up to their delivery to the shop;
 - c all the costs involving the handling of the goods up to the time they leave the shop.

- 3 The gross surplus is:
 - a the surplus made before the costs for running the shop have been deducted;
 - b the surplus made after the costs for running the shop have been deducted;
 - c the money which could be paid as a bonus to members.

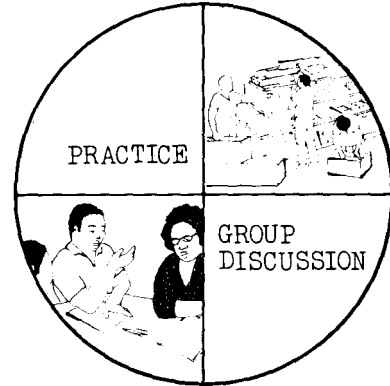
- 4 A shop sold goods for T\$20,000 and its average margin was 12%. What was the gross surplus?
 - a T\$8,000
 - b T\$2,400
 - c T\$1,667

- 5 A shop sold goods for T\$3,300, having paid T\$2,900 for them and T\$200 for running the shop. What was the net surplus?
 - a T\$3,300
 - b T\$400
 - c T\$200

- 6 Which of the following statements is correct?
- a The shop which sells more than any other shop will always have the highest gross surplus.
 - b The gross surplus depends on the margin only.
 - c The gross surplus depends on the margin and on the sales.
- 7 There will be a loss if:
- a the costs of running the shop exceed the gross surplus;
 - b the costs of running the shop exceed the net surplus;
 - c the gross surplus exceeds the net surplus.
- 8 Leakage will:
- a increase the gross surplus;
 - b decrease the gross surplus;
 - c not affect the gross surplus.
- 9 Which is usually the largest cost incurred in running a co-operative shop?
- a The costs of the building and the equipment.
 - b Interest charges.
 - c Wages.
- 10 Which of the following costs can most easily be changed by the committee?
- a The costs of the shop building.
 - b The costs of the goods.
 - c Staff wages.
- 11 Why is the depreciation cost of the shop building spread out over several years?
- a The cost is too large to be paid in one year.
 - b Because the building is used for several years.
 - c To obtain a bigger net surplus.
- 12 Of the following, which is more costly to a shop which has borrowed money?
- a To pay a yearly interest of 6%.
 - b To pay a monthly interest of 2%.
 - c There is no difference.

COMPLEMENTARY EXERCISES

To complete your studies of this topic you should take part in some of the following exercises which will be organised by your teacher.



GROUP ASSIGNMENTS

Discuss some of the following questions, first in groups, then present your conclusions to the other groups for critical examination.

1 To raise capital

To raise more capital many co-operatives have to borrow money to add to their own capital and the contributions from members. Discuss the most advantageous ways of raising money.

2 The working capital

Ask a few co-operative societies for balance sheets and calculate by how much the working capital has changed from one year to the next. Discuss whether the trend has been favourable or not.

3 Why a surplus is necessary

See page 48. Calculate the yearly net surplus and suggest ways of using it. Members' shares amount to T\$16,000. Would you recommend the society to cut prices next year?

4 To increase the surplus

In a small town there are three privately owned shops and one co-operative shop. This is the trading result of the co-operative shop for last year:

Sales	T\$	50,000	100%
- Cost of goods sold	-	44,250	88.5%
= Leakage (cost of goods lost)	-	750	1.5%
<hr/>			
= Gross surplus		5,000	10%
Wages	-	7,200	14.4%
House rent	-	2,400	4.8%
Interest	-	800	1.6%
Other costs	-	1,200	2.4%
<hr/>			
Net loss	T\$	6,000	- 13.2%

- a) Discuss possible ways of turning the result into a surplus during the coming year.
- b) Suppose the costs cannot be further reduced. To avoid a net loss, what would the sales increase have to be? (The margin is 10%)
- c) Prices are about the same in all four shops. What would you recommend that the co-operative shop do in order to increase its sales?

5 Examine the trading result

Examine the trading reports for last year of some co-operative shops, including the one you work in. Discuss the reports and answer the following questions:

- a) Do you consider the net surplus sufficient? If not, suggest some ways of increasing it.
- b) How should the net surplus be used for the maximum benefit of the members?

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