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Consolidation of Balance Sheet Components During Cooperative Mergers

Abstract

This report provides information on consolidating critical balance sheet components during cooperative mergers. It discusses the implications of combining assets and liabilities and provides information and examples on various methods of consolidating member equities. Several case studies of cooperatives that have merged are included. They provide actual examples on how equities were combined during mergers, consolidations, and acquisitions.

Key Words: Merger, plan, equity, assets, liabilities

Consolidation of Balance Sheet Components During Cooperative Mergers

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Preface

Cooperatives or cooperative leaders studying merging or in the midst of merging are likely to confront some difficult issues when planning to consolidate major balance sheet components—assets, liabilities, and equity. This report describes the implications and presents information and examples on methods for consolidating these important financial elements.

This information was obtained from: (1) literature by noted authors on cooperative mergers; (2) intra-agency development of examples and relevant information; and (3) case studies of several farmer cooperatives recently involved in mergers.

This report is intended to aid cooperative leaders and others interested in (a) better understanding financial aspects involved in mergers, and (b) developing a plan to combine major balance sheet components for the merger, consolidation, or acquisition being considered.

The authors thank the six cooperatives that participated as case-study subjects. Their contributions were essential for this report.

For brevity, the term "merger" is used throughout the report rather than specifying merger, consolidation, and acquisition in every instance.

The portions of this report that refer to the tax implications of mergers do not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other government agency. Hence, this report is not providing tax recommendations. Cooperatives studying or interested in tax issues of mergers should seek professional/legal tax advice.

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Highlights

Cooperative leaders pursuing merger will benefit by developing and following an organized plan to carry them through the process. Part of this plan entails the careful study of the characteristics and structure of the participating cooperatives' assets, liabilities, and equity. Major questions need to be answered pertaining to those structures:

- What are the assets, what will be needed, and what are they worth?
- How should assets be evaluated (book or appraised value)?
- How do debt-to-asset ratios compare?
- Must assets be sold to retire debt?
- Are liabilities at similar levels and structured the same?
- What types of equities do the cooperatives have?
- What are the redemption plans?
- Are the cooperatives current in redeeming equity?
- What alternatives are available for consolidating member equities?
- What redemption plan will best suit the unified cooperative?

These and other questions should be addressed in the merger plan. Doing so will require a thorough examination of each cooperative's balance sheet and financial characteristics. Every merger is different depending on the attributes of each cooperative, what precipitated the merger, and what each cooperative has to offer a unified organization.

Handling member equity is, perhaps, the most difficult financial issue in a merger. Member investment needs to be respected and protected. Alternatives for combining equity must take that into consideration.

Not all alternatives for combining equity provide complete member equality. Develop alternatives and assess attributes of each to narrow the field to the most suitable alternative given the conditions and the overall situation of the participating cooperatives.

This report contains 21 alternatives or examples for combining equity. Eleven are described in general. Ten are examples from cooperatives that participated

in a merger. Cooperatives considering merger may use them to help develop a field of alternatives.

Cooperatives usually don't face the same problems in acquisitions as they do in mergers. While member financial interests and their patronage still must be respected, the acquiring cooperative usually dictates most actions taken to combine assets, liabilities, and member equity, especially if the cooperative being acquired is financially weak. In any event, acquisitions are gaining in popularity given the relative ease by which the applicable transactions can be completed.

Cooperatives considering merger must work to let members know that their interests are being represented and protected and that their financial stake in the unified cooperative is important.

The new or unified cooperative should emerge with an equity capitalization and redemption program that closely adheres to the "user-owner" cooperative principle—the equity structure should reflect current patterns of usership. Cooperative leaders should adhere to that precept in developing the merger plan.

Consolidation of Balance Sheet Components During Cooperative Mergers

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Balance sheet characteristics of cooperatives involved in a merger are rarely identical. Problems often arise when organizations with different depreciable assets, liabilities, types of equity, and equity redemption programs attempt to combine their assets and equities into a single organization.

Asset evaluation, liability realignment, and equity transfer during cooperative mergers are delicate issues and must be handled in an equitable or mutually agreeable manner.

In a merger, one or more business organizations absorb another firm. The survivor maintains its identity. Many of its organizational features are operated on an expanded basis, given its increased size and capacities. Consolidation combines two or more business organizations into a new organization. In an acquisition, the assets of one cooperative are purchased by another.

This report examines and clarifies the alternative methods for evaluating and consolidating critical balance sheet components during mergers, consolidations, and acquisitions. The report provides references for cooperatives involved in planning and negotiating a merger, and/or for those interested in the types of financial structural changes that result from the consolidation of cooperative balance sheets during mergers.

Mergers result in expanded assets, realigned liabilities, and transferred and consolidated member equities. Cooperative members involved in mergers have a personal stake in the methods used to evaluate and consolidate these critical financial elements.

This report has seven sections. The first is a general plan for consolidating major balance sheet components during a cooperative merger. The second describes the appraisal of cooperative assets and handling liabilities, while the third analyzes and describes alternatives for consolidating member equities—some summarized from another literature source and some developed.

The fourth section provides some general alternatives for consolidating equity, examples borrowed from other literature and other developed examples. The fifth section includes case studies of cooperatives that have merged, some originating from a past study and some from recent case studies. Section six discusses some financial issues pertaining to merger. Section seven summarizes the report and discusses implications of the findings.

CONSOLIDATING BALANCE SHEET COMPONENTS

Cooperative leaders contemplating or actively pursuing merger will benefit by developing and following an organized plan that will carry the participants through the merger process. A well-developed plan for merger indicates steps to follow and the components or elements in each step.[1]

Part of the plan should include strategies for consolidating the balance sheet components of the participating cooperatives. A joint merger or study committee evaluates all implications of consolidating the participants' balance sheets and provides recommendations to the boards of directors about the most suitable strategies for completing the task.

Initial phases of those studies often involve outside consultants. Later phases of merger proposals usually involve a range of complex issues that require the outside assistance from legal counsel, accountants, and occasionally professional mediators.

This part entails careful study of the characteristics and structure of participants' assets, liabilities, and equity (figure 1). The figure portrays the

[1] See Swanson (ACS Research Report 43—Merging Cooperatives: Planning, Negotiation, and Implementation) for general information, guidelines, and step-by-step procedures for merging cooperatives.

consolidation of assets, liabilities, and equities of two cooperatives into a single organization.

The variations and implications of consolidating these major financial elements can be complicated. To limit disruption to the merger process, financial consolidations should be handled carefully. In proceeding with merging these components, a number of questions, such as those included in figure 1, need to be answered in their regard.

Successfully answering these and other more detailed questions requires a thorough understanding of the characteristics of each merger participant's financial statements. Thus, financial statements must be carefully examined by the merger committee.

The final plan or strategies for consolidating the financial elements may vary according to the status of the cooperatives contemplating merger. For example, cooperatives with a similar financial structure and similar financial strength and performance will find it relatively easy to consolidate financial elements.

On the other hand, consolidating the financial elements of cooperatives with significantly different structures and financial strengths may be more difficult. If one cooperative is financially strong and the other in danger of bankruptcy, the stronger cooperative may feel that the equity position of the weaker one should be adjusted in relation to current financial predicament in terms of debt and the probability of future losses without the merger.

Other circumstances may require special plans for financial consolidation—(a) the cooperatives have similar levels of financial success, but one is relatively larger than the other, (b) the cooperatives have similar financial performance, but one has superior operating assets in superior locations, (c) the cooperatives have a similar financial structure, but one owns property with windfall potential, (d) the cooperatives have different types of equity instruments or revolvement periods vary, etc. Such differences must be considered when planning the consolidation of financial (balance sheet) components of merging cooperatives.

A merger plan must examine possible tax implications associated with the various aspects of financial consolidation. Different methods for consolidating financial elements may have different tax implications. This may be especially true when cooperatives are merging across State lines, or when asset disposal returns windfall profits.

The mission of a merger is to create synergies, and at the very least, a financially and operationally sound cooperative that enhances the economic well-being of owner-members. A merger should produce greater economies of scale, less business duplication, a greater resource base from which to operate, and an expanded member base from which to derive and achieve broader market penetration, greater leadership abilities, and expanded capitalization.

The merged cooperative also has an opportunity for a new beginning by following important cooperative financial principles and practices, regardless of whether or not the participants completely followed them before the merger.

In other words, the merged organization has a renewed opportunity to improve or continue adherence to the "user-owned" cooperative principle regarding member capitalization, financial policies, and equity redemption. The members must have a substantial financial stake in their cooperative and the equity structure should reflect current patterns of usership.

ASSETS AND LIABILITIES

Assets

As cooperative leaders examine the value and quality of assets involved in a merger, questions invariably arise (figure 1):

(1) What assets (capacity) will be needed?
(2) What are the fixed assets worth?
(3) What depreciation, writeoff, or salvage valuation methods are used? Is there windfall potential?
(4) Should assets be considered at book value or revalued?
(5) Is any compensation necessary (if assets are sold)?
(6) What is the status of accounts receivable (and bad debts)?

The leaders need to determine what assets will be needed to adequately serve the members of the unified cooperative. In some cases, all assets will be retained, as when the merger involves complimentary cooperatives and there is little duplication or trade overlap. It may be more complex in other cases (duplication and overlap) and assets of both cooperatives are of equal quality and capacity and have similar locations.

Once the decision is made about which assets will be needed by the unified cooperative, the merging parties must agree on the value of assets.

It is generally advantageous to simply accept the balance sheet asset (book) values of the merging cooperatives. This is the simplest and most commonly used method in mergers. However, when using book values, make sure that asset values (e.g., inventory, investments, and fixed assets) are reported accurately.

On the other hand, when joining organizations

Figure 1-- **Consolidating Balance Sheet Components**

Cooperative A	Assets
+ Cooperative B	Assets
Unified Cooperative	Assets

(1) What assets (capacity) will be needed?
(2) What are the fixed assets worth?
(3) What depreciation, writeoff, or salvage valuation methods are used? Is there any windfall potential?
(4) Should assets be considered at book value or revalued?
(5) Is any compensation necessary (if assets are sold)?
(6) What is the status of accounts receivable (and bad debts)?

Cooperative A	Liabilities
+ Cooperative B	Liabilities
Unified Cooperative	Liabilities

(1) How do the total debt to total assets ratios compare (are debt levels equivalent)?
(2) Are accounts payable levels similar?
(3) Are asset sales to retire debt necessary?
(4) Are liabilities similarly structured (i.e., current, long-term)?

Cooperative A	Equity
+ Cooperative B	Equity
Unified Cooperative	Equity

(1) How are equities identified?
(2) What are the differences in equity types?
(3) What are the respective redemption plans?
(4) What are the redemption schedules (if applicable)?
(5) Are the cooperatives current in redeeming equity?
(6) What alternatives are available/applicable for consolidating member equities?
(7) What redemption plan will best suit the unified cooperative?

Assets = Liabilities + Equity

If tax implications are relevant to the situation, what are they?

use considerably different methods for depreciation, debt writeoff, salvage valuation, or have properties of possible windfall potential, procedures other than the general acceptance of book values may be necessary. Other procedures include evaluating assets on a liquidation basis, collateral basis, or appraisal basis.

The evaluation of assets of the cooperatives contemplating merger must reflect member-equity values. If book values are used, member-equity values also can be accepted. However, if assets are valued by appraisal or some other method, then member-equity values may have to be adjusted.

Reevaluation of assets and member equity may negatively impact some member good-will. Therefore, reevaluation must be done fairly and its impact well communicated to members.

When compensation for assets of one of the merging cooperatives is necessary (e.g., assets are sold or their value is appreciably high) the form of compensation must be negotiated. Compensation can be in cash, stock, notes, debentures, or book credit. Cash payments may be made in a lump sum or over a period of years.

Liabilities

Merger questions related to the examination of liabilities include (figure 1):

(1) How do the total debt to total assets ratios compare (are debt levels equivalent)?
(2) Are accounts payable levels current and similarly structured?
(3) Must assets be sold to retire debt?
(4) Are liabilities similarly structured (i.e., current, long term)?

Real differences in liabilities and long-term debt obligations can pose problems for merging cooperatives. However, differences must be analyzed in relative terms. The merger committee or analysts should start by examining the ratios of total debt (total liabilities) to total assets.

Ratio differences may indicate a possible source of friction between members of the participating cooperatives. If friction occurs, one method of alleviating the problem is to dispose of some of the assets from the cooperative(s) with greater debt to reduce the debt burden.

However, the outcome of such action (the sale of assets) must be carefully examined. First, to whom are the assets being sold. Will competitors be bidding on assets? If so, how will such a sale affect the unified cooperative's operations? Second, critical assets must not be sold simply to alleviate a difference in debt—the capacity of the assets that remain after sale must be sufficient to meet the unified organization's needs.

Therefore, in some cases, debt levels may have to be transferred as they are (or paid off in some other manner) so that the unified organization keeps the physical assets it needs to operate.

There is usually little concern when debt loads and structures are relatively similar. In most cases, such debt can be consolidated and/or restructured in a mutually agreeable manner.

Current liabilities should also be examined. If there are major relative differences in current liability categories—deposits received, advance payments, trade acceptances, notes payable, short-term loans, and current portions of long-term debt—the reasons for such differences must be clarified and a course of action set for resolving or accepting differences.

MEMBER EQUITIES

Member equity must be carefully examined during cooperative mergers. Member equity provides the definition and direct measure of members' investment and, thus, ownership in their cooperative. Data from 1991 (ACS Research Report 124—Equity Redemption and Member Equity Allocation Practices of Agricultural Cooperatives) indicate that equity made up 49 percent of assets for those cooperatives with active equity redemption programs (table 1). For those with inactive equity redemption programs (where equity is subject to but not redeemed) and those whose equity is not subject to redemption, equity made up 44 percent of assets. This ownership in their cooperative makes members particularly interested in how their equity is handled (i.e., transferred/exchanged) in a merger.

Table 1— **Equity redemption practices of agricultural cooperatives, 1991**[1]

	Percent
Active redemption programs	
Total equity to total assets	49
Unallocated equity to total equity	21
Inactive redemption programs	
Total equity to total assets	44
Unallocated equity to total equity	15
Systematic programs only	16
Special programs only	34
Systematic and special programs	26
Subtotal	76
No equity redemption program	10
Not subject to equity redemption	14
Total	100

[1] Rathbone and Wissman (ACS Research Report 124).

Figure 1 lists seven questions pertaining to consolidating members' equity:

(1) How are equities identified?
(2) What are the differences in equity types?
(3) What are the respective redemption plans?
(4) What are the redemption schedules (if applicable)?
(5) Are the cooperatives current in redeeming equity?
(6) What alternatives are available/applicable for consolidating member equities?
(7) What redemption plan will best suit the unified cooperative?

Cooperative leaders negotiating a merger must determine how to handle differences in equity types and what equity instruments should be used by the unified cooperative. They will also need to examine alternatives for consolidating equity and redeeming equity, and work out various related issues.

Allocated Equity

Equity capital in a cooperative is either allocated or unallocated. Allocated equity is capital assigned proportionally to each member on the basis of the patronage or business the member conducts with the cooperative.

Allocated equity is acquired in several different ways: (1) by direct investment from members (common stock, preferred stock), (2) through a retained patronage allocation (i.e., preferred stock, allocated equity), or (3) through per-unit retains. Conversely, unallocated equity is capital retained by the cooperative that is not assigned or designated to specific member accounts.

Cooperatives involved in mergers may have different allocated equity profiles. In some, equities may be accrued and labeled differently. Redemption plans and schedules may be at different stages. Others may carry old allocated equity of inactive, retired, or deceased members. Differences in the equity profiles of merging cooperatives may or may not cause problems. Small differences can usually be overcome easily. On the other hand, variations in redemption schedules and/or the presence of old allocated equity may create conflict between the members of merging cooperatives.

Unallocated Equity

While not assigned to a member's account, unallocated equity makes up varying amounts of total equity in cooperatives. In 1991, unallocated equity made up 21 percent of total equity for cooperatives with active redemption programs. For those cooperatives with inactive redemption programs, unallocated equity made up 15 percent of total equity (table 1).

Even though not individually assigned, members have a vested interest in how unallocated equity is handled. This is especially true when one cooperative has a much larger unallocated account in relation to its allocated equities than the other cooperative(s). It may be prudent to transfer some unallocated equities from the cooperative with the relatively larger amount into associated member allocated accounts. However, such a procedure requires careful study and administration.