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Building good management practices in Ethiopian agricultural cooperatives through regular financial audits

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ABSTRACT

The government of Ethiopia views agricultural cooperatives as important for increasing agricultural productivity and driving farm income growth. However, management deficits, including the lack of regular financial audits, poses a threat to the sustainability and commercial success of these local voluntary associations and the positive impact that they might have on the welfare of their members. This paper considers how the provision of financial audit services for agricultural cooperatives can be strengthened. We assess the current status of agricultural cooperatives in the country and the demand and supply of financial audit services for them. We then review the approaches taken in 11 other countries for providing financial audit services to agricultural cooperatives in order to identify approaches Ethiopian agricultural cooperatives might consider. Insights are gained on the need for capacity building within cooperatives on financial oversight, building internal incentives for cooperatives to have conducted regular financial audits on their accounts, addressing the deficit of auditors within Ethiopia, and creating reporting mechanisms so that any emerging financial problems within a cooperative are made known and addressed in a timely manner.

1. Introduction

Individual smallholder farmers generally are placed at a costly disadvantage in their engagements with buyers of their produce, with providers of agricultural inputs, or with the suppliers of key services if they enter into those engagements alone. Information constraints, small volumes, high transaction costs, low capital, insufficient credit, and other factors all work against the individual farmer profitably engaging alone in the market. Agricultural cooperatives are an institutional innovation often used to address this weakness of the individual smallholder farmer in the marketplace (Bernard, Spielman, Seyoum Taffesse, & Gabre-Madhin, 2010; Bosc et al., 2002; Rondot & Collion, 2001). Among other functions, such voluntary business associations of local farmers allow their owner-members, acting collectively, to obtain the information and to develop appropriate economies of scale that they need to participate profitably in both output and input markets, to reduce transaction costs, and to gain access to services, thereby deriving income gains for farmer-members. In principle, these cooperatives are owned and democratically controlled by their members, with each making contributions for the operations of the cooperative and accepting a fair share of the associated risks and benefits (ICA, 2014).

Despite their voluntary nature, the governance challenges associated with cooperatives operating effectively to attain the economic and social objectives for which they were established are as important for cooperatives as for any corporation, private firm, public agency, or other association. Good governance of a cooperative essentially concerns good management. Most cooperatives organize themselves around an elected board of directors drawn from the membership and staff who are employed by the cooperative to run its operations on behalf of its members, with the board having oversight on the staff and their activities. Through adherence in its operations and management to a set of agreed-upon norms and procedures, the cooperative is better managed and better able to provide the benefits that its members expect (Hannan, 2014a, 2014b). Four dimensions are commonly identified as being necessary to good governance: accountability, predictability, transparency, and participation (ADB, 1995; Brautigam, 1992). If the management capacity of an agricultural cooperative is deficient along any of these dimensions, the cooperative is unlikely to attain reliably the objectives for which its members established it.

A mechanism that is commonly used in all organizations to improve governance and to promote effective management is

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undertaking regular financial audits. Globally, the by-laws of most cooperatives and much of the national legislation governing their operations requires that such audits be carried out annually and the audit report shared with all members. Henrÿ (2012) asserts that such financial audits, together with broader management and social audits, is "a condition sine qua non for the sound development of cooperatives (p. 95)". When such audits are conducted regularly in a competent manner with the results provided to the membership in a manner that is broadly understood, such audits serve to promote good governance in the cooperative across all its four dimensions.

The government of Ethiopia encourages smallholder farmers in the country to pool their resources and efforts through local agricultural cooperatives. To better equip Ethiopia's agricultural cooperatives with the capacity to support their member farmers, the Agricultural Cooperatives Sector Development Strategy for Ethiopia was published in June 2012 (ATA, 2012). Among the critical support services for agricultural cooperatives that are not supplied in sufficient quantity or quality, the strategy identified regular financial audit services. Questions also have been raised about the independence of the financial audits of the cooperatives that are done. Increasing independent audit capacity is among the interventions proposed in the agricultural cooperatives strategy for Ethiopia. Over time, agricultural cooperatives increasingly are to be responsible for acquiring their own audit services using private sector auditors.

Given the importance of regular financial audits for the sustainability and commercial success of cooperatives, this study was undertaken to identify for the government of Ethiopia possible options it might exercise so that the financial auditing system for agricultural cooperatives in the country is more efficient, independent, serves the interests of members, and contributes to sustaining effective and well-managed cooperatives. As the challenges faced by Ethiopian agricultural cooperatives in this regard are not unique to Ethiopia, the insights gained should find application in other countries.

This paper is structured as follows. Section 2 provides a conceptual overview of the role of financial audits in the governance of cooperatives. Section 3 describes the study and the methods used. Section 4 describes agricultural cooperatives in Ethiopia, paying particular attention to the provision of financial audit services. In order to explore alternative models for the provision of financial audit services to agricultural cooperatives, Section 5 provides the results of a desk study of how audit services are provided to cooperatives in 11 countries around the world. The final section proposes interventions to improve the financial audit performance of agricultural cooperatives in Ethiopia.

2. Role of financial audits in the governance of agricultural cooperatives

The form that governance takes in cooperatives reflects their identity, values, and principles as autonomous association of individuals united voluntarily to meet their common needs (ICA, 2014). Of these characteristics, it is particularly their identity as democratic organizations that are controlled by their members that is most salient in determining the governance processes and mechanisms they use to manage their affairs and to achieve their objectives. To succeed, a cooperative needs to put in place a set of procedural norms and systems that enable the organization to address any divergence of interests among its owner-members and between members and the staff that run its operations that may threaten its viability (Cook & Burress, 2009). The principal focus for such governance processes is on how the interests of the membership are determined and prioritized, management of the cooperative takes action in support of those interests, and benefits accruing through these actions are distributed to owner-members.

Among the governance mechanisms common to most cooperatives is the requirement of regular financial audits. Financial auditing involves the independent examination of the recorded financial accounts for an organization in order to assess the accuracy of those records so that the true financial position of the organization can be verified. In the context of cooperatives, a financial audit primarily is conducted to monitor how well agents of the member-owners – primarily the management staff of the cooperative, but also the cooperative board – are utilizing the financial resources of the cooperative to advance the interests of the members (Pozzobon, Zylbersztajn, & Bijman, 2012). Audits are conducted with the expectation that reforms will be made if it is found that financial management does not meet the standards expected. As the implementation of such audits in cooperatives is to a large degree similar to financial audits of other organizations, there is not an extensive literature on them (Guinnane, 2001; Henrÿ, 2012). However, the importance of the information provided by financial audits in contributing to effective governance of cooperatives by their member-owners is somewhat more significant than for other organizations.

Regular financial audits of cooperatives generally are seen as providing an objective mechanism for ensuring accountability within a cooperative, ensuring that those cooperative board members and staff responsible for the management of the finances of the cooperative act prudently and use those resources in accordance with the objectives set by the owner-members. Accountability is one of the four dimensions of good governance, and the role of financial audits for cooperatives in this regard is similar to the role such audits play in most organizations. However, audits also strengthen within cooperatives the three other dimensions of good governance – predictability, transparency, and participation. The regularity of financial audits strengthens expectations within the cooperative that a consistent professional approach to the management of the cooperative will be used to respond to actions by anyone or to changing circumstances that challenge the ability of the cooperative to operate in the interest of its members. Institutionally, the cooperative will be strengthened by a stronger sense of predictability among members in how action is expected to be taken in the cooperative to respond to these challenges. Similarly, audits promote transparency by making available to the member-owners significant information on how well the staff and management of the cooperative are working in their interests, thereby reducing uncertainty, serving as a check on corrupt practices within the cooperative, and building trust among members.

Finally, such audits can promote increased participation by members in the activities of the cooperative. The results of the audits provide information to member-owners on which they can take action to safeguard or advance their interests. When audit reports are presented in a manner that makes sense to them, members should be expected to better engage in addressing financial management issues affecting the cooperative. However, for this to happen, members need to develop skills, and be supported in doing so, on how to make effective use of the information such audits provide, ideally in a process of social learning (Borda-Rodriguez & Vicari, 2013). The information from the audits is important, but without enabling the members to use that information creatively in seeking solutions to problems facing the cooperative, in seeking to optimize the returns that they receive from their participation in it, or in holding cooperative staff and management to account, most of the value of the audit for improved governance is lost. Participation in the cooperative is only enhanced through financial audits when the members have the ability to apply the audit information obtained to maximize the benefits they derive from their membership.