

# A Brief Introduction to Agricultural Cooperatives



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# A Brief Introduction to Agricultural Cooperatives

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**T**his publication is designed to help you learn more about agricultural cooperatives or to help you think through the process of organizing and operating such a business. While the focus is on creating a new cooperative, many of the ideas may be of interest to those thinking about reorganizing or expanding an existing agricultural cooperative. Likewise, many of the concepts apply to any type of cooperative business—agricultural as well as nonagricultural.

As you consider an agricultural cooperative, keep in mind that not all business concepts fit well into a cooperative form of business. It is important to explore alternative forms of business for meeting your economic goals. Perhaps a standard corporation or limited liability company might be better able to meet your goals and serve the business needs of potential cooperative members. After a short discussion about why someone might want to act cooperatively, this publication provides a very brief overview of alternative forms of business.

This publication explores important considerations in developing an agricultural cooperative:

- The nature of a cooperative, key elements for success, and common mistakes to avoid
- A comparison with other business types and a discussion of cooperatives' primary operating procedures

- The historical background of cooperatives, with an emphasis on the cooperative movement in the United States, including impacts of the Capper-Volstead Act and recent developments
- Common cooperative functions, including marketing, supply, and services
- Underlying economic principles that invite the creation of cooperatives—elements of market imperfection and the potential for increasing member returns through collective action
- Potential benefits and limitations of cooperatives
- Equity and debt considerations, including unique equity investment aspects, sources of equity, and equity redemption systems
- Legal organization, with emphasis on articles of incorporation and bylaws
- Characteristics of cooperative management—its role, functions, and tools
- The nature and role of cooperative directors as policymakers and individuals
- Membership responsibilities
- Cooperative influences on public policy
- Relationships and linkages between independent, federated, and centralized cooperatives

At the end of this publication, you will find sources for additional information—local and national

cooperative organizations as well as Web sites.

## *Why do something cooperatively?*

A compelling need might lead you to consider forming an agricultural cooperative. Perhaps you need to expand in existing markets or develop new markets beyond the bargaining power or supply potential of your business. Or, you might feel group effort is needed to secure lower-cost inputs or larger

## *What is a cooperative?*

- It's owned and financed by its members, who also are its customers.
- Its purpose is to provide services to members at the lowest possible cost—not to generate the highest possible return to investors.
- It is controlled by members, usually on a one-person, one-vote basis.
- Profits are distributed to members based on how much they use the cooperative, not on how much they've invested in it.

quantities of inputs. Additional services or higher quality might be more readily available with joint efforts. Perhaps you simply need to increase the net income generated by your business.

Whatever the need, creating a producer cooperative requires a cautious approach. If done properly, a cooperative can give farmers and ranchers a competitive edge by improving market returns or reducing operating costs. But, if done improperly, it can lead to disappointing financial returns.

### *The nature of a cooperative*

A cooperative is a special type of corporation that is owned and controlled by those who use its services. In furtherance of their mutual benefit, members finance and operate the business. By working together, members may be able to meet objectives that they could not meet as individuals. Hence, the financial returns to individual operations may be greater than they would be without cooperative effort.

In many respects, a cooperative is like any other partnership, corporation, or limited liability business. The physical facilities, functions, and business practices may be identical. Like any other corporation under state law, a cooperative has articles of incorporation and bylaws that govern its actions. It has an elected board of directors and usually is managed on

### *Key terms*

#### *Patronage*

Use of a cooperative by its members

#### *Equity*

Money directly invested in a cooperative

#### *Net returns or net savings (profits)*

The amount remaining after a cooperative subtracts its costs from its income

#### *Patronage dividends*

Distribution of net returns to members based on how much each member uses (patronizes) the cooperative

a day-to-day basis by professionals who function under policy set by the board.

In other significant ways, cooperatives are quite different. Differences stem from the nature of the cooperative's purpose, ownership, control, and distribution of benefits. The intent of a cooperative is to provide its services to members at the lowest possible cost—not to generate the highest possible return to investors. Yet, sufficient revenue must be generated to meet continuing capital needs.

As originally conceived, cooperatives were to be operated on a nonprofit basis. The term "profit" was avoided. Instead, revenues above costs were called "savings." A portion of savings was retained by the cooperative, and the remaining amount was returned to members as patronage dividends.

Today, most cooperative leaders no longer avoid the word profit. Instead, they speak of profit as

necessary for cooperative growth and enhanced returns to members. Net income (revenues above total costs) usually is returned over time to members as patronage dividends. Benefits typically are tied to the amount of use, not the amount invested. Returns to members' equity investment in the cooperative usually are limited in order to focus attention on returns based on use of the cooperative's services.

Most cooperatives are controlled democratically on a one-member, one-vote basis. However, some cooperatives permit a limited proportional vote based on the amount of use members make of the cooperative's services.

### *Key people for success*

For a cooperative business to be successful, the members, as users, must be active through their patronage, and they must be willing to make a capital investment in the business and to

participate in decision-making. They must be interested in the affairs of the cooperative, present ideas for improved performance, and promote the cooperative's use by others who could benefit from it.

Success also requires outstanding management. The board of directors, elected by members from within the membership, provides leadership by overseeing the cooperative's business affairs and establishing broad policies. Communication with the cooperative's professional management and with members is critical. Professional management must be well equipped to supervise and manage employees, capital, and physical resources; routine business activities; planning and goal setting; and implementation of board policy.

The importance of the cooperative's employees should not be overlooked. Beyond job competence, employees need to understand the cooperative's purposes, objectives, and operating procedures. Well-educated and trained employees can improve member relations; enhance the cooperative's image with customers, vendors, and regulators; and increase the general public's understanding of the cooperative.

### *Avoiding common mistakes*

Sometimes people believe that forming a cooperative will automatically solve business problems faced by individual operations.

In reality, forming a cooperative doesn't eliminate the limitations with which businesses must contend. Cooperatives are subject to the same economic forces, legal restrictions, and interpersonal relations as other businesses.

Even when a cooperative restricts the volume of product delivered from its members, it cannot control their production. Neither have cooperatives been very successful at pooling labor resources, providing machinery, or production activities. The inability to control production means that cooperatives can't fix prices in the marketplace. In most cases, the availability of substitute products enables customers to avoid paying artificially high prices. Also, growers frequently can market outside the cooperative and, in the short run, still benefit from prices fixed by the cooperative.

A cooperative may not be able to obtain market power. Frequently, member-patron ability to generate equity capital is not sufficient to acquire the size and diversification needed.

Forming a cooperative generally doesn't allow producers to eliminate marketing functions needed to move products to the consumer. However, a cooperative may be able to influence market structure—where and how marketing functions are performed. Marketing functions may be replaced by the cooperative. Hence, cooperative efforts may improve inefficient marketing practices.

Furthermore, cooperatives cannot be expected to help members sell their surplus or poor-quality products. Neither can a cooperative be expected to sell the highest quality or most complete services at rock-bottom prices. Instead, cooperatives need to provide “bang-for-the-buck” supplies and services to their members.

While a cooperative is subject to the same interpersonal problems as any business, additional problems typically occur, stemming in part from the fact that the cooperative is owned by many of those who patronize it. Differences in business acumen and objectives may put members at odds.

### *Be realistic*

- Don't expect a marketing cooperative to be able to control members' production or to raise prices for their products.
- A cooperative can't help members sell surplus or poor-quality products.
- Pay attention to people problems. Competing objectives may limit a cooperative's ability to meet its potential.

Directors of cooperatives frequently must choose between building the financial strength of the cooperative through retained patronage refunds and returning savings to members, who may want to receive a short-term benefit for investment in their own operations. Investing in the cooperative may help it meet its full potential in the longer run.

Limited objectives of some members may restrict the cooperative's volume and opportunities to reduce per-unit costs. Additionally, the democratic process, especially when large numbers are involved, may delay decision-making and restrict the expansion of business activities.

### *Toward making the cooperative a success*

Frequently, cooperatives that enhance members' competitive edge exhibit the same key elements. In the beginning, the use of professional advisors (frequently a manager) and committee structures for decision-making typically are important. Timeliness of decision-making is critically important. Also, keeping members informed and involved becomes an ongoing effort. Following sound business practices, conducting businesslike meetings, and maintaining a formal board/management working relationship also are important.

An experienced advisor on cooperative organization can be a real asset when forming such a

business. That person can help committee members seek members, choose a site, develop facilities, devise legal structures, acquire capital, finance operations, and enhance communications. An emphasis on communication can make members feel informed and involved, thus encouraging them to invest time and money in the cooperative as well as to patronize it.

A mindset that encourages sound business practices lays the foundation for success by developing an appropriate accounting system, preparing operating and capital improvement budgets and financial reports, communicating to the membership on a regular basis, and conducting long-range planning efforts.

Continuing education is vital to the successful operation of a cooperative. A democratic, majority-rule approach to governance requires an involved and enlightened membership. The cooperative's responsiveness to member needs depends on informed

members expressing themselves. Furthermore, members must recognize that they have a responsibility to participate in financing the operations of the cooperative and to educate those outside the cooperative environment—other businesses, government personnel, and the general public.

### *Contrasting a cooperative with other forms of business*

In many respects, a cooperative is the same as any other business entity. It is proprietary in the sense that it is owned by its investors and is operated privately, as opposed to being a public institution. It seeks to increase the economic well-being of its owners.

A major difference lies in how cooperatives distribute net income (profits). Cooperatives return net income to their investors based on investor patronage (usage of cooperative services or purchase volume). Other businesses tend to

#### *Keys to success*

- Professional advisors
- Communicating with members
- A mindset that encourages sound business practices
- Conducting businesslike meetings
- Maintaining a formal board/management relationship

distribute returns on the basis of investment in the business.

There are three basic business forms: proprietorship, partnership, and corporation. In addition, there are hybrid forms such as Limited Liability Companies (LLCs). Most, but not all, cooperatives are legally formed corporations. A cooperative not legally formed as a corporation is a partnership.

If you use anything other than your own name for a business conducted in Oregon, you must register the business name with the Corporate Division of the Oregon Secretary of State's office. That office's excellent Web site can help with many aspects of organizing and operating a business (<http://www.filinginoregon.com/>).

### *Proprietorships and partnerships*

Proprietorships are businesses owned and controlled by one entrepreneur (may include a spouse), who provides all equity capital, makes key management decisions, and accepts unlimited liability (extending to personal assets) for business debts. In exchange, the entrepreneur receives all profits (positive or negative) and pays income taxes as an individual. The business ceases to exist when the owner leaves or dies.

Many businesses in the United States are single proprietorships, but they produce a relatively small percentage of dollar sales generated by businesses as a whole. There is

no limit on the size of the business. No legal formalities are needed to form a proprietorship except perhaps obtaining local permits or licenses.

A partnership is similar except that it is operated by two or more "unrelated" persons or businesses. In many cases, people who form partnerships accept the role of general partner. They share in management decisions, invest in the business, and have unlimited liability for the partnership's debts. Partners pay taxes as individuals on net income generated by the partnership. In most cases, when one of the general partners leaves or dies, the partnership is dissolved.

A variation on the partnership is the limited partnership. In this form of business, there must be at least one general partner. The limited partners have no personal liability for partnership obligations. However, they may vote on matters such as general partner changes, admission of new limited partners, dissolution of the partnership, amendments to the partnership agreement, sale/exchange/encumbrance of partnership property, incurring extraordinary debt, or change in the purpose of the partnership's business. Their primary interest is the return on their investment. They pay taxes as individuals on those returns. When registering with the Corporate Division, the business name of a limited partnership must include the abbreviation LP at the end of the name.



In agriculture, limited partnerships sometimes are formed to control resources such as land. Sometimes, general partners in the farming operation may be limited partners in the landholding company.

Another variation is the limited liability partnership, which can be formed for service businesses. This form of organization limits partner liability for partnership debts to the amount of their investment. Other aspects of the partnership remain the same. When registering with the Corporate Division, the business name of a limited liability partnership must include the abbreviation LLP at the end of the name.

### *Corporations*

A corporation is a legally created being that can own assets, has the right to net income, can sign contracts, can sue and be sued in a court of law, and is liable for all business debts and obligations of the business. If an owner of the corporation dies or sells equity in the business, the corporation continues to exist—it is perpetual.

There is no minimum size for a corporate form of enterprise.

Articles of incorporation and bylaws must be filed with the Secretary of State. As with other types of businesses, recording fees, annual license fees, and annual reports must be filed. If these requirements are not met, the state will dissolve the business. The Articles specify the purpose of the corporation, the Bylaws identify operating rules and officers, and the reports include updated information about the corporation, such as current directors, change of address, etc. Shares of stock are given in exchange for cash and the value of property and services provided by the shareholders (owners) to the corporation. Annual and special meeting minutes must be recorded and archived. The overall management of a corporation is vested in a board of directors, which is elected by the shareholders.

In general, shareholders are liable for corporate acts only to the limit of their investments. A corporation has a life of its own and can be dissolved only by its shareholders or creditors. The identity of shareholders, managers, and directors makes no difference. Income is “double taxed”; the corporation pays taxes on net income, and after-tax income distributed to shareholders is taxable to shareholders at their individual rates. However, after-tax income may be retained by the corporation for investment up to specified IRS limits.

Corporations offer numerous possibilities for creating benefit programs for employees, who also may be shareholders. If properly constructed, those programs are tax deductible for the corporation.

They frequently include retirement plans, medical insurance programs, group or key-employee insurance coverage, and housing and meal expense programs. Estate planning is made easier by the transfer of shares. Important for many family corporations, the “original owners” of the corporation typically can maintain control of the business by having bylaws that require approval of 51 percent of the corporation’s stock for filling board of director positions and 67 percent for questions related to dissolution, merger, or sale of the corporation.

Most cooperatives are distinguished in the federal tax code as subchapter T corporations. Other categories include subchapter C (regular corporations), subchapter S (small, also known as tax option, corporations, which transfer all profits and losses back to shareholders), and nonprofit corporations, which vary in terms of the tax treatment of net income and losses.

Unlike other corporations, subchapter T corporations are chartered in Oregon (and many other states) under statutes that specifically address the unique nature of a cooperative form of business. Any income the cooperative earns is taxable to the

cooperative if it is derived from sources not associated with providing member services.

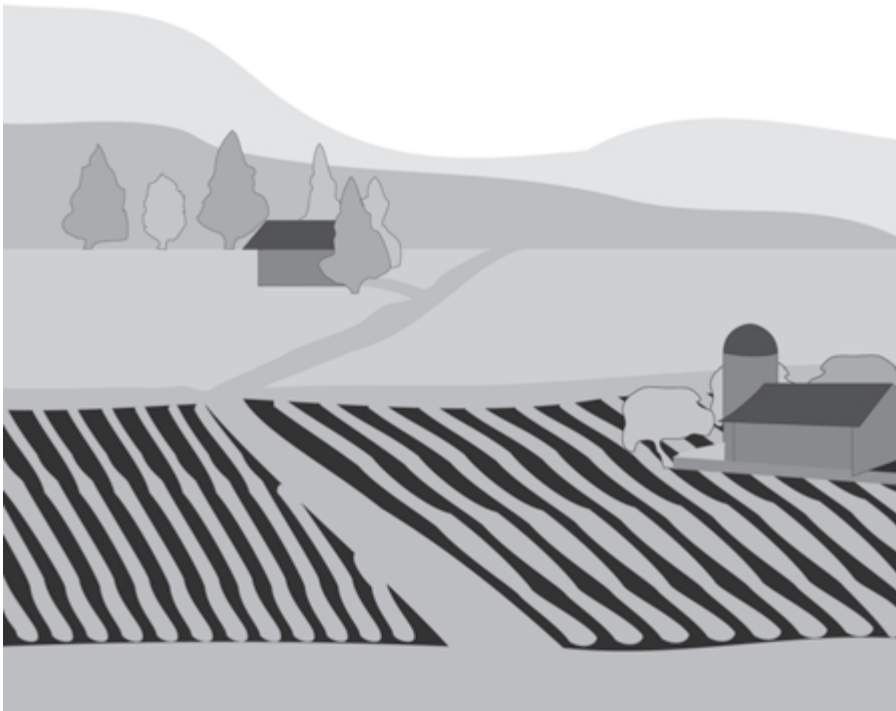
### *Limited liability companies*

Limited Liability Companies (LLCs) have become an increasingly popular business form for agricultural enterprises. A primary reason is the flexibility of an LLC with respect to liability protection and its tax treatment (income is taxed only once, as with a partnership). Increasingly, it is the preferred form of business when access to income, reduced formality, and protection from personal liability are important. In some cases, LLCs are used to own land, which in turn is leased to the operating business. In many cases, both are controlled by the same operators.

The organization of an LLC is fairly straightforward. The designation LLC must appear after the name of the business. The company must file a Certificate of Formation (similar to articles for a regular corporation) with the Secretary of State and pay applicable fees. As with a corporation, annual reports and renewal fees generally are required. An Operating Agreement (similar to a partnership agreement) is required in many states, but usually is not filed with the state.

The LLC has members rather than partners or shareholders. Any person or entity may be a member. There is no restriction on the number of members—one person may form an LLC. Members share





in gains and losses as specified in the Operating Agreement, but are taxed like partnerships. Ownership is based on certificates (shares), which may or may not be based on capital investment. Frequently, certificates are issued for management expertise, technical skills, etc. Like a corporation, the LLC owns all of its assets.

Voting rights may be based on ownership, a distribution formula for gains and losses, or an arbitrary rule. There may be managing members and nonmanaging members. The distinction typically is the same as that between general and limited partners. Unlike the perpetual nature of a corporation, the lifetime of an LLC may be specified or unlimited. Dissolution after the withdrawal of a member can be avoided by a provision in the LLC Operating Agreement.

No members are personally liable for LLC debts. However, as with other protected business forms, there is liability for debt guaranteed by a member or tort liability outside the LLC. Also, members cannot avoid liability related to taxes, environmental laws, and negligence or breach of a member's obligation to the LLC.

Single-member LLCs are taxed like individual proprietors, including self-employment tax. If there is more than one member, an LLC's net income can be taxed as it would for a regular corporation, or it can be distributed to members, who then are taxed as individuals (as in a partnership or subchapter S corporation). Nonmanaging members do not pay self-employment taxes. Estate planning rules for partnerships apply to managing members; for nonmanaging

members, the limited partnership rules apply.

### *Distribution of economic returns*

Investor liability is a key consideration affecting business organization. All owners (members) of a cooperative have limited liability equal to their equity investment. Losses, debts, and other claims on the business can be satisfied only up to the limit of the equity invested in the business. Creditors cannot seek additional outside funds from the owners to satisfy claims against the business.

Similar to subchapter S corporations, cooperatives under subchapter T pay no income taxes on net returns from "regular" operations. Only distributions to owners are taxable at the owner's individual rate. Cooperatives do pay other taxes, including those levied on property, sales, employment, and fuel.

Economic returns to cooperative members are emphasized over returns to invested capital. Return to investment in many cases is set at zero. Members usually receive returns based on their patronage (purchases or use of cooperative facilities and services). Typically, some net returns or assessments are retained to finance operating and capital needs of the cooperative. These retained returns are paid back to members at a later date on a patronage basis. While not

guaranteed, many cooperatives establish a desired retained returns payback schedule. Depending on the cooperative, the schedule may range from a few years to more than 20 years.

For tax management purposes, net returns from regular cooperative operations in a particular year can be handled in two ways. Part or all of those net returns can be identified by the cooperative as a dividend known as a “qualified allocation.” The cooperative must pay a minimum of 20 percent of that dividend to members as cash. The full amount of the dividend, whether received by the member or not, is treated by the member as income received in the year the dividend is earned. The 20-percent cash dividend helps members pay income taxes owed on the full amount of the dividend. The entire dividend is tax deductible from the cooperative’s earnings for that year. Any of the dividend retained in the cooperative and paid to the member at a later date is completely tax deductible for the member at that time since taxes were paid by the member on those monies in the year the dividend was earned. In other words, member dividends that are qualified allocations and retained by the cooperative don’t permit the member to defer taxes on those monies until they are received.

On the other hand, part or all of net returns may be identified by the cooperative as dividends that are “nonqualified allocations.”

Members expect to receive these dividends at a later date and pay income taxes on them in the year received. Meanwhile, the cooperative pays income taxes on these retained

dividends in the year they are earned. When paid out in later years to members, the cooperative treats these dividends as tax-deductible expenses. The advantage of retaining nonqualified allocations is that income taxes owed by the cooperative may be offset by tax credits. Those tax credits are usable only if there are income taxes due by the cooperative. An additional benefit is that members may find it to their advantage to defer income taxes on this type of dividend until the year it is received.

### *Historical background*

The concept of human cooperation within the community is not new. As early as 1752, Benjamin Franklin helped organize the first formal cooperative in the United States—the “Philadelphia Contributionship for the Insurance of



Homes from Loss of Fire”; it continues to operate. But, the organizational characteristics that underlie modern cooperative businesses have mostly been developed within the past 160 years. Many point to the formation of the Rochdale Society of Equitable Pioneers, Ltd. in 1844 as the first successful cooperative business. It was formed by a group of tradespeople in England as a consumer (buyer’s) cooperative.

While not explicitly stated, the cooperative principles observed by the Rochdale Society were the key to its success. The members controlled the business by a one-member, one-vote democratic process. Membership was open. With respect to ownership, equity was provided by the patrons, and each person’s equity was limited as a share of total equity. Limited dividends were paid on members’ equity investment, and income after all costs were covered was returned

to patrons as a patronage refund based on the value of the patron's purchases. All goods and services were exchanged at free market prices. Other principles that contributed to the Society's success included a duty to educate, cash trading only, no assumption of unusual risk, political and religious neutrality, and membership equality between the sexes.

Following the Civil War, agricultural cooperatives began to be formed in the United States. Most were patterned after the Rochdale system. The Grange and later groups such as CENEX (Farmers Union Central Exchange, Inc.) and the National Farmers Union (Farmers Educational and Cooperative Union of America) fostered the development of many cooperatives. But, in the 1890s, antitrust legislation began to put a damper on agricultural cooperatives. Subsequent court rulings effectively made farmer cooperatives illegal. Farmers were prosecuted for collective action—especially for activities that involved pricing agreements and terms of trade.

### *The Capper-Volstead Act*

In response to concerns about antitrust allegations, Congress passed the Capper-Volstead Act in 1922. It contained two key provisions. The first permits farmers to collectively market their products without the threat of antitrust action. By acting together, agricultural producers are permitted to create countervailing power when

bargaining with typically fewer, larger buyers. The second provision of the Act protects the public from “undue price enhancement” caused by monopoly action by a group of producers.

As a result of Capper-Volstead, agricultural producers not only may form associations, but those associations may form agencies. In order to reduce competition among producers, associations must be operated for the mutual benefit of their members, who must be agricultural producers. In addition, an association must deal in the products of its members to a greater degree than the products of nonmembers. Finally, an association must conform to at least one of the following rules: (1) no member of an association is allowed more than one vote because of the amount of stock or membership capital owned, or (2) the association does not pay dividends on stock or membership capital greater than 8 percent per year.

While Capper-Volstead provides limited antitrust exemption, agricultural cooperatives can be prosecuted under antitrust laws if they are involved in prohibited business practices. Specifically, they may not engage in “predatory” pricing practices or conspire or collude with third parties to fix prices, restrict members' agricultural output, coerce competitors or customers, combine with other firms to “substantially lessen competition,” or engage in boycotts. If an association is found to

be monopolizing or restraining trade to the extent that it “unduly enhances prices” of agricultural products, then it may be required to “cease and desist from monopolization or restraint of trade.”

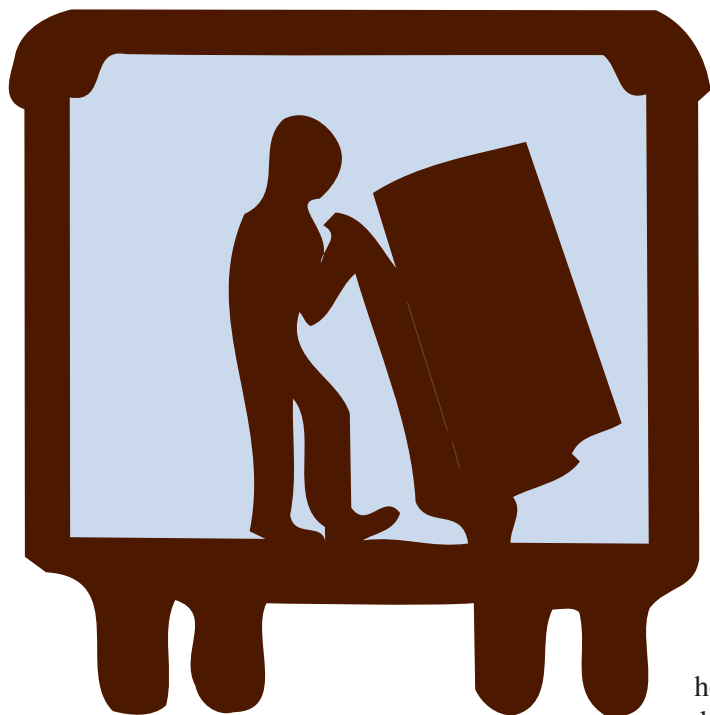
### *Recent developments*

Since the 1950s, agricultural cooperatives have continued to develop with only a modest amount of government help—broad research, education, and advice. While remaining separate, most agricultural cooperatives and general farm organizations have maintained friendly and complementary relationships.

Neutrality toward political parties is widespread, but agricultural cooperatives are increasingly involved in political action to influence agricultural policy and the economic and business environment. Because of an increasingly global economy, many agricultural cooperatives have organized their structure and business strategies around an international economic dimension.

Agricultural cooperatives have increasingly looked for ways to grow. Growth has come both internally and through consolidation of smaller cooperatives. Larger size has allowed many cooperatives to expand into value-added agricultural activities such as input manufacturing and product processing.

A 1998 USDA national survey of cooperatives (see USDA's Rural Business-Cooperative Service Web



site at <http://www.rurdev.usda.gov/rbs/pub/sr576.pdf>), found that about 3,600 cooperatives across the nation served 3.4 million members. Five years earlier, almost 5,000 agricultural cooperatives served more than 4 million members. Combined assets totaled about \$47 billion in 1998, up from just over \$31 billion in the earlier survey. Net business volume (excluding sales between cooperatives) generated more than \$104 billion, compared to \$76 billion 5 years earlier. Member investment in their agricultural cooperatives totaled almost \$20 billion, up from just over \$14 billion. By numbers of agricultural cooperatives, Minnesota continued to lead the way with about 390, down from about 425. That state also continued to have the largest total number of cooperative members, 330,000 compared to about 365,000 in the previous

agricultural cooperatives headquartered in Oregon fall into five major categories: supply, marketing, grains and oil seeds, fruit and vegetable processing, and dairy processing. In all, there were about 40 agricultural cooperatives headquartered in Oregon in 1998, with a total membership of just under 22,000. Five years earlier, there were more than 60 agricultural cooperatives serving more than 40,000 members. In the latest survey, net business volume for the 40 cooperatives amounted to about \$2.1 billion. The 60 cooperatives surveyed 5 years earlier did just over \$2.4 billion on an annual basis.

For both farm marketing and farm supplies, agricultural cooperative dollar volume has approached 30 percent of the total agricultural sector. Cooperative share of sales in many commodity categories is significant, especially for milk and

survey. Iowa led the way with highest net business volume of almost \$11 billion. Five years earlier, California led with just over \$8 billion.

Closer to home, in descending order of importance,

grains/oilseeds. For milk at the first-handler level, as much as 80 percent of sales go through cooperatives. Grain marketing approaches 40 percent, while about 20 percent of fruit and vegetable dollar sales go through cooperatives. For livestock, about 10 percent of sales typically move through cooperative channels.

The number of agricultural cooperatives has been declining, largely due to mergers and acquisitions intended to foster growth. Yet, the interest in cooperation seems to be increasing. Many agricultural businesses are looking at cooperation both as a way to help people socially and to help ensure the economic survival of their businesses.

Some observers of current agricultural cooperative trends refer to “value-added” or “new generation” cooperatives. Many cooperatives are increasingly combining traditional cooperative structures with links to limited liability companies, partnerships, or regular corporations. Rather than only buying supplies or producing and marketing commodities, farmer-owned cooperatives are finding ways to integrate vertically. They may control input availability and cost all the way through the production and sale of institutional and consumer food products. State and federal tax incentives have encouraged these more complex business structures and efforts to integrate vertically. In addition, these linkages can provide sources of

new capital for cooperative business growth.

### *Underlying principles of cooperation*

Cooperatives are formed to do something better than individuals could do for themselves or through a noncooperative form of business. Perhaps the goal is to develop market power in order to sell products at higher prices or enter new markets. Some cooperatives are created to obtain and deliver inputs such as feed, seed, petroleum, and fertilizer more economically. Others ensure the availability of needed services or pool risk.

Acting together, members can take advantage of economies of size or develop bargaining power. In doing so, the cooperative attempts to fulfill member needs at the least possible cost. However, in order to cover all costs and meet capital needs, the cooperative necessarily charges competitive market prices. The at-cost basis becomes reality when the cooperative returns surplus money (dividends) to members at the end of the fiscal year.

The basic principles underlying modern cooperatives include:

- The user-owner concept—The people who own and finance the cooperative should be its users.
- The user-control concept—The controllers and users of a cooperative are one and the same.

- The user-benefits concept—The cooperative's sole purpose is to provide and distribute benefits to users based on the amount of their use.

Members benefit both directly and indirectly from a cooperative. Direct benefits may include a better assurance of supply sources and access to product markets, which can directly increase the net income of their own businesses. Indirect benefits may include a greater influence on input and output markets, increased business knowledge, and participation in research and development activities.

By limiting the payments to invested dollars, cooperatives focus on their primary responsibility—providing needed products and services to members. Current users finance the cooperative in proportion to their use of its services. That investment usually is returned to the member on a scheduled basis.

Cooperatives primarily acquire capital in three ways.

- Direct investments may be made by members. As an example, a condition of membership may be an initial fee, which buys stock in the cooperative.
- Capital is also raised by retaining some net income rather than paying it out as patronage refunds. The resulting retained patronage returns are proportioned to members based on the amount of business (patronage) they have done with the

cooperative during a particular period of time, usually a fiscal year. These retains are paid to members over time.

- The third approach to generating equity is to create capital retains from earnings. Rather than paying back earnings to members, a selected portion is paid as equity capital stock. This stock usually is issued with regard to the member's level of patronage.

Some agricultural cooperatives are experimenting with the sale of preferred-type stock, which is sold primarily to nonmembers. Preferred stock does not confer voting rights. These investors expect dividends to be paid by the cooperative on a regular basis, and they risk no more than the loss of their investment. They pay taxes on dividends at their regular rates.

Broad economic decision-making by a cooperative usually is guided by vote of the members. Many cooperatives maintain a democratic approach to decision-making: each member has one vote regardless of the amount invested in the cooperative or use of its services. Increasingly, however, cooperatives are adopting or considering "member control" voting systems, which relate to the amount of patronage each member conducts with the cooperative.

Most agricultural cooperatives are not completely open for membership. Frequently, membership is restricted to commercial operators.

The word “commercial” in this context means a good or service produced for economic gain. In some cases, membership may be restricted further to accommodate perceived limits on market availability.

### Common cooperative functions

Cooperative business organizations can be found throughout the agricultural sector. They range in size from a few growers working to improve the marketability of their commodity to large agribusiness concerns serving the complex needs of thousands of members. Frequently, cooperatives are classified by the type of commodities they handle or the functions they perform. Many cooperatives combine functions.

#### Marketing

Marketing cooperatives include bargaining and processing organizations. Frequently, marketing cooperatives do some of each activity. Their primary role is centered around moving member products through marketing channels toward the ultimate consumer.

Some marketing cooperatives perform limited activities, but others assume responsibility for all marketing functions, e.g., receiving, grading, processing, packaging, labeling, branding, storing,

transporting, distributing, merchandising, etc. Marketing cooperatives are becoming more vertically integrated by increasing their ownership and control of facilities beyond the first-buyer level. In some cases, they own retail outlets that sell to the ultimate consumer.

Many marketing cooperatives have major outlets through hotels, restaurants, and institutions. Export is another growing area. Leading exports are nuts and nut products, fruits and related preparations, grains and related products, and oilseeds and oilnuts.

While some cooperatives are purely bargaining organizations (associations), many go beyond price and terms-of-trade negotiation. Most represent their members at the first-handler level. Those that are purely bargaining cooperatives are mostly in the fruit and vegetable industry and do not handle or take title to the product they represent.

### What do agricultural cooperatives do?

- Marketing—ranging from helping members sell their products at the first-handler level, to processing, distributing, retailing, and exporting
- Supplying high-quality products at reasonable prices to members
- Providing specialized services such as drying, credit, utilities, insurance, or trucking

#### Supply

These types of businesses frequently are referred to as purchasing cooperatives. They handle a wide variety of farm supplies and equipment. Frequently, members benefit from a supply cooperative’s ability to maintain a steady, dependable supply of products at competitive prices—even in times of shortages. Increasingly, supply cooperatives are adding general merchandise lines to increase sales to both members and nonmembers.

Many supply cooperatives have become more vertically integrated. In many cases, they manufacture the supplies that they distribute, especially in the case of feed, fertilizer, and petroleum products. As an example, cooperatives play a major role in providing petroleum products to agricultural businesses. Through regional organizations, cooperatives explore for crude oil and natural gas, but are mostly focused on refining and

manufacturing petroleum products and operating wholesale and retail distribution networks. However, some also conduct research and test new products.

At the retail level, many cooperatives provide bulk delivery and application services to members, as well as full-service facilities that provide on-farm maintenance, service stations, parts, maintenance, and accessories such as tires and batteries.

### *Service*

A wide variety of cooperatives provide services to agriculture, primarily credit, utilities, insurance, and specialty services. In some cases, cooperatives form special subsidiaries to perform these services for members. Specialty services include trucking, storage, drying, grinding, and a host of other activities.

### *Nonagricultural*

A relatively small number of cooperative memberships are in traditional agricultural marketing and supply cooperatives. Most are in cooperative forms of businesses owned by consumers, employees, nonagricultural businesses, public institutions, and nonprofit organizations.

A wide variety of consumer-owned cooperatives has been created to meet the need of goods and service users. In many cases

they are small, sometimes unstable, organizations that provide a source of high-quality or natural foods, housing, burial services, or day care. In other cases, at least on the surface, some cooperatives look like any large retail business. They may be involved in business activities as varied as general merchandise, medical services, utilities, or banking.

While consumer-owned cooperatives have remained popular in Europe, the picture in the United States has been mixed. Periods of widespread enthusiasm and success have been followed by disinterest and failure. Consumer-owned cooperatives were especially popular during the Great Depression, when people were desperate to overcome unemployment, poverty, and the belief that monopolists were extracting high profits by overpricing consumer goods.

Over time, the one type of consumer-owned cooperative that has remained strong and growing is the credit union. Credit unions and other surviving cooperatives, especially natural food retail cooperatives, typically exhibit four major characteristics:

- A need for the cooperative as expressed and acted upon by the members
- Competent managers and directors
- Adequate capitalization to meet both operating and long-term investment needs

- Supportive, well-informed, and educated members

Employee-owned cooperatives in the United States have experienced growth in both numbers and size. Much of the interest in this form of cooperation has centered on job preservation, productivity improvements, capital spreading, encouragement of employees to invest in the businesses that employ them, and creation of a democratic workplace. Very favorable tax law changes have encouraged employee participation in business ownership by establishing pension benefit programs that include employee stock ownership plans. Many agricultural and nonagricultural cooperatives are looking at ways to develop hybrid forms of cooperative membership that would give their employees an equity stake in the cooperatives that employ them.

Nonagricultural businesses have experienced success in many efforts to form cooperatives. Through cooperatives, many functions can be performed more efficiently, e.g., bulk purchasing, development of computerized distribution and billing systems, creation of a common identity, and advertising. Typical cooperative arrangements include one-business, one-vote democratic control and distribution of net income to members on the basis of use.

### *Underlying economic principles that may invite creation of cooperatives*

Much of the incentive to form a cooperative comes from the desire to overcome a common problem and thereby improve well-being. In many cases, the primary goal is to increase the net income generated by member businesses. Rational entrepreneurs frequently see cooperatives as a means to achieve that goal.

### *Elements of market imperfection*

If all markets were perfect, there would be no incentive to form a cooperative—or any other particular business type. Cooperatives frequently are seen as a means of countering imperfections in the economic system. There are many reasons for these imperfections.

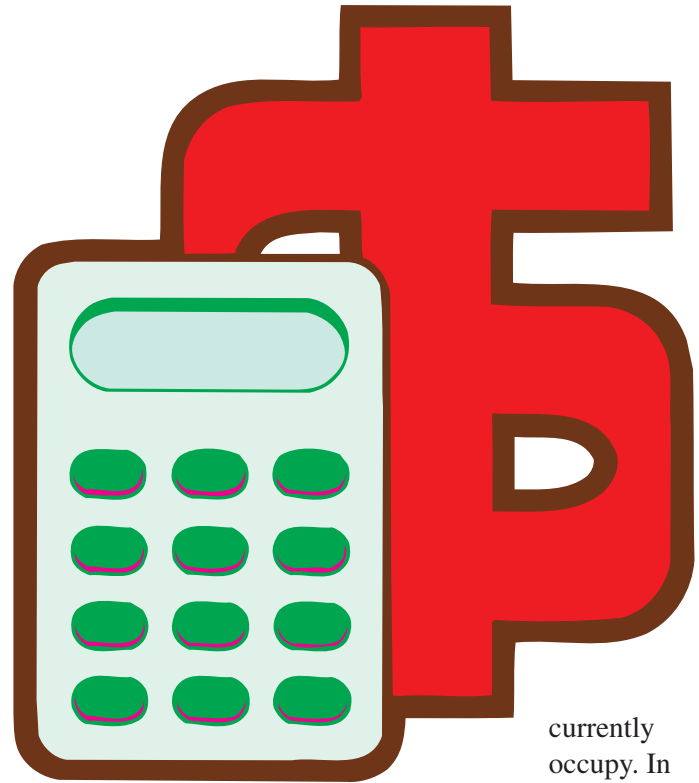
Economies of size usually are evident as businesses grow to accommodate a higher volume of goods or services at a lower cost per unit. For producers, this situation creates an imbalance in market power, as relatively large numbers of small producers face a few large buyers of their product or sellers of production inputs. When input providers are relatively few in number, they usually can sell inputs at prices above cost. Likewise, if there are relatively few buyers of an agricultural product, they may

pay less than competitive prices when there are large numbers of sellers.

Transportation costs may effectively deter agricultural producers from looking outside their local areas for better commodity prices or input costs. An imbalance of market power may result, as producers find themselves with only one firm to serve their selling or purchasing needs. This situation invites low prices and high costs for producers, typically reducing their profitability.

A lack of good market intelligence may create market imperfections. Information related to commodity pricing and terms of sale may be available only at some cost. For many firms, the cost of market information may be prohibitive. False cost/price signals may lead to misallocation of resources that reduces profits.

These examples of market imperfection are among many situations that may lead businesses to take action. A business may extend its activities into other levels of the marketing system or become larger in the level they



currently occupy. In some cases, contracts may help offset the imperfection. Frequently, however, these impediments can be overcome through collective action.

### *Increasing member returns through collective action*

Economies of size frequently are generated through cooperatives. As the size of the operation increases, and fixed costs (such as management charges) are spread over a larger volume of goods and services, per-unit costs can be expected to decrease. Efficiencies also can be generated through labor-saving machinery and equipment and through the operation of larger production and distribution facilities. At some point, however, per-unit costs are expected to increase, as inefficiencies associated with oversized



facilities begin to occur. In choosing a size of operations, cooperatives need to consider the optimal size that will bring the greatest return to members.

Forming a cooperative may be a way to integrate vertically into higher or lower levels in the marketing system. Higher returns may be obtained by collectively buying an existing business such as an input supplier or processor. Sometimes, creating a new business yields efficiencies. Location and size of these firms should be based on cost efficiency.

Cooperatives sometimes are formed to provide services in a quantity and quality not otherwise available. However, it is important to consider why those services are not being offered by other entrepreneurs. Are the services really needed, and will producing them generate a satisfactory return to the investment made to obtain them? Sometimes the honest answer is no. In other cases, good managers can find ways, through cooperative action, to cost-effectively obtain goods and services that otherwise would not be available.

On occasion, cooperatives are formed to better assure a source of supplies or market outlets—even under adverse market conditions. After all, a cooperative's first priority is to serve its members, not the highest bidder. When shortages of supplies occur, noncooperative

*Key terms*

*Market imperfection*

Situations that give one buyer or seller an advantage over another or that cause prices to vary from what they would be under simple supply and demand. Examples are when many small buyers must purchase from a single large supplier, or when transportation difficulties put producers in a more remote region at a disadvantage.

*Economies of size*

Reductions in per-unit cost that occur as a business grows. Economies of size can occur as a business spreads fixed costs over a larger volume of goods sold, or by efficiency enhancements such as labor-reducing equipment.

*Vertical integration*

Taking over upstream or downstream parts of the production and distribution process. For example, a dairy cooperative that represents its members by bargaining for better prices at the first-handler level could integrate vertically by building a cheese manufacturing facility, creating a brand identity, and establishing a retail store.

*Risk spreading*

Offsetting poor returns in one area by good returns in another. This becomes easier as a business diversifies. For example, if apple growers experience poor prices one year, a diversified fruit growers cooperative might be able to offset those losses by strong returns in another crop.

*Market power*

A business's ability to influence prices in its favor. Market power may be based on size or on the ability to control demand by building customer loyalty to a brand name.

businesses may move product to nonagricultural outlets that are willing and able to pay the highest price. Continuity of market outlets also can be better assured by focusing on the needs of members, not on exiting markets for higher returns elsewhere.

In an integrated cooperative business, there is great potential for increased returns through coordination of supply, production, and marketing activities. Two-way communication between marketing and production units can reduce costs and improve product prices. The cooperative can ensure the quantity and quality of product needed to satisfy market demands and hence bring greater returns to members. Supply operations then can be tailored to those production needs. Typically, the development of long-term arrangements for supply, production, and marketing linkages encourages more efficient investment. Furthermore, transaction costs, such as those related to frequent contract renegotiations, can be minimized or even eliminated.

Risk spreading may be a real benefit associated with cooperative business operations. Adverse market price or other conditions may be absorbed (averaged out) by pooling with other product lines that are not adversely affected. Also, vertical integration can help maintain returns by offsetting countercyclical price movements. As an example, higher prices for a smaller crop may be offset by

lower earnings from processing due to the smaller volume of product. Furthermore, diversity in input supply operations may allow cyclical problems in one line to be offset by good returns in others.

It is important, however, not to allow risk-reduction strategies to hide management inefficiencies by members or cooperative managers. For example, members should not receive average pricing for low-quality product that could be improved through better management.

Greater market power may be possible through cooperative action. If other firms are obtaining unusually high profits at the expense of individual businesses, collective action may transfer some of that market power and associated profits to members. Establishing a reputable brand name, if done successfully, may help to develop customer loyalty and transfer some market power toward the cooperative. Sometimes, cooperatives can develop sufficient market power to significantly alter the terms of trade in favor of members. However, that level of market power usually implies an ability to control the quantity and quality of member production. Forming a cooperative, alone, does not ensure that power.

All of these elements affect the cooperative's ability to operate competitive and efficient systems for the benefit of its members. A cooperative form of business can encourage lower per-unit costs for resources, while higher prices for

member commodities can increase revenue.

### *Prospective strengths and weaknesses of a cooperative business form*

Although a well-operated cooperative can bring many benefits to its members, it isn't a cure-all for their economic concerns. In starting a cooperative, it is important to balance possible benefits with potential limitations. In the process, you will develop a more realistic view of how a cooperative might enhance your individual business.

In many cases, the benefits and limitations of a cooperative depend on the type of business activity undertaken. In some cases, benefits are quite measurable in terms of bottom-line results of member businesses. In others, benefits may be more indirect and intangible, for example, impacts on market prices, improvements in quality, and better services. Benefits may become less measurable as time passes. In some cases, benefits and limitations may be unmeasurable in economic terms but subjectively measurable in social terms.

### *Potential benefits*

As members work collectively to set objectives, arrange financing, and establish operating procedures and methods for distribution of benefits, their individual operations may enjoy increased returns. Increased returns can come from a

number of factors. Higher prices for products or lower costs for inputs are common. Frequently, reductions in per-unit handling or processing costs may be evident. Quality improvements achieved through better operating procedures may be important. Or, a cooperative may be able to develop a new market or brand identification. Frequently, cooperatives have a positive influence on general price levels in competitive markets.

Cooperatives may have some flexibility in pricing. As an example, a cooperative may be able to reduce input prices when members face a price–cost squeeze. As a result, some of the economic benefits of the cooperative would move from the end of the year to midseason.

In assessing savings returned to members, it is important to consider both immediate cash payments (returned at the end of an operating year) and noncash returns that are revolved out as cash payments in the future. Cooperatives frequently make substantial payments to members to return savings that were retained for short- and long-term financing. These revolving funds may represent a substantial portion of the patronage dividends paid to members in a given year.

Improved service to better meet the needs of members frequently is a benefit of cooperative business operations—either by improving on existing services or by providing services not otherwise available. In

some cases, services are provided for a minimal return to the cooperative in order to meet the objective of satisfying member needs. Well-managed cooperatives find other, higher margin services to provide an overall blend of returns that adequately meets the needs of members.

A cooperative can help its members maintain high product quality, which leads to greater returns in the marketplace. Through information and advice, cooperatives can encourage production and marketing practices that will yield the highest net returns. For example, field representatives may work one-on-one with members to maintain schedules and quality specifications. The emphasis on

high quality frequently is reinforced by basing payment on members' meeting standards such as grades, harvest scheduling, and container requirements. Efforts to maintain high standards for product quality and reliability can pay off when buyers consistently purchase products at above-average prices—even during times of market surplus.

With respect to supply, a cooperative can sell inputs that provide the greatest yield gains, rather than those that provide the largest margin to the cooperative. In fact, the better cooperatives have smaller margins on farm supplies, in part because they relay production information from sources such as agricultural experiment stations

### *Potential benefits of agricultural cooperatives*

- Reduced per-unit handling or processing costs
- Dividends based on how much each member uses the cooperative
- Improved service
- More marketing power through greater size, brand identification, quality control, etc.
- Assured sources of supply at a reasonable cost
- Political influence
- Education to help members improve business practices
- Support for family farms
- Income generated in the local community



to members, who then can obtain the greatest use-value from purchased inputs. In some cases, cooperatives may have field representatives to help in that process.

To offset lower margins for farm input lines, many cooperatives sell other higher margin lines. As an example, many supply cooperatives sell high-volume, high-margin pet food and supplies in their retail outlets. Members benefit since mostly nonmembers purchase those items. The higher after-tax net returns are distributed to members in the form of patronage dividends.

Assured sources of supply may be an important motivating factor for starting a cooperative. Members

need a dependable, reasonably priced source of supply—even during times of extreme shortages and rising prices. Cooperatives, in their orientation toward member needs, can accept smaller margins rather than diverting supplies to higher-margin buyers.

A good example of cooperative devotion to member needs can be seen in the operations of petroleum and fertilizer supply cooperatives during severe shortages in the 1970s. To keep supplies moving to their members, many cooperatives confined sales to member-patrons. Many cooperatives purchased extra

petroleum and expanded transportation and storage capacities.

Refining and manufacturing capacity was increased, and a number of supply cooperatives formed an international petroleum trading and purchasing cooperative to acquire oil. At the same time, cooperatives worked in the political arena to obtain priorities for petroleum products necessary to meet food and fiber production needs. Furthermore, supply cooperatives took a leadership role in helping members conserve fuel and fertilizer.

After the petroleum crisis abated, cooperatives were aggressive in long-range planning to avoid future crises. Their efforts

were aimed at strengthening the supply position of their members. As an example, some cooperatives further expanded their refining capacity in order to increase control over their fuel sources.

A cooperative entering the marketplace may have a significant impact on the market's competitive environment. Product prices may increase, or input prices may move to lower levels. The quality of services from businesses in general may improve.

Many cooperatives find that pooling products of a specified grade can open up new market outlets. Large-scale buyers, who wouldn't work with individual members, may purchase from a cooperative. The cooperative also may be better able to meet the needs of overseas buyers. Both foreign and domestic buyers may be interested in value-added food brands processed by a cooperative. Many popular brands are in fact owned by cooperatives.

The political influence of individual businesses can be enhanced by cooperative action. In many cases, cooperatives join together in state or regional associations to lobby for legislation and administrative rules that will enhance member businesses. Much of the emphasis has been on influencing tax legislation.

In addition to helping managers and directors, cooperative educational efforts can have a positive impact on member business practices. Information on

marketing, production practices, and farm management can be presented conveniently by universities and other organizations through cooperatives. In addition to formal education, members can receive practical business experience through cooperative committee or board activities. All of these opportunities enhance member abilities to provide leadership in their communities.

Cooperative operations may be able to help family farms stay in business. Credit and supply cooperatives may help family operations grow and capture economies of size while remaining independent. Marketing and processing cooperatives can help ensure markets and the timing of sales under advantageous circumstances. A cooperative's ability to control product flow farther up the marketing system can bring greater financial rewards to individual family farm members.

### *Broader benefits to the community*

Cooperative business activities benefit more than members. The community and individual consumers also may benefit. These benefits may be local or regional in nature.

Much of the additional income generated by members from cooperative business operations finds its way back to local businesses as payment for goods and services. Cooperative employee salaries add to that economic activity. In addition, cooperative

businesses spend money on local goods and services and pay taxes. In many cases, cooperative personnel and members participate in community events and are involved in governmental activities.

Consumers benefit in many ways when they patronize cooperative businesses. In some cases, the primary benefit is access to high-quality, reasonably priced goods and services. In others, consumers gain access to a wider variety of items than otherwise would be available. Cooperatives tend to be on the leading edge of new product and process development. Their more efficient production and marketing systems may increase the availability of competitively priced products and services.

### *Limitations*

In many respects, cooperatives are subject to the same limitations as any business. They face the same economic environment, many of the legal restrictions, and similar interpersonal problems. In addition,

some unique problems relate to the agricultural industry in general and specifically to cooperative organizations.

Many of the pricing problems for agricultural products are related to the nature of demand for those products. Frequently, demand is very price-sensitive to changes in volume. Overproduction frequently triggers a dramatic drop in market prices, resulting in a significant decline in total revenue to producers.

Cooperatives cannot legally control members' production to overcome this problem. In some cases, they may be able to control the number of acres that members have under production. In other cases, they may be able to encourage the formation of a marketing order under government auspices to promote orderly (controlled) marketing programs that might offset adverse market conditions. However, there is little evidence that market orders are an effective price-enhancing tool.

### *Limitations of agricultural cooperatives*

- Inability to raise prices for members' products
- Disagreements among members
- Difficulties in building long-term equity when members want to receive dividends immediately
- Slow decision-making
- Unreliable member participation

Early in the history of cooperative development in this country, some enthusiasts argued that producers could control prices. That proved to be a myth. No matter how large the cooperative, control of production, even among its members, is not possible. In some industries, cooperatives have been able to influence demand for their goods and services through better production techniques, improved handling, and superior bargaining. But, regardless of its size, a cooperative can have little impact on the overall demand for agricultural output. Consumers simply have too many options. Furthermore, producers who choose not to be members of the cooperative can benefit from the cooperative's favorable market impacts without paying any of the associated costs—the free-rider effect.

Developing a cooperative is not necessarily a means of creating market power. There may be limitations on the amount of equity capital available to expand the business. Thus, reaching the size needed to influence market conditions and prices may not be practical. Other problems that frequently limit market power include a lack of long-run planning, management failures, and inferior visioning skills. Sometimes, new cooperatives have a favorable influence on prices, margins, and supply for a few years. However, longer term benefits in that regard may not be apparent.

A cooperative can't be expected to eliminate market functions. Instead, it may be able to provide more efficient marketing services that reduce the marketing margin necessary to move goods and services through marketing channels. Cooperatives providing their members with the highest quality services and supplies may in fact increase marketing margins. Prices charged by the cooperative may need to be higher in order to best serve the bottom-line interests of its members.

Cooperatives that pool member labor, land, and other capital for production activities generally have not been successful in the United States. Frequently, these types of cooperatives have been overcome by minimal net gains, decision-making problems, and disagreements over distribution of net returns. In limited cases, cooperatives formed to share specialized machinery and equipment have been somewhat successful.

The "people problems" experienced by any business are exacerbated in an organization characterized by user-owners. Misinformation and unrealistic expectations on the part of members, directors, and management can lead a cooperative to poor performance or even bankruptcy. Disagreements on objectives, policies, and approaches can lead to intense competition and duplication of services and facilities between cooperatives and other

types of businesses serving the agricultural community.

The limited objectives of some members can be an impediment. Building long-term financial strength through retained patronage refunds may be discouraged by some members who want increased short-run returns for themselves. Refusing to carry a diversity of goods and services of interest to the community at large may limit the cooperative's ability to reduce per-unit costs through increased volume.

The democratic nature of a cooperative can be a problem when significant decisions need to be made in a timely manner. Decisions frequently are delayed by the necessity to give attention to member relations in addition to strict business decisions. Although boards of directors may have the power to make these decisions, they typically are discussed with the general membership before decisions are finalized. With large groups, this process creates delays that can have a serious impact on decision-making.

If agricultural cooperatives don't have marketing or purchasing agreements with their members, they are at the mercy of voluntary participation. Members may avoid annual meetings, be fickle in their patronage of the cooperative, and resist providing their fair share of the capital needed to develop its full capacity for service to members. Thus, major expansions in the cooperative's services may be

limited, and improvements, if they occur at all, may be delayed.

### *Equity and debt considerations*

Like any other business, an agricultural cooperative needs funds to maintain the short-term, intermediate-term, and long-term assets necessary for operations. Short-term assets include inventory,

accounts receivable, and cash. Intermediate-term assets include machinery and equipment, while long-term assets include buildings and land. Funds may come from traditional debt instruments through banks or from the nationwide Farm Credit System (FCS).

FCS, a producer-owned cooperative, provides a wide range of financial services to U.S. agriculture. One unit of the system,

Agricultural Credit Bank (ACB), has the authority of a Farm Credit Bank to provide loanable funds of all kinds to agricultural, aquatic, and public utility cooperatives. Furthermore, ACB is authorized to provide international banking services for farmer-owned cooperatives. For more information on FCS and its U.S. government regulator, the Farm Credit Administration (FCA), visit FCA's excellent Web site (<http://www.fca.gov/FCA-HomePage.htm>).

Cooperatives usually obtain and handle funds from equity sources in a unique manner that fits their user-owner nature. Members make the equity investment in the cooperative's assets. Investment usually is made in proportion to the benefits received in the past or those expected in the future. By maintaining a strong equity position, members help assure that the cooperative can obtain credit, survive financial adversity, and make a long-term commitment to providing needed goods and services. In addition, a sizable equity investment may encourage lenders to give more favorable rates and terms for loans to a cooperative.

In many respects, the equity investment in any business can be thought of as risk capital. It serves as a buffer during hard times when losses may be experienced. Those losses are subtracted from the equity balances in the business—to the point of exhaustion.

### *Cooperatives and equity*

#### ➤ *What is equity?*

Equity is member funds that buy ownership in a cooperative. Equity funds have two major purposes. They serve as a buffer when losses occur, and they finance growth.

#### ➤ *How do cooperatives get equity?*

- Members make direct investments, such as through a membership fee.
- A portion of profits may be retained rather than paid out as patronage refunds.
- Members may be assessed a per-unit fee each time they use the cooperative. This fee is then deducted from the member's dividends.

#### ➤ *How are investors paid back?*

- Funds can be returned after a set time period (revolving fund plan).
- Members can be paid back based on how much they have invested and how much they use the cooperative (base capital plan).
- A percentage of each member's equity can be paid back regardless of when it was invested or how much the member uses the cooperative (percentage-of-all-equities plan).

### *Unique aspects of equity investment in a cooperative*

The rate of return on one's equity investment in a cooperative may be difficult to determine. Appreciation in the investment usually is not a factor, and there typically is no open market for selling the investment. However, when comparing returns with alternatives in noncooperative businesses, members need to include intangibles, such as improved access to markets and more reliable sources of supply. How have the member's overall business returns benefited from cooperative membership?

In most agricultural cooperatives, only qualified producers are permitted to make an equity investment. That investment, usually represented by common stock or membership certificates, provides the right to vote on cooperative policies. Unlike investor-owned businesses, cooperative member voting rights are not based on the number of equity shares or certificates owned by the member. Although some agricultural cooperatives allow for voting weighted by member patronage, most still subscribe to the principle of one vote per member. Some agricultural cooperatives issue preferred stock to members (as well as nonmembers). Preferred stock usually provides for an expected fixed rate of return on the investment, but does not confer voting rights.

Equity balances can be managed more easily in a cooperative than in other types of business because the board of directors can control the amount of equity redeemed back to the membership and the amount of current net earnings retained for building equity reserves. Some portion of net earnings usually is withheld as retained patronage dividends or per-unit capital retains. The unique part of this concept is that customers provide the equity capital for the business—unheard-of in an investor-owned firm.

Most equity in a cooperative is temporary in nature. There usually is an implied obligation for the cooperative to redeem it, although not on a fixed schedule. Thus, a cooperative's board of directors is free to choose the time of equity retains and redemptions so that the financial integrity of the cooperative will be maintained. Sometimes the cycle is longer than 20 years. Mandatory obligations to redeem equity typically are not a part of cooperative operations.

### *Cooperative equity sources*

The initial equity funding for an agricultural cooperative usually is obtained through direct investment from its members. Occasionally, well-established cooperatives seek direct investments from members to increase equity reserves. In either case, these sources usually provide a relatively small amount of capital.

For small, startup cooperatives, the willingness of members to invest directly can be an important test of their interest in forming the cooperative. A lack of interest in direct investment may not bode well for the cooperative's ability to maintain sufficient patronage levels. However, it may simply reflect producers who are hard-pressed for cash. In this case, it is much easier to retain funds from net earnings.

A second technique for raising equity funds is through retained patronage refunds. Under this system, portions of net income allocated to members are retained by the cooperative. In essence, members are investing new monies in the cooperative based on their levels of patronage. For most agricultural cooperatives, this technique raises the largest portion of equity. Its popularity stems from the easy, systematic nature of generating equity funds from net earnings in the most recent operating period.

Retained patronage refunds are particularly well suited for supply and service cooperatives, where it is difficult to determine charges per purchase unit. In addition, non-member patrons may be encouraged to become members, since retained patronage refunds typically can be used to purchase membership stock or certificates—eliminating the need for a direct cash investment. However, on the down side, retained patronage



refunds may make the cooperative overly dependent on earnings as a source of capital.

Fluctuations in net income (including losses) create uncertainty in the cooperative's ability to generate equity investment and to redeem older equity investments. Furthermore, misunderstandings may occur if members believe that patronage retains are a debt owed to them. In fact, they are equity risk capital that members invest to generate future benefits. They can be lost, or repayment can be delayed, due to declines in operating results, unwise capital investments, or untimely business expansions.

A third technique, often combined with retained patronage refunds, is per-unit capital retains. Member-patron investments are based on usage of the cooperative—not on a portion of net earnings. Some marketing cooperatives find this technique convenient. As an example, a processing cooperative might assess a \$1.00 retain for each ton delivered to the cooperative for processing. That amount is deducted from payments made to the member. This method is less common than patronage retains.

Cooperatives that favor per-unit capital retains frequently do so because this technique generates more stable equity investment (assuming a regular flow of product) that is independent of the cooperative's net income.



In addition, per-unit capital retains have the same advantages as patronage retains. To be effective, it is important for the board of directors to choose a retain rate that generates the amount of equity capital needed, to establish the speed with which it is generated, to set the rate of equity redemption, to consider the competitive environment of the cooperative, and to provide for adequate communication with the membership about the need for a capital retain and plans for its accumulation and redemption.

Many cooperatives downplay per-unit capital retains because they may reduce cash returned to members more dramatically. The per-unit capital retain system also suffers from the same “debt image” as patronage retains; members may believe that their equity risk investment is a debt owed to them with interest. Furthermore, per-unit capital retains may be seen as too easy a source of equity since they are generated regardless of operating performance.

A somewhat controversial technique for equity accumulation is known as unallocated equity. This approach builds equity accounts that are not allocated to individual members. These funds come from sources such as nonoperating interest and rent income, acquisition of business assets at prices below their assessed value, and net income generated from nonmember (or even member) services that is not required to be allocated.

A distinct advantage of unallocated equity accounts is that risk equity of this type may be viewed as more permanent by lenders and might encourage them to provide better rates and terms of repayment. Also, building these accounts through nonmember patronage may be a more palatable way to accumulate equity in the eyes of members.

The danger of this technique, however, relates to the potential for loss of member control over the cooperative's equity; it is not tied

### *Equity redemption plans*

- *Revolving fund plans*  
These plans involve paying back equity in the order in which it was received. The length of time is based on the period necessary to accumulate replacement capital and can be adjusted as needed by the board. Typical payback periods are about 10 years.
- *Base capital plan*  
This type of plan combines an assessment of annual capital needs and member use of the cooperative's services. Members who are underinvested (increasing their patronage) are assessed an additional amount of equity, and members who are overinvested (decreasing their patronage) start to receive repayment of their overinvestment.
- *The percentage-of-all-equities plan*  
A few cooperatives use this approach. It involves paying back a set percentage of each member's equity investment regardless of issue date.

directly to member equity accounts with corresponding member oversight. This dilution of member control may encourage management to make decisions about the cooperative's capital investment, thus diminishing the policy role of the board of directors. At times, unallocated equity may become a large percentage of total equity. When membership-allocated equity interests diminish, member loyalty to the cooperative may suffer. An increasing percentage of nonpatronage income may result in patronage dividends not being tied closely to member use of the cooperative.

### *Equity redemption systems*

From a philosophical viewpoint, cooperative equity redemption plans need to ensure that members invest in the cooperative based on use. Members who have built up equity over the years through direct investments, patronage retains, and per-unit capital retains will be overinvested if they decrease their use of the cooperative. Likewise, members who increase their use should not have their fair share of the equity investment subsidized by those who decrease their patronage.

Equity redemption plans also reinforce the idea that equity investments by members are intended to be short- to intermediate-term investments. Unless affected by declining net income or losses, equity usually is intended to be repaid in an orderly manner.

A good cooperative equity redemption plan has many benefits. It reduces conflict among active and nonactive members regarding the speed of redemption. It also may encourage member patronage. Members more directly see the link between investment and benefits. Consistent redemption of equity can give the member's equity investment greater value as collateral for loans. Perhaps even more important is the fact that consistent, timely redemption forces the cooperative to implement effective financial planning.

The advantages of a good cooperative equity redemption plan must be balanced with a number of disadvantages. The financial position of the cooperative may be weakened by revolving equity back to members. In the process of redeeming old equity, current members may see their patronage refunds reduced—a confrontation builder. Also, cooperatives attempting to remain price competitive may not generate enough revenue to repay equity investments in a timely manner.

The basic types of equity redemption plans include revolving fund plans, the base capital plan,

the percentage-of-all-equities plan, and the special situation plan. These types frequently are used in combination.

The revolving fund plan pays back equity in the chronological order that it was received. The length of time is based on the period necessary to accumulate replacement capital. An average time might be 10 years, but shorter periods such as 7 years might better reflect the relationship between investment and use. Payback periods may vary, depending on the product or service line that generated the invested dollars.

Revolving fund plans are popular because they are easy to understand and administer. The relationship between investment and use is strengthened if the revolving time is not too long. Furthermore, poor operating years or extraordinary demands for equity investment can be absorbed simply by extending the revolving period. Yet, to do so invites dissension from members who develop unrealistic expectations for redemption on a fixed schedule.

A base capital plan combines an assessment of annual capital needs and relative member use of the cooperative's services. Those members deemed underinvested are assessed an additional amount of equity, which either must be paid or carried at interest to compensate those members who are overinvested. Members who are overinvested start to receive a partial, if not full, redemption of their

overinvestment, depending on the proportion of underinvested members who increase their equity investment.

The base capital plan approach has appeal since it focuses on the relationship between member investment and use of the cooperative. Level of retained earnings is not a factor. Thus, the cooperative is able to directly adjust membership equity levels. Its main drawback is that cash-poor, underinvested members may not be able to respond quickly to calls for a greater equity investment. Compared to simply extending the payback period in a revolving fund plan, tension is increased within the cooperative—especially when a cooperative experiences high member turnover. Also, base capital plans are relatively difficult to administer and understand.

Used by a few cooperatives, the percentage-of-all-equities plan involves retiring a set percentage of each member's equity investment regardless of issue date. This method has the effect of rewarding new members more quickly for their patronage. Charging full margins for goods and services is easier because members more quickly see those margins returned. An added plus is that the system is easy to understand and administer. In addition, it can be adjusted easily to reflect changes in operating results.

A major disadvantage, however, is that the system makes it more difficult to establish a balance

between member equity investment and use. It also is difficult to implement if patronage and membership roles change frequently.

Special situations include member death or retirement, member bankruptcy or termination of agricultural business activities, relocation of the member from the cooperative's trade area, resignation of membership, and application of the member's equity to uncollectible accounts receivable. Special situations frequently get priority for equity payback.

### *Legal organization*

Since there is no federal incorporation law, cooperatives are incorporated under state law. Every state has cooperative incorporation statutes. In Oregon, incorporation is done under Oregon Revised Statute Chapter 62—Cooperatives (ORS 62). This section of the law was updated significantly in 1995. Modest changes were made in subsequent legislative sessions and are included in the 2001 edition, which is available on the Web (<http://www.leg.state.or.us/ors/062.html>). The law covers topics such as the purpose for which cooperatives may be organized, formation and amending of articles of incorporation, and the creation and substantive provisions of bylaws.

Anyone wanting to form a cooperative in Oregon should consult ORS 62 and an attorney well versed in cooperative law. The



basic documents that are prepared by the incorporators are the articles of incorporation and the bylaws. In Oregon and many other states, these documents are approved by and filed in the Corporation Division of the Secretary of State's Office.

Articles of incorporation are intended to describe the organization and its basic structures. Normally included are the cooperative's name, purposes, powers and limitations, place of business, numbers and terms of the initial set of directors, membership qualifications and rights, and capital stock structure. After approval for incorporation in Oregon, the Corporate Division issues a certificate if desired by the cooperative. That certificate includes a verification of the cooperative's name as it is registered in Oregon and confirms that the cooperative is duly incorporated in the state of Oregon. Each cooperative incorporated in Oregon must report annually to the Corporate Division to verify the name and address of the

corporation, names and addresses of the president and secretary, primary business activity, federal employer identification number, and any other information required under the rules of the Corporate Division.

The bylaws of the cooperative are a detailed listing of its structure and internal operations. They specify details such as membership qualifications and the rules for suspension or termination of membership, regular and special meetings and associated voting rights, capital structure, rules for distribution of net savings and the use of capital retains and revolving capital accounts, and rules for amending the bylaws or dissolving the corporation. Also included in the bylaws is a listing of director and officer qualifications, duties, and rules for election. The duties of the manager usually are identified in some detail.

In addition to the powers and restrictions under articles of incorporation and bylaws, many cooperatives that market member commodities have marketing contracts with their members.

Under these agreements, members may be required to deliver specified quantities and qualities of products to the cooperative, which has the power to act as an agent for the member in handling and marketing the products. The members provide associated capital as specified by the board of directors and pay penalties for commodities that don't meet specifications. The cooperative in turn agrees to properly account for all proceeds from sales and for all monies retained for investments.

Cooperatives, like other businesses, are required to stay informed about changes in applicable laws. State laws related to contracts, the Uniform Commercial Code, banking and insurance, workers compensation, unemployment insurance, securities, and taxation are among those that must be monitored. In addition, numerous federal laws and regulations must be followed.

### *Cooperative management characteristics*

The nature of cooperative management has changed over the years. It has evolved from a typical one-person operation where the manager did everything, including waiting on customers, keeping the books, and maintaining the facilities. Today, even small cooperatives often invest in a professional management team that typically is well educated and proficient in

## The people

- *Professional management*  
Directs the day-to-day affairs of the business, including personnel, facilities, equipment, and accounting.
- *Board of directors*  
Sets policies such as credit, pricing, purchasing, marketing, and services. Manages relations with members, professional management, employees, and the public.
- *Member-owner-users*  
Patronize (use) the cooperative, elect directors, and provide input on policy issues.

directing the day-to-day affairs of the cooperative.

Much of this emphasis on a high-quality management team is based on the experiences of cooperatives that have failed due to inept management. Overextension of credit, unsound collection practices, speculation in handling member commodities, poor-quality products and services, overexpansion of facilities, inadequate financial planning (including overly generous pooling of returns to members), and dominance by a single manager are but a few examples. Avoiding common management mistakes is critical for a cooperative's survival—especially a startup business.

## The role of management

Good cooperative management involves the successful combination of ideas, processes, materials,

facilities, financial resources, and people to produce products and services that meet the needs of member-owners. It focuses not only on day-to-day operations but also on formulating and executing policies, encouraging efficiency, ensuring high-quality service, and maintaining the financial strength of the cooperative. Management also must take steps to keep the business focused on increasing the cooperative nature of its existence—member control, serving first the needs of members, and a fair distribution of returns to user-members.

While many of the decision-making techniques are the same as those used in other businesses, a good cooperative manager must adjust measures of success. Low-margin services may be provided because they are in the best interests of owner-patrons.

In oversupply situations, marketing cooperatives may continue to receive commodities from their farmer-members and do the best they can to sell them; other businesses would not.

Managers frequently spend a significant amount of time dealing with issues related to equitable treatment of the cooperative's owner-patrons. When a cooperative deals with a complex array of services, commodities, and value-added activities, the issue of patronage returns can be complicated. Furthermore, assigning responsibility for member financing of the cooperative through patronage retains can create conflict.

Cooperative managers typically find themselves in constant contact with their owner-members. The members created the cooperative to provide needed products and services, and they frequently are involved in critiquing the performance of the business they own—almost every time they come into contact with the cooperative. Managers find themselves in direct communications with their members on a regular basis—not just at the annual meeting.

A patron-owned business that incorporates principles of democratic control presents unique personal challenges to a manager. Gone are the prospects of gaining control of the business through superior performance, political maneuvering, or outright

ownership. Instead, a cooperative manager must be resigned to being an employee, take action to involve the majority of members in important decisions, and yield to the democratic control of membership.

### *Resource management*

Many agricultural cooperative managers report that the most important key to their success is dealing effectively with employees—exhibiting superior leadership skills. Important factors include the selection of personnel, training, empowerment, and evaluation. Good supervisors are able to plan for the work load, delegate authority and related responsibility, set performance standards and review job performance, establish grievance procedures, and provide leadership.

Management should strive to provide motivation and create a corresponding rewards system. Each employee's compensation and benefits package should provide an incentive to do everything possible to benefit the cooperative and its patron-owners. Critical in this regard are the establishment of goals for employees, inspiring and recognizing good performance, developing a sense of mission through teamwork and a high degree of esprit de corps, creating an environment where employees are encouraged to be innovative, and maintaining two-way communication between supervisors and other employees.

Also, with regard to people, successful cooperative managers must focus much time and attention on relations with members, government agencies, and the general public. Two-way communication between management and members must be encouraged. By doing so, the cooperative can keep its membership active and encourage new members to join, share information on product and service quality and financial requirements, and update its policies and operating procedures. Reaching out to government agencies and the general public is critical to keeping a focus on the cooperative's objectives, accomplishments, benefits, and limitations, while building public acceptance and understanding of its mission.

Capital resource management is a constant concern of agricultural cooperative managers. This issue goes beyond the day-to-day management of cash, receivables, inventories, equipment, facilities, and payables to include investments in other cooperatives and obtaining favorable long-run financing. It also involves creating systems to encourage member-patron investments; maintain a financial position acceptable to lenders, suppliers, and buyers; and ensure financial practices consistent with sound business and cooperative principles.

Like any other business, equipment and facilities can represent a significant portion of a cooperative's assets. Thus, good

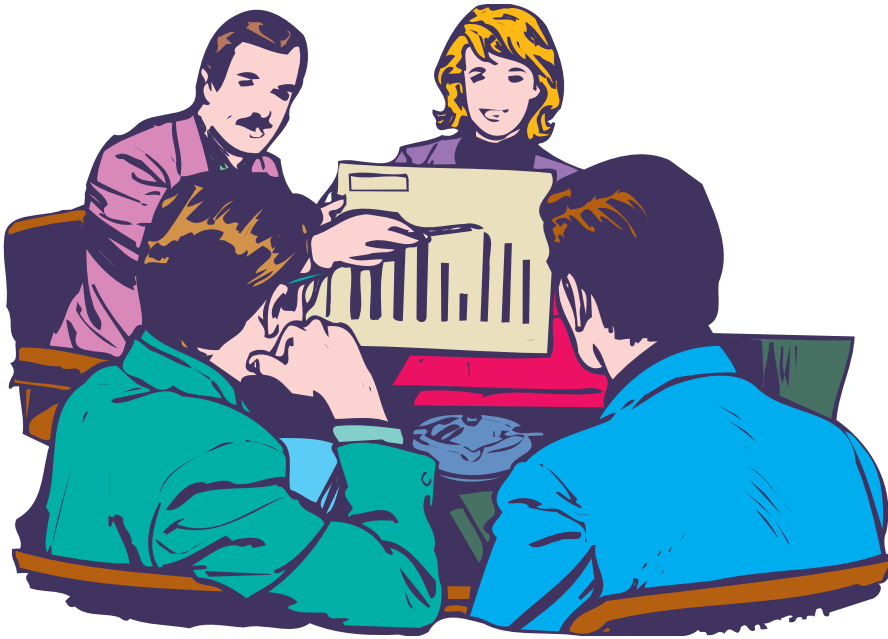
managers focus considerable attention on maintaining, upgrading, and replacing these assets to ensure maximum efficiency. In addition, safety, health, and environmental concerns are becoming increasingly important.

### *Management functions and tools*

Cooperative management typically focuses on the functions common to any type of business. Planning involves establishing policies and procedures that are consistent with the cooperative's mission. Once plans are developed, all available people, capital, and physical resources must be organized effectively to accomplish the plan. Through means of explanation and teaching, the resources of the cooperative then are directed to the day-to-day activities necessary to fulfill the plan.

Along the way, management must ensure that different units within the organization are coordinated so that the cooperative moves smoothly and without internal conflict toward meeting its goals. Periodically, management must check results against standards and take remedial action where warranted to eliminate unwanted events or improve operating efficiency.

These functions usually are accomplished by tools such as accounting systems; control reports; security and safety measures; training and evaluation



programs; personnel incentive packages; communications systems such as membership and employee publications, periodic and annual reports, member and employee meetings, and reports by educational and government agencies; and long-run planning efforts aimed at encouraging growth in services, facilities, and capital.

A proper accounting system includes financial statements such as balance sheets, profit and loss statements, enterprise accounts, and member equity and patronage accounts; proforma budgeting and cash flow management systems; and both internal and external audit systems to prevent errors or other leakages (e.g., employee, member, or nonmember theft). This system can help management evaluate actual versus expected results and facilitate planning and control. Control reports frequently include accounts receivable and inventory assessments, financial ratios, and information on operating results.

Security and safety measures refer to programs such as insurance for employees and assets; monitoring employees who handle assets such as cash; protecting against inventory, equipment, and facility theft and vandalism; programs to protect the safety and welfare of employees, patrons, and the general public; and strict adherence to environmental protection standards.

### *Management's role in strategic planning*

Along with boards of directors and employees, management typically plays an important role in developing a cooperative's strategic plan—its definition of mission and the environment in which it operates, the setting of objectives and strategies to reach them, and the creation of feedback systems that tell leadership whether these steps have been identified and implemented correctly. Continuous planning can help cooperatives position themselves in an

ever-changing agricultural business environment, but it requires time and money. Furthermore, it can be used as a technique to become proactive rather than reactive in charting a path for the cooperative's future. However, strategic planning requires the commitment of everyone in the organization—managers, directors, employees, and member-owners.

To be effective, six elements must be present in a strategic plan:

- A mission statement
- An assessment of the current condition and outlook for the future
- A statement of objectives and goals
- A strategy to meet those objectives and goals
- A means of implementing the strategy
- A feedback mechanism

When implemented successfully, the planning process greatly influences both the short-run and long-run character of the cooperative. It provides a means of systematically identifying and examining issues, problems, opportunities, and alternative courses of action. By creating a strategic thinking atmosphere, more effective decisions can be made, giving the organization a competitive edge in the marketplace.

A key element is the mission statement, which clearly states the purpose of the cooperative's

### *Six steps to strategic planning*

- Develop a mission statement.
- Assess the cooperative's operating environment.
- Establish objectives, with benchmarks for measuring results.
- Identify specific actions that will move the cooperative toward its goals.
- Combine all resources to implement the strategies.
- Obtain feedback to lead to improvements.

existence by defining the direction it will take and the boundaries within which planning will take place. A critical step in developing a mission statement is an assessment of the current operating environment and the likely future environment. The entire cooperative business is assessed as accurately and objectively as possible vis-à-vis its external environment and the strategic issues it faces. Then, compatible objectives are established, along with benchmarks for measuring both short-run and long-run results.

Next, strategies are developed to identify an exact set of actions that will guide the cooperative within its carefully analyzed resource constraints toward its goals. Implementation of the strategies implies marshalling all available resources. Finally, the feedback process measures how well the strategic plan was implemented and provides insights into how the

planning process can be changed in the future to better improve the position of the cooperative.

### *The nature and role of cooperative directors*

A board of directors provides leadership and guides the business affairs of a cooperative. It has a central role in strategic planning. Directors typically are members of the cooperative and are elected at the annual membership meeting. The cooperative's bylaws specify director eligibility, method of selection, term of office, and board organization.

Board membership brings great responsibility. Those selected need to be able to participate in the board's role of listening and communicating with both management and member-owners. As an advisory body to both management and membership, the board members must be able to provide

sound recommendations and guidance.

### *The role of the board as a policymaking body*

Directors and managers play unique roles in an agricultural cooperative. Directors typically focus more on the longer term and on policy issues, e.g., board/manager functions and relationships; member, employee, and public relations; organizational concerns; and operational policies related to credit, pricing, purchasing, marketing, and services provided to the membership. Problems typically arise when directors slip too far into the day-to-day management role. Instead, directors need to represent the general membership in developing goals and objectives, which management then implements through its control of daily operations.

A major function of the board is to stay in touch with the general membership so that member concerns can be taken into account during decision-making. Furthermore, policies established by the board of directors must be communicated to the membership. Particularly important is communication about the board's decision on distribution of year-end earnings to owner-patrons. When some portion of earnings is retained as operating or equity investment, the decision must be explained carefully.

Protection of the membership's financial assets is another



important function of the board. The membership places trust in the board to invest those assets wisely for increased benefits to members. In addition, the board has the responsibility to distribute those benefits equitably to a typically diverse membership.

Perhaps the single most important task of the board is to hire the general manager and review his or her performance on at least an annual basis. Beyond having a good business sense, the manager must have excellent leadership qualities, possess attitudes and goals that are compatible with the board's views, and understand the unique nature of a cooperative business. A written job description, achievable business objectives, and clear performance criteria are necessary for an effective review.

Regular self-evaluation needs to be done by the board. Much of that review may be fairly objective. Did the cooperative meet its dollar goals? Were board meetings held when planned? Was the business plan implemented? Was the manager evaluated on schedule? In addition, more subjective evaluation is needed and frequently calls for a collective opinion from the directors. Such questions might include: Is there a good working relationship between the board and the manager? Were board meetings conducted in a harmonious manner? Were the needs of members put above the needs of the directors? Is there a good relationship

between the cooperative and the general community?

### *Directors as individuals*

Electing a board member is one of the most important functions of a cooperative member. Board members can have a direct impact on the success of the cooperative and in turn on the profitability of the member's own business. Above all, a prospective director needs to be a strong supporter and patron of the cooperative and must understand its unique role in business. Getting along well with people is an important characteristic. So too is regular participation in cooperative meetings.

Since a board member makes business decisions for the cooperative, he or she must be able to think through business problems independently and to communicate effectively. The prospective board member needs to be aware of current events that might affect the cooperative. Leadership qualities and an orientation toward furthering the needs of membership also are important. Directors must be receptive to new ideas that may enhance the benefits or lessen the limitations of cooperative membership. A reputation for integrity, honesty, and respect for the law is critical.

Board membership typically requires a significant amount of time away from the director's own business. Directors need to be able to do more than just attend formal

meetings. Much time may be spent in communicating with members, preparing for meetings, representing the cooperative at public functions, and communicating with legislators and regulators.

### *Membership responsibilities*

Membership in an agricultural cooperative brings many responsibilities. As a democratically controlled organization, member participation and voting at membership meetings is important. Equally so is member patronage of the cooperative.

### *Distinctive features*

Those who belong to a cooperative business frequently are referred to as owner-member-patrons. They typically are agricultural producers who own the cooperative, which is in business to serve producer-members, who are expected to patronize (buy/use) its services. Many cooperatives require their members to patronize the cooperative in order to vote.

By design, the return on member investment is kept low to keep the focus on the benefits derived from membership. In turn, the focus is on increased returns to members' private business operations. For many members, a cooperative really is an extension of their own business that serves certain purchasing or marketing needs.

Essentially, members form cooperatives to provide services to



themselves on a nonprofit basis. Monetary gains are returned to them in proportion to their patronage. Members must realize that some net returns may be retained by the cooperative to finance its operations or increase its equity base. This money is returned to members over time as new retains become available.

### *Requirements*

To be successful, a cooperative's members must actively participate in overseeing its organization, sound management, and operation. Members need to make their wishes known. By doing so, their cooperative can better meet their needs.

Members need to understand the nature of their cooperative—its purpose for existence, objectives, benefits and limitations, operating structures, finances, and long-run planning processes. They need to be familiar with the cooperative's articles of incorporation and bylaws, the legal limitations on their operations and directors, and requirements for member participation and quality control.

Members must understand the long-range planning process for targeting future services,

facilities, and capital needs so that they can help the cooperative stay ahead of membership needs for new technology and other

resources. They also need to be familiar with the cooperative's legal papers so they can vote intelligently on changes and act responsibly in helping meet the organization's contractual obligations.

A broad role in the management of the cooperative is important for every member. In that regard, it is the responsibility of members to stay informed about the cooperative. They then can elect excellent people from among their own ranks to represent them in most management affairs. Members must take the time and effort to understand and evaluate board actions, while avoiding undue pressure on board members. However, directors need members to encourage and challenge them so that needed services can be provided by the cooperative.

Members must patronize their cooperative enough to ensure it an adequate amount of business. The bond between members and their cooperative is critical to a cooperative's success. This link implies loyalty to the cooperative and its objectives and goals. In turn, the cooperative influences the growth, development, and business environment for the member's personal enterprise and community.

Member involvement in the cooperative's business affairs gives

it competitive vitality and helps it stay in tune with the needs of its members. Thus, members develop a sense of ownership and responsibility for the cooperative's success. Yet, it is clear that maintenance of loyalty to a cooperative requires the organization not only to have competitive products, prices, and service, but also to exhibit honesty and provide timely, accurate information.

Many cooperatives rely on their members to find new members to replace those who leave farming or move away. In many cases, new members are needed to improve the financial strength or increase the dollar volume of the cooperative. Members frequently are able to encourage their nonmember neighbors to patronize the cooperative and perhaps later become members. When recommending others for membership in a processing or marketing cooperative, members must be especially careful to recommend only producers who can meet standards for high quality and consistent volume.

### *Cooperative influences on public policy*

Both elected and appointed officials regularly make policy decisions that affect agricultural cooperatives. The more progressive cooperatives have developed programs to influence that decision-making. By involving directors, managers, other employees,

and members, cooperatives potentially can have a positive impact on the policy environment in which they operate.

Once a cooperative completes its long-run business plan, meeting the objectives in that plan can be enhanced by crafting a complementary public policy program. It is better in this regard to be proactive than reactive in order not to miss opportunities to positively influence government decision-making.

Basic to a cooperative's public policy program is a written set of policy resolutions. These resolutions are designed to anticipate problems and opportunities. The policies can provide guidance to cooperative leaders as they attempt to influence decisions by governmental agencies and legislative bodies.

While some of these policy resolutions may originate with directors, management, or other advisors, it is important for membership to have a say over policy statements and to be able to enact changes or reject resolutions. Many agricultural cooperatives have found a resolutions committee made up of elected members to be a good way to sort through ideas for resolutions.

Through education and communication efforts, members can be encouraged to support favorable initiatives at the "grassroots" level. Direct contact between cooperative members and policymakers can be a very effective way to influence legislation and administrative rules.

This contact may occur at cooperative functions or through one-on-one contacts outside the cooperative environment. Financial support for election campaigns of officials who identify with positions important to the cooperative also can be useful. Direct contact between cooperative leaders and legislators and their administrative staffs can be just as helpful.

Cooperative leadership may find it helpful to build coalitions with trade associations and other industries that share common concerns. In doing so, cooperative leaders can strive for a patient, long-term approach that will build credibility with policymakers and lead them to solicit advice from cooperative members, directors, managers, and other leaders.

### *Relationships and linkages between independent, federated, and centralized cooperatives*

A cooperative's need for growth may go beyond its internal abilities to increase volume and services. Strategic alliances may be necessary. Strategic alliances are motivated by many economic reasons. Motives may include capturing economies of size, gaining market stability, or stabilizing seasonal patterns. Or, an alliance may simply be a cheaper, faster, and less risky way to acquire new

geographic territory, add new services, or expand facilities. As markets grow and economies of size increase, consolidation of operations may eliminate overlapping overhead costs, redundant advertising, or unnecessary facilities and record keeping.

Small, independent cooperatives may form joint ventures with one another that allow them to combine resources for certain business objectives while continuing to exist as separate business entities. They maintain individual business identities while jointly benefiting from expanded services, increased efficiency, and better control of operating costs and margins. In many cases, joint ventures eliminate some of the negatives of mergers. They do so by avoiding the difficulties and hostilities related to closing duplicate facilities, changing poor practices and policies, laying off excess employees, and disrupting community identities.

Federated cooperatives are formed by individual cooperatives. The member cooperatives maintain their identity as individual businesses while holding membership in the federated cooperative. On occasion, individuals are allowed to be members of federated cooperatives. By creating such an entity, cooperatives may be better able to provide services to their members than they could with their individual resources.

Federated cooperatives are designed to do such things as

facilitate joint marketing efforts or provide supplies or specialized services. Common federated business activities include the creation of marketing-in-common agencies and purchasing agencies for more economical acquisition of supplies.

Centralized cooperatives have individuals as members and maintain satellite facilities in strategic areas to serve those members. They frequently are formed by consolidations of previously independent cooperatives into a newly created cooperative. Motivations for such a change include situations where the names, images, geographical locations, product lines, or philosophical orientations of the original cooperatives are not compatible. Forming a new cooperative can create a neutral environment by eliminating former legal entities, names, and operating structures. With a fresh start, the new cooperative can adopt the strengths of the old cooperatives and eliminate perceived weaknesses. The downside, however, may be higher legal expenses. Furthermore, the new cooperative may not be able to retain the favorable identities associated with the former cooperatives.

Successful completion of consolidations can be difficult. A key element for success is one-on-one discussions between the agricultural members of each cooperative and between their boards of directors. As people

become acquainted, they can develop trusting relationships and open paths for leadership. In the process of those

discussions, all positions, opinions, and concerns need to be made clear among the participants.

If any problems are identified, there needs to be a sense that everyone is working objectively toward solutions. The focus needs to be on the future and on joint problem solving. A positive “we” environment needs to be established. Strategic planning is critical so that potential deadlocks can be avoided and issues and choices can be negotiated. The ultimate goal should be to form a strong, unified, and efficient cooperative that is progressive in its efforts to incorporate sound planning, negotiation, and problem solving. The new cooperative will be more likely to have the resources and strength to provide greater benefits to all of its members.

### *Sources for additional information*

Continuing education and training are important for those associated with an agricultural cooperative. Such activities can improve the



ability of directors, managers, and other employees to successfully control, finance, and operate a cooperative. In many smaller agricultural cooperatives, the manager may take responsibility for educational and training programs—regular newsletters, employee and member meetings, or even one-on-one contact with members and directors. Through education, even nonmembers can be encouraged to seek the benefits of cooperative principles and practices.

### *Selected organizations*

**The Agricultural Cooperative Council of Oregon (ACCO)** is a trade association of about 25 state and regional agricultural cooperatives that do business in Oregon. ACCO focuses on supporting educational programming related to agricultural cooperatives and also supports lobbying efforts on legislative issues of broad interest to its members. An annual meeting usually centers on educational topics of interest to agricultural cooperative managers, directors, and members.

Also, ACCO strongly supports the annual Cooperative Leadership Seminar, which is conducted by the Executive Institute for Northwest Cooperatives. The seminar is designed in part to educate agricultural cooperative directors and managers in areas such as the changing business environment, decision-making responsibilities, financial analysis and control, and improved communications and working relationships in an agricultural cooperative environment. ACCO is a member of the National Council of Farmer Cooperatives.

A contact for ACCO is Mr. John H. McCulley, Executive Secretary, ACCO, P.O. Box 2042, Salem OR 97308-2042. Phone: 503-370-7019. Fax: 503-587-8063. E-mail: [assoc@wvi.com](mailto:assoc@wvi.com)

The **National Council of Farmer Cooperatives (NCFC)** is a national association of cooperative businesses owned and controlled by farmers—food and fiber marketing, agricultural credit, and agricultural supply cooperatives. Its primary goals include the promotion of farmer cooperatives, liaison with governmental agencies, and serving as a communications link with agricultural cooperatives about emerging issues of interest. An additional goal is to serve as a forum to promote needed educational programs for cooperative directors, managers, and members; legislators and regulators; and the general public.

### Who can help?

- *Agricultural Cooperative Council of Oregon (ACCO)*  
John H. McCulley, Executive Secretary  
P.O. Box 2042, Salem, OR 97308-2042  
Phone: 503-370-7019; Fax: 503-587-8063  
E-mail: [assoc@wvi.com](mailto:assoc@wvi.com)
- *The National Council of Farmer Cooperatives (NCFC)*  
50 F Street NW, Suite 900, Washington, DC 20001  
Phone: 202-626-8700; Fax: 202-626-8722; Web site:  
<http://www.ncfc.org/>
- *U.S. Department of Agriculture (USDA)*  
Robert K. Haase, Cooperative Development Specialist  
Cooperative Services Program, Rural Business-Cooperative Service, 625 SW Salmon Ave., Suite 5, Redmond, OR 97756  
Phone: 541-923-4358, ext. 124; E-mail: [bob.haase@or.usda.gov](mailto:bob.haase@or.usda.gov)  
Web site: <http://www.rurdev.usda.gov/rbs/index.html>

NCFC can be contacted at 50 F Street NW, Suite 900, Washington, DC 20001. Phone: 202-626-8700. Fax: 202-626-8722. Web site: <http://www.ncfc.org/>.

A number of educational programs are identified and publications are accessible at <http://www.ncfc.org/resources/>

For more than 80 years, the U.S. Department of Agriculture (USDA) has sought to help agricultural cooperatives develop and prosper through the educational efforts of units such as the Agricultural Cooperative Service. In an effort to improve its service, USDA recently reorganized. The new **Rural Business-Cooperative Service** has

a cooperative development specialist in each state.

In part, this new agency is intended to help farmers determine the feasibility of a proposed agricultural cooperative venture, organize potential members to launch the corporation, and develop and implement a business plan. It also can help new cooperatives develop and complete producer surveys, conduct research and transmit findings about problems and issues, evaluate and determine the best business structure for the cooperative, and obtain information on financing available through the federal government's guaranteed loan programs.

For most of the past century, USDA's cooperative assistance has been concentrated on agricultural cooperatives. While agricultural marketing and supply cooperatives remain a primary focus of USDA's efforts, Rural Business-Cooperative Service plans to gradually expand the cooperative program to include assistance to all types of rural cooperatives.

The Cooperative Services program of Rural Business-Cooperative Service not only provides technical assistance, but also conducts cooperative-related research and produces information to promote public understanding of cooperatives. They have an excellent series of circulars and bulletins online (<http://www.rurdev.usda.gov/rbs/pub/cooprpts.htm>). For a general overview of all of the services of the Rural Business-Cooperative Service, visit their Web site (<http://www.rurdev.usda.gov/rbs/index.html>).

Those interested in rural cooperative development in Oregon can obtain one-on-one assistance from the Rural Business-Cooperative Service by contacting Mr. Robert K. Haase, Cooperative Development Specialist, Cooperative Services Program, Rural Business-Cooperative Service, 625 SW Salmon Ave., Suite 5, Redmond, OR 97756. Phone: 541-923-4358, ext. 124. E-mail: [bob.haase@or.usda.gov](mailto:bob.haase@or.usda.gov)

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