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**Basic Cooperative Principles &
Methods of Doing Business**

by

Brian H. Schmiesing
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Basic Cooperative Principles & Methods of Doing Business

Brian H. Schmiesing

As this conference progresses you will probably hear the word "restructuring" repeatedly. Forbes, a major business publication, recently pointed out, that "restructuring" is a euphemism. Euphemism refers to the use of a word or phrase that is less expressive or direct, but considered less distasteful. Restructuring has become the "sugar coated" term for a broad range of harsh realities confronting U.S. Agriculture and Rural America. Although international and national governmental policies have contributed to the current environment, poor management decisions, ineffective incentive systems, inefficient distribution and production systems should not be ignored. Yet these are terms which describe part of the reality of U.S. farming and cooperatives. Note I said PART not ALL.

For this reason I am speaking to you today with some hesitation about basic cooperative principles and methods of doing business. What are the basics? Hopefully, something "basic" is something we can agree on and assume is correct. But the current crisis in agriculture is requiring cooperatives and their patron-owners to question many of the traditional "basics." I no longer believe that traditional cooperative principles meet the criteria of being "basic." Although cooperatives are a distinct type of business enterprise, cooperatives also have much in common with investor-owned businesses.

I am also particularly concerned because you are in the most important business of agriculture--"the people business." You are dealing with the future of cooperatives and agriculture. In my talk I have the potential for seeding the seeds of destruction or growth.

Because of this fact, I am going to attempt explain why the "basics" simply cannot be assumed.

This paper will first define what is a cooperative principle. The dangers of viewing principles as cooperative objectives or independent of rules and discipline are discussed. Second, a set of commonly used cooperative principles are critically examined for their implications for cooperatives as business organizations. Third, an alternative set of principles are advocated to eliminate the confusion currently existing. Finally, a potential role of the Extension Service and vocational agriculture instructors in assisting their clientele in the current crisis is reviewed.

What Is a Cooperative Principle?

A cooperative principle is a statement of ideal values or conditions that uniquely identify organizations as cooperatives. Cooperative principles establish the boundaries in the which the cooperative can pursue its organizational objectives (2, pp.144-149)

Principles as Objectives

When applying cooperative principles, a major danger exists that the principles become objectives for the organization. We perceive "good cooperative objectives to come from good cooperative principles" rather than "good cooperative principles to come from good cooperative objectives." This is more than a play on words.

When cooperative principles become cooperative objectives, they distract patron-owners from establishing priorities on the "real" issues confronting cooperatives. Instead of evaluating their cooperatives on their accomplishments as business organizations or meeting patron-owner's objectives, attention is directed towards whether the cooperative is following the "rules." Business organizations that

concentrate on following "rules" become inflexible and lack the ability to adapt.

If we concentrate on the patron-owner objectives, cooperatives have the ability to adapt and to respond. However, if cooperatives do not have clarity in their objectives, cooperative principles can not perform their role. Principles should point out danger areas for cooperatives... dangers that may cause the organization to suffer the loss of its effectiveness in meeting patron-owner objectives.

Cooperative Principles Can Not Stand Alone

For cooperative principles to be effective they must be linked to rules and discipline. Rules are statements that translate the principles into actions by establishing what is acceptable. Discipline involves the legitimate sanctions that individuals are subject to for violating the rules.

Effective rules have three general characteristics. The rule must be perceived as directly linked to a clearly stated principle. The rule should be flexible and responsive to the changing environment. The rules must be seen as functional and reasonable by both the enforcer and enforcee.

Discipline is the legitimate sanction that individuals are subject to for violating the rules. Discipline must be consistent with the principles concerning discipline. The purpose of discipline is to suppress unwanted behaviors. Discipline must be linked to the rules being violated. Offenders must perceive and experience the discipline as being just. Discipline should be administered by the immediate supervisor rather than judicially.

The immediate supervisor of the cooperative system are the patron-owners. They have the responsibility to enforcing discipline upon the

cooperative system. To be effective enforcers of discipline, they must know the rules and principles of cooperative businesses.

Because most farmer cooperatives are corporations, the patron-owner can obtain information about the rules governing their cooperatives from two basic documents. The articles of incorporation contain the contractual agreement between the state in which the cooperative is incorporated and the cooperative. The by-laws represent the contractual agreement between the cooperative and its patron-owners.

State cooperative laws provide additional insights into the rules that govern the cooperative organization. Although these documents provide insights into the linkage between current rules and cooperative principles, they do not indicate how principles affect patron-owner attitudes towards cooperatives as business organizations.

Principles of Confusion

Clarity and simplicity are essential if cooperative patron-owners are going to use cooperative principles effectively: (1) the principles should communicate their message without a great deal of explanation; (2) more importantly the principles should use terminology or concepts that are generally understood by patron-owners; and (3) the principles should not lead to business activities that discourage solid business practices.

Two commonly cited cooperative principles could be more appropriately labeled as two principles of confusion. As a cooperative educator, I have found these two principles to be frequently misunderstood by patron-owners and students. This confusion makes the patron-owners unable to create the rules or discipline required for a successful business organization. The two principles which cause this confusion are "operation at cost" and "limited return on equity

capital."

Operation at Cost

What does "operation at cost" mean? For many people this implies that a cooperative should breakeven. In accounting terms this simply means total revenues minus total costs equals zero. This perception affects what patron-owners expect in pricing strategies and how patron-owners evaluate their cooperative's business performance.

If a cooperative is perceived as only needing to breakeven, what do patron-owners expect for pricing strategy? The cooperative should offer lower prices than an investor-owned business. Two basic problems exist with this pricing attitude.

First, in a competitive market economy, firms compete at least partially in terms of price. If a farm supply cooperative prices its products so it only breaks even, what will competing firms do? As the cooperative reduces its prices, the competitors will also reduce their price. Who benefits when this happens?

A patron-owner has equity capital invested in the cooperative and this capital has an opportunity cost. Opportunity cost refers to the fact that he or she could have invested the money elsewhere and earned a competitive rate of return on their investment. So the cooperative provides a competitive price but no return to the patron-owner's capital.

Another producer buys from the investor-owned business competing with the cooperative at the competitive price. This producer has no money invested in a business that is just breaking even and thus does not suffer loss represented by their opportunity cost of capital. Cooperatives should benefit those individuals that invest in the cooperative.

If patron-owners perceive breaking even as being acceptable

performance, what are the incentives to improve the organization? Costs can easily inflate to match cooperative revenues. Excess capacity that is not profitable is retained. Financial ratio analysis comparing cooperative and investor-owned businesses is not perceived as being proper. Also, the stress is not on what the cooperative can accomplish, but rather that the organization is getting by.

Just like any other business a cooperative must generate a net savings (profit). Cooperatives need net savings for the expansion of product lines, replacement of facilities, improvements in services, capital reserves for "hard times" and retirement of equities. These objectives can not be accomplished with a breaking even attitude.

Is Positive Net Savings Bad?

Limited return on equity is even more devastating because of the potential for the perception that making a positive net savings is bad. The actual intent of this principle is to insure that the return to the ownership of the cooperative is associated with use rather than stock ownership in the cooperative (1).

What is so wrong with a cooperative marketing farmer products and earning 30 to 40 percent rate of return on its invested equity? If ethical business practices are being followed, I do not think this is a "bad" situation.

A source of resistance to such returns is related to the fact that net savings distributions to farmers by cooperatives frequently takes the form of cooperative stock and cash. Since the patronage refunds are taxed as ordinary income, producers would prefer receiving a higher portion of their patron refunds as cash rather than stock. This tax treatment also makes producers feel that the cooperative should simply pay higher prices but that causes the nonmember problem that

was previously discussed.

For all the talk about the lack of investment by American business, we have a tax system that discourages producers from making long term commitments to cooperatives. I personally I would rather have the Federal government give farmers a \$2,000 dollar tax deduction for investing in their cooperatives rather than paying farmers \$2,000 for not raising a crop. Part of cause for the current difficulty in agriculture was the lack of tax incentives to invest in something other than land, machinery, buildings and breeding stock during the boom years.

An Academic Failure

One of the failures of the academic community has been inadequate exploration the issue of when the principle of limited return on equity can be appropriately applied. For example, assume we have a rural water system cooperative, which represents the only source of water and a closed membership. In such a situation, if the cooperative can meet its objectives in terms of equity redemption, capital improvements, service, etc. at a low return on equity, there is little to be gained by increasing the return to equity.

Another case where cooperatives may have a low rate of return is when a cooperative may be the only way to obtain the service. Investor-owned businesses have found the industry to have too low of return. However, a real danger exists here, because the market economy is sending a clear signal: "Capital should exit from the industry unless you find a way to improve the profitability." The natural tendency is to enter a business with the assumption that business will exist forever, when in reality the economic life of the firm may be relatively short. A business plan for exiting an industry in an orderly fashion is a valid business strategy. A low return on equity

in a market economy is telling you something, the real skill comes in deciphering the message.

A cooperative having a limited return on its equity may be performing a valid role. This role is vital when the cooperative has a form of closed membership and patron-owners lack an alternative source of the service. Another situation would be where the cooperative is part of a plan for exiting from the industry. If these conditions do not exist, patron-owners should be asking why the lower return exists and what can be done to correct the problem.

Are Cooperatives Aggressive Enough?

Cooperatives and their patron-owners should not feel guilty when they identify a business opportunity with a high return on equity. Successful businesses must be aggressive in their acquisition of profitable business opportunities. When cooperatives look for acquisitions do they look only toward cooperatives or do they look for the "best" acquisition? Or do cooperatives only look at investor-owned businesses as an acquisition when the organization is failing? These are two possible traps that cooperatives can fall into if they perceive themselves as being constrained by a limited return on equity.

The principles discussed can create dangerous goal confusion among patron-owners, boards of directors and management, which can lead down the path of failure. Profitable periods allow this goal confusion to be ignored. Stressful times bring the identity crisis to the the forefront as the overriding concern becomes survival rather than limiting profitability.

Equality Versus Equity

The previous section has discussed why two frequently used cooperative principles can cause goal confusion. A third principle

is at the middle of a major conflict in cooperatives. The principle is "democratic control" or sometimes stated as "one member-one vote." An individual's wealth or number of shares owned do not determine the number of votes they have in policy decisions. All members are equal at the annual meeting of the cooperative.

Equality of treatment can be argued for strongly when each patron-owner of the cooperative does approximately the same dollar amount of business volume. Traditional agricultural practices in the Upper Midwest during the 1950's very much fit into this scenario. But what happens when the structure of agriculture changes to where the farmers are very unequal in terms of their size and their contribution to the business.

Cooperative management is in the middle. Assume 10 percent of the patrons represent 80 percent of the business revenues. To survive as a business, cooperative management must meet the needs of these patron-owners. Yet, at the annual meeting, 90 percent of the patron-owners with 10 percent of the business volume will select the board of directors, who establish business policies. In such an organizational environment, will management be able to implement a price discount policy for larger customers? The cooperative principle of democratic control supports the objective of equality.

The alternative organizational environment is based on the objective of equity. All individuals having similar characteristics will be treated equally. However, this approach assumes we know which characteristics are appropriate. Should the number of votes be based on patronage? Should the number of votes be based on investment? If we use patronage, larger volume current patrons may vote for management and business policies that do not redeem the previous

patrons' investment. If we use investment, previous patrons with large investments may vote for management and business policies that redeem the previous patrons stock at the expense of the cooperative's expansion and growth. Who controls is an issue that must not be taken lightly, since it determines how a cooperative will react in its business environment.

An Alternative List of Principles

Successful businesses have cultures which are constantly reinforced by clearly defined values (3). Cooperative principles have an important role of defining a cooperatives culture, that is, how cooperatives approach their business operations and their environment. A central question is whether the principles create a culture of success or of failure. Hopefully, our discussion thus far has demonstrated the havoc that cooperative principles can cause with developing clearly defined business goals. However, you must realize that cooperative principles can and should assist in developing a system of development of rules and discipline that make cooperatives successful.

My wish list of cooperative principles are my perception of a set of principles that would enable patron-owners and management to create solutions for their unique set of objectives. The principles are the following:

1. A positive return based on use;
2. Patron-owner control;
3. Patron ownership through investment of risk capital;
4. Investment based on use;
5. Duty to educate.

The benefits of the cooperative organization should go to those individuals that use the services of the organization. A positive return implies a movement away from the misconception that cooperatives

should just breakeven. The educational challenge is showing how to determine how much positive return is required for a cooperative to be a successful organization.

The central issue is patron-owner control. The diversity of U.S. agriculture now requires that cooperatives have to develop patron-owner control systems that are consistent with the business environment faced. This emphasis insures that the needs of the patron-owners are addressed by management and that patron-owners are aggressive towards having a voice in their organizations. The educational challenge is increasing patron-owner's understanding of their rights and obligations in controlling cooperative organizations.

Patrons should own the cooperative. If patrons are going to control the business, they must have a financial commitment to the organization, i.e., they are making an investment of risk capital. Capital that can be lost through inefficiencies and mismanagement. The educational challenge is increasing patron understanding of how cooperative investment risk can be managed and methods of evaluating their risk exposure.

Most importantly, the investment in the organization should be based on use. Estates, retired farmers and widows should not have the risk capital in cooperatives. If a positive return exists to use, there exists an incentive for investment associated with its use. If patron-owners recognize that they are making a long-term investment based on their projected use of the organization, incentives are created for investment and monitoring the organization. The educational challenge is educating patron-owners about alternative methods such as base-capital plans which accomplish this principle (4).

Unlike the individual entrepreneurship where a single individual

creates an organization, cooperatives represent group action. This particular aspect requires considerable more education than the investor-owned corporation. Generally, in the investor-owned business, the investor and consumer of the products are distinctly different groups. Just because investors are dissatisfied with the financial performance of management does not imply that consumers or company suppliers are dissatisfied or vice versa. Within cooperative organizations, investment is linked to either the marketing the patron's product or the consumption of the firm's products.

Because of the structure of cooperatives, the need for education is much higher than the investor-owned business. The educational challenge is expanding the level of cooperative education to increase the cooperative system's effectiveness.

Role for Educators and Agents

I believe cooperatives exist to empower individual farmers to compete in our market economy. Educators and agents, through their educational efforts, also empower individual farmers. To discuss how we can empower we first must understand the concept of power.

Power is "...the ability to get all of what you want from the environment, given what's available."(2) Cooperative education empowers individuals because it increases the ability of individual to accomplish their goals. By knowing how the cooperatives are organized and operate, patron-owners can accomplish their objectives. Also, education enables individuals to assess the resources they have available to accomplish their objectives. But realize that power is frequently not liked by formal organizations, because new demands and changes will be demanded of the formal structure.

How Does Disempowerment Develop

How do individual or farmers suffer disempowerment within the cooperative system? A major source of disempowerment is the lack of specific terms in describing wants. For example, cooperatives and patron-owners are frequently talking about "service." What is service? Service is an ill-defined term. If a patron-owner mentions service, the need is to get a specific definition. The lack of clearly defined objectives also decrease goal achievement. Specific objectives results in a concentration on facts instead of personality and values.

For example, successful farm managers have very specific goals and objectives. They know their cost of production, they know their markets and they know their profit objective. No doubt you can think of farm managers, who do not know their cost of production, their monthly cash flow needs or how to market their commodity. The first producer has power, the second producer lacks power.

In presenting cooperative principles or business methods do not delegate the decisions to an "expert" or "consultant." Farmers should not give away their ability to reason through the issues confronting their cooperatives. Although experts do have knowledge that may be essential to the decision, only the individual farmer knows what is "best" for his or her particular situation. Another problem with "experts" and "consultants" is that you never can be sure that there is not a "hidden agenda." Experts are individuals and human. They may be motivated by money, security, and beliefs that you do not find acceptable.

Confluence

Confluence is the coming together of streams. In organizations this occurs when individual identity is sacrificed for the common

identity of the firm (2). This is not necessarily good! Individual perspectives may be drowned by group think or hero worship. The perceived benefit are feelings of security, togetherness, belonging, harmony, and calm. The usual results are loss of power, reduced self awareness, inefficiencies, low energy, low creativity, lack of risk taking and superficial relationships.

We in the cooperative family often fall in this particular trap. We can perceive the world as being "what is good for cooperatives is good for farmers." WRONG! A "good" cooperative deals with how the cooperative empowers the individual farmer to meet their objectives. Do not fall into the trap of defending the institution because the institution exists. If a cooperative can no longer effectively meet the objectives of producers we should terminate its existence.

Alternatives

In our educational efforts, we should attempt to get producers to examine the alternatives not a single solution. Do not assume that we can not change the rules of the game to generate alternative solutions.

A major threat to generating alternatives is dogma. Dogma is the positive, arrogant assertion of opinion. Just as agriculture became a believer in the dogma of growth, we should not now fall into the trap of the dogma of decline. Educate producers and our youth on how the system works and they will generate the alternatives.

Conclusion

Our current set of cooperative principles must be evaluated for their ability to generate businesses that will successfully meet the objectives of producers. Confusion about cooperative business objectives is extremely dangerous as we attempt to plot a course through the current crisis. We have to deal with realities rather than what we

would like to see in agriculture.

My recommendation to educators in their educational efforts with current and future producers: help these individuals practice selfness, aggression and arrogance in dealing with their cooperatives. Selfness being the perspective that an individual will get from a cooperatives what s/he wants without exploiting others. Aggressive in that they will aggressively pursue their needs in dealing with cooperative management and boards of directors. Arrogance is the self-confidence in one's self-worth and individual ability to make sound business judgements for their cooperatives. If this happens I am confident the producer and cooperative relationship will strengthen in the future.

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