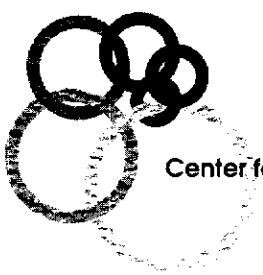
RESEARCH REPORT

NO. 3
MAY 1992

COOPERATIVE PRINCIPLES AND REGULATIONS: AIDING OR HAMPERING COOPERATIVES' EFFORTS AT VALUE-ADDED MARKETING?

S.D. Hardesty, Ph.D.
Consultant



Center for Cooperatives • University of California, Davis

TABLE OF CONTENTS

ACKNOWLEDGEMENTS

I extend a special thank you to the cooperative managers who gave generously of their time for this study. They shared their thoughts openly and made the interviews very interesting, as well as informative. I am also grateful to the lending officers and managers of the investor-owned firms who participated in this study. Ronald Peterson of Hanson, Bridgett, Marcus, Vlahos and Rudy, Robert Taylor of Tuttle and Taylor, and Teresa Castanias of KPMG Peat Marwick cheerfully provided me with guidance on legal and tax matters.

This project was funded by the University of California's Center for Cooperatives; I also appreciate the thoughtful feedback provided by Lee Garoyan and Charlie Moore.

Cooperative Principles and Regulations: Aiding or Hampering Cooperatives' Efforts at Value-Added Marketing?

EXECUTIVE SUMMARY

The ability of agricultural marketing cooperatives to compete with investor-owned firms (IOFs) in the food processing industry was assessed through a literature review and interviews with cooperative lenders and top managers at various cooperatives. The findings are discussed in this report and its companion, *Agricultural Cooperatives As Effective Marketers of Value-Added Products*. This report contains a literature review of cooperative principles and regulations and an analysis of the interview responses.

Cooperatives have historically been guided by the cooperative principles—user-financed, user-controlled and user-benefit. These principles are promoted by various federal regulations, such at Subchapter T and Section 521 of the Internal Revenue Code, the Capper Volstead Act, securities registration requirements and state statutes. Many of these regulations have similar requirements. Cooperatives' ability to compete with IOFs in the food processing industry may be constrained by these institutional factors. Cooperative specialists have concluded that cooperative regulations limit cooperatives' ability to obtain equity capital from both members and nonmembers; substantial capital is needed for a new firm to overcome the product differentiation achieved by IOFs in the food processing industry. The regulations also impose overly restrictive governance structures which may detract from their performance.

Various studies indicate that the cooperative principles can also affect cooperatives' behavior. The user-controlled principle can keep cooperatives' strategic options limited and prevent them from becoming market-oriented. Because of the user-benefit principle, investments in brand equity and distribution can be unattractive to members who can only receive the benefits of the cooperative for only as long as they patronize it. The user-benefit principle can also impair cooperatives' internal efficiency by causing underinvestment in physical assets. The user-financed principle can lead cooperatives to have insufficient amounts of permanent equity. Because there usually is no secondary market for cooperative securities and cooperative boards are often comprised only of producers (the user-controlled principle), cooperatives are susceptible to inadequate reviews of management performance. Some of the alternative sources which cooperatives have developed to overcome their financing constraints may violate the cooperative principles.

The findings of the interviews with cooperative lenders and management officers indicate that both cooperative regulations and principles are constraining cooperatives' abilities to fulfill the four basic requirements for being effective marketers of value-added products. The dividend and voting restrictions imposed by the Capper-Volstead Act and Section 521 restrict access to equity from nonmembers. Member equity capital is limited because of the lack of liquidity in the investment, members are not recognizing their responsibilities as spelled out by the user-financed principle and the wide variance in their abilities to invest in their cooperatives.

A solid strategic plan is another basic requirement for effective marketers. Cooperative boards have difficulty dealing with strategic planning issues. Most cooperative members have a short-term perspective of the user-benefit principle; they are used to having their cooperative be a home for their deliveries.

Because consumers' needs are rapidly changing, a firm must be market-oriented to be an effective marketer of value-added products. The cooperatives in this study have not broadly accepted the market-oriented concept. Cooperatives' efforts to have a broad product line can be hampered by regulations which restrict a cooperative's nonmember business. Furthermore, cooperative boards and members tend to be very protective of management's attention to their commodities and reluctant to invest in nonpatronage products. In addition, it is difficult for cooperatives to shift their orientation from their producers' needs to their customers' needs.

A strong management team experienced with value-added products is the fourth basic requirement for being an effective marketer of value-added products. A cooperative should recognize that its needs for managerial expertise expand as it integrates vertically. The cooperatives in this study appear to be relatively successful in fulfilling the requirement of having management experienced with value-added products. Their abilities to do so can be constrained by the user-controlled and user-benefit principles.

The responses from the lender and CFO interviews suggest numerous changes which can be made to improve cooperatives' abilities to fulfill the four basic requirements for being effective marketers of value-added products. Educational efforts with cooperative boards (and to a less degree, members) are paramount to improving cooperatives' abilities to fulfill the four basic requirements. Regulatory constraints should be reviewed carefully by cooperatives; numerous cooperatives have already rescinded their Section 521 status in order to be able to accumulate unallocated equity. The cooperative principles should also be reconsidered. A cooperative marketing value-added products should apply a less traditional interpretation of the user-benefit principle than the traditional, first-handler cooperative. Many cooperatives have implemented joint ventures with IOFs and public stock issues to overcome their financial constraints; some of these programs do not adhere strictly to the cooperative principles.

The cooperative principles and special cooperative regulations provided appropriate guidance over the behavior of cooperatives organized to function solely as first handlers for their members' commodities. As cooperatives choose to become marketers of value-added food products and compete with IOFs, they need to make some changes in their longstanding practices. They may find it necessary to compromise some of the cooperative principles as they strive to be successful marketers of value-added products.

Cooperative Principles and Regulations: Aiding or Hampering Cooperatives' Efforts at Value-Added Marketing?

I. INTRODUCTION

Agricultural production is the major source of raw material in food manufacturing; however, its importance is declining as a proportion of the value of the end product. Many agricultural marketing cooperatives have opted to engage in continued vertical integration by marketing value-added products. In order to compete effectively with investor-owned firms (IOFs), these cooperatives must have effective marketing programs.

As part of this study, a broad range of literature was reviewed to identify the elements which form the foundation of an effective marketing program. These requirements are discussed in the companion to this report, *Agricultural Cooperatives As Effective Marketers of Value-Added Products*. Four basic requirements are identified which cooperatives must fulfill in order to be effective marketers of value-added products. First, they need a well thought-out strategic plan which utilizes a niche strategy and has a competitive orientation. Second, the plan and its supporting programs should be market-oriented, rather than producer-oriented. Marketers of food products have achieved a high degree of product differentiation; thus, the third requirement that cooperatives must satisfy is financial capital to overcome this barrier to entry. Fourth, cooperatives must have management experienced with value-added products in order to broaden their expertise and perspective as they strive to be value-added marketers.

Empirical evidence indicates that cooperatives are thus far strongest in the commodity-oriented segment of the food processing industry.[1] Cooperatives' competitiveness may be constrained by institutional factors. They were formed to render economic benefits to their members. Unlike IOFs, cooperatives are essentially nonprofit enterprises operating for the mutual benefit of their members. They are governed by special federal and state regulations and guided by cooperative principles. Some of these regulations and principles may limit cooperatives' access to debt and equity capital, and consequently constrain their ability to finance product and market development activities. They may also impose less obvious constraints on cooperatives' abilities to be effective marketers of value-added products, such as impairing their abilities to be effective strategic planners, have a market orientation and hire management experienced with value-added products. Nevertheless, some agricultural marketing cooperatives have become well-known for their food products and have had successful new product introductions.

The specific objectives of this study are to identify and analyze regulations and other factors unique to cooperative organizations which constrain their abilities, specifically, to finance new products, and in general, to be effective marketers of value-added products. These objectives will extend this study beyond the cooperatives' financial management practices.

Cooperative principles and regulations are described in the next section. Literature regarding the effects of these institutional forces on cooperatives is also reviewed. In the following section, findings from interviews conducted with cooperative lenders and Chief Financial Officers at select cooperatives are analyzed; the interviews focused on examining how cooperative principles and regulations can constrain cooperatives' abilities to satisfy the four basic conditions required to be an effective marketer of value-added products. A summary and conclusions are presented in the final section.

II. LITERATURE REVIEW

Although cooperatives and IOFs are competitors in the food manufacturing industry, cooperatives are governed by cooperative principles, and special tax provisions and other regulations. Cooperatives' limited presence in highly processed food products markets may be partially attributable to these institutional factors. In this section, cooperative principles and regulations most commonly mentioned in the cooperative framework are described and analyzed; the regulations include Subchapter T and Section 521 of the Internal Revenue Code, the Capper Volstead Act, securities registration requirements and state statutes.[2] There is substantial overlap in the requirements of these regulations. Laws applicable to both cooperatives and

[1] This evidence is also presented in the report, *Agricultural Cooperatives as Effective Marketers of Value-Added Products*.

[2] This report should not be used as a tax or legal reference document. It does not contain a comprehensive review of statutes and regulations affecting cooperatives. Such matters are highly technical and can only be properly addressed by specialists.

IOFs are not included in this study. Regulations applicable to California cooperatives are highlighted. Because many cooperative regulations promote the cooperative principles, these principles are described first.

A. Description of Cooperative Principles

The following information regarding cooperative principles was extracted from a publication by James Baarda, entitled *Cooperative Statutes and Principles*. The basic purpose of a cooperative is to provide economic benefits to its members; its primary objective is not to pay dividends on invested capital but rather to "...operate as a vehicle to contribute to producers' own operations by marketing products..." (p.19). The cooperative principles provide behavioral guidelines for cooperatives as they act to fulfill this objective. The essence of cooperative principles have changed little since their development by a group of English flannel weavers in 1844.

Baarda reports that the four cooperative principles are: 1. cooperatives are owned and democratically controlled by those who use their services; 2. cooperatives' net margins are distributed to users in proportion to their patronage; 3. returns on investment are limited; and 4. cooperatives are financed substantially by those using their services. He states that the "...first three principles are considered of prime importance by most writers as fundamental principles of a truly cooperative business enterprise...The fourth principle is a restatement of the ownership feature of the first principle. It is stated separately because of current interest in member financing techniques..." (pp.4-5). These principles are often summarized as "user-controlled, user-financed and user-benefit" and will be referred to as such in the remainder of this report.

B. Description of Federal and State Tax Provisions

Unless otherwise noted, information regarding the federal tax provisions discussed below was obtained from the publication, *Tax Management Portfolios—Taxation of Cooperatives* by Clark and Erickson.

1. Subchapter T

The federal taxation of cooperatives is generally governed by the provisions of Subchapter T of the Internal Revenue Code. Subchapter T provides for the single tax treatment of cooperatives and their patrons. Under Subchapter T, a cooperative can deduct, from taxable income, patronage dividends paid in cash or as a qualified allocation, and cash paid for the redemption of nonqualified allocations.

Cooperatives distribute their earnings to their members as qualified and/or nonqualified allocations. Subchapter T requires that qualified allocations be taxable to members when the notice of the allocation is issued, regardless of when the member actually receives a cash payment of the allocation. This practice is inconsistent with the Internal Revenue Service's (IRS's) treatment of allowing farmers to realize other taxable farm income upon constructive receipt, rather than upon accrual. A nonqualified allocation of patronage dividends is not taxable to members until the cooperative redeems the allocation in cash to the member or the member sells his/her allocation. The nonqualified allocation is taxable income to the cooperative; most cooperatives usually offset this income with deductions or losses. When the cooperative redeems the nonqualified allocation, it generates a deduction equal to the amount of the redemption.

In order to qualify for Subchapter T, the cooperative must "operate on a cooperative basis." Although the Internal Revenue Code and regulations do not define "operating on a cooperative basis", its meaning has been interpreted in many IRS rulings and court decisions. The courts have generally defined the term according to common understanding of the cooperative principles, "user-controlled, user-financed and user-benefit".

"User-controlled" is usually accomplished by providing for voting on the basis of one member-one vote. The IRS, however, has recognized that some form of weighted voting may be permissible if the weighting is in some manner proportionate to current patronage. The IRS has also in the past suggested that any form of weighted voting must limit any single member's voting power to no more than 5% of the total voting power. There is, however, no statutory or judicial case authority for such a limitation.

The user-financed principle generally requires each member's equity contribution to be proportionate to the member's patronage. Not all patrons must have an ownership interest and Subchapter T does not specify a minimum proportion of member financing.

The user-benefit principle requires that a cooperative pay or allocate margins to its patrons on the basis of their patronage, with the option of paying dividends on capital stock (also subject to restrictions described later in this section). This principle was the cause of IRS's challenge of the practice of retaining some pa-

tronage earnings as unallocated equity. The IRS contends that this practice is inconsistent with providing "service at cost". However, the IRS has taken a liberal position with regard to another aspect of the user-benefit principle—functional netting. Netting of returns within functions of a cooperative is permissible, provided that the cooperative gives notice of this practice to its patrons. Many cooperatives pay the field price for a commodity and then divide up the cooperative's overall net margins among all members. This "functional netting" broadens the concept of equal treatment to members delivering different commodities.

2. Section 521

Section 521 is the second federal tax provision having a major effect on cooperatives. Cooperatives qualifying under Section 521 are allowed deductions for dividends paid on capital stock and for patronage-based distributions of nonpatronage income when calculating their taxable income. Under the Securities Act of 1933, such cooperatives are exempt from registration and prospectus provisions regarding the issuance and distribution of securities.

Firms which qualify under both Subchapter T and Section 521 are called "exempt" cooperatives, while those qualifying only under Subchapter T are called "nonexempt" cooperatives. Only nonexempt cooperatives can have unallocated equity generated from nonpatronage income. To qualify for Section 521, an agricultural marketing cooperative must meet the following requirements:

1) it must restrict membership to farmers (no nonproducer members);

2) its dividend rate on capital stock may not exceed 8% or the legal rate of interest in the State of incorporation, whichever is higher;

3) 85% or more of its capital stock (other than nonvoting preferred stock) must be owned by current patrons;

4) all patrons, members and nonmembers, must be treated equally, including the distribution of patronage dividends;

5) the value of products marketed for members must equal or exceed the value of products marketed for nonmembers;

6) it may have equity reserves only to the extent required by State laws or that are reasonable and necessary for capital purposes;

7) it must operate on a cooperative basis; and

8) it must meet certain recordkeeping requirements.

Both Section 521 and Subchapter T have the "operate on a cooperative basis" requirement. Section 521's third requirement specifically promotes the user-financed principle. Its first, second, fourth, fifth and sixth requirements relate to the user-benefit principle.

Under the fifth requirement, ingredient purchases are permissible so long as they are necessary in putting the members' agricultural product into a marketable condition. Numerous cooperatives purchase products from nonproducers to round out their product lines. Such sideline sales of nonmember, nonproducer products are allowed if necessary to the effective marketing of the items which the cooperative members produce—if the dollar volume of the incidental sales does not exceed 5% of the total retail sales of the marketing function. Commodity purchases from nonproducers are only permissible in the event of an emergency, such as severe crop damage.

Section 521's sixth requirement allows an exempt cooperative to maintain reserves for very limited purposes, such as a sinking fund for buildings, machinery and equipment required in the business. The cooperative's investments must be closely related to the purpose of the cooperative. For example, a cotton cooperative used its unallocated equity to purchase a wool processing company to broaden its economic base. It incurred substantial legal and consulting fees in the transaction which were charged against patronage income. The IRS ruled that the transaction was unrelated to the purpose of the cooperative and revoked the cooperative's exempt status. The cooperative was not returning the sale proceeds of the members' products less necessary marketing expenses because it incurred the "unrelated" expenses.

Section 521's exemption of a cooperative's capital stock dividends and nonpatronage income from taxation are attractive. An IOF's capital stock dividend payments are not deductible, nor are those of a nonexempt cooperative. Nonexempt cooperatives' nonpatronage income is taxed. However, many cooperatives have found Section 521's requirements to be onerous. Consequently, most large cooperatives have given up their exempt status while retaining their Subchapter T qualification.

3. California's tax treatment of cooperatives

The following information regarding California's tax treatment of cooperatives was provided by Ronald Peterson, an attorney with the San Francisco law firm, Hanson, Bridgett, Marcus, Vlahos and Rudy, in the form of a personal communication. California's tax

provisions operate in a substantially similar fashion to the Federal provisions with three major differences. One major difference is that California provides more favorable treatment to cooperative members by allowing them to defer their tax liability on retained patronage dividends and per-unit retains until the equity is redeemed, thereby eliminating the distinction between "qualified" and "nonqualified" allocations. Another major difference is that no distinction is made between exempt and nonexempt cooperatives. The third major difference is that patronage-sourced income to the cooperative is not subject to California tax irrespective of whether or not it is distributed or allocated (as in the case of an unallocated reserve).

C. Description of Antitrust Exemptions

The following information regarding the Capper-Volstead Act was obtained from the Farmer Cooperative Service's (now Agricultural Cooperative Service) publication, *Legal Phases of Farmer Cooperatives.* The Capper Volstead Act is the major statute affecting cooperatives' antitrust status. It was enacted to permit the organization of cooperatives to countervail the monopsony power held by many IOFs that purchased from cooperatives. It does not exempt agricultural marketing cooperatives from antitrust laws; rather, it permits farmers to collectively market their products without violating Section 1 of the Sherman Act which prohibits conspiracies in the restraint of trade. Cooperatives remain subject to other antitrust laws such as the monopolization provisions of Section 2 of the Sherman Act; thus, the protection provided by Capper Volstead does not extend to a merger between a cooperative and an IOF. In order to qualify for protection under Capper Volstead, a cooperative must meet the following requirements:

1) it must have a maximum stock dividend rate of 8% *or* a one member-one vote system;

2) the value of products marketed for its members must equal or exceed the value of products marketed for nonmembers;

3) it can have no nonproducer members; and

4) it can provide voting rights only to members.

These requirements relate to the user-benefit and user-control principles. Capper Volstead's firstrequirement is similar to the second requirement of Section 521. The second and third requirements of the Capper Volstead Act are identical, respectively, to the fifth and first requirements of Section 521. A cooperative can qualify for tax treatment under Subchapter T and not meet the requirements of the Capper Volstead Act. For example, a cooperative can have a 10% stock dividend rate and a proportional voting structure and still meet the requirements of Subchapter T.

D. Description of Securities Regulations

Except where otherwise noted, the following information regarding federal securities regulations was extracted from a presentation made by Ronald C. Peterson entitled "Legal Aspects of Farmer Cooperative Equity Capital Structures." Cooperatives, as well as IOFs, issue a variety of securities as part of their financing programs. The Securities Act of 1933 (1933 Act) applies to the initial offer and sale of securities. Section 5 of the 1933 Act requires that issuers file a Registration Statement containing a prospectus regarding an initial offering with the SEC; Section 521 cooperatives are exempt from this requirement under Section 3(a)(5) of the 1933 Act.

The Securities Act of 1934 (1934 Act) requires annual and periodic reports for securities that are subsequently traded, but exempts cooperatives as defined in the Agricultural Marketing Act of 1929. However, it does not exempt cooperatives which have registered securities under the 1933 Act. Nevertheless, Peterson reports that no cooperative registers its membership and marketing agreements and patronage instruments, except the National Grape Cooperative Association. California's Food and Agriculture Code exempts cooperatives' membership certificates, stock or other securities from state securities qualification or registration requirements.

The apparent exemption of cooperatives' patronage-based securities is widely utilized. Capital stock trading activity among cooperative members and former members occurs without registration of the stock. Resales of patronage-based instruments to outside investors are governed by numerous regulations; this complex topic is beyond the scope of this study.

Although voluntary member investment programs are uncommon among cooperatives, demand deposit programs have become a moderately important source of working capital for some cooperatives. In a recent case, Reves v. Ernst & Young, the U.S. Supreme Court ruled that such demand notes were securities and subject to the 1934 Act (Taylor). Some cooperatives are relying on the intrastate offerings exemption and continue to operate their demand deposit programs which are restricted to members (and in some cases include employees also) residing with the cooperative's

state of incorporation. Peterson states that California's clear exemption of patronage-based instruments may not carry through to member investment programs, such as demand deposits.

E. Description of States' Incorporation Statutes for Cooperatives

In addition to Federal regulations, cooperatives are subject to special statutes in the state in which they are incorporated. The information discussed below regarding the state incorporation statutes for cooperatives is extracted from previously cited publications by Baarda, and Peterson (only the California statutes). Many of the state statutes have requirements similar to those in Subchapter T, Section 521 and Capper Volstead.

There are statutes which support the cooperative principle of user-benefit. Thirty-four states have statutes stating that cooperatives shall be deemed nonprofit, since they are organized to make profit for their members as producers, rather than for themselves. Similarly, forty-three states have statutes requiring cooperatives' net margins to be distributed, rather than retained as profit; IOFs are not similarly restricted. Thirty-six states have statutes requiring distribution of cooperatives' margins on a patronage basis; some of the statutes define the apportionment criteria.

The user-benefit principle is also supported by statutes limiting cooperatives' stock dividends (similar to the Section 521 and Capper Volstead Act requirements). Thirty-six states limit dividends on common stock to 8% (including California), eight states have a 6% maximum, two states have a 10% ceiling and two states have a 12% limit. Many states (including California) impose the same limits on preferred stock dividends. Forty states permit cooperatives to do business with nonmember producers; in most cases, there is no requirement that the cooperative deal with nonmembers on a cooperative basis.

Various state statutes reinforce the cooperative principle of user-control. In California, cooperatives must restrict their membership and issuance of common stock to producers. Thirty-six states currently *require or did require* cooperatives to have a one-member/one-vote system (similar to the Capper Volstead Act), while five states *permit* cooperatives to have a one-member/one-vote system. Twenty-eight states have statutes permitting patronage-based voting. There are statutes in 31 states requiring cooperatives to elect board members by geographic districts.

The user-controlled principle is also promoted by member participation statutes in numerous states. Thirty-nine states have statutes requiring cooperatives to have annual member meetings. Forty-three states permit special meetings; most states require a petition from a certain percentage of the members. IOFs usually have similar provisions to protect their stockholders' investments.

Statutes regarding the composition of cooperatives' boards also promote the user-controlled principle. Forty states require board directors to be members of the cooperative, while eleven allow officers, directors, or members of member associations in a federation be directors. Two states mandate that the majority of a cooperative's directors be members and two others require two-thirds to be members or representatives of member associations in a federated organization. Twenty-five states permit boards to appoint a director whose duty it is to represent the public interest, rather than primarily members' interests, and three of the states require the appointment of public directors. IOFs do not have restrictions on the composition of their boards.

States have promoted cooperatives by permitting intercooperative cooperation. Thirty-four states have enacted such statutes, in response to antitrust considerations. These statutes enable cooperatives to enhance their marketing strength by forming marketing agencies in common, and even merging in some cases. IOFs do not receive this preferential treatment. This protection is similar to that provided under the Capper Volstead Act.

F. The Effects of Cooperative Principles and Regulations

The descriptions in the preceding section indicate that there are numerous cooperative principles and regulations which can affect cooperatives' behavior. In this section, studies regarding the effects of various cooperative regulations and principles are reviewed. The findings from studies regarding the consistency of certain cooperative financing programs with cooperative principles are also summarized.

1. Effects of cooperative regulations

Several cooperative specialists have noted that cooperative regulations restrict cooperatives' access to capital. In 1987, the National Council of Farmer Cooperatives-Legal, Tax and Accounting Committee's (NCFC/LTA) Subcommittee on Capital Formation and Structure conducted a survey of issues affecting cooperatives' capital structures. They reported the "...presence of internal corporate structural elements which

slow down or block certain avenues of capital development and inhibit the retention of existing capital" (p.37). They noted that cooperatives are facing an economic environment which has demanded industry consolidation but that the legal structure of cooperatives is slowing down or even precluding such activities.

In the Subcommittee's 1989 report, it is noted that cooperatives receive "special (some would say favorable) treatment under state and federal statutes relating to taxation, trade regulation and regulation with respect to the offer and sale of securities. Such treatment is not without cost. An agricultural cooperative is generally required to conform its financial structure to assure that it is, in fact, run for the benefit of its members as patrons and not as investors" (p.31). They cite the requirements of the Capper-Volstead Act and state that such provisions sharply curtail the ability of agricultural cooperatives to raise capital through sources commonly used by IOFs. Although nonmember investors threaten the user-benefit principle by posing the risk that the cooperative will benefit them more than its members, the 8% limitation on dividends serves as a strong disincentive to common or preferred stock investments. When a cooperative has nonmember activity, it must prove to its members that their returns are sufficiently enhanced from nonmember activity to justify accumulations of capital to which they do not otherwise have any permanent claim.

Centner discusses how overly restrictive governance structures arising from statutory provisions regarding the organization of cooperatives may detract from cooperative performance. The statutes promote the user-controlled principle. They can limit organizational and managerial flexibility; for example, some states restrict cooperative board membership to members. Centner notes that many cooperatives still operate on a one-member/one vote basis. This may cause underrepresentation of the interests of members conducting large amounts of business with the cooperative. Some cooperatives have adopted a proportional voting structure (weighing voting proportionate to the member's share to deliveries or capital investment) to alleviate this problem.

Centner also notes that, if a cooperative pays only 20% of its patronage dividend in cash to meet the requirements for a qualified allocation, some of its members can have negative after-tax cash flows. This can create member resistance to high retain rates for equity programs. *When* capital gains are given favorable tax treatment, cooperative members can be at a tax disadvantage because they are not able to generate capital gains through their cooperative. The lower tax rate for capital gains on investments can more than offset the preferential tax treatment which cooperatives receive by being able to distribute patronage dividends without taxation.

The restrictions on nonmember business imposed by Section 521 and the Capper Volstead Act make it difficult for cooperatives to diversify into totally unrelated activities. Staatz notes that this causes cooperatives to have a portfolio management problem. These laws are designed to promote the user-benefit principle. Thus, cooperative management may prefer more conservative business strategies and may opt against developing risky value-added marketing programs.

2. Effects of cooperative principles

The effects of cooperative principles on cooperatives' behavior are reviewed by several cooperative specialists. Knutson discusses how strict adherence to cooperative principles may detract from cooperative performance. He evaluates the extent to which adherence to these principles conflicts or supports the adjustments required by cooperatives to maintain competitiveness. These adjustments include developing integrated production/marketing systems and improving their equity positions. He concludes that the user-controlled and user-benefit principles hinder cooperatives' abilities to make the aforementioned adjustments.

Knutson also states that cooperatives may be jeopardizing their long-term viability if they ignore the need for proportional voting, closed membership and unlimited returns on capital. Conversely, it can be argued that the user-financed and user-benefit principles promote the competitiveness of cooperatives because the users/members/owners require management to be highly accountable for their cooperative's performance. Knutson adds that some cooperative specialists contend that a one-member/one-vote system is the truest form of user control, and closed membership and unlimited returns on capital violate the user-benefit principle.[3]

Cooperative principles have fostered open membership policies. Helmberger provides a theoretical justification for the practice of closing memberships at cooperatives which have market power due to vertical integration and brand equity. The cooperative will perceive its average net revenue as peaking at a particular level of production and then declining as output

[3] These traditional interpretations of the cooperative principles are evaluated in the next section.

increases further; thus current members will pressure the cooperative to restrict membership in order to maximize their returns. This situation is most likely to occur when a cooperative sells differentiated products. The cooperative can protect its premium returns by restricting its output (and consequently, its members' deliveries).

Youde and Helmberger conducted a survey in 1964 of the relationship between cooperatives' membership policies and the market structures in which they operate. They found that centralized marketing cooperatives with substantial market power were highly likely to maintain restricted membership policies; however, federated cooperatives had open memberships even when they possessed market power. Youde's 1977 update indicated that, relative to other coops, those that restrict membership: 1) have a higher market share; 2) advertise more; 3) are protected from new competition by barriers to entry; and 4) deal more heavily in finished consumer products. This empirical evidence is consistent with Helmberger's theoretical conclusion; cooperatives marketing value-added products tend to close their memberships to protect the enhanced returns earned by their members.

Murray uses coalitional analysis to evaluate the effects of the user-financed and user-controlled principles on cooperatives. Cooperative managers and members form separate coalitions because they have different objectives for the cooperative. Consequently, tension between a cooperative's management and its members increases as capital needs rise. Murray states that the members have an incentive to undercapitalize the cooperative because they feel an imperative to invest heavily in their own farming operations. On the other hand, the cooperative's managers promote investment in capital assets, because it increases their managerial flexibility and cooperative growth. Thus, cooperative managers push for unallocated reserves and base capital financing plans. Management's actions represent "...an implicit acceptance that the members cannot be relied upon to produce sufficient voluntary funds for the development of the cooperative..." (Murray, p. 85). Although these actions may ensure the long-term viability of the cooperative by providing for adequate capitalization, this solution has the major disadvantage of compromising the user-financed and user-controlled principles.

The user-controlled principle creates differences between the decision processes of cooperatives and IOFs. Garoyan hypothesizes that the differences in the decision processes have the following effects in an oligopolistic market situation: "...(1) cooperatives are more risk averse because of the composition of farmer-hired management in the decision process; (2) given an option of investment that include one venture oriented toward the farm production sector and another oriented toward consumer marketing, the cooperative will opt for farmer-oriented business investments, ceteris paribus; (3) in the long run, processing activity costs will be indistinguishable between cooperatives and IOFs, but the distribution cost advantages may be possessed by IOFs; and (4) a greater reluctance of cooperatives to eliminate unprofitable products and services, and therefore lower rates of returns on assets employed is evident" (p. 1098). He concludes that large cooperatives are not effective competitors but are able to survive because members have been willing to accept less than market returns. Garoyan's comments imply that the user-controlled principle of cooperatives undermines their competitiveness; due to the producer-control, they are not market-oriented and their strategic options are limited.

Several agricultural economists state that cooperatives' performance is affected by their unique property rights structure, which is attributable to cooperative principles and various regulations. Jensen and Meckling contend that the "...production function depends on the contracting and property-rights system within which the firm operates" (p.470). They note that the most significant feature of cooperatives is that they are a "tied equity" firm; that is, a cooperative's residual earnings are contractually tied to members' transactions, rather than to their investment in the cooperative. This feature promotes the user-benefit principle and affects the investment behavior of cooperatives in various ways.

Staatz suggests that, because of the tied equity feature, cooperative members can pressure the cooperative to increase current earnings at the expense of future earnings. Vitaliano notes that the cooperatives' tied equity feature limits their potential sources of equity capital. Cooperatives are not an attractive investment for outside investors because their residual earnings are distributed on the basis of member patronage.[4]

Condon discusses how cooperatives tend to be undercapitalized because they suffer from the horizon

[4] However, cooperatives may form noncooperative subsidiaries which do not have the tied-equity structure and which can consequently be attractive investments to outside investors.

problem; because of a cooperative's tied equity feature, its members can accrue the benefits from their investment in the cooperative for a limited time horizon—only as long as they are patrons of the cooperative. Staatz also notes that the horizon problem may cause cooperatives to speed up their equity redemptions and increase stock dividends; this is likely to occur if there is a strong contingent of retired members.

Rhodes describes how an investment-oriented cooperative management can undermine the interests of current cooperative members because of the horizon problem. He uses the term "hunter cooperative" to describe a cooperative that seeks to maximize profitability with little attention to its members' current needs. He states that such organizations are often disloyal to their members in that the capital contributed by current members is used to finance entry into new activities from which current members do not benefit. Rhodes' concerns relate to protecting the user-benefit and user-financed principles. It should be noted, however, that current members often benefit from previous members' investment (particularly in developing brand names, distribution and new products.) Vertical integration as a value-added marketer is impossible to achieve without investing for future returns.

Porter and Scully discuss how the horizon problem is more acute with respect to intangible assets such as brand equity and distribution systems. "Intangible assets are not included in cooperative stock values when issued, and their value cannot be realized in capital gains, since tax laws disallow capital gains to coops. Since claims on cash flows generated by investment in intangible assets cannot be realized through ownership of stock, the return is in the form of a patronage dividend and the claim ends with participation" (Porter and Scully, p.496). Condon suggests that such adverse effects of the horizon problem can be overcome by educating cooperative boards regarding the need to guard the cooperative's long-term interests.

Schrader elaborates that the horizon problem causes financially successful cooperatives to be unable to recognize appreciation of members' equity. Most cooperative members can realize capital gains only upon dissolution of their cooperative. The value of an enterprise as an IOF may exceed the value of the patron's participation in a limited patronage horizon. The value of the benefits associated with their cooperative membership should equal or exceed their cost of capital. The value of membership in a cooperative relative to the investment required increases as a member's patronage horizon lengthens, and decreases as the member's cost of capital increases. Clearly, the value of membership decreases when members' equity investments are disproportionately higher than their patronage shares. Dividend payments diminish the disparity resulting from differences in the patronage horizons of various members. The presence of unallocated equity increases the divergence between the value of participation in a cooperative and its value as a going business by patrons with a short patronage horizon. Several cooperatives have resolved this dilemma by restructuring wholly or partially as investor-owned firms.

The horizon problem can also impair a cooperative's internal efficiency. Fama has shown that a portfolio of investments adopted by a firm whose residual claims are limited in horizon will be suboptimal to those of a firm with an infinite horizon. Centner states that cooperatives may either underinvest relative to IOFs or they will tend to invest in shorter-term projects. Caves and Peterson comment that the absence of a market for equity claims distorts the cooperative's investment incentives and hence impairs its internal efficiency. Similarly, Porter and Scully discuss how cooperatives are more likely than IOFs to be factor price inefficient because the horizon problem and the nontransferability will result in less capital per unit of output than in an IOF. Thus, the user-benefit principle can cause cooperatives to be operationally inefficient by underutilizing capital factors.

The lack of a secondary market for members' equity can lead to problems with measuring the performance of a cooperative's management. This results in a principal agent problem. Centner, Condon, Porter and Scully and Staatz all note that the cooperative's board must replace the stock market as the control mechanism on management. This structure promotes the user-controlled principle; however, none of the preceding authors review the boards' ability to perform this function effectively. A producer group with a relatively homogeneous experience base can have a limited understanding of strategic options, financing alternatives, market orientation and the need of management experienced with value-added products.

The lack of a market for member equity can also cause a portfolio problem for members. Caves and Peterson, Centner, Porter and Scully, Staatz and Vitaliano all discuss how investing in the cooperative to members means investing in the same line of business as the farm. It is a consequence of the user-financed principle. Because equity is not usually trans-

ferable, members cannot diversify or specialize in response to their risk preferences and are forced to bear risks that are insurable through diversification.

Staatz, as well as Vitaliano, mentions that cooperatives can lack adequate sources of debt financing because some lenders consider cooperative equity to be insufficiently permanent. Most cooperatives have revolving fund equity programs which epitomize the user-financed principle. It is the most commonly used equity redemption program used by cooperatives in the United States. Some lenders view equity obtained from revolving funds as junior, subordinated debt. Many cooperatives have addressed this problem by developing unallocated reserves as a form of permanent equity which facilitates long-run planning and provides management greater flexibility.

G. Consistency of cooperative financing programs with cooperative principles

Unallocated equity is just one of the nontraditional financing sources utilized by cooperatives. Cooperatives may be reluctant to utilize some financing alternatives which they believe are inconsistent with cooperative principles. Dunn, Knutson, and Dunn, et al. review the compatibility of some financing programs with cooperative principles. Dunn, et. al. note that investment-based (as opposed to patronage-based) equities can be an important source of capital, particularly if issued under equity reinvestment programs or employee stock ownership programs. Such investments should carry no voting rights and should have a fixed return rate or one based on broad financial market measures.

However, investment-oriented equity capital violates the user-financed principle. Dunn, et al. note that public stock issues also compromise the user-benefit principle (and are therefore detrimental to cooperative members' welfare), even when the stock is issued by a subsidiary. They comment that "...there is an inherent conflict in the objective of providing the highest possible return to investors and in the long-term goal of serving the needs of farmers" (p. 47). If the investors have voting rights, the user-controlled principle is also violated. However, Dunn concludes that flexibility is essential and that cooperative principles should be viewed as guideposts or goals, not as absolute acid tests.

Dunn, et. al. caution that, although joint ventures with IOFs enable cooperatives to have access to markets, capital, technology and to pool risk, these "...benefits must be weighed against the inherently conflicting objectives of the two types of organizations and the potential for loss of control..." (p.46). Although unallocated reserves can be a source of permanent capital or risk capital, Dunn, et. al. and Knutson state that such programs can undermine the user-controlled and user-financed principles. From a purely theoretical standpoint, they find that equity capital gained from patronage assessments is preferable; they note, however, from a pragmatic standpoint, cooperatives must look at all financing alternatives.

Cooperatives have historically been guided by the cooperative principles—user-financed, user-controlled and user-benefit. These principles are promoted by various federal regulations, such at Subchapter T and Section 521 of the Internal Revenue Code, the Capper Volstead Act, securities registration requirements and state statutes. Many of these regulations have similar requirements.

Cooperatives' ability to compete with IOFs in the food processing industry may be constrained by these institutional factors. Cooperative specialists have concluded that cooperative regulations limit cooperatives' ability to obtain equity capital from both members and nonmembers; substantial capital is needed for a new firm to overcome the product differentiation achieved by IOFs in the food processing industry. The regulations also impose overly restrictive governance structures which may detract from their performance.

The cooperative principles can also affect cooperatives' behavior. Producer-dominated boards which are fostered by the user-controlled principle can keep cooperatives' strategic options limited and prevent them from becoming market-oriented. The user-benefit principle can also deter cooperatives from making investments in brand equity and distribution to become marketer-oriented; such investments can be unattractive to members who benefit from their cooperative membership for only as long as they patronize it. The user-benefit principle can also impair cooperatives' internal efficiency by causing underinvestment in physical assets. The user-financed principle has led many cooperatives to adopt revolving fund equity programs, which cause cooperatives to have insufficient amounts of permanent equity. Because there usually is no secondary market for cooperative securities and cooperative boards are often comprised only of producers (the user-controlled principle), cooperatives are susceptible to inadequate reviews of management performance. Some of the alternative sources which cooperatives have developed to overcome their financing constraints may violate the cooperative principles.

III. FINDINGS FROM INTERVIEWS

Cooperatives marketing value-added food products need effective marketing programs. As noted in the introduction, there are four elements which form the foundation for an effective marketing program. First, cooperatives need a well thought-out strategic plan which utilizes a differentiated or niche strategy and has a competitive orientation. Second, the plan and its supporting programs should be market-oriented, rather than producer-oriented. The third requirement that cooperatives must satisfy is substantial financial capital to overcome the high degree of product differentiation which marketers of food products have achieved. Fourth, cooperatives must have management experienced with value-added products in order to broaden their expertise and perspective as they strive to be value-added marketers.

To gain further understanding of the effects of cooperative principles and regulations on cooperatives' abilities to satisfy these requirements, interviews were conducted with three different types of business professionals. Loosely structured meetings were held with the Chief Financial Officers (CFOs) of four small- to medium-sized IOFs to validate the four basic requirements for an effective marketing program. These IOFs all market value-added food products. Extensive interviews were conducted with five lending officers who have worked with cooperatives and top management (primarily CFOs) at thirteen cooperatives. The lender and cooperative CFO interviews are summarized, respectively, in Appendices A and B. In this section, the lenders' and CFOs' responses are analyzed to determine the degree to which cooperatives are satisfying the four basic requirements. Each requirement and the factors constraining the cooperatives' abilities to fulfill it are evaluated in a separate subsection. Comparisons are made with IOFs' practices.

A. Analysis of financial capital requirement

The capital required for producing and marketing value-added products can be substantial. IOFs have achieved a high degree of product differentiation which a cooperative must overcome to be a successful marketer. One cooperative CFO described the importance of the financial capital requirement by placing it into a competitive context; he stated that, in the food business, a firm must grow constantly or lose market share. The lenders' and CFOs' responses are consistent with the findings from the literature review indicating that cooperatives' access to capital is constrained. One CFO remarked that his cooperative is losing out on growth opportunities because it is undercapitalized.

A few of the CFOs in this study stated that cooperatives' access to equity from nonmembers is limited by dividend and voting restrictions contained in state statutes, the Capper Volstead Act and Section 521. However, the lenders' and CFOs' responses indicate that access to equity from members is the most significant financing constraint faced by cooperatives. This access appears to be constrained primarily by the cooperative principles.

Cooperatives face greater constraints than IOFs in retaining income to finance their value-added programs. A lender commented that cooperatives' equity capital programs are often unsatisfactory because they are volume driven. Revolving fund programs epitomize the user-financed principle; equity retains are based on a member's usage of the cooperative. Retains from revolving funds are frequently the sole source of equity for cooperatives. The size of the retains vary due to delivery volumes and the retain rate; often, the retain rate is low when earnings are low. The CFOs remarked that their members do not consider themselves to be their cooperative's owners/investors. Many do not understand the financial requirements of their cooperative and are not accepting their responsibilities as dictated by the user-financed principle. They consider their equity retains to be deductions from their earnings, rather than investments. IOF stockholders must make a direct payment to invest in their firms and consequently have a greater understanding of their investment actions.

Furthermore, the CFOs in this study commented that members' abilities to invest in their cooperative vary widely. In particular, smaller and younger operators can have tight cash flows which make investing in a cooperative difficult. The user-financed principle and various regulations foster reliance on members as the primary source of equity capital for a cooperative, regardless of their capacity to invest. IOFs do not face this problem of forcing investment by individuals with limited cash flows; investment in an IOF is voluntary.

Two of the CFOs in this study indicated that the lack of liquidity in members' investment is the main constraint which they face in raising equity from their members. There usually is no secondary market for a cooperative member's capital retains because cooperatives are structured to provide returns to users, rather than to investors. This is attributable to the user-benefit principle. IOF stockholders generally have a readily accessible market for their stock.

The horizon problem also contributes to members' reluctance to invest in their cooperative. It also is attributable to the user-benefit principle; cooperative members derive benefits from their membership only as long as they are patrons of the cooperative. Members who are considering retirement usually lack the incentive to invest in their cooperative. When IOFs invest extensively in product and market development activities, the future benefits of these expenditures become capitalized into the price of the firm's stock (and make up for the current returns that the stockholders are foregoing). Most cooperatives do not have any such mechanism and consequently suffer from the horizon problem. Some members have dismissed the horizon problem because the benefits of their investment in their cooperative are passed on to their offspring. However, urbanization forces are eliminating this possibility for some members. Cooperatives' ability to raise member equity is also constrained by the ego problem, which occurs because members frequently compare their cooperative returns with those of their neighbors. Deferral practices can help to mitigate the ego problem; members are less reluctant to invest in their cooperative when its returns are competitive. Both IOFs and cooperatives are provided some latitude by the Financial Accounting Standards Board in how they allocate some product and market development expenses. Most of the cooperatives in this study charge all of their product and market development expenses against the current year's return. Others do spread the costs over several years through deferral practices. Without deferrals, a cooperative with an unstable membership can charge its product and market development expenses unfairly against a loyal member group while these members end up sharing the benefits with more opportunistic individuals who join the cooperative only after its returns begin to increase.

Most, but not all, of the multiple-commodity cooperatives in this study use pooling to calculate their returns. Pooling is another accounting practice which can address the ego problem. Functional pooling enables the cooperative to spread its market development costs for a particular commodity over the volume of all of its commodities. This method more closely approximates the manner in which IOFs operate and the diversification effect stabilizes the members' returns. The major drawback to pooling is that the premium returns from value-added programs for a particular commodity can be greatly overshadowed by the mediocre returns for other commodities sold on a commodity basis.

The user-controlled principle can also keep cooperatives from gaining access to certain resources to finance their value-added marketing programs. Alternative structures, such as acquisitions, joint ventures and certain leases can be complex transactions. One CFO indicated that his board became quite ponderous when considering such matters. Quick decisionmaking can be difficult to achieve when a board lacks financial expertise. Extensive and proactive education programs should be provided to cooperative board members regarding their cooperative's financial condition and financing alternatives.

B. Analysis of strategic planning requirement

Strategic planning is a relatively new concept to most of the cooperatives in this study. A well-focused strategy is critical to the successful implementation of a value-added marketing program. One cooperative in this study demonstrated its commitment to long-term planning through its willingness to incur negative returns from an acquisition for three years in order to build its markets.

The CFOs indicated that, historically, their mission has been to provide a home for their members' product, which is an immediate user benefit. Being a marketer of value-added products requires substantially more strategic planning and a longer-term perspective than does cooperatives' historic mission of providing a home for their members' deliveries. Thus, longstanding perceptions of the user-benefit principle can hamper a cooperative's strategic planning efforts.

The user-benefit principle also impedes cooperatives' strategic planning efforts because it creates the horizon problem. When a cooperative implements a value-added strategy, it provides a long-term benefit to its membership which can be collected only as long as a member utilizes the cooperative. Cooperatives with a majority of older members have little incentive to engage in strategic planning.

The dual orientation of some cooperatives is also problematic to effective strategic planning. A few cooperatives reported being low-cost producers, and nichers or differentiated marketers. This mixing of strategies can be troublesome because of their competing staffing and operational requirements. For example, a cooperative cannot adequately finance its value-added ventures while investing substantial capital to improve the efficiency of its commodity-oriented production facilities.

Several of the CFOs reported having difficulties getting their boards to deal with strategic planning;

they tend to stray toward operational issues. Also, the lenders indicated that there is a tendency among cooperative boards to have very short-term perspectives. This cannot be totally mitigated by the longer-term perspectives of their management staffs. Boards of directors are the chief policymakers of firms. IOF boards usually include individuals with an understanding of strategic planning and financial management, and with a broad range of management expertise. Cooperative boards are almost exclusively composed of producer members who usually do not have nonfarming business experience. This circumstance is attributable to the user-controlled principle and statutes in numerous states prohibiting nonmembers from serving on cooperative boards.

The CFOs' responses indicate that their efforts to educate their members on strategic issues are limited. It is doubtful that most cooperative members are knowledgeable about their cooperative's strategic options and resource requirements. A cooperative's membership, its board and management need to be in agreement about the cooperative's mission. Cooperatives' strong adherence to the user-controlled principle requires that a cooperative's board and membership have a clear understanding of the requirements of the mission and the ensuing responsibilities of members.

Once management has educated the board and membership about the value-added strategy, each member should have the opportunity to voice his or her opinion of the strategic direction. A cooperative undertaking a value-added strategy needs complete understanding and support from its board and its membership. Some cooperative members may prefer to stay with the traditional cooperative objective of providing a competitive home for their member's deliveries. Others have tight cash flows which prohibit them from making large investments in a cooperative. The objectives of both types of producers are not well-served by a cooperative with a value-added marketing program. Such a cooperative has greater financing requirements and a different user-benefit philosophy than a commodity- oriented cooperative. Management must defer to the majority. Minority members have the option of joining another cooperative, forming a new one, or selling their commodities to an IOF.

C. Analysis of market orientation requirement

A market orientation is another basic requirement for being an effective marketer of value-added products. It is embodied in a firm's strategic plan and implemented through marketing programs. Cooperatives and other firms must meet the rapidly changing needs of consumers in order to be successful marketers of food products. Only a few of the CFOs mentioned being a consumer-driven firm; this indicates that the cooperatives in this study have not broadly accepted the market-oriented concept.

Cooperatives' abilities to be market-oriented are hampered by the narrow scope of their product lines. This is partially attributable to Section 521 and the Capper Volstead Act which both restrict a cooperative's nonmember business. Section 521 also requires that a cooperative's investments must be closely related to the purpose of the cooperative. However, the lenders' and CFOs' comments suggest that attitudinal factors fostered by the user-benefit principle impose the greatest constraint on cooperatives' abilities to broaden their product lines.

Several of the cooperatives in this study are single-commodity cooperatives. Two of the CFOs remarked that their cooperative's commodities limit the range of products which they can market and make them vulnerable in the event that a particular commodity falls out of favor with consumers. One CFO reported that his cooperative had added new commodities to its membership base with extreme reluctance. Several CFOs commented that their boards and members are very protective of management's attention to their commodities and reluctant to invest in nonpatronage products. This short-term interpretation of the user-benefit principle hampers the cooperative's ability to broaden its product line to meet customer's needs and strengthen its marketing program. IOFs are unconstrained in the scope of their product lines.

There is another way in which the traditional interpretation of the user-benefit principle hampers cooperatives' efforts to be market-oriented. The longstanding mission of many cooperatives has been to provide a home for their members' products; it is difficult for them to shift their orientation to their customers' needs. Some of the CFOs expressed concern over their inability to control their members' delivery volumes. Developing value-added marketing programs is difficult with large and/or unstable raw product volume levels. IOFs generally contract with producers for a specific tonnage level to control their production levels. Some of the cooperatives in this study have transferable acreage and delivery rights programs. Such programs foster the long-term fulfillment of the user-benefit principle. They enable the

cooperative to manage its marketing programs and production facilities more effectively than if raw product volumes are allowed to fluctuate sharply.

Market-oriented firms generally gain consumer awareness of their differentiated products by advertising. Cooperatives' relatively low advertising expenditures have been noted by cooperative specialists[5] and by the CFOs. When the CFOs in this study were asked to compare their advertising and promotion programs to those of their competitors, only one CFO responded that his cooperative currently spent more than its competitors. Advertising represents investment in an intangible asset—brand equity. Such investments can be difficult for management to justify because they generate long-term benefits. The user-benefit principle traditionally provides for the distribution of a cooperative's current earnings on the basis of current patronage, not past investment. Thus, only members planning to stay with a cooperative for an extended period have some limited incentive to support an advertising program; they must share the return with future members who do not fund the investment. A mechanism which enabled cooperative members to realize capital gains could make investment in intangible assets more attractive.

D. Analysis of management requirement

A strong management team experienced with value-added products is another one of the basic requirements for being an effective marketer of value-added products. A cooperative should not assume that its existing management has the expertise to successfully manage another part of the vertical chain. The need for well-qualified management cannot be overstated, since cooperatives are competing with some large food conglomerates having highly qualified management officers.

As noted in the literature review, cooperative boards have a heavier burden regarding management control than IOFs. Because of the user-benefit and user-financed principles, and various cooperative regulations, there usually is no stock market to measure the performance of cooperatives. However, the board's ability to perform this responsibility is questionable; due to the user-controlled principle and various state statutes, many cooperative boards are comprised solely of producers. One CFO commented that his cooperative's board members are not particularly well qualified to serve on the board due to their lack of training and experience in business management; however, they were very loyal to management. Another CFO reported that his cooperative's board was overwhelmed by its CEO for several years. If the board cannot carry out its evaluation of management's performance, the need for a highly skilled management team becomes even more important.

The lenders commented that many cooperatives overlooked the need for new management expertise when they integrated vertically into value-added products. However, the lenders indicated that there have been noticeable improvements in cooperatives' management personnel during the past ten years. They cited cooperative boards' reluctance to share control with management as one reason why cooperatives have difficulty attracting management experienced with value-added products. This represents another instance in which the user-controlled principle can conflict with cooperatives' efforts to be value-added marketers. The lenders also identified inadequate compensation as another factor contributing to recruitment difficulties. This can result from a short-sighted trade-off fostered by the user-benefit and user-controlled principles; cooperative boards have historically focussed on reducing their cooperatives' expenses in order to increase their members' earnings.

The CFOs at a few of the cooperatives in this study reported that management is evaluated by comparing the cooperative's returns against competitive field prices. This practice can also be detrimental to efforts to attract qualified management. Experienced managers recognize that value-added programs are costly and can reduce a firm's current returns substantially while building future returns. The board should expect increases in the cooperative's returns in the long-term; however, single year comparisons do not take such factors into account. Many board members are concerned about protecting only their members' short-term user-benefits. Thus, both cooperative principles and cooperative regulations can hamper a cooperative's ability to have the management expertise needed to be an effective marketer of value-added products.

In the next section, the findings from the lender and CFOs interviews and the literature review are summarized and the conclusions of this study are presented.

IV. SUMMARY AND CONCLUSIONS

Cooperatives who are competing with IOFs in marketing value-added food products are constrained by institutional factors. The literature review and interviews with cooperative lenders and management offic-

[5] These findings are discussed in the companion to this report, *Agricultural Effective Marketers of Value-Added Products.*

ers indicate that both cooperative regulations and principles impose unique constraints on cooperatives' abilities to fulfill the four basic requirements for being effective marketers of value-added products. The major effects on each requirement are outlined below.

1. Adequate Financing
   A. Access to equity from nonmembers is limited by the dividend and voting restrictions imposed by the Capper-Volstead Act and Section 521.
   B. Many cooperatives' members do not recognize their financial responsibilities as their cooperatives' owners/investors.
   C. Cooperatives' equity capital programs are often unsatisfactory because they are volume-driven. The traditional revolving fund structure does not provide permanent capital.
   D. Because of the user-benefit principle, cooperatives provide returns on the basis of patronage, rather than investment, thereby eliminating members' incentive to invest.

2. Strategic Planning
   A. Because of the user-controlled principle, cooperative boards are primarily (often exclusively) composed of producer-members, who often have difficulty dealing with strategic issues. Some state statutes restrict cooperative board membership to producer-members.
   B. Most cooperative members have a short-term perspective of the user-benefit principle; they are accustomed to simply having their cooperative be a home for their deliveries.
   C. A value-added strategy provides long-term benefits to cooperative members. Most cooperatives do not have any mechanism to allocate the capitalized value of these returns; thus, members can only collect the benefits only as long as they utilize the cooperative.

3. Market Orientation
   A. Section 521 and the Capper Volstead Act restrict a cooperative's nonmember business, which can be necessary to offer a broad product line.
   B. The user-benefit principle causes cooperative boards and members to be very protective of management's attention to their commodities and reluctant to invest in nonpatronage products.
   C. Market-oriented firms invest in advertising, product development and new distribution; most cooperatives are reluctant to invest in such intangible assets because they generate long-term, rather than short-term, benefits.
   D. The user-benefit principle makes it difficult for cooperatives to shift their orientation from their producers' needs to their customers' needs; most cooperatives are unable to control their members' delivery volumes in response to market forces.

4. Strong Management Team Experienced With Value-added Products
   A. Cooperative boards historically have embraced the user-controlled principle and have been reluctant to share control with management.
   B. Some cooperative boards have been unwilling to offer competitive salaries in an effort to minimize the cooperative's costs; these short-term savings may be at the expense of increased long-term returns.
   C. Some cooperative boards have a longstanding practice of comparing the cooperative's returns against field prices, while experienced managers recognize that value-added programs require investment in future returns at the expense of current returns.

The responses from the lender and CFO interviews suggest numerous changes which can be made to improve cooperatives' abilities to fulfill the four basic requirements to being effective marketers of value-added products. These changes are summarized below and reviewed in detail in the companion report to this study, *Agricultural Cooperatives As Effective Marketers of Value-Added Products.*

1. Educational Programs

   Expanded educational programs are needed for cooperative boards (and to a lesser degree, members) regarding financing requirements and programs, strategic planning, and marketing principles and programs. Such efforts should include the incorporation of educational items at all Board meetings, as well as educational seminars for board members.

2. Alternative Financing Programs

There is a wide variety of alternative financing programs which cooperatives can implement. In doing so, they may find that these new tools also enhance their ability to fulfill the other basic requirements for being an effective marketer of value-added products.

3. Regulatory Constraints

The advantages and disadvantages of "preferential" cooperative regulations should be evaluated carefully by cooperatives. Numerous cooperatives have already rescinded their Section 521 status in order to be able to accumulate unallocated equity; cooperatives that do not qualify under Section 521 may still be able to file under Subchapter T. A nonexempt cooperative can also establish a noncooperative subsidiary that is not constrained by any cooperative regulations.

4. Less Traditional Interpretations of the Cooperative Principles

Cooperatives should consider less traditional interpretations of the cooperative principles, examples of which are listed below:

a. relax the user-controlled, user-financed and user-benefit principles to allow for various financing programs, such as joint ventures with IOFs and public stock issues.
b. compromise the user-financed principle by accumulating unallocated equity from nonpatronage earnings. Section 521-exempt cooperatives are prohibited from utilizing this financing source.
c. broaden the user-controlled principle and appoint nonproducer board members to enhance the cooperative's strategic planning abilities and strengthen its market orientation.
d. rely on a less traditional interpretation of the user-benefit principle than first-handler cooperatives in order to justify the investment in advertising, product development and distribution needed by a market-oriented firm.

The cooperative principles and special cooperative regulations provided appropriate guidance over the behavior of cooperatives organized to function solely as first handlers for their members' commodities. However, when a cooperative chooses to market value-added products, there are many changes which it must make. There are many programs which the cooperative can implement to enhance its ability to fulfill the four basic requirements for being an effective marketer of value-added products. Some of these changes may undermine the traditional cooperative principles and/or regulations; however, such compromises may be essential to cooperatives striving to compete in the highly competitive food processing industry, and can be implemented without endangering the cooperative nature of the organization.

BIBLIOGRAPHY

Baarda, James R. *Cooperative Principles and Statutes*. Washington, DC:Agricultural Cooperative Service Research Report No. 54, U.S. Dept. of Agriculture, March 1986.

Caves, Richard E. and Bruce C. Peterson. "Cooperatives' Shares in Farm Industries: Organizational and Policy Factors." *Agribusiness*. 2(1986):1-19.

Centner, Terence J. "The Role of Cooperatives in Agriculture: Historic Remnant or Viable Membership Organization?" *Journal of Agricultural Cooperation*. 3(1988):94-106.

Clark, Irving and Philip L. Erickson. *Tax Management Portfolios—Taxation of Cooperatives*, No. 229-2nd edition. Washington, DC, Bureau of National Affairs, 1990.

Condon, Andrew M. "The Methodology and Requirements of a Theory of Modern Cooperative Enterprise." *Cooperative Theory: New Approaches*, ed. Jeffrey S. Royer, pp.1-32. Washington, DC:U.S. Department of Agriculture, ACS Service Report 18, 1987.

Dunn, John R. "Basic Cooperative Principles and Their Relationship to Selected Practices." *Journal of Agricultural Cooperation*. 3(1988):83-93.

Dunn, John R., Tracy L. Kennedy, and Randall E. Torgerson. "Cooperatives' Best Hope for Farmers' Economic Survival: Senate Study." *American Cooperation* (1988):42-48.

Fama, Eugene. "Agency Problems and the Theory of the Firm." *Journal of Political Economy*. 88(1980):288-307.

Garoyan, Leon. "Developments in the Theory of Farmer Cooperatives: Discussion." *American Journal of Agricultural Economics*. 65(1983):1096-1098.

Helmberger, Peter G. "Cooperative Enterprise as a Structural Dimension of Farm Markets." *Journal of Farm Economics*. 46(1964):603-617.

Jensen, Michael C. and William H. Meckling. "Rights and Production Functions: An Application to Labor-managed Firms and Codetermination." *Journal of Business*. 52(1979):469-506.

Knutson, Ronald D. "Cooperative Principles and Practices: Future Needs" *Farmer Cooperatives for the Future*, ed. Lee Schrader and William Dobson, pp.34-41, West Lafayette, IN:NCR-140, Purdue University, 1985.

Murray, Gordon C. "Management Strategies for Corporate Control in British Agricultural Cooperatives—Part 2." *Agricultural Administration*. 14(1983):81-94.

National Council of Farmer Cooperatives-Legal, Tax and Accounting Committee. *Annual Report of the Subcommittee on Capital Formation & Financial Structure of Cooperatives*. Washington, DC. 1987 & 1989 issues.

Peterson, Ronald. *Legal Aspects of Farmer Cooperative Equity Capital Structures*. Presented at National Society of Accountants for Cooperatives Far Western Chapter Fall Seminar, Fresno, CA, September 16, 1987.

Porter, Philip K. and Gerald W. Scully. "Economy Efficiency in Cooperatives." *Journal of Law and Economics*. 30(1987):489-512.

Rhodes, V. James. "The Large Agricultural Cooperative as a Competitor." *American Journal of Agricultural Economics*. 65(1983):1090-1095.

Schrader, Lee F. "Equity Capital and Restructuring of Cooperatives as Investor-Oriented Firms." *Journal of Agricultural Cooperation*. 4(1989):41-53.

Staatz, John M. "The Structural Characteristics of Farmer Cooperatives and Their Behavioral Consequences" *Cooperative Theory: New Approaches*, ed. Jeffrey S. Royer, pp.33-60. Washington, DC:U.S. Department of Agriculture, ACS Service Report 18, 1987.

U.S. Department of Agriculture, Farmer Cooperative Service. *Legal Phases of Farmer Cooperatives*. Washington, DC:FCS Information 100, 1976.

Vitaliano, Peter. "Potential Benefits and Costs to Agricultural Cooperatives From Assuring Access to Input and Product Markets." *Farmer Cooperatives for the Future*, ed. Lee Schrader and William Dobson, pp.64-70, West Lafayette, IN:NCR-140, Purdue University, 1985.

Youde, James G. and Peter G. Helmberger. "Marketing Cooperatives in the U.S.: Membership Policies, Market Power, and Antitrust Policy." *Journal of Farm Economics*. 48(1966):23-36.

APPENDIX A
Lending Officer Interviews

In this section, the methodology used for the interviews with the lending officers is presented first. It is followed by a summary of the interview responses.

A. Lending officer interview methodology

Five individuals engaged in financing agricultural cooperatives were interviewed. These individuals are associated with the major debt financing sources for agricultural cooperatives—commercial banks, life insurance companies, private placements and CoBank. The interviewees were not randomly selected; to keep project costs manageable, all of the lenders (except the CoBank officer) were located in the Sacramento Valley. The interview with the CoBank officer located in Denver was conducted by telephone.

Rather than being queried directly about constraints faced by agricultural marketing cooperatives, the lenders were asked questions about cooperatives' financial structures, strategic planning efforts, managerial expertise and membership governance issues. They were also asked to comment about some of the nontraditional financing programs employed by some cooperatives. Although the findings discussed below are not derived using quantitative analysis, they represent the observations of individuals with a combination of over 50 years of experience financing agricultural marketing cooperatives.

B. Lending officer interview responses

When the lenders were asked about cooperatives' financial structures, all of them indicated that they do not provide financing specifically for new products. Instead, debt financing for new products is provided through increases in operating loans and/or term loans. The lenders identified some troublesome aspects with cooperatives' equity structures. Two of the lenders noted that equity levels in cooperatives follow the commodity cycle, are volume driven, and therefore, are unstable. Cooperatives need more permanent equity. One lender commented that members are reluctant to provide equity because most cooperatives do so little to service equity. Many cooperatives have long revolvement periods but do not pay dividends on capital stock. Due to the long revolvement periods, most cooperative members think that they will not get their equity back. This lender also remarked that cooperative members usually think of themselves as users of the cooperative, rather than as member/owners. They would be more likely to think of themselves as investors if they had to make a direct payment to meet their equity requirements, rather than having the funds deducted from their patronage dividend payments.

All of the lenders agreed that cooperatives should continue to consider alternative financing sources and build their unallocated equity by seeking ways to earn nonpatronage income. However, three lenders expressed reservations about cooperatives' abilities to participate in joint ventures because their members generally have parochial attitudes; they usually require management to focus their attention on their basic commodities. This means that cooperatives frequently forego exploring products involving other commodities. One lender suggested that cooperatives should investigate creating noncooperative subsidiaries and finance part or all of the subsidiary through a private offering; if the business was successful, the cooperative could buy out the subsidiary.

The lenders were not satisfied with most cooperatives' strategic planning efforts. One lender responded that cooperatives are not strategy-oriented because they have very short-term perspectives. There is a conflict because most cooperative members want to maximize their short-term returns, while management wants to maximize the value of the cooperative. In a similar vein, another lender reported the attitude and philosophy of a cooperative board is very important to his lending decision. He cannot support a cooperative whose board does not understand and actively engage in long-range planning. Another lender commented that the primary objective of most cooperatives is to provide a home for their members' deliveries. Most cooperatives got started for this reason and few cooperative members are interested in getting a premium return from their cooperative.

Four of the lenders stated that board and member education of strategic planning and financing requirements is critical. The members must concur with the cooperative's strategic direction and understand its financing requirements. One lender specifically indicated that members should recognize that the cooperative is their investment and is an entity having value which should be protected.

Two of the lenders felt that cooperatives' management personnel have improved substantially during the last decade. However, they reported that cooperatives are lacking in managers experienced in value-added

products. One lender stated that individuals with such expertise do not usually want to share their power with a board and members. The other lender cited poor compensation levels as the primary reason why cooperatives do not attract individuals experienced in value-added products.

The lenders found the governance structure of most cooperatives to be troublesome. Four of the lenders indicated that cooperatives are too democratic and consequently have a hard time reacting to changes in the marketplace. One lender elaborated that a cooperative needs a small board or a relatively homogeneous membership to make critical decisions; otherwise, the cooperative ends up compromising its goals and practices to the lowest common denominator among its membership. Three of the lenders stated that cooperatives need outside directors. One lender noted that a members-only board is the biggest weakness in cooperatives' planning and control processes. Another stated that outside directors provide an opportunity to get particular expertise and objectivity; this lender felt that cooperatives were in particular need of financial and legal expertise.

The lenders also expressed dissatisfaction with member delivery governance practices. Two lenders noted that most cooperatives do not restrict member deliveries; consequently, the cooperatives' returns are compromised by occasionally having to dump product into a market to reduce inventories. Another lender stated unrestricted deliveries make planning difficult for a cooperative. The cooperative can suffer from excess production capacity and must find markets for widely varying volumes of raw product. This lender also stated that since cooperatives are usually undiversified, they face marketing diseconomies and have less flexibility in utilizing their excess capacity.

The comments of the lenders interviewed for this study indicate that cooperatives are sacrificing their long-term opportunities in order to address their members' short-term needs. Specifically, these lenders observed that:

1. cooperatives need more permanent equity;
2. cooperatives need stronger strategic planning;
3. cooperative boards and members tend to be very parochial in considering new business opportunities; and
4. cooperative boards can be strengthened by adding expertise from outside directors.

APPENDIX B
Cooperative Manager Interviews

The interviews with cooperative CFOs concerned the same topics as did the lender interviews. However, the discussions were more extensive and more information was collected regarding each cooperative's financing programs. The methodology used in this part of the study is first discussed. The responses to the interview questions are then presented.

A. Cooperative CFO interview methodology

Any cooperative marketing consumer products was considered a potential candidate for the study. Various cooperative experts were asked to identify cooperatives marketing consumer products. Those selected for this study represent varying sizes and commodity groups, including dairy products, fruits and vegetables, pork and nuts. Six of the cooperatives are located in California; the other seven are geographically disbursed. The thirteen cooperatives included in this study were:

AgriPac	Cabot Creamery
Calavo	Diamond Walnut
Farmland	Land O'Lakes
Lindsay Olive	NORPAC
Ocean Spray	Pacific Coast Producers
Sunkist	Sunsweet
TreeTop	

Most of these cooperatives sell products under their corporate names. All of them have introduced new products during the past two years; some of these new products were for the food service sector, rather than consumers. Two of the cooperatives listed above, Farmland and Land O'Lakes are both farm supply and marketing cooperatives. Management officers interviewed at these two cooperatives were involved with just the marketing arms.

The CFOs were initially contacted by telephone and asked to participate in the study. They were then sent a letter briefly explaining the purpose of the study and confirming an appointment for a personal interview. Each cooperative provided a copy of their most recent annual report prior to the interview. The interviews were conducted at the cooperatives' headquarters.

At one cooperative, the Chief Executive Officer (CEO) was interviewed, rather than the CFO. Both the CEO and CFO were interviewed at another cooperative. At another cooperative, the treasurer and Vice President for Acquisitions were interviewed instead of the CFO. The interviews at two cooperatives included the CFO and another member of the finance staff. All of these respondents will be referred to as CFOs for the sake of simplifying the reporting.

During the structured interviews, the CFOs were asked a broad range of questions regarding their cooperative's finances (including opinions regarding specific cooperative financing issues), strategic planning practices, marketing programs, management personnel, and membership governance policies. The CFOs' responses are reported question by question. The responses are not quantified because the number of participants in this study is small and because most of the questions were open-ended. To facilitate reporting the results, the term "few" is used to refer to two to four respondents, five to seven respondents are classified as "several", and eight to twelve respondents are categorized as "most". Many of the questions were interrelated and the CFOs often responded to one question while answering another. These multi-question responses were annotated when the questionnaires were reviewed after the interviews were completed. The responses for each category of questions are grouped together below, regardless of the order in which the questions were actually asked.

Several of the CFOs had extensive management experience at IOFs. These individuals usually provided comparisons between the practices of cooperatives and IOFs. Differences in the practices of cooperatives and IOFs are highlighted, as are factors constraining cooperatives' practices. The interview responses are presented in the following four subsections.

B. Cooperative CFO interview responses—financing programs

Information regarding the cooperatives' financial structure and practices was extracted from their annual reports and supplemented with numerous questions during the interviews. The financial data from their annual reports for the most recent fiscal year are displayed in Appendix C. The cooperatives in this study were very diverse. Their net sales revenues ranged from $70 million to $3.4 billion and asset values from $37 million to $1.3 billion. Equity levels varied from $8 million to $476 million. The lowest amount of

debt financing was $25 million and the highest was $877 million. The debt-to-equity ratios ranged from a low of 1.27 to 1 to a high of 3.84 to 1.

Six of the cooperatives in this study are multiple commodity cooperatives; four of them maintain a single pool for all of the commodities. Seven of the cooperatives are single commodity cooperatives. Two of the thirteen cooperatives in this study qualify as "exempt" from taxation under Section 521. Although these cooperatives can allocate earnings from nonpatronage business without being taxed, they are unable to maintain any unallocated equity as permanent equity.

The CFOs were asked to described their equity programs. Most of the cooperatives have revolving fund programs, with revolvement periods ranging from four to eighteen years. The others utilize base capital programs. Several use or have used nonqualified notices to allocate equity to their members , thereby enabling the members to defer their income tax liabilities until the retains are redeemed.

Most of the cooperatives have permanent equity in the form of unallocated equity, which has been earned primarily from nonpatronage business. Sunkist has generated enough unallocated equity from its trademark licensing program that it has allocated and even revolved some of this equity. Several of the CFOs remarked that they are trying to build more permanent equity through nonpatronage earnings. One of the cooperatives used patronage earnings as its primary source of unallocated equity. This cooperative's CFO stated that the cooperative's goal is to have one-third of its equity in unallocated earnings. One CFO was investigating retaining the cost savings attributable to capital expenditures as unallocated equity.

Although several of the CFOs had considered public stock offerings, only one had actually proceeded with the transaction. Land O'Lakes has financed a portion of its subsidiary, Country Lake Foods, with public stock offerings. Several CFOs discussed why they have not pursued this financing source; they cited the following reasons: cooperatives' earnings are too low to attract outside investors; cooperative boards do not want to share control; the new organizational form would compromise the firm's cooperative nature; and spinning off part of the cooperative as a publicly-traded firm would be a sound business decision only if the cooperative could not raise capital in any other way. A few of the CFOs indicated that the eight percent limit on capital stock dividends imposed by Section 521, the Capper Volstead Act and state statutes affects their ability to raise capital through public stock issues.

None of the cooperatives have financing from venture capitalists. Several of the CFOs had considered this source and concluded that it was too expensive. Additionally, one CFO stated that it would require substantial effort to educate venture capitalists about cooperatives.

It is apparent that the cooperatives in this study are working to diversify their equity capital sources. Although the majority of the cooperatives use revolving funds as their primary source of equity, a few have established base capital plans which provide more financial flexibility and stability to the cooperative. All of the CFOs expressed a desire to have permanent equity in the form of unallocated earnings.

As previously noted, cooperatives are decreasing their reliance on CoBank and commercial banks for debt financing. Most, but not all, of the CFOs reported that their cooperatives still have some financing from these sources. One CFO reported that his cooperative has hit its borrowing limit with its regional CoBank. There are numerous nonbank sources of debt available to cooperatives. Several of the cooperatives have financing through industrial development bonds. Although tax reforms have reduced the amount of financing which firms can obtain in this form, the CFOs still considered industrial development bonds to be an attractive source for financing new facilities. Tax reforms have also reduced the attractiveness of capitalized leases; however, a few of the cooperatives still utilize them. Only Ocean Spray is currently issuing commercial paper, although two other cooperatives in this study have previously used this short-term financing source. Senior notes are also a financing source for several cooperatives; insurance companies or pension funds find these long-term instruments attractive because they have repayment priority over all other debt.

A few of the cooperatives have obtained financing from their members by issuing subordinated debt to their members. Several others have considered this source. One CFO noted that his members had no interest in this source while another CFO remarked that the members found the option unattractive because of the cooperative's poor earnings. Three of the cooperatives are operating grower/member deposit programs with short-term maturities. None of the cooperatives are registering the deposits as securities; they are relying on the intrastate offerings exemption.

The cooperatives have also adopted alternative resource structures to facilitate their expansions. Despite the tax reforms, several of the cooperatives still use operating leases. Several of the cooperatives are sharing resources with other cooperatives by engaging in joint ventures with them. One CFO remarked that his cooperative's joint ventures had been extremely successful and the partners were considering expanding the joint venture's product line. Several other CFOs reported that they had considered joint ventures with other cooperatives. One of them stated that cooperatives were too antagonistic towards each other to engage successfully in joint ventures. Another reported that although his cooperative was not involved in joint ventures with other cooperatives, they had been engaged in short-term business agreements with various cooperatives.

Several of the cooperatives are partners with IOFs in joint ventures; a few specifically mentioned providing copacking services to maximize the use of expensive facilities. A few of the cooperatives had contracted with IOFs to have copacking services provided. Four CFOs reported that they had considered joint ventures with IOFs. One of these CFOs stated that his cooperative had set up a holding company for such endeavors; however, their efforts had been unsuccessful because the transactions must be completed in a "swift and nimble manner" but his cooperative had taken a ponderous approach which is typical of cooperatives. Another CFO remarked that such arrangements are not attractive to IOFs because cooperatives typically offer raw product and ask the IOF to provide the capital.

Limited partnerships are another form of a joint venture. One cooperative had organized limited partnerships with some of its members primarily to acquire and lease property and equipment back to the cooperative under various operating and capital lease agreements. There can be member relations problems with such programs. Not all members have the financial capacity to make such investments. The CFO stated that some of the cooperative's members have complained that the investment partners are earning unreasonably high returns at the expense of the rest of the membership.

The CFOs were asked a series of questions about financing new products. When asked what sources they used to finance new products, they all reported that they do not seek financing specifically to fund new products. They generally use operating capital to fund the growth and charge the expenses against patronage earnings. One CFO reported that his cooperative maintains a special fund for research and development (R&D) expenses; additions to the fund are deducted from patronage earnings. Another CFO noted the use of leases (both operating and capital) to finance equipment required for new products. A few cooperatives use term debt for some of their new product financing.

Several of the CFOs reported that they had obtained debt financing when acquiring an IOF. As previously noted, acquisitions are an alternative to internal product development. One of the CFOs emphasized that his cooperative had made an acquisition to gain new distribution channels, rather than to broaden its product line. Another CFO remarked that acquisitions were less risky than internal development of new products and markets.

The CFOs were asked if a detailed financial analysis is conducted in evaluating new products. All but one responded affirmatively; however, the evaluation efforts varied significantly. Most project the product's cash flow for three to five years. A few have targeted return on investment rates which must be met. A few conduct extensive consumer testing and revise their financial projections accordingly.

One cooperative purchased an IOF even after its board was informed that the acquisition would have negative returns for the first three years. The CFO remarked that the purpose of the acquisition was to build permanent equity and that while his board is concerned about the current year's return, they are more concerned about the longer term.

Another CFO commented that he could not consider any new product which did not breakeven its first year when his cooperative's returns were poor. Now that the cooperative's returns are improving, they are rolling out new products more slowly than their IOF competitors and have consequently sacrificed market share. Similarly, another CFO will not consider any new product which has a negative return during its first year. He stated that his cooperative does not have the margins to absorb such losses; consequently, his cooperative's return would not be competitive and the cooperative would lose membership. Another CFO remarked that his cooperative has developed enough brand equity to earn premium returns; consequently, it can launch new products which initially have negative returns and still earn a competitive return for the cooperative overall. He stated, however, that his cooperative has foregone introducing new products with development costs large enough to make the

cooperative's return uncompetitive; instead, the cooperative has opted to license its brand to other companies for such ventures.

Some of the cooperatives defer their product or market development expenses. A few have research and development equipment which they depreciate. Many of the costs of an acquisition can be depreciated, including goodwill. One cooperative spreads its market development expenses (slotting fees, introductory allowances, rollout promotion costs) over at least two years. Another cooperative defers market development costs associated with new products (in excess of normal advertising and promotion costs) by accumulating them during the first three years and then amortizing them equally over three or five years, beginning in the year in which the costs were incurred.

Most of the cooperatives do not defer any product or market development expenses; the expenses are charged against the current year's patronage return. One CFO remarked that being unable to defer these expenses is the biggest constraint that his cooperative faces with new products. Most of the new products which the cooperative considers involve market development costs which, without deferral, would make the cooperative's return uncompetitive.

The final segment of the CFO interviews concerned their opinions regarding financing matters. Public stock issues were mentioned previously as a potential source of additional equity capital for cooperatives. The CFOs were asked if a cooperative were to publicly issue stock, would there be an inherent conflict between the investors' and members' objectives? Most of the CFOs agreed that there would be a conflict. A few elaborated that the investors would want to pay the lowest possible price for the raw product, while the members would want to receive the highest possible price. Two CFOs commented that the members would have a much longer-term interest in the cooperative than would the nonmember stockholders; the members have limited delivery options as producers, while the nonmember stockholders have a multitude of investment options. One CFO responded that member conflicts would arise because those who could not afford to invest as individuals would resent the members who invested and earned a superior return, presumably at the expense of the overall membership. Such a conflict can arise with any voluntary membership investment program. Among the remaining CFOs who felt that the conflict between members and stockholders was not inevitable, one stated that cooperatives would benefit from the capitalist drive which serves IOFs. Another CFO remarked that publicly issuing stock can be beneficial to a cooperative if its members have a clear understanding of the objectives of the transaction. This opinion illustrates the importance of member education of their cooperative's objectives and requirements.

The CFOs were asked if a cooperative would be disloyal to its current members if it uses their capital to finance entry into new activities from which the current members do not receive immediate benefits. Most of the CFOs did not consider such an action to be disloyal; they remarked that it is necessary for a cooperative to invest in the future to strengthen itself. One CFO pointed out that such investments are both an advantage and disadvantage of cooperative membership; the current members benefit from investments financed with previous members' equity retains.

Members are the major, and sometimes only, source of equity capital for cooperatives. All of the CFOs responded affirmatively when asked if they considered their members to be investors of the cooperative. Most of them concurred that their board members considered themselves to be investors; one CFO noted that his board members are frequently concerned about the cooperative's rate of return on assets. However, the CFOs stated that most of their members did not consider themselves to be investors of the cooperative. One CFO commented that his members did not feel that they had a responsibility to provide capital to the cooperative. Another CFO responded that most of his members are just looking to get the best price for their product for the year. Another commented that his members usually want to minimize, rather than optimize, their investment in their cooperative.

In the literature review, the tied equity problem, the horizon problem, the liquidity problem and the portfolio problem were all identified as factors causing cooperative members to be reluctant to contribute equity capital to their cooperatives. The CFOs were asked to comment on the validity of these factors. None of the CFOs felt that their members' willingness to invest would increase if their returns were tied to their investment, rather than their patronage.

A few CFOs validated the horizon problem. Two CFOs commented that the benefits of the cooperative are passed down through the generations in the members' families. One CFO responded that because of urbanization forces, the horizon problem had become the biggest stumbling block in raising equity faced by his cooperative; members are investing in the coopera-

tive with increased reluctance because urbanization forces prevent them from passing down the benefits of their cooperative membership to their offspring. A few of the cooperatives have developed transferable delivery rights programs. These programs enable cooperatives' members to accrue capital gains when they sell their rights, thereby alleviating the horizon problem.

Several of the CFOs concurred that the liquidity problem contributes to members' reluctance to invest in the cooperative. Two CFOs responded that the liquidity problem was the main constraint which they face in raising equity from their members. One CFO noted that their cooperative was considering developing a revolvement program specifically for retired members. Another CFO commented that they would have to register their capital stock certificates if members were allowed to sell their stock (although this may not always be the case). A few of the CFOs commented that the lack of equity liquidity was not a factor for their cooperatives because they allowed their members to sell their stock; one even allowed sales to nonmembers. Registration requirements for such securities vary from state to state.

The portfolio problem appears to constrain cooperative members' equity investment only in a theoretical sense. None of the CFOs indicated that it affected their members' willingness to invest in the cooperative. A few commented that most of their members have diversified their farming operations. Risk aversion was not validated as a contributing factor to members' reluctance to contribute equity capital to their cooperatives. None of the CFOs indicated that it was a contributing factor; two of them noted that, to the contrary, their members are big risk takers.

Other factors affecting cooperative members' willingness to invest in their cooperative were also examined. Most of the CFOs agreed that tight cash flow situations make equity retains very problematic for some of their members, particularly the smaller or newer operators. The CFO of a dairy cooperative remarked that his cooperative's equity requirements are particularly burdensome because the members also have to finance their capital-intensive dairy production units. Several of the CFOs responded affirmatively when asked if a lack of investment orientation contributed to their members' reluctance to invest in their cooperative. Presumably, their members also do not consider their farming operations to be investments.

Most of the CFOs concurred that their members have an "ego problem" with retains; that is, they continually compare their after-retain returns with those of their neighbors, even though the neighbor may be selling directly to a processor. Two CFOs elaborated that a cooperative's successes breed confidence among the membership; when returns are poor, members are reluctant to risk further capital.

Thus, the cooperatives interviewed for this study recognize that their access to the equity capital needed to finance their value-added ventures is constrained. Most of their members do not consider themselves to be investors of the cooperative. Tight member cash flows, the lack of liquidity in member equity and the ego problem also limit the amount of equity that cooperatives are able to raise from their members. The cooperatives utilize a variety of debt financing sources, including senior notes, commercial paper and industrial development bonds. They also have developed alternative resource structures; joint ventures appear to be particularly successful. Some cooperatives enhance the feasibility of new products by deferring some of their product and market development costs. Other cooperatives apply very stringent criteria when evaluating their new product opportunities.

C. Cooperative CFO interview responses—strategic planning programs

Prior to developing its financing programs, a firm should establish its organizational goals. The cooperative CFOs were asked several questions regarding their cooperatives' organizational goals and strategic planning program. Their cooperatives are engaged in varying degrees of strategic planning. Several of the CFOs reported that their cooperatives began formalized strategic planning during the past five years. Management usually drafts a strategic plan which is presented to the board at a multi-day retreat. The plan usually spans five years and is updated annually.

Most of the CFOs indicated that their cooperatives have mission statements which their boards have approved. They were asked to describe their cooperative's primary objective. All of the CFOs mentioned enhancing, or maximizing, returns to their members, which is consistent with cooperative principles. However, only one specifically mentioned "long-term". Three of the CFOs mentioned being consumer-driven firms, while another three noted providing a home for their members' deliveries as being part of their cooperative's primary objective. One CFO stated that cooperatives had historically been established to promote competitive markets for commodities. Thus, he added, many members do not expect premium returns from their

cooperative. Two of the CFOs specifically reported that insulating their members' returns from short-term cyclical patterns is also a primary objective.

When asked to describe their cooperatives' strategic orientation, several of the CFOs responded that their cooperatives are differentiated marketers. The others stated that their cooperatives were nichers; one CFO remarked that his cooperative lacks the capital to become either a low-cost producer or a differentiated marketer. A few of the CFOs reported that their cooperatives have dual orientations; they are low-cost producers, and nichers or differentiated marketers. They consider themselves to be low-cost producers of commodity-like products, but are developing value-added products as nichers or differentiated marketers. One of these CFOs remarked that the first priority for his cooperative's capital is its production facilities; once its production side is efficient, the cooperative will be able to spend money of its marketing program.

Responses were mixed when the CFOs were asked if their boards were appropriately involved in policymaking, as opposed to operational issues. Most of the CFOs agreed that their boards had been moving in this direction; however, a few stated that their board members tended to stray to operational issues. One CFO remarked that his cooperative's board tends to focus on immediate operating problems to the detriment of the cooperative's long-term needs. Most of the CFOs identified their strategic planning retreats as the primary effort undertaken by management to make their board more long-term oriented. Several of the CFOs stated that board education in strategic issues is an ongoing process. One CFO noted that he continually emphasizes financing requirements and the cooperative's financial condition to the board. Another CFO responded that management discusses consumer research results and other marketing matters to broaden the board's understanding of marketing issues. A few of the CFOs remarked that their board members attend seminars sponsored by universities, banks and cooperative-oriented organizations. The third party nature of this education enhances its credibility.

The CFOs were also asked to describe actions taken by its cooperative's management to make its members' more long-term oriented. The efforts with the membership were not nearly as extensive as those with their boards. Confidentiality concerns prevented management from presenting information on strategic issues and capital programs in member publications or meetings; management does not want its competitors to obtain information about the cooperative's strategic issues. One CFO noted that the education process is most effective when conducted one-on-one between a board representative and a cooperative member.

D. Cooperative CFO interview responses—marketing programs

Strategic planning provides the foundation for effective marketing programs. The CFOs were asked various questions regarding their marketing programs. Most of them expressed satisfaction with the effectiveness of their marketing programs. However, one CFO was dissatisfied because his cooperative's marketing programs relied too heavily on pricing and promotion, and not enough on consumer pull.

As previously noted, several of the cooperatives in this study are single-commodity cooperatives. There is wide variation in the degree to which agricultural commodities can be processed into various food products. For example, the number of products which can be made with milk appears to be limitless. Figs, on the other hand, have a narrower scope of application. Two of the CFOs remarked that their cooperative's commodities limit the range of products which they can market and make them vulnerable in the event that a particular commodity falls out of favor with consumers. One CFO reported that his cooperative had added new commodities to its membership base with extreme reluctance. Another CFO noted that his board has resisted broadening the cooperative's geographic scope, although the action would help expand the cooperative's shrinking deliveries and spread overhead costs. Several CFOs commented that their boards and members are very protective of management's attention to their commodities.

Most of the CFOs responded affirmatively when asked if their cooperative has adequate diversification in its product line. One CFO was not satisfied because the cooperative's product line is not a balanced portfolio; it does not contain enough processed products. This concern is consistent with previous findings indicating the dearth of cooperatives in highly processed food sectors. The CFO of an exempt cooperative stated that it is very difficult for his cooperative to develop a new product containing at least fifty percent the members' commodity (a Section 521 requirement) and which meets the cooperative's rate of return requirements. Another CFO responded that his cooperative does not and cannot make the major commitment to the research and development needed to broaden its product line.

All of the cooperatives in this study use some nonmember product as an ingredient. Most of them also supplement their members' deliveries; this is necessary when crops are small or when a year-round supply is needed to maintain a market presence. One CFO commented that such purchases have high working capital requirements since they require full payment while payments for member deliveries are spread throughout the year.

A few of the cooperatives market items made exclusively from nonmember product. They have items copacked for them in order to fill out their product line. One CFO emphasized that a complete product line is a critical part of their marketing strategy. Three of the cooperatives acquired firms which produce nonmember products in order to generate nonpatronage earnings and build permanent equity. One CFO remarked that such activities also spread some of the cooperative's marketing and overhead costs, while another CFO remarked that it is difficult for his board to recognize the marketing economies gained from such products. One of the CFOs reported finding it difficult to expand its nonpatronage business because its board is requiring that new nonpatronage products must breakeven during their introductory year. Another CFO made the more general comment that his cooperative's board "will not approve new products at the members' expense".

All of the cooperatives in this study market products to the retail sector and most market their products in the other three major market segments—food service, industrial and export. One cooperative emphasizes its private label program while the others focus on their own brands (although most do have private label programs). When the CFOs were asked to compare their advertising and promotion programs to those of their competitors, only one CFO responded that his cooperative currently spent more than its competitors. Another CFO reported that his cooperative historically has spent more than its competitors, but that it had cut back on its advertising program when it began experiencing financial difficulties. Another CFO stated his cooperative's spending was comparable to that of its major competitors. The remaining CFOs indicated that their cooperatives spent less than their competitors.

E. Cooperative CFOs' interview responses—management

Management is responsible for developing and implementing the strategic plans, and the financing and marketing programs discussed in this section. Most of the cooperatives in this study reported that their management teams have extensive experience with value-added products, including the large food conglomerates. One CFO responded that most of his cooperative's management staff was "home-grown", but that its marketing and sales managers have food company backgrounds.

As previously noted, cooperative boards have a heavier burden regarding management control than IOF boards, because there is no stock market to measure the performance of cooperatives. However, the board's ability to perform this responsibility is questionable. One CFO commented that his cooperative's board members are not particularly well qualified to serve on the board due to their lack of training and experience in business management; however, they were very loyal to management. Another CFO remarked that as his cooperative has become more manufacturing and marketing oriented, the board members have been less able to provide policy guidance. The cooperative had grown away from its roots and was struggling with the dilemma. Sometimes management can be too strong; one CFO reported that his cooperative's board was overwhelmed by its CEO for several years. If the board cannot carry out its evaluation of management's performance, it has to rely on a very skilled and strong management team to become a successful value-added marketing firm.

At several of the cooperatives, the performance of the management is measured against goals stated in annual business plans. At one cooperative, performance is also compared against the goals in a longer-term three-year plan. One CFO reported that his cooperative's management evaluation is very informal; the CEO and Board meet and discuss management's performance.

The management at a few of the cooperatives are evaluated by comparing the cooperative's returns with competitive field prices. One CFO commented that his cooperative used to have blind member loyalty; the members did not focus on the cooperative's returns. There no longer is this "warm, fuzzy feeling" among the membership; they are now very return-oriented, constantly comparing the cooperative's return with those of its competitors.

There also is a growing emphasis on performance reporting in the annual reports of most cooperatives. Most of the thirteen cooperatives in this study report the cost of the raw product in their statement of operations. Among these cooperatives, a few included the

rate of return on equity or assets in their annual reports and a few compared their returns with competitive field prices. Several reported five- or ten-year trends for various financial indicators.

All of the management teams have incentive programs; the sizes of the bonuses vary with the manager's level or salary, and the cooperative's performance level. At one cooperative, all employees are eligible to receive a bonus. Although cooperatives cannot award stock options or have "profit-sharing" programs like IOFs, they have developed incentive packages for their management teams.

F. Cooperative CFO's interview responses—governance

Cooperatives and IOFs differ substantially with respect to their governance. Cooperative members usually require a more democratic structure than do stockholders of IOFs. The CFOs were questioned about various governance issues, including the composition of their boards, in order to assess the effects of cooperative principles and regulations.

The boards of the cooperatives in this study ranged from nine to 39 members. Federated cooperatives tend to have the larger boards. A few of the boards have nonproducer members, such as the cooperative's CEO, university advisers and previous board chairmen. One cooperative has a supplier as an appointed member on its board. Although some states restrict cooperative board membership to grower-members, none of the CFOs mentioned this restriction. A few did mention the desire to have outside directors providing business expertise. In this study, none of the cooperatives appointed individuals experienced with value-added products to their boards.

The cooperatives in this study have moved away from the traditional one member-one vote voting structure, which can provide a strong voice for members with low delivery levels. Only three of the thirteen still utilize this structure. Most have a proportional voting system. A few utilize a combination of the two, by providing at least one vote to each member and supplementing it with additional votes based on delivery levels. Most cooperatives are now providing the greatest representation to their heaviest users.

As previously noted, one of the lenders interviewed for this study stated that cooperative decisionmaking can involve many compromises if the membership is not homogeneous. The CFOs were asked about the homogeneity of their membership. All of them responded that the financial conditions of their members vary widely. Some have very small operations, while others have very large operations. In some cases, the members are absentee owners. Membership regulation is one of the main policy areas which cooperative boards must deal with. Most of the cooperatives in this study do not have open membership policies; they accept applications for membership only during a specified period and restrict membership to producers of specific varieties.

The cooperatives control delivery volumes in various ways. One CFO responded that his cooperative has specific tonnage agreements with its members; the tonnage level can be prorated by the cooperative before plantings occur. The cooperative must seek supplemental tonnage from its membership before it can buy from nonmembers. A few of the cooperatives control delivery levels through transferable tonnage delivery rights; excess tonnage is treated as nonmember product and earns a lower return. These acreage or tonnage delivery rights must be purchased from the existing membership. Three of the cooperatives limit member deliveries to acreage as specified in member contracts. One of the cooperatives does not limit its members' deliveries; however, it is also under no obligation to accept any of the deliveries.

Several of the cooperatives in this study do not control delivery volumes. One CFO noted that although his cooperative needs large volumes to cover its fixed costs, it is forced to be a nicher because it does not have the capital to be a differentiated marketer. However, its infrastructure is not set up for niche items.

Cooperative boards also have authority over operating and capital budgets. Several of the CFOs indicated that their boards favored investing in production facilities rather than marketing programs. They cited several reasons for this tendency, including the board's preference for things which they can touch and feel, the cooperative's previous marketing program failures, the immediate benefits from production facilities, and their lower risk. Conversely, one CFO reported that his board tends to be more willing to invest in marketing programs; because the members do not understand marketing, they do not closely scrutinize such projects.

To conclude the interviews, the CFOs were asked what they would like to change about cooperatives in general. They tended to return to issues which had previously been discussed. A few readdressed the financial constraints faced by their cooperatives. One of these CFOs remarked that "...members need to understand that their cooperatives are trying to give

them a good return; cooperatives need adequate capital to generate the good returns." Two of the CFOs want tax reform in the form of deferring retained patronage earnings until they are paid in cash to cooperative members. They feel that the current tax laws constrain cooperatives' ability to raise equity capital because many members currently have negative after-tax cash flows on their patronage earnings.

Some of the CFOs shared the lenders' concern regarding the short-term orientation of many cooperatives. Four of them responded that cooperatives should be more strategically oriented. One CFO elaborated that "...cooperatives need to take more risks and be more progressive; they tend to hold on to their roots." Another CFO wanted cooperatives to realize that "...they are a corporation and have to do what is best for the firm, not for an individual or a commodity." The responses of three of the CFOs indicate concurrence with the lenders' assessment of cooperatives' governance shortcomings. These CFOs stated that they would like (more) outside directors on their boards. One remarked that "...being a good farmer does not necessarily mean being a good manufacturer or marketer."

The cooperatives interviewed for this study have all vertically integrated beyond first-stage handling of their members' products; they are competing to varying degrees with IOFs producing value-added food products. The cooperative CFOs' responses indicate general satisfaction with their cooperatives' direction and performance. However, they identified various areas needing improvement. Many of their comments address their abilities to be effective marketers of value-added products and the factors constraining these abilities.

APPENDIX C
Select Financial Measures by Cooperative

(all dollars in thousands—most recent fiscal year)

COOPERATIVE	SALES	ASSETS	DEBT	EQUITY	DEBT/ EQUITY (%)
AgriPac	$144.0	$120.3	$92.1	$28.2	327
Cabot	$70.0	$39.7	$31.5	$8.2	384
Calavo	$153.6	$36.8	$25.2	$11.6	217
Diamond Walnut	$167.5	$104.9	$70.8	$34.1	208
Farmland	$3,377.6	$1,352.9	$876.9	$476.0	184
Land O'Lakes	$2,414.8	$748.4	$469.5	$278.9	168
Lindsay Olive	$58.5	$41.2	$30.6	$10.6	289
NorPac	$238.4	$156.7	$120.8	$35.9	336
Ocean Spray	$942.1	$560.2	$353.2	$207.0	171
Pacific Coast Producers	$172.2	$100.8	$53.2	$47.6	127
Sunsweet	$182.2	$89.0	$51.2	$37.8	135
Sunkist	$1,066.5	$229.0	$176.2	$52.8	334
TreeTop	$268.0	$143.4	$112.0	$31.4	360

source: annual reports

ABOUT THE CENTER FOR COOPERATIVES

The Center for Cooperatives was established by the California Legislature in 1987 as a center in support of research, education, and extension activities to "advance the body of knowledge concerning cooperatives in general and address the needs of California's agricultural and nonagricultural cooperatives."

The Center's objectives are to promote:

- EDUCATION. The Center offers formal and informal educational programs to those involved in cooperative management and develops teaching materials for all levels of interest.

- RESEARCH. To help the state's cooperatives reach their objectives, research is conducted on economic, social, and technical developments. A practical aspect of this research: the provision of competitive research grants, and studies for government agencies on how cooperatives can help achieve public policy objectives.

- OUTREACH. The Center is prepared to inform the public on cooperatives and their significance to the economy of California.

Located on the University of California, Davis campus, the Center is a University-wide academic unit. Its teaching and research resources are drawn from interested professionals from all University of California and state university campuses, other colleges and universities, as well as sources indigenous to the cooperative business community.

The Center is prepared to receive gifts and contributions from the public, foundations, cooperatives and other like sources and is establishing an Endowment Fund.

For information about the Center or its programs or publications, call 916-752-2408 — FAX 916-752-5451 or write: The Center for Cooperatives, UC Davis, Davis, CA 95616.