Understanding Cooperatives:

Cooperative Business Principles

Cooperative Information Report 45, Section 2

USDA Rural Development
Committed to the future of rural communities.

United States Department of Agriculture Rural Development

Cooperative Programs

August 1994
Slightly Revised
April 2011

A building has a foundation which supports the rest of the structure. Without it, the building probably would not stand very long. The cooperative form of business also is built on a foundation — a set of guidelines that create its uniqueness and explain the relationship between it and its members. These guidelines are referred to as principles and distinguish a cooperative from another kind of business.

This section explains what cooperative principles are, how they evolved, and what principles are followed today.

A cooperative is defined as a user-owned and controlled business from which benefits are derived and distributed equitably on the basis of use or as a business owned and controlled by the people who use its services.

In many respects, cooperatives resemble other businesses. They have similar physical facilities, perform similar functions, and must follow sound business practices. They usually incorporate under State law by filing articles of incorporation, granting them the right to do business. They draw up bylaws and other necessary legal papers. Members elect a board of directors. The board sets policy and hires a manager to run the day-to-day operations.

But in other ways, cooperatives are distinctively different from other businesses. These differences are found in the cooperative's purpose, its ownership and control, and how benefits are distributed. These are usually referred to as cooperative principles and explain the way a cooperative operates.

To understand how cooperative principles are defined today, we need to look at their history.

History of Cooperative Principles

One of the earliest cooperative businesses was the Rochdale Equitable Pioneers' Society, founded in England in 1844. The original group consisted of 28 people, ranging from flannel weavers to shoemakers. They were individual craftsmen or entrepreneurs who came together on Toad Lane to purchase supplies and consumer goods cooperatively. The original subscription was one English pound for one share of stock.

The Rochdale Society took the best ideas developed throughout the history of cooperatives and molded them into one set of good business practices and policies that, 150 years later, evolved into principles of cooperatives. These principles distinguished cooperatives from non-cooperative businesses.

Milton said, "A good principle, not rightly understood, may prove as harmful as a bad principle."

The Rochdale Policies and Practices were:

- Open membership.
- One man, one vote.
- Cash trading.
- Membership education.
- Political and religious neutrality.
- No unusual risk assumption.
- Limited interest on stock.
- Goods sold at regular retail prices.
- Limitation on the number of shares owned.
- Net margins distributed according to patronage.

Although outdated in many respects, they are still considered first expressions of modern cooperative principles.

Definitions

Discussion of today's cooperative principles and practices should be prefaced with a definition of terms:

A cooperative principle is an underlying doctrine or tenet that defines or identifies a distinctive characteristic. It clearly sets the cooperative apart from other businesses. (And as Milton said, "A good principle, not rightly understood, may prove as harmful as a bad principle.")

A cooperative practice is an action that supports, complements, or carries out a principle. The practice is particularly important for a cooperative to achieve success, yet it is not necessarily unique to cooperatives.

Traditional Principles

Various writers over the past century or so have analyzed and observed the application of cooperative principles. Allowing for slight differences in terminology, four principles emerge from rather lengthy and diverse lists as being recognized and widely practiced for nearly 150 years. These are more than just good practices, policies, or common sense. They are the principles that continue to distinguish a cooperative from other kinds of business. They are recognized in Federal and State statutes as criteria for a business to qualify as a cooperative.

The four traditional principles are:

- Service at cost;
- Financial obligation and benefits proportional to use;
- Limited return on equity capital; and
- Democratic control.

Service at Cost

Members unite in a cooperative to obtain services otherwise not available, to get quality supplies at the right time, to have access to markets, or for other mutually beneficial reasons. Acting together gives members the advantage of economies of size and bargaining power. The cooperative attempts to fulfill member needs at the least possible cost. Determining true costs at the point of transaction, however, is practically impossible. A necessary practice, therefore, is to charge competitive market prices. The objective of generating sufficient income to cover costs and meet continuing operating capital needs is critical. The cooperative's operations are reduced to an at-cost basis at the end of its fiscal year when surpluses are returned to members.

Financial Obligation and Benefits Proportional to Use

Members gain both direct and indirect benefits from their cooperative. A direct benefit is an assured source of supply and markets for their products, which can directly increase their income. Indirect benefits to members are "policing" the market of goods and services, leadership development, and increasing business knowledge. How much benefit members receive from the cooperative depends on their level of participation. Members may have the privilege of sharing in the benefits of the cooperative, but also must share in the responsibility of providing financing based on proportional use or financial losses.

Limited Return on Equity Capital

Members form a cooperative to get a service: providing supplies, marketing their products, or performing specialized functions. The primary purpose in cooperating is to get a needed service or product, not a monetary return on capital investment. Limiting the payment, if any, for members' capital used to operate the cooperative supports the principle of distributing benefits proportional to use.

The basic idea, however, is that current users finance their cooperative in proportion to use, and that returns to their financial investment are secondary to the value of services received.

Democratic Control

One way cooperative members exercise control is through voting at annual and other membership meetings. Member-owners of a cooperative corporation, in most instances, have one vote no matter how much money they have invested in stock or how much they patronize the organization.

Some say the term "member control" more accurately describes today's cooperatives than the term "democratic control." Member control recognizes that members can control a cooperative either through one vote per member or through a voting system that relates to the size of the patronage each member does with the cooperative. Examples of proportional voting are based on the dollar volume of business, the acres of cropland, or the units of produce marketed through the cooperative.

Practices

In addition to operating under these principles, cooperatives follow other generic practices, many of which are followed by other businesses and organizations.

Open Membership

This policy is considered a traditional principle by food, health, housing, and other types of consumer cooperatives. Yet, it does not distinguish them from public stock corporations that allow anyone to buy stock. Agricultural cooperatives are limited to bona fide farmers, and even some of these have closed membership. The type of cooperative and its purpose will largely determine whether it can practice open membership.

Abraham Lincoln said, "Important principles may and must be flexible."

Continuing Member Education

Keeping owners educated about what is happening in their industry is important for any business, but it is vital in a cooperative for at least three reasons:

1. Democratic control, exercised through majority rule, requires that the entire ownership be informed and involved to ensure enlightened decisionmaking.
2. The cooperative can be responsive to members' needs only if members express them and recognize that they must bear the financial burden to fulfill those needs.
3. Unfamiliarity with the cooperative form of business in this country means that our education system, at any level, does not give much instruction about cooperatives in business and economics courses, and, therefore, the cooperative must conduct its own educational efforts.

Cooperation Among Cooperatives

This statement was adopted by the International Cooperative Alliance in 1966 as a "principle" that cooperatives should pursue to advance the concept of cooperation worldwide. It is good policy also wherever members' resources can be used more effectively and the public interest served more efficiently.

Contemporary Principles

Abraham Lincoln said, "Important principles may and must be flexible."
Today's principles are simple, flexible, and few in number, yet continue to define and identify the distinctive characteristics of the cooperative form of business in a forward-looking manner.

- The User-Owner Principle: People who own and finance the cooperative are those who use it.
- The User-Control Principle: People who control the cooperative are those who use it.
- The User-Benefits Principle: The cooperative's sole purpose is to provide and distribute benefits to users on the basis of their use.

Conclusion

To understand and explain a cooperative's principles, the answers to several questions will help:

- Who are the members of the cooperative?
- What is the cooperative's goal?
- How is the business financed?
- How is control exercised?
- Who benefits from its existence?

A cooperative is different from other businesses in the American free enterprise system, yet it plays a vital role. Using the answers to the above questions will help in understanding its difference and uniqueness.

(See also the International Co-operative Alliance (ICA) statement of cooperative identity and principles. www.ica.coop/coop/principles.html) ■

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This circular is one of a continuing series that provides training information and presentations for education resource persons who may or may not be familiar with the cooperative form of business. This series provides the basic background material they need and in a form that can be readily adapted, with limited preparation time, to a lecture or other presentation.