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MODULE



## Basics of an agricultural cooperative







Managing your Agriculture Cooperative

## MODULE 1

### Basics of an agricultural cooperative

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This training material has been developed by the organizations listed below.



**Agriterra** is an organization for international cooperation founded by rural people's organizations in the Netherlands. Agriterra offers, among others, farmer-to-farmer advice and direct financial support to rural people's organizations in developing countries so that they become strong and representative organizations. These organizations are indispensable for the promotion of democracy, for a better distribution of income and for the economic development of a country. If farmers organize themselves to jointly coordinate their production and to improve their presence in the market, they stand a better chance to succeed in increasing their incomes and in the creation of employment. Agriterra aims to promote such economic activities and to stimulate, support and finance the international cooperation between rural people's organizations in the Netherlands and those in developing countries.

<http://www.agriterra.org>



**Centre for International Development Issues Nijmegen (CIDIN)** is an interdisciplinary academic institute addressing issues of inequality, poverty, development and empowerment. It carries out undergraduate and postgraduate education in development studies, as well as research in a variety of subjects related to development, economics, sociology and anthropology. CIDIN has broad experience in interdisciplinary research on rural development and value chains, collection action and market integration, impact assessment of value chain codes and standards, and gender theory, policy and mainstreaming.

<http://www.ru.nl/cidin>



**Cooperative College of Kenya (CCK)** is located 17 kilometres from Nairobi city centre in a serene environment. The College was established in 1952 to train government cooperative inspectors to oversee the activities of the cooperatives in Kenya. The College has grown until now it is pursuing a charter to become a university. The broad aim is to equip the staff of the cooperative movement and the associative economy with appropriate managerial and supervisory skills in order to contribute more effectively to the development of cooperatives. The College offers Degree Diploma and Certificate courses in Cooperative Management and Banking. It also offers short courses that target the employees and management of cooperatives. The College is ISO 9001:2008 certified.

<http://www.cooperative.ac.ke>





**Cooperative Facility for Africa (COOP<sup>AFRICA</sup>)** is a regional technical cooperation programme of the International Labour Organization (ILO) in support of cooperative development. It promotes favourable policy and legal environments, strong vertical structures (such as cooperative unions and federations) and improved cooperative governance, efficiency and performance. The programme covers nine countries in East and Southern Africa (Botswana, Ethiopia, Kenya, Lesotho, Rwanda, Swaziland, Tanzania mainland and Isles, Uganda and Zambia) from the ILO Office in Tanzania with technical support from the ILO Cooperative Programme (EMP/COOP) in Geneva. It was launched in October 2007 with core funding from the UK Department for International Development (DFID). COOP<sup>AFRICA</sup> is a partnership initiative involving a range of international and national organizations.

<http://www.ilo.org/coopafrica>



**Empowering Smallholder Farmers in Markets (ESFIM)** is a partnership between national farmers' organizations in eleven countries and AGRINATURA. ESFIM's overall objective is to generate demand-driven action research supportive to the policy activities undertaken by farmers' organizations to strengthen the capacities of smallholder farmers in developing countries to generate remunerative cash income from markets by creating an enabling policy and regulatory environment as well as effective economic organizations and institutions.

<http://www.esfim.org>



**International Labour Organization (ILO)** is the tripartite UN agency that brings together governments, employers and workers of its member states in common action to promote decent work throughout the world. The ILO views cooperatives as important in improving the living and working conditions of women and men globally. Its Cooperative Programme (EMP/COOP) serves ILO constituents and cooperative organizations based on the ILO Recommendation 193 on the Promotion of Cooperatives Recommendation, 2002. EMP/COOP works in close partnership with the International Cooperative Alliance (ICA) and is part of the Committee for the Promotion and Advancement of Cooperatives (COPAC).

<http://www.ilo.org> and <http://www.ilo.org/coop>



**International Training Centre of the ILO** is the training arm of the ILO. Its Distance Learning and Learning Technology Applications (DELTA ) programme has a double mandate of strengthening the Centre's internal capacity in applying state-of-the-art learning and training methodologies and processes as well as providing training services to outside partners and customers. It provides these services in line with ILO Recommendation 195 on Human Resources Development. Its Enterprise, Microfinance and Local Development (EMLD ) programme offers training on cooperatives and the social and solidarity economy as well as, among others: entrepreneurship education and training; enabling business environments for sustainable small enterprise development; value chains and business development services and women's entrepreneurship development.

<http://www.itcilo.org>



**Food and Agriculture Organization of the United Nations** leads international efforts to defeat hunger. Serving both developed and developing countries, FAO acts as a neutral forum where all nations meet as equals to negotiate agreements and debate policy. FAO is also a source of knowledge and information, helping developing countries and countries in transition modernize and improve agriculture, forestry and fisheries practices and ensure good nutrition for all. Since its founding in 1945, it has focused special attention on developing rural areas, home to 70 per cent of the world's poor and hungry people.

<http://www.fao.org>



**Kenya National Federation of Agricultural Producers (KENFAP)** is a registered non-political, non-commercial, democratic membership federation that was founded in 1946 as Kenya National Farmers' Union (KNFU). Its mission is an empowered Kenyan farmer with a strong voice making informed choices for improved sustainable livelihoods. As the legitimate 'voice' of the Kenyan farmers, its key role is to articulate issues specifically affecting farmers and the general agricultural sector. KENFAP serves its members by offering representation, lobby and advocacy services. It facilitates cooperation and networking among its members and with national, regional and international associations. It also provides consultancy services and carries out research activities in the interest of the farming community.

<http://www.kenfap.org>



**Moshi University College of Cooperative and Business Studies (MUCCoBS)** is the oldest cooperative training institution in Tanzania, accumulating the experience of 48 years in the fields of cooperative accounting, cooperative management and rural development. MUCCoBS came into being as a result of upgrading the former Cooperative College into a Constituent College of Sokoine University of Agriculture (SUA) in May 2004. It offers cooperative and business education at both undergraduate and postgraduate levels. It provides opportunities for acquisition, development, promotion, dissemination and preservation of knowledge and skills in cooperative, community, business, organizational and entrepreneurship and any other area as may be determined by the University College through training, research and consultancy activities.

<http://www.muccobs.ac.tz>



**The Nigerian Cooperative Development Centre (NCDC)** is located at kilometre 61, Abuja–Lokoja highway. It occupies a 14-hectare plot of land away from the city centre to ensure a conducive research and learning environment. The Centre provides technical backup to the Federal Department of Cooperatives and the entire cooperative movement. It does this through research and adoption of global best practices in cooperative policies, legislation and training. It also generates and analyses cooperative data to support policy and programmes for the development of the cooperative sector, including the training of a cadre of competent cooperative management, supervisory and training personnel.



Royal Tropical Institute

**The Royal Tropical Institute (KIT)** in Amsterdam is an independent centre of knowledge and expertise in the areas of international and intercultural cooperation. The Institute aims to contribute to sustainable development, poverty alleviation, and cultural preservation and exchange. Within the Netherlands, it seeks to promote interest in and support for these issues. KIT conducts research, organizes training activities, and provides consultancy and information services. Central to KIT's approach is the elaboration of practical expertise in policy development and implementation. The Institute stewards cultural heritage, organizes exhibitions and other cultural events, and provides a venue for meetings and debate. A key objective underlying the Institute's work is to enhance and exchange knowledge of and understanding for different cultures. "KIT is a not-for-profit organization that works for both the public and the private sector in collaboration with partners in the Netherlands and abroad" (Mission Statement).

<http://www.kit.nl>



**UGANDA COOPERATIVE ALLIANCE LTD**

**Uganda Cooperative Alliance Ltd. (UCA)** is an umbrella organization of cooperative organizations in the country. It was registered in 1961 with the aim of promoting the economic and social interests of cooperatives in Uganda. It was formed for the purposes of promoting, advocating and building the capacities of all types of co-operatives in the country (primary societies, district and national unions). In its development activities, UCA has concentrated on six key areas: capacity building in primary societies and area cooperative enterprises; development of a strong cooperative financial system based on members' savings; technology transfer; women's empowerment; creation of youth self-employment and environmental protection and improvement.

<http://www.uca.co.ug>



**WAGENINGEN UR**  
*For quality of life*



**Wageningen University & Research Centre (WUR)** explores the potential of nature to improve the quality of life. A staff of 6,500 and 10,000 students from over 100 countries work everywhere around the world in the domain of healthy food and living environment for governments and the business community-at-large. Its Centre for Development Innovation (CDI) works to create capacities for change. It facilitates innovation, brokers knowledge and develops capacities with a focus on food systems, rural development, agri-business and the management of natural resources. The Centre links Wageningen University Research Centre's knowledge and expertise with processes of society-wide learning and innovation.

<http://www.wur.nl/UK> and <http://www.cdi.wur.nl/UK>

# List of abbreviations

ACE	Area Cooperative Enterprise
BoD	Board of Directors
CAF	<i>Caisse des Affaires Financières</i>
COAINE	<i>Cooperativa Agropecuaria Integral Nor Este</i>
CSR	Corporate Social Responsibility
FONDOECA	<i>Fondo para el Fortalecimiento Economico de las Organizaciones Economicas Campesinas</i>
ICA	International Cooperative Alliance
ILO	International Labour Organization
MFI	Microfinance Institute
NGO	Non-Governmental Organization
OCFCU	Oromia Coffee Farmers Cooperative Union
UCA	Uganda Cooperative Alliance
VCF	Value Chain Finance

# ABC Glossary

**Asset** An asset is a resource controlled by the cooperative as a result of past events, and from which future economic benefits are expected to flow to the cooperative. An asset can be tangible, such as a warehouse, or intangible, such as marketing knowledge or a patent.

**By-laws (or constitution)** Rules agreed upon by the founder members for the internal structure and operations of the cooperative, its representation vis-à-vis third parties as well as for the rights and obligations of members in an objective form, binding all present and future members who have accepted these regulations by their signature. In some countries, by-laws are also referred to as *constitution*.

**Source:** Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.

**Commercialization** Change of objects of a cooperative society from member-promotion to profit-maximization, to increasing the market share and to grow, among other things, by expanding its business with non-members, the search for external investors, and thereby, almost total adjustment to the rules of an investor-oriented enterprise.

**Source:** Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.

**Cooperative audit** An independent examination of, and expression of opinion on, the financial statements, management performance and social reports of a cooperative by an appointed auditor, who carries out his/her duties according to accepted cooperative audit standards and in compliance with a statutory obligation.

**Source:** DGRV/ILO, Operational guide for audit on cooperatives (forthcoming).

<b>Corporate governance</b>	<p>The framework of rules and practices by which a Board of Directors (BoD) ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders (financiers, customers, management, employees, government, and the community).</p> <p><b>Source:</b> <a href="http://www.businessdictionary.com/definition/corporate-governance.html">http://www.businessdictionary.com/definition/corporate-governance.html</a> (accessed 7 Oct. 2011).</p>
<b>Dividend (on paid-up shares)</b>	<p>Participation of members in the surplus of a cooperative by payment of dividend on share capital in proportion to their paid-up share contribution, provided that the cooperative makes a surplus that can be distributed among the members and the general meeting approves such distribution. In cooperatives, dividend on share capital is usually restricted, e.g. to the interest rate paid for long-term savings deposits.</p> <p><b>Source:</b> Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.</p>
<b>Equity capital</b>	<p>Equity capital or owned capital of a cooperative is composed of members' paid-up shares, the open and hidden reserves and provisions.</p>
<b>External finance (funds)</b>	<p>Financing of an enterprise by contributions from members (financing by shares) and by borrowed capital, members loans, saving deposits by members and non-members (financing by credit), grants, donations, i.e. capital coming into the enterprise from outside.</p> <p><b>Source:</b> Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.</p>
<b>Farm inputs</b>	<p>The resources that are used in farm production, such as chemicals, equipment, feed, seed, energy, etc.</p> <p><b>Source:</b> <a href="http://www.websters-online-dictionary.org/definitions/Farm+inputs">http://www.websters-online-dictionary.org/definitions/Farm+inputs</a> (accessed 7 Oct. 2011).</p>

**Market price**

Unique price at which buyers and sellers agree to trade in an open market at a particular time.

**Source:** <http://www.businessdictionary.com/definition/market-price.html> (accessed 7 Oct. 2011).

**Market segmentation**

The process of defining and subdividing a large, homogenous market into clearly identifiable segments having similar needs, wants, or demand characteristics. Its objective is to design a marketing mix that precisely matches the expectations of customers in the targeted segment.

**Source:** <http://www.businessdictionary.com/definition/market-segmentation.html> (accessed 7 Oct. 2011).

**Patronage refund**

Distribution of surplus (economic results) in proportion to the volume of transactions between the members and the cooperative enterprise, usually when prices charged to members were originally too high (in the case of a supply cooperative) or when prices paid out to members were originally calculated too low (in the case of a marketing cooperative).

**Source:** Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.

**Pledged assets**

Asset used as collateral for a loan. A pledged asset is transferred to the lender from the borrower to secure the debt. Ownership of the asset remains with the borrower during the loan period. When the debt has been repaid, the pledged asset is transferred back to the borrower. The lender assumes ownership of the loan if the borrower defaults on the loan.

**Source:** <http://www.businessdictionary.com/definition/pledged-asset.html> (accessed 7 Oct. 2011).

**Surplus**

Term used in cooperatives for the economic results at the end of the financial period.

**Source:** Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.



<b>Transaction costs</b>	<p>Mainly costs for the preparation and execution of business transactions, costs for collecting and processing relevant information (in order to identify the best offer, business opportunities and risks). Cost for drawing up agreements and controlling their implementation.</p> <p><b>Source:</b> Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.</p>
<b>Value chain</b>	<p>The series of consecutive steps that are required to bring a product (a good or a service) from conception, through the different phases of production, production, processing and logistic handling, to final customers. In each of these steps value is added to the product.</p>
<b>Value chain finance</b>	<p>The flow of financing within a subsector, among value chain actors, for the purpose of getting product to market.</p> <p><b>Source:</b> <a href="http://www.cgap.org/gm/document-1.9.2312/africaday_Theme6.pdf">http://www.cgap.org/gm/document-1.9.2312/africaday_Theme6.pdf</a> (accessed 7 Oct. 2011).</p>
<b>Voucher system</b>	<p>Internal financial control system for cash or check payments that relies on vouchers to (1) establish the propriety of transactions, (2) establish the amount being paid, and (3) name the ledger account(s) in which the transaction is to be recorded.</p> <p><b>Source:</b> <a href="http://www.businessdictionary.com/definition/voucher-system.html">http://www.businessdictionary.com/definition/voucher-system.html</a> (accessed 7 Oct. 2011).</p>



# Introduction

## Why this training package on the management of agricultural cooperatives?

Agriculture is a crucial sector for global development as “farmers feed the world”. Agriculture is also the second greatest source of employment worldwide.<sup>1</sup> Historically speaking, agriculture has been key in the development paths of many countries. Within the diversity of cooperatives worldwide – one finds for instance cooperatives amongst news agencies, schools and green energy suppliers – agriculture remains a sector where cooperatives are a prominent form of enterprise. This package is motivated by the conviction that *“strong and representative agricultural organizations are indispensable for the promotion of democracy, for a better distribution of income and for the economic development of a country.”*<sup>2</sup> Evidence shows that

many countries with an important agricultural sector, such as, for instance, Argentina, Ethiopia, France, India, the Netherlands, New Zealand, as well as the United States of America, also have strong agricultural cooperatives.<sup>3</sup> However, agricultural cooperatives face numerous external and internal challenges. External challenges may be linked to markets, regulations, infrastructure or climate change. Challenges that are internal to the cooperative usually have to do with governance and management issues. Cooperatives are enterprises for which the primary aim is not making profit but responding to members’ needs and aspirations. Cooperative members **own** their enterprise through cooperative shares, they **control** their enterprise

1 The service sector is the most important source of employment in the world. See: <http://www.ilo.org/public/english/dialogue/sector/sectors/agri/emp.htm> (accessed 7 Oct. 2011).

2 *About Agriterra*, <http://www.agriterra.org/en/text/about-agriterra> (accessed 22 Sep. 2011).

3 Source: *Global 300*, <http://www.global300.coop> (accessed 7 Oct. 2011).



through democratic mechanisms, and, finally, they are the principal **users** of the cooperative services. This makes the cooperative a resilient but also a complex and challenging business model. Cooperatives may find themselves stretched between (at times conflicting) members' interests, business opportunities and social considerations.

## What is My.COOP about?

*My.COOP* stands for “*Managing your agricultural cooperative*”. The My.COOP training package aims to strengthen the management of agricultural cooperatives so that they can offer high quality, efficient and effective services to their members.

The package draws on the ILO training series developed by the Materials and Techniques for Cooperative Management Training Programme between 1978 and the early 1990s. Today, My.COOP is a broad partnership initiative initiated by the ILO Cooperative Facility for Africa and ILO's Cooperative Branch. It is the result of a collaborative effort involving a wide

range of partners such as cooperative development agencies, cooperative colleges, cooperative organizations, organizations of agricultural producers, universities and agencies of the United Nations. More information on the partners can be found in the list that is included at the beginning of this document.

The objective of this training material is to enable (existing and potential) managers of agricultural cooperatives to identify and address major management challenges that are specific to cooperatives in market oriented agricultural development.

As stated above, cooperatives may find themselves stretched between (at times conflicting) members' interests, business opportunities and social considerations. Within such context cooperative managers should ensure sound decision-making on service provision for services that are common to many agricultural cooperatives, including supply of farm inputs and marketing. These issues are reflected in the structure of the My.COOP training package:

- ▶ **1** Basics of Agricultural Cooperatives
- 2** Cooperative Service Provision
- 3** Supply of Farm Inputs
- 4** Cooperative Marketing

## For whom is My.COOP?

My.COOP has been designed for existing and potential managers of agricultural cooperatives as well as for members involved in managerial tasks of the cooperative. The material presumes that these women and men already possess some practical experience as active members in agricultural cooperatives. The material is not developed for people who are starting an agricultural cooperative for the first time.

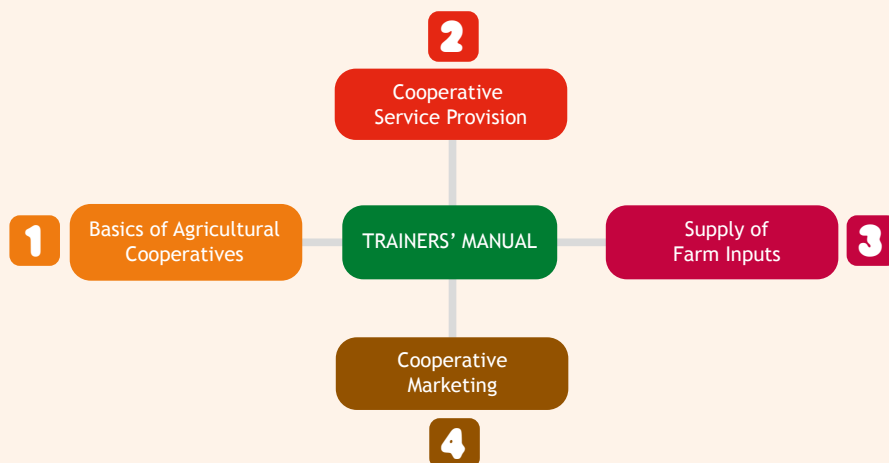
In addition, the My.COOP package can be a helpful tool for organizations

and individuals that train agricultural cooperatives. These can include:

- leaders and managers of cooperative structures, such as unions, federations and confederations;
- cooperative trainers working in cooperative colleges, non-governmental organizations (NGOs) and other (including private) training providers;
- cooperative officers and extension staff of government departments and agencies.

## What's in the package?

The training package consists of one trainer's manual and four modules, as shown in the diagram below.



Each module consists of several learning topics. A learning topic consists of brief content descriptions that are complemented with real life cases from various parts of the world that present solution solving approaches to common challenges in the management of agricultural cooperatives. Besides, each topic offers explanatory boxes on definitions

and concepts as well as self-assignments that help the self-learner to apply the contents to his or her own cooperative or situation. Modules and topics can be used independently from each other, in any given order, in line with the training needs.

## My.COOP online

My.COOP is more than a training package. My.COOP is also a website ([www.agriculture-my.coop](http://www.agriculture-my.coop)) where you can find not only the package but

also related services and tools online, such as a distance learning platform for training of trainers and a mobile learning kit.



# About Module 1:

## Basics of Agricultural Cooperatives



This module discusses some of the basic characteristics of an agricultural cooperative and how it can be managed.

An agricultural cooperative is an example of a collective action organization. The weak bargaining position of individual small farmers vis-à-vis large suppliers, traders and processors has been one of the main reasons for farmers to organize and act collectively. Agricultural producers voluntarily organize themselves to meet common economic, social, and cultural needs. For that purpose, they jointly own an enterprise. By purchasing inputs together, addressing collectively environmental challenges and jointly selling farm products,

productivity, sustainability and the bargaining power of farmers greatly improves.

An agricultural cooperative is set-up to promote the interests of its farmer-members, who are also the owners. But as it is an enterprise operating in a competitive environment, it also has to satisfy the customers that buy products or services from the cooperative.

A cooperative is an organization with dual character: it is, on the one hand, an association of persons who came together for their common needs and aspirations to be met, and on the other hand, it is an enterprise with distinct values and principles, serving its members while taking into account the interests of its customers and the wider community. Cooperative service provision is further explained in Module 2. Modules 3 and 4 deal in detail with two types of services: input supply services and marketing services.



## Content of this module

This module deals with the challenges that are involved in managing agricultural cooperatives, such as: How to deal with duality? How to respond to changes in the market? How to govern and manage a cooperative successfully? How to respond to changes in the environment and the climate?

The module is split up into four sub-sections with the following topics:

**Topic 1: Basics of an Agricultural Cooperative**

**Topic 2: Challenges for Cooperatives**

**Topic 3: Cooperative Governance**

**Topic 4: Management, Capital Formation and Finance.**



## Learning objectives

After studying this module, you will be able to:

- explain the distinctive features of cooperative enterprises;
- suggest ways to align the interests of the members with the interests of the enterprise;
- suggest ways to balance social and economic objectives;
- explain the different functions an agricultural cooperative can perform and the different services it can provide; and
- identify which (global) developments influence the functioning of your cooperative and see the opportunities that arise from them.





# TOPIC 1

## Basics of an Agricultural Cooperative



## Introduction to the topic

Why do cooperatives exist? What distinguishes a cooperative from other farmer organizations? What are the principles that guide the establishment and operation of a cooperative? Why do farmers join a cooperative? These are the main questions that will be answered in Topic 1.

## The need for collective action

Farmers have trading links with suppliers of farm inputs and buyers of farm products. Such suppliers produce in large quantities. Also, buyers that process and trade farm outputs in general do operate on a much larger scale compared to the farm. Farmers, therefore, are often confronted by more resourceful trading partners.

This unequal trading relationship brings high risks for the farmers. They often do not have proper information on market conditions. As a result, they may be treated unfairly, for instance by receiving a lower price for farm products than they would have received under competitive market conditions. Or they receive low quality inputs, because they do not have the resources to assess the quality of the inputs, or no alternative suppliers are available.

The weak bargaining position of individual small farmers vis-à-vis much larger suppliers, traders and processors has been one of the main reasons for farmers to set up collective action organizations such as cooperatives. By purchasing inputs and selling farm products jointly, the bargaining position of farmers is greatly enhanced. Other reasons for farmers to set up cooperatives will be presented throughout this module.

## Why set up a formal collective action organization?

If there is a need for farmers' collective action, how should this be organized? Collective actions can be carried out by an informal group. However, when the joint activities are maturing over time, the group will often choose a legal form. In many countries, the suitable legal form for economic collective action by farmers is a cooperative.

If formalization is chosen, a formal procedure of registering the cooperative will have to be followed. This will involve preparing specific papers and documents, among others. Once formalized, there will be a specific legal regime applying to cooperatives. In some countries this is a regime only applicable to cooperatives,

in other countries there are no distinctive legal rules, and cooperatives are treated as any other enterprise. Formalization brings with it several advantages. First of all, if the cooperative becomes a legal entity, the members might benefit from a shift in liability for business transactions from the collective of the members to the cooperative. Second, members' relationships with the cooperative will become formalized, too, i.e. by regulating the option of terminating membership and claiming back shares, etc. Third, the legal regime normally provides for internal decision-making procedures, as well as rules for accounting for expenditures and investments. Fourth, in some countries, cooperatives experience favourable tax treatment compared to non-cooperative competitors.

### Informal economy

Today, cooperatives are increasingly becoming an attractive option for the formalization of the informal economy. Informal economy workers in the same business often work individually or in small groups and, quite often, compete with each other. By forming and using the services of a cooperative they forge solidarity, obtain a voice and can strengthen their businesses - for example through bulk purchasing the commodities they deal in, or in defending their interests. Around the world, cooperatives are considered important organizations in agricultural development as they can offer the potential for producers to organize, have a voice and improve their livelihoods.

Source: Sam Mshiu, "The Cooperative enterprise as a practical option for the formalization of informal economy", The ILO Cooperative Facility for Africa (2010), Informal Economy Conference, South Africa.

The advantages of formalization become important when the group wants to enter into contracts with buyers regarding the delivery of special quantities and qualities of farm products. Opportunities for supplying such products to major retailers and producers of branded food products are also increasing for smallholder farmers. As part of their Corporate Social Responsibility (CSR) strategy, international food companies increasingly source their raw material from organized smallholder farmers. These companies even support the establishment and management of formal farmer groups.

Formalization also brings more opportunities for decent work. For instance, the registration of a cooperative means legal recognition that permits cooperatives to access appropriate tax and accounting regimes and hence social security coverage for the workers. It can also be easier for a formal organization to access public training programmes or labour inspection programmes, which may lead to improved safety and health conditions at the workplace (e.g. the workplace can be organized in sections that logically follow the work flow, locking chemicals in a safe place, installing toilets, and providing information on the prevention and treatment of HIV/AIDS, among others). However, there could be a tension between the role of the

farmer as a member of a cooperative committed to decent work and his/her role as an employer of (seasonal) labour at the farm site.

## Why do agricultural cooperatives exist?

Farmers have set up cooperatives for all kinds of activities in support of the farming activities. To understand the *rationale behind the formation* of an agricultural cooperative, one can ask two questions:

### Decent work

Work is important for women and men to earn a living. But work is more than that. The quality of work is equally important. That is what the ILO calls: “decent work”.

Decent work involves work that is productive and delivers a fair income, security in the workplace and social protection for families, better prospects for personal development and social integration, freedom for people to express their concerns, organize and participate in the decisions that affect their lives and equality of opportunity and treatment for all women and men.

Source: <http://www.ilo.org/global/topics/decent-work/lang--en/index.htm> (accessed 7 Oct. 2011).

### How can farmers benefit from collaborating with other farmers?

Consider a farm that is producing maize. This farm may need farm inputs, such as seeds, fertilizers, and pesticides. It may need credit for investments in equipment and storage. The farm may need irrigation water. On the output side, the farmer needs to find a market for the maize. The farmer needs to collect information on markets and prices. For most of these activities the farmer does not have the resources and skills. Also, it is rather inefficient if each farmer is selling his/her own products. Sometimes there is not even a market where the farmer can purchase inputs. By joining forces with other farmers, our maize farmer may set up a cooperative that is collectively bargaining with input suppliers, that may even produce the inputs itself, that provides credit, that takes care of selling the maize of several farms, and may also organize an irrigation system. These activities can be carried out by one cooperative or may be better accomplished by separate specialized cooperatives.

### Why do farmers prefer to set up a cooperative for purchasing inputs and selling farm products instead of trading with a private firm?

Actually, in many countries and many sectors farmers do contract with private companies that supply inputs and services. However, the private companies may not be reliable in their services, or may take advantage of the weak bargaining position of farmers. There are also situations where such private companies may not exist. In situations of market failure, cooperatives provide the solution, because they supply the services/inputs that are otherwise not available, or, by their very existence, force private suppliers to ask fair prices. Thus, cooperatives can provide the missing inputs, can provide inputs at lower

prices and higher quality, and can sell the farm products without exploiting the farmers. Cooperatives enable the farmers to specialize in on-farm production activities, while still benefiting from economies of scale and scope in input supply and output marketing, without bearing the risk of being exploited by more resourceful trading partners.

## Distinct features of cooperatives

### Definition of a cooperative

A cooperative is an organization that is established for promoting the interests of its members and that is structured as both an association and an enterprise. The generally accepted definition of a cooperative is the one adopted by the International Cooperative Alliance (ICA) and the International Labour Organization (ILO):



*“A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically-controlled enterprise”<sup>4</sup>*

Thus, a cooperative is both an enterprise and a collective action organization.

In the case of an agricultural cooperative, a group of farmers have established an organization that works to protect and promote their common interests. As all of the members of the group have an (economic) interest in what the collective organization does, they all want to be involved in the decision-making. This requires a decision-making structure that gives all members a voice or a vote. If the organization is a small one, all members can be directly involved in the decision-making process. In this process, proposals are discussed, pros and cons are weighed, and decisions are taken on the basis

<sup>4</sup> ILO *Promotion of Cooperatives Recommendation*, (R193, 2002) and the ICA *Statement on the Cooperative Identity*, (1995). The term “persons” in the definition can refer to individuals but also to legal persons such as firms. Cooperatives whose members are legal persons are also called entrepreneur cooperatives. Besides, there are cooperatives that have a mixed member base, involving for instance local government, non-profit organizations, and enterprises and so on. It depends on national legislation whether such forms of cooperatives can be set up.

## Other farmer organizations

Besides cooperatives, there are many other collective action organizations of farmers. Farmer organizations exist in many forms and provide a variety of services. They range from formal organizations like national farmer unions to informal farmer groups and village associations. Different names are used for the same or similar types of organizations, such as producer organization, rural producer organization, agricultural producer organization, agricultural cooperative, farmer association, producer group, and producer association.

of a majority of the votes. In practice, decisions are often taken by consensus, which means that an accommodation is reached that takes care of the interests of all members.

In a larger organization, members use their voice not for directly discussing and voting on project proposals but for electing representatives. The BoD takes decisions on behalf of the members and is accountable to the membership for the outcome of its decisions. The rules for electing the BoD and for reporting

back to the members are usually written down in the by-laws (or statutes) of the cooperative.

As the above definition explains, an agricultural cooperative is not only an association of farmers, it is also an enterprise. The enterprise has a management structure, it often has employees, and it owns assets such as a warehouse, a truck, a piece of land, a processing plant or only an office building. These assets are owned by the cooperative, while the cooperative is jointly owned by the farmer-members. Therefore, the use of these assets is decided upon in the democratic decision-making process mentioned above.

## Cooperative Principles

In establishing and operating a cooperative, farmers and their advisors often use the Cooperative Principles to guide them. Also, governments use the Cooperative Principles in designing legislation on cooperatives. The Cooperative Principles can be considered as the practical expression of the values behind collaboration in cooperatives. These principles have been developed over a long period of time, since the first cooperative was established in 1844 by the Rochdale Pioneers in the UK. There are seven Cooperative Principles<sup>5</sup> that were reformulated by the ICA General Assembly in 1995. These principles guide the establishment and operations of cooperatives worldwide.

### Principle 1: Voluntary and open membership

Cooperatives are voluntary organizations, open to all persons able to use their

<sup>5</sup> The principles can be found at the website of the ICA: <http://www.ica.coop/coop/principles.html> (accessed 27 Sep. 2011).





services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

### **Principle 2: Democratic member control**

Cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary cooperatives members have equal voting rights (one member, one vote) and cooperatives at other levels are also organized in a democratic manner.

### **Principle 3: Member economic participation**

Members contribute equitably to, and democratically control, the capital of their cooperative. At least part of that capital is usually the common property of the cooperative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their cooperative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the cooperative; and supporting other activities approved by the membership.

### **Principle 4: Autonomy and independence**

Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including



governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy.

### Principle 5: Education, training and information

Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of cooperation.

### Principle 6: Cooperation among cooperatives

Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.

### Principle 7: Concern for the community

Cooperatives work for the sustainable development of their communities through policies approved by their members.

## Principles and practice

While the Cooperatives Principles are important guidelines for those establishing cooperatives, giving training on cooperatives, or working on cooperative legislation, they are what they are: guidelines. In practice, not all countries and all sectors follow these guidelines literally. An example of the diversity in practice relates to democratic decision-making. While the one-member-one-vote principle is still dominant among most cooperatives, in some countries a more proportional voting system has been introduced. Also among (national) cooperative unions voting is often proportional, related to either the volume of trade or the number of ownership shares. Another example of 'principles in practice' relates to the principle of member economic participation, which also becomes increasingly differentiated. Members can have various financial relationships with their cooperative, and in some countries even non-members may participate in the equity capital of the cooperative (or its subsidiaries).<sup>6</sup>

<sup>6</sup> For a good overview of different financial/ownership structures of agricultural cooperatives, see F. Chaddad and M.L. Cook: "Understanding new cooperative models: An ownership-control rights typology", in *Review of Agricultural Economics* (Milwaukee, Wisconsin, Agricultural & Applied Economics Association, 2004), Vol. 26, No. 3, pp. 348–360.

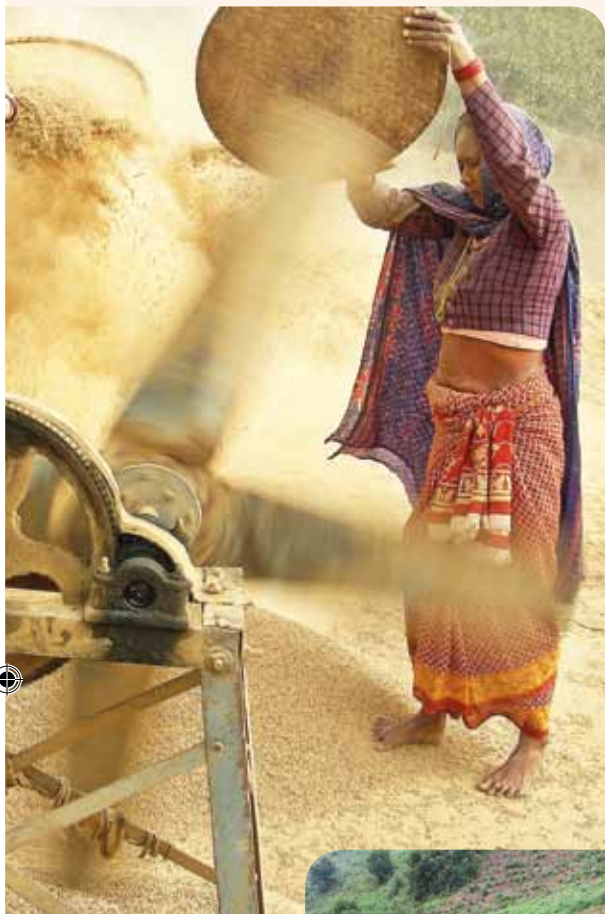
Putting the Cooperative Principles into practice is sometimes a challenging task. For instance, in some countries and some sectors, farmers become members of an agricultural cooperative because only through the cooperative do they have access to inputs like fertilizers. Also, government or donor funded programmes for rural development may require farmers to join a cooperative in order to receive benefits.

Unfortunately, those entities where members are forced to join, or so-called cooperatives that only exist for accessing temporarily available subsidies, may encounter difficulties in their sustainability and even in their day-to-day operations. Members in such so-called cooperatives do not have a sense of ownership, are not committed, and may easily free ride on the entity. As soon as the outside opportunity terminates, the entity may fall apart. These entities are not genuine cooperatives.

Another challenge in practice is that, despite a policy of non-discrimination, in some countries not everyone is free to join a cooperative as they may not meet the membership requirements. An example is when membership is only open to those having land, while the law prevents women from owning land. This deadlock can be broken by landless women who can establish a women's cooperative to create specific income opportunities for them. It can be a rural savings and credit cooperative to support production and marketing of their traditional handicrafts, or marketing of fruits and vegetables that they grow.

Also, protecting the independence of a cooperative could be difficult. In the past, especially in developing countries and in communist states, cooperatives





have suffered from heavy state control and interference resulting in little benefit for the members. For instance, cooperatives were used to control the production and export of coffee, tea and cocoa. The prices set by these cooperatives were often political prices, giving farmers few incentives to increase output or quality. Today, most governments have shifted away from direct interference in cooperative affairs and towards facilitating cooperative development. The example of Milk Vita, a dairy cooperative in Bangladesh, illustrates that the shift from a government initiative to a farmer-owned cooperative can lead to significant benefits for the farmers involved.





### Case 1.1: Milk Vita - from a government initiative to a farmer-owned cooperative

In the early 1970s the Bangladeshi government, along with several development partners, initiated a dairy cooperative union that established a production chain and enabled dairy producers to sell their produce to locally-based cooperative societies. This was a strategic move in many ways, as the union provided a mechanism for enhancing income security and organizing small rural farmers, while strengthening local access to services, increasing product quality and allowing affordable prices for urban consumers. While under the control of the state, the initiative struggled to provide adequate returns and was in constant need of subsidy. Then, in 1991, Milk Vita became a genuine farmer-owned cooperative that sought to support the long-term interests and aspirations of members and their communities.

No longer were civil servants directing the dairy cooperative, now the members obtained full control over milk processing and marketing activities. Choices were no longer based on politics but on sound business principles based on member needs. These determined the strategies of the cooperative. Membership and earnings have increased more than tenfold, and Milk Vita is now considered to be one of the most successful commercial dairy enterprises in Bangladesh. Today, Milk Vita collects milk from over 150,000 farmers through a network of 1,200 village cooperatives. The result has seen well over 300,000 people – cooperative members, their families and communities – lifted above the poverty line. So impressive are the results of Milk Vita that its approach has been replicated across other sectors and territories in Bangladesh.

**Source:** J. Birchall: *Rediscovering the cooperative advantage: Poverty reduction through self-help* (ILO, Geneva, 2003).



### Self-assignment 1.1

Consider the Milk Vita case above. How come the cooperative only became successful after it became independent from the government?

Do you know of similar experiences in your country? How is the independence of your cooperative guaranteed?

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## Cooperation among cooperatives

As the sixth Cooperative Principle indicates, cooperatives often work together. Local cooperatives, usually called primary cooperatives, join forces in setting up a cooperative union. For instance, a number of primary cooperatives from different villages collect the products from their members, but the actual marketing of these products is done by the cooperative union. Because the union sells on behalf of a number of primary cooperatives, it can benefit from economies of scale in product handling, such as sorting and grading, storage and packaging, while it also has a better bargaining position than the individual primary cooperative. Cooperative unions often collaborate in a cooperative federation.

Figure 1.1 shows an ideal type of collaboration scheme among cooperatives at different levels. In reality, not all levels are present in all countries. Different countries follow different structures, depending on their needs. Also, the nomenclature may differ, particularly for the apex organization. A cooperative confederation is often called a national cooperative union; a cooperative federation may also be known under the name of central/sectoral cooperative union; and a cooperative union may also be called a regional or district cooperative union.

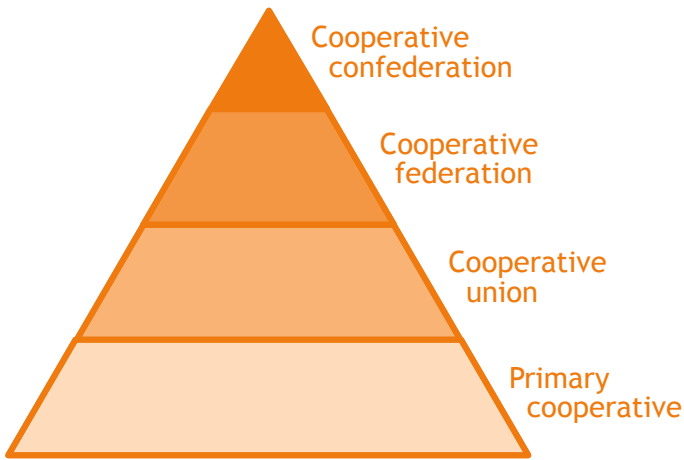
The organization of cooperatives in Figure 1.1 is visualized as a pyramid. This indicates that the number of organizations decreases at each higher level. The pyramid structure does not indicate a hierarchical structure. The collaboration is actually built up from the bottom. Thus, a higher level organization works for the lower level organization. For instance, a cooperative union provides services, for instance the supply of fertilizers, to its members, primary cooperatives. The primary cooperatives are the ones that jointly decide on the strategy and activities of the cooperative union.



It should be emphasized that the cooperative pyramid does not necessarily exist in all countries. If there is a need for more federated structures, the pyramid can be built up from the bottom. Some countries and some sectors may limit their structures to two or three layers, others may go for the full four-layer pyramid.



**Figure 1.1: The cooperative pyramid**



## **Cooperatives and the community**

While cooperatives provide direct benefits to their members, they often also deliver benefits for the community and the region. Depending on the by-laws (statutes) of the cooperative, non-members can also have access to the products and services provided by the cooperative. Other examples of wider community benefits are: creating and sustaining employment opportunities; members' experience in democratic management that can be used outside the cooperative; a school set up by a cooperative that is open for children of non-members, etc. Thus, non-members may also benefit from the presence of cooperatives. These wider economic and social benefits are often reasons for governments to support cooperatives, for instance by giving them favourable tax treatment or exempting them from anti-trust regulation.

Cooperatives that sell their products under the fair trade label are obliged to provide services for or to invest in the community. Case 1.2 gives an example of the Oromia Coffee Farmers Cooperative Union in Ethiopia, which puts part of its surplus into a social fund to be used for community-oriented activities.



## Case 1.2: Cooperatives, Fair Trade and the Community

The Oromia Coffee Farmers Cooperative Union (OCFCU Ltd.) is a smallholder coffee growers' owned cooperative union in Ethiopia that groups 129 cooperatives with 128,361 households and 800,000 families. OCFCU is a democratic member-owned business operating under the Cooperative Principles. All the cooperatives work in line with fair trade principles and 28 of them are fair trade certified. Seventy per cent of the Union's profits from export sales are distributed back to the 129 cooperatives. The cooperatives then distribute 70 per cent of the net profit as dividends back to the member farmers and use the remaining 30 per cent for capacity building, investment on fixed assets, social services and reserves. So far, OCFCU has accomplished 74 community development programmes with the fair trade premium and the Union's social fund in areas such as water development, education, health and electricity.

**Source:** <http://www.oromiacoffeeunion.org> (accessed 7 Oct. 2011)



## Farmers' reasons for joining a cooperative

This topic started with the question about the need for collective action. The general answer is that farmers obtain economic benefits when working together instead of working alone. In this section we look in more detail at the motives of farmers in setting up or joining a cooperative.

Farmers have different motives for setting up a cooperative or becoming a member of an existing cooperative. The motives depend on the type of product, the structure and strategy of the farm, and the structure and operation of markets. Whatever the reason, the fundamental objective is to improve farm income. Table 1.1 shows the reasons of the farmers and the activities of the cooperative that fulfil the needs and aspirations of the farmers.

**Table 1.1: Reasons for farmers to join a cooperative**

Rationale for farmers	Activities by the cooperative
Lower prices for inputs	Bargaining (on behalf of the group)
Easy access to inputs	Make inputs available at short distance from the farm
Higher quality of inputs	Quality control
	Own production of inputs
Higher prices for farm outputs	Bargaining (on behalf of the group)
More transparent markets	Collecting and distributing market information
	Organize market (e.g. auction, farmers' market)
Access to (secure) markets	Establish long-term relations with buyers (e.g. niche markets)
Access to technical assistance	Provide technical assistance directly or intermediation to access these services from other providers
Access to education and training	Provide member education, training and information
Access to credit	Provide credit directly or intermediation to access credit from other providers
Increase value of farm products	Joint sorting, grading, storing and packaging of farm products
	Joint processing of farm products
Reduce market risks	Using a pool for selling farm products
Reduce production risks	Provide insurance directly or intermediation to access insurance from other providers



While negotiation with suppliers and with buyers has always been a core activity of the cooperative, a number of other motives/activities have become relatively more important.

Nowadays, cooperatives have to take more care of the total quality of products, which is in the interest of their members as well as of their customers. This not only involves the quality of the product but also the quality of the way the product is being produced (e.g. under responsible social and environmental conditions). This quality focus may require more technical assistance and higher quality inputs for the members. It also implies more quality grading and sorting of member products, as well as more strict quality

control procedures. Finally, it means that the cooperative will translate customer demands into specific requirements for the quality of members' products and communicate these to the members.

In addition to economic motives, individual farmers can have non-economic reasons to join a cooperative:

- experience a sense of belonging to a group;
- find protection within a group;
- comply with the norm in a community;
- obtain status and respect, by becoming active in the decision-making and management of the cooperative; and
- access and obtain additional education and training.







# TOPIC 2

## Challenges for Cooperatives



## Introduction to the topic

Topic 2 discusses the internal and external challenges that cooperatives face. As a cooperative has a rather complex organizational structure, it is prone to internal tensions. Also, the many different demands on cooperatives from the social and political environment force cooperatives to make difficult trade-offs. The dynamic external environment of the cooperative, both in the political and the market domain, propels cooperatives to continuously seek appropriate responses. The outside world does not only pose threats, it also presents opportunities for farmers and their cooperatives. Taking advantage of these opportunities requires entrepreneurship of both members and cooperative leaders.

## Dealing with duality

One of the most interesting and at the same time most challenging characteristics of the agricultural cooperative is its dual nature. A cooperative is both an *association* of members and an *enterprise*. The association is where the democratic decision-making takes place, while the enterprise conducts the business activities in support of the members. In practice, there is often no clear-cut distinction between these two parts of the organization, certainly not in the mind of the members. Still, it is useful to point out this duality, as it often creates tensions. In addition to the duality in the organizational structure, the cooperative faces other dualities that are potential sources of conflict.

First of all, there may be a tension between the social and economic objectives of the cooperative. As cooperatives are embedded in a community and benefit from the community (making use of social and human capital as well as natural resources available in the community), they are also expected to be concerned for the community. But a cooperative has a primary economic function and has to be run in a business-like manner to remain sustainable. Although member needs may not be easily separated from community needs (for instance a health centre is as much a need of the members as the wider community), there is a difference in priorities. This situation requires clear communication and good management. The cooperative should make clear that the viability of the cooperative is in the interest of the whole community, and that this viability requires making choices and safeguarding its financial sustainability. The cooperative should make a clear distinction between its civic role and its business activities. Case 2.1 of a women's cooperative in Uruguay, *Delicias Criollas*, illustrates how a cooperative may deal with the tension between social and business objectives.



## Case 2.1: A women's cooperative as a commercial enterprise with social responsibilities

Almost all cooperatives and community organizations are established to fight for a social cause. When individuals are weak, associations can provide strength and open up opportunities. But cooperatives are also businesses, and they have to compete in a market that makes no concessions. The social responsibilities of cooperatives are often weakened by the harsh conditions of the market. This is precisely the challenge that *Delicias Criollas*, a women's cooperative in Uruguay, confronted by shifting its focus from institutional support to commercialization.

*Delicias Criollas* has its roots in the *Asociación de Mujeres Rurales del Uruguay* (Uruguayan Association of Rural Women), a group of women producers' organizations in rural Uruguay. As in many other parts of the world, women in Uruguay face particularly difficult obstacles to gaining economic independence. For several years, the *Asociación de Mujeres Rurales* worked on strengthening women's enterprises in such areas as the production of preserves, honey and baked goods. The association was the channel for institutional support, mainly through training, managerial advice, and access to credit. Eventually it became apparent that, while some of the groups were fulfilling the association's objective of providing enhanced opportunities for women, many of the enterprises had difficulties in accessing the market and becoming profitable businesses.

The cooperative *Delicias Criollas* was set up in 2004 to mark a clear separation between the association's civic role and its business activities. It was not enough to support women's organizations so that they could produce excellent products, there was a need to find a market for those products. *Delicias Criollas* turned its efforts towards creating a strong brand, developing marketable products, and finding outlets for their sale. While this is an ongoing process, *Delicias Criollas* has worked towards the long-term sustainability of the cooperative by developing sophisticated products and creating supply arrangements with supermarkets and exporting companies. It has also found a very important business opportunity in selling to institutions, which in turn use their products as gifts. This marketing effort has not lost sight of the cooperative's reason for existence, which is creating better living conditions for rural women. The success of the brand lies in its ability to tell the story of women's entrepreneurship behind the product. *Delicias Criollas* is a good reminder that lofty goals need down-to-earth methods to be accomplished.

**Source:** Based on an interview with Lucia Pardo, founder of *Delicias Criollas*, an Agriterra partner.

This tension between social and economic objectives may also be caused by the external environment. When other organizations support the development of cooperatives, such as governmental organizations and NGOs, they often do so with an explicit demand on the cooperative to perform a social function. In return for financial and other support, these organizations expect the

cooperative to provide services to the community at large. Sometimes the cooperative is required to include as many smallholders in the cooperative as possible, while from a pure efficiency point of view some limitations may be justified. While social functions are important for cooperatives, they should not become the dominant objective. An agricultural cooperative is primarily set up in support of producers of agricultural commodities. When the cooperative is able to support its members, and these members live in a community, there will automatically be positive spill-over to the community.



Another tension relates to the expertise of the leadership in a changing external environment. In the past, cooperatives were strongly related in some regions to political realities – being set up with support from local authorities, and often receiving financial support from the

(local) government and performing public functions; nowadays cooperatives are increasingly considered as businesses. Recent developments in national and international markets – such as demands for higher quality and stricter quality control – require leaders to have good managerial and marketing skills. As cooperatives continue to be embedded in communities and farmers continue to operate in a strongly regulated industry, today's leadership also needs to have political skills. Leaders that combine these qualifications may be hard to find. In medium to large cooperatives this is solved by inserting a clear division of tasks between the directors who take care of

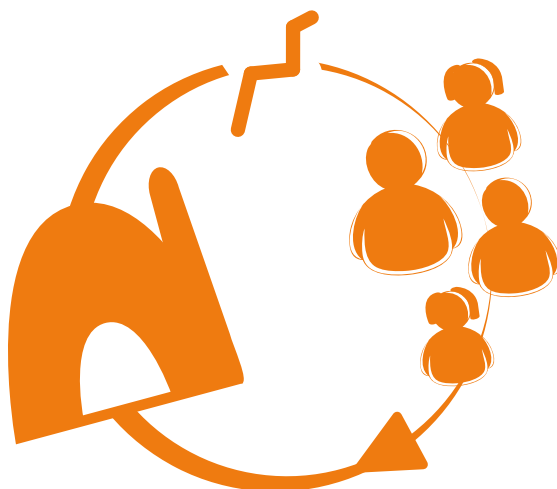
the external relations of the cooperative and the manager who is responsible for running the enterprise.

A last tension relates to the potential conflict of interests between members and the cooperative enterprise. While in theory there cannot be such conflict of interests, as the enterprise is set up to support the interests of the members,



in practice such conflict often arises. Members may pursue short-term interests, particularly in times of distress, while the viability of the enterprise requires a more long-term perspective. For instance, short-term oriented members may favour a higher price for their products over investments that are needed for the long-term sustainability

of the cooperative enterprise. This classical horizon problem is a challenge for the BoD. Only a board with sufficient legitimacy can afford to take unpopular decisions. Good communication to the members of the ways in which the investments eventually will benefit them is absolutely necessary.



### Self-assignment 2.1

Dualities in cooperatives create tensions, but the case of *Delicias Criollas* in Uruguay shows that these can be solved by making good use of market opportunities, in this case selling the story of women's entrepreneurship.

What is the marketing story of your cooperative? How do you communicate that story to your customers?

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# Key functions of cooperatives in agricultural markets

Although all agricultural cooperatives work for the benefit of their member-farmers, they can have different functions (see Table 2.1).

Table 2.1: Main functions of agricultural cooperatives

Type of agricultural cooperative	Main function(s)
Marketing cooperative	Selling farm products Substituting middlemen and other intermediaries
Supply cooperative	Purchasing and reselling farm inputs (seeds, feed, fertilizers, pesticides, energy, water)
Insurance cooperative	Providing insurance, thereby reducing on-farm risks
Credit and savings cooperative	Providing credit and support savings Making self-financing possible through mobilizing savings of rural people
Other services: machinery, animal and plant breeding, farm relief	Supporting on-farm production with services that can only be maintained efficiently at a scale larger than the single farm

Many agricultural cooperatives offer a range of services to their members. When cooperatives perform more than one of the functions listed in Table 2.1, we call them multipurpose cooperatives.

Even if the cooperative has a focus on one of the listed functions, it can perform many different tasks. For instance, a marketing cooperative may only collect farm products and bargain with customers (comparable to a bargaining association). But it may also sort, grade, store, and package the members' products. A marketing cooperative for perishable products may also process the product into a less perishable form (for instance milk into cheese or butter). The marketing cooperative may limit itself to selling to traders and wholesalers, but it may also engage in retailing to the final consumer (Module 4 elaborates on cooperative marketing). Also, supply cooperatives may perform various tasks. They may limit themselves to collective purchasing of inputs and then distribute these among its members, but they may also start producing the inputs themselves, which is the case with animal feed cooperatives (see Module 3 for more details on supply services).

Whether the cooperative aims at delivering just one type of service or at providing a wide range of services depends on the local situation. If services are provided by others at competitive prices, there is not much reason for a cooperative to step into this market. However, if there is no supply of inputs and no reliable market, the cooperative may decide to take up these functions. Particularly in remote rural areas cooperatives choose to combine several functions. As such a multipurpose cooperative grows over time, it may be split up into several specialized (or single-purpose) cooperatives. It is up to the members to decide on the range of activities and functions.

### A multipurpose cooperative

This is a cooperative society with objectives that address multiple needs of its members. For instance, a village cooperative in a remote area may serve simultaneously as savings and credit cooperative, supply and marketing cooperative, consumer cooperative and cooperative providing social and medical services.

Source: Münkner, H.H. and J. Txapartegi Zendoia (2011), Annotiertes Genossenschaftsglossar, Annotated Co-operative Glossary, Glosario cooperativo anotado, International Labour Organization, Geneva.

A multipurpose cooperative has the advantage that farmers can shop for all their requisites at one address (the one-stop-shopping formula). The farmer can discuss both input requirements and market opportunities with the same technical expert of the cooperative.



The disadvantages of a multipurpose cooperative lie in the lack of strategic focus, the very diverse expertise the managers need to have, and the dilution of investment funds over multiple projects. Also in a multipurpose cooperative, it is

more difficult for the members to monitor and control the leadership. Still, the case of Cooagronorte in Colombia shows that a cooperative can succeed in finding the right balance between different activities, by ensuring solid financial backing.



## Case 2.2: An integral approach to member satisfaction

Many cooperatives face the dilemma of whether to provide a wide range of services or to specialize in just a few. Each of these options has advantages and potential disadvantages. When financial and administrative resources are scarce, it may be better to become good at providing just a few services, such as buying inputs or offering credit. On the other hand, members of cooperatives have many different needs, and it is likely that some of these needs are closely related to each other. For example, farmers may need support for farming activities, but this support would be worthless if they are unable to find adequate sales opportunities after the harvest. However, there is a danger that if the cooperative offers too wide a variety of services, it may spread itself too thinly and put too heavy a burden on its finances.

For the Agricultural Cooperative of North Santander, or Cooagronorte, a cooperative of rice growers in north-eastern Colombia, it was clear that an integral approach was necessary to ensure the well-being of its members, as well as the cooperative's own viability. Rice farmers in this part of Colombia face a major challenge: because the region borders with Venezuela, the local market is flooded with Venezuelan rice, which is much cheaper. For this reason, farmers need to transport their product to the centre of the country, where they face the competition from major domestic brands. For over a decade, Cooagronorte has established a policy of guaranteeing a minimum purchasing price, which is often much better than the market price. But the cooperative has realized that a competitive price is only one of the many factors that allow farmers to stay in business despite the difficult market conditions. Cooagronorte's approach has been to offer support for farmers from production to commercialization, and also beyond the farm: today the cooperative offers technical advice, credit, marketing services and even health insurance.

What makes this wide range of services possible is a virtuous cycle in which overall farmer well-being leads to better productivity, and greater productivity is the financial foundation that enables the cooperative to provide integral support for farmers. Despite being smallholders with average farm sizes of less than seven hectares, the members of Cooagronorte have some of the highest yields and lowest per-hectare cost for rice farmers in Colombia. This translates into a better income for the cooperative. Solid finances mean that the cooperative can continue to fund its farmer support programmes and maintain high levels of productivity. Is the approach successful? According to the cooperative's manager, the best proof is that after four decades of operation membership continues to increase.

**Source:** Based on an interview with Nelson Trujillo, President of Cooagronorte, an Agriterra partner organization.



## Self-assignment 2.2

List the kind of services your cooperative provides to the members. Write down the advantages and disadvantages of each of these services. (See also Module 2 on cooperative service provision).

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## How do cooperatives respond to changes in agricultural markets?

Food and agricultural markets in developing countries have undergone tremendous changes in the past decades. Globalization has intensified the integration of agricultural sectors of developing countries into global trade patterns. This has been paralleled by an on-going liberalization of the agricultural sectors in many developing countries, leading to privatization of state enterprises, and often, higher levels of foreign investment in domestic food marketing and production. Particularly, supermarkets have become dominant actors in the domestic food value chain in many countries.

As a result of the developments in national and international markets, small-scale farmers are faced with more competition. They are also facing (final) customers that demand higher quality assurance, and that force them to adapt their production techniques to higher standards. In many sectors there has been a shift from public to private food standards, and the implementation of strict traceability requirements, in response to consumers' concerns about food safety. In addition, rising incomes in many parts of the world and the consumer's "search for variety" have led to greater product differentiation and market segmentation (Module 4 elaborates on market segmentation). Agricultural products, previously traded as standardized commodities, are increasingly valued for specific traits and are differentiated according to their inherent quality attributes. Changing tastes and preferences of consumers are also linked to a rising concern for social and environmental effects of global business, which results in a growing demand for traceable products manufactured under responsible social and environmental conditions. These changes in consumer



demand offer opportunities for cooperatives and their members, when the cooperative can provide guarantees to its customers that the members produce in a responsible way. They can also involve risks, as the costs involved for ‘more responsible products’ may outweigh the benefits, or because the new demands raise barriers to access markets.

These developments in agricultural markets have increased interdependency among the different players in the market. These players can be called actors in a value chain. A value chain can be defined as the series of consecutive activities that are required to bring a product (a good or a service) from conception, through the different phases of production, processing and logistic handling to final customers. A value chain consists of both activities (transforming or handling the product) and actors. The actors are the farms and firms that actually handle the product. In each step of the value chain, value is being added to the product. In addition to the direct chain actors there are other organizations involved, supporting the smooth operation of the value chain. Box 2.1 gives an example of a rice value chain in Rwanda (Module 4 gives more information on value chains).



Farmers producing speciality products are more dependent on their buyers than are farmers producing commodities; and buyers purchasing customized products are more dependent on their suppliers than buyers of commodities. Interdependency among actors in the value chain requires coordination. Specialized farmers, cooperatives and customers will more closely coordinate (or align) their individual decisions and activities. For example, farmers producing beans for the international market do so under strict quality requirements, the cooperative makes sure that the members know the requirements and helps them with technical assistance, and the trader makes

sure that during logistic handling the quality is maintained, all to guarantee the quality to the retailer. Such a high level of 'vertical coordination' implies detailed contractual agreements among the different value chain actors.

Cooperatives can play a major role in helping farmers to enter into and benefit from such vertical coordination in value chains. They are the linking pin between farmers and buyers, they can provide the buyer with information on product and production characteristics, and they can provide the members with information on market demand and quality requirements. Cooperatives can obtain the necessary certificates on behalf of their members when it is too expensive for individual farmers to obtain a certificate. Often, apex bodies can support their members (primary cooperatives or cooperative unions) in obtaining the required certificates and in developing the bargaining skills needed under these new market conditions.

## Cooperative entrepreneurship in agriculture

Although the main objective has not changed – the empowerment of small producers – cooperatives nowadays need different means to achieve this goal. Instead of focusing only on the defensive role they used to play in the past (such as trying to obtain better prices for producers by strengthening their bargaining power), agricultural cooperatives are now challenged to take on a more proactive role in marketing, and engaging in value chain integration. A successful transition to this new role requires the acquisition of particular managerial capacities. For instance, in Africa many cooperatives have restructured their activities in response to changing political and market conditions.<sup>7</sup> Cooperatives that have managed to adapt to new market systems, the number of which continues to increase in many countries, are recording better performance than they did in the past era of state control. Such cooperatives seem to have reinvented the business wheel that they had lost when they were tied by restrictive regulation and adverse political sentiments. Whereas the future of cooperative development in a liberalized economic environment seems to be bright, the challenge is how to apply business virtues in the less-adapted cooperatives too.

The new managerial competences and the new perspective on the role of cooperatives in a value chain context are summarized under the concept of

7 F.O. Wanyama, P. Develtere and I. Pollet: *Reinventing the wheel? African cooperatives in a liberalized economic environment*, COOP<sup>AFRICA</sup> Working Paper No. 1 (Geneva, ILO, 2009), [http://www.ilo.org/public/english/employment/ent/coop/africa/download/wp1\\_reinventingthewheel.pdf](http://www.ilo.org/public/english/employment/ent/coop/africa/download/wp1_reinventingthewheel.pdf) (accessed 22 Sep. 2011).



cooperative entrepreneurship. Cooperatives need to become more innovative, more market and customer oriented and more strategic in their external relations. Apart from the more conventional features of entrepreneurs, such as being alert to new opportunities, possessing good judgment in uncertain conditions and daring to take risks, in order to deal successfully with current challenges, agricultural cooperatives also require the capacity to build new partnerships and to make strategic use of networks and relations with other stakeholders (more on this in Module 4).

## Can agricultural cooperatives become more entrepreneurial?

Because a cooperative is a collective action organization, governed on behalf of and by the members, it is not always clear who will be the entrepreneurs and to what extent the cooperative has to become entrepreneurial.<sup>8</sup> (One should first acknowledge that members are entrepreneurs on their own farm. In their farming activities they are taking risks, they are applying product and process innovations, and they are open for new business opportunities.) The cooperative, being an organization of and for its members, should provide support that facilitates the entrepreneurship of the members, for instance by providing training or helping members to find new markets. However, a cooperative is a collective organization, and it cannot support all members when they seek opportunities in very diverse directions. Thus, at the level of the cooperative, agreements have to be found among members on which individual entrepreneurial activities will be supported and which will not. The authority of the leadership, based on expertise and legitimacy, will play a major role in these difficult decisions. Another issue that will influence the direction and scope of member entrepreneurship is the position of the cooperative in the value chain. For instance, if the cooperative has a profitable and sustainable trading relationship with a major customer, the entrepreneurial activities of the members should not jeopardize this relationship. As the cooperative is trading on behalf of the group, it cannot easily revoke an ongoing trading agreement when a few farmers want to target other customers. Finally, in a larger cooperative there are also, in addition to farmer entrepreneurs, manager entrepreneurs. Good managers often desire a certain amount of autonomy to take decisions and to venture into new business opportunities. It is eventually up to the BoD, as the representative of the membership, to decide how much operational freedom the managers will be given. When managers want to

<sup>8</sup> J. Bijman and B. Doornewert: "Collective entrepreneurship and the producer-owned co-operative", in *Journal of Co-operative Studies* (Manchester, 2010), Vol. 43, No. 3: pp. 5–16.



exploit new business opportunities, it is their task to provide the BoD and the members with the best information on the advantages and disadvantages of the proposed projects. The BoD (for small projects) or the general assembly (for major investments) will then decide on the proposed projects. Good communication and a trustful relationship between the BoD and professional management is crucial for entrepreneurial cooperatives.

For value chain customers that seek new business relationships with (smallholder) farmers, cooperatives can be the right intermediary. The main benefit of working with cooperatives rather than with multiple individual smallholder producers is lower transaction costs. The cooperative takes care of (horizontal) coordination among farmers, including monitoring compliance to quantity and quality agreements. In addition to collecting the products, the cooperative may also engage in sorting, grading and packaging. Finally, cooperatives can obtain the certificates that today's customers want to see.



Cooperatives can certainly become more entrepreneurial. And in some markets they need to become entrepreneurial if they do not want to lose out to their competitors. However, cooperatives should realize that this may bring some tensions or dualities into the organization. Strong entrepreneurship by managers and strong entrepreneurship by members do not go together very well. If the manager sees new business opportunities and the cooperative decides to proceed into new products and markets, the individual members have to comply with these collective decisions. Sometimes it is possible to set up separate subsidiaries within the cooperative for different groups of members. If

the heterogeneity within the cooperative membership becomes too great, it may be better to spin off certain activities into a new cooperative.

An interesting development in food markets that can be beneficial for entrepreneurial cooperatives is the greater emphasis that large food processing and food retail companies currently put on CSR. Sourcing from smallholder farmers is one of the targets of CSR; strengthening environmental sustainability in the production of raw materials is another target. Both issues favour cooperatives, particularly in developing countries. This also presents a solution to potential conflict between business and social objectives. In complying with the CSR demands of their customers, cooperatives make good business when paying attention to the social needs of the members.



### Self-assignment 2.3

How does your cooperative deal with the opportunities and threats of stronger entrepreneurship by members and managers?

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# TOPIC 3

## Cooperative Governance



## Introduction to the topic

Once a cooperative has been established, members need to direct and control the activities of the cooperative enterprise. The questions of who within an enterprise has the right to decide, who is responsible for a specific decision, and who is accountable to whom, are all issues of corporate governance. More formally, we can define corporate governance as the structures and systems of control by which managers are held accountable to those who have a legitimate stake in an organization. It is particularly about the decision-rights of the board and managers, and the need for transparency in decision-making.

This topic addresses first the basic features of governing a cooperative. As a cooperative is a democratically-controlled enterprise, the extent to which its members are in control is crucial for its autonomy. The topic starts with the concept of corporate governance itself and then goes through different aspects of “cooperative governance”, like the allocation of decision-rights, the issue of accountability, the relationship between members and board, and the relationship between board and professional managers.

## Corporate governance within a cooperative

While cooperatives are also corporate bodies, they exhibit a number of structural characteristics that make their governance more challenging than the governance of non-cooperative enterprises. First, cooperatives apply democratic decision-making, while most enterprises apply autocratic decision-making. In other words, in a non-cooperative enterprise the top manager really is the boss: he/she has the right to make decisions, while in the cooperative the members are the “boss”: they ultimately possess the rights to decide what the cooperative should do, through the BoD that they themselves elect. Second, cooperatives apply delegation in their decision-making structure. While the members may possess the final decision-rights, in practice they have delegated these rights to a BoD. And the BoD, in turn, may have delegated some of the decision-making rights to professional managers, such as decisions on operational matters.

The key questions of cooperative governance relate to the allocation of decision-making rights among members, BoD and professional management. Tightly connected to the distribution of decision-rights are the issues of control, reporting and accountability. In a cooperative, members need to control the BoD and (indirectly) the professional management. The “mirror of control” is reporting: the BoD needs to report back to the members (for instance in the General Assembly), and the managers need to report to the BoD. Finally,

accountability is a key governance issue. A decision-making person or body that has been given certain decision-rights also takes responsibility for the decision and actions he/she takes. Thus, those taking decisions are accountable to cooperative members for the actions taken on the basis of these decisions.

When seeking appropriate governance structures in cooperatives one must take into account the following characteristics of cooperatives:

- Although cooperatives are primarily economic organizations working for the benefit of their members, they are also social organizations, concerned about the community in which they operate.
- Members of the cooperative have a dual relationship with the cooperative: they are both owner of the cooperative and customer of the products and services offered by the cooperative.
- The members of the BoD are elected by the membership, while professional management and staff are recruited. In some countries, the BoD also performs the main management functions. In small cooperatives, staff tasks are often taken on by the members themselves.
- Many cooperatives are multipurpose cooperatives; that is, they provide many different products/services to their members. Owing to the many different interests that (groups of) farmers have in the activities of the multipurpose cooperative, the governance of such a cooperative is more challenging.

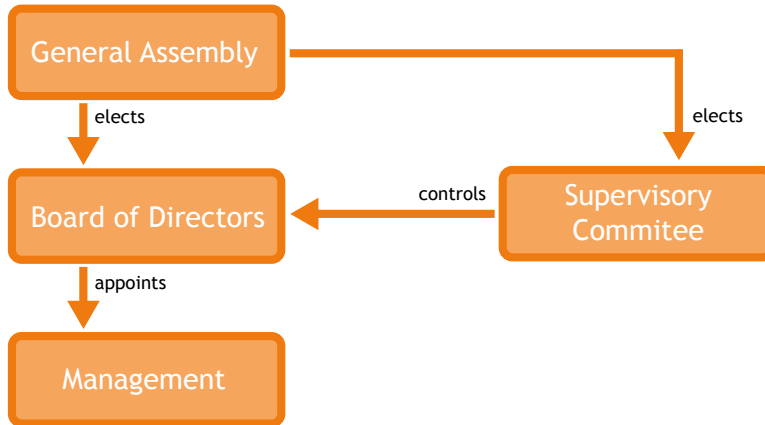
## Cooperative governance

### How does cooperative governance work in practice?

The classical model of cooperative governance implies that all members together, as constituting the General Assembly, usually convened in the annual meeting, elect the BoD. These directors appoint the executive managers, or they take up the management tasks themselves. Most cooperatives also have a supervisory committee<sup>9</sup>, chosen from among the members, which performs the task, on behalf of the General Assembly, of controlling the BoD. There can be several other committees, appointed by the General Assembly and/or BoD. Figure 3.1 presents the main governing bodies in any cooperative.

<sup>9</sup> Sometimes called a supervisory board. When the supervisory committee has the limited mandate of only assessing the financial accounts, it is named the financial committee.

**Figure 3.1: The Classical Model of Cooperative Governance**



## The BoD

The members, together in the General Assembly, are the most important stakeholders of a cooperative. They are not only the main users of the services provided by the cooperative, they are also jointly the owners of the cooperative enterprise. Still, the main governing body in the cooperative is the



BoD. The BoD develops the mission and vision of the cooperative, sets the strategy, directs the managers of the cooperative, communicates with the business partners of the cooperative, and reports to the membership. Therefore, electing the board members of the cooperative is one of the crucial issues in cooperative governance.

A number of questions arise regarding the election of members to the BoD:

- What type of person do we want in the BoD?
- Do the members of BoD represent the members of the cooperative (e.g. percentage of female members)?
- How long is the term and how many times can he/she be re-elected?
- Can only members be elected or also outside experts?
- Should more emphasis be put on managerial expertise or on political connections?
- Is it more important for BoD members to have technical skills or conceptual skills?
- Are the members of the board good communicators (with members, with managers/staff, with third parties)?

As is the norm in any democratic organization, the members of the BoD are elected for a limited period of time, often three or four years. Depending on the statutes of the cooperatives, members may or may not be permitted to be re-elected several times. It is a good policy to have members of the BoD step down after three terms in office. While the expertise of the incumbent board members is an important asset of the cooperative, it is good to change periodically, for several reasons. One reason is that the BoD needs to reflect the (composition of the) membership. As the membership changes, for instance when new members with different interests enter the cooperative, the BoD needs to change as well. Another reason relates to the necessary expertise of the board members. Cooperatives operate in a dynamic economic and political environment. Effectively dealing with the current environment may necessitate different skills and knowledge from those that suited the environment of ten years ago. If elected leaders remain in office too long, this may lead to inflexibility and short-sightedness.

The cooperative must strike a balance between the competing merits of longer and shorter periods in office. On the one hand, it is desirable for board members to be in office long enough to provide continuity of strategy and policy and to develop expertise that results in an increased contribution to the performance of the cooperative. On the other hand, room should be regularly be made for new members with new insights. In order to maintain expertise in the BoD, not all members start their office in the same year. If the term of office is three years, only one third of the board positions are open for election each year.

In some countries, cooperatives invite outside experts (in accounting, marketing, etc.) to participate in the BoD, in order to be in a better position to control the management. This is mostly the case in large cooperatives with a professional management.





### Self-assignment 3.1

What is the expertise of the members of the BoD of your cooperative? What kind of expertise do you think is missing?

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### Why hire professional managers?

In small cooperatives, the BoD usually also carries out the day-to-day management tasks. These organizations cannot afford to hire professional managers. However, as cooperatives become larger, professional managers are often appointed to manage the enterprise. These managers report back to the BoD on a regular basis. Major decisions are still taken by the BoD.

There are three main reasons for cooperatives to hire professional managers:

- as the cooperative grows it becomes increasingly difficult for elected leaders to govern the cooperative, manage daily operations, and simultaneously have time to manage their own farms;
- the members of the cooperative often do not have the management skills and experience to manage the enterprise effectively;
- managing an enterprise in a dynamic market requires quick decisions and a rapid response to changing conditions and new opportunities in the market. However, committees or elected leaders tend to be slow and bureaucratic, while professional managers with delegated authority can often manage the enterprise more effectively.

Although the need for hiring a professional manager might be recognized, finding the right manager can be a challenge.

### Women in cooperative governance

Women should not be left out from the governance of the cooperative. The same applies to youth and disadvantaged groups. In many countries, women perform a large share or even the predominant share of farming activities. It is therefore prudent that they get involved in the leadership of the cooperative at all stages and are encouraged to participate in meetings and decision-making

processes. This can be enhanced by development of gender policies, which give guidelines on how to involve women and other vulnerable groups in governance.

A checklist of questions can help to assess whether women can exercise their rights and obligations as cooperative members of mixed agricultural cooperatives:<sup>10</sup>

- Is joint membership or dual membership encouraged?
- Do women have a right to vote if the cooperative membership is household-based?
- Is women's role in rural cooperatives/crop production fully recognized or valued?
- Do women members attend committee meetings, join in discussions, and exercise their voting rights?
- Are women members involved in decision-making?
- Do women participate in the economic affairs of the cooperative and monitor its progress?
- Is the language used at meetings understandable to all participants, or only those with some formal education?
- Are cooperative meetings (committee meetings, general assemblies, etc.) scheduled at times that are suitable for women, and are amenities such as child care facilities made available?
- Is information about forthcoming meetings easily accessible to women? Is care taken to use the right channels?
- Do women members participate in elections, and stand for election as office holders?

## Challenges in cooperative governance

The cooperative is likely to encounter challenges in its governance structure. These particularly relate to the relationship between the members on the one hand and the leadership on the other hand, where there may be conflicts of interest arising from differing goals. In economic literature these challenges are called 'agency problems'.

<sup>10</sup> ILO/ICA: *Gender issues in cooperatives: An ILO/ICA perspective* (a gender sensitization package) (Geneva, 1995), <http://www.ica.coop/gender/ica-ilo-manual/index.html> (accessed 22 Sep. 2011).

## Agency problems

In a cooperative the members delegate tasks or decisions to the BoD. The membership expects that the BoD's decisions will be in the interests of the members. However, BoD members may have private interests. If the members have full capacity to monitor the decisions of the BoD, there is no problem. However, in reality, members do not have the competences and resources to monitor the behaviour of the BoD.

The two classical means to prevent the BoD from pursuing private interests are (1) having a supervisory committee that controls the board, and (2) the periodic re-election of board members. The General Assembly also has the power to dismiss the full BoD, if necessary.

Another agency problem can occur between the BoD and the professional management. The latter usually has much better knowledge of the operations of the enterprise and/or the demands of customers. There is a risk when cooperatives become manager-driven. Managers may abuse their information and knowledge advantage by pursuing their own interests and not the interests of the cooperative.

There are two general solutions to agency problems. The first solution is to align the interests of the principal with those of the agent, for instance in making remuneration of the agent partly dependent on the performance of the cooperative. The second solution is to increase the amount of information that the principal receives about the behaviour

of the agent. In other words, communication and transparency are crucial for the principal to exercise his/her control task. In practice, these two solutions are often applied together.

How can an agricultural cooperative deal with the agency problems in the BoD–manager relationship?

There are different ways for dealing with agency problems. Let us give three examples:

### Agency problems

A classical agency problem is between a principal (person A) who delegates a task or decision to an agent (person B). The principal gives an incentive (e.g. a salary or a one-time payment) to the agent to carry out the task. The problem is that the principal does not have full control over the agent and does not have full information on what the agent is doing. As a result, the agent can shirk his/her responsibilities, which means that the agent puts in less effort or delivers lower quality. Performance cannot be easily be measured by the principal, as collecting full information is costly or just impossible. The question then is what combination of incentives and control leads to the best performance.



- linking manager benefits to specific performance measures of the cooperative, such as the milk price paid to the members of a dairy cooperative;
- attracting managers from the farming community and the families of members. These managers share the norms and values of the community and are therefore less likely to misuse their power;
- when the management responsibility is given to professionals, the BoD needs to also become more professional, either by the training and education of board members or by hiring outside experts to advise the BoD.

The next case, on artificial insemination in a dairy farmers' cooperative in Kenya, illustrates how reaching consensus among members and managers about critical needs and specific ways to address them can help solve conflicting interests, in this case between members and management.



### Case 3.1: From determining needs to executing actions

Members of cooperatives need good managers, and managers need members – but they may not always see eye to eye. These discrepancies arise from the simple fact that members are interested in their own well-being, while managers need to ensure the well-being of the organization, and these two things are not always compatible. For example, members may have a very specific idea about what would be a good intervention by the cooperative, but the managers may consider that idea either impossible or too expensive to execute. This creates a conflict: members see managers as detached bureaucrats who think they “know best”, and managers can see members as dreamers with unrealistic expectations.

Dealing with these sorts of tensions is essential to ensure that members' needs are met effectively in a way that is sustainable for the cooperative. The implementation of an artificial insemination program by the Ngwataniro Dairy Farmers' Cooperative in Kenya offers some important clues about how involving both members' and managers' perspectives in defining the problems is a key to their successful solution.

The dairy farmers in the Rift Valley of western Kenya depend on good milk production to ensure their survival. About five years ago it became obvious to the managers of the Ngwataniro cooperative that improving the breeds of the cows was a necessary condition to increase productivity and ensure better incomes. An artificial insemination programme would result in a long-term improvement of the genetic stock and increase milk production, but the process would require money and time. The top management brought the entire leadership of the cooperative on board with the idea, and then presented the case to the member assembly.

The members were all too aware of the need for better cattle breeds and agreed that artificial insemination was the best way forward, so they enthusiastically supported the idea and committed themselves to its implementation.

Crucial to the success of the artificial insemination project was the fact that members did not see it as something imposed from the top, but rather as part of a process in which their voices were heard and their needs taken into account. This helped mobilize the members around the common goal, and made it possible to raise the necessary funds to carry out the process. Low productivity was a chronic problem that members helped identify, and artificial insemination was a solution they felt they owned. The support of members was crucial for the success of the programme. Apart from providing a concrete improvement in their livestock and milk productivity, the artificial insemination project also helped build a sense of confidence between the members and the management that ultimately strengthened the cooperative.

**Source:** Based on a written report prepared by the Swedish Cooperative Centre.

## Other governance challenges

There are a number of other challenges that can affect cooperative governance, such as a lack of commitment of members, low representation of certain groups of members in governing functions, lack of skills, and lack of autonomy.

### Commitment

Members may be unwilling (through low commitment) or unable (because they lack the necessary competences) to participate in the governance of the cooperative, particularly to control the BoD. Solutions can be found in capacity building, for example through education and training. See below for a longer discussion on commitment.

### Inclusion

Gender imbalance in leadership results in under representation of a significant part of the cooperative member base. A solution could be to take affirmative action and encourage the election of women in leadership roles. This might require providing leadership training for women or making practical changes to how governance is handled (meeting times, culture of decision-making, etc.). Gender imbalance in leadership may also lead to adverse treatment of women members. Giving membership to the whole family instead of to one individual and investing in gender awareness training and improving the capacity of women to participate in decision-making processes can contribute to a solution

for this problem.

In addition to women, other members can also face discriminatory practices. This risk is especially high in a multipurpose cooperative. A reason for these bad practices can be that the BoD or managers favour particular activities or products.

## Skills

Another challenge is to make sure the members of the BoD and the managers have the right skills and knowledge, particularly if the market environment is changing. Leading a cooperative requires both lobbying (political and social) and entrepreneurial skills, and this obviously entails a cost. In case of a lack of skills, it requires an investment in capacity building. If one is not yet present, hiring a professional manager is another option.

## Autonomy

Agricultural cooperatives often receive substantial support from outside stakeholders, including governmental agencies, donors and development NGOs. This support in general is greatly appreciated and in some cases even indispensable to the establishment of the cooperative. However, cooperatives are and should remain autonomous member-based organizations. This implies that external organizations supporting the cooperative should not take control, and that members should not see the cooperative as a vehicle for accessing external support rather than using their own initiative. Even when receiving outside support, the cooperative should remain member-based and member-driven.

Autonomy is also at stake if leaders of the cooperative use the organization for political purposes; when, in their decision-making, the members of the BoD do not place the interests of the membership centrally but their own political ambitions. In this case a solution is to de-link the cooperative and politics, to ensure good control by members, and to restrict the number of terms in office.



### Self-assignment 3.2

How do you view your cooperative in terms of female leadership? How many women fulfil leadership roles? What are in your experience advantages of having women leaders in your cooperative?

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## Member commitment

### What about member commitment?

Having good reasons to set up a cooperative and/or become a member does not automatically mean that members remain committed to the objectives of their cooperatives, or continue to invest in the collective over a long period of time.

Three elements of commitment are usually distinguished:

- a strong belief in and acceptance of the objectives and values of the organization;
- the willingness to make an extra effort for the organization;
- the desire to remain with the organization.

#### Definition of member commitment

The preference of members to continue to trade with the cooperative even when the price or service offered by the cooperative is temporarily less attractive compared to the price or service offered by another firm.

Member commitment is important for cooperatives for a number of reasons:

**Member commitment allows the cooperative to prepare realistic work and budgets, including sound investment plans.**

Long-term investments require some guarantee that members continue to patronize the cooperative. When members easily withdraw their patronage, the BoD may be reluctant to make otherwise efficient investments because they fear idle capacity. Because remaining members are negatively affected by the exit of others (because the cooperative facilities will be run at lower efficiency), there is traditionally a strong social pressure within the community of members to remain committed.

## Being a member of a cooperative requires investment in time and effort

As cooperatives are member-controlled organizations, members need to participate in the governing bodies, to attend the General Assembly to elect board members, and to approve (or disapprove) the strategies, policies and financial accounts of the organization. If members are not committed, they may not want to invest time and effort in participating in the governance of the cooperative. Participation and commitment have a reinforcing effect. Not only does participation in the governance support commitment to the organization in general, it also provides the commitment to the decisions of the BoD, and thereby, makes implementation of those decisions easier. In other words, the more committed the membership the more likely the cooperative can make decisions by consensus, which in turn supports smooth and efficient implementation of decisions.



## Cooperatives are usually financed by their members. Weak commitment results in low willingness of members to provide (additional) equity capital.

A cooperative needs working capital and investment capital to run the enterprise in an efficient and effective manner. As the third cooperative principle states, members contribute to the capital of their cooperative. If a cooperative has a surplus, the BoD and General Assembly can decide to distribute the surplus among the members or to retain this surplus in the cooperative, for new investments. Weakly committed members are more likely to push for distribution of surplus, which results in the cooperative enterprise to have less capital available for new investments.

## Commitment reduces costs in member-cooperative transaction and prevents opportunistic behaviour.

Committed members are less likely to free ride on their cooperative. In addition, committed members are more willing to exchange private information with the cooperative enterprise, such as information on the quality of the products delivered. For instance, in dairy cooperatives, committed



members may be more likely to report events like the contamination of the milk with antibiotics (used to treat sick cows). Milk with even a small amount of antibiotics has severe effects in cheese making because the antibiotics block the working of bacteria that coagulate milk fats, an important step in the cheese making process. If the cooperative cannot fully trust its members, it has to install expensive control measures.

The risk of fluctuating or low member commitment is illustrated in the next case of pig producers and slaughtering cooperatives in the Netherlands.



### Case 3.2: Low commitment can lead to the end of the cooperative

Commitment can sometimes be very difficult to maintain. In the Netherlands, most pig producers were members of a slaughtering cooperative. However, when a private trader offered a higher price, which was possible because private slaughterhouses in neighbouring Germany or Belgium offered higher prices, farmers had an incentive to deliver their pigs to the trader and not to their own cooperative. Eventually all slaughtering cooperatives went bankrupt.

## What can be done to keep members committed?

Member commitment can be affected by social, economic and organizational factors. There are at least two economic factors affecting commitment: dependency and direct economic benefit. The extent of dependency varies with the availability of alternative options to the farmer. A farmer that does not have alternative supply or marketing options is likely to be more committed. The extent of direct economic benefit of membership is determined by the amount of services that the cooperative provides and by the price and quality of these services. Better quality leads to stronger commitment.

Does the cooperative offer a good price for farm products, compared to other buyers? Does the cooperative offer good quality and low priced inputs, compared to other suppliers? Also important is whether the cooperative pays on time. It is not unusual for cooperatives to delay payments to farmers. If this is common practice, members might consider selling to private traders if they are in need of fast cash. The case of the Kabianga Cooperative in Kenya shows how instant payment through *invoice factoring* solved the lag between production and payments.



### Case 3.3: Invoice receipt systems to ensure continued payments

One of the major financial challenges faced by farmers around the world is that they need money for family consumption and for paying farming costs, but income only arrives after the harvest season. To make matters worse, payment for the crops usually does not occur immediately, but after a significant delay. Often, farmers are so strapped for cash that they will sell quickly to buyers, even at a relatively low price. This locks producers into a vicious circle from which it is hard to escape.

Tea producers in western Kenya were faced by exactly this predicament.

Although tea can be produced more or less continuously throughout the year, farmers had to wait up to three months to be paid after the leaves were sold at auction in Mombasa. Even though many of these farmers were associated in the 3,000-member-strong Kabianga cooperative, the lag between production and payment made it difficult for them to finance their operation continuously and adequately. The cooperative decided to take two steps to remedy the situation. First, it reopened a tea processing factory so that it could sell the tea directly to the Mombasa auction without going through intermediaries. Second, to guarantee financial support, it approached Biashara Factors, a microfinance institution that provides invoice factoring services.

Invoice factoring is a clever idea to help farmers deal with delayed payment. Farmers sell to their buyer (in case the Mombasa auction) and issue an invoice. Typically farmers would just wait for 30 to 90 days until the payment came through. Under the new arrangement, however, farmers go to the factoring company (in this case Biashara) and sell their invoices. Almost immediately, farmers receive between 70 and 90 per cent of the value of their sale from the factoring company. After the tea is sold at the auction, the factoring company collects the payment and pays the remaining money to farmers, minus interest and a processing fee.

Invoice factoring has strengthened the finances of the Kabianga Cooperative. Members are much better able to repay their debts, and other farmers have been lured to join by the possibility of receiving regular payments. The volume processed in the factory has increased, and this in turn has given the cooperative more solid backing to seek additional sources of funding to expand its services. As the cooperative becomes more and more self-sufficient, it depends less on the services of Biashara, but continues to offer the simple but powerful service of invoice factoring.

**Source:** Based on the case study "Micro-factoring: Instant payment on delivery of tea in Kenya", published in The Royal Tropical Institute, Amsterdam, and International Institute of Rural Reconstruction, Nairobi: *Value chain finance: Beyond microfinance for rural entrepreneurs*, (Amsterdam, KIT Publishers, 2010), and on an interview with Billy O'Mathu, President of Biashara Factors.

Cooperatives can tie in their members not only by paying the highest price and offering the best services; they can also offer a package of services (e.g. supplies in combination with technical assistance, or marketing in combination with credit). The package makes it unattractive for farmers to leave the cooperative.

An important social factor that influences member commitment is the presence of norms of solidarity in a community. If it is the norm to be a member of the cooperative and/or to help each other, members are more likely to be committed. Such norms are usually stronger in small communities, and work less well in a cooperative that covers a large geographical area. Another social factor is the presence of trust. Do the members trust the leadership? In other words, has the leadership shown, over the years, that it is trustworthy?

Low trust in the leadership leads to weak commitment of the members.

The third set of factors that affect commitment are organizational factors. As stated above, there is a mutual relationship between participation and commitment.

Members who actively participate in the decision-making of the cooperative are generally more committed to the cooperative. Another organizational factor is communication. Farmers want and need to be informed about everything the cooperative does and decides, not only because they are supposed to participate in the governance of the cooperative, but also because membership is voluntary. If members are not informed about what the cooperative decides, and particularly about why specific decisions are taken, they become less committed.

Another organizational factor affecting commitment is the heterogeneity of the membership. When the cooperative has many different members, for instance in terms of products they deliver or in geographical locations, then members can easily get the impression that some (group of) members get better treatment than other members. This perception can be reduced by being as transparent as possible about what services are offered to which group of members. Also, introducing the proportional cost principle may reduce distrust about uneven treatment. The proportional cost principle means that those members for whom the cooperative incurs high costs also pay a higher fee. Of course, the advantages of introducing this principle have to be weighed against the disadvantages of weakening the principles of solidarity and equity.



In sum, commitment is important for all cooperatives. Committed members are more likely to stay with the cooperative, to participate in the governance bodies of the cooperative, to abstain from free riding on cooperative services, to invest in the cooperative, and to defend the cooperative towards others. Commitment can be maintained or even strengthened by good communication between members and the cooperative, having trustworthy leaders, offering good services, and paying prices as least as good as alternative buyers.



### Self-assignment 3.3

What, in your cooperative, do you do to keep members committed? What are, in your experience, the main challenges to ensure that members remain loyal to their cooperative? And what are the solutions to these challenges?

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# TOPIC 4

Management, Capital  
Formation and Finance



## Introduction to the topic

This topic concentrates on business management aspects that are specific to agricultural cooperative enterprises. It does not cover those general aspects of business administration that are common to commercial and cooperative enterprises. Managerial tools such as business planning, budgeting, preparation and analysis of financial statements, which are essential management tools in both a cooperative and a commercial enterprise, will therefore not be discussed in details in this topic. It is assumed that the audience has a basic understanding of these tools.

We start this topic with some general statements on management, to explain what roles managers play in a cooperative enterprise. The issue of who performs the management functions, the BoD or professional management, has been dealt with in the previous topic and will not be repeated here. In this topic the focus is on how best to perform the management functions. This topic also addresses the issue of finance. Members are the main source of capital for agricultural cooperatives, but many other sources exist. Although it is important not to become dependent on external funding, so as to remain autonomous, a lack of capital can seriously constrain the functioning of a cooperative. One way of solving the issue of obtaining sufficient capital is to look at the challenge from a value chain perspective: value chain actors can support each other in obtaining and sharing credit. The last aspect of management dealt with in this topic is audit.

## Cooperative management

Managers, whether they work in a cooperative enterprise or another type of firm, have different roles to play. All managers have three principal roles: an interpersonal role, an informational role, and a decisional role (see Table 4.1). In a cooperative, the weight and the content of these roles may be different from those in other types of businesses.

### The interpersonal role

The manager has an interpersonal role: he/she interacts with other persons, as leader of the technical team, the staff members of the cooperative, and as liaison to other parts of the organization and to other organizations. In a cooperative, the manager is the liaison between the enterprise and the BoD (representing the membership). The manager is accountable to the BoD and the members.

### The informational role

The manager plays an informational role: he/she collects and disseminates information, such as on the operational processes of the cooperative enterprise, on the performance of persons and departments, and on external developments and customer demands. Only on the basis of accurate and up-to-date information can the manager take his/her decisions and make proposals to the BoD. In a cooperative, the role of spokesperson is usually assumed by the chairman of the BoD, but he/she can share this role with a professional manager.

### The decisional role

The manager takes decisions about the operations of the cooperative enterprise, for instance in allocating resources and employees to different tasks. The manager may also develop new plans on the basis of his/her assessment of the changing environment and new market opportunities. Thus, the manager is also an entrepreneur. Another task of the manager is to negotiate with outside parties, such as in purchasing supplies or in selling farm products. Finally, the manager should resolve conflicts that arise among employees or between members and the cooperative (in consultation with the BoD).

**Table 4.1: The three roles of the manager<sup>11</sup>**

Interpersonal role	Informational role	Decisional role
Leader	Monitor	Entrepreneur
Liaison	Spokesperson	Allocating resources
Conflict resolution		Negotiator

### What kinds of skills do managers need?

Effective management of a cooperative requires two types of skills. First, the manager needs the general management skills and knowledge that would also be required in a non-cooperative enterprise having the same operations. These include skills in financial and technical matters and in human resource management. Second, the manager needs to understand the specific organizational structure and governance of the cooperative. While in other businesses managers are at the top of the organizational pyramid, taking most of the strategic decisions, in a cooperative there is always a BoD that is directly

<sup>11</sup> Adapted from: <http://www.bola.biz/mintzberg/mintzberg2.html> (accessed 7 Oct. 2011).



involved in deciding on the current and future activities of the cooperative. Thus, managers in a cooperative have less freedom to take decisions than managers in non-cooperative enterprises. This implies that not all managers will fit in a cooperative organization. Those that consider their autonomy to be of utmost importance may not fit well in a cooperative. Another element specific to the cooperative is that the manager often has to explain his/her decisions to the members. For members to be kept committed, they must be given plentiful information about the manager's decisions and the consequences for their own farms. It is common in cooperatives that managers regularly speak at member meetings.

As cooperatives are increasingly participating in coordinated value chains, managers need to have specific skills and expertise related to logistics, quality control, tracking and tracing, certification, etc. If such expertise is not available, managers should

receive appropriate training. In hiring new managers, explicit attention should be given to the skills, knowledge and experience candidates have in supply chain management and quality management.

Another type of management skill that is increasingly important, both

when cooperatives grow and when they become more embedded in a value chain, relates to human resource management. Managing the employees in the operational area of marketing may be more challenging compared to that of managing production workers, because being a good marketer relies more on personal skills. This requires that the general manager himself/herself has good knowledge of marketing theory and practice. It also requires specific combinations of incentives and control to ensure that marketing employees put in the necessary effort. Case 4.1 gives an example of the human resource challenges for a cooperative and how they can be solved by smart organizational design.





### Case 4.1: Organizational re-design to lower dependency on sales agents

In 1999 the Bolivian coffee cooperative COAINE (Cooperativa Agropecuaria Integral Nor Este) experienced problems with its marketing personnel, who did not inform members of the prices they received when selling the product. Prices were higher than those reported back to the members. The employees were fired but took with them most of the market information and customer contacts. As a result, COAINE failed in its obligations to international clients and almost went bankrupt. It found a solution by decentralizing marketing decision-making by installing regional marketing committees. These committees function as supervisory committees for the commercial personnel of COAINE. From 2002 onwards COAINE was back again as a coffee exporter.

Source: Rubén Monasterios, case-interview for base-line organizational strength, part of impact assessment small-grant fund, *Fondo para el Fortalecimiento Económico de las Organizaciones Económicas Campesinas* (FONDOECA), May 2011.

Another expertise that is of high importance for managers of cooperatives is financial management. Managers need to be able to manage the finances of the cooperative in a transparent way, not only to be able to report to the BoD but also to be able to explain the finances of the cooperative to the ordinary members. As the members are formally the owners, they have the right to receive information on the financial situation. Also, when the cooperative has to comply with all kinds of supply chain requirements, managers should be able to make the cost/benefit analysis of new requirements and inform the BoD and members.

## Capital formation and finance

Cooperatives, like all businesses, need capital to invest in new projects and new assets. The necessary funds may come from different sources: members, retained earnings, and external finance. For agricultural cooperatives, access to capital and finance is a major challenge. Financial service providers such as banks generally regard the agricultural sector as too risky and involving high transaction costs. They doubt the ability and willingness of agricultural entrepreneurs to repay their debts. Potential lenders may also perceive high risks because they lack understanding of the agricultural sector, and have no way to evaluate the risks involved.

It is common among cooperatives that their members put in a certain amount of capital. As providers of risk capital (or equity capital), the members become

the owners of the cooperative enterprise. Even when outside supporters (government, NGOs) provide subsidies and other funding, the members should remain the main source of finance for the cooperative. To become a member, persons contribute a certain amount of money or payment in kind to finance the jointly-owned cooperative enterprise for the duration of membership. This contribution can be claimed back upon termination of membership.

The capital (or reserve fund) created through the retention of earned surplus represents a commitment by members who would otherwise have had that portion of surplus distributed among them. The decision on the surplus distribution is formally taken by the General Assembly, usually on a proposal from the BoD.

Members can also provide credit to the cooperative. This is attractive for both sides. The members usually receive interest that is above that which they would receive on a savings account. The cooperative pays an interest that is lower than that which it would have to pay when borrowing from a commercial bank. This is a classical advantage of a cooperative, where a durable and trustful relationship between members and cooperative leads to low transaction costs (commercial banks charge higher interests because of the risk of default). Another advantage of this kind of external financing is that it comes from the members, i.e. the cooperative remains independent of banks and donors.

External finance can come from cooperative and commercial banks, microfinance institutes (MFIs), cooperative support organizations, suppliers, buyers or others. In the majority of cases, external capital providers are motivated by profit and expect security in the form of collateral, as well as a commercial interest rate. In the case of agricultural cooperatives finance can also come (partly) from donor organizations, either directly or indirectly (as is the case in the Rwanda rice chain).

### Value chain finance

Value chain finance is offered when one or more financial institutions link into the value chain, offering financial services that build on the relationships in the chain. The seller, the buyer and the financial agent work together, using the business relations in the value chain as a carrier to provide financial services. (See Module 4 for more information.)

Source: The Royal Tropical Institute, Amsterdam; and International Institute of Rural Reconstruction, Nairobi: *Value chain finance: Beyond microfinance for rural entrepreneurs*, (Amsterdam, KIT Publishers, 2010).

When the cooperative earns a surplus<sup>12</sup> it can be distributed in different ways. One part goes to the members in proportion to their trade volumes with the cooperative. This is called patronage refunds or reimbursements. Another part is retained as reserves in the cooperative in order to finance investments for growth and development of the organization. Most cooperatives do not pay out a dividend on member shares. It is more common that members receive a fixed interest on their capital contributions, as members do not contribute to the equity capital of the cooperative to receive the highest return on investment, but because the cooperative needs capital to carry out its activities.

The way in which the surplus is distributed is stipulated in the by-laws of the cooperative, although the exact figures can be decided upon by the General Assembly, usually on the basis of a proposal from the BoD. One can imagine that each year, if there is a surplus, tough discussions take place on whether to pay out a patronage refund, which is mostly favoured by the members, or to retain it in the cooperative as part of equity capital or indivisible reserves (for instance for future investments). Members are more likely to accept the outcome of this discussion when they are satisfied about the services of the cooperative and trust its leadership.

It can be difficult to satisfy both members and their financial needs and to assure the financial viability of the cooperative, The next case, on the Katerera Area Cooperative Enterprise in Uganda, illustrates how the cooperative dealt with the chronic problems of access to credit and resources by integrating credit and marketing services within the same cooperative structure.



### Case 4.2: Linking financial and marketing services

Lack of credit and lack of markets are sometimes two sides of the same coin. Farmers may find buyers who will pay good prices for their crops, but they lack the resources to finance their production. Or they may have adequate financial resources, but have to sell their crops below the market price.

The Uganda Cooperative Alliance (UCA) has come up with an innovative way of tackling these two problems at the same time: the Integrated Cooperative Enterprise model, in which a credit union and a marketing cooperative work hand in hand.

12 "Cooperatives calculate the prices for transactions with their members near costs. In order to cover market related risks, a small profit margin must be included that will, however, be returned to the members at the end of the financial year, should the risk not have materialized, and should the balance sheet show a profit. This redistribution, in the form of patronage refunds, calculated pro rata of the transactions with the cooperative, thus constitutes a deferred price calculation/reduction. Therefore, instead of speaking of "profit" in this connection, one should speak of temporary surpluses." H. Henry: *Guidelines for Cooperative Legislation*, 2nd edition (Geneva, 2005) p. 47.

With the support of the UCA, the Katerera Area Cooperative Enterprise (ACE) has been able to establish an integrated enterprise model that has benefited its members, and assured the financial sustainability of the cooperative.

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The integrated model involves two different cooperatives. The first is the Rukooma credit union, which analyses farmers' needs and extends loans so that farmers can finance their production of cotton, maize or beans. Producers are given a grace period, and are expected to pay at the end of the marketing season. The second is the marketing cooperative, the Katerera ACE. After the harvest, farmers take their crops to the Katerera ACE, where they are given a voucher that is worth 75 per cent of the agreed value of the crop. The farmer then goes to the credit union, where the voucher can be cashed or deposited for saving. If a credit had been given, the loan is recovered from the sales voucher. From the remainder of the sales value, Katerera ACE collects a commission that allows it to cover its operational costs and turn a profit.

The strength of the integrated model is that the credit union (Rukooma) is financing the work of the marketing cooperative (Katerera), and at the same time the marketing cooperative is providing the mechanism that guarantees repayment to the credit union. The complementary work of these two cooperatives assures the financial sustainability of the credit union and allows it to attract further funding. It also enables the marketing cooperative to maintain a stable and predictable supplier base that is needed to negotiate a good price in the market.

Source: Based on a written assessment of the Katerera ACE provided by Mascha Middelbeek, Agriterro liaison officer.

## How can the cooperative attract more capital from the members?

As stated above, the members are the main source of finance. When the cooperative wants to develop new activities and wants to become more entrepreneurial, additional equity capital is often needed (it is usually very difficult to obtain additional loans for risky ventures or the cost of capital

becomes too high). What can the cooperative do to attract more capital from the members?

The cooperative needs to provide transparent information to both members and potential members on which they can make a sound judgment regarding whether or not to invest in the cooperative. Members will only invest if they are aware of the level of risks of the investment and hence the likely benefits. They should be the final judges of whether any investment will take the cooperative closer to the commonly agreed objectives.

Improving the services offered and the overall efficiency of the cooperative will also affect funding, attracting more members and more business, and raising member commitment. Funding and efficiency can reinforce each other, in two ways. First, cooperatives with sufficient funds are able to invest in appropriate technology that reduces costs or improves quality, or both. As a consequence of the state-of-the-art technology, they are generally more likely to earn a surplus that contributes to improving the financial status of the cooperative. On the other hand, a cooperative using poor or outdated technology and with insufficient funds has greater difficulty in improving its level of efficiency. Possible ways of breaking this vicious circle include looking for ways to use labour more efficiently, ensuring that paid staff numbers are not excessive, and that individuals are committed to the work. Another approach includes retaining part of the surplus whenever possible, as for example in normal agricultural years.

Second, members' loyalty or their volume of turnover with the cooperative can be maintained or raised through competitive pricing policies, favourable payments and access to credit. Extending credit facilities and making prompt payment for deliveries requires working capital. This is another case where money is needed to make money. Short-term cooperative loans or good value commercial loan finance may help achieve a level of turnover that could trigger the process.

In certain processing and marketing cooperatives (so-called new generation cooperatives), the founder members purchase delivery rights that guarantee that the cooperative will purchase a given amount of produce each year and that members will deliver a certain amount of produce. These rights are freely transferable among members, which gives them a market value. As a consequence, members have an incentive to behave in a way that maintains and increases the value of their rights.



### Self-assignment 4.1

Both the rice value chain (Box 4.1) and the case of Katerera Area Cooperative Enterprise in Uganda (Case 4.1) show examples of innovative ways of addressing both the financial needs of an agricultural cooperative and of its members. What is the financial need of your cooperative and that of your members? What kinds of (potential) ways do you consider to address these needs?

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## Value Chain Finance

External financiers may be willing to provide credit to a cooperative if they value relations within the value chain. Box 4.1 illustrates how the rice cooperative in Rwanda (see also Box 2.1) accessed credit from a microfinance organization and the conditions that made this “risky” business feasible.









The farmer presents the voucher to the MFI office, and the MFO pays the farmer the full value of the paddy delivered, after deducting the production loan and interest (7). The value depends on the price the cooperative has negotiated with the trader (it sells to the trader who offers to pay most). The trader pays the cooperative through the MFI (8), enabling the cooperative to repay its credit line. This system works well because all payments are made through the MFI, and both the cooperative and the MFI are custodians of the warehouse and jointly control the flows of paddy into and out of it.

The MFI's credit officers helped the cooperative carry out an internal assessment to find out why the cooperative was continuing to lose money. They discovered this was mainly due to transport expenses. The cooperative used to hire lorries to carry paddy to millers in Kigali; the costs were so high that it was impossible to make a profit. The cooperative was too new to be able to buy its own lorry, and it had nothing to use as hard collateral to get a loan. So the MFI leased a five-ton truck to the co-op (9), and it started to generate a net income. Why a lease rather than an investment loan? Because the MFI still owns the truck until the cooperative has paid off the lease. That reduces the MFI's risk.

Thanks to lower transport costs, better governance and transparency, and fewer production leakages, the cooperative started making a profit in 2008. The cooperative retains around ten per cent of its profits as savings and then distributes the remainder to its members as a dividend (10).

**Source:** The Royal Tropical Institute, Amsterdam, and International Institute of Rural Reconstruction, Nairobi: Value chain finance: *Beyond microfinance for rural entrepreneurs* (Amsterdam, KIT Publishers, 2010).

## Audit of cooperatives<sup>13</sup>

An audit is generally defined as “An independent examination of, and expression of opinion on, the financial statements of an organization by an appointed auditor, who carries out his/her duties according to accepted audit standards and in compliance with a statutory obligation”.<sup>14</sup> Whereas this definition focuses mainly on financial audit and is general, a cooperative audit can be defined as an independent examination of, and expression of opinion on, the financial statements, management performance and on social reports of a cooperative by an appointed auditor, who carries out his/her duties according to accepted cooperative audit standards and in compliance with a statutory obligation.

Cooperatives, as other enterprises carrying out economic activities above a

<sup>13</sup> This section is based on DGRV/ILO/COOPAFRICA: *Operational guide for audit of cooperatives*, (forthcoming).

<sup>14</sup> M. Barnes (ed.): *Financial Control*, Engineering Management series (London, Thomas Telford, 1990), p 24.

certain volume, are subject to audit. However, it is important to mention that the audit of cooperatives goes beyond the common requirement for verification of data contained in financial reports, as the success of a cooperative lies not only in the surplus made or the growth and market share achieved (market success). A cooperative must also succeed in promoting the interests of its members and the wider community. To assess this, special forms of audit are necessary, often referred to as management (or performance) audit, and social audit.

## Why should cooperatives be audited?

Cooperative activities and their performances should be regularly evaluated and supervised in the form of an audit for the following reasons:

- The members of the cooperative have the right to know whether the cooperative enterprise is managed properly.
- Large cooperatives often employ managers to run the enterprise. In order to ensure that there is a proper check on the efficiency and integrity of the employees, the board and members require a systematic and thorough check of the accounts and operations.
- Members of the cooperative who deposit their funds with the cooperative and non-members who do business with the cooperative would like to satisfy themselves that their transactions are safe.
- Newly established cooperatives are often managed by honorary managers who may lack the necessary qualifications, and in some instances there are no proper governance structures, resulting in insufficient or non-existent financial management reporting. Without audit mechanisms, neither organizational weaknesses nor management and financial problems will be apparent. Such shortcomings can culminate in financial losses that directly affect the members and in misuse of cooperative funds by board members and management.
- The cooperative audit can be used by management as a tool to improve the performance of the cooperative.
- The audit can be used to report on the CSR of the cooperative. Although CSR is inherent to a cooperative, it needs to be reported in a credible way. The audit can provide this credibility.

In most, if not all, countries, registration of a cooperative renders it a legal entity. The fact that a cooperative is registered means that it has to comply with respective legislation. In some countries, it is a statutory requirement that all registered cooperatives should be audited regularly (in many countries,

annually) and that such audited financial statements be submitted to a monitoring body. Cooperative audits can also be used by cooperatives that are not yet formerly registered. In some countries, small cooperatives can undertake audits less frequently, for example, once every two years rather than yearly. Although in some countries cooperatives are exempt from compulsory audit, taking advantage of this exemption is not recommended.<sup>15</sup>

## External and internal audit

It is also important to draw a distinction between external and internal audit. *An external audit* refers to audit carried out by a body that is external to, and independent of, the enterprise being audited.<sup>16</sup> In the case of a cooperative, the person or the audit firm asked to audit should not have any links with the cooperative.

*An internal audit* is audit that is carried out by an employee or officer of the cooperative. Cooperatives can also use other internal structures like supervisory committees or financial committees to perform internal audits. While in some countries internal auditors are members and are thus not professional auditors, in other countries internal auditors are qualified professionals that may be members of the Institute of Internal Auditors. But even if the internal auditors are not professionals, they should have full knowledge of the (financial) operations of the cooperative.<sup>17</sup>

The work of internal and external auditors should be coordinated to ensure maximum efficiency and effectiveness. Cooperatives benefit more if they commission both an internal audit and an external audit.

Generally, by establishing an effective cooperative audit system, the performance of the cooperative will improve, which will lead to higher trust of the membership in the cooperative, leading to better commitment. So all in all: cooperative audit serves the interests of the members, the creditors, and the management of the cooperatives.

## Audits

**Financial audit** is the verification of accounts of a cooperative.

**Management audit** is the assessment of management's performance in conducting the cooperative business. It is complementary to financial and social audit.

**Social audit** is a method to evaluate the non-financial performance of a cooperative, and can be described as a process of measuring the cooperative's effect on individual members, employees, their households and the community at large.

Source: DGRV/ILO, *Operational guide for audit of cooperatives* (forthcoming).

<sup>15</sup> [http://www.fairtrading.nsw.gov.au/pdfs/Cooperatives\\_and\\_associations/cooperatives/Coop\\_submission\\_Cooperative\\_Development\\_Services\\_Ltd.pdf](http://www.fairtrading.nsw.gov.au/pdfs/Cooperatives_and_associations/cooperatives/Coop_submission_Cooperative_Development_Services_Ltd.pdf) (accessed 7 Oct. 2011).

<sup>16</sup> <http://www.oecd.org/dataoecd/4/3/35079748.pdf> (accessed 7 Oct. 2011).

<sup>17</sup> [http://www.turnkeyconsulting.co.uk/resources\\_support/faq\\_article.php?id=14](http://www.turnkeyconsulting.co.uk/resources_support/faq_article.php?id=14) (accessed 7 Oct. 2011).

## Key Learning Points

In this module we have presented the basic characteristics of an agricultural cooperative, both its main organizational features and its main functions. Most cooperatives perform several functions, as members demand a range of services, from supplying inputs, through providing credit, to processing and marketing farm products. In addition to providing direct support for the member farms, cooperatives often provide social services to the community. Finding a good balance between economic functions and social functions is a challenge for each cooperative. The bottom line, however, is that for the cooperative to survive it must be economically viable while providing services to its members.

Cooperatives face challenges in meeting the demands of all their stakeholders. Although cooperatives work for the benefit of their members, other stakeholders, like customers, NGOs, governments and the community in which the cooperative resides, all have an interest in what the cooperative is doing. Making legitimate choices among the demands of the different stakeholders requires a clear strategy and a transparent decision-making process.

Marketing cooperatives operate in a value chain. Closely coordinated value chains provide new opportunities for producing and marketing high-value products. As marketing to demanding domestic and foreign customers requires compliance to strict quality requirements, often certified by third parties, cooperatives can help their members in improving the quality of the products and in obtaining the necessary certificates.

The internal governance of the cooperative is based on what the internationally recognized Cooperative Identity Statement and the national cooperative legislation prescribes. Cooperatives apply democratic decision-making, thus giving all members a voice. Decisions are taken in a delicate interplay between all members (convened in the General Assembly), the BoD (elected from and by the membership) and the professional management. Large cooperatives often have professional management, which is accountable to the BoD.

Managers of a cooperative play different roles and need different skills. Financial management is a challenge, not only because access to finance is often difficult but also because managers have to be able to manage the finances in a transparent way. Audits can be used to assess the performance of a cooperative and to help to gain trust and commitment.

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