

The Co-operative Formation Decision



Discussing the co-operative option.

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The notes are not comprehensive and do not provide the totality of information and advice needed to make the business, legal, financial and management decisions in forming a co-operative.

There are a number of critically important publications that you need to acquire:

- Co-operatives Act 1996
- Co-operatives Regulations 1997
- Guide to Forming and Running a Co-operative
- Model Rules of a Non-Trading co-operative with shares (Government Guaranteed)
- Model Rules of a Non-Trading co-operative with shares
- Model Rules of a Non-Trading co-operative no shares
- Model Rules of a Trading co-operative.

The legislation is available from Information Victoria, 356 Collins Street, Melbourne. The Guide and the Model Rules can be obtained from Consumer Affairs Victoria:

Consumer Affairs and Co-operatives

The Co-operatives Act 1996 can also be accessed directly through the Consumer Affairs site.

The Co-operative Federation of Victoria Ltd has developed a series of **Legislation Information Sheets** on provisions in the Co-operatives Act 1996.

Expertise can facilitate the formation decision. Legal and accounting skills, for example, would be desirable. These may be internal to the group or brought in as external advisers. Experts are necessary but could be problematic if they have little experience and/or understanding of co-operatives. An accountant or a lawyer may have the necessary accounting and legal skills but have little knowledge of or experience in working with co-operatives. This creates a risk for the formation decision. If the experts do not have the necessary experience and/or knowledge, then, it is essential that they have an ability to acknowledge their shortcomings, and understand the issues and a capacity to be objective - a willingness to apply their experience and knowledge to the co-operative option.

The Formation Decision is when individuals and groups decide whether or not to form a co-operative or some other form of business enterprise. It is not a simple decision and requires rigorous analysis of the appropriateness of the different forms of business e.g. sole proprietor, partnership, co-operative and company. The formation decision should precede the formation process.

These notes, therefore, aim to guide the process of deciding whether or not to form a co-operative.

A Misunderstanding

The Co-operative Difference

The Philosophical Difference

The Purpose Difference

The Structural Difference

The Active Difference

A Misunderstanding

Sometimes, it is assumed that a co-operative is just like any other business and it can be started by following the same procedures that are used to form an investor-owned company and that it does not matter what form of business is established. This is a misunderstanding that occurs because co-operatives and investor owned companies are both businesses and incorporated.

It does matter, however, what form of business is established. A co-operative should be formed out of conviction - the belief that it is an appropriate form of business for its members. A decision to form a co-operative could also be ad hoc or opportunistic - in the absence of conviction. An example of an ad hoc decision is when a dominant individual or individuals persuade a group to accept the co-operative model and their acceptance is because of their deferral to the individual(s) and not because of their understanding of and support for the co-operative model. If the group does not understand and support the co-operative model, then, the co-operative should not be formed for the basis for the foundation of a co-operative is a mutual need and decision and an informed understanding and agreement.

An example of an opportunistic decision is one that is based not on the nature of co-operatives but because it is believed to be, for example, the cheapest form of incorporation. This is not a proper basis for forming a co-operative because it ignores the differences between co-operatives and investor-owned companies and the competing values that underpin either form of business - differences that should be understood before rather than after formation.

There are important differences between co-operatives and investor-owned companies and anyone wishing to start a co-operative should recognise and examine these differences. It is critical that the differences are studied and analysed as a prerequisite to deciding whether or not to form a co-operative. A co-operative must be formed for the "right" reason - mutual action to meet a mutual need through a democratic business. Of course, co-operatives can be formed for the "wrong" reason but forming a co-operative for the "wrong" reason builds-in the ingredients of eventual failure.

The Co-operative Difference

The key co-operative differences are the philosophy, purpose and structure of a co-operative and the active involvement of its members. The potential members of a co-operative need to be clear about why they are forming and joining a co-operative:

How will they benefit from the services of the co-operative?

Will they accept the obligation of membership and use the co-operative?

Do they understand and agree that the co-operative difference is a marketing advantage?

Will they contribute to the ongoing success of the co-operative through continuing active membership?

Do they understand and accept the need for ongoing co-operative education programs and are they committed to participate?

The following table briefly summarises the differences between co-operative, investor and public businesses:

	Co-operative Business	Investor Business	Public Business
Purpose	Service-driven	Profit-driven	Mix of service and profit-driven
Ownership	Ownership vested in members	Ownership vested in capital	Ownership vested in State and/or capital
Owners	Member users	Investor owners of capital	Investor and/or State owners of capital
Voting	One vote per member irrespective of number of shares and usage	Number of votes depends on number of shares owned.	Number of votes depends on number of shares owned.
Management	Management responsible to members	Management responsible to capital	Management responsible to investor and/or State capital
Shareholding	Choice of shareholding or non-shareholding. If shareholding, constant value and limit on proportion held.	Changing value of shares and no limits on shares owned.	Changing value of shares and any limits on shares owned dependent on legislative requirements.

The Philosophical Difference

A co-operative is owned by the users of the co-operative who benefit from their membership.

This difference is expressed in the statement of co-operative values and principles adopted by the International Co-operative Alliance. The values and principles of co-operation are integral to and essential for co-operative practice. The potential members need to understand and accept the principles of co-operation - voluntary and open membership, co-operative education training and information, democratic member control, member economic participation, autonomy and independence, co-operation among co-operatives and concern for community.

This is where the co-operative principles are very important. The philosophy and practice of member ownership and control is fundamental to a decision to form a co-operative and the group needs to be convinced about the desirability and practicality of the co-operative form of business. Member ownership and control is fundamentally different from investor ownership and control.

In considering the formation of a co-operative, therefore, it is necessary to study co-operative philosophy and principles - what they mean in practice and whether or not you agree with them. The principles are included in Victoria's Co-operatives Act 1996. They are not just rhetoric. They are designed to guide the practice of co-operatives. The co-operative principles should be examined and discussed for they are practical guides. There must be agreement that there is a co-operative difference and that there is a co-operative reason for forming a co-operative that makes a co-operative different from private and public enterprises.

Individuals and organisations become members of co-operatives to secure cheaper and/or better services that are not available individually e.g. lower energy costs. Investors become shareholders of a company to secure a return on an investment - not to use the business service or product.

The Purpose Difference

The decision to form a co-operative must be based on a group of individuals and /or organisations and/or businesses in a community who have a common need and a commitment to work together on a mutual basis to meet their needs.

The purpose difference is a logical outcome of the philosophical difference. It is important, therefore, to discuss the purpose difference. A co-operative exists to serve its members through mutual action. The primary purpose of an investor owned company is to generate profits for its investors.

Co-operatives have benefits and limitations and these need to be clearly understood and accepted. Co-operatives are influenced by the same economic forces, legislative requirements and laws that influence other businesses.

There is a need to distinguish between and separate common business issues and specific to co-operatives business issues and how they reflect and reinforce the purpose difference. People problems can influence all forms of business. In a co-operative, people problems can be aggravated by the users being the owners. Members may use the co-operative but not understand and accept the obligations of ownership. Members must have a sense of ownership beyond their actual membership. A manager may be committed to maximizing profitability at the expense of service to members and genuine accountability to the board.

In recent years, there has been increasing concern about the corporate governance of investor owned companies and the need for independent directors who do not have financial dealings with the business. For a co-operative, however, all or a majority of directors should have financial dealings with the co-operative as user-members.

It is common in investor owned companies for the board to determine the remuneration of CEO's and managers and argue that only the board is qualified to make this determination. In a co-operative, however, the members decide who decides and how they decide the remuneration of CEO's and managers.

While co-operatives are service orientated, they can also have the future dilemma of choosing between building the financial strength of the co-operative or increasing returns to its members.

The Structure Difference

A co-operative is also democratic i.e. there is one vote per member irrespective of their use of and shares held in the co-operative. Any dividends and rebates paid to members are, however, based on use.

In theory, large and small users belong to co-operatives because of a common commitment to mutual action to meet a mutual need through a democratic business. But, a co-operative can develop structural tensions if there are initial or developing large users who either initially or over a period of time develop a view that their control of the co-operative should be in direct proportion to their use.

Co-operatives are democratic. Important decisions may be discussed with members and this requires time and resources and may delay decisions but this is not necessarily an impediment to efficient and effective business decision-making. It does mean, however, that members have to be consulted and involved. In contrast,

in an investor-owned company votes depend on the number of shares owned and it is only a minority that has to be consulted and involved - if at all.

A co-operative's democracy depends on the active involvement of its members. This may be difficult and members may not be fully committed to attending annual meetings, providing capital and using the co-operative. But, then, the board and/or the manager may not themselves be committed to co-operative education - educating members about the obligations of co-operative membership. A lack of commitment, however, could encourage active users to question co-operative democracy and, therefore, the continuing relevance of the co-operative business structure.

The Active Difference

Having examined these differences and decided that there is agreement on the philosophy, purpose and structure of co-operative, the individuals, and/or businesses and organisations who are involved need to establish whether or not they will be active members.

A co-operative is created to meet the needs of those forming the co-operative. It is not created to meet and support someone else's needs. Co-operatives which are formed by individuals and organisations for other people have a problematic future and usually fail.

In the 1980's, for example, a number of co-operatives were formed in Victoria to create employment for the unemployed under a Victorian Government Co-operative Development Program. Some of the co-operatives were formed by local business people and professionals and others committed to doing something for their community. But many of the citizens and directors who formed these co-operatives did not become users - the users were meant to be the unemployed others. These co-operatives no longer exist and a major contributing factor being that the others either did not become users or if users they did not form the co-operative and the non-users remained the controllers of the co-operative.

An investor owned company is created to generate wealth for its founders and profits for its shareholders.

Having decided to become a member of the proposed co-operative, the individuals and organisations who are involved need to establish whether or not as potential members of the co-operative they have the necessary understanding and commitment to work co-operatively together - and what this means.

All co-operatives must develop a criteria for active membership. To be a member of a co-operative it is necessary to be an active user of the co-operative's services and

products. There is no value in having any members who are not active users. Inactive members undermine the co-operative and members who become inactive should be removed from membership.

An active membership criteria is required under the Co-operatives Act but it is also a fundamental principle of co-operative practice. It is important for members of the group to decide whether or not they are committed to use the co-operative's services and be active in the affairs of the co-operative by attending meetings, voting on issues, asking questions, voting for directors and standing as directors.

In contrast, a company is capital driven and, therefore, the shareholders are primarily interested in a return on their investment - rather than democratic ownership and control of the company. Investors are not required to use the products and services of companies in which they invest - to be active shareholders. If the primary concern of individuals and organisations is a return on investment, the formation of a co-operative is an inappropriate response. Of course, members of a co-operative are concerned to protect the value of their shareholding but their primary interest is service from the co-operative and that the co-operative is efficient and effective.

The initial basis for testing the ability of potential members to be active members is the willingness of individuals and organisations to work within a group and to study and assess the proposal for the development of a co-operative - including co-operative values and principles during the co-operative formation decision process.

If the potential members are willing to work together to educate themselves about the co-operative option and how co-operative values and principles will be practiced in their co-operative, then, there is a basis to form a co-operative. If this willingness is absent, then, the co-operative should not be formed.

From Decision to Process

These characteristics and differences are important. It is critical that there is a realistic discussion of what co-operatives can and cannot do.

Having made the formation decision, individuals and organisations can now initiate the **formation process**.