# THE REVOLVING-FUND PLAN OF COOPERATIVE FINANCING AND ITS APPLICATION IN MICHIGAN

Thesis for the Degree of M. A.
MICHIGAN STATE COLLEGE

Saul B. Klaman

1942

This is to certify that

thesis entitled

"The Revolving-Fund Plan of Cooperative
Financing and its Application in Michigan

presented by

Mr. Saul B. Klaman

has been accepted towards fulfilment
of requirements for

M. A. degree in Economics

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Date Sep 29, 1942

# THE REVOLVING-FUND PLAN OF COOPERATIVE FINANCING AND ITS APPLICATION IN MICHIGAN

by

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A THESIS

Submitted to the Graduate School of Michigan State College of Agriculture and Applied Science in partial fulfillment of the requirements for the degree of

MASTER OF ARTS

Department of Economics

1942

THESIS

## ACKNOWLEDGMENTS

The writer is deeply indebted to Mr. Arthur Howland, of the Extension Section of the Economics Department, who gave generously of his time and was a constant source of guidance and inspiration throughout the preparation of this study.

Grateful acknowledgement is due Dr. Harald S. Patton, Head of the Department of Economics, for carefully reading the manuscript and offering invaluable counsel and assistance in its organization and revision.

I wish to express my thanks to Dr. O. Ulrey and Dr. H. E. Larzelere of the Agricultural Economics staff for suggesting the undertaking of this study and helping in its early preparation, and to Mr. C. L. Nash of the Extension Section of the Economics Department and Professor C. R. Upham of the Accounting Department for their aid in procuring pertinent information from the Michigan cooperative associations included in the thesis.

Finally, grateful appreciation is expressed to the managers and officials of those Michigan cooperatives who so willingly furnished the data necessary for the study.

TABLE OF CONTENTS

LIST OF TABLES

| Table | | Page |
|---|---|---|

## INTRODUCTION

General Purpose of Investigation. In view of the increasing attention being given to the revolving-fund plan as a method of cooperative financing and in view of its recent adoption by many Michigan cooperative associations, it was deemed appropriate to undertake a thorough investigation of this financial plan in both theory and practice. The specific purposes of this study were therefore: (1) to fully explore the nature, techniques and methods of operation of the revolving-fund plan, (2) to describe its advantages by indicating how it may overcome the problems and inequities associated with other financing methods and enable associations to conform to federal and state legal cooperative standards, (3) to study the general application of the revolving-fund plan by Michigan associations and indicate the changes in their organization and financial structure necessitated by its adoption, (4) to appraise, in so far as possible, the general effects which the operation of the revolving-fund plan has had on the membership, financial, and business programs of selected Michigan associations.

Source and Scope of Data. The primary data for this study upon which chapters IV and V are based were obtained from two principal sources: (1) personal interviews with managers and officials of various Michigan cooperatives, using a questionnaire prepared by the writer in collaboration with Mr. Arthur Howland, extension economist,[1] and (2) office records available in the Extension Section of the Economics Department,

[1] See Appendix

pertaining to all the Michigan associations that have adopted the revolving fund plan of financing.

Information as to the general nature and techniques of the revolving-fund plan was obtained primarily from publications of the Farm Credit Administration, the American Institute of Cooperation, State Agricultural Experiment Station bulletins and from numerous conferences with Mr. Arthur Howland.

# CHAPTER I

## FINANCIAL STRUCTURE AND PRACTICES OF FARMERS' BUSINESS ORGANIZATIONS AS JUDGED BY COOPERATIVE STANDARDS

Most farmers' cooperative associations, like other business organizations, have obtained their equity capital through the issuance of stock, supplemented by the retention of earnings, without reference to any relationship between capital contribution and individual patronage. In contrast to this procedure the revolving plan of financing provides that each patron shall contribute capital to the association in direct proportion to the use which he makes of its facilities. It envisages a continuous and fluid form of financing, contemplating the return of earlier capital contributions with new funds automatically supplied by current patrons.[1] The development of the revolving-fund plan has been an outcome of efforts to overcome problems and inequities associated with traditional methods of financing and to evolve an alternative system which would be both financially sound and in conformity with legal cooperative standards as defined in Federal and State enactments and regulations. The major purpose of this chapter will be to describe the general financial and membership inequities which seem to be inherent in the corporate structure of associations using the older financing methods, and to show wherein the practices of many of these cooperatives fail to comply with the legal cooperative requirements.

### Methods of Obtaining Capital

To furnish a background for later discussion, financing methods used

[1] For a full discussion of the nature of the revolving-fund plan, see Chapter II, pp. 29-33.

prior to the development of the revolving capital plan may be briefly outlined. No attempt will be made to describe the financing procedure in detail but simply to sketch its basic nature.

Farmers' cooperative associations may obtain their initial capital from two principal sources: (1) subscription to capital by local farmers and other individuals, and (2) loans from various sources. Members' subscription to capital may take one of two forms depending upon whether the association is incorporated on a stock or non-stock basis. Stock associations usually require each member to subscribe to one or more shares of common stock and perhaps to preferred stock as well (if two classes of securities are issued) varying with the capital needs of the organization and its ability and willingness to acquire funds from outside sources--e.g. non-farmer subscriptions and/or general bank loans. The par value of each stock share is usually low, ranging from \$1.00 - \$10.00 with a view to permitting participation by farmers with limited means of investment. Since as indicated above, there is usually no relationship between capital contributions and individual patronage, a member may purchase \$10, \$25, or \$100 worth of stock regardless of the proportionate use which he makes of the association's facilities, although the by-laws of many cooperatives limit the number of shares which any individual may hold. In general, the corporate instruments used by stock cooperatives are similar to those of private profit corporations, and most of the older cooperatives have been organized under the general corporation laws of their respective states.

Initial capital subscription to non-stock associations (for which provision is now made in most state incorporation laws) usually takes the form of membership fees such as so much per person, per acre, or per cow etc. "The tendency is to require only a nominal initial membership fee and have members make other subscriptions to general or special funds."[1] The non-stock basis of financing is adaptable to organizations whose initial capital requirements are small, e.g. livestock shipping associations, pool marketing associations and milk bargaining associations, but cannot generally be utilized by cooperative businesses such as elevators, creameries, general supply associations, etc. whose need for physical facilities is far too great to be provided merely by membership fees. The traditional non-stock cooperative, like the ordinary stock organization, maintains no relationship between financial contributions and individual patronage. Neither type of association usually makes any provision for the subsequent return of members' original capital contributions.

Additional capital for the subsequent expansion or maintenance of operations may be obtained through: (1) additional sales of stock or "membership," (2) deductions from the proceeds of sales, (3) assessments on members, (4) additional borrowings, and (5) principally from surpluses built up by the retention of earnings. When cash arising from retains and operating profits is maintained in the business, members and patrons are usually not given individual certificates to evidence the amount of capital that they have in effect contributed in this way.

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[1] Stokdyk, E. A., "The Financial Structure of Cooperatives," American Cooperation, 1934, American Institute of Cooperation, Washington, D. C., p. 165.

## Problems and Inequities Inherent in the Corporate Structure of Ordinary Stock and Non-stock Associations

The use of the traditional financing methods has given rise to situations inequitable and undesirable from the standpoint of both the member and the association. Mr. Arthur Howland, Extension Economist at Michigan State College and the person perhaps most responsible for the introduction of the revolving-fund plan to Michigan cooperatives, has outlined the problems inherent in the older types of corporate structure under the following 7-point statement.

"1. A dwindling membership so that ultimately the control of the cooperative passes into the hands of a relatively small number of persons.

2. A trend toward control of the cooperative by non-patrons who are not actively interested in the services of the cooperative but become more concerned with the return upon their investment.

3. Frozen investments of members who provided the original capital for the business.

4. Unequal distribution of the financing burden.

5. Lack of an effective program for admitting new members upon a basis which would be fair to the old members and at the same time afford the new members a reasonable method for accumulating the investment required by the cooperative to finance the facilities required to handle the business.

6. Lack of a program which would enable eligible non-member patrons to become members and to share in the profits earned upon their business.

7. Retention of cash arising from retains and operating profits to provide for the retirement of indebtedness and for expansion of the business without giving to the members and patrons a certificate to show the amount of their equity in the assets of the corporation which has been withheld from them."

On the basis of experience in Michigan, the following comments may be made on these points:

(1) The first problem arises primarily from the frequent inability of the association to balance the constant loss of membership through natural causes--death, change of residence, retirement from farming--with an offsetting increase of new members. It is obvious that the proportion of members to total patrons will decrease when the association strives to increase business volume, by reaching beyond its existent membership. However not only may the proportion of members decrease, but also the actual number of members, if the association lacks an effective membership program. Such a condition inevitably leads to a concentration of control in the hands of a few as exemplified by four Michigan "cooperative" creameries which in 1935 were owned by less than 10 per cent of their patrons.[1] Such associations may then more aptly be described as private business organizations under farmer ownership.

(2) The second problem is a result of the failure of the association to retire the equities of the member, when he ceases to patronize the association. Of 283 cooperative organizations operating in Michigan in 1938, 107 do not provide in their by-laws that the voting stock of non-producer, non-patron members be retired or converted into non-voting stock.[2] Since, in many cases, the increase in active membership is insignificant, the control of the association may be ultimately vested in non-patron and non-producer members. Even if these ex-patrons or non-producers do not actually control the association they present interests conflicting with those of the current producer-members and

1 Unpublished study of Cooperative Creameries in Michigan by W. O. Hedrick.
2 Larzelere, H., "Financial Management Analysis of Farmers' Cooperatives in Michigan," Michigan Agr. Exp. Sta. Special Bulletin 315, (1942), p.33.

patrons. When a member ceases to patronize the association he is no longer interested in economic services through effective marketing and purchasing as is the patron member, but rather with the returns on his invested capital. That the purely financial interests of the ex-patron member are inconsistent with cooperative ideology and if allowed to dominate will lead to uncooperative practices, is all too obvious. E. A. Stokdyk has reported that the failure of many cooperatives has been due to the accumulation of stock in the hands of non-producers and outsiders more interested in dividends on stock than in effective marketing and purchasing.[1] W. O. Hedrick reported that out of 41 cooperative creameries in 1935 in Michigan, there were 6 in which from 51-80 per cent of the members were non-patrons, 11 in which the proportion was between 21 and 50 per cent, and only 7 which had 100 per cent member patronage. In 1936, C. L. Nash, Extension Economist at Michigan State College, reported that "many potato cooperatives are drifting into a situation in which a too-high per cent of their stock is held by non-producers..."

(3) That the investments of the members, who provided the original capital, tend to become frozen in the association is due to: (1) the lack of a stock retirement provision in the financial organization; and (2) the lack of any market where the member may dispose of his stock holdings. The combination of these two factors makes it difficult for the original members (or their heirs in case of death) to recover their

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[1] Stokdyk, E. A. "Revolving Capital--Its Larger Benefits," News for Farmer Cooperatives, (July 1939), Farm Credit Administration, Washington, D. C., p.14.

capital contributions when, for one reason or another, they cease to patronize the association. Robotka and Laughlin have stated: "Experience demonstrates that capital contributions in stock organizations tend to become frozen, sometimes to such an extent that periodical reorganizations are necessary in order to bring about a reallocation of the capital burden and to retain control of the organization in the hands of producers."[1]

(4) The financing burden is inequitably distributed among the members since the purchase of stock or other equities is not proportioned on a patronage basis. In the case of stock cooperatives where each member may be required to purchase a minimum amount of stock regardless of whether he delivers 100, 500 or 5,000 units of products to the association, it is apparent that, in proportion to the patronage contributed, the small producer is bearing a greater share of the financial burden than is the large producer. The former invests more capital than is required by the cooperative to handle his small amount of business, while the latter contributes less than is needed to finance his share of business, thus creating a situation in which the small producer helps to finance the patronage of the larger producer. It is clear that the large patronage contributors receive a greater amount of service for the capital they invest than do those who contribute a small amount of patronage. Subsequent shifts in the amount of patronage tend further to widen the disparity between the amount of capital and the amount of business contributed by individual members.

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[1] Robotka, Frank and Laughlin, Gordon C., "Cooperative Organization of Iowa Farmers' Creameries," Farm Credit Administration Bulletin No. 14, Washington, D. C., (April 1937), p.46.

(5) After the association has been operating for a few years it is faced with the problem of establishing a program by which new members may be admitted on a basis which is fair to the old members. Such a program is lacking in the ordinary stock and non-stock associations. The original members, of necessity, assume the weighty financial risk and burden that accompanies the organization of a cooperative. They must assume the responsibility of financing the needed land, buildings, and other equipment, in addition to providing the bulk of the operating capital. The earnings realized after the association has started operations, may be retained in the form of surplus in order to help finance the association. Consequently dividends on stock and patronage may not be paid out for a good many years. As a result of these accumulated earnings, the original stockholders have acquired an enhanced equity in the business. To admit new members on a basis equitable to the old members, the former would be expected to pay for stock they may acquire, a price corresponding to the book value per share outstanding.

Prospective members, however, may frequently be unable or unwilling to make such an investment. In some cases the required investment would not be fair to the new member, since the amount involved might be greater than that needed by the association to finance the handling of his business. Thus what is a financially fair procedure from the old members' viewpoint, may seem decidedly unfair in the eyes of the new members--a conflict which lacks a solution under the common methods of financing.

(6) An even more basic problem seems to be the lack of a method for enabling eligible non-member patrons to accumulate the investment necessary for membership. This problem has already been indirectly

discussed with reference to the problem of a dwindling membership. Eligible non-member patrons do not acquire membership in an association either because they have no incentive to do so, or because they do not have the ability to make the required financial investment. Under the traditional financial plans the usual method of obtaining membership is through the purchase of some form of equity, but since most of the ordinary stock or non-stock associations furnish neither the incentive nor the means for acquiring this equity, the eligible non-member patron continues to remain outside the fold of membership. Even though some associations provide for the distribution of patronage dividends to non-members in the form of paid up stock, its application has been limited by the reluctance of cooperatives to unduly expand the amount of outstanding stock entitled to cash dividends.[1]

(7) Associations that place the cash arising from retains and operating profits in their reserve fund, as described by Mr. Howland under point 7, may or may not credit these withheld sums "on their books" to members on the basis of patronage. Regardless of the practice employed, if members are not given certificates in evidence of their increased equity (and they are usually not in the ordinary association) psychological and real difficulties evolve. When members do not receive such certificates of interest, they feel that the accumulated capital belongs to the association, rather than to them individually. Lacking any tangible proof, they tend to feel that the association has accumulated surplus capital in which they have no actual equity. The members may then lose

[1] This consideration is more fully discussed below, p.21

interest in the association and assume an impersonal feeling toward it referring to the cooperative as "they" instead of "we," since they have not been clearly shown that the cooperative's financial gain is also their gain. As J. W. Jones expressed it: "Telling the members that the association is theirs will never be so effective in convincing them that they actually own and control the organization as providing them with concrete evidence of ownership."[1]

A real problem arises in the event that a member moves out of the vicinity, and he owns no certificate evidencing his equity in the association's surplus. Although the association might have allocated this member's equity "on the books," they will probably be unable to locate him when they wish to distribute his earned share of the capital, thus depriving him of his rightful increment. In the event of death, the allocated capital will probably never be distributed either since the heirs of the deceased have no tangible evidence of the latter's equity in the capital surplus.

For those associations which accumulate an unallocated surplus, a perplexing problem arises in the event of dissolution, liquidation or reorganization of the association. Should this surplus be divided exclusively among the members and if so in what proportion? Shall the non-member partons who have contributed to this surplus fund be included in its distribution? Since many associations keep no record of the patronage of non-members, it would be rather difficult to determine what proportion of the whole they were entitled to and in what ratios it should

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[1] Jones, J. W., "The Member's Position in his Association," News for Farmer Cooperatives, (Oct. 1936) Farm Credit Administration, Washington, D. C., p.13.

be divided among them. In a few cases "ex-members might bring legal action to obtain a portion of the funds on grounds that the reserves were excessive and that since they had contributed to them they were entitled to share in their distribution."[1] It does not seem that an equitable basis of distribution in which members, non-member patrons and ex-members would share in direct proportion to their contributions, could be determined. Even if the accumulated surplus had been allocated on the basis of patronage, complete fairness could not be attained since those who had moved away, and the heirs of those members who had died would probably not share in the distribution.

## Legal Cooperative Standards

The use of the older financing methods not only gives rise to vital problems and serious inequities, but also tends to be accompanied by financial and business practices that are not in conformity with legal cooperative standards as defined in federal and state enactments and regulations. Cooperative legislation was not formulated by "modern experts" simply to have an arbitrary body of rules to which cooperatives should adhere, but represents rather the legal expression of basic doctrines developed by the original Rochdale Pioneers and fundamental principles emerging from the experiences of the farmer cooperative movement, which have proven to be essential in order to meet changing operating conditions. Compliance with the provisions of cooperative enactments therefore enables the association to uphold these basic concepts, in

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[1] Stokdyk, E. A., "The Financial Structure of Cooperatives," <u>American Cooperation</u>, 1934, American Institute of Cooperation, Washington, D. C. p. 179.

addition to being granted certain practical advantages or exemptions contingent on such conformity.[1]

Federal legal cooperative standards are embodied in three acts: The Capper-Volstead Act of 1922, the Revenue Act of 1926 as subsequently amended, and the Agricultural Marketing Act of 1929 with its later amendments.

The Capper-Volstead Act was designed to exempt farmers' cooperative organizations from the penalties of the Sherman Anti-Trust Act[2] provided they adhere to the standards set forth which include basic principles distinguishing cooperative associations from private business organizations. Three fundamental concepts contrasting cooperative associations with private businesses are: (1) democratic control by members; (2) payment for the use of capital limited to a maximum dividend rate and (3) sharing the benefits and savings of cooperation in direct proportion to the patronage of the individual member.[3] The Capper-Volstead Act specifically incorporated the first two principles, while the last is a basic requirement for corporation income tax exemption under the Federal Revenue Acts. In the former act it is provided that farmers' cooperatives shall be limited to the processing, preparation for market and marketing of agricultural products. It infers that only persons engaged in the production of such agricultural products are entitled to hold voting stock in the cooperative organization. The Act further provides that associations shall <u>either</u> limit dividends on stock to not in excess of 8 per cent

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1 See p.16 for the advantages granted.

2 The Clayton Act of 1914 exempted only non-stock, non-profit organizations from Sherman Anti-Trust penalties, but made no provisions for cooperative stock, profit, organizations.

3 Fetrow, W. E., "Three Principles of Agricultural Cooperation," <u>Circular E-24</u>, Farm Credit Administration, Washington, 1940, p. 2

per year or limit the voting rights of individual members to one vote regardless of the amount of stock held, but does not require conformance to both provisions. A definite requirement of the Capper-Volstead Act is that at least 50 per cent of the association's business must be transacted with its member producers. No specific provision is made for the declaration of patronage dividends except to state that associations shall be operated for the "mutual benefit" of its members.

The Federal Revenue Act of 1926 which sets up standards determining whether cooperatives may qualify for income tax exemption is the most inclusive of all the federal enactments, including the basic provisions of both the Capper-Volstead and Agricultural Marketing Acts and incorporating additional requirements. This act broadens the possible activities of farmers' cooperative associations to include not only the processing and marketing of agricultural products, but also the purchasing of supplies and equipment. It stipulates that essentially all of the voting stock of the association must be owned by the producers who patronize the association. The Revenue Act specifically requires (in contrast to the optional requirement of the Capper-Volstead Act) that the dividend rate on capital stock shall be fixed at not to exceed the legal rate of interest in the state of incorporation, or 8 per cent per year whichever is greater. On the other hand it places no limitation at all on the voting rights of members. In addition to requiring that at least 50 per cent of the association's marketing and purchasing businesses, each considered separately, be transacted with members, the Revenue Act further specifies that the value of the purchases made for persons who are neither members nor producers may not exceed 15 per cent of the value of all its purchases. A provision of the Federal Revenue Act not included in either of the other federal acts states that cooperatives shall return to producers the proceeds from the sale of their products less necessary marketing expenses on the basis of the products furnished by them, and that supplies and equipment shall be sold to members or other persons at cost plus necessary expenses. Finally, and of basic importance, this act, in contrast to the others, makes definite provision for patronage dividends requiring that the earnings of an association, other than the limited dividends on capital stock and reasonable reserves for necessary purposes, must be distributed to both members and non-members alike upon a patronage basis.

The Agricultural Marketing Act of 1929, as amended in 1933, further widens the meaning of the term "cooperative association" to include, in addition to the marketing and processing of agricultural products and the purchasing of supplies and equipment, the furnishing of farm business services. As regards the ownership of voting stock this act is more precise than the preceding federal acts requiring that at least 90 per cent must be owned by producers of agricultural products. It is to be noted that such producers are not required to be patrons of the association as is stipulated in the Federal Revenue Act. Provisions relating to the limiting of dividends on stock, limitations on voting rights, and proportion of member and non-member business are essentially the same as those given in the Capper-Volstead Act, and like this act makes no definite reference to patronage dividends except to state that associations shall be operated for the "mutual benefit" of its members.

In addition to the federal statutes, cooperative associations organizing in the state of Michigan should comply with the cooperative standards as set forth in the Michigan law.[1] These statutes are more liberal than the federal statutes in that they provide for the formation of consumer cooperatives instead of being restricted to farmer cooperatives. Any agricultural cooperative which meets the requirements of the federal statutes will also comply with the requirements of Michigan statutes. Under the Michigan Act, the members of a cooperative may establish such rules as they deem desirable as to qualifications for membership and the rights to acquire or hold voting stock. General provisions as to the proportion of member and non-member business, limits on dividends to be paid on stock and limitation on voting rights are the same as those stated in the C pper-Volstead and Agricultural Marketing Acts, and while provision is made for the declaration of patronage dividends as in the Federal Revenue Act, such dividends do not have to be distributed to members and non-members alike if the cooperative is of the profit type. It seems well then to set forth the distinction between the profit and non-profit type cooperative as defined in Michigan statutes.[2] Profit type cooperatives are required to either limit the dividends payable upon capital stock and/or membership investment to not to exceed 7 per cent per year, or limit the voting rights, and are not required to distribute patronage dividends to non-members upon the same basis as members. Non-profit type cooperatives, on the other hand, are prohibited from paying dividends or interest upon stock and/or membership investment and must distribute patronage dividends upon a like basis to both members and non-members.

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[1] Act 327, P. A. 1931.

[2] Act 327, P. A. 1931, Sec. 98.

For maintaining the cooperative standards as provided for in federal and state enactments and regulations, two practical benefits accrue to the cooperative organization: (1) eligibility to borrow from the Bank for Cooperatives at low interest rates, for comparatively long terms, and in accordance with a favorable repayment program and (2) qualification for exemption from federal income and various other taxes and fees. As a result of these two advantages (principally the latter) the association may be able to effect substantial financial savings. Notwithstanding the benefits to be realized, however, many ordinary stock and non-stock associations, while conforming to the Michigan statutes have not availed themselves of the benefits provided by compliance with the federal acts. In the discussion of the legal standards only those which the writer deems to be representative of basic cooperative principles will be dealt with.[1]

## Compliance with Legal Cooperative Standards

The early types of farmer cooperatives as exemplified by Michigan cooperative creameries in existence during the 1890's and very early 1900's would comply with few if any of the present legal cooperative standards. They operated basically as private business organizations, their only claim to the name "cooperative" being the fact that they were farmer owned stock companies--the idea of farmers' associating themselves

[1] Although the legal requirements that "essentially all of the voting stock" be owned by producers who are patrons (Federal Revenue Act) or "at least 90 per cent of the voting stock" be owned by producers (Agricultural Marketing Act) are basic in keeping control in the hands of active producer members, they are not discussed here since a fuller treatment is presented in the general discussion of the problem of having the control of the cooperative ultimately vested in the hands of non-patron, non-producer members (See pp.5-6).

together seeming enough to warrant the use of the word "cooperative." The immature idea of cooperation is shown by the fact that dividends as high as 10 per cent, 25 per cent and even 30 per cent were paid to stockholders who, in most cases, comprised a very small proportion of total patrons. Net earnings, whether realized from the spread between prices received for butter and cash prices paid for butter fat, or from the deduction of flat processing charges of 2 or 3 cents a pound, were usually distributed on the basis of stock holdings instead of patronage, even though the bulk of the creameries' business was with non-member producers.

Minimum Proportion of Business with Members. Although progressing considerably from the early day cooperatives in philosophy, aims and methods, the modern producer cooperative in many of its actual operating practices still deviates from the accepted legal standards. Fundamentally a farmers' cooperative buying or marketing association is a business organization and as such depends for its success upon a satisfactory volume of business. The great emphasis placed upon business volume by commercial cooperatives is manifested in their attempts to increase patronage with little regard to a membership program designed to enable new patrons to attain legal membership status. In fact many associations, in their anxiety to attract patrons, grant them the same practical benefits that are given to members.[1] No discrimination is made between members and non-members in the distribution of any trade benefits, and some

[1] It will be remembered that a requirement of the Federal Revenue Act is that cooperatives shall distribute patronage dividends to members and non-members alike and as indicated here and more fully in the discussion on page 24, to adhere to this requirement makes it difficult for the ordinary association to maintain its proportion of member business at 50 per cent. Michigan statutes, however, do not require all cooperatives (the profit type) to distribute patronage dividends to members and non-members alike. See below p. 15.

cooperatives go so far as to deny the payment of dividends on stock to members in order to distribute maximum benefits to patrons through payment of higher prices. This non-differentiated treatment effectively destroys any incentive a patron might have towards attaining membership. The cumulative result of these practices is to develop a situation wherein the non-member business of an association exceeds in value that of members, thus deviating from a basic legal standard.

Analysis of data collected by the St. Paul Bank for Cooperatives in a survey of Michigan cooperatives effectively illustrate that membership and patronage are far from synonymous, only 47 per cent of the total patrons in all Michigan associations being members. Table I shows the total number of patrons, number of member patrons and percentage of patrons who were members for each type of association operating in Michigan as of 1937.

Table 1. Number of Patrons, Member Patrons, and Per cent of Member Patrons for Various Types of Michigan Associations, 1937.*

| Type of Association | Number of Associations | Number of Patrons | Number of Member Patrons | Per cent of Patrons who were members |
|---|---|---|---|---|
| Dairy | 55 | 32,573 | 19,496 | 59 |
| Livestock | 31 | 9,834 | 4,842 | 49 |
| Grain | 25 | 11,911 | 4,397 | 37 |
| Fruit | 21 | 3,459 | 2,308 | 66 |
| Potato | 23 | 1,052 | 661 | 62 |
| Combination | 30 | 11,390 | 4,606 | 44 |
| Farm Supply | 67 | 34,500 | 12,168 | 35 |
| Merchandise | 20 | 8,471 | 5,179 | 61 |
| Total | 272 | 113,190 | 53,657 | 47 |

* Table is adapted from a similar table given in H. Larzelere, "Financial Management of Farmers' Cooperatives," Mich. State Coll. Agri. Experiment Station, Special Bulletin 315, (1942) p. 5.

The percentage of patrons who were members ranges from as low as 35 per cent for farm supply associations to 66 per cent for fruit cooperatives. This condition exemplifies the lack of an effective membership program and indicates that a large number of patrons of the ordinary stock and non-stock associations have no voice in the determination of cooperative policies.

The proportion of business transacted with members by various types of Michigan associations is indicated in Table 2 below. Because the average volume of business contributed by individual member patrons was generally greater than that of non-member patrons, most cooperatives were

Table 2. Proportion of Business Done with Members by the Various Types of Cooperative Associations in Michigan, 1937.*

| Type of Association | Number of Associations | No. Doing less than 50% of their Business with Members | No. Doing Between 50-85% of their Business with Members | No. Doing 85% or more of their Business with Members |
|---|---|---|---|---|
| Dairy | 55 | 14 | 27 | 14 |
| Livestock | 31 | 5 | 10 | 16 |
| Grain | 25 | 8 | 15 | 2 |
| Fruit | 21 | 0 | 8 | 13 |
| Potato | 23 | 1 | 7 | 15 |
| Combination | 30 | 9 | 20 | 1 |
| Farm Supply | 67 | 35 | 21 | 11 |
| Merchandise | 20 | 6 | 9 | 5 |
| Total | 272 | 78 | 117 | 77 |

*Source: H. Larzelere, "Financial Management of Farmers' Cooperatives," Mich. Agr. Expt. Station Bulletin 315, May, 1942, p.21.

able to maintain 50 per cent of their total business with members even though less than 50 per cent of their patrons were members. However, of the 272 associations, 78 or almost one-third were unable, for reasons indicated above, to comply with this legal requirement. Of those that did meet the standard, the majority (117 in number) maintained less than 85% of their business with members. And according to the "Statistical Handbook of Farmers' Cooperatives" published by the Farm Credit Administration in 1938, in 80 of these 117 Michigan cooperatives, the proportion of member business was less than 70 per cent. It would seem that an effective membership program (except in unusual cases) should enable the 78 associations failing to conform to the legal standard, to increase the proportion of their member business to the required 50 per cent, and enable the other Michigan organizations to also increase their member business.

The Payment of Patronage Dividends. The principle of "patronage dividends" requires distribution of earnings to patrons in proportion to the volume of business transacted with the cooperative and as such is one of the basic characteristics distinguishing the cooperative from the private capitalistic organization. W. O. Hedrick goes so far as to say that such benefits distributed to members is the most important cooperative feature among associations.[1] Indeed it is the realization of this principle that bears out the cooperative ideology of reward on the basis of patronage rather than on the basis of capital contributions, the prevailing private business practice. The distribution of patronage dividends gives formal recognition to the fact that a vital contribution of the member to his cooperative is his loyal patronage. It is basically

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[1] Hedrick, W. O., "A Decade of Michigan Cooperative Elevators," Michigan Agr. Exp. Sta. Special Bulletin No. 291, (1938), p.34.

and fundamentally a democratic principle (economically democratic, at least) in that all those who contribute to the success and welfare of the association are rewarded in direct proportion to their contribution. The patronage contributions of the many do not find their way into the pockets of the few as is the case in the private business organization.

Despite the ideological significance manifested by the patronage dividend principle and despite its material advantages, there exist many cooperatives of the ordinary stock and non-stock type that do not conform to this legal requirement. The primary reason why cooperatives fail to distribute patronage dividends is that it is financially inexpedient for them to pay out cash to patrons. To do so in many cases would be to reduce working capital to a level inconsistent with efficiency. Thus, the failure of many cooperatives to distribute patronage dividends is due not to a willful intent to deviate from established cooperative principles but rather to their financial structure which allows them little alternative. In 1935 Dr. Hedrick reported that most Michigan cooperative creameries observed all the "Rochdale principles" with the exception of benefits distribution. As of 1938, only 6 out of 15 capital stock fruit and vegetable associations in Michigan declared a patronage dividend, while of the non-stock associations only 2 out of 11 saw fit to distribute a patronage dividend.[1,2] Of 98 Michigan cooperative elevators, 27 had failed (up to 1935) to authorize any patronage dividends since their

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1 Motts, G. N., "Fruit and Vegetable Cooperatives in Michigan," Mich. Agr. Exp. Sta. Special Bulletin No. 317, (1942), p.47.

2 While 8 of the 11 non-stock associations operated on a pooling basis and returned all earnings minus commissions and cost, such costs can not always be accurately determined and hence some excessive earnings might accrue which are not issued to members but applied to surplus.

organization.[1]

It may be advanced that cooperatives, in order to declare patronage dividends and still maintain adequate working capital needs, should distribute such dividends in the form of stock. Indeed some stock organizations have resorted to this plan, but many do not wish to have a large amount of stock outstanding, and since no definite provisions for stock retirement are made by the usual stock association, this condition might result. It is primarily for this reason that most stock associations do not issue stock dividends in recognition of patronage.

Not only does the Federal Revenue Act require the distribution of patronage dividends by cooperatives as a condition for income tax exemption, but it also stipulates that such returns "must be distributed to members and non-members alike." The principle here again is that patrons although not members are contributing to the business success of the association and should be rewarded proportionately rather than have the profits from their business accrue to members only. Some idea of the extent to which cooperatives adhere to this principle is shown by the fact that only 18 out of 98 cooperative elevators in Michigan distributed patronage dividends to both members and non-members alike.[2] In general, cooperative associations deviating from this principle do so primarily because of four reasons: (1) they find it too difficult or costly to keep accounting records of non-member business; (2) they wish to further the incentive to obtain membership and hence pay patronage dividends only to members; (3) associations feel that members assume more responsibility

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1 Hedrick, W. O., "A Decade of Michigan Cooperative Elevators," Mich. Agr. Exp. Sta. Special Bulletin 315, (1938), p. 89-90.
2 Ibid, p. 83

for the success of the association and incur greater financial risks than do non-members and hence are entitled to a greater reward, and (4) some associations rely upon the earnings from non-member business to pay income taxes and build up their capital structure.

Obviously the last three reasons represent more deliberate cooperative policies than does the first. For some cooperative businesses, the keeping of non-member records is almost impossible. This situation is particularly exemplified by the type of transient business such as that conducted by gas and oil stations. To keep a complete record of the business contributed by each passing motorist would tax the capacities of the most ardent cooperator. Other associations, though more easily able to keep accounting records of non-member business, are not willing to incur the additional expense nor expend the extra effort required for this procedure.

The second reason actually needs no further elaboration. It is natural for associations in their quest for increased membership to offer as many incentives as possible to the non-member patron and prospective member not a patron of the association, so that they will be desirous of attaining membership status. Patronage dividends, being one of the foremost advantages that a cooperative may offer, are thus reserved to the member only, in the hope that the non-member, in his desire to obtain patronage dividends, will seek to gain membership in the association.

The third reason, grows out of the fact that in most associations of the ordinary stock or non-stock type, members assume the responsibility of financing the association and incur the risk of financial loss. Thus their well-being is more closely interrelated with the fortunes of the cooperative than is that of the non-member patron, who incurs none of the financial responsibility and none of the attendant risks. Thus to differentiate between the responsibilities and risk assumed by the member and non-member, the association issues the patronage dividend only to the former. Of course, this reason is actually a corollary or subsidiary of the second reason, since as patronage dividends are distributed only to the member, the non-member will be encouraged to assume the necessary responsibilities and risks of membership, in order to receive the benefits of the patronage dividend. The statement of the last reason, which is of limited applicability, requires no elaboration.

On the other hand, it will be recalled that many associations in their quest for increased business volume have resorted to the policy of equality of treatment to all patrons. Those associations endorsing this principle and declaring a patronage dividend have distributed such a dividend to both members and non-members alike, thus complying with the cooperative standard as set forth in the Federal Revenue Act. It will also be remembered, however, that this equality of treatment tends to deaden the incentive towards membership. As Dr. Hedrick has expressed it: "Little reason remains why anyone should formally unite himself to an association, when he already receives its most prized benefit (patronage dividends) without membership responsibilities.[1] The obvious result of a policy of non-differentiation in associations which lack an effective membership program is to develop a condition where non-member business accounts for a large proportion of the association's total business and in many cases for more than the allotted 50 per cent as stipulated in the

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[1] Hedrick, W. O., Op.Cit., p. 85.

Capper-Volstead Act. It may be concluded therefore that the observation of the one cooperative standard of "patronage dividends to all alike" almost automatically leads to the violation of the other cooperative standard of "at least 50 per cent of the business with members." It thus becomes increasingly difficult for the association with the traditional stock or non-stock capital structure to observe both standards simultaneously--the basic reason being that no effective method for attaining membership is provided along with the "equality of treatment" procedure, so that a non-member may eventually gain the status of a member as he continues to patronize the association. One of the prime advantages of the revolving-fund plan is that it handles this situation effectively.

Limited Dividends and "One Man One Vote" Principle. "The principle of limiting dividends on stock aims at making the member the beneficiary by virtue of the fact that he has contributed patronage rather than by virtue of the fact that he has contributed capital."[1] This principle is thus consistent with the patronage dividend principle and the general cooperative ideology which seeks to diminish the importance of capital as a distinguishing feature between members, and emphasizes the fact that the farmer joins a cooperative to avail himself of its marketing and purchasing services and not to speculatively invest his capital in the hope of lucrative returns. Both the "limited dividends" and "one member, one vote" principles limit the use of capital as the basis of control of the association, by giving all contributing members an equal voice in the affairs of the association. Many farmers' associations have gradually

[1] Robotka and Laughlin, Op.Cit. p. 8.

drifted into private hands because control was based on capital with no limit placed on returns to this capital. It has already been indicated that the Michigan cooperative creameries of the 1890's and early 1900's paid dividends on stock far in excess of the current legal standards of 7-8 per cent, sometimes reaching as high as 25 and 30 per cent. This practice, however, was not completely abandoned even as these associations began to divest themselves of their predominant private business tendencies, for Dr. Hedrick found that as late as 1933, 19 cooperative creamery associations could not secure income tax exemption because of failure to limit dividends on stock. In 1938, 4 of the 15 stock type fruit and vegetable associations studied by G. N. Motts, failed to adhere to a limited dividend policy,[1] while of 98 elevator associations reported on by W. O. Hedrick in the same year, 12 permitted unlimited dividends to be paid on capital stock.[2] Although a few present day associations thus still deviate from the legal standard of limiting dividends on stock, the number so doing is much less than the number not conforming to the two cooperative standards previously discussed (majority of business with members, and the distribution of patronage dividends to members and non-members alike). Moreover the practice of declaring dividends in excess of the legal standard can be easily curbed by a change in management policy; whereas the violation of the latter two standards are in many cases unavoidable outgrowths of the common stock or non-stock capital structures and cannot be curbed without very seriously upsetting the business and financial structure of the association. For example, for the ordinary

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1 Motts, G. N., Op.Cit. p. 53.
2 Hedrick, W. O., Op.Cit. p. 84.

stock association to require all those transacting business with the cooperative to become members, might be to drastically curtail the business volume of the association, while to distribute patronage dividends to patrons might substantially weaken the capital structure for many.

The policy of limiting each member to one vote is almost a universal practice among all cooperative associations, although recently some have tended away from this principle and based voting on the volume of business contributed--considered by some authorities to be a more democratic procedure than the traditional Rochdale principle. In any case, this principle is not a positive legal standard[1] and conformance to it, besides not being required, is not practiced by revolving fund associations any more than it is by traditional stock and non-stock associations. Hence no further discussion on this principle is needed.

In summary one might say that the general problems and inequities (discussed in pp. 4-10) inherent in the corporate structure of associations operating under the traditional financing methods and the failure of these organizations to conform to the legal cooperative standards are manifestations of two basic fundamental failings: (1) the lack of a sound cooperative membership program and (2) the lack of a sound, equitable financing program. A perusal of the factors discussed in this chapter will reveal that they fall under one or both of these inclusive deficiencies. It was to overcome these two inherent weaknesses that a new method of cooperative financing was sought. For many cooperatives the solution seems to have

[1] It is but an alternative for the "limited dividends" principle.

been found in the revolving-fund plan. A general discussion of the nature and potential advantages of this new financing program is discussed in the following chapter.

## Chapter II

## NATURE AND POTENTIAL ADVANTAGES OF THE REVOLVING-FUND PLAN OF COOPERATIVE FINANCING

### A. GENERAL NATURE OF REVOLVING-FUND PLAN

In the words of Dr. E. A. Stokdyk, deputy governor of the Farm Credit Administration, the revolving-fund plan of financing cooperatives "has been likened to a water wheel, picking up water, using it to create the power that turns the mill machinery and returning the water to the mill-stream."[1] The plan contemplates having the patrons finance their own marketing activities as they make use of the association, and having the cooperative return the original capital as new contributions are continually made. Although "the revolving capital type of financial structure has become known as the modern set-up in both stock and non-stock associations"[2] it has actually been used in modified form, for several decades. While first attracting attention between 1918-1924, when a few of the larger associations on the West Coast adopted it, the principle had been applied as early as 1900 by the East Highland Fruit Association (now the Gold Buckle Association) and other citrus associations in California.[3] The original revolving concept has been traced, by a Mr. George Farrand, to Holland where 150 years ago "employees in a work shop were paid a bonus which ultimately revolved."[4]

When a new association is organized under the revolving-fund plan, the original capital may be subscribed for in much the same manner as is

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1 Stokdyk, E. A., "Financing Farmers' Cooperatives," Circular E-20, Farm Credit Administration, Washington, 1939, p. 6.

2 Stokdyk, E. A., "The Modern Set-up in Cooperative Financial Structure," American Cooperation, 1938, American Institute of Cooperation, Washington, p.705

3 Ibid, p.705

4 Ibid, p.705

provided in the ordinary stock or membership fee methods of cooperative financing. Members may contribute capital according to their individual ability or on a qualifying basis, for which certificates of equity or membership are issued. Some organizations provide that the original capital be contributed by members on a production basis in accordance with acreage operated, number of cows owned, or expected use of facilities. Whatever the method of original financing used, however, the revolving plan contemplates the continuous inflow of new capital and the retirement of earlier contributions as conditions permit.

For an operating association which has already obtained its initial capital to reorganize under the revolving-fund plan entails a definite technical procedure affecting its corporate structure and the individual stock holdings of each of its members. These procedures and the technical problems involved are discussed at length in chapter V.

When the initial capital has been acquired and the cooperative begins to function, additional working capital is provided in the case of marketing cooperatives through means of the "retain" which is a deduction of a specified sum per unit of product delivered by each patron. The accumulated retains, added to the original capital of the organization, are credited to the account of the patrons and eventually evidenced in some form of individual certificate. "Since this retain is collected upon the products delivered to the cooperative by the patron at a specified rate per unit, it follows that the accumulated retains will be proportionate to the volume of business and therefore the stock issued for retains will also be proportionate to the volume of business."[1]

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[1] Howland, Arthur, "An Automatic Membership Program and Revolving Plan of Financing," Mimeograph, Dept. of Economics, Michigan State College, p.194

The association's capital may also be augmented by distributing patronage dividends in the form of certificates, and retaining the cash in the organization. Here, as in the case of the retain, the patrons capital contribution and his capital stock (or other security) holdings will be in proportion to his patronage. Purchasing associations which, by their nature are unable to employ the retain feature, operate the revolving plan solely by issuing patronage dividends in the form of certificates and retaining the corresponding funds for use in carrying on the operations of the association.

When a sound capital structure has been built up enabling the association to liquidate its outside indebtedness and/or acquire additional needed physical facilities and adequate working capital, the cooperative may at the discretion of the board of directors retire the oldest outstanding certificates. Here the "revolving" feature comes into play, since each year new certificates are issued for the current retains and patronage dividends while old securities are retired in order of issue. When a member ceases to patronize the association, his capital investment is ultimately retired, since once the plan is set to revolving, only those who make use of the association's facilities contribute the capital which is used to repay the oldest outstanding contributions.

From the standpoint of the cooperative, the plan provides for constant additions to the capital structure and periodic retirements of a portion of it. From the standpoint of the individual, the plan provides for continual investment in the association, in proportion to the use which he makes of its facilities and for periodic returns of his earlier capital contributions. The following tables may illustrate clearly how the revolving plan works out in practice. It is assumed that the capital will not be revolved until the mortgage debt is retired. Because of the

Table 3a Operation of Revolving-Fund Plan from Standpoint of the Cooperative Association.

| Year | Total Membership Investment at beginning of yr. | Mortgage Debt | Capital Added by Retain of 2¢ per lb. butter fat | Capital Revolved | Total Membership investment at end of year |
|---|---|---|---|---|---|
| 1941 | $30,000 | $50,000 | $10,000 | $ 0 | $40,000 |
| 1942 | 40,000 | 40,000 | 14,000 | 0 | 54,000 |
| 1943 | 54,000 | 26,000 | 12,000 | 0 | 66,000 |
| 1944 | 66,000 | 14,000 | 14,000 | 0 | 80,000 |
| 1945 | 80,000 | 0 | 15,000 | 10,000 | 85,000 |
| 1946 | 85,000 | 0 | 9,000 | 14,000 | 80,000 |
| 1947 | 80,000 | 0 | 11,000 | 12,000 | 79,000 |

Table 3b Operation of Revolving-Fund Plan from Standpoint of Individual Patron.

| Year | Investment at beginning of yr. | Capital Contributed by 2¢ butter fat investment | Capital Revolved | Investment at end of year |
|---|---|---|---|---|
| 1941 | $300 | $100 | $ 0 | $450 |
| 1942 | 450 | 150 | 0 | 600 |
| 1943 | 600 | 50 | 0 | 650 |
| 1944 | 650 | 225 | 0 | 875 |
| 1945 | 875 | 125 | 100 | 900 |
| 1946 | 900 | 200 | 150 | 950 |
| 1947 | 950 | 100 | 50 | 1000 |

Source: Stokdyk, E. A., "Revolving Capital--How it Works," News for Farmer Cooperatives, Feb. 1938, Farm Credit Administration, Washington, p.15

impossibility of foreseeing conditions which may necessitate changes in financing requirements, the board of directors, in accordance with their duties as a policy determining body, is usually given broad discretionary powers in the determination of the amount of the deduction to be made (if any), the size of the capital fund to be established and the time to revolve the capital, to enable them to effect such adjustments as may be necessary to meet changing business conditions.

B. ADVANTAGES OF REVOLVING-FUND PLAN OVER OTHER METHODS OF FINANCING

As indicated at the conclusion of Chapter I, the two basic objectives of the revolving-fund plan of financing are to maintain: (1) a sound membership program, and (2) a sound and equitable financing program. Rather than discussing here the methods and techniques by which the revolving plan provides for sound membership and financing programs, it seems more advisable to relate these programs to the points discussed in Chapter I, thereby specifically revealing how this new financing method enables associations to overcome problems and inequities inherent in the older types of corporate structure and to conform to legal cooperative standards. It is realized that a certain amount of repetition will be necessary in presenting the material in this fashion, but it is hoped that such repetition as there is will be counteracted by the greater clarity which is given to the basic task of overcoming the failings of the traditional financing methods.

(1) As A Means of Expanding Membership and Maintaining Member Interest

Under traditional methods of financing, the general problem of dwindling membership and the failure to conform to the legal standard requiring the transaction of a majority of business with members, result from the lack of an effective program which would enable eligible non-member patrons to automatically attain the status of membership. This shortcoming is effectively overcome by the "automatic membership" feature when incorporated with the revolving-fund plan. As indicated by its name, this feature constitutes a plan whereby all eligible non-member patrons are automatically converted into members as they continue to patronize the association. This plan takes effect when the capital stock credits arising from the retains and/or patronage dividends are distributed to the patrons in the form of certificates. (It is to be noted that retains and patronage dividends are credited to non-members as well as members.) The patron eligible to membership has his first capital credits applied towards the payment of voting securities until he has accumulated the required holdings, after which he is credited with non-voting securities.[1] Clearly then the sole process of patronage enables the non-member patron to accumulate the investment required for membership. Since most cooperatives have placed their certificates on a $1.00 par value basis and permitted each patron to become a voting member upon acquiring one such share, the automatic membership process is also a rapid one. In any event, all eligible non-member patrons subsequently attain membership status. The cooperative need exert no pressure or provide any special incentives and the member need make no special purchase of stock or make any other extra capital contribution.

Eventually, then, patronage becomes synonymous with membership and the problem of maintaining a majority of business with members disappears. As the association's volume of business expands with the increase in numbers of patrons, so does the size of membership increase as the new patrons automatically become members. Except for the time-lag involved until a patron attains membership, a cooperative on the revolving-fund plan should be able to maintain close to 100 per cent of its business with

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[1] A full description of the voting and non-voting securities used by associations operating on the revolving-fund plan is presented on pp. 45-48.

members. Moreover, by continually providing for new members, the loss of older members through natural causes is offset and hence the danger of ultimately having the control of the association center in the hands of a few persons is effectively prevented.

Not only does the number of members tend to increase under the revolving capital plan, but also the membership interest and loyalty, for each producer maintains a financial stake in the cooperative enterprise in proportion to the volume of business he transacts through the association. When members are thus given a financial interest, they think of the association as their business, and intimately associate the welfare of the cooperative with their own personal welfare. Thus, they are likely to maintain an active interest in association affairs, realize it is to their advantage to patronize the cooperative, and to remain loyal during times of low prices or other adverse conditions.

(2) <u>As a Means of Preventing Control by Non-active Members</u>

A prime disadvantage of the older financing methods is that they may ultimately allow the control of the cooperative to drift into the hands of non-producer, non-patron members whose sole interest lies in the return upon their investment. Such an interest is decidedly at odds with that of patronizing members,[1] and one which frequently leads to the practice of declaring dividends in excess of the legal cooperative standard. Thus to eliminate the inactive member from any control in the policies of the association is a major objective of the revolving fund plan, and one that is effectively accomplished through the capital

[1] See above p.6 for a full discussion.

rotating feature. Since the rotating scheme provides for the periodic retirement of the members' capital investment, and since by the nature of the revolving plan, only those who patronize the association contribute the current dapital to it, those members who cease to patronize the association will gradually have their entire investment liquidated. Nor is it necessary to wait for their entire holdings to be retired before eliminating non-patron members from any control in the association since it is usually required that such inactive members must surrender their voting securities for conversion to non-voting securities. The revolving-fund plan thus provides an effective method for keeping the voting control and the permanent capital of the cooperative in the hands of patron members, thereby eliminating any possible conflict of interests between member and non-member patrons, and lessening the possibility of declaring dividends in excess of the legal standard. This is an achievement of fundamental importance, for if the association is to be kept on a true cooperative basis, ownership must be geared with patronage. It is the combination of ownership with patronage that distinguishes the true cooperative from the private business corporation.

Just as membership becomes geared to patronage under the "automatic membership" feature of the revolving-fund plan, so does ownership become synonymous with patronage through the rotating capital feature. On the one hand, there is an effective plan for the admittance of eligible non-member patrons; on the other, an equally effective program for the elimination of all non-producer, non-patron members. The result of the interaction of these two schemes is to assure a cooperative in which the producer is at one and the same time, a <u>patron</u>, a <u>member</u>, and an <u>owner</u>--

a sound foundation upon which the success of any association may be built.

In addition to the major advantage discussed above, an obvious but not unimportant effect of the rotating capital feature is to solve the problem of "frozen investments" commonly associated with the traditional methods of financing.[1] Since all outstanding capital certificates are eventually retired in numerical order, any member leaving the association through natural or other causes will have his investment gradually returned to him at face value until his entire holdings are ultimately liquidated.

(3) As an Equitable Means of Distributing the Financing Burden

It is universally recognized among cooperative leaders that the financial burden of the association, to be equitably distributed, should be proportioned according to patronage. Indeed, since it is propounded that the cooperative benefits and advantages should be shared by members in direct proportion to their patronage (the basis of the patronage dividend principle) it is but the next logical step to conclude that the responsibilities of supporting the cooperative, financially or otherwise, should be shared on the same basis. Such a patronage basis of financing is provided for in the revolving-fund plan. Each member and patron contributes periodically to the association's capital in exact proportion to the volume of business transacted through the association. As the original retains and/or patronage dividends are consecutively returned to patrons, new deductions are constantly made on current volumes of business, thus always maintaining the patron's capital investment proportionate to his utilization of the cooperative. The revolving plan places the

[1] See above pp. 6-7.

financial burden upon the active patronizing farmers. Unlike the practice under the older financial plans, no producer, no matter how large or small, carries a greater financial burden in proportion to his volume of business than any other producer.

A further manifestation of the equitableness of the revolving-fund financing program is, that provision is made for the admittance of new members upon a basis that is fair both to them and to old members. As noted in the preceding chapter, under the traditional financing methods, to admit new members upon a basis fair to old members would require the former to pay for stock at a rate corresponding to the book value rather than the par value per share.[1] Such a financial outlay, however, might be greater than the amount the prospective member is able or is willing to invest. Nor would it be equitable from the new member's standpoint to require him to make an investment to such amount, since it would probably exceed the sum needed by the cooperative to finance his business. Under the older financial plans it is thus difficult to harmonize the interests of the old members with that of the new ones. Under the revolving capital plan, however, the old members, even though accumulating a large capital investment prior to the admittance of any new members, have this capital eventually returned to them through the rotating feature and continue to provide new capital on the basis of patronage--the same basis upon which eligible patrons are admitted to membership. Hence since both the old and new members continue to contribute capital proportionate to their patronage, and since old members have their original investment refunded, both are on the same financial basis. The new member is afforded a

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[1] See above p. 8.

convenient method for accumulating the capital necessary to finance his business and is not required to invest more than this essential sum, simply because the original members have accumulated a large equity. It is, therefore, the combination of the rotating capital feature and the patronage basis of financing that assures complete fairness, enabling new members to contribute capital on the same basis as the old members.

That the revolving capital plan has been recognized as the ultimate method of achieving an equitable financial structure is evidenced by the statements of cooperative authorities. Tom G. Stitts, Chief, Cooperative Research and Service Division of the Farm Credit Administration, has recently written: "It is a fundamental principle that the amount of capital each member invests should be in proportion to the volume of products he sells and the volume of supplies he purchases through his association... As the means of spreading the financial responsibility fairly and proportionately among the patrons, no better device has been invented than the revolving-fund system."[1] Ward W. Fetrow, Associate Chief, Cooperative Research and Service Division of the Farm Credit Administration succinctly stated that: "The revolving method of cooperative financing is the ultimate phase of the basic cooperative philosophy that every man support his organization to the extent he uses it and benefits from it."[2]

The revolving capital plan, in contrast to other financial plans, also makes it feasible to provide members with tangible evidence of

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1 Stitts, T. G., "Burning the Mortgage--An Old Co-op Custom," News for Farmer Cooperatives, (October, 1940), Farm Credit Administration, Washington, p.7.

2 Fetrow, W. W., "Three Principles of Agricultural Cooperation," Circular E-24, Farm Credit Administration, Washington, 1940, p.7.

their proprietorship. The nature of the plan, previously described, makes it possible for associations to maintain for capital purposes the cash arising from retains and net earnings and at the same time issue to patrons transferable certificates evidencing the amount retained from each one. The older financing methods make no provision for issuing certificates of interest in the association's surplus, and the ordinary stock and non-stock associations, simply retain the earnings on an unallocated basis (particularly during the period of capital accumulation) thus tending to discourage membership participation, interest and loyalty. Although, under the revolving capital plan, not all earnings may be evidenced by capital certificates, the greater part are issued as patronage dividends (in the form of certificates) and since complete patronage records of both members and non-members are kept, it is a simple matter to allocate the remainder of the earnings on the basis of patronage. Thus through tangible evidences of financial interest and allocated shares in the association's capital, the members are given a feeling of ownership and control, assured that the equity and reserves will be credited to the individual patrons "rather than that an untouchable surplus will be accumulated which is solely in the hands and under the control of the corporation--i.e., in the control of the management and the directors."[1]

Another distinct advantage of the patronage basis of financing, not usually realized by patrons at the outset, is the savings which accrue to them, resulting from the deduction of retains and the issuance of patronage dividends in certificates rather than in cash. Experience shows that investments of members in revolving capital funds of well managed

[1] Jones, J. W., "The Member's Position in His Association," News for Farmer Cooperatives (Oct. 1936), Farm Credit Administration, Washington, p. 7.

cooperatives have been of the soundest nature and prove to be the principal source of savings for members of many cooperatives.[1] It is not uncommon for members to express great surprise and satisfaction when they realize they are the owners of an automatic savings account.

(4) As a Solution to the Problem of Patronage Distribution

Because the common type of financial and corporate structure makes it impracticable to distribute patronage dividends in any form other than cash, most ordinary stock or non-stock associations many times find it financially inexpedient to distribute such a dividend, and hence deviate from a fundamental cooperative standard. The solution of this problem by the revolving-fund plan has been suggested above and is a further manifestation of the sound financial program which this plan provides. By making provision for the distribution of patronage dividends in some form of stock certificate, the association is in no danger of depleting its working capital and is enabled to meet its financial needs. A moment's reflection will reveal that only under the revolving plan is it expedient to continually issue capital certificates in recognition of patronage, for through the orderly retirement of such certificates, the accumulation of an excessive amount of outstanding securities is effectively prevented. To issue patronage dividends in stock under the older financial plans with no retirement provisions would result in a progressive expansion in the association's outstanding capital stock eligible for cash dividends.

On the other hand, the ordinary stock or non-stock type association, in order to demonstrate that it has operated successfully, may be lead to

[1] Stokdyk, E. A., "Revolving Capital--How it Works," News for Farmer Cooperatives (Feb. 1938) Farm Credit Administration, Washington, p.15.

issue a patronage dividend--the commonly accepted measure of success--even though such an action might jeopardize the financial position of the association. Granted that not to declare the dividend would be not to conform to the legal standard, yet to issue the dividend in cash might be to weaken and eventually cause the association to fail. Though the results of either action are undesirable, obviously the latter involves the more serious consequences. The point of emphasis here is that associations whose financial structure makes practicable only a cash patronage dividend, may encounter financial failure when due to management policy or membership pressure, patronage dividends are issued in spite of the need for cash in the business. That the revolving plan corrects this difficulty has been demonstrated.

The revolving-fund plan makes it feasible and desirable to issue patronage dividends to both members and non-members alike--a further requirement of the Federal Revenue Acts. Since, as already explained, the revolving plan provides for an "automatic membership program," there is no need to provide further financial incentives for membership, by making members only the beneficiaries of the patronage dividend. Nor is there any need to "favor" members only with a patronage dividend for assuming more responsibility and incurring greater financial risks than the non-members, for this is not the case under the revolving plan. Both member and non-member patrons assume equal responsibility and financial obligations, since both are required to contribute to the association on the basis of their patronage, hence, obviating any reason for discrimination, and making it only just to award any financial returns to both on the same basis. Lastly the additional difficulties and costs incurred in the keeping of non-member records are, almost universally, more than offset by the financial savings resulting from income tax exemption.[1]

(5) As a Means of Building a Sound and Flexible Structure

A final advantage of the revolving-fund plan, one that has been suggested throughout the previous discussions, but important enough to warrant separate attention, is that it provides a practical method for building a sound capital structure, enabling the association to retire outside indebtedness and acquire additional needed physical facilities. The retain feature allowing for the periodic deduction of a certain percentage from the proceeds of patrons' sales insures a constant inflow of working capital, while the issuance of patronage dividends in certificates enables the association to retain the cash for capital purposes. The combination of these two features allows for an adequate fixed and working capital structure at all times. Messrs. Robotka and Laughlin have shown in a recent study that revolving-fund type organizations because of their capitalization method were more efficient in reducing the rate of indebtedness than were other types of associations. It seems worthwhile to quote their findings: "Organizations that do not use the revolving-fund plan usually pay debts out of earnings, for which no evidence of proprietorship is issued to patrons. Their ability to pay debts is affected directly by the margin left after meeting competitive prices. Revolving-fund associations provide for shifting the debt from original creditors to

1 Adherence to the legal standard of distribution of patronage dividends to members and non-members alike, as stipulated in the Federal Revenue Act, entitles the association to income tax exemptions, provided, of course, the other legal requirements are met. See above p. 16.

current patrons by specific deductions for which certificates of indebtedness are issued. Revolving-fund associations are thus able to make regular payments on debts while paying current competitive prices because the payment to patrons is made in the form of revolving-fund certificates."[1]

1 Robotka, Frank and Laughlin, Gordon C., "Cooperative Organization of Iowa Farmers' Creameries," Farm Credit Administration Bulletin No. 14, Washington, 1937, p.44.

# CHAPTER III

## TECHNIQUES AND VARIANT PROCEDURES IN SET-UP AND ADMINISTRATION OF REVOLVING-FUND PLAN

### A. SOME TECHNICAL AND POLICY PROBLEMS

#### Securities Used for Corporate and Financial Structure of Revolving-Fund Organizations

Basically, the corporate and financial program of cooperatives on the revolving-fund plan, contemplates the use of two major types of securities--voting and non-voting. The voting securities are held by the member during the life of his membership while the non-voting securities used solely for financing purposes, are the revolving certificates, being gradually retired as they are called in for payment. The right to hold voting securities is restricted to those who meet the qualifications for membership and who maintain their status as qualified members. Should the member lose his eligibility by ceasing to be a producer or patron, his voting securities are called and cancelled and he is issued non-voting securities of equal value, in exchange, thus eliminating him from any voice in the control of the association.

The par value of the voting security is usually placed at a nominal sum so as to allow the prospective member to obtain voting rights with a minimum of financial difficulty and so that the retirement of such securities will not be an undue financial burden to the cooperative. Most associations place a par value of from $1.00 to $5.00 on their voting certificates and allow each patron to become a voting member upon obtaining one such share of voting stock. The total amount of voting securities which each member is allowed to own is usually limited to not more than $10.00, although usually no member is allowed to have more than one vote, the remainder of the member's investment being evidenced by some form of non-voting certificates. No restrictions are placed upon the amount of non-voting securities each member may hold, and generally they receive preference over the voting certificates as to payment of interest or dividends, and are paid in full before any payment is made on voting securities, in the event of liquidation of the cooperative. In contrast to voting securities, non-voting certificates are usually transferable provided that they are first returned to the cooperative to make a record of the transfer.

Although it has been reported that few stock associations operate on the revolving capital plan, this plan is easily adapted to both the stock and non-stock associations.[1,2] As a matter of fact there is actually little difference between these two types of organization in associations that plan their financial structure on the revolving basis. The superficial difference is manifested in the varied types of securities used to evidence member investments. Generally, the capital stock associations issue common stock as the voting security and preferred stock as the non-voting revolving security, while the non-stock association issue "membership certificates" and "certificates of indebtedness" as evidences of voting and non-voting securities respectively. The certificates of indebtedness, issued against authorized deductions from the patrons' sales or returns, has been defined as "a written acknowledgement of the debt of the association for the sum stated on the certificate to the person

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1 Stokdyk, E. A., "Financing Farmers' Cooperatives," Circular E-20, Farm Credit Administration, Washington, 1939, p. 8.

2 In Iowa Robotka and Laughlin found that no cooperative creameries having capital stock used the revolving-fund plan as a method of financing.

named therein,"[1] and as such is part of the long term debt of the cooperative. It, thus, technically differs from the preferred stock certificate which constitutes a qualified proprietary interest in, and is, part of the capital account of the association. Further technical differences may be that a specific financial obligation is represented by certificates of indebtedness and that they bear a rate of interest rather than a dividend rate. Robotka and Laughlin in their study of Iowa Cooperative creameries have stated that there is a vitally important distinction between certificates of indebtedness and shares of stock in that shares of stock are not usually liquidated during the normal course of operations whereas it is definitely expected that certificates of indebtedness shall be liquidated through means of the "retains."[2] However, it should be borne in mind that no capital stock associations in Iowa were operating on the revolving-fund plan. This supposed important distinction between stock and certificates of indebtedness disappears when stock associations plan their capital structure on the revolving basis, for then shares of stock which may be used as revolving securities are liquidated during the normal course of operations just as are certificates of indebtedness. Technically and legally, it may be admitted that certificates of indebtedness differ from preferred stock, but actually they both serve the same practical purpose--that of evidencing capital contributed by patrons on other than a qualifying or proprietary basis, and destined for retirement instead of permanent investment.

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1 Bakken and Schaars, "Economics of Cooperative Marketing," McGraw Hill Book Co., 1938, p. 394.

2 Robotka and Laughlin, "Cooperative Organization of Iowa Farmers' Creameries," Farm Credit Administration Bulletin No. 14, Washington, 1937, p.49.

The fact that the term "certificate of indebtedness" conveys the impression to members and others that the association is in debt, has led many cooperatives to abandon the use of this term in favor of others more representative of their distinctive financial structure. The result has been the emergence of a variety of names to evidence capital contributions to the revolving fund, some of which are: certificates of equity, certificates of interest, revolving-fund certificates, advance fund certificates, and reserve fund certificates. Although predominantly used by non-stock associations, these securities may and have been used by stock organizations along with their regular stock issues.[1] The usage of these varied types of revolving securities should not confuse the reader, for fundamentally they are all merely names representing patrons' automatic capital contributions with no material differences existing between them.

## Should Revolving Certificates Bear a Definite Maturity Date and a Fixed Interest Rate?

A technical question arising in connection with the issuance of revolving certificates is whether such certificates should bear a definite date of maturity and a fixed rate of interest? The primary argument offered by those favoring a definite due date and a fixed interest rate is that a certificate bearing such provisions on its face is then more easily negotiable, making it possible for members to liquidate their investment when they are in urgent need of cash. In reality, however,

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[1] Although rarely using these types of securities, many stock associations in Michigan make use of certificates of indebtedness for their revolving securities for reasons which have been advanced on p. 86.

assurance of payments of either principal or interest depends not upon what is written on the face of the certificate but upon the success of business operations and the policies of the organization. Therefore, if an association is unable, because of a lack of earnings, to meet its obligations as stated on the certificate, its value to the investor is no greater than one which provides for no definite maturity date or fixed interest rate. One cooperative leader has suggested that cooperatives are under an ethical obligation to pay interest on revolving certificates when the revolving fund extends over a long period of time, for then the member must look far ahead for the return of his principal in addition to assuming a financial risk.[1] However, such an obligation may be undertaken without requiring that the association pay a <u>fixed</u> <u>rate</u> of interest, but rather permitting the <u>rate</u> <u>to</u> <u>be</u> <u>discretionary</u> with the board of directors and not to exceed a stated limit. In no case should the association obligate itself to make a mandatory payment of interest but always make such payment contingent upon satisfactory earnings.

One advantage ascribed to certificates bearing a fixed maturity date, both in theory and practice is that the holder of these securities are given a certain protection against an unethical policy making board who may simply postpone retirement of these obligations indefinitely, even though the operations of the association have made it possible to liquidate them. In such an event legal recourse may be had by holders of interest bearing certificates with stipulated maturity dates.

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[1] Mr. E. J. Tracy in discussion with Mr. John Lawler concerning the latter's article "The Revolving Fund Finance Plan in Operation," <u>American Cooperation 1928, Volume I</u>, American Institute of Cooperation, Washington, p.474.

On the other hand it is felt by many cooperative leaders that both the theoretical advantage of greater negotiability and the actual advantage of protection to the investor attributed to the certificate with a definite maturity date and interest rate are more than offset by the disadvantages of such a certificate to the cooperative. When an association feels obliged to pay a fixed interest rate and retire a certain portion of its certificates at a specified date in the future, it may be placed in an embarrassing position in a year when earnings are not sufficient to meet the required payments. Some associations may borrow, deplete reserves, or otherwise jeopardize their financial position in order to fulfill their obligations and maintain financial integrity. To paraphrase a statement by James W. Jones of the Farm Credit Administration, an adequate capital structure is a prime necessity and a cooperative should not endanger its security by pledging itself to redeem a certain portion of its certificates at any particular time.[1]

Another disadvantage of securities bearing a definite maturity date grows out of the fact that there is usually a wide disparity between the amount of securities issued each year due to variations in retains collected and earnings distributed as patronage dividends. Such a situation may result in large retirements one year and small ones the next, necessitating constant adjustments in the association's capital structure which may prove exceedingly difficult to cope with.

## Determination of Revolving Period

In view of the greater disadvantages of the definite maturity date

[1] Jones, J. W., "The Member's Position in his Association," News for Farmer Cooperatives (Oct. 1936) Washington, p. 13.

and fixed interest rate it is suggested that both the time of retirement and payment of interest should be left to the discretion of the board of directors. With a flexible rotating period and discretionary rates of interest payment, revolving certificates may be retired (in order of issue), and interest paid, only when the financial condition of the association warrants such action. There is no "deadline" that the cooperative need meet. When the revolving fund contains excess capital reserves, a large portion of the certificates may be revolved; when it contains little more than the required working capital, a small percentage of the capital may be revolved.

Generally associations should make no revolution of capital until their mortgage debt is repaid, reserves are established and the association has enough working capital for normal operating requirements. The usual membership pressure to revolve the capital as soon as possible must be overcome by impressing upon members the necessity for maintaining a sound financial structure. In practice certificates should be revolved at least every 4 or 5 years to maintain their marketability and realizable value, but should not be revolved more often than once in two years for then the costs of the certificates, of issuing them and of keeping the records of their issue and cancellation becomes excessive.[1]

## Determination of Amount of Retain

For the marketing association, one of the principal factors determining the period of capital rotation is the amount of the "retain"

[1] Howland, Arthur, "An Automatic Membership Program and Revolving Plan of Financing for Cooperatives," Mimeograph, Department of Economics, Michigan State College.

collected annually, for it is this deduction from the proceeds of sales of patrons' products which comprises a major portion of the revolving fund.[1] A study of 36 marketing cooperatives of various types by E. A. Stokdyk showed that the capital retain varied from 0.3% of net returns to producers to 19.4%, with the majority of associations having retains of from 2 to 5 per cent of net returns.[2] Many associations base their retain upon an actual monetary sum per unit of product (i.e. 1¢ per lb. or 2¢ per bushel) rather than on a percentage of the sales price, for they feel that the former method permits a greater degree of certainty, enabling the management to plan the financial structure more accurately than would be the case if the retain were based upon the sales price which may be subject to wide fluctuations. In any event, the amount of the retain should be adjustable to meet varying price or production situations to enable the association to meet its financial obligations and requirements, rather than have a fixed retain which may be unsuitable in the face of current membership problems and financial needs. In determining the amount of the retain to be levied, Mr. Stokdyk believes that there are four main factors to be considered:

1. The type of operation conducted by the association.
2. The stage in history of association which has been reached.

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[1] As explained above, p.31 the retain is not adaptable to the purchasing association which obtains its working capital solely through retaining earnings in the business while allocating them to patrons in the form of dividend certificates. As shown in chapter IV, many marketing associations in Michigan have chosen not to make use of the retain, operating the revolving program solely through the patronage dividend feature. However, throughout the country, most of the marketing associations adopting the revolving-fund plan employ the retain feature.

[2] Stokdyk, E. A., "The Modern Set-up in Cooperative Financial Structure," American Cooperation, 1938, American Institute of Cooperation, Washington, p.707.

3. The competitive situation in the industry
4. The understanding or lack of understanding by membership of the function of the retain.[1]

The influence of these factors upon the size of the retain seems apparent, but a word of comment may be appropriate regarding the latter two which are inter-related and which affect all associations regardless of type of operation or age. When the industry in which the cooperative is engaged is highly competitive, it becomes difficult to levy a large retain from the proceeds of sale, for patrons are desirous of receiving as high a cash return as possible. They may decide to patronize other organizations which pay a higher cash price rather than have part of the proceeds from sales of their products kept in the association in the form of a retain. It is thus necessary for the marketing cooperative on the revolving-fund plan to carry on an educational program explaining to members the purpose and use of the retain. They must be made to understand that its function is to finance the association, that it is credited to them and evidenced in the form of a certificate, and that when a sound capital structure has been established and certificates begin to revolve, they will receive the full value of the amount which has been deducted from the proceeds of their sales. When members and patrons lack an understanding of the function of the retain, it is not only the size of the deduction that is affected but the whole revolving program (in the case of the marketing association depending upon this feature to raise their working capital).

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[1] Stokdyk, E. A., "The Modern Set-up in Cooperative Financial Structure," American Cooperation 1938, American Institute of Cooperation, Washington, p. 707.

B. THE REVOLVING-FUND PLAN AS INSTITUTED BY PIONEER ASSOCIATIONS

Before discussion the application of the revolving-fund plan to modern Michigan associations, it seems appropriate to present a description of the techniques and variant procedures of this financing plan during its adolescent period of operation. It is felt that such a presentation will not only be of general interest but of considerable value for comparison purposes with the present operational modes and techniques as used by associations in Michigan and elsewhere. A search of the available literature revealed an analysis of the early application of the revolving-fund plan in sections of California and New England as exemplified by a large poultry association in the former state and a few of the larger dairy cooperatives in the latter section. The techniques employed by these two types of organizations were distinctly different and will serve to demonstrate how the revolving plan may be adapted to the individual needs of a particular type of cooperative.[1]

Poultry Producers of Central California

It was on the first day of January, 1924, that the Poultry Producers of Central California abandoned the traditional capital stock plan of financing in favor of the revolving-fund plan. The description of the plan by Mr. Lawler, general manager of the association when the new financing plan was adopted, did not reveal the type of security used to designate voting control but the revolving securities were termed "advance fund

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1 The following descriptions are taken in the main from two primary sources: Lawler, John, "The Revolving Fund Finance Plan in Operation," American Cooperation, 1928, Vol. I, American Institute of Cooperation, pp. 469-479 Hall, Reuben, Conference on the Financing of Dairy Cooperatives, American Cooperation, 1925, Vol. II, American Institute of Cooperation, pp. 153-175

certificates," and evidenced ownership in the "advance fund." Provision was made for a retain based upon a stated sum per unit of product rather than upon a percentage of the sales price. Specifically it was provided that one cent per dozen of eggs be deducted from the proceeds of the sale of patrons' products, which deduction would be evidenced to patrons by the "advance fund certificates" to be issued quarterly in multiples of $10.00. The "advance fund" was authorized to the amount of $500,000, subject to adjustment by a vote of the members. When the fund exceeded the authorized amount "advance fund certificates" equivalent to the excess would be called and retired in order of issue. The board of directors was given authority to retire outstanding certificates only during that season of the year when the association did not require a large amount of capital for operating purposes. Such a degree of flexibility is obviously necessary in the marketing of a seasonal product. It is evident from the above provisions that the revolving certificates did not bear a definite maturity date, while at the same time a patron was practically assured of payment for a part of his holdings when the "advance fund" exceeded $500,000.[1]

Although not bearing a definite maturity date the "advance fund certificates" did bear an interest rate fixed at 6% contrary to what has since been deemed the more advisable procedure of permitting the interest rate to be left to the discretion of the board of directors. The revolving certificates were endowed with the right of free transferability and were

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1 This sum was probably selected as being basic to the needs of the association and hence the retirement of certificates when the fund was below $500,000 would be financially unsound.

subordinate only to the outside debts and liabilities of the association. Mr. Lawler stated that the "advance fund certificates" could be compared to preferred stock, the certificates having the advantage of a reasonably definite maturity date about two years from date of issue. This statement indicates that the full possibilities for the utilization of preferred stock were not realized at the time, for preferred stock may be and has been used to evidence revolving capital and in such capacity may be endowed with a "reasonably definite maturity date" just as the "advance fund certificates" were.[1]

An interesting and practical use to which the revolving plan may be put is demonstrated by Mr. Lawler's description of the Poultry Producers' "feed finance fund." When it was suggested to establish a feed and supply department in the association many members were in favor of the plan but a few were vehemently opposed being unwilling to have the working capital of the association used for this purpose. Therefore it was necessary to develop a plan to provide working capital for the proposed feed and supply department without calling on the opposed members nor using any of the capital already supplied for the merchandising of eggs. Thus there was developed a second revolving fund similar to the original one, and known as the "feed finance fund." Initial capital for this fund was raised by voluntary subscription of members and by the issuance of certificates in payment for feed refunds and for other assets. Only those patrons who

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1 The technical differences between preferred stock and various types of revolving certificates have been indicated below, p.47 . Actually it was shown that they both serve the same fundamental purpose of evidencing revolving capital, and hence any provision as to the time of revolving this capital may be given to both types of securities.

made use of the feed and supply department contributed capital towards it. Since no retains could be provided for in a purchasing department, the fund was augmented by issuing patronage dividends in the form of "feed finance fund certificates" to purchasers of poultry feed, and retaining the cash for capital purposes. Thus all additions to the fund came directly from overcharges or gains in the feed department. The method of retiring the "feed finance fund certificates" was the same as that used for the "advance fund certificates" and the former bore the same technical and legal provisions as the latter.

The two funds were distinctly segregated, each fund being used to retire its' respective certificates and being invested in the assets needed in the respective departments. For example, the money in the "advance fund" was invested in the land, buildings and equipment needed for the poultry and egg department, in addition to the supplies, eggs and accounts receivable. On the other hand, the money from the "feed finance fund" provided the necessary capital for land, buildings, milling machinery and equipment, feed and accounts receivable for the feed and supplies department. In the event of liquidation, however, the assets of the entire corporation would be used to repay the indebtedness of the association, but the remaining assets would be divided into their respective departments, those in the "advance fund" being used to retire the "advance fund certificates" while the assets in the "feed finance fund" would be utilized for the retirement of the "feed finance fund certificates."

## Dairy Associations in New England

The first application of the revolving principle of financing in

New England occurred in the early 1920's when the New England Milk Producers Association, a bargaining organization, adapted the plan to the needs of the larger dairy associations. Contrary to its early use in California, the plan was based on a capital stock structure, and as such was termed the "rotating stock plan." This rotating plan was primarily developed as a means of adjusting the members' investment so as to be exactly proportionate to the value of the product marketed through the association, which was early recognized to be the most equitable basis for investment. The method of adjustment, similar to that used by present day revolving-fund organizations, can best be indicated by resorting to the example used by Mr. Reuben Hall in his description of the technique.[1]

At the outset each member was required to make an investment proportionate to the number of cows which he owned.[2] Thus assuming the required per cow investment to be $25.00, the contributions of any 5 members of the association would be as shown in column 2 of table 4 below. As the members marketed their milk through the association, 5 per cent of the milk check each month was deducted as a retain (in contrast to the California association which based its retain on a definite sum per unit of product) and held in the special "capitalization rotation fund." At the end of the year the total sum withheld from the 5 members, was $420 or 30 per cent of their total combined investment of $1400. This fund of

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[1] Hall, Reuben, "Conference on the Financing of Dairy Cooperatives," American Cooperation, 1925, Vol. II, American Institute of Cooperation, Washington, pp. 153-155.

[2] It is not clear from Mr. Hall's description whether all new members were required to invest on this basis or simply those who formed the association and contributed the initial capital.

Table 4. Method of Adjusting Members Individual Investment on the Basis of Patronage, Used by Dairy Cooperatives in New England, 1921-25*

| Member | No. of Cows Owned | Required Initial Investment | Investment Remaining after Retirement of 30% of Initial Investment | Contribution made through deduction of 5% from monthly milk check | Final Adjusted Investment |
|---|---|---|---|---|---|
| A | 10 | $250 | $175 | $60 | $235 |
| B | 8 | 200 | 140 | 50 | 190 |
| C | 6 | 150 | 105 | 50 | 155 |
| D | 12 | 300 | 210 | 80 | 290 |
| E | 20 | 500 | 350 | 180 | 530 |
| Total | 56 | $1400 | $980 | $420 | $1400 |

*Data taken from Reuben Hall, "Conference on the Financing of Dairy Cooperatives," American Cooperation 1925, Vol. II, p. 154

$420 was therefore used to retire 30 per cent of each man's original stock-holdings and, in addition each was given new stock equal to the value of his contributions made during the year. This method of determining the proportion of each member's stock to be retired, on the basis of the proportion of the total retains to the total members' original investment differs from the usual method of retiring the stock in order of issue at the discretion of the board of directors. The ultimate goal of adjusting each member's investment to the value of his products marketed will be achieved in any case, however. To continue with the example, each member's original investment was reduced by 30 per cent and then increased by the amount of his annual contribution resulting in the adjusted proportionate investments shown in column 4 of table 4.

Through this constant process of recall and readjustment, a member ceasing to patronize the association, had his investment totally taken up and distributed among the remaining members, eliminating him from membership, as is done among present day revolving capital associations.

If additional capital were required each man would contribute to the capitalization fund in accordance with his ability, not necessarily his patronage, but his investment would be ultimately adjusted in proportion to the products marketed in accordance with the procedure described above. The New England Milk Producers Association also recognized that additional capital could be accumulated through earnings by distributing patronage dividends in the form of stock instead of in cash (the common procedure in use today by associations operating on the revolving capital plan) and advised the dairy associations to adopt this practice.

In accordance with the one man, one vote principle, the New England Milk Producers Association developed what at that time was considered a special class of stock called "voting stock" which sold for $10.00 per share with only one share allowed to each producer. This "special stock" is obviously equivalent to the present day common stock used for voting purposes. Realizing the importance of maintaining control of the cooperative in the hands of patron producers at all times, the N.E.M.P.A. embodied a provision (common among all present day revolving-fund associations) requiring each producer to surrender his voting stock upon payment of its face value, when he ceases to be a producer or a patron of the cooperative. However, the plan makes no specific provision for the conversion of voting stock to non-voting stock and it is not clear whether this practice was followed. (Among present day revolving-fund associations organized on the stock basis, this practice is commonly pursued.) Definite restrictions were placed on the sale of voting stock, the member being required to offer his stock to the cooperative 30 days prior to the time he was permitted to offer it for sale to any other person.

The second class of stock utilized by the New England dairy associations on the "rotating stock plan" was termed "patronage stock," and had no voting rights. The "patronage stock" carried a 6 per cent dividend rate and bore the same restrictions as to transferability previously mentioned in reference to the "voting stock." The broad statement made in 1928 by Mr. Lawler, general manager of the Poultry Producers of Central California to the effect that general restrictions surrounding the transfer of ownership of stock hinders their marketability, indicates that this practice was common among capital stock associations organized under the revolving-fund plan. Thus, in comparing the relative merits of stock and certificates of indebtedness for use in the revolving capital structure many cooperative leaders were definitely in favor of the latter since they were freely transferable enhancing their value through wider marketability.[1] However, this common advantage of the certificate of indebtedness over the stock share no longer necessarily exists today, since the latter security may be and has been given the same attribute of unrestricted transferability as the former.

In devising the "rotating stock plan," the N.E.M.P.A. felt that they had found a method of keeping control in the hands of patron

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[1] Mr. E. J. Tracy, general counsel for the Cooperative Pure Milk Assn., Cincinnati, Ohio, in 1928, stated: "If common stock is used in revolving fund, limited in its sale to members, its value is not as great as certificates of indebtedness which may be transferable to anybody." "Contracts or other Membership Control Methods," American Cooperation 1928, Vol. I, p.313.

producers, of maintaining their investment proportionate to the service which they received, and of preventing outside factors from gaining control of the organization--all commonly accepted advantages of the modern revolving-fund plan.

The study of the early use and adaptation of the revolving capital idea, as reflected in the financing programs of the Poultry Producers of Central California and the New England Milk Producers' Association indicates that the basic technique and objectives of the revolving-fund plan have not changed in almost twenty years. The two examples chosen indicate that at the outset the plan was adapted to both the stock and non-stock type of cooperative and could be utilized by associations regardless of the type of commodity marketed. The past twenty years have witnessed a large increase in the popularity of the revolving plan until today it is being used by associations in nearly half the states, with 200 cooperatives in California and nearly 100 in Iowa adopting the new financing plan.[1] With this huge growth have come improvements, refinements, and adaptations for all purposes, but the basic objectives of providing for sound and equitable financial and membership programs formulated during the twenties continue to be the same.

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[1] Stokdyk, E. A., "Revolving Capital--Its Larger Benefits," News for Farmer Cooperatives, (July 1939), Farm Credit Administration, Washington, p.14

## CHAPTER IV

## THE APPLICATION OF THE REVOLVING-FUND PLAN BY MICHIGAN COOPERATIVES

Out of approximately 350 Michigan farmer cooperatives in existence as of 1942, 42 are currently operating under the revolving-fund plan of financing. It will be the purpose of this chapter to indicate the general application of the plan by these associations, to analyze the changes undergone in their organizational and financial structures, and to describe the technical nature of their membership programs. The earliest adaptation of the revolving capital plan by a Michigan association occurred in 1928, when the Coldwater Dairy Company in Branch County saw fit to institute the plan in their organization. Since this association was the pioneer in the "revolving-fund movement" in Michigan it seems appropriate to give some attention to its background, conditions leading to the adoption of the revolving stock program and the general effects which the plan has had on the cooperative organization.

### A. THE PIONEER ASSOCIATION: COLDWATER DAIRY COMPANY

The association was originally organized in 1920 with 154 members but after only four years of operation suffered a financial failure primarily because of an original capitalization considerably in excess of the real assets.[1] In 1924, thirty-eight of the largest stockholders assumed control of the organization and operated the dairy primarily as a private business with producer ownership. Under the direction of these men, the financial status constantly improved, all outstanding debts were

[1] The following paragraphs are based primarily upon statements made by Mr. G. S. Coffman, Manager of the Coldwater Dairy Co., in the course of an interview and correspondence with the writer.

liquidated, and by 1928 the association was operating on an efficient, profitable basis.[1] The 38 stockholders were anxious, however, to find some financial plan whereby some 330 or so non-member patrons of the "cooperative" would be given a definite interest and representation in association affairs. Basically the stockholders believed it to be desirable for the patrons to eventually acquire sole ownership of the dairy.

This desire on the part of the stockholders was prompted not only by their cooperative spirit and philosophy, but also by practical considerations. The Coldwater Dairy Company had for four years been operating cream stations in conjunction with cream routes. It was found that the procurement costs of the cream stations averaged nearly 2¢ per pound of butterfat more than the costs of the cream routes with an inferior grade of cream coming from the cream stations.[2] Hence the owners decided to discontinue the operation of the cream stations in an effort to lower procurement costs, raise the quality of cream and thus make possible the payment of a higher price to the producers. In order to effect these measures, however, the volume of cream obtained from the cream routes had to be increased to compensate for the discontinuance of the cream stations and maintain a reasonable production in the plant. It was thus necessary to induce the producers formerly delivering to cream stations to join the cream routes, and to increase the volume of collections on the latter. To accomplish this purpose it was felt that the heretofore

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1 Debts totaling $17,770 were paid off.

2 Farmers did not bring their cream to the stations until they had accumulated a full 100# can. The cream, therefore, was often several days old before being brought to the cream stations.

impersonal relationship between the patrons and the association would have to give way to a truly cooperative condition by which the patrons would be given a personal financial interest in the association eventually leading to ownership and control of the organization.

At this time, the company was operating some dairy routes in Indiana, and since the interests of Indiana producers were involved, it was suggested by the secretary-manager of the Michigan State Farm Bureau that a conference be held with the Indiana State Farm Bureau in the hope of evolving an effective program that would be of definite interest to all producers. It was at this conference, held on February 28, 1928, that Mr. Settle, President of the Indiana State Farm Bureau, "suggested that a revolving stock company might work out advantageously. His thought was that a revolving stock company would give the Indiana producers, that were selling to the Coldwater Dairy Company, representation in the creamery they were patronizing."[1] This idea was well received by the owners of the dairy and they proceeded to work out the details of such a revolving plan, emerging with a completed program on June 16, 1928. In addition to providing for patron ownership of the association, a main objective of the program was the elimination of non-producer members whose sole interest was a profit on their investment.

The plan was embodied in the form of an "Agreement" signed by the officers of the Coldwater Dairy Company in which was listed the conditions upon which the patrons would acquire ownership of the dairy.[2] Essentially,

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[1] Quoted from the letter, Aug. 7, 1942, received by the author from Mr. G. S. Coffman, present manager of the Coldwater Dairy and one of the original 38 stockholders.

[2] For text of agreement see p.66.

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## AGREEMENT

The Coldwater Dairy Company hereby agrees:

1. Upon the plan recommended by the Indiana Farm Bureau Federation
2. With the Patrons of Coldwater Dairy Company, who will become sole owners of Coldwater Dairy Company upon acquisition of the capital stock acquired upon the following conditions:

The Coldwater Dairy Company shall withhold one cent (1¢) per pound on all butter fat purchased from said patrons.

Each and every patron who shall have delivered 1000 pounds of butter fat shall be entitled to receive one share of capital stock of the Coldwater Dairy Company with a par value of Ten Dollars, ($10.00) per share, to be issued out of the Treasury Stock of the Company, at the end of each month.

The Company agrees to pay an amount equal to the par value of the stock so issued in cash to the Trustee of the original shareholders as part payment of the stock acquired from said shareholders for the total sum of Thirty Nine Thousand Five Hundred Forty Dollars, ($39,540.00), until fully paid.

It is further agreed that the earnings from the operation of the Company shall accrue and be refunded when finances permit to the patrons of the Company and any rebates shall be based on the pro-rata share of butter fat sold to the Company as evidenced by certificates issued for lots of one thousand pounds each.

It is also understood and made a part of this agreement that the original stockholders shall not participate in the earnings of the Company, however, there shall be paid an amount equal to six per cent (6%) interest at the end of each calendar year, which shall be computed on the average unpaid balance of said purchase money obligation during each year.

This agreement is made effective as of June 16, 1928.

SIGNED

Coldwater Dairy Company

W. C. KEMPSTER
President.

G. S. Coffman
Secretary.

G. S. Coffman
Treasurer.

it was provided that the company should withhold one cent (1¢) per pound on all butter fat purchased from the patrons and that upon the delivery of a thousand pounds of butterfat, a patron would be entitled to one share of capital stock with par value of $10.00, to be issued by the association monthly. No definite provision was made in the agreement or the by-laws of the Association (nor has any been made since) for revolving the capital stock; it was contemplated that the outstanding stock would be retired in order of issue whenever the financial position of the association made such a step possible. The new revolving stock program actually went into effect on July 1, 1928 at which time the operation of all cream stations was discontinued, making possible the beginning of a quality program, the reduction of procurement costs and the payment of higher prices to producers.

The revolving plan has been in continuous effect at the Coldwater Dairy since its inception and on July 1, 1942, began its 15th year of operation. During these years of operation, many advantages have accrued to the cooperative. The most apparent effect of the revolving stock plan has been to constantly increase the association's active membership. As indicated previously there were only 38 stockholders (3 of whom were non-patrons) and approximately 330 non-member patrons when the revolving fund plan was initiated. Immediately after its adoption, active membership increased to 338 and continued upward until by the end of 1941 there were 1475 patron-members, an increase of 3783% over the original number. The trend of membership growth is indicated in Table 5. A yearly increase is evidenced in every year with the exception of two, 1933 and 1934. The depth to which the depression had sunk during these years caused many

Table 5. Growth of Membership in Coldwater Dairy Company Since the Inception of the Revolving-Fund Plan

| End of Year | Total Members | Yearly Increase | End of Year | Total Members | Yearly Increase |
|---|---|---|---|---|---|
| June '28 | 38* | | | | |
| Dec. '28 | 338 | 300 | 1935 | 1098 | 114 |
| 1929 | 490 | 152 | 1936 | 1184 | 86 |
| 1930 | 712 | 222 | 1937 | 1194 | 10 |
| 1931 | 955 | 243 | 1938 | 1299 | 105 |
| 1932 | 1152 | 197 | 1939 | 1348 | 49 |
| 1933 | 1120 | - 32 | 1940 | 1442 | 94 |
| 1934 | 984 | - 136 | 1941 | 1475 | 33 |

* Number of members at time of adoption of revolving plan.

dairy producers to cease operations accounting for the decrease in the association's total membership.

With the constant increase in patronage, there came a steady growth in the association's volume of business. This growth is indicated in Table 6 which shows the actual butterfat deliveries rather than the dollar volume of sales, since the latter is always greatly affected by price fluctuations. The decrease in butterfat volume in the years 1933 and 1934 may again be attributed to the severity of the depression causing a general decline in the association's patronage. The decrease in volume of business shown for 1941 was due to a strike of the employees which necessitated the suspension of operations for a period of five months. The average volume per month of operation was, however, considerably greater than in the preceding year.

Table 6. Physical Volume of Business of the Coldwater Dairy Company Since the Adoption of the Revolving-Fund Plan.

| End of Year | Pounds of Butter-fat Deliveries | Yearly Increase | End of Year | Pounds of Butter-fat Deliveries | Yearly Increase |
|---|---|---|---|---|---|
| 1928 | 133,956 | - | 1935 | 864,222 | 89,410 |
| 1929 | 397,036 | 263,080 | 1936 | 928,756 | 64,534 |
| 1930 | 564,238 | 167,202 | 1937 | 1,015,231 | 86,475 |
| 1931 | 746,959 | 182,721 | 1938 | 1,190,775 | 175,544 |
| 1932 | 907,085 | 160,126 | 1939 | 1,402,385 | 211,610 |
| 1933 | 874,727 | -32,358 | 1940 | 1,477,611 | 75,226 |
| 1934 | 774,812 | -99,915 | 1941 | 1,299,713 | -177,898 |

The expansion in business volume was due not only to an increase in the total number of patrons, but also to the increased patronage of producers transacting business prior to the adoption of the revolving program. It was estimated by the manager of the Coldwater Dairy Co. that these patrons increased their business transactions by 15% when they realized that through their patronage they were gradually acquiring ownership and control of the organization. The payment of higher prices made possible by lower procurement costs and a better quality product was another factor influencing patrons to increase their volume of patronage.

The automatic membership feature of the revolving stock program has made it possible for the Coldwater Dairy to increase its membership in direct proportion to its increase in business volume. Patrons are credited with $1.00 worth of stock after they have delivered 100 lbs. of cream, virtually becoming members as soon as they begin patronizing the association.[1] Thus, since 1933 the proportion of business transacted with members has been 100 per cent. The proportion of member business for each of three years prior to the adoption of the revolving plan and for each year since its adoption is indicated in Table 7. The data for the years 1931 and 1932 were not available but Mr. Coffman, manager of the cooperative, stated that there was a steady increase during these years gradually approaching 100 per cent.

A material advantage accruing to the Coldwater Dairy ever since the adoption of the revolving stock program has been the savings realized

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[1] Actually the original provision of issuing patrons a $10 common stock certificate after delivering 1000 pounds of cream to the plant is still in effect, but patrons are given the right to vote after accumulating $1.00 in stock credits and hence may be considered members at this time.

Table 7. Proportion of Business of Coldwater Dairy Company Transacted with Members, 1925-1941.

| End of Year | Percentage of Member Business | End of Year | Percentage of Member Business |
|---|---|---|---|
| 1925 | 10 | 1933 | 100 |
| 1926 | 10 | 1934 | 100 |
| 1927 | 10 | 1935 | 100 |
| New Plan Adopted June, 1928 | | 1936 | 100 |
| 1928 | 20 | 1937 | 100 |
| 1929 | 40 | 1938 | 100 |
| 1930 | 60 | 1939 | 100 |
| 1931 | - | 1940 | 100 |
| 1932 | - | 1941 | 100 |

as a result of exemption from various taxes and fees.[1] The total sum thus saved over a period of 14 years has been estimated by Mr. Coffman at approximately $15,000. Even when the additional yearly bookkeeping expense of about $300 is taken into consideration the total net savings realized, over the whole period, is approximately $11,000.[2]

Prior to the adoption of the revolving plan, of $19,570 in outstanding common stock, $2,500 or almost 13 per cent was in the possession of non-patron members. The relatively small percentage of stock in the hands of inactive members may be attributed to the short period of time which the organization had operated; had there been a longer period of operation it is probable that more of the stockholders would have reached the inactive state thus increasing the percentage of stock held by non-patron members since no provision was made for stock retirement. However, this may be, the initiation of the revolving stock plan effectively corrected

1 Associations meeting the required state and federal cooperative standards may claim exemption from income taxes, excess profits tax, undivided profits tax, stamp taxes, and various privilege taxes. They may also claim exemption from the application of the State Securities Act on the sale of securities up to $30,000.

2 If the additional yearly bookkeeping cost were approximately $300 for each year, the total cost over the 14 years would be $4,200. However, this sum of $300 was estimated by Mr. Coffman as the cost for recent years of operation. During the early years of operation, when patronage was much lower, the additional bookkeeping cost was certainly not as high. Hence it must be assumed that the total cost is somewhat less than $4,200.

this condition and prevented any further accumulation of stock in the hands of inactive members by continually retiring their holdings (as they reached this stage). Since the reorganization of the cooperative under the revolving stock plan, 11,308 shares have been issued with total value of $113,080, and over a period of eleven and a half years, 9554 of these shares, or $95,540 worth, have been retired. Additional stock has been issued since this last tally and as of December 31, 1941, the outstanding stock totaled $27,160 (2716 shares). Over the whole period of operation then, the fund has revolved approximately $3\frac{1}{2}$ times or about once every 4 years. This period of revolution has kept within the standards advocated by Mr. Howland of "at least once in 5 years and not more than once every two years."

Prior to 1939 all earnings of the association were applied to surplus, but since complete and permanent patronage records were kept (after the adoption of the revolving plan) the proportionate share of this surplus due to each patron could be easily determined on this basis. Since 1939, the Coldwater Dairy has issued a cash patronage dividend each year, distributing $7,011.92 in 1939, $14,776.11 in 1940 and $12,997.13 in 1941. Although, as previously brought out, the issuance of a patronage dividend in cash is apt to endanger the financial position of the cooperative, the Coldwater Dairy has been able to maintain a sound capital structure because they have realized fairly large earnings throughout the years and the retain feature has provided it with a constant inflow of capital. However it is felt by the writer that the payment of patronage dividends in capital stock, allowing the association to retain the cash, is a much more advisable procedure.

On the whole, the revolving program has met with the approval of both patrons and management. The former have felt that the plan has provided an equitable method for financing the association, while the latter has emphasized the fact that membership interest in the association has constantly been kept alive.

## B. APPLICATION OF THE REVOLVING-FUND PLAN BY MICHIGAN ASSOCIATIONS IN GENERAL

The success of the revolving fund plan in the Coldwater Dairy Co. led Mr. Arthur Howland, extension economist at Michigan State College, to investigate the possibilities of applying this financing program to other cooperatives throughout Michigan. A brief resume of the early investigation of the plan is best related by Mr. Howland himself:

> "In my work with cooperatives, I was able to acquire a realization of some problems which seemed to be basic and common to all cooperatives.[1] Many of those problems seemed to have been eliminated by the revolving program of financing used by the Coldwater Dairy Company. I, therefore, made a very careful study of the principle involved in their program and over a period of some four or five years (1933-1938) engaged in studying plans that were used by other successful cooperatives throughout the country, principally the revolving plan used by the Washington poultry and egg cooperatives and others along the Pacific Coast, and the certificate of indebtedness program used by the Dairymen's League in New York. In that study leading to the development of this program I secured much valuable assistance and counsel, both legal and financial, from Mr. E. A. Stokdyk, president of the Berkely Bank for Cooperatives, Mr. Metzgar, president of the St. Paul Bank for Cooperatives, and Mr. S. D. Sanders, Cooperative Bank Commissioner, who had previously been president of the Washington Egg and Poultry Cooperative Association and largely instrumental in the successful development of the revolving program in that organization. I took the Coldwater plan together with plans used by the Dairymen's League and the Washington Egg and Poultry Cooperative Association, combined their desirable features and

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[1] These problems have been listed below, p. 4, and discussed throughout the first part of Chapter I.

adapted those features to meet the Michigan and Federal cooperative statutory requirements and the basic cooperative principles of the original Rochdale system."

The technical features of Mr. Howland's final adaptation of the revolving-fund program departed from the Coldwater plan in three significant instances. (1) It provided for two types of securities--voting and non-voting, in contrast to Coldwater's provision for just a voting security, (2) it made the retain feature optional rather than compulsory and (3) it provided for the distribution of earnings in stock credits rather than have them accumulate as undivided surplus, a practice followed by Coldwater until 1939. Since 1939, the Coldwater Dairy Co. has been issuing patronage dividends, but in cash rather than in capital certificates as provided by Mr. Howland's set up.

Types of Associations Adopting the Revolving Plan

The first Michigan associations to adopt the revolving fund plan, as proposed by Mr. Howland were the Detroit Packing Company and the Producers Dairy of Niles, both of whom embraced the new financing program in the spring of 1938. The former association is unique in that it is the only cooperative packing company in the country, originally organizing in 1933 when it acquired the assets of the old Detroit Packing Company, a private corporation. It was primarily through a loan from the Central Bank for Cooperatives at Washington that the association was enabled to begin its operations in this year.[1] The present farmer owned and controlled corporation differs from all other revolving-fund organizations in Michigan in that it is not a local association but rather has

[1] Voss, F. A., "Marketing Michigan Livestock (Survey of Transportation Trends and Market Outlets)." Master's Thesis, Michigan State College, 1940, p.69.

its voting stock distributed throughout the state, held partly by local livestock associations and partly by individuals. Because of the financial situation inherited from the old corporation which was dominated by a few large stockholders and creditors, the present Detroit Packing Company has the most complex corporate structure of any revolving capital association in the state, issuing five distinct classes of securities.[1]

Since 1938, 39 cooperatives of varying type have seen fit to adopt the revolving plan, making a total of 42 Michigan cooperatives (including the Coldwater Dairy Company) operating under his new financial program as of September, 1942. The complete list of associations showing commodity type, location and original date of organization, and chronologically arranged according to the date of adoption of the revolving plan is presented in Table 8. From the table it may be seen that from eight to ten associations have adopted the plan in each year since 1938, when four cooperatives organized under it. Thirteen commodity types are represented among the 42 revolving-fund organizations with a dominant representation among creameries, followed by general supply and fruit associations. Specifically, there are included 13 creameries, 9 supply cooperatives, 5 fruit associations, two each of elevators, cheese factories, canning associations, potato and livestock cooperatives,[2] and one representative each of cooperative stores, gas and oil stations, and

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1 See below pp. 78,83,85

2 The two livestock associations grouped together are in reality performing different functions, the one being a packing company, while the other is an auction sales association. However, since the cooperatives were here grouped by commodity type, it was deemed best to place them in the same category.

Table 8. Michigan Cooperative Associations Adopting the Revolving-Fund Plan.

| Association | Type | Location | Original Date of Organization | Yr. of Adoption of Revolving Plan |
|---|---|---|---|---|
| 1. Coldwater Dairy Company | creamery | Coldwater | 1920 | 1928 |
| 2. Detroit Packing Company | livestock | Detroit | 1933 | 1938 |
| 3. Producers Dairy of Niles | dairy | Niles | 1934 | 1938 |
| 4. Norway Canning Assn. | veg. canning | Norway | 1936 | 1938 |
| 5. Farmers Co-op Trading Company | co-op store | Hancock | ? | 1938 |
| 6. Allegan Farmers Cooperative Assn. | supply | Allegan | 1923 | 1939 |
| 7. Bellevue Farmers Cooperative Elevator Co. | elevator | Bellevue | 1916 | 1939 |
| 8. Cherry Growers, Inc. | canning | Traverse | 1930 | 1939 |
| 9. Fremont Cooperative Creamery Co. | creamery | Fremont | 1904 | 1939 |
| 10. Jordan Valley Cooperative Creamery Co. | creamery | East Jordan | 1931 | 1939 |
| 11. Marcellus Cooperative Creamery Co. | creamery | Marcellus | 1927 | 1939 |
| 12. North Branch Co-op Oil & Gas Co. | gas and oil | North Branch | 1939 | 1939 |
| 13. Riverside Fruit Exchange Inc. | fruit | Riverside | 1939 | 1939 |
| 14. Stephenson Marketing Association | potato | Stephenson | 1921 | 1939 |
| 15. St. Louis Cooperative Creamery | creamery | St. Louis | 1915 | 1939 |
| 16. Hillsdale Cooperative Assn. | supply | Hillsdale | 1915 | 1940 |
| 17. Three Rivers Co-op, Inc. | supply | Three Rivers | 1918 | 1940 |
| 18. Tri-state Cooperative Assn. | creamery | Montgomery | 1914 | 1940 |
| 19. Watervliet Fruit Exchange Inc. | fruit | Watervliet | 1940 | 1940 |
| 20. Ypsilanti Farm Bureau Assn. | supply | Ypsilanti | 1920 | 1940 |
| 21. Litchfield Dairy Assn. | creamery | Litchfield | 1911 | 1940 |
| 22. Houghton Cooperative Potato Warehouse Assn. | potato | Houghton | 1935 | 1940 |
| 23. Milburg Growers Exchange | fruit | Milburg | 1926 | 1940 |
| 24. Glenn Co-op Company | supply | Glenn | 1941 | 1941 |
| 25. Michigan Egg Marketing Assn. | eggs | Eaton Rapids | 1941 | 1941 |
| 26. Batavia Cooperative Co. | supply | Batavia | 1915 | 1941 |
| 27. Dairyland Cooperative Creamery | creamery | Carson City | 1925 | 1941 |
| 28. Lawrence Cooperative Creamery Co. | creamery | Lawrence | 1897 | 1941 |
| 29. Muskegon Celery Growers Assn. | celery | Muskegon | 1915 | 1941 |
| 30. Wixom Cooperative Company | supply | Wixom | 1916 | 1941 |
| 31. Four County Cooperative Assn. | elevator | Marcellus | 1917 | 1941 |
| 32. Ewen Produce Company | cheese factory | Ewen | 1941 | 1941 |
| 33. Watton-Covington Cooperative Creamery | cheese factory | Covington | 1942 | 1942 |
| 34. Farmers Cooperative Creamery Co. of Marion | creamery | Marion | 1916 | 1942 |
| 35. Hopkins Cooperative Creamery Co. | creamery | Hopkins | 1920 | 1942 |
| 36. Middleville Creamery Company | creamery | Middleville | 1909 | 1942 |
| 37. Eau Claire Fruit Exchange, Inc. | fruit | Eau Claire | 1936 | 1942 |
| 38. Martin Farmers Cooperative Co. | supply | Martin | 1920 | 1942 |
| 39. Salem Cooperative Company | creamery | Burnipa | 1920 | 1942 |
| 40. Pearl Grange Fruit Exchange Inc. | fruit | Benton Harbor | 1921 | 1942 |
| 41. Edmore Marketing Association | supply | Edmore | 1922 | 1942 |
| 42. Hemlock Cooperative Auction Sales Assn. | livestock auction sales | Hemlock | 1942 | 1942 |

egg, milk and celery marketing associations. The wide representation here revealed, repudiates the oft-heard statement that the revolving plan of financing is adaptable to only certain types of cooperatives.

<u>Organization Structure Prior to Adoption of Revolving Plan</u>

The organizational structure of Michigan cooperatives prior to the adoption of the revolving-fund plan is shown in Table 9.[1] Of the 34 cooperatives, 27 were originally organized as profit associations under the Michigan cooperative laws. Of the seven non-profit associations, five were organized on a non-stock basis, while two had capital stock.[2] The basic reason for the predominance of the profit type of organization was the fact that cooperatives found it impractical to comply with the Michigan statutory provision requiring non-profit associations to confine their entire business activities to members only.[3] As will be indicated at a later point, the recent reclassification of cooperatives under the amendments to the Michigan statutes has lead associations, in adopting the revolving plan of financing, to organize on a non-profit basis.[4]

Table 9 shows that 29 cooperatives were organized on a capital stock basis while five were non-stock or membership associations. In conformance with standard practice every capital stock organization issued

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1 The association numbers used in this table correspond to the numbers beside the associations in Table 8, and hence may be identified by referring to the latter table. Since 8 of the 42 cooperatives listed in Table 8 organized under the revolving-fund plan at the outset, they obviously could not be included in Table 9.

2 It should be remembered that non-profit associations may be organized with or without capital stock, while all non-stock associations are also of the non-profit type.

3 It is especially impractical for the type of transient association such as gas and oil stations.

4 See above, p. 82

Table 9. Organization Structure of Cooperatives Prior to the Adoption of the Revolving-Fund Plan.

| Association Number | Date Organized | Corporate Type | Securities Used: Voting: Class | Voting: Par or Stated Value | Financing: Class | Financing: Par or Stated Value | Financing: Dividend Provisions |
|---|---|---|---|---|---|---|---|
| 1 | 1920 | P | common | $10 | common | $10 | Max. 6% |
| 2 | 1933 | P | Class B common | 1 | Class A common | 1 | " 7 |
| | | | | | Class A pfd. | 10 | 4 pfd. |
| | | | | | 10 yr. pfd. | 20 | 4 pfd. |
| 3 | 1934 | P | common | 10 | common | 10 | Max. 7 |
| 4 | 1936 | NP | membership | 0 | 0 | 0 | 0 |
| 5 | ? | P | common | 5 | common | 5 | ? |
| 6 | 1923 | P | " | 10 | " | 10 | Max. 7 |
| 7 | 1916 | P | " | 10 | " | 10 | " 6 |
| 8 | 1930 | P | " | 10 | preferred | 10 | 8 pfd. |
| 9 | 1904 | P | " | 10 | common | 10 | unlimited |
| 10 | 1931 | P | " | 10 | " | 10 | Max. 7 |
| 11 | 1927 | NP | " | 10 | " | 10 | None permitted |
| 14 | 1921 | P | " | 10 | " | 10 | Max. 7 |
| 15 | 1915 | P | " | 10 | " | 10 | " 6 |
| 16 | 1915 | P | " | 10 | " | 10 | " 7 |
| 17 | 1918 | P | " | 100 | " | 100 | " 7 |
| 18 | 1914 | P | " | 10 | " | 10 | " 7 |
| 20 | 1920 | P | " | 10 | " | 10 | " 7 |
| 21 | 1911 | P | " | 10 | " | 10 | " 7 |
| 22 | 1935 | NP | membership | .25 | 0 | 0 | 0 |
| 23 | 1926 | P | common | 10 | preferred | 10 | 5 pfd. |
| 26 | 1915 | P | " | 10 | common | 10 | Max. 7 |
| 27 | 1925 | NP | membership | 10 | membership | 10 | none permitted |
| 28 | 1897 | P | common | 10 | common | 10 | unlimited |
| 29 | 1915 | NP | membership | 5 | membership | 5 | none permitted |
| 30 | 1916 | P | common | 10 | preferred | 10 | 5 pfd. |
| 31 | 1917 | P | " | 100 | common | 100 | Max. 7 |
| 34 | 1916 | NP | " | 10 | " | 10 | none permitted |
| 35 | 1920 | NP | membership | 10 | membership | 10 | " " |
| 36 | 1909 | P | common | 10 | common | 10 | unlimited |
| 37 | 1936 | P | " | 10 | preferred | 10 | Max. 4 |
| 38 | 1920 | P | " | 10 | common | 10 | Max. 7 |
| 39 | 1920 | P | " | 10 | " | 10 | " 7 |
| 40 | 1921 | P | " | Non-par | " | Non-par | " 7 |
| 41 | 1922 | P | " | 10 | " | 10 | " 7 |

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common stock as its voting security with the Detroit Packing Company issuing a special type called class B common. The par value of the common stock was set at $10 per share by 24 of the 29 capital stock associations, compared with two at $100 per share, one each at $5 and $1, with the remaining association issuing non-par stock. Of the five membership associations, two placed a value of $10 on their certificates, one required a fee of $5, another had a nominal requirement of $.25, while the last required no initial membership investment whatsoever, simply asking that the producer sign a marketing contract before attaining member status. The latter two associations, Nos. 4 and 22, located in the Upper Peninsula, were financed entirely through the Farm Security Administration, and one of the two conducted its business operations on leased property.

Most of the capital stock associations used the <u>same class</u> of stock (common) for <u>both</u> their <u>voting</u> and <u>financing securities</u>, only five of the 29 cooperatives employing two classes of securities. Four of these five associations used preferred stock as their financing security while the Detroit Packing Company (No. 2) made use of three securities for financing purposes, class A common, class A preferred, and 10 year preferred. The par value of the preferred stock was placed at $10 by each of the four associations, corresponding in every instance to the par value of their common stock. The Detroit Packing Company vested its three classes of financing securities with $1, $10 and $20 par values respectively.

The diversity found in the corporate structure of cooperatives has been commented on by one writer in the following terms:

> "The entire subject of the corporate structure of a cooperative is related to problems which existed at the time the specific corporate program was adopted. Whether an association is organized upon a stock or non-stock basis, whether it uses voting only

or both voting and non-voting securities, and whether it uses more than one class of non-voting securities is dependent upon its particular financing problems, the corporate statutes, "Blue Sky" laws, cooperative philosophy, and lessons learned in the cooperative financing of other associations."[1]

## Organization Structure After Adoption of Revolving Plan

Table 10 shows the organization structure of the 42 Michigan cooperatives currently operating under the revolving plan of financing. Since the code numbers[2] of the associations correspond to those given in Table 9, comparisons may be easily made as to structural type prior to and after the adoption of the revolving-fund plan for the 34 associations in operation before reorganizing as revolving capital cooperatives. The other 8 associations were originally organized on the revolving-fund plan.

A noticeable change evidenced in Table 10 is the actual and proportional increase in the number of non-profit type associations. Of the 42 associations, 19 or 45 per cent are of the non-profit type as compared to 7 out of 34 or 20 per cent in existence just prior to the adoption of the revolving plan. Among the 34 associations in operation before adopting the revolving plan, 15 are now organized as non-profit associations, indicating that, in their reorganization, 8 cooperatives were converted from the profit to the non-profit type.[3] A comparison of the two tables

[1] Motts, G. N., "Fruit and Vegetable Cooperatives in Michigan," Special Bulletin 317, Mich. State Coll. Agric. Exp. Sta., 1942, p.46

[2] Each association will bear the same code number throughout this chapter.

[3] Conversely, it is interesting to note that while 8 profit cooperatives converted to non-profit associations, not one of the 7 non-profit associations changed over to the profit type when they reorganized under the revolving plan.

Table 10. Organization Structure of 42 Michigan Cooperatives Subsequent to the Adoption of the Revolving-Fund Plan

| Association Number | Date Revolving Plan Adopted | Corporate Type | Securities Used | | | |
|---|---|---|---|---|---|---|
| | | | Voting | | Financing | |
| | | | Class | Par or Stated Value | Class | Par or Stated Value |
| 1 | 1928 | P | common | $10 | common | $10 |
| 2 | 1938 | P | class A common | 1 | cert.of interest | face value |
| | | | | | class A common | 1 |
| | | | class B common | 1 | class A pfd. | 10 |
| | | | | | 10 yr. pfd. | 20 |
| 3 | 1938 | NP | common | 1 | C.I.D.* | face value |
| 4 | 1938 | NP | membership | 0 | " | " " |
| 5 | 1938 | P | common | ?** | pfd. | ? |
| 6 | 1939 | P | " | 1 | " | 1 |
| 7 | 1939 | P | " | 1 | class A pfd. | 1 |
| | | | | | class B pfd. | 1 |
| 8 | 1939 | P | " | 1 | pfd. | 1 |
| 9 | 1939 | P | " | 1 | " | 1 |
| 10 | 1939 | NP | " | 1 | C.I.D. | face value |
| 11 | 1939 | NP | " | 1 | " | " " |
| 12 | 1939 | P | " | 1 | class A pfd. | 1 |
| | | | | | class B pfd. | 1 |
| 13 | 1939 | P | " | 1 | pfd. | 1 |
| 14 | 1939 | P | " | 1 | " | 1 |
| 15 | 1939 | P | " | 1 | " | 1 |
| 16 | 1940 | P | " | 1 | " | 1 |
| 17 | 1940 | P | " | 1 | " | 1 |
| 18 | 1940 | P | " | 1 | " | 1 |
| 19 | 1940 | P | " | 1 | " | 1 |
| 20 | 1940 | P | " | 1 | " | 1 |
| 21 | 1940 | P | " | 1 | " | 1 |
| 22 | 1940 | NP | membership | 1 | C.I.D. | face value |
| 23 | 1940 | P | common | 1 | pfd. | 1 |
| 24 | 1941 | P | " | 1 | " | 1 |
| 25 | 1941 | NP | membership | 25 | C.I.D. | face value |
| 26 | 1941 | P | common | 1 | pfd. | 1 |
| 27 | 1941 | NP | " | 10 | " | 10 |
| 28 | 1941 | P | " | 1 | " | 1 |
| 29 | 1941 | NP | membership | 5 | C.I.D. | face value |
| 30 | 1941 | P | common | 1 | pfd. | 10 |
| | | | | | revolving pfd. | 1 |
| 31 | 1941 | P | " | 1 | pfd. | 1 |
| 32 | 1941 | NP | " | 1 | C.I.D. | face value |
| 33 | 1942 | NP | membership | 10 | " | " " |
| 34 | 1942 | NP | common | 1 | " | " " |
| 35 | 1942 | NP | membership | 10 | " | " " |
| 36 | 1942 | NP | common | 1 | " | " " |
| 37 | 1942 | NP | " | 1 | " | " " |
| 38 | 1942 | NP | " | 1 | " | " " |
| 39 | 1942 | NP | " | 1 | " | " " |
| 40 | 1942 | NP | " | 1 | " | " " |
| 41 | 1942 | NP | membership | 1 | " | " " |
| 42 | 1942 | NP | " | 0 | " | " " |

* Certificates of indebtedness

** Data not available

[illegible]

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also indicates that of these eight associations, six were reorganized during 1942 while the five cooperatives newly organized in 1942[1] all chose the non-profit type so that each and every association adopting the revolving plan of financing during this year saw fit to organize as non-profit cooperatives. The reasons for the unmistakeable trend towards this form of organization are associated with the recent Michigan statutory amendments making it more practical for associations to organize on a non-profit basis.

Under Michigan corporation statutes, stock type associations are required, at all times from the moment of organization, to maintain at least $1000 of paid-in capital.[2] Non-profit associations, however, may organize upon a non-stock basis, thereby making it advantageous for cooperatives not requiring a $1000 of paid in capital (particularly at the beginning of their organization) to use the non-profit sections of the corporation statutes. A second advantage to be derived by the non-profit association lies in the provision that all non-stock, non-profit type corporations operating in a territory larger than one county and having a membership in excess of 500 are permitted to provide for delegate representation for purposes of voting at membership meetings. In the stock type association (and all profit type cooperatives are organized on a stock basis) the absence of such a provision tends to disenfranchise voters who find it impractical to attend the meetings and exercise their power to vote. This condition obviously does not make for democratic

[1] Actually only 4 new associations were formed during this year, but association No. 32 was not organized until the latter part of Dec. 1941 and for purposes of operation may be considered to have actually got under way in 1942.

[2] Act 327 P.A. 1931, Sec. 4, (d,3)

procedure. Lastly, non-profit associations are not required to pay the privilege fee* as are the profit type corporations.

Not withstanding these real advantages, most cooperatives, as indicated by Table 9 were originally organized on a profit basis, primarily because of a ruling of the Michigan Supreme Court handed down in 1925 which holds that corporations organized under the non-profit statutes are acting in excess of the authority granted in their charter if they transact business with non-members. Obviously to abide by such a provision would be impractical for many cooperatives dependent for efficient operation upon a large volume of business. Although this ruling has not been abrogated, Michigan cooperative associations have recently been re-classified as non-profit type corporations for purposes of taxation if: (1) they do a majority of business with their own members, (2) they do not pay dividends on capital stock or interest upon membership investment, and (3) they distribute their earnings upon a cooperative plan to all persons who have done business with them during the year.[1] The first of these provisions, by permitting non-profit associations to carry on business with non-members, at last made it practicable for cooperatives to organize on a non-profit basis. And in view of the advantages to be gained by doing so, newly organized or reorganized cooperatives have adopted a corporate structure which would enable them to be classified as non-profit associations. According to Mr. Howland, the future will continue to witness an increasing number of associations taking the opportunity

* A tax provided for the privilege of exercising corporate franchises within the state of Michigan.

1 Reclassified by Michigan state legislature in 1941 by amending Act 327, P.A. 1931, sections 98, 99, 101, 103, 104, 105, 106, 108, 109 and 117 and repealing secs. 110-116 of said act.

to organize as non-profit type corporations, as they adopt the revolving plan of financing.

As shown in Table 10, 34 associations are currently organized with capital stock while 8 are non-stock or membership associations. Of the 29 stock associations operating prior to the adoption of the revolving - fund plan, only one (Association No. 41) changed over to a membership basis in reorganizing under the new plan, while only one of the original 5 membership associations converted to a capital stock basis indicating that associations tend to maintain their stock or non-stock structure when reorganizing as revolving fund associations. In every instance capital stock associations issued common stock as their voting security, while non-stock associations, of necessity issued some form of "membership" to evidence voting rights.[1] This practice is uniform regardless of whether an association is organized under the revolving-fund plan or any other plan of financing. Whether an association chooses to be stock or non-stock will generally determine the voting security to be used and neither the choice of capital type or voting security need be changed when adopting the revolving plan, for it is as easily adaptable to the stock as it is to the non-stock type of corporation.

Although the voting security remained unchanged in the 34 associations that reorganized their capital structure, its par or stated value was altered in 27 cases. The predominance of the $1.00 value is evident from a glance at Table 10. Of the 41 associations for which data was available, 33 vested their voting securities with a $1.00 value, four

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[1] The Detroit Packing Company issued two types of common stock, class A and class B.

issued securities of $10 value and one each of $5 and $25. The dominance of the $1.00 voting security in contrast to the $10 par value prior to the institution of the revolving plan is not difficult to understand if one bears in mind that a basic purpose of the revolving-fund plan is to expedite the membership of all eligible non-member patrons. Since the patron's accumulated retains or/and patronage dividend credits are first applied towards voting certificates, the lower the value of these certificates the sooner does the patron attain member status. The seemingly high $25 stated value maintained by the Michigan Egg Marketing Association (No. 25) is in actuality but a nominal sum for its members, all large business firms, to contribute; to the grading station operators that constitute the membership of the association, $25 is probably less of a financial sacrifice than $.25 is to a small producer. The possibilities of increasing the membership of this cooperative are small also since there are only a total of 36 grading stations in Michigan.

A fundamental departure in the capital structure of the revolving-fund organization from that of other financial type organizations lies in the differentiation of securities according to the status of the holder. As indicated on page 78, all but five cooperatives in operation before adopting the revolving plan of financing issued no other security but common stock, giving voting power to all persons contributing capital regardless of whether or not they continued to be producers or patrons. Under the revolving capital structure every Michigan association, with the exception of the Coldwater Dairy Company, issues a financing security entirely distinct from the voting security. As explained in Chapter III it is almost standard procedure for revolving capital associations to employ at least two types of securities--voting and non-voting. The advantages of using a non-voting security for financing purposes are that it may be sold to all persons without fear of losing control to non-active members; it may be endowed with the attribute of free transferability, and it may be issued in exchange for a voting security when a member loses his eligibility to vote.

In general, Michigan associations use two types of securities for revolving purposes: preferred stock and certificates of indebtedness with one association (Detroit Packing Company) employing both certificates of interest and class A common stock. It will be noticed that three associations use two classes of preferred stock, only one of which, in each instance, revolves. Associations No. 7 and 12 revolve their "class B preferred" while Association No. 30 provides for an issue described as "revolving preferred" stock. Although certificates of interest and class A common stock are its revolving securities, the Detroit Packing Company has two other financing securities, class A preferred and 10 year preferred stock. The reasons for employing more than one type of financing security are determined by the individual situation in each organization, but usually those that do not revolve are given a higher investment status as to rates of interest and priority and are issued to the old stockholders who may have been given no evidence of their increased equity throughout the years and who as a result claim preferential treatment over new stockholders.

It is evident from Table 10 that all 18 associations using the certificate of indebtedness are of the non-profit type. This uniformity of pattern is explained by the fact that under the Michigan statutes non-profit associations are not permitted to pay dividends on capital stock nor interest upon membership investment. Hence in order to be able to pay interest on their financing security (and thereby enhance its value) the non-profit cooperatives have adopted the certificate of indebtedness which is technically and legally an evidence of a debt and not an equity instrument. Hence with the present trend towards the adoption of the non-profit type of corporate structure, we may expect an increase in the use of the certificate of indebtedness as a revolving security. Of the 23 profit associations, 21 use preferred stock (or a special class of preferred) for their revolving security, while only one non-profit association (No. 27) issues preferred stock upon which no dividend may be paid.

The par value of the financing securities is also kept low with $1.00 preferred stock the most prevalent. The certificates of indebtedness are not endowed with any uniform par or stated value, simply being issued to patrons for whatever sum has accumulated to their credit, and hence may be said to carry a "face value."

## Financing Program Prior to Adoption of Revolving Plan

Under the older financing methods, it was the general policy of Michigan associations to restrict the transferability of their financing securities, only nine associations permitting them to be freely transferred. All the associations issuing preferred stock, allowed this security to be freely transferable, while just four of 25 associations issuing common stock only, followed a similar practice. The explanation is of course a simple one. Since the preferred stock carried no voting rights, there was no danger in allowing it to be freely transferred; indeed its value was enhanced by vesting it with this quality. Common stock, on the other hand, carrying with it voting privileges, could be endowed with this characteristic only at the risk of having non-producers gain a voice in the control of the association and ultimately (possibly) complete control. Each of the four associations allowing their common stock to be freely transferred had a large percentage of non-producer members as a result.

In every case where preferred stock was issued, provision was made for retirement at a fixed date. As has been indicated in Chapter III, to thus obligate an association to retire a definite amount of securities at a definite date in the future is a financially inexpedient policy. The lack of a retirement provision in those associations which issued common stock only, led, in many cases, to the inequities elaborated in Chapter I, namely frozen investments, non-producer, non-patron control and an inequitable financial distribution with the weight of the burden borne by the older members of the association.

In accordance with the general policy of issuing common stock only, prior to the adoption of the revolving-fund plan, most Michigan associations made no provision for a fixed interest or dividend rate. Of five associations issuing preferred stock, four provided for a fixed dividend payment, and three of these stipulated that such dividends should be cumulative. As indicated in Table 9 the maximum interest or dividend rates for all associations ranged from 4 to 8 per cent, with three associations providing for unlimited dividends and five non-profit associations making no return on stock or membership investment in compliance with statutory requirements. The 7 per cent maximum rate was the most prevalent, with 17 associations incorporating such a provision. In addition to being the general "going rate" of interest at the time, the dominance of this rate may be explained by the fact that the Michigan General Corporation Act provides that a cooperative may pay a dividend rate "not exceeding 7 per cent per annum" to the holders of paid up capital stock.[1] The general practice of most associations was to provide for as high a maximum rate as permitted by the statutes, increasing the value of their stock, and giving them wider leeway in the determination of the actual rate. The three associations that provided for unlimited dividends (Nos. 9, 28 and 36) are the oldest cooperatives from the standpoint of original organization, being formed in 1904, 1897 and 1909 respectively, during which time the general concepts of cooperative principles or standards were scarcely understood and rarely followed.

Financing Program Subsequent to Adoption of Revolving Plan

A general picture of the financing programs of 41 Michigan associations currently operating on the revolving capital plan is shown in Table 11. Since all of these associations, except the pioneer Coldwater Dairy Company, adopted the plan under the general guidance and influence of Mr. Howland the general uniformity of their financial set up is not surprising. This is strikingly evidenced in column 2 of Table 11 where it may be noted that all associations (with the exception of Coldwater Dairy Company, still using common stock) allow their financing securities to be freely transferred, regardless of whether the revolving security

[1] Act 327, P.A. 1931, Sec. 106

Table 11. Outline of the Financing Program of 41 Michigan Cooperatives Operating on the Revolving-Fund Plan.

| Association Number | Security Used | | | Interest or Dividend Payments | | | | Source of Capital | |
|---|---|---|---|---|---|---|---|---|---|
| | Class | Freely Transferable | Fixed Date of Retirement | Rate Fixed | Maximum | Cumulative | Determined By Whom | Retains | Patronage Dividends |
| 1 | common | no | no | no | 6% | no | board | x | |
| 2 | cert.of interest | yes | no | no | 5 | no | board | x | |
| | class A common | " | " | " | 7 | " | " | | x |
| | class A pfd. | " | " | yes | 4 | " | by-laws | | |
| | 10-yr. pfd. | " | yes | " | 4 | " | " | | |
| 3 | C.I.D. | yes | no | no | 3 | no | board | | x |
| 4 | C.I.D. | " | " | " | 5 | " | board | x | x |
| 6 | pfd. | " | " | yes | 3 | " | by-laws | | x |
| 7 | class A pfd. | " | yes | " | 3 | yes | by-laws | issued for old stock | |
| | class B pfd. | " | no | " | 3 | no | by-laws | | x |
| 8 | pfd. | " | " | no | 4 | " | board | x | x |
| 9 | pfd. | " | " | " | 4 | " | board | x | x |
| 10 | C.I.D. | " | " | " | 5 | " | board | | x |
| 11 | C.I.D. | " | " | " | 5 | " | board | | x |
| 12 | class A pfd. | " | yes | yes | 4 | yes | by-laws | purchase obligation | |
| | class B pfd. | " | no | no | 5 | no | board | | x |
| 13 | pfd. | " | " | " | 3 | " | board | x | x |
| 14 | pfd. | " | " | " | 3 | " | board | | x |
| 15 | pfd. | " | " | " | 3 | " | board | | x |
| 16 | pfd. | " | yes | yes | 4 | " | by-laws | | x |
| 17 | pfd. | " | no | " | 3 | yes | by-laws | | x |
| 18 | pfd. | " | " | " | 3 | no | by-laws | | x |
| 19 | pfd. | " | " | no | 4 | " | board | x | x |
| 20 | pfd. | " | " | " | 4 | " | board | | x |
| 21 | pfd. | " | " | " | 3 | " | board | | x |
| 22 | C.I.D. | " | " | " | 5 | " | board | | x |
| 23 | pfd. | " | " | " | 3 | " | board | x | x |
| 24 | pfd. | " | " | " | 4 | " | board | | x |
| 25 | C.I.D. | " | " | " | 5 | " | board | x | x |
| 26 | pfd. | " | " | " | 3 | " | board | | x |
| 27 | pfd. | " | " | none permitted | | | state laws | | x |
| 28 | pfd. | " | " | no | 5 | no | board | | x |
| 29 | C.I.D. | " | " | " | 5 | " | board | x | x |
| 30 | revolving pfd. | " | " | " | $2\frac{1}{2}$ | " | board | | x |
| | pfd. | " | yes | yes | 5 | yes | by-laws | | |
| 31 | pfd. | " | no | no | 3 | no | board | | x |
| 32 | C.I.D. | " | " | " | 3 | " | board | x | x |
| 33 | C.I.D. | " | " | " | 5 | " | board | x | x |
| 34 | C.I.D. | " | " | yes | 5 | " | by-laws | x | x |
| 35 | C.I.D. | " | " | no | 4 | " | board | | x |
| 36 | C.I.D. | " | " | " | 3 | " | board | | x |
| 37 | C.I.D. | " | " | " | 4 | " | board | x | x |
| 38 | C.I.D. | " | " | " | 4 | " | board | | x |
| 39 | C.I.D. | " | " | " | 3 | " | board | | x |
| 40 | C.I.D. | " | " | " | 4 | " | board | x | x |
| 41 | C.I.D. | " | " | " | 3 | " | board | | x |
| 42 | C.I.D. | " | " | " | 4 | " | board | | x |

is designated as preferred stock, certificates of indebtedness or certificates of interest. It is generally agreed among authorities that such a right is desirable, for the negotiability of the security is thereby enhanced, and the patron may dispose of his holdings, if he is in immediate need of cash, without waiting for them to be called and retired by the association. Since the above named securities are not endowed with voting rights, they may be given the advantage of free transferability without fear of the control of the association becoming ultimately vested in the hands of non-producers. Here then lies a definite advantage of providing for both voting and non-voting securities.

A discussion of the advisability of vesting revolving securities with a fixed date of retirement, or allowing the retirement date to be discretionary with the board of directors, was presented in Chapter III where it was concluded that the latter procedure was the more desirable. All Michigan associations, with the exception of one (No. 16) adhere to the latter policy, providing in general that all revolving certificates shall be retired "in whole or in part in the consecutive numerical order of issue in the sole discretion of the Board of Directors."[1] In the case of those associations issuing more than one financing security (Nos. 2, 7, 12 and 30), it is the <u>non-revolving</u> security <u>only</u>, in every instance, that has a fixed date of retirement.

Of the four associations providing for a fixed dividend rate on preferred stock prior to the adoption of the revolving capital plan,

[1] This phrase is quoted from the certificate of indebtedness used by Michigan associations, but regardless of the revolving security used, the general provision of a discretionary retirement date is the same in all associations.

only two now so provide, and in neither case is the fixed rate applied to their revolving security, but to other financing securities (carried over from their "pre-revolving fund" organization). However, seven additional associations have endowed their securities with a fixed interest (or dividend) payment and of this total of nine, five have applied this fixed rate to their revolving security. Although, as has been previously advanced, it is not wise for a cooperative to obligate itself to pay an annual fixed rate of interest, all nine associations are not in fact so obligated since only four provide that such rate shall be cumulative and only one applies this provision to its revolving security. Actually, then those associations providing for non-cumulative dividends are obliged, if they declare a dividend (or interest payment) to pay such dividend at the prescribed fixed rate, but having not declared any, they are not obligated to make up the passed dividend in the future. The lone association (No. 16) applying a fixed, cumulative dividend to its revolving security, although existing conditions unknown to the writer might require such a policy, is following a practice not in harmony with the general one in Michigan, and one which would seem to be inadvisable in that the association is held for the payment (eventually) of dividends for a year in which little or no earnings may have been realized.

It may be mentioned at this point that it is a general practice among Michigan associations to provide that earnings may be distributed in the form of patronage dividends only after the payment of interest or dividends on outstanding financing securities at specified rates. Without such a mandatory provision, the board of directors may be inclined not to declare any dividends and distribute all earnings on the basis of patronage, since the volume of patronage dividends is commonly accepted as the measure of cooperative success. Such a practice obviously deprives persons of a just payment for the use of their capital and gives the association an unfair competitive advantage in that they are actually receiving their capital at no cost and hence may be enabled to pay a higher price to patrons or return a greater patronage dividend. Thus the insurance of a reasonable return for the use of capital when earnings justify it, seems to be a fair provision and one that is not contrary to cooperative philosophy.

Michigan revolving-fund associations provide for a maximum interest or dividend rate on financing securities ranging from $2\frac{1}{2}$ - 7 per cent. A maximum rate of 3 per cent is provided by 16 associations, with 13 cooperatives allowing a 4 per cent payment and 12 associations providing for a 5 per cent maximum return. Obviously the present rate of return is considerably lower than the 7 per cent maximum rate generally provided for by these associations prior to the adoption of the revolving plan of financing. This reduction may be attributed to the general decrease in the "going rate" of interest throughout the country since 1929. With both government and private lending institutions reducing their interest charges, it was but logical for the cooperatives to follow suit, for they felt they should not pay a higher return on their invested capital than they had to pay for borrowed capital.

As indicated in the general description of the operation of the revolving capital plan, associations acquire their working capital through provision for a retain or/and the payment of patronage dividends in the form of securities, retaining the cash in the organization. Table 11 shows that every Michigan association but the Coldwater Dairy Co. provides for the payment of patronage dividends in securities, but only 15 associations make provision for a retain. Of the 26 cooperatives not providing for the retain, only nine are of the supply type in which such a provision is inapplicable, leaving a total of 17 organizations able but evidently unwilling to institute the retain measure. This reluctance may be attributed to the fact that the retain feature is a comparatively new one in the cooperative program and is not understood in all its phases by the patrons. Many of them lack information on the basic purpose of the retain and it is difficult to convince them that the deductions from their sales returns, accrue to them as savings. The boards of directors thus felt that until such time as it was essential for financing and until the members gained a clearer insight into the idea, it would be more expedient to operate the revolving capital plan without the retain feature.

## Membership Policy Under the Revolving Plan

In Table 12 is presented an outline or conspectus of the membership policy as it operates under the revolving capital plan in Michigan. A basic purpose of presenting this information in tabular form was to clearly reveal the almost complete unanimity with which the associations ascribe to certain provisions. In 40 out of 41 cases, non-patrons are not permitted to hold membership, and in the exceptional case (the Coldwater Dairy Co.) may do so only until such time as their securities are revolved. In this latter case, non-patrons do not immediately lose the right to vote, for, as will be recalled the Coldwater Dairy Co. provides for only one security used for both voting and financing purposes

Table 12. Outline of Membership Policy of 41 Michigan Cooperatives Operating on the Revolving-Fund Plan.

| Association Number | Membership Investment Required: To Become a Member | Membership Investment Required: Before Holding Revolving Securities | May Non-Patrons Hold Membership | May Persons Ineligible for Membership Acquire Revolving Securities | Provision for Voting Securities of Members Who Have Become Ineligible for Membership |
|---|---|---|---|---|---|
| 1 | $10 | $10 | Yes, until securities are revolved | No | Retired as securities revolve |
| 2 | class A common 1<br>class B common 2 | 1<br>2 | No | Certificates of interest but not class A common stock | None (voting rights canceled) |
| 3 | 1 | 1 | " | yes | Called and converted into C.I.D.'s |
| 4 | None | None | " | " | Canceled |
| 6 | 1 | 10 | " | " | Called and converted into pfd. stock |
| 7 | 1 | 10 | " | " | " " " " class B pfd. stock |
| 8 | 1 | 1 | " | " | Called and converted into pfd. stock |
| 9 | 1 | 10 | " | " | " " " " " " |
| 10 | 1 | 2 | " | " | " " " " C.I.D. |
| 11 | 1 | 10 | " | " | " " " " " |
| 12 | 1 | 10 | " | " | " " " " class B pfd. stock |
| 13 | 1 | 1 | " | " | Called and converted into pfd. stock |
| 14 | 1 | 15 | " | " | " " " " " " |
| 15 | 1 | 10 | " | " | " " " " " " |
| 16 | 1 | 5 | " | " | " " " " " " |
| 17 | 1 | 10 | " | " | " " " " " " |
| 18 | 1 | 5 | " | " | " " " " " " |
| 19 | 1 | 1 | " | " | " " " " " " |
| 20 | 1 | 10 | " | " | " " " " " " |
| 21 | 1 | 5 | " | " | " " " " " " |
| 22 | 1 | 1 | " | " | Canceled |
| 23 | 1 | 1 | " | " | Called and converted into pfd. stock |
| 24 | 1 | 10 | " | " | " " " " " " |
| 25 | 25 | 25 | " | " | Canceled |
| 26 | 1 | 10 | " | " | Called and converted into pfd. stock |
| 27 | 10 | 10 | " | " | " " " " " " |
| 28 | 1 | 10 | " | " | " " " " " " |
| 29 | 5 | 5 | " | " | Canceled |
| 30 | 10 | 10 | " | " | Called and converted into revolving pfd. stock |
| 31 | 1 | 10 | " | " | Called and converted into pfd. stock |
| 32 | 1 | 10 | " | " | " " " " C.I.D. |
| 33 | 10 | 10 | " | " | Canceled |
| 34 | 1 | 10 | " | " | Called and converted into C.I.D. |
| 35 | 10 | 10 | " | " | " " " " " |
| 36 | 1 | 10 | " | " | " " " " " |
| 37 | 1 | 1 | " | " | " " " " " |
| 38 | 1 | 10 | " | " | " " " " " |
| 39 | 1 | 10 | " | " | " " " " " |
| 40 | 1 | 1 | " | " | " " " " " |
| 41 | 1 | 1 | " | " | Canceled |
| 42 | None | None | " | " | " |

and holders of this security (common stock), regardless of their status, continue to have membership privileges, until their holdings are eventually called and retired in numerical consecutive order as the capital rotates. In all other cases (with one exception discussed below) it is provided, as soon as it is evident that a member has become a non-patron, that his voting stock shall be called and converted into an equal value of revolving securities or if voting privileges are evidenced by "membership," it is simply cancelled. As evidenced in Table 12, the revolving securities, into which the voting stock is converted, may be either some form of preferred stock or certificates of indebtedness. The only stock association which does not provide for the calling and conversion of its voting securities is the Detroit Packing Co. which simply cancels the ineligible member's voting rights and permits him to retain the stock.

Though in general persons ineligible to membership are not permitted to hold voting securities, they may acquire and hold revolving securities in 39 out of 41 cases. Any person or institution desirous of investing in these associations may do so just as they would in a private corporation. Their investment entitles them to share in the earnings of the association but not in the control. Since the revolving security of the Coldwater Dairy Company carries voting rights, persons ineligible for membership are not permitted to acquire this stock. The Detroit Packing Company, issuing two classes of revolving securities permits only its certificates of interest to be acquired by non-producers, since its revolving "class A common" stock is endowed with voting privileges. Thus all these associations follow the practice of issuing two general types of securities, one specifically to evidence voting rights, the other to finance the association. For only on such a basis is the cooperative able to distribute its financing securities widely, tapping many sources of capital, without endowing the non-producer non-patron investors with a voting and possibly controlling share in the organization.

The par or stated value of the voting security usually represents the investment required of a patron to attain membership--that is when a person acquires one share of voting stock, he is vested with the right to vote. In accordance with the low par value then ($1.00 in most cases) the investment required for membership is a nominal sum, most producers gaining the voting privilege very shortly after commencing to patronize the association.

The investment required of members before they are allowed to hold revolving securities is greater than the membership requirement in 22 out of 41 cases. Seventeen of these 22 associations require that the member shall have $10 invested in voting securities before retains and/or patronage dividend credits may be evidenced to them in the form of revolving securities. These cooperatives feel (and it would seem justifiably) that it is not unfair or unreasonable to require that members shall contribute to the organization at least $10 in capital not bearing interest.[1]

## SUMMARY

The general changes wrought in the organization structure, and financial and membership programs of Michigan associations adopting the revolving plan of financing may be briefly summarized as follows:

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[1] The voting securities of the revolving-fund associations seldom carry an interest rate.

## Organizational Structure

1. A trend during 1941-42 towards the adoption of the non-profit type of corporation.

2. A general decrease in the par or stated value of both the voting and non-voting securities.

3. The adoption of a financing security entirely distinct from the voting security.

## Financing Program

1. Provision that the financing securities shall be freely transferable.

2. Retirement date of financing securities left to the discretion of the board of directors.

3. A general decrease in the maximum interest or dividend rate that may be paid on certificates or stock.

4. Working capital obtained in all cases through the issuance of patronage dividend credits in stock, retaining the cash and in a minority of cases through the provision for a retain.

## Membership Policy

1. Nominal investment required for membership which may be acquired automatically through patronage of the association.

2. Non-patrons are not permitted to hold or retain membership in an association; voting stock called and converted into revolving securities when holder ceases to be a patron.

3. Persons ineligible to membership may acquire non-voting securities subject to retirement on a revolving basis.

## Chapter V

## APPRAISAL OF EXPERIENCE WITH REVOLVING-FUND PLAN IN MICHIGAN

Since the revolving plan has only recently been adopted by Michigan cooperatives, any appraisal of the effects of the plan upon their membership, financial, and business programs must of necessity be limited and incomplete. The full effects of this method of financing materialize only after a cooperative has had a sufficiently long period of time in which to "grow into" the operational results of the program, and cannot be ascertained in so short a period as one, two or three years, the length of operation in most Michigan associations. It is this recency of adoption which presents the primary limiting factor to an adequate analysis of the revolving plan in Michigan.

A second limiting factor has been the lack of time available to the author in which to gain information from a greater number of associations through personal interview. With the aid of Messrs. Howland, Nash and Upham of the Economics Department at Michigan State College it was possible to personally visit eleven organizations. The data obtained from these associations and appraised in this chapter, are based entirely upon the questionnaire prepared by the writer in collaboration with Mr. Arthur Howland.[1] An attempt to obtain information from a larger number of cooperatives through the mail questionnaire proved ineffective.

A final limitation of lesser consequence results from the incompleteness

[1] See Appendix.

and inaccuracy which characterizes a part of the data procured from a few of the associations. This last condition was by no means due to a willful intent on the part of cooperative officials to withhold or "color" any of the requested information, but rather to the fact that part of the data asked for was not easily available (requiring hours to "dig out" of the records in some instances) in which case it was either not given or roughly estimated resulting in a certain degree of inaccuracy.

Notwithstanding these limitations, it is felt that the information obtained from the eleven associations personally visited, do afford a basis for making reasonably valid observations and comparisons as to general conditions preceding and following the adoption of the revolving capital plan. The data permit an appraisal of the immediate rather than the long time effects of this modern financing plan on: (1) the membership program, (2) financial structure and, (3) business operations of Michigan associations. While the number of organizations sampled in the survey is small, they do represent a cross section of the major commodity types of cooperatives operating in Michigan.

Types of Cooperatives Included in Survey. Among the eleven associations which were interviewed in this study there are represented 4 major commodity types including 4 creameries, 3 fruit cooperatives, 3 supply organizations, and one elevator. As indicated in Table 13, 9 of the 11 organizations, in addition to the major commodity handled, deal in at least one other commodity, while 4 associations handle two supplementary commodities. The volume of business done by these cooperatives during 1941 varied widely from approximately $40,000 to nearly $2,000,000. It happens that the four

Table 13. Types and Sales of 11 Revolving-Fund Associations in Michigan (Business Year 1941).

| Association* Number | Major Commodity Type | Sales of Major Commodity | Other Commodities Handled | Sales of Other Commodities | Per cent of Sales of Other Commodities | Total Volume of Sales |
|---|---|---|---|---|---|---|
| 1 | Creamery | $1,826,825 | Honey<br>Supplies & Merch. | $36,452<br>30,221 | 3.5% | $1,893,498 |
| 2 | Creamery | 1,021,721 | Livestock<br>Supplies & Merch. | 114,103<br>95,558 | 17 | 1,231,381 |
| 3 | Fruit | 156,046 | Supplies | 165,346 | 51 | 321,392 |
| 4 | Fruit | 30,988 | Supplies | 22,409 | 42 | 53,397 |
| 5 | Fruit | 123,179 | Supplies | 50,161 | 29 | 173,341 |
| 6 | Supply | 155,484 | Grain & Beans<br>Eggs | 29,757 | 16 | 185,241 |
| 7 | Supply | 118,080 | None | None | 0 | 118,080 |
| 8 | Creamery | 423,614 | None | None | 0 | 423,614 |
| 9 | Elevator | ? ** | Supplies | ? ** | ? ** | 42,198 |
| 10 | Supply | 323,682 | Grain & Beans<br>Eggs | 5,918<br>2,261 | 2.4 | 331,862 |
| 11 | Creamery | 527,627 | Eggs | 134,768 | 20 | 662,395 |

* The code numbers do not correspond to the numbers given in the tables in Chapter IV for it was deemed best not to identify the associations appraised in this chapter by name.

** The sales volume for each class of commodity was not determined in this association.

associations doing the largest volumes of business were all creameries. The business volume contributed by the sale of supplementary products ranged from 2.4% to 51% of the total volume of sales among the associations. Although Association No. 3 did 51% of its business in the sale of supplies during 1941, it is still considered to be a fruit cooperative for it was originally organized and still functions with the primary purpose of marketing its patrons' fruit products. In general, the cooperatives have combined the sale of some form of farm produce with the handling of general farm supplies to utilize their facilities and personnel more effectively, cater to the convenience of patrons, and maximize their volume of business.[1]

## A. EFFECTS ON MEMBERSHIP PROGRAM

### Membership Situation Prior to Adoption of Revolving Plan

In Chapter I was presented a discussion of common membership problems and inequities inherent in the older financial plans used by cooperative organizations. In attempting to determine whether the Michigan associations had fallen prey to these conditions, prior to their adoption of the revolving-fund plan, data were obtained relating to the three basic difficulties: (1) a dwindling membership, (2) the existence of a large proportion of non-member patrons, and (3) a condition of non-producer, non-patron membership. The information obtained from 9 Michigan associations is concisely shown in Table 14.[2] By comparing the number of members in the year of largest total membership with the total number existent at the time the revolving capital plan was adopted for each association, one may determine whether a condition

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1 Although Association No. 11 has expanded its operations to include more than one commodity, it has not seen fit yet to deal in the general farm supply business.

2 Only 9 of the 11 organizations are included in this table, since the other 2 associations were organized at the outset under the revolving capital plan.

of stagnant or dwindling membership existed. In 6 of the 9 associations shown, it may be seen that the interim between the year of greatest membership and the year in which the revolving plan was adopted witnessed a decline in total number of members. It is of especial interest and significance to note that in 5 of the 6 associations the year of largest membership was attained shortly after the original date of organization (in two cases the year of organization and the year of greatest membership were synonymous) and declined thereafter over a long period of years. This situation obviously reveals that only for a brief span of time were these associations able to gain new members, after which they lapsed into long periods of stagnant and declining membership varying from 8 to 20 years.[1] The apparent reasons for this general condition have been given in Chapter I and need not be reiterated here.[2]

In 8 of the 9 organizations reporting, non-producers and non-patrons were permitted to maintain membership status. It is evident, however, that in all but one case such inactive members constituted but a small minority of the total membership. Generally the associations had not lapsed into the condition of non-producer, non-patron control characteristic of many cooperatives operating on the older financial plans, but they were of course confronted with the conflicting interests of non-patron and patron members. Association No. 1 presents a prime example of how control of the cooperative may ultimately be vested in the hands of non-producer, non-patron members, having had as inactives 210 or 81% of its total membership of 260 prior to

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[1] Four of the five associations were in this condition for 14, 15, 16 and 20 years respectively.

[2] See below pp. 5 and 9.

Table 14. Membership Situation of 9 Michigan Associations Prior to the Adoption of the Revolving-Fund Plan.

| Assn. No. | Number of Members when Originally Organized | | Year of Largest Membership | | Membership at Time of Adoption of R.F.P. | | Non-Producer, Non-Patron Members at Time of Adoption of R.F.P. | Non-Member Patrons at Time of Adoption of R.F.P. | Per cent Non-Member Patrons were of Total Patrons |
|---|---|---|---|---|---|---|---|---|---|
| | Date | Total Members | Year | Membership | Year of Adoption | Membership | | | |
| 1 | 1911 | 28 | 1933 | 320 | 1940 | 260 | 210 | 2500 | 98 |
| 2 | 1914 | 100 | 1920 | 700 | 1940 | 650* | 16 | 700* | 52 |
| 3 | 1926 | 64 | 1926 | 64 | 1940 | 59 | 6 | 300 | 85 |
| 6 | 1923 | 50 | 1924 | 175 | 1939 | 160 | 20 | 850 | 86 |
| 7 | 1918 | 28 | 1924 | 300 | 1940 | 28 | 0 | 800 | 97 |
| 8 | 1931 | 320 | 1938 | 435 | 1939 | 435 | 64 | 290 | 44 |
| 9 | 1916 | 160 | 1938 | 203 | 1939 | 203 | 20* | 500* | 73 |
| 10 | 1916 | 23 | 1940 | 597 | 1941 | 597 | 10 | 400 | 41 |
| 11 | 1920 | 154 | 1920 | 154 | 1928 | 38 | 3 | 330 | 90 |

* Estimated

Table 14. Membership Situation of 9 Mi[illegible],
Adoption of the Revolu-

| Assn. No. | Number of Members when Originally Organized | | Year of Largest Membership | | Membership at Tim of Adoption of R.T | |
|---|---|---|---|---|---|---|
| | Date | Total Members | Year | Membership | Year of Adoption | Members |
| 1 | 1911 | 28 | 1933 | 320 | 1940 | 260 |
| 2 | 1914 | 100 | 1920 | 700 | 1940 | 650* |
| 3 | 1926 | 64 | 1926 | 64 | 1940 | 59 |
| 6 | 1923 | 50 | 1924 | 175 | 1939 | 160 |
| 7 | 1918 | 28 | 1924 | 300 | 1940 | 28 |
| 8 | 1931 | 320 | 1938 | 435 | 1939 | 435 |
| 9 | 1916 | 160 | 1938 | 203 | 1939 | 203 |
| 10 | 1916 | 23 | 1940 | 597 | 1941 | 597 |
| 11 | 1920 | 154 | 1920 | 154 | 1928 | 38 |

* Estimated

the adoption of the revolving-fund plan. The manager of the association attributed this condition to the lack of a stock retirement provision, the common reason for the outgrowth of this situation in most associations. He stated that since the stock (all common stock carrying voting rights) yielded a 7 per cent dividend the members, after they had reached the inactive stage, wished to hold it as an investment and that non-producers were actually permitted to acquire this stock at the outset for investment purposes.

The existence of a very high proportion of non-member patrons, prior to the adoption of the revolving capital plan was a condition prevalent among all 9 associations. As shown in Table 14 the proportion ranged from 41 to 98%, with 6 associations having more than 70% of their patrons, non-members. Besides leading to the deviation from the legal cooperative standard requiring at least 50 per cent of the organization's business to be transacted with members, such a situation is decidedly undemocratic in that only a small proportion of the total patrons have a voice in the control of association affairs. As previously pointed out the basic cause for the existence of a large number of non-member patrons was the lack of adequate procedure enabling them to attain membership status.[1]

Membership Situation Since Adoption of the Revolving Plan

Any general analysis of the effects which the revolving plan of financing has had on the membership program of cooperatives is not only limited by the general factors mentioned at the beginning of this chapter but particularly by the individual conditions peculiar to each association. Whether the number of members has been increased or eligible non-member patrons granted membership status in accordance with the purposes of the

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[1] See below p. 9.

revolving plan may depend upon the desires of the current membership and the manner in which cooperative officials utilize the provisions of the plan.

A summary of membership and patronage changes since the institution of the revolving capital plan for 10 associations is given in Table 15 from which certain conclusions may be drawn. It is strikingly evident that with the completion of the first year of operation under the revolving plan the membership totals increased in every case and more than doubled in many instances. Association Number 1 increased its membership more than 1000%. The automatic membership feature of the revolving capital program seems to have operated rather effectively at the outset. However, as the plan continued to operate, the number of members did not generally increase. In 5 associations in fact it remained almost stationary. The explanation for this apparent failure of the automatic membership process to progress varies with conditions existent in the individual association. The 25 members of Association No. 5, (a fruit cooperative) recently organized, wish to maintain a small membership for the time being. These members, all large producers, account for most of the marketing business of the association, whose facilities are not yet expanded to handle a larger volume, while the non-member patrons confine the bulk of their patronage to the purchase of general farm supplies. The non-member patrons are all given patronage credits which will shortly be issued to them in the form of voting and revolving securities enabling those eligible for membership to attain this status.

Association No. 6 has been unable to increase its membership for two years because a fire in 1940 caused a loss which made it impossible to declare a patronage dividend in 1940 or 1941. Since this association does

Table 15. Number of Members and Patrons Preceding and Following the Adoption of the Revolving-Fund Plan in 10 Michigan Associations.*

| Association Number | 1938 | | 1939 | | 1940 | | 1941 | | 1942 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Members | Patrons | Members | Patrons | Members | Patrons | Members | Patrons | Members | Patrons |
| 1 | - | - | 260 | 2550 | 2972 | Unknown | 4027 | Unknown | - | - |
| 2 | - | - | 650 | 1334 | 2000 | " | 2000 | " | - | - |
| 3 | - | - | 59 | 353 | 127 | 527 | 295 | 700 | - | - |
| 4 | - | - | 25 | 25 | 47 | Unknown | 50 | Unknown | 50 | 78 |
| 5 | - | - | 18 | 18 | 25 | 65 | 25 | 404 | - | - |
| 6 | 160 | 990 | 313 | 1200 | 313 | 1300 | 313 | 1500 | - | - |
| 7 | - | - | 28 | 828 | 300 | Unknown | 500 | 900 | - | - |
| 8 | 435 | 661 | 725 | 825 | 784 | " | 975 | Unknown | - | - |
| 9 | - | - | 203 | 683 | 243 | " | 243 | " | - | - |
| 10 | - | - | - | - | - | - | 597 | 987 | 750 | 2500 |

* Except for Associations No. 4 and 5, which organized at the outset under the revolving plan, the first year in which data are given represents the year just prior to the adoption of the plan.

not provide for a retain, its eligible non-member patrons can attain membership only through the receipt of stock issued in evidence of patronage dividends. Association No. 9 did not add to its membership during 1941 since its members voted not to issue a patronage dividend in this year (because of low earnings) thus preventing the enfranchisement of its non-member patrons. The personal observation and conclusion of the writer is that poor management and lack of an educational program in this association were primary factors leading to low earnings and no patronage dividends.

A cooperative official in Association No. 2 stated that all the non-member patrons became members immediately after the adoption of the revolving capital plan in 1940 so that few additions could be expected in the following year. Association No. 4, a small cooperative recently organized, has simply been lax in issuing voting securities to evidence the patronage credits that have accrued to its patrons.

The existence of a large number of non-member patrons in some associations has already been partly explained above in discussing individual factors preventing a general membership increase in cooperatives, but a very general explanation may still be in place. It may first be noted that the total number of patrons is not indicated for every association in Table 15. Some of these associations did not have complete patronage records readily available, while others explained to the writer that since patrons became members so quickly separate records were not maintained.[1] Be that as it may, a basic cause for the continued existence of non-member patrons among revolving-fund organizations, is the general laxity of these associations

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[1] The manager of Association No. 1 told the writer that although he kept no distinct patron and member records, he now believed that such records would be desirable and felt that he would like to have this information always at hand. He stated that it would not be a difficult task for the office staff to maintain such records.

in issuing voting securities. Many patrons accumulate enough patronage credits or retains to entitle them to voting privileges but are not officially classified as members until the association has issued them their voting certificates. To deal justly with these patrons, it is felt that associations should distribute voting securities as quickly as possible (without causing an undue amount of clerical work or expense). At any rate it may be concluded that if the automatic membership program is operated as it was intended, all eligible non-member patrons will be eventually enfranchised. The word "eligible" should be stressed here for each of the associations in which the existence of non-member patrons may be noted conduct a general supply business, either as their major enterprise or as a supplementary one (Associations No. 3, 5, 6, 7 and 10) and count among their patrons a group of non-producers (who purchase general supplies for home and garden use) who are ineligible for membership. This factor is not an unimportant one in explaining the presence of a part of the non-member patrons, particularly in those associations predominantly engaged in the sale of supplies.[1]

Although patronage is not quite yet synonymous with membership, it should be noted that (in those associations where the data were available) the trend of patronage has been decidedly upward since the adoption of the revolving capital plan. Although this steady increase cannot wholly be attributed to the workings of the plan, it seems certain from evidence gathered that many new patrons are attracted by the patronage dividend program (most associations did not issue patronage dividends prior to

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[1] It should be noted in Table 15 that the associations having the largest number of non-member patrons (Associations No. 3, 6, 7, 10) did the major share of their business in the sale of supplies.

the adoption of the revolving capital plan) and the prospect of quickly gaining membership through a financially equitable and unburdensome procedure.[1] Prospective patrons are decidedly in accord with the principle of contributing to the financial structure of the association in direct proportion to the use which they make of its services and facilities.

It will be recalled that, except for one case (Association No. 1) the existence of large numbers of non-producer, non-patron members was not prevalent among the cooperatives prior to the adoption of the revolving plan. According to the information obtained from most of the associations the few ineligibles that held membership were eliminated or in the process of elimination soon after the adoption of the revolving program. The manager of Association No. 1 stated that most of the voting stock held by the inactive members had been converted into non-voting securities and that the remainder of the original 210 non-patron members (in existence before the adoption of the revolving plan) would shortly be eliminated. Most of the associations had no exact record of the number of members that had been retired during the operation of the plan by reason of their having become ineligible since its adoption. In this connection it should be emphasized that as soon as a member's ineligibility has been ascertained, his voting stock should be converted as quickly as possible rather than allow him to continue to exercise

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1 See the discussion of comments on the program by non-member patrons, p.129.

voting privileges which should no longer be his.

## B. RELATION TO FINANCIAL PROGRAM

### Corporate Situation Prior to Adoption of Revolving Plan

The second distinct phase of the revolving capital plan as indicated previously is the provision for a sound, equitable financing program. To effect such a program it is necessary at the outset of reorganization under the revolving plan to call in and redistribute the outstanding stockholder equities according to a definite procedure. Before outlining the effect of this reorganization on the capital structure of the association, it will be well to indicate briefly the proportion in which the outstanding voting securities were held by patron and non-patron members.[1] As would be expected from the fact that only a small number of non-producers and/or non-patrons were counted among the membership rolls of associations prior to the adoption of the revolving-fund plan, the amount of outstanding voting securities held by such members was relatively insignificant in most cases. As shown in Table 16 Association No. 1 (with a large number of inactive members[2] before it instituted the revolving capital plan) was the only cooperative with the bulk of its voting stock concentrated in the hands of non-producer, non-patron members. The cooperative actually functioned as a private business organization during this time with its owners realizing a profit from the sale of products delivered by patrons, 98% of whom were non-members. It is interesting to note that this association whose cooperative status had been so questionable

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[1] It will be recalled that in all but a few cases voting securities were synonymous with financing securities under the older methods of financing.

[2] "Inactive members" always refers to those who are non-patrons or non-producers.

formerly has with the adoption of the revolving plan, set a prime example throughout the state of true "cooperativeness", having increased its active membership more than a thousand fold, regularly returned earnings to all patrons, transacted almost 100% of its business with members, eliminated nearly all inactive members, and in general has operated sound, equitable membership and financial programs.

Table 16. Outstanding Voting Securities Held by Non-Patron, Non-Producer Members in 9 Michigan Cooperatives Just Prior to Adoption of Revolving-Fund Plan

| Association Number | Total Voting Securities Outstanding | Amount Held by Non-Patron, Non-Producer Members | Per cent Held by Non-Patron, Non-Producer Members |
|---|---|---|---|
| 1 | $17,660 | $15,010 | 84.9 |
| 2 | 27,280 | 400 | 1.5 |
| 3 | 13,270 | 900 | 6.7 |
| 6 | 23,065 | 2,000 | 8.7 |
| 7 | 5,150 | 0 | 0 |
| 8 | 14,830 | 700* | 4.7 |
| 9 | 14,580 | 1,500 | 10.3 |
| 10 | 19,420 | 2,750 | 14.3 |
| 11 | 19,570 | 2,500 | 12.8 |

* Estimated

Table 16 also shows that, in addition to Association No. 1, 3 cooperatives had more than 10% of their voting securities in the possession of non-producer, non-patron members. This condition rendered the associations ineligible to borrow from the Bank for Cooperatives which requires, under the Farm Credit Act of 1933, that "at least 90% of the voting stock" must be held by producer members.[1] It should also be borne in mind that the Internal Revenue Act of 1926, although not providing for any definite percentage, states that "essentially all of the voting stock" or of the voting memberships in non-stock corporations, must be owned by producers who patronize the association. That the voting securities of inactive members have been retired since the adoption of the revolving-fund plan or are in the process of being converted into non-voting securities has already been indicated in the previous section (see p.109).

## Reorganization of Financial Structure Essential in Adoption of Revolving Plan

For an existing association to reorganize under the revolving capital plan, requires fundamental changes in its financial structure affecting the individual stock holdings of every member. The reorganization and redistribution of outstanding stock equities is carried out along a well defined pattern in accordance with the principles and requirements of the revolving plan of financing. At the outset, the association must call in for retirement all outstanding stock, after which it reissues stock or other certificates reapportioned between voting and non-voting securities. The general practice in Michigan associations is to distribute the bulk of the capital stock value in the form of financing securities with but a small portion issued as voting stock. Data, accurate enough to be usable, could be obtained from only 7 associations in illustration of this fact and is shown in tabular form on page 113. This table clearly reveals that the proportion of original outstanding stock reissued as financing securities was invariably far greater than that issued as voting stock and

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[1] See above, p. 14.

may fairly be said to be indicative of the general trend throughout Michigan. This conclusion is justified because of the inherent nature of the revolving plan of financing. It will be recalled that voting securities are issued solely to evidence voting rights and not to simultaneously aid in financing the association as is the general practice under the traditional financial programs. For the specific purpose of financing, revolving-fund organizations issue a special class of security, not endowed with voting rights, variously called preferred stock, certificates of indebtedness, certificates of interest, etc.[1] Thus only a nominal amount of capital is evidenced by voting stock, enough so that each member holds at least one share plus an additional

Table 17. Redistribution of Outstanding Stockholder Equities of 7 Michigan Cooperatives Reorganizing Under the Revolving Capital Plan.

| Association Number | Total Stockholder Equities Outstanding | | Outstanding Equities Reissued As:** | | | |
|---|---|---|---|---|---|---|
| | | | Voting Stock | | Financing Securities | |
| | Common | Preferred | Amount | Per cent | Amount | Per cent |
| 1 | $17,660 | $ 0 | $1,000 | 5.7 | $16,100 | 91.2 |
| 3 | 13,270 | 7,750 | 2,671 | 12.7 | 18,269 | 86.9 |
| 6 | 23,065 | 0 | 1,136 | 4.9 | 19,218 | 83.3 |
| 7 | 5,150 | 0 | 260 | 5.0 | 4,890* | 94.9 |
| 8 | 14,830 | 0 | 922 | 6.2 | 13,908* | 93.8 |
| 9 | 14,580 | 0 | 1,970 | 13.5 | 12,610 | 86.5 |
| 10 | 19,420 | 7,780 | 5,170 | 19.0 | 18,900 | 69.5 |

* Estimated

** The total amount of securities reissued does not equal the original amount of equities outstanding in all cases since some of the original stock is still outstanding. This fact also accounts for the percentages of each class of reissued security not totaling 100%.

[1] It should be remembered that the Coldwater Dairy Co., adopting the revolving capital plan in 1928, is the lone example of a Michigan revolving-fund organization issuing but one security for both voting and capital purposes.

required amount usually not exceeding $10, while the financing securities, as the name would imply, are issued to provide the capital needs of the association. It is of interest to note that in the two associations (Nos. 3 and 10) issuing both common and preferred stock prior to the reorganization under the revolving capital plan, there was a far greater amount of common stock, (the voting security), outstanding than there was preferred stock. This, of course, is in striking contrast to the financial structure of these associations after their reorganization and is indicative of the general change that cooperatives having more than one class of stock must undergo when adopting the revolving-fund plan.

The initial task of recalling and retiring the outstanding stockholder equities is usually a difficult one, primarily because the members are not completely aware of the effect which the financial reorganization will have on their individual holdings. Many are reluctant to give up their stock for they believe they will receive in return but a nominal amount of voting stock and not be reimbursed for the full value of their original stock equities. To correct this apprehension it is the duty of the manager, board of directors and other cooperative officials to explain fully the financial effects which the reorganization will have on the member.[1] Briefly each member will be reissued the full value of his original stock holdings, distributed between voting and financing securities. He will be issued only as much voting stock as he is required by the association to hold.[2] The rest of his stock value and usually the greatest

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[1] The manager of one association told the writer that he visited each stockholder personally to get them to sign away their capital stock and permit the organization to operate on the revolving-fund plan.

[2] The amount of voting stock a member is required to hold before he may be issued revolving securities varies with the association but usually does not exceed $10. See Table 12, p. 94.

proportion will be reissued to him in the form of non-voting securities. It should be clearly brought out to the member that the reorganization will entail no financial loss on his part but that he will receive the full value of his holdings, distributed between two securities.

Disposition of Unallocated Surplus. The method of dealing with an accumulated surplus in reorganizing under the revolving capital plan follows no well defined pattern as does the disposal of the outstanding securities, but varies rather with the individual conditions in each association. Generally, two choices are available to an association. It may determine the equity of each member in this surplus, and distribute it (or evidence of ownership in it) among them, or it may simply carry over the entire amount in the reorganization. One writer on the subject advises the disposition of the surplus in accordance with the first procedure. He suggests that: "If an association wishes to change to the revolving plan and has an undivided surplus accumulated from previous earnings, it is desirable to determine the previously earned equity of each member in this surplus, and issue evidence of this 'ownership' to each member on the basis of his previous patronage."[1] It may be argued however that if complete patronage records are not kept so that non-member patrons as well as members may be included in the distribution of the surplus, this process may be unfair to the former who have contributed to the accumulation of this fund. Such an argument was used by the manager of one Michigan association in convincing the members that the surplus should not be distributed among them. At the time of reorganization, the stock-

1 Weaver, O. T. "Revolving-fund financing for co-op gins." News for Farmer Cooperatives (Sept. 1937), Farm Credit Administration, Washington, p. 14.

holders of this association wished to have the unallocated surplus divided among them in proportion to the earned equity of each. The manager persuasively argued however that many non-member patrons had helped to build up this surplus over a period of years and were justifiably entitled to share in any distribution. Since complete patronage records had not been maintained, the stockholders acquiesced to the manager's suggestion of carrying over the entire surplus to the capital structure of the reorganized association. In view of the varying conditions existent among cooperatives at the time of reorganization, no definite rule may be advocated for the disposition of an unallocated surplus; the procedure followed should be the one most financially expedient. Among 9 Michigan associations reporting in this study, the policy of carrying over the surplus seems to be generally favored, all but one organization following this practice.

Successful Operation of Plan Dependent Upon Adequate Earnings

Having reorganized its corporate and financial structure, the association is then ready to carry out the financial program in accordance with the needs of the revolving capital plan. Upon the successful execution of this financial program depends the realization of the basic purposes and potential advantages of the revolving plan in all its phases. For the plan is essentially one of financing and a failure at this stage inevitably defeats the purpose of the plan, preventing the development of the membership program and having repercussions on vital phases of the business program. The successful operation of the entire revolving-fund plan is dependent on the ability of the association to realize adequate earnings from its operations. Without sufficient earnings it is extremely difficult for the plan to operate as it was intended. In fact, the plan cannot otherwise begin to function, for actually the whole developmental process depends for its start upon the net profits of the association. It is the earnings of the organization that enables the cooperative to declare and issue a patronage dividend in the form of certificates, permitting it to retain the cash to build up its capital structure and consequently liquidate outside indebtedness or/and provide for additional facilities. Since the first patronage credits are applied to voting stock the total number of members will be constantly increased as the automatic membership program begins to function. And with this growth in membership, the association is enabled to raise (or maintain) the proportion of its member business to the required legal minimum of 50 per cent and usually much higher. Finally the accumulation of earnings enables the cooperative to build up a fund to use for the retirement of its outstanding non-voting securities, setting the revolving process in motion. Obviously, it is the amount of the association's yearly earnings that will determine when the stock shall begin to revolve--(the larger the earnings, the sooner the funds will become available for the stock retirement) at which time the revolving capital plan actually begins to function. A few cases from among the Michigan associations reporting in this study will serve to demonstrate the importance of earnings to the successful operation of the plan.

The case of Association No. 6 illustrates how, through no actual fault of its own, the financial program of a cooperative may fail to operate as it was intended. The fire that occurred here in 1940 caused a net loss in operations amounting to slightly more than $2,500, making it impossible to declare a patronage dividend in this year. Nor was it feasible to declare a patronage dividend in 1941 even though earnings of $1,450 were realized, for these had to be applied to the capital structure of the association seriously weakened by the loss of the previous year. Because of this unfortunate occurrence, the cooperative has been unable to operate the revolving-fund plan since its adoption and has thus realized none of its advantages. It has been unable to strengthen its capital structure adequately to allow for the liquidation of outside indebtedness or the acquisition of additional facilities. The automatic membership program has been defeated, for having declared no patronage dividends, voting securities have not been issued and total membership has not increased for two years.[1] Consequently the proportion of business transacted with members has not yet reached the required 50% level preventing the association from realizing the financial savings resulting from qualification for tax exemption. Lastly the failure to accumulate earnings has lengthened the time required to put the revolving feature into operation, and until this vital operation is started the revolving-fund plan cannot truly be said to be functioning as it was intended. It also becomes increasingly difficult to maintain the members' interest and convince them of the advantages of the plan when the revolving feature is long delayed.

The failure of Association No. 6 to effectively operate its financial program, defeating the purposes of both the membership and business programs has admittedly been due to an unfortunate event beyond the

[1] The membership did increase immediately after the adoption of the plan in 1939 because patronage dividends were declared out of the earnings of the previous year. Table 15 on p.106 shows that since 1939 the total number of members has remained at 313 although non-member patrons have increased.

normal control of the organization. However, the case of an association operating under normal business conditions and still failing to execute the revolving plan successfully may be cited by reference to Association No. 9. This organization, adopting the new financial plan during the fiscal year 1939-40 issued sufficient patronage dividends during this year to qualify for income tax exemption and has declared none since. It is perhaps more than coincidental that the earnings of this cooperative fell from $1,545.93 in 1939-40 to $992.75 in 1940-41. At any rate, its membership has not increased over this two year period thus failing to realize the purpose of the automatic membership feature. The earnings, in general, have not been sufficient to build up a sound capital structure or provide for the addition of sorely needed facilities. And unless earnings can be increased in the near future, the orderly retirement of outstanding non-voting securities will not be accomplished, and the fundamental purpose of the revolving program will be defeated. It is not too much to say that the whole revolving-fund plan ceased to operate in this association with the failure to continue the distribution of patronage dividends. Capital has not been sufficiently increased, membership has remained stationary, and an equitable financing program has not yet been realized, since the patrons have not contributed capital to the association in accordance with the use which they have made of its facilities.[1]

In sharp contrast to the cases illustrated above, we may cite the case of Association No. 8, which adopted the revolving capital plan in 1939 and has operated it most successfully ever since. The underlying cause of the success of the plan in this association has been the constant growth in

[1] Most Michigan associations (including Association No. 9) do not provide for a retain, hence it is only through the issuance of patronage dividends in the form of certificates that new members may be added, and by retaining the cash in the association, financing is carried out on an equitable basis in proportion to the patronage of each patron.

earnings realized during the three years of its operation. From $4,695 in 1939, this cooperative was able, in 1940, to increase its earnings to $7,377 and at the end of 1941 reported an even greater growth with a net profit of $12,697. These earnings have enabled the organization to build up a sound capital structure and acquire additional facilities of which they were sorely in need. In their three years of operation under the revolving-fund plan, they have issued large patronage dividends in certificate form varying from approximately $16,500 to nearly $19,000.[1] Their membership has consequently been increased and the proportion of their business transacted with members has risen to 90% (from 52%) while their total volume of business was being greatly expanded. Finally, and probably most important, the revolving feature of the plan is operating as it was intended, for the large fund accumulated from the steadily growing earnings has permitted this organization to call and retire a portion of its outstanding non-voting securities.

Additional cases might be cited, but it is felt that the elaboration of the conditions existent in the above three associations, effectively serve to demonstrate the fundamental importance of the financial program to the general success of the revolving plan, and more particularly the vital role of earnings in determining the successful execution of this financial program. In general the other associations reporting in this study have been able to realize sufficient earnings to build up their capital structure, and issue enough patronage dividends in securities to increase membership and proportion of member business to well above the necessary 50% (see Table 20, p.125), but owing to the recency with which the plan has been adopted, have not yet begun to revolve their capital.

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1 These totals were roughly approximated from the voting stock and certificates of indebtedness issued during the years 1939, 1940 and 1941.

## C. EFFECTS ON BUSINESS OPERATIONS

### Total Volume of Business

Although the two basic objectives of the revolving capital plan are to provide for sound and equitable financial and membership programs, the attainment of these has an indirect but consequential effect on the business programs of an association. The general increase in membership and patronage usually associated with the initiation of this new financing method ultimately leads to a growth in the organization's total volume of business.[1] This development was clearly indicated in the case of the Coldwater Dairy Co. which experienced a steady increase in butterfat deliveries over a period of 14 years.[2] Such a definite trend can, of course, not be revealed in other Michigan associations where the revolving plan has been only recently instituted. However, data obtained from 10 Michigan associations on the dollar volume of sales before and since the adoption of the revolving-fund plan indicate in each case an increase in varying degree shortly after the institution of the plan. While dollar volume of business will reflect changes in prices as well as physical volume, the very substantial increase in dollar sales and the known increase in total patronage indicate an actual business growth representing product contributions of new patrons. The general increase in business volume for 10 Michigan associations is shown in Table 18.

### Business Transactions of Old Patrons

Having generally concluded that the revolving-fund plan tended to

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1 Although all of the associations reporting in this study did not increase their total membership, reasons for which were explained on pp. 105-108, all that had the data available indicated a definite increase in the total number of patrons.

2 See Table 6, p. 68.

Table 18. Dollar Volume of Sales of 10 Michigan Associations Before and Since Adoption of the Revolving Capital Plan.

| Association | 1937 | 1938 | 1939 | * 1940 | 1941 |
|---|---|---|---|---|---|
| 1 | $ - | $1,213,547 | $1,303,193 | $1,564,391 | $1,893,498 |
| 2 | - | 778,476 | 827,082 | 894,350 | 1,231,381 |
| 3 | 165,349 | 210,223 | 220,273 | 215,454 | 321,393 |
| 4 | - | - | 18,197 | 40,634 | 53,397** |
| 5 | - | - | - | 91,489 | 173,341** |
| 6 | 178,215 | 133,483 | 123,079 | 131,929 | 185,241 |
| 7 | 109,251 | - | 84,385 | - | 118,080 |
| 8 | 282,737 | 263,960 | 242,359 | 308,377 | 423,614 |
| 9 | - | 24,541 | 27,757 | 38,906 | 42,198 |
| 10 | 176,934 | 167,409 | 211,007 | 248,448 | 331,862** |

* The year before which the dotted line appears indicates the date in which the revolving plan was adopted for each association.

** Business year does not correspond to calendar year but extends into following calendar year.

attract new members and patrons to an association, and thereby increase its volume of business, it was desired to determine what effect, if any, the initiation of this financing program had on the patronage of those members and patrons previously transacting business through the association. The answers obtained to this question from 9 cooperatives are shown in Table 19. No final conclusion may be drawn from so small a sample but the general effects seem to be suggested from the consistency of the replies. In no case did an association reply that the effect of the plan was to decrease the patronage of the older members (although a space was allotted for such a possibility on the questionnaire.) Four of the 9 associations reported a definite increase in the volume of patronage varying from 10 to 20 per cent, while the remaining 5 indicated that there had been no

Table 19. Effect of Revolving-Fund Plan on Patronage of Members and Patrons of 9 Michigan Associations Transacting Business Prior to its Adoption.

| Association | Effect | Apparent Explanation (by Manager) |
|---|---|---|
| 1 | None | Plan has not operated long enough for members to understand advantages. When plan starts to revolve members should increase patronage to realize higher patronage dividends. |
| 2 | None | Members transacted all their business with association prior to adoption of plan |
| 3 | Increase 15 - 20% | Anxious to obtain larger patronage dividends. |
| 6 | Increase % not known | Anticipated patronage dividends and prospect of becoming members. |
| 7 | None | ------------------ |
| 8 | Increase 10% | Better prices for butterfat. |
| 9 | None | Stock has not yet revolved so that members do not understand practical benefits to be derived from increasing their volume of business. |
| 10 | None | ------------------ |
| 11 | Increase 15% | (1) Better prices for a higher quality product. (2) Patrons liked idea of receiving patronage dividends. |

noticeable effect up to the time of their reply. The most frequent explanation given by managers for the increased patronage was the general attraction of the patronage dividend and the desire of patrons to receive as large a dividend as possible. Of the 3 associations offering an explanation for the fact that the patronage of their members and patrons remained the same, 2 indicated that the plan had not been in operation long enough for the members to fully grasp the significance of the advantages offered. The manager of Association No. 1 seemed convinced that as soon as the stock started to revolve, the members would have confidence in the plan and attempt to increase their volume of business to take fullest advantage of the patronage dividend program. However, at present he stated, "they are not quite sure of the idea", and he is trying to clarify the whole program through frequent explanations in the house organ. The manager of Association No. 9, although offering the same general explanation, for the lack of patronage increase, seems to have made little effort towards informing the members of the nature and techniques of the revolving plan of financing. It may be emphasized here that information of this type should constantly be kept before members during the early period of operation and that such procedure is often a potent factor in determining the general success of the plan.

## Proportion of Business Transacted with Members

The effect of the automatic membership program on Michigan associations is strikingly revealed by the notable increase in proportion of business transacted with members that has followed its inauguration. This manifestation of the automatic membership feature becomes even more significant when one recalls that the total volume of business in these associations has steadily increased since the adoption of the revolving capital plan. Under the traditional financing methods an increase in business volume was usually followed by a general decline in the proportion of member business because of the inability of associations to keep membership growth apace with business growth.[1] Table 20 shows that

[1] See above pp. 17-20 for an explanatory discussion.

Table 20. Proportion of Member Business for Each of Three Years Prior to the Adoption of the Revolving Capital Plan and Since its Adoption in 10 Michigan Associations.

| Association Number | Years Prior to Adoption of R.F.P. | | | Years Subsequent to Adoption of R.F.P. | | |
|---|---|---|---|---|---|---|
| | 3rd | 2nd | 1st | 1st | 2nd | 3rd |
| 1 | 4% | 4% | 4% | 97 | 97 | - |
| 2 | 51* | 50* | 50* | 90 | 98 | 98 |
| 3 | 53 | 52 | 51 | 60.8 | 90 | - |
| 4** | - | - | - | 100 | 100 | - |
| 5** | - | - | - | 80 | 77.8 | - |
| 6 | 35* | 35* | 35* | 36.7 | 42.1 | - |
| 7 | No records kept | | | 95 | 95 | - |
| 8 | 52 | 52 | 52 | 90 | 90 | 90 |
| 9 | 40 | 40 | 40 | 70 | 80 | - |
| 10 | 58.7 | 59.6 | 54.2 | 59 | - | - |

* Rough estimates.

** Not in operation prior to adoption of plan.

6 of the 10 Michigan associations reporting, transacted 90% or more of their business with members, two between 75 and 80% and the remaining two associations 59% and 42.1% respectively.[1] The failure of Association No. 6 (a supply cooperative) to appreciably increase the proportion of its member business demonstrates the close ties with which the membership, financial and business programs are interbound. It will be recalled that

[1] The data for the Coldwater Dairy Co., the 11th association reporting in this study, has already been shown in tabular form on p. 69.

this organization suffered a fire loss after the adoption of the revolving program which prevented it from declaring a patronage dividend. No voting stock could therefore be issued to eligible non-member patrons to increase the total number of members. Hence the proportion of business transacted with members was not effectively increased particularly since the total volume of business had grown.[1] The necessary order of development thus seems to be: earnings ⟶ patronage dividends ⟶ issuance of voting stock ⟶ increased membership ⟶ increase in proportion of member business. Association No. 10 with only 59% of its business done with members is a general supply organization which counts many non-producers among its patrons who are ineligible for membership. The slight decrease in the percentage of member business during the operation of the revolving plan in Association No. 5 is accounted for by the fact that this organization, as previously explained, has not increased its membership primarily because of a lack of adequate facilities.

## Financial Savings Realized by Associations

A practical business advantage realized by many Michigan associations since the adoption of the revolving plan of financing lies in the exemption from various taxes and fees granted to them.[2] This realization presents tangible evidence in support of the fact that the revolving capital plan makes possible the adherence to the state and federal legal cooperative requirements, for the associations listed in Table 21 were unable to claim income tax exemptions under the older financial plans.[3] Although the

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[1] The slight increase that did take place may be attributed to the increased patronage contributed by the existing membership.

[2] For types of taxes included in exemption, see footnote to p. 70.

[3] In Chapter I was presented a discussion on cooperative standards and why cooperatives on older financial programs have not been able to adhere to some of them. In Chapter II it was shown how the revolving plan of financing enables associations to meet cooperative standards.

Table 21. Additional Expense, Gross Savings, and Net Savings Resulting from Adoption of Revolving-Fund Plan for 9 Michigan Associations.

| Association Number | Additional Yearly Expense | | | Savings Resulting from Exemption from Taxes and Fees | |
|---|---|---|---|---|---|
| | Book-keeping | Printing | Total | Gross | Net |
| 1 | $ 840 | $ 50 | $ 890 | $6,000 | $5,110 |
| 2 | 1,000 | 100 | 1,100 | 2,800* | 1,700 |
| 3 | Unknown | 8 | Unknown | 955* | Unknown |
| 5 | 40 | - | 40 | 2,275 | 2,235 |
| 6 | 85 | 15 | 90 | 0 | 0 |
| 8 | 400 | 75 | 475 | 2000-4000 | 1525-3525 |
| 9 | 75 | 19.75 | 94.75 | 290 | 195.25 |
| 10 | 300 | 75 | 375 | 1,100 | 725 |
| 11 | 300 | - | 300 | 1,075* | 775 |

* Roughly estimated.

operation of the revolving-fund plan necessitates additional bookkeeping and printing expenses (because of the cost of keeping complete patronage records, and printing and issuing stock certificates), Table 21 shows that in all but one case these costs have been more than counteracted by the financial savings realized. The net savings of 8 Michigan associations ranged from slightly less than $200 to a little more than $5,000. The manager of Association No. 1 was convinced that the savings accruing to his organization were directly attributable to the operation of the automatic membership program. Prior to the inauguration of this program the association was transacting for less than the required 50% of their business with members but there was no expedient method for increasing membership for "the farmers were simply not interested in purchasing stock in the organization."[1] Association No. 6, the lone organization

[1] Statement made by the manager to the writer in an interview.

unable to gain tax exemption is the same association, it will be recalled, that was unable to declare a patronage dividend because of a fire loss, and hence unable to increase its membership nor raise the proportion of its business transacted with members to the necessary 50 per cent.

### D. LOCAL REACTIONS TO REVOLVING PLAN AS CONVEYED BY ASSOCIATION MANAGERS

An attempt was made to determine the general reactions to the revolving-fund plan by asking what the most frequent comments, favorable and unfavorable, relative to the program were. It was not possible to interrogate member and non-member patrons directly so that the manager of each association was relied upon to report the comments most frequently heard from these sources. The presentation of the varied reactions may serve to indicate which aspects of the plan are most appreciated and which need more clarification to be completely understood. Favorable reactions relating to member and non-member patrons are presented below.

#### Favorable Reactions

I Relating to Members

1. Members have developed a definite interest in the association heretofore not shown. They feel that they are now the owners of the association whereas previously they felt that the organization was owned by a few stockholders and had an indifferent attitude toward its success.
2. The increased interest of members has tended to further the cause of cooperation.
3. Members look to the association as a community program.
4. Members expressed great satisfaction when they received payment for their stock which had revolved.

5. Patronage dividend aspect is well liked and many complain when it is not paid.
6. Members like the plan particularly because it helps to pay off debts.
7. They feel that each one of the members is treated equally and fairly under the revolving program.
8. Members have said that the plan provides for a most equitable method of financing the association.

II <u>Relating to Non-Member Patrons</u>

1. Non-member patrons like to be treated the same as members.
2. They express a great deal of interest in program; wish to know how they may become members and how much they have to trade.
3. Non-member patrons are transacting more business to receive patronage dividends and become members.
4. They express satisfaction when profit-sharing stock is issued to them.
5. The first year of operation, non-member patrons wished to receive patronage dividends in cash, now they want to receive stock instead. The cooperative has been able to improve its buildings and service and patrons are more satisfied.

III <u>Relating to Both Member and Non-Member Patrons</u>

1. Substantial increase in total business has been realized since the adoption of the plan.

2. Patrons do not complain about prices. They trade regularly and encourage others to do likewise.
3. It has been possible to build a quality program because patrons complain less about sanitary requirements and are willing to accept low quality cream back.
4. The plan finances itself from the contributions of current patrons in proportion to their volume of business. Working capital is always provided.

It seems unnecessary to elaborate upon the reactions presented above since they are in the main self-explanatory. The general advantages of the revolving-fund plan under which most of the listed reactions fall have been rather fully dealt with in Chapter II and in part in the present chapter. Indicating the general favorable reactions of member and non-member patrons is of significant importance in revealing what advantages of the program are most appreciated by these groups during the early period of operation. A general increased interest in the association is evidenced in the comments of both, while satisfaction with the financing program and the equitableness of the entire plan has been frequently expressed.

The unfavorable reactions reported were not many, most associations indicating there were none from either group. The few comments that were made relate to members only and are listed below.

Unfavorable Reactions

1. It is difficult to get members to understand the entire plan.
2. Some members have complained that the retains are too large.

3. A few do not wish non-members to share in the patronage dividends.

4. Some have refused to accept the stock when issued.[1]

An examination of these reactions reveals that all may be attributed to the lack of an effective educational program. Before patrons can acquire an understanding of the revolving plan, information must be constantly provided explaining the objectives, operation and techniques of the entire program. When they are made to realize that the retains deducted from the proceeds of their sales accrue to them in the form of stock credits and that the securities issued to them will eventually be redeemed in cash as they revolve, their complaints as to the size of this retain will gradually subside (unless the sum deducted is unnecessarily large.) Similarly as they realize the value of the stock issued to them they should no longer have any qualms about accepting it. To convince members that it is fair for non-member patrons to share in the patronage dividends is a task that can also be accomplished through the general educational program. They should be constantly reminded that under the revolving plan of financing, non-member patrons contribute to the association on the same basis as do members and it is consequently unjust to discriminate against them in the awarding of patronage returns. It does not seem therefore that the unfavorable reactions mentioned above need endure if an enlightened educational policy is maintained, and

[1] One manager reported that from his own personal standpoint the operation of the plan necessitated a great deal of work. Although a valid objection, it is more than counteracted by the financial savings resulting from the operation of the plan as shown in Table 21, p. 127.

that if the plan is executed successfully, they will disappear anyway as the operations take effect over a period of years revealing the advantages in fact.

## E. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

As indicated at the start of this chapter, the full effects of the revolving-fund program on Michigan cooperatives cannot yet be ascertained owing to the recency with which the plan has been adopted. It is possible, however, to draw a few summary conclusions from the analysis presented, suggest the basic needs required for the success of the plan and indicate its probable order of development as the cooperatives "grow into" it. The conclusions drawn are based upon the 11 organizations included in the survey.

Generally Michigan associations organizing under the revolving capital plan have been enabled to meet all state and federal legal requirements as evidenced by their qualification for income tax exemption.[1] The savings resulting from this benefit far exceeded the additional expenses necessitated for the operation of the entire revolving-fund plan. The total dollar volume of business for all associations has steadily increased since the adoption of the plan and there has been a tendency for the older members and patrons to increase their patronage to avail themselves of largerpatronage dividends. Of the total volume of business, the proportion transacted with members has exceeded the required 50 per cent, and has reached 90 per cent or more in a majority of the associations.

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[1] The legal requirements are discussed in Chapter I and it will be recalled that the Federal Revenue Act includes the requirements of all the other federal acts, so that an association meeting the requirements of this act complies with those of all other acts.

With the inauguration of the automatic membership program, total membership in all associations immediately increased but has since remained stationary in a few organizations for particular reasons varying with each cooperative (see pp. 105-108). The total number of patrons has shown, in the case of each surveyed association, an increase since the adoption of the revolving plan indicating that producers might have been attracted by its potential advantages, while the non-producer, non-patron members are gradually being eliminated as associations convert their voting stock into equal values of non-voting securities.

Owing to the relatively short period of operation under the revolving-fund plan, the financial program of most Michigan associations has not yet developed to the point where they have actually begun to revolve their capital. At present they are authorizing patronage dividends and issuing them in the form of securities, enabling the cooperatives to retain the earnings for the purpose of retiring outside indebtedness and acquiring additional operating facilities. In short, they are now in the process of becoming adequately financed. When they have been able to accumulate a fund in excess of their actual capital needs, the next phase of the financial program will be to start revolving the securities they have issued. It is usually not until this feature of the program is reached that the members acquire a realization of the practical financial advantages that accrue to them and a full understanding that they will receive cash for their revolving securities after the cooperative becomes adequately financed.

Until such time, then, as the members do acquire a complete understanding of the operations and potential advantages of the revolving-fund plan, it is basically essential that the association carry on an effective educational program. This program should be devoted to an explanation of the fundamental objectives of the plan, the operational procedure required to realize such objectives, the immediate and ultimate advantages accruing to the association and individual members, and, in the case of a reorganized cooperative, the general effect which the institution of the plan will have on the financial investment of each member. It is vital that members and patrons be constantly informed about the nature and techniques of the revolving plan for it has been a lack of understanding on their part that has deterred its progress and defeated its purposes in not a few associations. In addition to and in conjunction with the basic need for an educational program, rather definite procedural steps must be taken with the adoption of the new financing plan if it is to work out successfully. It, therefore, seems pertinent at this point to briefly outline the developmental process of the revolving capital program as cooperatives gradually "grow into" it:

1. The association must adapt its corporate structure and develop its financial program to meet the requirements of the plan.

2. It is necessary that the association have sufficient earnings to enable the program to operate as intended. (i.e. be able to issue patronage dividends.)

3. When the first patronage dividends are issued in the form of securities, the association will be permitted to retain the cash, increasing its capital, while the total number of members will be increased as the "automatic membership

program" begins to function. Simultaneously, the total amount of outstanding securities will increase.

4. The elimination of inactive members may then be accomplished through the conversion of their voting stock into an equal value of non-voting securities.
5. As the capital continues to accumulate (from the retention of cash from earnings) the association's outside indebtedness may be liquidated or/and additional needed facilities may be provided.
6. The capital begins to revolve when funds become available for the retirement of outstanding non-voting securities at which time the plan actually begins to function.

As indicated previously, Michigan associations in general have passed through the first five stages of the program but have not yet begun to revolve their capital. Until this phase of the plan is reached, a completely equitable financial program has not been achieved. Membership investment is not maintained proportional to their current volume of business until their previous investments start to revolve back to them. For the same reason new members cannot be admitted upon a basis that is fair to the old members until the latter's accumulated investment is gradually returned through the retirement of their financing securities. It also follows that the investmentsof the members who provided the original capital for the business are frozen until such time as their securities are revolved for there is usually no market for such securities until their value is established by the ability of the association to retire them. And, to reiterate, the members do not acquire a complete understanding of the revolving-fund program nor realize its practical advantages until the capital has actually begun to revolve. Therefore, because the operation of the plan has not yet been fully developed, the analysis of its effects upon Michigan associations has necessarily been limited. In view of the limitations of this study it is suggested that a further investigation might be conducted at a later date after the associations have been given an opportunity to develop the program more completely. Such an investigation would be of value in accomplishing a two-fold purpose: (1) a rather complete appraisal of the full effects of the revolving capital plan upon Michigan associations, and (2) a comparison with the present study, indicating the progress made by the organizations and recording the effects of the plan at two different stages in its development.

## APPENDIX

### QUESTIONNAIRE USED TO OBTAIN INFORMATION ON THE EXPERIENCE OF MICHIGAN ASSOCIATIONS WITH THE REVOLVING-FUND PLAN

Character of organization

1. State the value of products marketed in your last fiscal year:

| | | | |
|---|---|---|---|
| Dairy | $ ________ | Potatoes | $ ________ |
| Eggs | $ ________ | Livestock | $ ________ |
| Fruit | $ ________ | Other ________ | $ ________ |
| Grain and Beans | $ ________ | Total Farm Products | $ ________ |

2. State the value of supplies sold during your last fiscal year:

| | | | |
|---|---|---|---|
| Gas and oil | $ ________ | Other Merchandise | $ ________ |
| General Farm Supplies | $ ________ | Total Supplies | $ ________ |

Membership Program: (Member should be interpreted as one who is eligible to vote.)

3. Estimate the number of members when originally organized__________ In what year prior to adoption of the revolving plan did you have your largest membership?________. How many members did you have in that year? ________.

4. How many members did you have just prior to the adoption of the revolving plan? ________ How many non-member patrons? ________ How many of these members were ineligible to membership after the revolving plan was adopted because they were non-producers? ________ How many because they were non-patrons yet producers? ________

5. Show by years since the automatic membership program was adopted what effect it has had upon the number of your members and patrons.

| Fiscal year ending in | Number of Members Eligible to Vote | | | Number of Patrons | | |
|---|---|---|---|---|---|---|
| | Added | Lost | Total Membership | Added | Lost | Total Patrons |
| 1938 | | | | | | |
| 1939 | | | | | | |
| 1940 | | | | | | |
| 1941 | | | | | | |
| 1942 | | | | | | |

6. How many of the members lost since the adoption of the automatic membership program were lost by reasons of becoming:

| | 1938 | 1939 | 1940 | 1941 | 1942 |
|---|---|---|---|---|---|
| Non-producers | | | | | |
| Producer non-patrons | | | | | |

Financing Program

7. Please enclose balance sheets and operating statements for each of 3 years before the adoption of the revolving-fund plan for each year since its adoption.

8. State the amount of outstanding stockholder or member equities just prior to adoption of revolving-fund program. (Note:- If this information is identical with that of last balance sheet prior to adoption of revolving plan, a copy of this balance sheet will be sufficient.)

| | |
|---|---|
| Preferred stock or other non-voting securities | $________ |
| Common stock or other voting securities | $________ |
| Unissued stock credits | $________ |
| Allocated surplus or reserve | $________ |
| Undivided surplus (enter deficit in red) | $________ |

9. Just prior to adoption of revolving plan how much of the voting securities were held by non-producers?_________ How much of the voting securities were held by non-patrons, yet producers?_________

10. In adopting the revolving plan, how much of the outstanding stock and stock credits existing prior to adoption of the program was reissued as voting stock (or membership)?_________ How much was issued in non-voting securities?_________ How much of the existing surplus at the time of adoption of plan was issued as voting securities?_________ How much was issued in non-voting securities?_________

11. Please supply data for the following schedule for each year since the adoption of the revolving-fund plan.

| Fiscal Year | Net Earnings for the Year | Retains Collected During Year | Patronage Dividends Issued in Year | Voting Securities Issued | Non-voting Securities | |
|---|---|---|---|---|---|---|
| | | | | | Issued | Retired |
| 1938 | | | | | | |
| 1939 | | | | | | |
| 1940 | | | | | | |
| 1941 | | | | | | |
| 1942 | | | | | | |

12. State the amount or percentage of securities which have been transferred by years since the adoption of revolving plan:

| | 1938 | 1939 | 1940 | 1941 | 1942 |
|---|---|---|---|---|---|
| Voting | | | | | |
| Non-voting | | | | | |

13. State the approximate range (high and low) of dividends or interest paid on securities and the average dividend declared: Before the program was adopted, preferred stock, range_________average_________; common stock, range_________average_________. After the program was adopted, preferred stock, range_________average_________; certificate of indebtedness, range_________average_________.

Business Program

14. Have the members and patrons who were doing business with the association prior to the adoption of the revolving program, increased or decreased their volume of business?_________ Estimate the percentage of increase or decrease_________. Explain apparent reason for increase or decrease _________.

15. What was the percentage of business done with members for each of 3 years prior to the adoption of the revolving-fund plan and for each year since its adoption?

| | | |
|---|---|---|
| 1935________ | 1938________ | 1941________ |
| 1936________ | 1939________ | 1942________ |
| 1937________ | 1940________ | |

16. Estimate the yearly average additional bookkeeping expense caused by the adoption of the revolving-fund plan and automatic membership program?_________. Additional printing expense _________.

17. Estimate the yearly average savings from all taxes, fees and reduced interest costs as a result of the revolving program._________

18. What effect has the program had on the credit standing of the association?
    ______________________________________________________________

    On your credit policies and operations insofar as your members and patrons are concerned?______________________________________________

Membership Reaction and Interest

19. In general what are the most frequent comments made relative to the program?
    (a) From members?
        1. Favorable ____________________________________________
           ______________________________________________________
        2. Unfavorable___________________________________________
           ______________________________________________________
    (b) From non-members?
        1. Favorable_____________________________________________
           ______________________________________________________
        2. Unfavorable___________________________________________
           ______________________________________________________
    (c) Manager's estimation of program
        1. Favorable_____________________________________________
           ______________________________________________________
        2. Unfavorable___________________________________________
           ______________________________________________________

20. Since adoption of the revolving plan, what has been the effect on membership interest in the association as shown by the following factors?
    (a) Attendance at membership meetings? Per cent increase_________ Per cent decrease_________, same_________.
    (b) Complaints on organization policies? Per cent increase_________, Per cent decrease_________, same_________.
    (c) Other evidences__________________________________________
        _________________________________________________________

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