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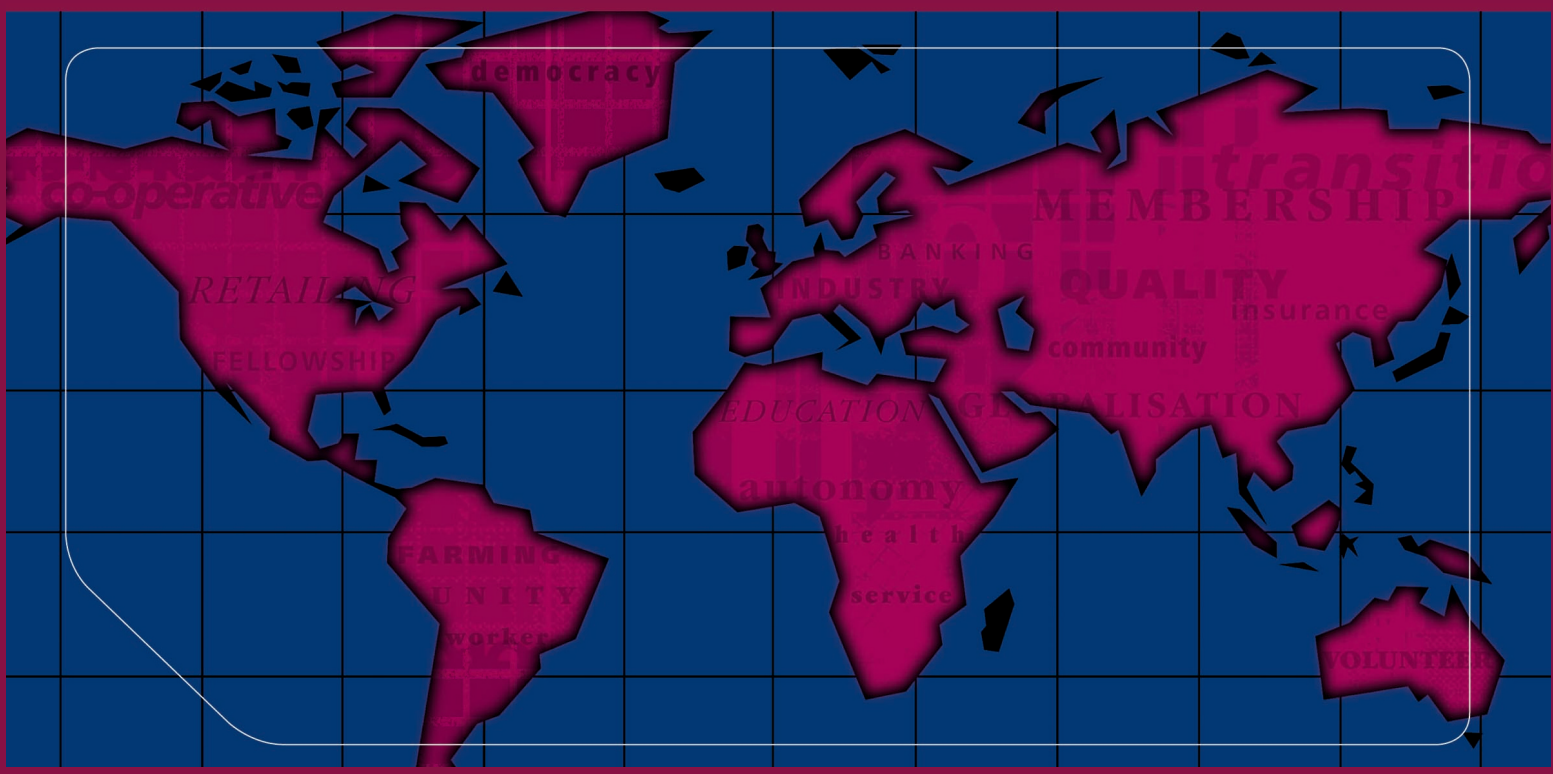

THIS ISSUE:

GOVERNANCE, ACCOUNTING AND ACCOUNTABILITY AND FUTURE PERSPECTIVES

REFEREED PAPERS: NEW APPROACHES TO GOVERNANCE IN WORKER CO-OPERATIVES. THE UK CO-OPERATIVE GROUP CRISIS AND-GOVERNANCE FAILURES. CO-OPERATIVE BOARD PERFORMANCE. ECONOMETRIC MODELLING FOR PERFORMANCE AND GOVERNANCE IN AGRICULTURAL CO-OPERATIVES. MULTI STAKEHOLDER MANAGEMENT IN CO-OPERATIVES.

EXECUTIVE OPINION: INTEGRATED ACCOUNTING AND REPORTING AT VANCITY. GOVERNANCE AND SUSTAINABILITY IN TIMES OF RAPID CHANGE IN THE CO-OPERATIVE AGRICULTURAL SECTOR. CO-OPERATIVES UK CODES OF CONDUCT. GOVERNANCE CHALLENGES FOR CO-OPERATIVE BANKING FROM A FRENCH PERSPECTIVE

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Recognition of *International Journal of Co-operative Management*

The Journal is listed in *Cabells Management Directory,* the premier journal listing agency in the USA.

Notes on the Contributors

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A Note From The Guest Editor

Sonja Novkovic

This volume is a compilation of works related to co-operative governance, coming from scholars as well as practitioners and apex organizations in the co-operative movement. This special issue followed the *International Symposium on Co-operative Governance* at Saint Mary's University in September 2013. [http://www.smu.ca/academic/sobey/mm/governance-symposium.html].

Co-operative governance is about democratic decision-making in organizations: an issue that shares features of political democracy yet has its differences in the economic implications of the collective decisions. On the other hand, co-operative governance is similar to governance in other firms, but unlike others, it has to provide opportunities for participation by members in, or outside, the organization. Governance in co-operatives is a particularly pertinent subject in light of innovations under market pressures that lead to demutualization's, as well as questions of effective democratic governance systems that prevent oligarchic tendencies or isomorphism and ensure co-operative longevity.

The Blueprint for a co-operative decade [http://ica.coop/en/media/library/member-publication/blueprint-co-operative-decade-february-2013] outlines member participation as one of the differentiating pillars of co-operative organizations, together with sustainability and co-operative identity. These three pillars are complemented by the two enablers – supportive legislation and access to co-operative capital. The co-operative movement thus recognizes the need to elevate member participation in co-operatives (participation includes members' right to information, voice and representation) in order to continue to be relevant and gain the competitive edge in the fast changing economic environment.

Challenging traditional views and systems of governance, a paper by Ryszard Stocki in this volume is a discussion of the appropriate loci of decision-making that make best use of the cumulative knowledge in co-operative organizations. The author argues that centralized decision-making, either by elected directors or by the oligarchs, is inadequate in co-operatives and proposes a system of 'common meritocracy' to deliver diverse and flexible decision-making systems.

Johnston Birchall talks about four key components of effective governance: member voice; representation; board expertise; and management execution. He discusses governance failures of the Cooperative group in the UK, where expertise and member voice were lacking, resulting in oligarchic management and a weak Board.

Art Sherwood and Keith Taylor revisit the agency theory of governance and decision-making and illustrate that particular institutional logics differentiate co-operative governance from that in investor owned firms, more specifically in relation to advocating democracy. See Yang and Fabio Chaddad deliver an empirical paper that explores how board diversity and CEO characteristics impact performance. The authors suggest qualitative analysis as more appropriate for co-operatives than the typical quantitative financial indicators applied in the literature.

Silvia Sacchetti and Ermanno Tortia discuss the complexities of multi-stakeholder governance. The multi-stakeholder co-operative form is indigenous in some parts of the world, but most notably in more recent decades it emerged as a separate legal form in Italy, Spain, France and Canada (Quebec province). The authors highlight the path of development of multi stakeholder governance for a case of a social enterprise, demonstrating its advantage over contractual market relations.

These academic pieces are followed by a series of practical cases and lessons about effective co-operative governance. They demonstrate how the practice of co-operative governance is both rich and diverse. It rests on a clear vision that penetrates

the organization and membership, and on the appropriate information and co-operative performance indicators that drive decisions and hold decision-makers accountable. In this respect the paper by Joanne Westwood, writing about integrated reporting, is particulary pertinent. Van City Credit Union is known for its leadership in sustainable business practices and excellence in serving its local and global communities.

Bob Yuill reflects on the experience of the Scottish Agricultural Organization Society (SAOS), making a case that clarity about the role of apex organizations in general, and the support they provide for governance systems of primary co-operatives in particular, is an effective path to build resilience and competitive edge. The role for apex organizations is also featured in Ed Mayo's contribution about codes of co-operative governance produced by Co-operatives UK – the apex trade organization for the UK co-operative movement – as guidelines in good governance. The author outlines key differences between codes for co-operatives and investor owned enterprises, stressing the importance of member engagement and participation in co-operative decision-making.

Jean-Louis Bancel and Olivier Boned contribute a conversation about governance challenges in the context of growth. Focusing on co-operative banks, the authors highlight questions of continued member control but also the required training to ensure director expertise and accountability to members.

Some of this volume's contributors look at old issues in new ways; others challenge co-operatives to develop their own performance indicators and codes of governance to fit the people-centered business model.

Overall, the authors clearly advocate the co-operative difference and propose governance methods, systems and outcomes to fit this paradigm.While good business governance is a necessary condition, it is not sufficient for the longevity of the co-operative model.

Rather, rethinking participatory decision-making from members to management to directors and co-operative networks is a path to resilience of the co-operative system.

Sonja Novkovic

Common Meritocracy Challenge. How members of the Mexican co-operative "Pascual" tack between oligarchy and democracy

Ryszard Stocki

Abstract

Michels (1962) claims that any democratic system ultimately evolves into an oligarchy. Similar conclusions are drawn by DiMaggio and Powell (1983) and the phenomenon of co-operatives becoming oligarchies is generally accepted in the co-operative literature. Olgarchisation of democratic organizations can be defined as the transfer of power from democratically elected bodies to an informal elite — a group of people who have real influence on the decisions of the organization. This paper demonstrates that oligarchies are by-products of general tendencies to transfer decision making power to the incompetent in any form of democracy. Democratic systems are the result of an attempt to solve a variety of problems by simplifying rules. Common meritocratic governance based on expertise is proposed. An example is provided using the published case of the Mexican Co-operative Pascual (Hernandez, 2006), reinterpreted as the members' push toward a *common meritocracy*.

Key Words

Governance, Meritocracy, Democracy, Participation, Co-operative, Pascual, Oligarchy, Subsidiarity, Expertise, Decision Making.

Introduction

The consumer entering a well-stocked sport shop has at their disposal literally hundreds of kinds of shoes; beyond the variety of sizes, colors and materials designed to fit one's personal needs, shoes are adapted to diverse terrain, weather, and of course, anticipated sport activities. This is how "shoe technology" responds to behavioral and environmental variability in our sport activity. If we compare governance systems and the systems' response to human, environmental and cultural variability, we must admit that we are a long way from abandoning Aristotle's categorization of major political systems, as shown in Table 1 (p10). Even incorporating the concept of institutional logic, we still hope to find simple solutions to the challenge of diversity.

In this paper, I claim that oligarchy is not an outcome of organic necessity as Michels (1962) claimed, but the result of the inability to abandon old frames of thought about diversity, and the attempt to reduce it, instead of respond to it. Diversity in governance concerns not only organizational diversity, which was somewhat dealt with in the concept of organizational isomorphism (DiMaggio & Powell, 1983) and later in institutional logic (Friedland & Alford, 1991; Bettis & Prahalad, 1995), but it also concerns personal diversity and topic domain diversity related to the decision making process. In this paper, I indicate where such frames of thinking are born and how contemporary cognitive studies and organizational psychology help us to deal with them. Table 1 depicts the traditional division of government systems as described by Aristotle in *Politics, Book III Chapter 7* (Barnes, 1984), with the number of those holding power in columns, and the group of stakeholders profiting from power in rows. The term *constitution* was changed to *democracy*, and *democracy to mobocracy – the rule of the crowd,* as they better convey the contemporary meaning. I also added the concept "meritocracy" to "aristocracy" as that government form is, in its assumptions, similar to Aristotle's concept.

Our historical experience has shown that none

of the systems has performed well in the long run. There is a common agreement that democracy is the best system. Making use of an example from a Mexican worker co-operative, I will show how members of a co-operative intuitively fight for diversity and in fact try to create a new common meritocratic workplace. In her two studies (2001 and 2006), Sarah Hernandez has qualitatively analyzed the Sociedad Cooperativa de Trabajadores Pascual in Mexico City. Her thorough and well-grounded research as well as distinct separation of facts from interpretation has allowed me to make use of her study as an empirical basis for this paper. Hernandez concludes her study with the claim of the necessity of accepting inherent paradoxes in a democratic workplace. I will try to show that these paradoxical efforts of the co-operative members are governed by an implicit drive toward a common meritocracy as a more effective form of governance.

Before we embark on the study of the Pascual case, the theoretical framework for a revision of Aristotle's categorization must be laid. In the first section, I update the concept of expertise and competence, as today they are key sources of "merit". Of course, Aristotle was aware of the importance of different skills in government, e.g., he compares them in *Book 7, Chapter 7* of his *Politics*. He was also aware that oratory or military skill may play a role in becoming a ruler. But he could not be aware of the diversity of cognitive functioning discovered from the 1980s onwards by cognitive psychologists, or new conceptualisations of expertise (Ericsson & Smith, 1991). According to these conceptualisations (p. 2), *the study of expertise seeks to understand and account for what distinguishes outstanding individuals in a domain from less outstanding individuals in that domain, as well as from people in general.* What is new is the focus on one domain. In section two, guided by Vroom's empirically-based model (2003), I show how expertise is linked to governance and substitutes Aristotle's three categories with a spectrum of decision-making situations.

In the third section I question the interest dimension of Aristotle's model, and in between the concepts of self-interest and common interest introduce the idea of the "common good" related to the concepts of "sustainability" or "public good," though not synonymous to them. The Mexican co-operative Pascual and its governance practices are introduced in the fourth section . In the final section I discuss the common meritocracy and compare it with the paradox perspective and other close concepts such as adhocracy, knowledge management, and meritocracy.

Table 1: **ARISTOTLE'S CATEGORIES OF POLITICAL SYSTEMS**

Interest	One	Few	Many
Self-interest	Tyranny	Oligarchy	Mobocracy
Common interest	Monarchy	Aristocracy (Meritocracy)	Democracy

Source: The Author: Based on Based on Barnes (1984)

Explaining achievement and failure

People have always had a tendency to build general theories, including those of achievement, in keeping with the rule of saving cognitive resources for other purposes. Of course the oldest general theories are those of "luck" or "fate," but more recently similar simple theories have been encountered, e.g. the triangle theory of intelligence (Sternberg, 1985) or theories of wisdom (Peterson & Saligman, 2004; Ferrari, 2012). General theory approaches are so appealing because they explain many phenomena by means of a relatively simple theoretical apparatus. They are attractive both for their creators and the general public as they offer simple tools to deal with the complexities of life.

The traditional concept of aristocracy (the rule of the excellent) is also based on the same general

concept. Of course such magical panacea which explain everything once and for all and offer easy prescriptions for life are popular in politics, medicine, religion, education, management and almost all aspects of everyday life. In the early eighties, increasingly more research (for a more detailed enumeration see Stocki & Łapot, 2014) offered evidence that our mind is modular in nature, and that achievement is also related to domain-specific training and practice. Expertise in any field consists of domain- and task-specific knowledge. In management studies, numerous studies appeared on the characteristics of good leaders or employees, and recruitment companies began offering new diagnostic tools.

Contrary to general theories, the specialised theories explain limited and specific phenomena by means of a relatively complex apparatus. This does not make them very popular. By presenting a domain-specific paradigm, I do not wish to discredit the general theories. Theories of wisdom or intelligence may simply reflect achievement in domains important for social success or those linked to core domains (Wellman & Gelman, 1992) which are present in other primary and secondary domains (Hirshfeld & Gelman, 1994; Siegler & Crowley, 1994).

Governance structure in the domain general and domain-specific paradigms

The classical Aristotelian categories of political systems presented in Table 1 account for the variability in interest and number of decision makers. As was mentioned above, attempts to account for other variations in types of institutions do exist, e.g., Rothschild-Whitt (1979) differentiate between bureaucratic and collectivist-democratic organizations, while proponents of institutional logic (Friedland & Alford, 1991) go even further to create a meta-theory of logic which may operate on different levels of analysis from individuals, through groups, organizations, inter-organizational networks or geographic communities to markets, industries and organizational fields (Thornton & Ocasio, 2008). All of these attempts seem to seek one general theory, however.

One perspective is lacking, namely that of domain-specific tasks, i.e., tasks related to particular situations in particular contexts. This context is present in the principle of subsidiarity (Carozza, 2003). *The Oxford English Dictionary* (2010) defines subsidiarity as:

> *"the idea that a central authority should have a subsidiary function, performing only those tasks which cannot be performed effectively at a more immediate or local level. The concept is applicable in the fields of government, political science, cybernetics, management, military (Mission Command) and, metaphorically, in the distribution of software module responsibilities in object-oriented programming (according to the Information expert design guideline). Subsidiarity is, ideally or in principle, one of the features of federalism, where it asserts the rights of the parts over the whole."*

One corollary of subsidiarity is that standard problems should be solved on the lowest levels while strategic issues should be addressed at a higher organizational level, and in both cases the decision makers should be prepared to solve them. So the concepts of domain specificity and subsidiarity are in fact two views of the same phenomenon. In practice, however, due to popular faith in general theories, e.g. in elitist systems, all decision making leaves the rank-and-file level for that of the oligarchs or democratically-elected representatives. Oligarchy, in contrast, can be defined as:

> *"A concentration of entrenched illegitimate authority and/or influence in the hands of a minority, such that de facto what that minority wants is generally what comes to pass, even when it goes against the wishes [whether actively or passively expressed] of the majority (Leach 2008, p. 329).*

Michels (1962) distinguishes two forces of oligarchization. One is the development of the leaders' charismatic and professional leadership due to time spent in office. The other is the loss of willingness and ability of the masses to challenge the leaders. In terms of the expertise

theory, in this situation an expertise gap arises: a small group develop some forms of expertise through experience and the larger group lose it.

Any form of institutional and non-topic related thinking sooner or later results in the leaders making incompetent decisions. Task variability does not translate to governance variability. Based on his study of thousands of small work teams, Vroom (2003) first distinguished team competence (i.e., competence related to the processes of decision making, we may consider it a general competence) and then team expertise (expertise related to the topic under discussion or decision making). The same distinction is true of leaders. They may or may not be competent in the decision making processes, nor may they be competent in the topic under discussion.

Vroom takes the leader's decision process competence for granted and does not introduce it into his expert system, but we know that this knowledge is not so obvious, especially for newly-elected leaders. As there is always a variety of topics under discussion, there will be topics where either leaders or the general public are incompetent, thus pointing to a system where decisions ought to be taken by competent persons, which may be called meritocracy. In meritocratic governance, expertise is a condition that legitimizes authority. Taking into account the increasing number of domains of expertise and their growing complexity, expertise can hardly ever be concentrated in a small group (aristocracy or democratically-elected elite). This is why most democratic or meritocratic elites end up as oligarchies, which are not effective in the long run.

This dysfunctionality of narrow elites (e.g. oligarchies and dictatorships) was historically proven by a Polish economist, Kwiatkowski (1947), who demonstrated how the spread of expertise related to widespread understanding of complexities of the environment led to the development of nations; on the level of teams there are studies of groupthink (Janis, 1972; Esser, 1998; Hart, 1990); Pathologies on an organizational level have also been studied by numerous researchers (e.g. Sutton, 2007; Hostie, 1973; Vaughn, 1999); and in a co-operative context, the incompetence of leaders was analyzed in the studies of Kibbutzim by Shapira (2008), among others.

In Table 2, I propose a new differentiation of democratic organizations, taking into account knowledge as the basis for legitimacy of power. Part A of the table shows what happens to expertise if power is based on democratic legitimacy - the domain general approach. This table may be considered a knowledge supplement to Leach's content, where three aspects of power are presented: (i) the exerciser(s) of power; (ii) its means of execution; and (iii) why the majority went along with it (Leach, 2008). Part B of the table shows the situation of meritocratic power, legitimized by task-specific knowledge, forming the contribution of this paper.

The main characteristic of the domain-specific approach is distribution of power throughout the organization based on expertise in a variety of topics. The question now remains, how such a system may function practically. Vroom's (2003) participative decision making model may help us here.

In Vroom (Vroom & Jago, 1988; 2007; Vroom, 2003) five forms of participation of team members in the decisions are distinguished: (i) individual decision without consultations (counterpart to Aristotle's tyranny or monarchy) (ii) individual decision after individual consultations, (iii) individual decision after group consultations, (iv) group decision moderated by the leader (the latter three forms related to Aristotle's oligarchy and aristocracy), and finally (v) group decision not moderated by the leader (democracy and mobocracy). What should be noted at this point is the difference between forms (i), (ii), (iii) and (iv), (v). In the first three the leader is an integral part of the organizational system, while in the last two he or she is outside of the system.

These five forms of decision making could also be depicted as different degrees of control variable. In other words, legal/control form is a dependent variable in an equation with 12 independent variables. Vroom specifies 11 factors that determine the choice of a decision making form but as mentioned earlier, I propose to add one more aspect — leader competence. We should remember that

Table 2: **ANATOMY OF OLIGARCHY IN DOMAIN GENERAL AND DOMAIN-SPECIFIC APPROACHES TO DEMOCRATIC ORGANIZATIONS.**

A. DOMAIN GENERAL APPROACH – LEGITIMACY BASED ON ELECTION OF REPRESENTATIVES		
Legitimate (elected)	**Formal Power**	**Informal Power**
	Authority	**Influence**
	• Expert in some topics • Ignorant of some topics • Tendency to make decisions on all topics • May reluctantly turn to competent advisors for help, especially at the beginning of their term	• Expert in some topics • Ignorant of some topics • Tendency to take power in all topics or undermine formal power • Source of conflictr term
Illegitimate (non-elected)	**Coercion**	**Manipulation**
	• Present when an elected body or non-elected employee (an expert) exceed their legal responsibilities • Uncontrolled transfer of power from the domain of expertise to the domain of ignorance • Coercion threatens the existence of the organization	• Knowledge, access to data, experience are all subject to uncontrolled manipulation. • Uncontrolled transfer of power from the domain of expertise to the domain of ignorance • Manipulation weakens the organization by undermining trust
Legitimate or illegitimate	**Oligarchy**	
	• Creates a "portfolio" of limited expertise sufficient to keep control over the organization • No incentive to search for the best expertise • Informal relationships protrude control	
B. DOMAIN SPECIFIC APPROACH – LEGITIMACY BASED ON DOMAIN EXPERTISE		
Legitimate (expert in the topic of the decision)	**Formal Power**	**Informal Power**
	Authority	**Influence**
	• Authority based on expertise • If no expertise available in the organization either external expert or team work • Formal power throughout the organization depending on the domain. Every task may have a different expert • In the case of common topics all members and employees may turn out experts and accordingly should all be given chance to voice their opinion and make the decision (e.g. through referenda)	• Experts who decided not to participate in the decision process and who question it afterwards • Experts under some hidden agenda (e.g. conflict of interest) not expressing their expertise overtly but influencing the process indirectly
Illegitimate (ignorant in the topic of the decision)	**Coercion**	**Manipulation**
	• In the case of general domains like business strategy, some (e.g. financial officers) may have a tendency to exceed their domain • Every member of the organization should have the right to a complaint procedure to avoid illegitimate coercion • When one's expertise is questioned or experts disagree the issue should be transferred to a peer group for dispute resolution	• Individuals may feel experts, though their expertise has not been formally recognized. The recognition of expertise should be based on criteria that are as clear and as objective as possible • Some topics may cause problems in defining the domain of expertise and the ensuing selection of experts – trans disciplinary teams are required in this case
Legitimate or illegitimate	**Oligarchy**	
	• Teams with power are created only temporarily and dissolved after a decision is made, oligarchy transfers to adhocracy • If one type of decision dominates the life of an organization the ad hoc group of experts may ossify to an oligarchy and have the tendency to take over solutions to other problems •To prevent oligarchy individual development of all members is required for real participation, with main topics being: business literacy, decision making techniques, sales competencies, etc.	

some of these factors are highly related to co-operative difference. The local geographic nature *(locality)* of co-operatives helps individuals to make decisions together. Democratic and participative decision making makes the decision making process slow. Co-operative values and principles increase *goal alignment,* and diminish l*ikelihood of disagreement. Personal development* goes along with the co-operative principle of training and education, showing that decision making may be also a good (if not the best) type of training. Of course Vroom enumerates *subject matter expertise* and *team competence* and we *add management competence.* There are also situational decision characteristics such as *decision significance, importance of commitment* and those related to trust in the leader — *likelihood of commitment.*

Goal alignment revisited

One of Vroom's aspects of decision-making is goal alignment, or to what extent individual interests are aligned with organizational goals. In Aristotle's systems there were only two options: individual interest and common interest. An interesting analysis of those two interests is conducted by Wojtyła (1979). He calls the two attitudes individualism and totalism (not to be mistaken with totalitarianism). According to individualism, the good of the individual is achieved at the cost of the community, while in totalism the opposite happens, the good of the community is achieved at the cost of the good of the individuals. For true engagement of experts in meritocracy, the experts have to be convinced that they are working for themselves. So there has to be some common good defined which goes beyond the interests of either individuals or institutions which is more a synergy than a compromise. This is closely related with the concepts related to "public good" introduced by Ostrom, namely that of common-pool resources and common property regimes – the commons (Allen, 2014).

We may look at sustainability as the good of future generations, and view sustainable development as finding the common good between present and future generations. All of these concepts are examples of the common good. The common good is very difficult to arrive at. There seems to be only one route here — through participation. Participation is defined by Wojtyła as a person's transcendence in an action, when the action is performed together with others (Wojtyła, 1979, p. 152). This rather atypical definition underlines three aspects: the person becomes a better person through participation (transcendence, development); the person acts; that is, he or she has the ability to and wishes to do something; and the action is done together with others, i.e., the good of one person aligns with the good of another person. In an approach somewhat similar to Vroom's, Wojtyła defines general domain rules for concrete domain-specific expertise to be used to create a new approach.

In Table 3, I present an updated categorization of governance systems based on the discussion so far. It should be noted that while the second and last lines of the table depict a general domain approach, the middle three rows try to account for the whole spectrum of meritocratic, domain-specific decision making.

Table 3: **UPDATED ARISTOTLE'S TYPOLOGY OF GOVERNANCE SYSTEMS**

Interest	One	Few	Many
Self-interest	Tyranny	Oligarchy	Mobocracy
Common good, arrived at through goal alignment	Spectrum of participation techniques depending on at least 12 factors proposed by Vroom		
	Different groups and sizes depending on the nature of the problem and situation		
	Expertise	Meritocracy	Common Meritocracy
	• One expert decision maker	• A small and the same group of decision makers	• A large group of decision makers
Common interest	Monarchy	Aristocracy	Democracy

Empirical evidence

Now, after we have discussed the variability of expertise and variability of interests, I would like to use empirical data gathered by Hernandez (2006) in the process of a grounded theory approach to illustrate how this updated classification could be used. Hernandez conducted 45 interviews in the Mexican Sociedad Cooperativa de Trabajadores Pascual (Pascual). The interviews were accompanied by observation, analysis of documents, and additional interviews with managers.

Pascual is a fast growing successful Mexican worker co-operative. It produces and distributes soft drinks from natural fruit pulp. In 2006 it had 4200 workers (including 1000 members and 3200 employees) who were working in 4 plants and 12 distribution centers. It used to be a private enterprise owned by Rafael Víctor Jiménez Zamudio, who established it in 1930s. The co-operative started as the result of a three-year struggle of the workers with the owner for their rights. After winning in court and being supported by a newly-elected President, they used the owner's debt in wages as purchasing capital and decided to create a co-operative to maintain their jobs. The strike and fight for their rights won them much public support, both financial and moral, from all spheres of Mexican society. A highly democratic and egalitarian organizational culture was born during the times of the long strike. Pascual workers were very careful in listening to the advisors, and ultimately started to distance themselves from them.

Pascual's general organization follows the Mexican General Law of Co-operative Societies. Every two years the members elect Supervisory and Administrative Boards and four thematic committees. Re-election in consecutive terms is prohibited. Significantly, Pascual managed to implement real participation on the level of labour processes. Today, the members feel like owners and when necessary, execute their ownership rights, confronting managers who are too focused on production and seem to forget humane conditions of work. Although workers appreciate specialization of work, they eliminate any attempts to create hierarchical management structures. What is important and emphasized is that they are not there for the organization, but the organization is there for them. The co-operative, together with its systems and processes, is treated instrumentally by the workers as means to fulfill their needs, not only financial but also social and even entertainment. They seem to intuitively perceive the human being as a physical, spiritual and psychological whole. The co-operative is very sensitive to knowledge management. This can be seen not only in the employees abiding by specialized work practices, but also highly developed educational and training programs, including their own schools. As a result of all these practices, workers on the shop floor have incomparable freedom in decision making, without the necessity even of informing their management. The managers' focus on processes and workers' focus on their long term well-being give rise to many conflicts which are usually resolved by sticking to the long-term good of the workers, and not the short-term advantages of the business processes.

In an attempt to describe the co-operative's actions which pull it either to the oligarchy or democracy extremes, Hernandez scrupulously enumerates the empirical evidence for both tendencies. She writes in the conclusion that the dynamic of the play between the two extremes is best understood when a paradoxical approach is assumed. This, however, requires the acceptance of coexisting contradictions. Let us have a look at some of these contradictions and explain them in terms of the domain-specific, common meritocracy paradigm described above.

1. Mexico's national law regarding co-operatives, as any law, is based on the principle of general domain and power distributed through elected representatives of the membership. In this situation the general assembly, which consists of all members, will be overpowered by members who are not experts in all the decisions to be taken. The lack of representation of non-member employees causes an even further loss of all expertise they have. Accordingly, the rank-and-file expertise may find it difficult to reach decision makers. Distancing of some members from this and other elected bodies may be the result of not having real power legitimized by expertise voices in such bodies. So some form of learned helplessness may occur expressed by reducing

time at meetings, absenteeism, apathy, worker's intimidation and coercion.

2. The short two-year term and lack of re-election make the administrative bodies a place of constant flux but also opportunity for development of team expertise. The elected bodies are similar to ad hoc teams, which have more opportunities to respond to current issues leaving the key issues to General Assembly. This impedes the formation of oligarchies.

3. The internal independent judiciary committee elected by the general assembly is an expert body specializing in conflict resolution. This recognizes the fact that free will and much freedom naturally cause conflicts, and both have to be counterbalanced by systems which allow them to be solved.

4. The co-operative's educational committee supports the development of expertise in all members in philosophy and practice of the co-operative. The co-operative also seeks support from external experts when it lacks internal expertise. Such practices may be treated as evidence for common meritocratic, domain-specific governance. It is worth noting that when outside advisors had too much power during general assemblies the co-workers got rid of them. Similar influence of advisors was a feature in the early stages of development of "Solidarity" in Poland, but "Solidarity" did not have enough awareness of their influence and allowed the advisors to impose their language, which was called semantic violence (Staniszkis, 1984), and which finally lead to "Solidarity's" failure in the 1990s when confronted with free-market economy.

5. Two of the six representative bodies address general issues, while four other committees are elected to address domain-specific issues in education, welfare, conflict resolution and technical control. The technical committee consists of representatives of all departments, which increases domain specific expertise in solving problems.

6. A big issue at the time the study was conducted — namely the continuity of management when such short term in office is allotted — might not be a problem today, when markets change more rapidly. This is particularly true about technological changes. The habits of long term managers might work against the co-operative. Thinking in terms of long periods of time may ultimately result in a closing off and separation from the world (encapsulation), where systems are outdated the moment they are complete. Short terms naturally promote more agile technologies and strategies, openness to markets and responsiveness in addressing clients' needs.

7. The flow of information from rank-and-file is guaranteed by representatives who are dismissed and replaced if communication fails. This flow of information and a domain of expertise seem to be broadened to the workers' personal issues. The workers are not divided as regards their private versus work life. This is why the representatives may choose the good of a person in opposition to the profit of the co-operative. This indicates the co-operative is really a partnership of persons and not a partnership of capital.

8. The nomination of representatives is based first of all on their honesty, amiguismo (favoritism), charisma. As being an honest or good person requires personal sacrifices (e.g., to avoid corruption, political skill, sensitivity to others), being a good person can be viewed as another domain of expertise rather than an attitude or personal feature. We may hypothesize that the co-operative members have an intuitive view of the domain, and this is why they are so effective in selecting the right persons to represent them. Educational achievements and administrative skills simply do not overlap with the domain the co-operative members have in mind. Perhaps the analysis of this domain of expertise could reveal the probable source of this and other co-operative success. Similar tacit domains can be found in other successful co-operatives, e.g. the English "SUMA" (Łapot, personal communication).

9. The Pascual members are rather skeptical about professional managers. They intuitively differentiate between the domain of co-operatives and capital investment companies and so avoid becoming isomorphic to such companies.

10. In their shop floor politics the workers, on the one hand, are ready to question the expertise of their supervisor; on the other hand, they may propose that their bossy supervisors be elected to governing bodies. This may not be so much a reflection of their cynicism, but some intuitive differentiation between the domains of the shop floor and higher levels of management. It should be noted that nominating someone in order to get rid of them from the shop floor level may result in a lack of expertise in higher level functioning and competency requirements there.

11. The meritocratic character of the decision making process is also reflected in the length of meetings, which last from 4 to 10 hours. Team members want to take informed and competent decisions, and the meetings most probably become occasions to gain expertise they lack.

The examples above show that Pascual could be viewed as a co-operative approaching a harmonious common meritocracy and the struggle between oligarchic and democratic governance is due to the limitations of the concepts and their legal status and not the paradoxical intentions of the co-operative members.

Discussion

Brewer (1999) has said that people have problems, but universities have departments. A parallel truth may be valid for co-operatives: co-operative members and clients have problems, but they have committees and assemblies to solve them. Firstly, the problems people have are not addressed properly because of lack of multi disciplinarity, and secondly, because of violation of the subsidiarity principle, i.e. solving problems where there is the highest expertise.

I began this paper with a criticism of both the traditional approach to governance as well as the new approach, one concentrated on institutions.

I have tried to show that these approaches are deeply rooted in the mechanisms of our thinking. Economizing on time and simplicity we tend to create simplistic models for solving problems — the result is always the same — not approached by experts, the problems are either postponed or not solved at all.

Starting from the assumption of considering everyone in a co-operative as a free decision maker able to make decisions in his or her narrow domain of expertise, I proposed to substitute the traditional governance models with a new approach where no institutional entity will be the center of interest; rather a problem defined in a specific, usually narrow domain takes center stage. Such a problem requires domain-specific expertise, which should be selected among all competent individuals, and not only elected representatives. This requires changing the way legitimacy is defined, not as being formally and legally elected, but as expert in the problem at hand. I call such a system a *common meritocracy.* On the basis of a Pascual Co-operative from Mexico, I have tried to show that what might be seen as the contradictory tendencies of oligarchy and democracy can also be seen in terms of meritocratic governance.

My point of view does not contradict the existence of paradoxes, nor does it propose eradicating them. I agree that they do exist and always have to exist, but they could be more easily solved if the decision makers were more competent and were aware of the complex psychological, political and economic processes behind them. Table 4 summarizes some of the conclusions drawn by Hernandez (2006) and my additional interpretation based on common meritocracy.

It is very difficult to talk of common meritocracy without referring to the elitist concept similar to that of an Aristotelian aristocracy. Meritocracy, a term coined by Young (1958; 1994) was often used to refer to a new intellectual elite which was to govern the world. The concept is anti-democratic and authors

Table 1:
PARADOXICAL AND MERITOCRATIC PERSPECTIVE OF VIEWING THE PASCUAL GOVERNANCE

Paradoxical perspective (Hernandez, 2006)	Common meritocracy perspective
Anti-democratic forces exist alongside participation, engagement, free expression of ideas and direct decision making (p. 127)	Democracy is contested, similarly as the previous owner was contested for lack of recognition of all personal needs and for not using all available expertise.
Paradox between oligarchy and democracy: **For oligarchy:** *development of charismatic and professional leadership, individual search for power; corruption; amiguismo (supporting friends); shop floor politics; and varying degrees to which each leader allows participation.* **For democracy:** *skepticism toward and willingness to challenge authority; readiness to recall representatives; expectations that the representatives maintain contact with rank-and-file; honesty and effectiveness; expectation to participate fully in board and committee meetings; participatory culture (belief in workers' right to self-determination and commitment to defend this right) developed through the labour struggle. (p. 128)*	Meritocratic governance requires commitment, expert knowledge, education and business literacy. All of this requires time and effort. So the paradox is born within each individual. By following selected leaders and engaging in all practices leading to oligarchy, the members want to save time for themselves. Exactly the same motivation may lie behind some pro-democratic behavior – whenever responsibility is delegated to others. So the real controversy is between allowing things to happen, and engaging in what is happening – acting. The latter option, acting, requires preparation on all the various levels of several domains of expertise. It is conditioned by agreement regarding the values, by efficacy, expert knowledge and the will to act according to one's views. In the case of failure it requires the courage not to change ones' views to save the positive image of self.
Rather than testing whether co-operatives will inevitably deteriorate into oligarchies or capitalist partnerships, we can explore how the paradoxical forces interact to shape the particular organizational structure. (p. 128)	Recognizing that meritocratic governance is the issue allows for the systematic increase in those activities (training, awareness of co-operative difference, increasing business literacy, and literacy in other everyday life domains) which allow meritocracy to be more and more common, allowing everyone to make decisions all the time, not only when a term in an elected body arrives. This helps to overcome the paradoxes.
Co-operatives seek to institute a business whose main motive is the well-being of the workers. In order to achieve this goal, the co-operative becomes embedded in an internal contradiction between the need to be productive to improve the economic well-being of the workers, and the need to do so in a humane and democratic manner.	Research shows how a "humane democratic manner" leads in the long run to long term productivity, well-being, health, etc. So there is no paradox as long as we take a long term perspective into account. If the paradox appears it is a symptom of a lack of awareness of this long term perspective – and so missing expertise.
Co-operative is best understood as a site of unresolvable contestation between oligarchic and democratic forces. (p. 129)	The contest arises from the amalgamation of knowledge and ignorance within the same democratically elected role (details in Table 2). The fission of the role into domain specific task could facilitate finding the best fit between possible expertise and each decision. The present paradoxical behavior of the co-operativists may be an attempt to manage the dysfunctional amalgamation within the existing system..
T*he larger implication of recognition of a paradox in the cooperativist workplace is that we will not find in co-operatives the "utopian" harmonious solution to the ills of our current economic and work organization. (p. 129)*	The paradox will always exist as it is inherent to the human condition. Whenever we are free to make a choice a paradox arises. Some organizational structures and systems are reflections of these internal paradoxes (e.g. stable and results based pay), but the recent history of organizing shows that we are closer and closer finding harmony in the workplace.
...our understanding of cooperativism needs to see this type of organization as having the kind of diversity that we observe among private businesses. Presumably, each type of co-operative will have different kinds of paradoxical forces shaping its organizational structure and working relations. To understand such diversity we need to explore how the internal contradictions are experienced in different kinds of co-operatives. (p. 129)	Recognizing individual diversity and reflecting it in organizational structures and systems is one of the tasks of good governance. Yet analogically to diversity of human languages we should remember some cultural universals that pervade all co-operatives or even all organizations just as linguistic universals pervade all languages. It seems Co-operative Values and Principles may be treated as such universals..

using it often refer to ideas of social Darwinism (Kamolnick, 2005; Schwarz, 1996; Leyva, 2009). As such, meritocracy is a victim of the same amalgamation of expertise and ignorance as democracy, as it does not reflect the diversity of domains and human expertise. Some light to new solutions was proposed by the concept of polycentricity. Ostrom et al. (1961; Allen, 2014) defined it as "many centers of decision-making which are formally independent of each other." What is most important, Ostrom showed how effective such governance is. Referring to this definition, we may define common meritocracy as a system of decision-making where each task or decision is made by a set (center) of decision makers most competent in the domain of the decision. Thus, unlike Ostrom's concept, the centers are not stable but they are created ad hoc each time. This resembles the concept of adhocracy (Toffler, 1970; Waterman, 1990; Minzberg, 1989; Dolan, 2010), particularly when they refer to the prospect of managing competence given by new information technologies. Presently, after a proper inventory of expertise is performed, an ad hoc team of competent decision makers could be named in just seconds. I do not know of any organization where such a system has been implemented as a governance form. It is only used as a knowledge management tool.

An important aspect of this theoretical proposal is the fact that co-operative members do not have a conceptual framework related to common meritocracy. Notions of domain-specificity and generality, expertise, narrow or implicit expertise and domains are absent from the co-operative members' language and as a result, they are forced through some form of semantic violence to express their views in the language they know, which results in contradictions, misunderstandings and inconsistencies. The grounded theory approach allowed Hernandez to gather a very reliable set of data, which have been interpreted slightly differently in this paper. Following co-operative inquiry (Heron, 1996), akin to grounded theory, the new interpretation should be confronted with the interviewees, and ideally a new interpretation should be agreed on with them. Otherwise, a new study should be conducted with organizational expertise in mind. The knowledge management and shared conditions paradigms and concepts may be useful in this respect. It should be noted that knowledge management systems are often used as a support system parallel to the traditional forms of governance. What the paradoxes of the Pascual Co-operative show is that its members question the democratic system at its roots.

An issue that requires separate consideration is the definition of what is the common good of a co-operative. Another issue is the implicit domain of expertise of being a good person in the views of the co-operative members. We may expect to reveal the fundamentals of co-operatives as they are framed in the concept of an ideal co-operative member. Framing this concept not in moral but psychological terms of developing a certain kind of expertise may help in persuading co-op members to engage in such development.

Still another issue arises, that is, what should be done if we admit the importance of individual expertise in a community like Pascual's. In a rather futuristic next paper (Stocki and Bielecki, in preparation) we propose what such a model of meritocratic governance might be in a co-operative hospital. One of the reasons why meritocracy is more possible now than ever before is development of mobile technology, which allows participation in decisions for even millions of members. I believe that the introduction of elements of popular meritocratic decision-making in some organizations will take place within several years' time.

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Innovation in the governance of large co-operative businesses: the alarming case of UK Co-operative Group

Johnston Birchall

Abstract

The paper provides a distillation of the authors and others research into the history and background of the UK Co-operative Group combined with more immediate research findings on governance in big co-operatives. The paper reviews the recent reported events concerning the failures of due diligence and governance leading to the catastrophic commercial failures at the former Co-operative Bank and the UK Co-operative Group. It concludes with an advocacy for the Barber, Birchall and Mayo (2014) *Myners* Plus proposals for governance reforms for the UK Co-operative Group.

Key words

Business History, Co-operative Bank, Co-operative Group, Democracy, Governance, Membership Engagement

Introduction

The Co-operative Group is one of the world's largest co-operatives. It is a 'family of businesses' that, as well as its supermarket chain, includes a bank and insurance business, funerals, travel and farming that together turnover $23 billion. It has a mixed ownership, with nearly eight million individual members and 127 corporate members (the most important of these being 12 independent regional consumer co-operatives). It is the UK's fifth biggest food retailer operating across the country with 4500 retail outlets and nearly 90,000 employees (Co-operative Group, 2014). Amongst its other wholly-owned businesses are the UK's largest funeral services provider, and the third largest pharmacy chain. One interesting feature of this co-operative is that in 1997 a decision was made to get out of the superstore business and focus on smaller supermarkets and convenience store trading, in which it is now pre-eminent.

The Group used to boast that it was the largest co-operative in the world, but according to the World Co-operative Monitor it is in fact third after the Swiss consumer co-operatives Co-op Swiss and Migros. (Euricse, 2013) It also used to boast that it owned the world's most ethical bank, and the Bank did indeed win many prizes for its ethical investment stance. (Birchall, 2005) However, because of recent catastrophic losses, the Group has lost control of the Bank and is now (in June 2014) itself on the verge of bankruptcy. In 2012 the Bank posted a loss of £648 million, and then in June 2013 a capital shortfall of £1.5 billion was discovered, followed by a further £400 million in March 2014. The Group now owns only around 20 per cent of the Bank; hedge funds have taken control and soon the Bank is to be floated on the stock exchange.

In March 2014 the Group itself posted a loss for 2013 of £2.6 billion. The life insurance business has already been sold, and some of the other businesses in the Group – the pharmacy chain, the farms and probably the funerals – will also have to be sold. A report by Sir Christopher Kelly has just been published (May 2014) detailing what went wrong and who is to blame. A report by Lord Myners, published almost simultaneously, has condemned the Group's governance structure as being completely unfit for purpose, and proposed a new structure based on a 'plc'(public limited company) type board, a larger member representative council and direct elections by members (which would mean that the current regional and main boards would cease to exist). The Group is currently planning for the imposition of this new governance structure, which will involve the dissolution of the regional and main boards and direct elections to a new board of directors and a member representative council. If the new governance structure is not agreed and enacted in the next few months, it is likely that the banks that are owed £1.4 billion by the Group will force it into 'administration'.

This paper begins by providing a short history

of the Group and the Bank, showing how its current governance structure has come about. Then it provides a summary of what has happened since its current troubles began in 2009, asking what has gone wrong and why. Then it asks who is to blame; is it a failure of management or of governance? It finds that governance has to take a large part of the blame, and so examines the recent innovations that have led to the current peculiar and unsatisfactory governance structure. It then looks forward to the redesign of governance that has been called for by Lord Myners, and explains the work of this author and his colleagues at Co-operatives UK in helping with this process. It provides a method for evaluating alternative governance structures using an analytical framework first proposed in Birchall's study of the world's largest co-operatives. (Birchall, 2014)

A short history of the Co-operative Group and of its governance

In 1863, a group of small retail co-operative societies set up a North of England Wholesale Society, in 1872 renamed the Co-operative Wholesale Society (known as CWS). With hundreds of local retail co-ops in membership, it had a guaranteed market that enabled it to grow steadily until it became one of the biggest manufacturing and wholesaling businesses in the world (Birchall, 1994; Wilson et al, 2013).

The sector began to decline rapidly from the 1960s onwards due to increasing competition from supermarket chains. At first the movement's 'ambulance society', Co-operative Retail Services, took the strain by taking over many ailing societies that otherwise would have gone bankrupt. Then it also began to be at risk from being unable to absorb any more losses, and from the 1970s onwards the CWS itself began to absorb some retail societies, taking in 41 by 1990.Then the first merger from strength occurred when the regional North Eastern Society volunteered to amalgamate, and from then on some of the largest regional groupings such as United Society and CRS also merged with CWS. In 2001, after the merger with CRS, it changed its name to the Co-operative Group and set up a new governance structure that is still largely in place today.

The Group is thus a hybrid society, 22 per cent owned by independent societies (127 of them, but with 12 regional consumer co-operatives dominating) and 78 per cent owned by the eight million individual members. This is unique among consumer co-ops, as the other three largest are either primary (Co-op Swiss, Migros) or secondary (S Group). In the largest 60 co-operatives worldwide there are only four more; the three largest US farmer co-ops (CHS, Land of Lakes and Dairy farmers of America) and the French bank, Credit Agricole (see Birchall, 2014). Before the merger with CRS that prompted a governance review in 2001, CWS had been unpopular with the board members of retail societies because it had been seen as biased towards its corporate members, and this had delayed mergers with regional societies (Wilson et al, 2013).

After 2001, it had a complicated three-tier structure of 45 area committees, eight regional boards and a main board, with the area committee members taking the place of members in general as the voting body making up the AGM. It was a compromise structure that ensured that activists from the old CWS and CRS would continue to be influential, but it had some dire unintended consequences. It stopped members in general from having voting rights except to the area committees, because members of the area committees provided the voting constituency for the regional and main boards. It meant that in order to be on the main board, directors had to serve on the areas first, then the regions, and had to stay elected to both these tiers in order to stay on the main board. It was – and is – a precarious existence that gives rise to factionalism and prevents many people who cannot afford the huge amount of time involved from standing for a board.

Because members have to serve for two years at each tier before becoming eligible for the next, it also restricts the pool of candidates eligible to be on the main board. Also, the size of the main board is still comparatively large at 20 people (five from the corporate members, 15 from the regional boards – until 2009 it was even larger, at 33). Finally, though the main board has the right to appoint up to three independent experts to the board, it has not chosen to do so, and its members do not have the

skills or experience to govern such a large and complex set of businesses. (Myners, 2014).

The UK Co-operative Bank began as the Banking Department of CWS in 1872, set up to meet the needs of the hundreds of retail co-operatives in membership. It used to be said that it was neither a bank nor a co-operative! It was only in 1971 that an act of Parliament enabled it to become a wholly owned subsidiary, and in 1974 that it became a clearing bank. Even then, it was never a co-operative in its own right, unlike the European co-operative banks that, following a completely different evolutionary path, had their own customer-members and a group structure with independent local societies and powerful central banks.

In the late 1980s Terry Thomas was appointed as chief executive. He saw the potential of the Bank in an ethical and environmental 'niche market' and in 1992 he launched its now famous ethical policy. A liquidity crisis in 1994 led the Board briefly to consider selling the Bank, but from then onwards it became more and more profitable for the Group (Birchall, 2005). When, in 1997 the Lanica Group launched a hostile takeover of CWS it was the Bank that they most coveted.

In 2006, the Group launched a genuine dividend card for members, and changed the rules so that customers could become members through the Bank as well as through the retail stores. It thus came closer to being a real co-operative, though it is notable that when the Bank merged with the Britannia Building Society in 2009, the Britannia's members had to vote on it, while the Bank's members (really the Group's members) were not asked. Until the recent loss of control, the Bank was one of three subsidiary boards (the others being Food and Specialist Businesses). Until 2011 it was a large board of 20 members but, under strong advice from the regulator, this was reduced to 14. Unlike the main board, it has appointed independent experts to its board; since the loss of control in 2013, these have become the majority.

What went wrong?

In August 2009, the Co-operative Bank merged with the Britannia Building Society. It was the second largest society in the UK, with 254 branches, 2.8 million customers and assets of £35 billion that made it six times larger than the Bank by assets. It had the traditional low risk member business, but also a high-risk specialist arm of commercial lending, which it carried out through intermediaries with reliance on the wholesale money market; this made it unusual for a building society. Because of the profits made from the commercial lending and the sub-prime market it had been able to pay an annual bonus to members but this came with greatly increased risk: the commercial side was half the loan book, but over 90 per cent of risk-weighted assets, and the Society had a higher exposure to subprime than any other building society. (Kelly, 2014)

It was, as the Kelly Report comments, a surprising time for the Bank to be contemplating a merger a year after the global banking crisis, especially with a society that had such a different risk appetite. However, the Bank needed to reduce its cost by scaling up, so it looked like an attractive proposition. Even before the merger, Britannia began to post losses on its commercial arm. The Bank's due diligence was cursory; phase one was done by KPMG but the auditors had no access to Britannia's loan book, and phase two was done in house with no records kept to determine how well it was carried out. The business case for the merger deteriorated but nobody noticed, and the Board was kept in the dark about it. After the merger, the losses piled up but by continually pushing the bad news into the future the Bank's managers were able to survive until, late in 2013, they had to admit to a capital shortfall of £1.5 billion. Four other problems added to the losses. Instead of modifying its IT platform as most other banks have done, the Bank decided to invest in a completely new platform. It did not have the capacity to achieve this, and eventually it had to abandon the scheme at a loss of £300 million. Between 2010 and 2012, a managerial initiative called Project Unity led to managers being swapped around between the Group and the Bank, causing more disruption. Despite the Bank's claim to be driven by ethical values, it was as dependent as other banks on the profits from payment protection insurance (which

amounted to between six and eight percent of the Bank's income). With claims now being made that stretch back to the 1980s, the final bill for this shameful ethical lapse is still unknown.

Finally, the Bank had an ambitious plan to buy a part of the Lloyds Banking Group that was a legacy of the old Trustee Savings Bank. With 632 branches, five million customers, and assets of £53 billion, it would have enabled the Bank to become a 'challenger bank' to the big four investor-owned banks. When, in April 2013 it finally withdrew from negotiations, a bill for £73 million in transaction costs was added to the losses. More seriously, the 'Verde' deal, as it was known, had been a massive distraction.
Kelly comments:

> *Without the distraction caused by Verde, the emerging capital issue might have been better recognised and more effectively addressed at an earlier stage (2014, p81).*

The Bank's ex-chairman blamed the Government for applying pressure to pursue the deal, but the Kelly Report finds that there is no compelling evidence of pressure from government ministers or anyone else. It comments that the Bank's managers and board were capable of making their own mistakes without any help!

At first, the Group's board thought they could save it by a partial flotation in which the bondholders would become shareholders, absorbing most of the losses. In return, the Group was to inject new capital. Co-operatives UK commissioned a report on the governance of minority investor-owned co-operatives that predicted how such a hybrid of a co-operative with a minority of shareholders would be governed (Birchall, 2013). However, events overtook the Group's offer (and gave Birchall's report a shelf-life of just four days!), when US hedge funds took an ownership stake and insisted on a much tougher deal that led to the Group's ownership stake dwindling to just 30 per cent.

In April 2014 the Group announced losses of £2.6 billion. It has already lost control of the Bank, and its 30 percent ownership stake has declined further to around 20 per cent as demands are made of the shareholders to plug a new £400 million hole in its finances caused by continuing losses from the Britannia loan portfolio, and fines for miss selling of insurance and for administrative errors made in bank statements. The Group has its own problems. In 2009, it bought the 750 stores from a retailer called Somerfield, at one stroke leaping from a market share of 4.5 per cent to 7.2 per cent of the retail food market, and into fifth place behind the big four supermarket chains. Yet seven years on it has lost most of the gains from this, partly because of the fierce competition within the food retail market, and partly because of poor management and governance failure (documented in graphic detail by the Myners Report, 2014).

It may be that by the time this paper is published the Group will have been put into administration. If it does survive, it will be by selling off its farming, pharmacy, insurance and funeral businesses. Whether it survives depends largely on the acceptance of a new governance structure that satisfies its creditor banks that it will be well governed in the future. In this unfolding drama, governance takes centre stage.

Who is to blame?

The loss of the Bank and the current capital shortfall in the Group are partly attributable to failure of management, and in the Kelly Report the CEOs of both the Group and the Board come in for criticism. However, ultimately the managers have to be accountable to, and controlled by, their boards. There has been a massive failure of governance. The Bank and Group boards failed to see the extent of the Bank's – and then the Group's –deteriorating capital position, and seemed content with whatever information and explanation was provided to them. They failed to discuss the most important issues, such as the growing losses from the Britannia commercial loan portfolio and the poor performance of the Group's retail stores. They were easily distracted from the hard grind of meeting the competition and ensuring customer satisfaction.

When the managers pursued particular projects such as the Verde deal or the IT platform, they

failed to notice that things were going wrong, and did not offer any challenge. They did not ensure that due diligence was done and had a superficial and amateurish approach to risk management. All of these failures and more are detailed in the Kelly Report and Myners Review. In a chapter on governance, the Kelly Report says of the Group Board:

> *"One of the most surprising features of this whole episode is that the Board seemed unaware of its limitations." (2014, p115)*

Even the five members of the Board who were themselves chief executives of retail co-operatives were inexperienced by industry standards. The training of board members was far from rigorous. The chair who led the Board after 2007 had no experience prior to being appointed. After the 2007 review of governance they had the power to appoint up to three independent professional directors, but did not do so. The executive of the Group also did not understand the financial services industry, and the relationship between the CEO and board deteriorated.

> *"The Co-operative Group thus found itself in a situation in which it had a strong-willed chief executive and a board too weak and inexperienced to hold him adequately to account." (2014, p116)*

The Bank's difficulties took many of the members of the Group Board by surprise. The Group Board and Co-operative Bank Board both failed in their oversight. The chair of the Bank (who, at the height of the Bank's troubles in November 2013, was arrested for trying to buy class A drugs) was 'a wholly unsuitable person to chair the Co-operative Bank Group board' (Kelly, 2014 p120). The independent directors on the Bank board, and the regulator became increasingly frustrated but were unable to make an impact.

The Myners Review is even more scathing. Myners was invited to become an independent director on the Group Board in December 2013, so that he might devise a new, more fit for purpose governance structure. He refused to accept payment, except for the £1 cost of becoming a member of the Group, and assembled a team of top business school academics to help him. In February 2014, a two year deal with the Chief Executive, Euan Sutherland that gave him a salary of £6.6 million over two years, and other deals with top managers, was leaked to the Observer newspaper. Sutherland resigned, declaring the Group 'ungovernable'. Myners then hit back at the Group board members with an interim report that declared the loss of the CEO to be a 'catastrophe', and outlined a completely new governance structure. By April he had himself resigned from the Board, citing as his reason the fact that, despite more than half the Group's assets being wiped out in the last five years, the directors were stubbornly refusing to admit their part in the failure.

The proposed governance structure

The Myners Report, published in May 2014, has as its aim 'to develop a set of practical reforms that will protect the Group from the deplorable governance failures that have been exposed over the last year'. (2014, p7) It sets out three principles:

1. A new board that has the skills and experience needed
2. A powerful representative forum of elected members
3. Extension of full membership rights to all individual members

What this means in practice is that there will be a new, independent chair of the Board who has had no previous relationship with the co-operative. The entire board will be replaced by a new 'plc' type board elected directly by the individual members of the Group, and qualified entirely by their skills and experience in the business. The regional boards will be disbanded, and a new member representative council (MRC) of about 50 members will be voted in, again directly by the full membership. This council will look after the social goals of the co-operative. Crucially, a nominations committee will be set up, with one or two members of the MRC on it, but controlled by the board so it can ensure its own succession and

make sure it retains the right skills and experience needed for effective governance.

In his view, Myners is like a medical doctor diagnosing the problem and writing a prescription. There can be no deviation from this even if the Board members are unwilling to vote for it. He wants to make clear that his proposals are fully compatible with the core values and principles of co-operative ownership. However, a team from the trade association, Co-operatives UK decided to propose some key amendments that might also be considered. (Barber, Birchall and Mayo, 2014). Calling their report 'Myners plus', they argued that the chair of the Board and the MRC should be the same person rather than the two people Myners wanted, because otherwise there would be discord and the costs of governing would be too high. They proposed that the nominations committee be a sub-committee of the MRC rather than the Board and that the member representatives be in a majority. This is so that the board does not become self-perpetuating. They insisted that the splitting of the social from the economic goals of a co-operative, with the member council monitoring the social aspect and the Board the economic, was a retrograde step because the social and economic should be seen as all part of the same strategy to achieve a 'co-operative advantage'. At a special general meeting, the Group accepted the principles behind the Myners proposals, while allowing for a certain amount of discussion about the details. It may be that the Myners plus approach will also be taken into account in the deliberations, but only time will tell.

An evaluation tool for assessing governance structures

The Myners plus report takes as its starting point a simple analytical framework for governance proposed by Birchall in his study of the governance of large co-operatives that was commissioned by Co-operatives UK and published just before the Myners Report. (Birchall, 2014) This study uses the World Co-operative Monitor to identify the top 10 co-operatives in each of six industry sectors, making 60 co-operatives in total. It then provides a useful summary of the governance structure of each, attempting to sum up their wide variety of structures that mostly – Co-operative Group excepted - seem to work quite well.

The variety in governance structures shows that there never has been a single blueprint for good governance, and that co-operatives have adopted structures that they first borrowed from others and then adapted over time. They have evolved, adapting to changed circumstances, mutating (perhaps with mistakes that have proved useful, as in biological evolution) and occasionally being redesigned. In some cases, one suspects, inertia has set in. There are no neat divisions into two or three governance systems, such as the European two-tier model, or the US unitary board. Instead, the Report asks us to imagine that we have to cut up a long chocolate cake that is cut into four pieces.

The first piece is member voice, the base level of engagement with members that can be quite informal but is necessary in order to involve at least some members in governance. The second piece is representation, the channeling of the energy that comes from member involvement into a smaller set of elected representatives who can carry the members' voice into the governance structure. The third is expertise, which is needed to ensure that the business does not take unacceptable risks and works effectively on behalf of members, and the fourth is management, that puts all of this into practice. The problem is that the cake can be cut unevenly into the four pieces so that some are small and some larger; sometimes after three pieces have been cut there is no cake left – this is sometimes what happens to member voice that gets left out altogether.

Member voice is orchestrated by some of these co-operatives in innovative ways that are not too costly and work well – informal meetings that encourage exchange of views and information, and that motivate members to vote for their representatives. Without it, boards tend to be self-selecting and to engage in circular routines with nomination committees and complex rule-governed behaviour that ensures nothing but oligarchy. Representation is not difficult to organize, provided the members are divided into natural constituencies by geographical area or interest group. It tends to result in large, unwieldy boards and is better funneled into an even larger representative assembly where, provided they have real powers, representatives can keep an eye on the board of directors.

Expertise is achieved by having a small, mixed board of representatives and appointed experts.

Around half of the 60 boards have independent appointed experts on them, and we can expect more to follow. Most boards achieve some balance between representativeness and expertise by controlling the appointment of new board members through nomination committees. This can become undemocratic, particularly when they neglect member voice and make sure only their recommended candidates get elected. It is better to open up elections of representatives to competition while ensuring expertise through appointing extra independent board members.

What should be the place of management? Most co-operatives have an executive board or committee of top managers that relates to a separate board of directors, but among the 60 co-operatives there are some interesting permutations. Having a large assembly of representatives enables some co-operatives to have a smaller, mixed board of directors and managers that seems to work well. It is all about the effective distribution of different types of authority.

Conclusion

Using this simple framework, the Myners plus report summarizes the situation in relation to the Co-operative Group. The existing structure has a large element of representation, but not much member voice and hardly any expertise. The Myners proposal would amplify the expertise and the direct voice of members, but arguably at the expense of representation. In the view of this author, the Myners plus suggestions would enable the Group better to balance the three elements and so produce a new governance structure that will help it to recover from its current malaise.

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[1]Also published in the volume of the 2nd International Co-operative Summit, Quebec 2014

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Unique Expectations of Co-operative Boards: taking on the challenges of the democratic enterprise

Arthur Sherwood and Keith Taylor

Abstract

The expectations for governing boards of co-operative enterprises continue to evolve and adapt in synch with various political crises seen across the globe. Take for example the banking crisis of 2008. Financial co-operatives were seen as a viable antidote to the excesses of the investor-owned financial institutions. But the economic crisis was so deep that it revealed a number of governance challenges embedded in robust co-operative sectors in Spain and the U.K.

Using the lens of the institutional logics perspective, we address the common and unique expectations of co-operative vs. investor owned corporate boards of directors. Building on prior governance literature, we discuss tensions created between various perspectives and identify and succinctly describe three common expectations including teaming, vigilance and strategic behaviors. Then, we take a deeper look at the unique co-operative expectation of being advocates for democracy and the challenges this poses including being played for suckers, tyranny of the majority (and minority), democratic despotism and pragmatism. We close with an exploration of co-operative democracy in practice and highlight resulting questions of interest to researchers and practitioners.

Keywords

Co-operative Boards, Co-operative Democracy, Co-operative Governance

Introduction

The world has experienced serious economic, social and political disruptions in the last decade. The ICA's Blueprint for a Co-operative decade states,

> *"in the second half of 2012, following five years of financial turbulence the more developed economies of the world remain in a state of crisis from which there is still no apparent exit, and the developing economies are being impeded in their pursuit of the Millennium Development Goals. In many nations, governments are in retreat, cutting their social and public spending, leaving citizens even more vulnerable to economic turmoil. In others, inequality continues to increase as economic power is shifting dramatically with consequential social impacts." (ICA, 2013, p2)*

The authors go on to say,

> *"In the midst of this uncertainty and suffering, co-operatives can provide some hope and clarity of direction for citizens around the world. Uniquely amongst models of enterprise, co-operatives bring economic resources under democratic control. The co-operative model is a commercially efficient and effective way of doing business that takes account of a wider range of human needs, of time horizons and of values in decision making." (ibid)*

In this "co-operative decade" the stated aim is to bring co-ops to the forefront as the acknowledged leader in economic, social and environmental sustainability, the institutional model preferred by people, growing faster than other forms of economic enterprise.

But, can democratically owned businesses actually make these differences? Are the elected governors just window dressing on what is really just another conventional business? These questions then beg a

third: can democratically owned and controlled businesses really simultaneously deliver on the promise of enterprise performance and a robust and thriving democracy when the practice of democracy poses so many challenges, and faces persistent pressure and tension from the tradition of return on capital as the dominant priority in market-based enterprises?

Boards of co-operative organizations have a variety of expectations placed upon them that are unique to the co-op model. Cornforth identifies the tension between the management, board, and their democratic obligations to member-owners (2004); Spear, Cornforth and Aiken, (2009) point out the unique skills needed for competent governance; Birchall (2014) distinguishes the necessary governance differentials and adjustments needed between co-operatives of differing scales.

The logic of the institution will guide analysis about which of these tensions are in effect and how they should be managed. Our first contribution builds on this evolving discussion of tensions and challenges through a lens new to the literature on co-operative governance. We take a look at boards from an institutional logics perspective (Thornton, Ocasio and Lounsbury, 2012) in order to identify potentially paradoxical behavioral expectations held of these agents. We also draw from the broader governance literature to identify overlapping behavioral expectations of investor-owned corporation (IOC) and co-operative-owned corporation (COC) governors including teaming, vigilance, strategy and being advocates for democracy. We argue that the institutional logics of both IOC and COC indicate the first three are common expectations (although likely to have different flavors of implementation) while being advocates for democracy is unique to co-operatives.

These four expectations become the pillars that lead to a board's success, but the tensions created by the resulting paradoxes must be managed. Identifying the logics and related behavioral expectations is important as it takes our understanding one step closer to helping co-operative practitioners address the challenges and tensions arising from them.

Our second contribution is to address the challenges of democracy and the dangers the democratically controlled enterprise faces. Spear (2004) highlights that much of what a co-operative was designed to do has the potential to degenerate into what is essentially a managerially entrenched and powerfully controlled enterprise due to limited controls either from the market or the ownership. He states:

> *"This weakness in turn weakens the original market advantage of such enterprises in trust and collective goods, by reducing trust and reducing the incentives and controls for good performance. In the worst case the result is sleepy managers, cozy board relations and poorly performing social enterprises that eat into its asset base, often accumulated over generations, until it is taken over or fails, as markets become more competitive." (Spear, 2004, p.49)*

This is a concerning insight. The implication is that there is an expectation for boards to be effective in their democratic control, and if they are not, the results can be catastrophic. There is a point at which co-operatives may move toward isomorphic tendencies, standardizing into what looks like an IOC which in turn conceptualizes members instrumentally as mere consumers, producers or laborers, with governance becoming dominated by financial – not democratic-concerns (Malo and Vezina, 2004). This then leads to the downward spiral of diminishing market advantages (Spear 2004).

We will dig deeper into the potential vulnerabilities of democracies drawing from the work of Vincent Ostrom (1997). We will then argue that boards are critical to providing the countervailing measures called for by Spear (2004) including opportunities for protecting, perpetuating and practicing democracy.

Review of three seminal co-operative governance papers

Past research has examined governance challenges and tensions from a variety of perspectives and approaches. While we do not provide an exhaustive review of this literature below, the three pieces we highlight lay a foundation for understanding the

challenges and tensions co-operative boards face.

Cornforth (2004) reviewed a variety of theoretical perspectives that highlighted this tension including agency, stewardship, democratic, stakeholder, resource dependency and managerial hegemony theories. The author argued that a paradox perspective was needed in order to deal with these tensions, as using just one theoretical lens was too one-dimensional. In other words, we do not look at one facet, but a number of facets when identifying the various challenges facing a co-operative. The tensions identified included the question of who governs (representative vs. expert boards), the question of board roles (conformance vs. performance) and the question of relationships with management (controlling vs. supporting).

Spear, Cornforth and Aiken (2009) studied social enterprises in the UK identifying a variety of common challenges including: recruiting board members with the right skills and expertise, choosing appropriate legal and governance structures, managing the diversity of external stakeholder interests, managing membership, the power of boards to control management, managing the interdependencies between board and management and balancing social and financial goals. These challenges reveal multiple tensions including balancing stakeholder interests, organizational outcome expectations and how to be both supportive and controlling of management.

Finally, Birchall (2014) recently presented findings in a report for Co-operatives UK examining the governance of large consumer co-operatives. Two challenges noted by the author include ensuring expertise on the board and managing the cost of a participatory model of governance. He goes on to indicate that successful governance is all about effective distribution of various forms of authority. Again, it becomes apparent that these challenges create tensions. How can co-operatives develop the expertise to make decisions on behalf of their members and invest in a participatory model while keeping the financial and non-financial costs from going off the rails? How to have distributed authority that does not undermine successful board-management relations yet allows for appropriate control on behalf of members? Birchall states:

> *"In designing governance structures, we struggle to give some weight to each of four different types of authority: voice, representation, expertise and management. We have to listen to the voice of the members, to find an effective way of representing them, to find the expert help they need, and to find ways of encouraging and controlling managers. Only when all four types of authority are present can a co-operative be governed effectively" (Birchall, 2014 p22)*

Clearly getting these tensions balanced is a challenge to co-operative boards.

The challenges of being a co-operative enterprise

But why are these challenges? Why do these tensions exist at all? We argue that the tensions arise from two arenas: 1) the institutional logic of the co-operative enterprise and 2) the nature of the agency relationship. Approaching this from the institutional logics perspective allows us to explore behavioral expectations that develop for directors as agents in order to follow the logic of the organizational type.

The democratic governance expectation is particularly interesting because of unique importance placed upon it by co-operatives (democratic governance is a mandatory feature). This characteristic, while challenging, can also be the source of market advantage. Birchall (2012) discusses the comparative advantages of member-owned organizations derived from ownership, control and benefits. The set of 'comparative advantages' is directly derived from the nature of the member-owned business. In order to avoid degeneration of this co-operative advantage (due to the dangers noted earlier by Spear 2004), it is critical for boards to meet their behavioral expectations related to democracy.

We will go deeper into the democracy expectations and bring in the perspectives of noted political scientist, Vincent Ostrom. Linking to Ostrom's work (Ostrom, 1997) allows us to further

understand the vulnerabilities of democratic representation and voice and the expectations that may arise for boards in order to counteract and/or avoid these vulnerabilities. We've structured our contribution into three components. First, we will frame the expectations of governing boards as agents informed by institutional logics. Although we look at both IOC and COC directors through a narrow - agency - lens, we seek to make the case that ideal type co-operative and investor owned corporations have different institutional logics that lead to particular expectations of board directors.

Second, we will identify the common expectations of co-operatively-owned and investor-owned corporations and briefly describe each including teaming, vigilance and strategic behaviors. Third, we take a deeper look at the unique expectations of co-operative boards to act as advocates of democracy, noting the special challenges this expectation poses to directors in structuring democracy as an asset rather than a liability.

We will use co-operatively owned corporations (COC) and investor owned corporations (IOC) for our discussion. When formed as a corporation, the two different ownership types typically will have boards of directors, separate legal existence, limited liability for owners and continuity of existence (i.e. existence that continues regardless of specific owners). The key point of departure lies in the breadth of stakeholder needs, with COC's typically having a more diverse set than IOC's (Spear et al, 2009). It is commonly understood that the primary interest of IOC shareholders is the maximization of wealth, whereas the primary interests of COC member-owners are diverse and subject to a one-member, one-vote democratic process. This understanding allows us to focus on the resulting overlapping and contrasting agent expectations stemming from their institutional logics.

Agency in the Institutional Logics of Co-operative vs. Investor Owned Corporations

Boards sit at an interesting place in the set of agency relationships of both COCs and IOCs that link to many of the aforementioned tensions. They are delegated an enormous amount of authority from owners while at the same time delegating nearly all this authority to management, often through a general manager such as a CEO. Making this even more interesting (and challenging) is that the number of owners is often high resulting in the inability to directly hear or represent all voices equally. Board directors are tasked to process the numerous voices and transmit interpretations of those desires within a complex organizational structure, while controlling for a dynamic market environment.

This raises interesting questions about what might be the appropriate base assumptions of boards regarding their work expectations, and what the situations might be that influence or determine them. What might determine the base assumptions for COCs and IOCs and how might this impact directors' perceptions?

One perspective that is useful in exploring these questions is that of *institutional logics.* The institutional logics perspective is a:

> *"Meta theoretical framework for analyzing the interrelationships among institutions, individuals, and organizations in social systems" (Thornton et al, 2012, p2)*

More specifically, institutional logic is defined as:

> *"the socially constructed, historical patterns of cultural symbols and material practices, including assumptions, values, and beliefs, by which individuals and organizations provide meaning to their daily activity, organize time and space, and reproduce their lives and experiences"(ibid).*

Theory related to agency often assumes bounded rationality (e.g. Eisenhardt, 1989). Because agent-actors can't know everything, they must rely on something to make decisions and act on behalf of their principals. Institutional logics can fulfill at least some of this role, ultimately impacting the perception of behavioral expectations placed upon agents through an understanding of key components in the above definition: historical patterns, cultural

symbols, material practices, assumptions, values and beliefs of their organization. These expectations, laid upon and perceived by the governors will ultimately impact the governance systems/models employed by them. Furthermore, the logical orientation of an institution may impact the types of agents –and their concurrent motivations - which seek to participate in the governance systems of the firm.

If we assume that the specific logic of the institution influences actual and perceived expectations, we can assume that it both constrains and enables the actors in their level of agency, or ability to act. Agency is defined as an actor's ability to have some effect on the social world---such as altering the rules, relational ties or distribution of resources (Scott, 2008). Institutional logic argues that "agency, and the knowledge that makes agency possible, will vary by institutional order" and that "each institutional order has its own sense of rationality" (Thornton et al., 2012:pg. 4 and pg. 7). Thus, from an institutional logics perspective, we can anticipate that expectations placed upon and perceived by boards of differing institutional orders will also vary (as in this case, the logical differentiation between a COC and IOC).

Both COCs and IOCs must be profitable businesses in order to sustain themselves. They both have owners that invest equity, boards that act as agents of the owners and an enterprise. Thus, each has business, owners, and capital as part of their logic. At this point we can start to detect the departure of the two business models. Ownership in IOCs may be divided unevenly, with one shareholder able to hold multiple shares. The amount of shares determines the portion of the profit each owner may receive in dividends and the number of votes they have in electing the board of directors. This in turn leads to a widely held understanding that the primary value upon which the corporation should focus is maximization of shareholder wealth. IOCs are shareholder wealth *building mechanisms* and this is central to their institutional logic.

In contrast, ownership in COCs is evenly distributed with each owner having a single share. Each owner has one vote in the election of the board of directors. Rather than profits being distributed based on how many shares an owner has, it is distributed based upon patronage, or the value of economic transactions with the COC. This difference arose as a consequence of COCs being formed to meet the needs of their owners (Malo and Vezina, 2004; the scope of these needs may very well be wealth related but can start or evolve to be quite broad and diversified) and on the basis of democratic control by owners of the business. The widely held understanding is that COC's place primary value on meeting shareholder needs. COCs are needs meeting mechanisms and this is central to their institutional logic.

Maximizing shareholder wealth vs. satisfying owner needs as primary values likely impacts the institutional logics of IOCs and COCs, and in turn, the expectations held of directors' behavior for each rests on set of values that is quite different. Particularly interesting is the broader scope that COCs have in owner needs beyond creating monetary wealth for owners-members.

Many COCs around the world have embraced a set of broadly held values that are guided by a universal set of "Co-operative Principles." (ICA 1995). These principles and values are identified in Table 1.

Table 1:
CO-OPERATIVE PRINCIPLES AND VALUES

Seven Co-operative Principles	Co-operative Values
1. Voluntary and Open Membership* 2. Democratic Member Control 3. Member Economic Participation 4. Autonomy and Independence 5. Education, Training and Information 6. Cooperation among Co-operatives 7. Concern for Community *Membership assumes ownership in co-operatives, but it has a wider scope in democratic voice and patronage benefits.	• Self Help • Self-responsibility • Democracy • Equality • Equity • Solidarity • Honesty • Openness • Social Responsibility • Caring for others

It is interesting to note that only one of these addresses economic participation, and that the only one specifically articulated in both principles and values is that of democracy. The principles and values that sit aside economics should broaden the scope of the logic of this institutional type well beyond that of the IOC.

From this point forward, we assume that there are certain overlapping and distinguishing aspects of institutional logics that will lead to overlapping differentiated behavioral expectations held of, and perceived by, boards of directors.

Review of the literature on Directors' Behavioral Expectations

Multiple scholars, both from the traditional corporate and the co-operative arenas have identified contrasting perspectives on the role of boards (e.g. Cornforth, 2002; Finkelstein, Hambrick and Cannella, 2009). From this, the question arises as to what an agent is to do for the owners of the business and the impact they can ultimately have on the organization. Finkelstein et al (2007) indicate the key question to be "How do boards affect organizational choices, strategies and performance?" (229). This implies that directors are affecting those choices through their governing behaviors derived from their personal filters (mental models) of what they should do as governors.

McGinnis defines governance as:

> *"the process by which the repertoire of rules, norms, and strategies that guide behavior within a given realm of policy interactions are formed, applied, interpreted and reformed" (McGinnis, 2012, pg. 6).*

While there may be multiple levels of governance including that of operations in an institution, our focus here is that of the board of directors and their expected behaviors in the process defined by McGinnis.

COCs and IOCs have elected boards with certain common expectations of their governance duties as they act out their agency role. But as discussed in the previous section, there is a difference in who has the elector power and in the institutional logic each starts with, which then begins to separate and distinguish COCs from IOCs.

Figure 1 below illustrates a model of four board behavioral expectations that find their roots in the paradoxical theoretical perspectives. Each of the component expectations are labeled as behaviors. Because board governance is at least in part an act of agency, there are expectations that boards "do" something on behalf of those electing them to their positions.

Figure 1: Components of Board Governance Expectations

The core expectation components of the framework are teaming, vigilance, strategic, and advocates for democracy behaviors. Democracy behaviors are in grey as these are considered to be the unique set of expectations of COC vs. IOC and may very well sit at the heart of the co-operative enterprise's comparative advantage. The next three sections define and describe each behavioral expectation component. We will treat teaming, vigilance and strategic behaviors succinctly and delve deeper into the unique challenges of being advocates for democracy for co-op boards.

Expectations of Board Teaming Behaviors

A team is "a specific type of group composed of members who are interdependent, who share common goals, and who must coordinate their activities to accomplish these goals" (Kogler Hill, 2013, p287). According to Finkelstein et al (2009) almost all theoretical framings related to boards identify two such common goals or roles that they work toward fulfilling on behalf of their owners. First, boards of directors have the common purpose

of playing a role of linking the organization to its external environment. Second, they play an internal role related to control and administration. Each of the subsequent components of board governance expectations (vigilance, strategic, democracy) relate to one or both of these roles.

This of course can create tensions for boards as they try to understand if each director is a representative (e.g. democratic perspective) or to control vs. collaborate with management (e.g. agency vs. stewardship theory).The logic of either corporation type will establish that boards are expected to come together to accomplish a set of internal and external common purposes, although what this looks like and the degree to which the group is cohesive will surely vary.

Expectations of Vigilance Behaviors

Vigilance appears to have strong support as an expectation and the greatest overlap in expectations between co-operative and other forms of business. Vigilance behaviors can be considered acts of intentionally paying close and continuous attention to avoid risk.

Vigilance behaviors are observable as boards play their internally focused "role in administration and internal control, putatively (and legally) responsible for setting policy and monitoring management" (Finkelstein et al., 2009: p228) thus having a role focused on conformance (Cornforth, 2004).

Fama and Jensen (1983) point out that boards play the role of ratifying and monitoring top management decisions and that they are central in ensuring that shareholder best interests are served by management actions. The authors point out that this is the case for various types of organizations from corporations to financial mutual to not-for profits, akin to fiduciary responsibility (Joyal and Swansen 2011).

The key insight from the above is that board vigilance behaviors are expected from all types of board governed organizations. Not only are they expected by virtue of their logics, they are legally mandated to do so. Of course, which behaviors and how well these are carried out will vary from organization to organization resulting more or less effectiveness and more or less impact on an organization's ultimate performance as it relates to meeting shareholder/stakeholder/owner interests. Perhaps the words of Fama and Jensen (1983) summarize this well:

> *"Such boards always have the power to hire, fire, and compensate the top-level decision manager's and to ratify and monitor important decisions."(Fama and Jensen, 1983, p 311).*

Being highly vigilant can create tensions with both teaming and being part of the strategic process. Asking the difficult questions can place strains on the group (both in the board and with management) as well as be seen as obstructive to moving forward with strategy.

Expectations of Strategic Behaviors

Strategic behaviors are those acts that are part of the strategic process of the organization. Stewardship theory indicates that the board's role is to help improve performance and add value and support to management (Cornforth, 2004; Donaldson, 1990). Thus far, agency theorists have focused most of their attention on the monitoring role of boards and less on strategy and its formulation (Finkelstein et al., 2007).

While this may be the case, there has been growing pressure over time toward a higher level of board expectations, from the implementation of Sarbanes-Oxley act in the US to director liability issues, to directors wanting to play a primary role in advising and evaluating (Lorsch and Maclver, 1989). Yet, the literature also indicates that there are powerful norms not to question management, and penalties for boards and directors that do so (Westphal and Khanna, 2003).

Tensions are created as boards work to determine how to balance strategic behaviors with those of vigilance (support vs. control). And it becomes even more challenging for directors of co-operatives as

they have unique expectations placed upon them relating to democratic control.

Expectations for Advocates for Democratic Behaviors

To this point, we have briefly overviewed three behavioral expectations that are common to both COCs and IOCs. While each of these has inherent tensions between and within, behavioral expectations of board agents by principals are that they are to be fulfilled to the degree that it is consistent with their understanding of the institutional logic, as well as their own self interest (to paraphrase Tocqueville, "rightly understood").

The expectation of acting as democracy advocates is the point of COC distinction. The reasoning for this is quite simple; IOCs are not designed to be democracies and COCs hold democracy as core to their institutional logic and design. Co-operatives as democracies have long been the subject of scholarly attention (for example see Bernstein, 1976; Cornforth, 1995) with recent attention brought to how their unique nature brings comparative advantage to the enterprise (Birchall, 2012).

A long standing question is, what does it mean to be a co-operative democracy and how would impact upon owner expectations of the board? Isn't it basically about holding an election with each member-owner getting a vote, and check, democracy work is complete? To further address these questions, we turn to the writing of democracy scholar, Vincent Ostrom. Our intention from here forward it to use his thinking to go deeper into the challenges of democracy in general, and in co-operatives in particular, with the implications for boards as they fulfill yet another expectation, and act as advocates for democracy. This in turn helps take the countervailing steps called for by Spear (2004) and protects what may be the comparative advantage of COCs.

In addressing the reasons for crises of democracies around the world, Ostrom (1997) considers:

> *"Perhaps the answer is to be found in the superficial way we think about citizenship in our democratic societies. How people conduct themselves as they directly relate to one another in the ordinary exigencies of life is much more fundamental to a democratic way of life than the principle of 'one person, one vote, majority rule. Person-to-person, citizen-to-citizen relationships are what life in democratic societies is all about. Democratic ways of life turn on self-organizing and self-governing capabilities rather than presuming that something called 'the Government' governs".*
> *(Ostrom, 1997, p3).*

This is worth considering for the society of the co-operative as well. If being a democracy means more than "just one person, one vote, majority rules", then what are the implications of this to the institutional logic of the COC and the subsequent perceived expectations member-owners should have of elected boards?

Starting with the words of Ostrom, we can draw some parallels to COCs. The members make up the citizens of the COC democracy. They elect the board of directors. The board of directors is the elected part of the governing structure and the management is typically the appointed part of the governing structure. But from Ostrom's perspective, this is not what makes a democracy go beyond superficiality. The citizens retain governing power through this election and appointment approach having self-organized and developing, maintaining and utilizing self-governing capabilities. The citizen owners *delegate* authority and power, but do not abdicate authority and power to their agents.

In a robust and resilient COC democracy, member-owners have the capabilities for and are engaged in self-governance through participating in the processes of reflection and choice. Certainly they use agents to act on their behalf, but again the use of agents is an act of delegation to help the system work. Delegates are themselves members of the co-operative. In order to make good decisions on behalf of the majority of member-owners, having

member-owners participate in the process of reflection that leads to choices appears critical.

Ostrom states that:

> *"democratic societies are necessarily placed at risk when people conceive of their relationships as being grounded on principles of command and control rather than on principles of self-responsibility in self-governing communities of relationships" (ibid, p4).*

If indeed the co-operative values and principles are taken as guidelines by COC boards, one can begin to see how fundamental this is to the institutional logic of COCs: democratic member control, self-help, self-responsibility, democracy. And to support a vibrant democracy: education, training and information, autonomy and independence, concern for community, caring for others, social responsibility, openness. The majority of the values and principles appear to be directly or indirectly about supporting a robust, self-governing democracy.

To have a robust and resilient democracy, Ostrom argues that it must be about *power with*, rather than power over. But this does not just spontaneously occur nor is it free from vulnerability. Multiple types of vulnerabilities have been identified including being played for suckers, tyranny of the majority, democratic despotism, and pragmatism. As democracies, co-operatives are vulnerable to each, and each presents a challenge to their boards.

Being Played for Suckers

Misaligned interests between principals (owners) and agents (board directors) is a core issue concern with agency theory (Eisenhardt, 1989).

This vulnerability is evident when after an election, whatever voiced alignment with the public evaporates in favor of hidden agendas and actions of winning coalitions (Ostrom, 1997). A COC is vulnerable if those on the board work to be elected based on one premise, with a hidden agenda upon which they base their actions. Owners-members can also be played for suckers if the elected board communicates one thing with the intention of acting in another. This manipulation and lack of candor breaks down trust, alienates members and disillusions them about the COC and how it connects to their values.

Tyranny of the Majority

Tocqueville (1835-40) and Madison (Hamilton, Jay and Madison, 1788) both identified this as a vulnerability via the majority vote mechanism. Ostrom (1997) refers to this vulnerability "as a sickness of government" where the majority decisions benefit the majority but leave the minority needs and interests behind. The vulnerability moves into a full on crisis when the majority restructures the co-op in such a manner that forces an abdication of authority, empowering the board to act on its interests alone.

Democratic Despotism

Tocqueville (1835-40) identified this vulnerability to arise when things are good, and the people are kept happy.

This leads to a sort of benevolent autocracy where, "power is absolute, minute, regular, provident and mild. It would be like the authority of a parent if, like that authority, its object was to prepare men for manhood; but it seeks, on the contrary, to keep them in perpetual childhood: it is well content that the people should rejoice, provided they think of nothing but rejoicing. For their happiness such a government willingly labors, but it chooses to be the sole agent and the sole arbiter of that happiness; it provides for their security, foresees and supplies their necessities, facilitates their pleasure, manages their principal concerns, directs their industry, regulates the descent of property, and subdivides their inheritances: what remains, but to spare them all the care of thinking and all the trouble of living?" (Ostrom, 1997,p 16).

Ostrom identifies this as a "sickness of the people" and states:

> *"Democracies are in serious difficulties when a sickness of the people creates a dependency, a form of servitude, in which the people no longer possess the autonomous capabilities to modify their constitutional arrangement and reform their system of government in appropriate ways" (ibid, p17).*

But can this possibly apply to COCs? Arguably, COC businesses are especially vulnerable as there is considerable attention paid to customer service and member-owner needs. If needs are not met, complaining and working to change the system are expected. But what if people are satisfied for a significant period of time? Why bother to know how to actively participate in the democracy? It is not hard to imagine member-owners saying to themselves *the* board *will do* it and even more so, the *excellent management will take care of us.* Perhaps a member-owner does have a concern but things are generally just fine, right?

This long term member satisfaction may in fact lead to democratic muscle atrophy. And when a need to engage does arise, the skills no longer exist within the membership and even within the board and management. This atrophy can lead to a vicious cycle of a fear of democracy, with actors working to stifle participation of voice, representation and information sharing through indirect action of ignoring member-owners to active stifling through manipulating process (the aforementioned problem of coerced abdication).

Pragmatism

The pragmatic paradigm originates from the presidential administration of Woodrow Wilson (Ostrom, 1997). Participatory mechanisms of governance are perceived as cumbersome, and prone to engagement of sub-optimal agents. Instead, knowledge leaders or experts are elevated to leadership positions, and elite-labeled amateurs are excluded from participatory governance processes. As globalization and business competition intensifies, the deference to pragmatic governance threatens to weaken democracy. Under such a system, the users of crucial public goods are kept from informing elite agents working on their behalf - what Aligica and Boettke (2009) refer to as a public service paradox. The agents then exhibit a cloistered worldview, informed by a shallow knowledge pool of information dissemination. Pragmatic governance opens channels for exploitation in that it obscures participation in reflection and choice by the public (owners) as it may interfere with the "necessary" business at hand and create distractions by introducing the challenges the COC principles and values bring (again, the delegation authority is abdicated).Ostrom (1997) states of Wilson's pragmatic thinking:

> *"Governments could presumably govern in democratic societies without regard for the processes of crafting and re-crafting the common knowledge, shared communities of understanding, patterns of social accountability, and mutual trust necessary for self-governing society (ibid, p 20)".*

Wilson essentially argued that the original intentions –institutional design and structure- and future desired states were not of importance; rather, the pragmatic situation of today is what matters most. The government had grown up and those original values were nice, but not practical. Clearly, this is an argument that professional management of COCs may be tempted to make and thus move closer toward what Spear (2004) cautioned against. They might argue democracy is hard and messy and dealing with all those members reduces our agility in the marketplace and our capacity to respond to competitive pressures. And these things are likely true; this is why pragmatic governance is such a dangerous vulnerability of COC democracies. Practical business needs as identified by professional management can potentially trump all else. The COC loses its value edge, and ultimately its comparative advantage.

Each of these vulnerabilities is real, and unfortunately, they are often not well understood by members of COC democracies. Avoiding becoming victim to these vulnerabilities implies both defensive and proactive behaviors. Thus boards must become the champions of democracy, and have the consequent expectation to be *advocates for democracy.*

Avoiding Vulnerabilities, Strengthening "Self Governing" Democracy

What might these advocacy behaviors be? Here, we do not propose any grand scheme, but instead choose to highlight some examples, with the intent that this will lead into a body of research on best practices for individuals in board governance positions.

Board governors (directors) must be explicitly aware of their responsibilities as advocates of democracy; at the same time, they must also build a self-regulating system that keeps them in check as well. Simply put, the membership body has delegated certain responsibilities and rights to the elected members who serve on the board of directors; at no time should this be perceived as the membership at large partaking in a wholesale abdication of their fundamental constitutive rights over the co-op.

Practice Democracy

Co-ops are common resource regimes, meaning they are owned collectively, with major decision-making authority being vested in the best interest of the collective. Any democratically governed institution requires optimal access by its members, owners, or citizenry (optimization being quite subjective, dependent on the habits, self-reflection, and reasoning of the citizenry). And yet paradoxically, boundaries and rules are of critical importance for co-operatives to offer the degree of participation demanded by the member-owners (some co-operatives may prefer direct participation, whereas others desire strong representation in a top-down management team). Processes should be put into place that reinforce predictable, concise, understandable avenues by which member-owners might engage in their co-operative. One such example is in the U.S. food co-operative sector, in which a sizable share of the co-operatives are implementing Carver's highly conceptualized Policy Governance® model; this then allows co-ops to follow a common, structured framework, and improve upon it. Concurrently, co-operative directors from across the country can share their experiences in interacting within that framework.

From this line of thinking questions arise such as, do various co-operative sectors (i.e. electric, food, etc.) across ownership models (worker, consumer, producer) adhere to specific governance practices? If so, how did they evolve and adapt? Could co-operatives optimize their governance through inter co-operative linkages (cross-pollination)?

Protect Democracy

Co-operatives must guard against capture, atrophy, and mal-intent. The practice of democracy helps to "bake-in" democratic culture, and adherence to the co-operative principles generates additional incentives which drive member-owner participation (specifically the return of patronage dividends). But what about those co-operatives that are currently captured by a small faction, or are under threat of demutualization? Proper laws and regulatory regimes can help guard co-operative democracy against such self-serving behavior as is the case with a New Mexico electric co-op whose management refused to grant its member-owners access to the co-op's by laws, thereby creating a power differential (one group is left with an upper-hand, having privileged knowledge of the rule of the game of their co-operative). But so too can mobilized co-operative advocates guard against such behavior. Credit unions are always under threat of demutualization, particularly when such a process can line the pockets of the sitting CEO. The US-based Credit Union National Association and other member credit unions have banded together to prevent select credit unions from demutualization by organizing public opinion against the demutualization effort, thereby preserving the co-op for future members.

Interesting questions arise from this including, what can we learn from demutualization –and counter demutualization- drives? Perhaps such cases may provide insight as to how co-op democracies atrophy? How do we identify an optimal regulatory framework that enhances co-op competitiveness and entrepreneurship? Do "model-laws" exist which might inform such ends?

Promote Democracy

Robert Putnam in his book Bowling Alone (2000) documented the declining arenas for civic participation. Fewer venues for civic engagement and governance result in fewer individuals with self-governing capabilities. Co-operatives are then tasked to not only promote internal venues for participatory democratic governance, but to do so in a challenging market environment. Boards will need to seek to create opportunities for participation in democracies that simultaneously strengthen democratic skills and lend toward market advantage. Examples may include activities such as building community conversations as seen in food co-operatives in Wisconsin (Sherwood, 2014) and multi-layered governance opportunities as seen in Affinity Credit

Union in Saskatoon (ibid). Internal organizational processes are demystified, and member-owners are made to feel empowered to participate. These are intentional, proactive steps boards can take, but there are other avenues created through required operations to build opportunities to participate in the process of reflection and change in the organization turning member feedback into an act of democratic participation.

Questions arising include, what are the avenues available to promote democracy? How can boards influence the entire co-operative to build and provide these opportunities for democratic participation and help members take advantage of these opportunities? What skills do members need in order to do so effectively? What are the results of these efforts in terms of performance and comparative advantage?

Perpetuate Democracy

The practice of democracy is a practice of applied education. It follows that the more democracies that exist, the greater the likelihood that individuals will be capable to engage in democratic self-governance. Therefore, the proliferation of co-ops is one strategy toward this end.

Another strategy is the continued development of robust participatory mechanisms within the co-op in an effort to engage as many member-owners as possible and thus build a pool of democratic leaders to take the co-op forward. Take for example the North Carolina State Employee's Credit Union (SECU; 2014). The $30 billion co-op has a location in every county of the state, and each location has a member advisory council serving as the locality's de facto board. These board members then can access the larger co-op structure. But of greater interest to the topic of perpetuation, this then creates a more engaged member-ownership and a pool of people capable of effective democratic governance within and outside SECU. In this manner, democratic self-governing tendencies are perpetuated throughout the organization and in the community.

Interesting questions arise including, do nations or regions with higher/lower densities of co-operative enterprises create more/fewer new co-operative start-ups? Do they have fewer/greater instances of demutualization? What are the mechanisms (policy, example, training etc.) through which boards can take action now that bolsters the likelihood that democracy will continue into the future?

Conclusions

Clearly there are many questions ahead with which practitioners will continue to grapple and researchers will continue to build understanding. Our paper has argued that co-operative boards share some of the same tensions and challenges of investor owned boards, but appear to have an even greater challenge to their logic of needing to meet diverse member needs through a democratic enterprise.The democratic nature brings a variety of unique vulnerabilities that must be attended to through actions such as practice, protection, promotion and perpetuation by governing boards. As the Blueprint points out, the external challenges are great. The related need is great for the research community to continue their efforts to understand effective governance of co-operatives in a way that deals with the paradoxical tensions and challenges faced by directors, as they work to live up to their expectations framed by their institutional logics.

Notes

[1]This paper approaches directors in their role as agents, although the literature on co-operative governance highlights the importance of the stewardship role, as directors are typically also members of the co-operative.

[2]We use this term to create distinction between the two models in order to help compare and contrast. In reality, individual corporations vary from this ideal type where we find co-ops having a narrower set of stakeholder needs to address, and IOCs focusing on more than simply maximizing shareholder wealth.

[3]Interestingly, in a co-operative that holds a diversity of values that at times appear to be in conflict, it may be possible for the democracy to suffer from a *Tyranny of the Minority*. This occurs when a small group forces their ideology to the forefront, attempting to bypass the democratic

process and the agents in place. This is done using the priority the co-operative places on a related value and then leveraging this to make their squeaky wheel gain attention. This is worth further exploration as, if a minority indeed is able to circumvent the processes used, the resilience of the democracy may be questionable.

[4]For further details of the events around the Socorro electric co-operative, see this article: http://www.informedcynic.com /SEC/sec-docs-jan-2010-dec-2010/081810-SEC_Investigates_Financial_Irregularities.pdf

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The Relationship between Performance and Governance in Agricultural Co-operatives. A structural equation modeling approach

See Yang and Fabio R. Chaddad

Abstract

Previous research in co-operative governance has modeled the relationship between performance and governance using econometric methods such as two-stage least squares (2SLS) estimation and three-stage least squares (3SLS) estimation. We use an alternative modeling approach to co-operative governance—structural equation modeling. Treated in a novel way, co-operative performance is measured as a latent variable. Our main contribution to the literature is a robust measurement model providing evidence that co-operative performance is best measured by qualitative indicators in addition to quantitative financial indicators. Our structural equation model suggests that performance of agricultural co-operatives is weakly associated with governance practices.

Key Words

Agricultural Co-operatives, Board Structure, CEO Characteristics, Econometric Performance Measurements, Governance, Structural Equation Modeling, Qualitative and Quantitative Measures.

Introduction

The field of corporate governance has become an area of renewed scholarly interest over the past two decades. Corporate scandals in the late 1990s and early 2000s brought to surface the fact that firms were not implementing effective internal mechanisms and that external market mechanisms were not being used properly. Legal standards were obsolete allowing firm managers to portray opportunistic behavior without much consequence. As a result of failed corporate governance systems, shareholders were losing billions of dollars. More recently, the 2008 global financial crisis showcased failed governance systems in many developed economies that resulted in government bailouts of the corporate sector. A strong, sound corporate governance system is important to protect the interests of shareholders and the well functioning of the global economy.

Since the birth of corporate governance research, multiple surveys of the literature have been published (Dennis, 2001; Hermalin and Weisbach, 2003; Shleifer and Vishny, 1997). With growing attention to its unique organizational structure, co-operative governance is a relatively new field of study. The results from previous research in investor-owned firms (IOFs) are informative to co-operatives, but due to differences in organizational structure and objective, those results may not be applicable. Whereas the objective in an IOF is to maximize shareholder value, the objective in a co-operative tends to be broader. Co-operatives do not have a share price. The objective of a co-operative is to satisfy the needs of its member-owners. That need varies depending on the function(s) of each co-operative.

Another major difference between IOFs and co-operatives is in board structure. The CEO typically controls the board in an IOF. If the CEO has alternative motives, he is in the perfect position to exercise moral hazard behavior. In U.S. agricultural co-operatives, the board is dominated by member-owners elected by the membership and independent of management, which reduces the chances of managerial opportunism (Burress et al, 2011; Chaddad and Iliopoulos, 2013).

Past research in co-operative governance has attempted to investigate the relationship between co-operative performance and variables measuring internal mechanisms of governance (Bond, 2009; Burress et al, 2011; Cook and Burress, 2013).

In a recent study, Franken and Cook (2013) examined the relationship between co-operative performance, the characteristics of board structure, and CEO tenure. Using a three-stage least squares (3SLS) approach, they estimated four models with each model using a different measure of co-operative performance. The measures of co-operative performance were a United States Department of Agriculture (USDA) defined extra value index (EVI), return on asset (ROA), return on equity (ROE), and a co-operative health factor. Our study uses the same data examined by Franken and Cook (2013), but we modify the Franken and Cook model in order to gain insight on the optimal way to measure performance in co-operatives.

While we also examine the relationship between co-operative performance, the characteristics of board structure, and CEO tenure, in contrast to Franken and Cook's modeling method, we use structural equation modeling to estimate the hypothesized relationships between the variables. In addition, we treat co-operative performance in a novel way—as a latent variable—using several quantitative and qualitative measures as indicators, described later in the paper.

Our study aims to answer the following question: What is the relationship between the variables measuring board structure, CEO characteristics, and co-operative performance? We use a structural equation modeling approach to examine the relationship between co-operative performance and variables related to board structure and CEO characteristics. Structural equation modeling is a common approach in psychology, sociology and other social sciences, but a relatively uncommon approach in corporate governance research. A key contribution of our study is the resulting measurement model, which uses a latent variable to measure co-operative performance. We found that the best indicators of co-operative performance were qualitative measures concerning the state of the co-operative's objective—such as member satisfaction and ability to achieve vision—rather than quantifiable financial measures. This finding further supports the idea that a co-operative's objective is broader than profit maximization. Therefore, effective corporate governance practices in IOFs can only be used as a reference by co-operatives, rather than guidelines to best practice. Corporate (IOF) governance and co-operative governance should not be treated as the same.

Literature and Hypotheses

In this section, we discuss each manifest, or independent, variable in our study. We present a brief literature review of each variable analyzed in corporate governance literature and draw the implications of each variable in co-operative governance practices, which allows us to state the model hypotheses. Table 1 (below) presents the summary of the set of hypotheses guiding our empirical analysis. The following variables are hypothesized to affect co-operative governance.

Table 1: **SUMMARY OF HYPOTHESES**

	Variable Definition	**Expected Effect on Co-operative Performance**
Board Size	Total number of board directors	-
Board Independence	Equals "1" if at least one independent, non-patron director with voting rights	+
Board Diversity	Total number of female board directors	+
Board Equity Ownership	Percentage of ownership collectively held among directors	+
CEO Tenure	Total number of years	+

Board Size

The optimal board size has been a topic of interest for years in corporate governance research. Consistent with Jensen and Meckling's (1976) agency cost theory, scholars have found that smaller boards are more effective (Jensen, 1993; Lipton and Lorsch, 1992). Smaller boards allow for better alignment of objectives between owners and managers (Hermalin and Weisbach, 2003). There are fewer opinions in the boardroom and more business is accomplished. Smaller boards encourage each director to be active and engaged, which reduces the potential for free riders. Because smaller boards are more efficient, smaller boards also increase firm performance—which was measured using Tobin's Q as an approximation of market valuation (Yermack, 1996).

In co-operatives, a large board size may increase the free rider, control, and influence cost problems (Cook, 1995). These three problems, which are part of Cook's vaguely defined property rights, are problems specific to the cost of ownership in agricultural co-operatives. Board members have an incentive to free ride and shirk with a large board and their behavior may go unnoticed. With a large board, it is harder to monitor managers. Influence cost problems can arise between board members with heterogeneous, and sometimes conflicting, interests. Overall, a large board size not only increases the agency costs between member-owners and managers, but it also increases the collective decision making costs between board members (Hansmann, 1996).

Therefore, we hypothesize that:
Hypothesis 1: A larger board size will increase agency costs leading to a decrease in co-operative performance.

Board Independence

The presence of independent directors is an important attribute of board composition. The role of independent, non-patron directors in co-operatives is to serve as an unbiased member of the board. Previous empirical research, however, has not been able to find a significant relationship between board composition and firm performance (Cochran et al, 1985; Kosnik, 1990). Although independent directors contribute outside expertise and experience, their presence does not necessarily increase firm performance (Bhagat and Black, 1999; Bhagat and Black, 2002; Pham et al, 2011). Multiple independent directors serving on one board may lead to a free rider problem. There may be an incentive to shirk because less participation results in the same residual claim. Contrary to the previous conclusion, some older studies suggest that independent directors do in fact increase firm performance (Rosenstein and Wyatt, 1990; Baysinger and Butler, 1985; Hermalin and Weisbach, 1988).

Independent directors have an incentive to be a good monitor for reputational purposes. A good reputation increases the likelihood that an independent director will be offered additional board seats in the future. When board equity ownership is included in the analysis, independent directors have stronger incentives to be active monitors of management.

In co-operatives, directors are appointed by the member-owners and thus are independent of the CEO's realm. In IOFs, independent directors tend to be within the CEO's personal network. This relationship leads to influence control problems and a higher cost of monitoring managers for owners. Co-operatives may lack expertise in certain industries or skills; therefore, the addition of independent (non-member) directors helps strengthen the overall board (Staatz, 1987). Independent directors may thus increase board effectiveness and reduce the control problem between member-owners and managers. In this study, independent directors are measured as "1" if there is at least one independent, non-patron director with voting rights on the board.

Therefore, we hypothesize that:
Hypothesis 2: Non-member directors bring outside expertise to the board of directors leading to an increase in co-operative performance.

Board Diversity

As the newest research component of board composition, board diversity has received increased scholarly attention within recent years due to social pressures. Board diversity can include gender and racial divides amongt others, but the focus of board diversity in this study only relates to gender. The era

of the "old boy's club" is seeing reform throughout the world. Some countries such as Norway and Spain have enacted legislation requiring that a certain minimum percentage of board directors be female (Adams and Ferreira, 2009). The literature suggests that gender diversity brings new perspectives and experiences to the board leading to an enhanced competence profile (Alvarez and McCaffery, 2000; Carter et al., 2003; Rose, 2007). Adams and Ferreira (2009) find that females have better attendance records, which suggests that females are better monitors than males. Because of their role as good monitors, it is possible that the presence of female directors may be equivalent to that of an independent director.

Although there is a positive correlation between the presence of female directors and firm performance, there has yet to be evidence of a significant relationship (Adams and Ferreira, 2009; Erhardt et al, 2003; Miller and Triana, 2009; Rose, 2007). In agricultural co-operatives, the presence of female directors is a rare event. Yet, the presence of female directors as good monitors should decrease the control problem between managers and member-owners. Female directors may also decrease the influence cost problem among board members if they are considered equivalent to independent directors. In this study, board diversity is measured by the number of female directors on the board.

Therefore, we hypothesize that:
Hypothesis 3: Board gender diversity will allow better monitoring leading to an increase in co-operative performance.

Board Equity Ownership

Research in equity ownership has focused on the relationship between significant equity shareholders, also known as block holders, and firm performance. Block holders have the incentive and ability to monitor management since they have a larger investment and ultimately, more to lose. Consistent with agency theory, block holders ensure that shareholder and manager objectives are aligned to reduce agency costs. Consequently, the presence of block holders increases firm performance (Boubakri et al, 2005; Gillian and Starks, 2003; Gorton and Schmid, 1999).

An extension of the research in equity ownership focuses on managerial equity ownership. An increase in managerial ownership leads to a decrease in agency cost because of aligned objectives (Jensen and Meckling, 1976; Daily and Dalton, 1997). When a manager becomes a shareholder, he is less likely to engage in opportunistic behavior because he has more "skin in the game".

The above reasoning applies to board members and co-operatives. Board equity ownership creates an incentive for board members to be active monitors of managers. With a higher stake in the co-operative, board members have more wealth to protect. As active monitors, the control cost in co-operatives may be reduced because of an aligned objective function. Board members are able to reduce the likelihood of moral hazard and opportunistic behavior of managers. In this study, board equity ownership is measured as the percentage of ownership collectively held among directors.

Therefore, we hypothesize that:
Hypothesis 4: Board equity ownership creates an incentive for board members to be active monitors leading to an increase in co-operative performance.

CEO Tenure

Consistent with the literature on board equity ownership, managerial equity leads to an increase in firm performance (Mehran, 1995). As a part of a CEO's compensation plan, managerial equity increases as CEO tenure increases. CEO tenure is expected to increase performance because longevity allows for familiarity and better decision making. Some scholars disagree with this finding arguing that longevity allows for more managerial discretionary power, opportunistic behavior and shirking. In IOFs, the CEO usually has control of the board. With increased tenure, the CEO tends to include board members within his direct circle of friends. The power and control of this position is perfect for opportunistic behavior if the CEO has ulterior motives. When CEOs do not act in the best interest of shareholders, firm performance decreases (Daily et al., 1998; Mangel and Singh, 1993; Shleifer and Vishny, 1997).

The organizational structure of a co-operative limits the CEO's control over the composition of the board. Because the CEO is limited in power, his role as CEO may differ from that of his IOF counterpart.

In this case, longevity is a positive attribute of a co-operative CEO. As tenure increases, familiarity of the company and industry increases as well. More experience allows the CEO to make well-informed decisions on behalf of member-owners. In this study, CEO tenure is measured as the total number of years serving as CEO.

Therefore, we hypothesize that:
Hypothesis 5: As CEO tenure increases, co-operative performance will increase due to CEO familiarity and experience with the firm.

Data and Methods

The structural equation modeling (SEM) approach was chosen as the technique for this paper for two reasons: the use of latent variables and the ability to control for endogeneity (Nachtigall et al., 2003). Latent variables are unobserved variables constructed by indicators. Since an issue in co-operative governance research is determining what measure(s) best represent(s) co-operative performance, latent variables are well suited for co-operative governance research. Co-operatives do not have a stock price and due to different objective function(s) it may not be appropriate to solely measure performance as a quantitative financial measure. SEM allows for various indicators—quantitative and qualitative—to construct a latent variable representing co-operative performance.

The SEM approach also allows for the specification of relationships. In simple terms, a researcher is able to specify the direction(s) of the relationship between variables.

Before presenting the data, it is essential to clarify some of the basic terminology used in SEM:

a) *Latent variable:* an unobserved variable
b) *Manifest variable*: an observed, independent variable
c) I*ndicators:* the manifest variables constructing a latent variable
d) *Measurement model:* the component that relates the latent variable(s) and its indicators
e) *Non-nested measurement model:* models that are structurally different
f) *Structural model:* the component that relates latent variables with other latent variables or manifest variables
g) *Structural equation model:* the entire model composed of two parts—the measurement model and the structural model
h) *Error variance:* represents all omitted causes including any random or measurement error

In this section, we will first discuss our data and the manifest variables. We will then present the two competing non-nested measurement models.

The data used for this study is from Burress et al (2011) and Franken and Cook (2013). The data analyzed is a combination of financial data—return on asset (ROA), return on equity (ROE), and extra value index (EVI)—obtained from the United States Department of Agriculture (USDA) Co-operative Statistics database and board characteristics data obtained from a 2010 survey of board chairs. The survey was administered to the top 1000 co-operatives in the U.S., which "constitute over 90% of the U.S. agricultural co-operative business volume" (Franken and Cook, 2013). Of the 1000 surveys administered, 460 were received. Burress et al. (2011) provide a detailed description of the sample.

Our study uses two different forms of the data used in Franken and Cook(2013). Due to confidentiality agreements with the USDA, the raw financial data was unattainable. In order to maximize the number of observations in each model, the first measurement model (Model One) was analyzed using raw data from the 2010 survey of board chairs and the second measurement model (Model Two) was analyzed using the correlation matrix from Franken and Cook's (2013) study. In Table 2 (p48), the summary statistics for all variables used in the study are provided. The correlation matrix presented in Franken and Cook's (2013) study is provided in Table 3 (p49).

After accounting for missing data, the final sample size in measurement model one is 373 observations and the final sample size used to

estimate measurement model two is 367 observations.

Manifest Variables

There are five manifest variables examined in our study. These variables measure various characteristics of board structure and CEO tenure. The five manifest variables include: *CEO Tenure, Board Size, Independence, Equity,* and *Female.* Refer to Table 2 for a summary of statistics of these manifest variables.

CEO Tenure is reported as the number of years served. The average CEO tenure is 10.40 years with a minimum tenure of six months and a

Table 2: **DESCRIPTIVE STATISTICSS**

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
EVI_2005	454	7.89%	108.69%	-343.00%	2282.00%
EVI_2006	454	3.71%	12.86%	-45.00%	174.00%
EVI_2007	458	7.22%	10.92%	-19.00%	94%
EVI_2008	460	11.85%	13.03%	-26.00%	97.00%
EVI_2009	460	11.30%	27.57%	-56.00%	519.00%
EVI_2010	453	32.84%	533.50%	-256.20%	11353.86%
ROA_2005	454	7.09%	28.75%	-19.00%	605.00%
ROA_2006	454	5.92%	5.96%	-19.00%	39.00%
ROA_2007	458	7.43%	6.81%	-11.00%	45.00%
ROA_2008	460	8.26%	7.15%	-18.00%	62.00%
ROA_2009	460	8.10%	9.35%	-52.00%	104.00%
ROA_2010	453	6.66%	8.86%	-52.33%	139.19%
ROE_2005	454	48.58%	793.43%	-630.00%	16902.00%
ROE_2006	454	12.65%	17.54%	-159.00%	181.00%
ROE_2007	458	17.54%	15.53%	-17.00%	121.00%
ROE_2008	460	20.70%	30.18%	-503.00%	128.00%
ROE_2009	460	18.00%	42.28%	-503.00%	522.00%
ROE_2010	453	15.61%	19.92%	-88.80%	169.19%
Cooperative Health*	453	8.01%	1.34%	2.00%	10.00%
Cooperative Characteristics:					
Employees	460	195.08	641.33	0.00	9738.50
CEO Tenure	451	10.40	8.66	0.50	50.00
Board Size	456	9.07	4.23	5.00	51.00
Independence (=1 if outside voter)	459	0.02	0.15	0.00	1.00
Board Equity (% held in total)	398	11.27%	16.70%	0.00%	100.00%
Female (No. of Female Directors)	437	0.13	0.37	0.00	3.00

•Respondends rated their co-operatives on a scale from 1=poor to 10=excellent on the following factors: Member Satisfaction, Competitve Position, Profitability, Achieve Vision and Overall Performance

Source: Franken and Cook (2013).

maximum tenure of 50 years. *Board Size* is the total number of board directors. The average board size is composed of nine directors. The smallest board has five directors and the largest board has 51 directors. *Independence* equals 1 if "at least one independent, non-patron director serves on the board and is extended voting rights" (Franken and Cook, 2013). Two percent of survey responses or nine co-operatives have independent, non-patron directors with voting rights. *Equity* is the percentage of ownership collectively held among directors. The average equity holding is 11.27% with a maximum equity holding of 100%. *Female* is the number of female directors on the board. The average number of female directors was less than one with the maximum as three.

Table 3: **CORRELATION MATRIX(N = 367)**

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
CEO Tenure	1																								
Log(Employees)	-0.01	1																							
Board Size	-0.07	0.55	1																						
Independence	-0.08	0.17	0.22	1																					
Equity	-0.01	-0.07	0.04	0.09	1																				
Female	-0.03	0.14	0.19	0.07	0.00	1																			
Coop Health	0.25	0.05	0.02	0.06	0.08	-0.05	1																		
ROA_2010	0.08	-0.11	-0.03	-0.01	-0.09	-0.05	0.07	1																	
ROA_2009	0.07	-0.08	-0.05	0.02	-0.04	-0.03	0.16	0.75	1																
ROA_2008	0.09	-0.03	-0.13	0.08	0.07	-0.07	0.23	0.19	0.34	1															
ROA_2007	0.02	-0.05	-0.07	0.07	0.09	-0.04	0.16	0.20	0.26	0.54	1														
ROA_2006	0.11	0.03	-0.03	-0.02	-0.04	0.02	0.21	-0.04	0.10	0.32	0.58	1													
ROA_2005	-0.05	-0.07	-0.06	-0.02	0.03	-0.02	0.06	-0.03	-0.04	-0.02	0.02	0.04	1												
ROE_2010	0.05	0.03	0.00	0.05	-0.08	-0.05	0.07	0.73	0.57	0.15	0.11	-0.01	0.06	1											
ROE_2009	0.07	0.03	0.01	0.05	0.01	-0.01	0.16	0.27	0.50	0.22	0.14	0.11	0.04	0.43	1										
ROE_2008	0.08	-0.01	-0.03	0.05	0.03	-0.04	0.19	0.07	0.20	0.44	0.20	0.16	0.05	0.14	0.80	1									
ROE_2007	0.04	-0.01	-0.05	0.06	0.04	-0.08	0.14	0.13	0.23	0.43	0.73	0.41	-0.01	0.28	0.30	0.39	1								
ROE_2006	0.05	-0.07	-0.07	0.01	-0.02	-0.05	0.14	-0.03	0.01	0.15	0.25	0.57	0.00	0.12	0.16	0.23	0.47	1							
ROE_2005	-0.06	-0.07	-0.05	-0.01	0.03	-0.02	0.03	-0.03	-0.04	-0.06	-0.06	-0.06	0.99	0.06	0.03	0.03	-0.06	-0.05	1						
EVI_20010	0.10	0.16	-0.03	0.01	-0.01	0.01	0.28	-0.22	-0.13	0.03	-0.11	0.16	-0.02	0.18	0.08	0.05	0.03	0.23	-0.03	1					
EVI_2009	0.07	-0.10	-0.06	0.02	-0.03	-0.01	0.20	0.63	0.88	0.28	0.16	0.11	-0.04	0.61	0.59	0.28	0.25	0.19	-0.04	0.10	1				
EVI_2008	0.04	-0.11	-0.12	0.07	0.00	-0.12	0.23	0.13	0.27	0.73	0.30	0.22	-0.02	0.20	0.31	0.59	0.57	0.44	-0.03	0.15	0.37	1			
EVI_2007	0.01	-0.11	-0.08	0.05	0.06	-0.05	0.16	0.17	0.22	0.41	0.75	0.42	-0.03	0.19	0.20	0.32	0.92	0.54	-0.08	0.00	0.27	0.60	1		
EVI_2006	0.05	-0.08	-0.06	0.00	-0.04	0.03	0.14	-0.06	0.02	0.11	0.22	0.55	-0.02	0.09	0.11	0.23	0.52	0.84	-0.06	0.27	0.17	0.51	0.64	1	
EVI_2005	-0.06	-0.08	-0.05	-0.01	0.03	-0.04	0.03	-0.04	-0.05	-0.04	-0.04	-0.05	0.99	0.04	0.02	0.05	-0.04	-0.04	0.99	-0.06	-0.07	-0.01	-0.05	-0.06	1

Source: Franken and Cook (2013).

The Measurement Models

The co-operative performance measure is treated as a latent variable in the two competing non-nested measurement models, but each model has a different set of indicators. In Figure 1 (see below), measurement model one is presented with five measures of co-operative health as determinants of co-operative performance. The five measures are *Member Satisfaction, Competitive Position in the Industry, Profitability, Ability to Achieve Vision*, and *Overall Performance*. These measures are important indicators in defining the objective function of co-operatives. The measures were rated by co-operative Board Chairs on a ten-point Likert scale with one equaling "poor" and ten equaling "excellent".

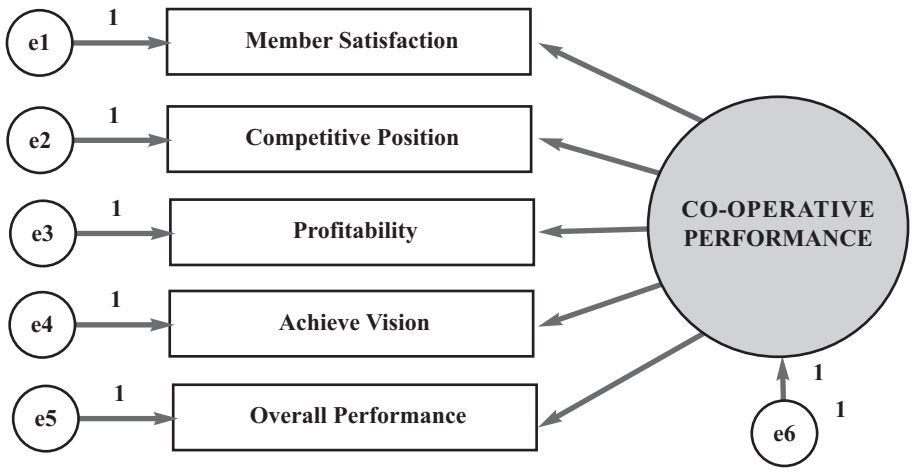

Figure 1. **Measurement Model One**

As shown in Figure 2 (see below), two indicators determine co-operative performance in measurement model two. The indicators are *Co-operative Health* and *ROE 2010*. The manifest variable measuring *Co-operative Health* is an average of the five measures listed above. Franken and Cook (2013) decided to create an overall *Co-operative Health* variable due to the high correlation among the five co-operative health measures .

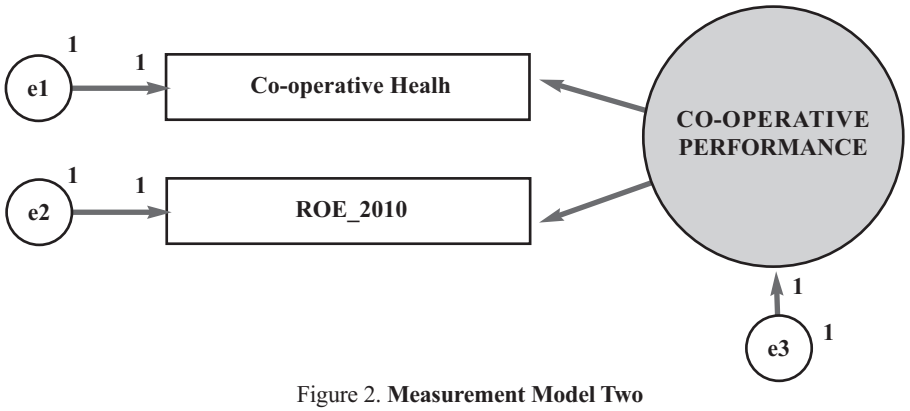

Figure 2. **Measurement Model Two**

Data and Methods

The results in this section were estimated using a maximum likelihood estimator in Amos, an SPSS add-on for structural equation modeling. The analysis of results from measurement model one and measurement model two is presented in the Appendix. Based on this analysis, the best-fit measurement model one is then chosen. Next, we introduce the complete structural model specifying the relationships between governance manifest variables and co-operative performance. This structural model is fitted to the data allowing us to test the hypotheses presented in the theoretical section.

The Structural Equation Model

With a chosen measurement model one, we now introduce the structural model to examine the hypothesized relationships between governance manifest variables and co-operative performance. The structural model includes the five manifest variables of interest: CEO Tenure, Board Size, Independence, Equity, and Female. In Figure 3, the complete structural equation model is presented[3]

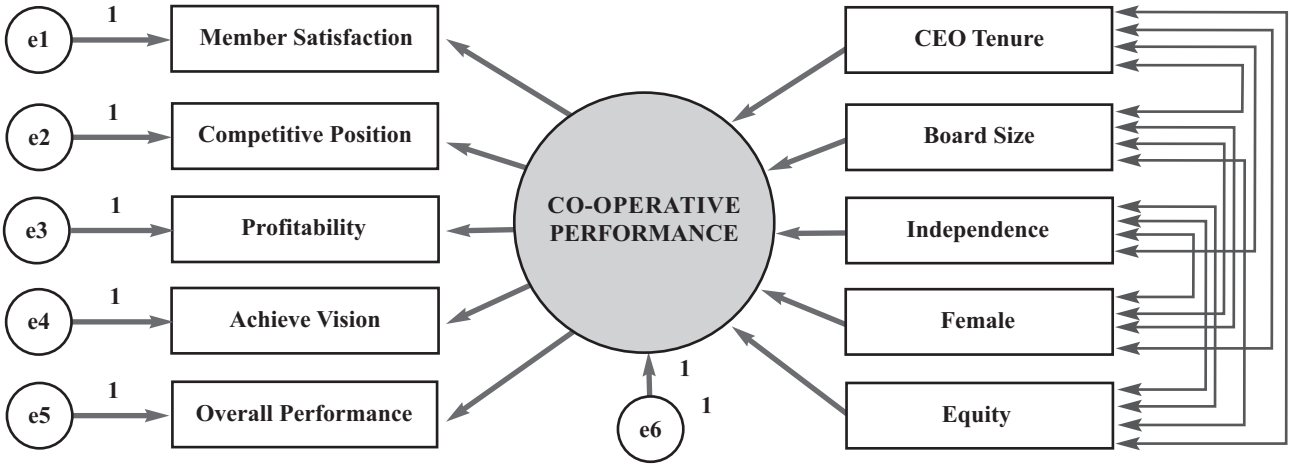

Figure 3. **Path Diagram: Structural Equation Model**

In Table 4, a summary of coefficients and fit statistics is presented for the structural equation model. Figure 6 presents the standardized results. Based on the chi-square fit statistic ($\chi 2 = 42.058$, 25 df, $p = 0.018$), we would reject the null hypothesis indicating that the structural equation model is not a good fit to the data. As noted in the Appendix, a small sample size could result in a significant chi-square. The other fit statistics (i.e. NFI = 0.973, GFI = 0.977, and TLI = 0.980) fail to reject the null hypothesis. Because of the additional fit statistics, we are confident that the structural equation model is a good fit to the data.

Table 4
ESTIMATED COEFFICIENTS AND FIT STATISTICS FOR STRUCTURAL EQUATION MODEL

	(1) Structural Equation Model
Board Size	0.010 (0.809)
Independence	0.739 (1.955)
Female	-0.123 (-0.854)
CEO Tenure	0.032* (5.039)
Equity Ownership	0.005 (1.637)
Competitive Position	1.212*
Profitability	1.424* (19.096)
Member Satisfaction	1.123* (17.301)
Achieve Vision	1.223* (20.176)
Overall Performance	1.311* (24.718)
X^2	42.058 (df = 25, p = 0.018)
Normed-Fit Index (NFI)	0.973
Goodness-of-Fit Index (GFI)	0.977
Tucker-Lewis Index (TLI)	0.980
N	373

*Denotes significance at the 0.001 level (two-tailed) • z-statistics in parentheses

As noted in the analysis of measurement model one, all five indicators of *Co-operative Performance* are statistically significant. *Overall Performance* remains the strongest indicator of *Co-operative Performance* and *Member Satisfaction* remains the weakest indicator. Only 9% of the variance in *Co-operative Performance* is explained by the five manifest variables, which suggests that governance variables alone are not strong predictors of co-operative performance. Adding control variables, such as co-operative size or industry dummies, might help increase the explained variance of the dependent variable in the structural model.

The estimated coefficient signs for the manifest variables were as predicted by theory except for the coefficient sign on *Female* and *Board Size.* We hypothesized that the presence of female directors would increase co-operative performance (Hypothesis 3).

The estimation results indicate that the presence of female directors actually decreases co-operative performance. Although the result is statistically insignificant, there are justifications as to why female directors might decrease co-operative performance. Of the sample frame, the average number of female directors was less than one with the maximum of three. Although female directors may be present in the boardroom, co-operative boards are still dominated by their male counterparts. The sample may be representative of the population, but there is not enough influence from the presence of female directors to make a statistically significant impact on co-operative performance.

We hypothesized that as board size increases co-operative performance would decrease (Hypothesis 1). The coefficient provides a positive, but statistically insignificant result. The organizational structure of co-operatives may support our rejected hypothesis. In co-operatives, board directors are member-owners elected by fellow member-owners. The dynamics of the boardroom are altered in terms of monitoring because there is separation between the CEO and board directors. The chance of managerial exploitation through director appointment is reduced. Because of this reason, a larger board in co-operatives may increase performance.

The coefficient estimates for *Independence* and *Equity* provide evidence for a positive, but statistically insignificant relationship with *Co-operative Performance.* The presence of independent directors increases performance (Hypothesis 2). Like the explanation for female directors, the statistically insignificant coefficient may be a result of low influence. Only nine co-operatives of the 459 observations had an independent, non-patron director with voting rights. The maximum number of independent, non-patron directors with voting rights sitting on a board was one. As predicted by theory, board equity ownership increases co-operative performance (Hypothesis 4). Board directors have more wealth to protect with a higher stake in the co-operative. Likewise, the statistically insignificant coefficient may be a result of low influence with the average board equity at 11.27% of total equity.

The only statistically significant coefficient is CEO Tenure. As tenure of a CEO increases, co-operative performance is expected to increase as well (Hypothesis 5). The organizational structure of a co-operative is the reason for this positive, statistically significant relationship. A co-operative CEO is better positioned to make well-informed decisions because the CEO is limited in power. This separation of CEO influence and board directors allows for longevity to be a positive attribute of co-operative performance.

As noted above, only 9% of the variance in *Co-operative Performance* is explained by the five manifest variables in the structural model. The relationships between *Co-operative Performance* and the manifest variables result in only one statistically significant causal path—CEO Tenure to *Co-operative Performance*. Adding control variables to the model and controlling for endogeneity will likely result in better fit of the structural model. Restating and perfecting the relationships between performance and the manifest variables may also increase model fit.

Summary and Conclusions

Our study contributes to the co-operative governance literature by treating co-operative performance in a novel way—as a latent variable. We provide evidence of a good fit measurement model with a high percentage of variation explained and strong fit

statistics. Based on the results obtained from the measurement model, we conclude that the best indicators of co-operative performance were qualitative measures (i.e. factors concerning the state of the co-operative's health) rather than quantitative measures (i.e. ROE, ROA). This finding suggests that co-operative performance is correctly modeled as a latent construct and should be treated differently from corporate performance. The different objective functions of co-operatives and IOFs determine the definition of performance. Because a co-operative is created for the benefit of its member-owners, factors concerning member satisfaction and the co-operative's ability to achieve its vision are relevant indicators of co-operative performance.

It is important to note that our study is one of the first attempts at using structural equation modeling in co-operative governance research. At the forefront of discovery, we were able to contribute a strong measurement model—which treats co-operative performance as a latent variable—to the literature. We find evidence that qualitative factors measuring the state of the co-operative's health best define co-operative performance. Further research should focus on the structural model with attention to defining the correct relationships between co-operative performance and the variables measuring board structure and CEO tenure.

Acknowledgements

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Notes

[1]In order to achieve model identification, the error variance (e6) on the latent variable (Co-operative Performance) is fixed to one. This assumes that the only indicator variables of Co-operative Performance are the ones specified in the model.

[2]A couple of assumptions are made to achieve model identification. The error variances (e1 and e2) on the indicators are fixed to one. The error variance (e3) on the latent variable Co-operative Performance is also fixed to one.

[3]The following assumptions are made to achieve model identification: the five indicator variables of Co-operative Health are measured with error, the error variance (e6) is fixed to one, the five manifest variables are correlated, and the five manifest variables are measured without error.

Appendix

Fit of the Measurement Models

In structural equation models, the null hypothesis states that the model is a good fit to the data. Based on the chi-square fit statistic ($\chi 2 = 12.692$, 5 df, $p = 0.026$), we would reject the null hypothesis for measurement model one. However, additional fit statistics must be analyzed to determine model fit because a small sample size could cause a significant chi-square value. In structural equation modeling, a non-significant chi-square is evidence of a good fit model. The most common reported fit statistics fail to reject the null hypothesis indicating that measurement model one is a good fit. In Table 5 (p 54), a summary of fit statistics is provided.

Columns (1) and (2) of Table 5 (p 54) report estimates of the coefficients for both measurement models. The standardized results for measurement model one are presented in Figure 4 (p 55). The results show that all five indicators of Co-operative Performance are statistically significant. The strongest indicator of Co-operative Performance is Overall Performance, which Co-operative Performance accounts for 92% of the variance. The weakest indicator, Member Satisfaction, has 59% of its variance accounted for by Co-operative Performance. The strong, statistically significant results in this measurement model lend additional evidence that the model fits the data well and co-operative performance should be modelled as a latent variable.

In measurement model two, we fail to reject the null hypothesis based on the chi-square fit statistic reported in Table 6 (p 54) ($\chi 2 = 1.012$, 1 df, $p = 0.314$). Several of the most commonly reported fit statistics provide further support that the null hypothesis cannot

be rejected. We therefore conclude that measurement model two is a good fit to the data. The standardized results for measurement model two are presented in Figure 5. Neither indicators (Co-operative Health and ROE 2010) are statistically significant measures of co-operative performance. Co-operative Performance accounts for only 3% of the variance in both indicators. The remaining 97% of each indicator's variance is accounted for by the unique factor (e3).

In selecting the best measurement model, we consider both how well the model fits the data and the statistical significance of latent variable indicators. In comparing competing non-nested models, we look at the models' AIC, BIC, and CAIC . All indices are lower in measurement model two. Measurement model two has a better fit to the data, but the coefficient estimates are not statistically significant. Measurement model one has a good fit, but it does not fit the data as well as measurement model two. All coefficient estimates in measurement model one are statistically significant. For this reason, we opted to use measurement model one in our structural model to test the hypotheses between governance variables and co-operative performance.

Table 5: **SUMMARY OF MEASUREMENT MODEL FIT STATISTICS**

	(1) Model One	(2) Model Two
χ^2	12.692 ($df = 5$, $p = 0.026$)	1.012 ($df = 1$, $p = 0.314$)
Normed-Fit Index (NFI)	0.991	0.437
Goodness-of-Fit Index (GFI)	0.986	0.997
Tucker-Lewis Index (TLI)	0.989	0.985
Akaike Information Criterion (AIC)	32.692	5.012
Bayesian Information Criterion (BIC)	71.908	12.823
Consistent Akaike Information Criterion (CAIC)	81.908	14.823

Table 6: **ESTIMATED COEFFICIENTS FOR MEASUREMENT MODELS**

	(1) Model One	(2) Model Two
Competitive Position	1.268* (18.719)	---
Profitability	1.490* (18.719)	---
Member Satisfaction	1.173* (17.290)	---
Achieve Vision	1.280* (20.225)	---
Overall Performance	1.372* (24.846)	---
Co-operative Health	---	0.183 (1.003)
ROE 2010	---	0.183 (1.003)
N	373	367

*Denotes significance at the 0.001 level (two-tailed) • z-statistics in parentheses

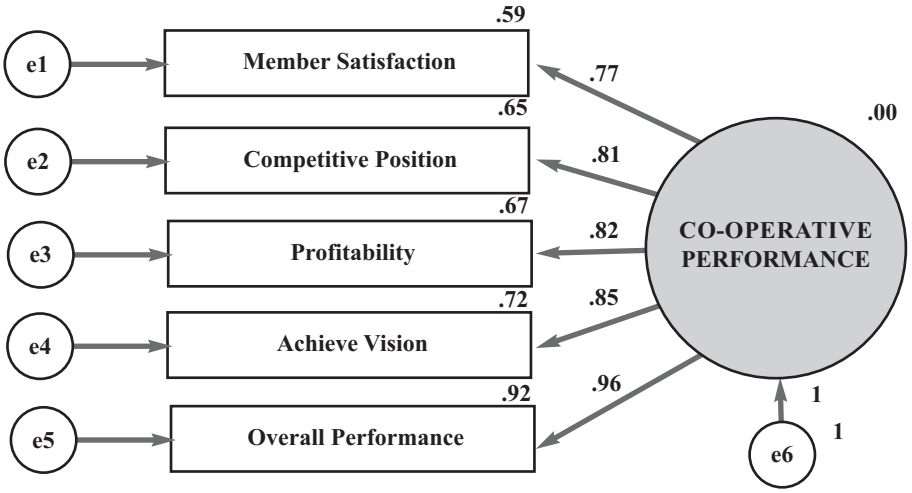

Figure 4. **Measurement Model One Results (N = 373)**

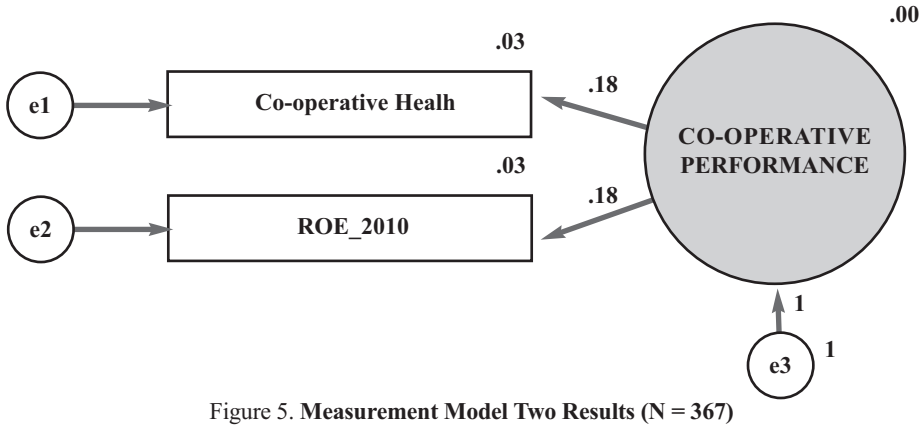

Figure 5. **Measurement Model Two Results (N = 367)**

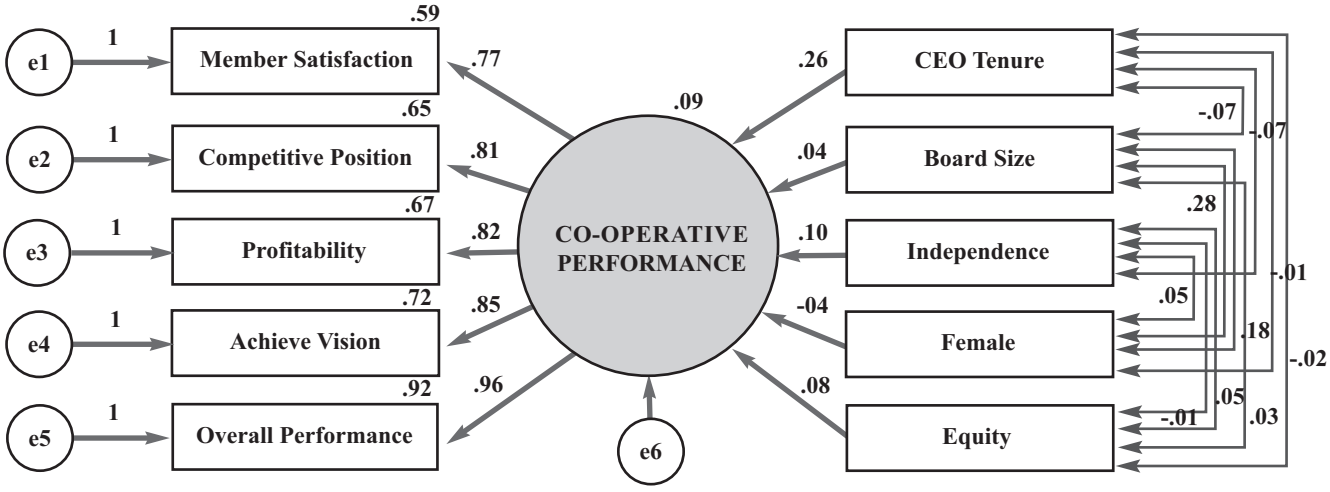

Figure 6. **Standardized Results for Structural Model (N = 373)**

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Multi-stakeholder Governance. A social enterprise case study

Silvia Sacchetti and Ermanno Tortia

Abstract

The scope of this paper is to highlight the features of multi-stakeholdership in the presence of contract incompleteness, and to provide an illustration with a focus on not-for profit social enterprises. Using case study analysis, we observe how the governance of a social enterprise has evolved to reflect changes in community needs. We show that the progressive inclusion of emerging organisations to achieve the much advocated balance of interests, as opposed to contractual coordination.

The findings highlight that multi-stakeholdership diffused co-operative attitude with which founders and managers created a network of patrons, who give voice and answers to specific social needs.The paper then builds on these findings to elaborate on the factors that affect the survival of the social enterprise. Our major conclusion in this respect is that, over time, the internalization of relevant contractual effects within organizational boundaries can guarantee economic sustainability and the production of broad societal value.

Key Words

Contract Incompleteness; Deliberation; Inclusion; Internalization of Contractual Effects; Networking; Multi Stakeholder Governance; Social Enterprises; Social Co-operatives.

Introduction

The paper highlights the features of multi-stakeholdership in the presence of contract incompleteness and provides an illustration with a focus on not-for profit social enterprises. Using case study analysis, we observe how social enterprise governance has evolved to reflect changes in community needs by means of the progressive inclusion of emerging patrons. We argue that such changes are at the heart of the social and economic performance of the organisation and of the welfare of patrons and communities.

Below we highlight the theoretical argument that supports multi-stakeholder governance, drawing upon a variety of effects that point out that shared decision-making amongst patrons functions as a source of welfare for groups and for the collective as a whole. The first part of Section Two considers the argument of incompleteness related to contractual forms of coordination. The second part considers the ability of deliberative and co-operative praxis to increase communication and knowledge production, improving trust and therefore overcoming decision-making costs through the production of positive effects. The first part of Section Three considers the methodology and introduces the case study. Section Four presents our findings. A discussion follows. In Section Five we present a rejoinder with an update of the analysis following the economic crisis. Our concluding remarks in Section Six consider more broadly the implications for the debate on the actualisation of multi-stakeholder coordination.

The main ends of patrons in the context of the social enterprise do not coincide with the exclusive pursuit of private benefits but rather with the pursuit of social goals. The institutional arrangements that reflect pro-social and inclusive motivations are (i) limited distribution of profits, (ii) the explicit social goal of activities, and (iii) the presence of a plurality of patrons in the board of directors[1]. All of these features are coherent with the realization of a governance structure that builds on heterarchical or horizontal power relations with the aim of allowing inclusion and preventing the imposition of exclusionary objectives (Sacchetti and Sugden 2003). Institutional literature suggests that in

contexts where control over strategic aims is not exercised in an exclusive way and where coordination occurs by means of constant and intensive communication, contrary to the neo-institutionalist approach, ownership costs can be reduced[2].

As advocates of democratic governance suggest, participation in strategic level of decision making supports patrons' understanding and motivation to carry decisions through also at operational levels (Ostrom, 1990; Ben-Ner and Gui, 1993; Poteete, Janssen, and Ostrom, 2010). Besides, deliberation as praxis can become less costly as patrons learn how to debate and respectfully share knowledge and perspectives. There can be, in other words, a learning curve that lowers the costs of decision-making even in the presence of multiple patrons. Some of the literature also points at the role of trust (Sacchetti and Sugden, 2009; Uzzi, 1999; Gambetta, 1988; Fukuyama, 1995,1999; 2001). When trust is in place, commitment extends beyond contractual specifications, emphasising flexibility and responsiveness to changing environmental conditions and needs. This aspect is even more relevant when taking into account complexity and uncertainty surrounding the production of social services (a sector of activities where social enterprises are particularly diffused), which would increase not only the cost of the service but also the costs of contracting, monitoring, sanctioning and coordinating multiple patrons. Trust therefore is a strategic and dynamic resource, or a *multiplier of social value*. Trust in fact can leverage social benefits by reducing costs and by increasing responsiveness to a changing context, for example by facilitating knowledge sharing, and the introduction of social innovation.

In these respects, multi-stakeholder organisations show the potential to produce a social surplus that goes beyond the simple sum of what would be attained through contractual interaction, or through conventional organizational forms, both private and public. The ability to identify and involve different groups of patrons, bringing in multiple objectives and values, can result in the production of a social surplus (both monetary and non-monetary) for the actors involved. The outcomes of inclusive, deliberative processes can lead to specific welfare benefits, for example: improved quality of life, related to different aspects of the work environment; strengthening of social relations in the community; improved quality of services for users; decreasing social inequality (Deci and Ryan, 2000; Erdal, 2011; Wilkinson and Pickett, 2009).

One further implication is that prices can be lower and under specific circumstances services can be offered without fees or at non-market prices for the beneficiaries (Borzaga, Depedri and Tortia, 2010). Given the social objective of the organization, costs can be reduced and benefits increased for some patrons as a result of intrinsic motivation, good communication, trust and social capital. Lower prices can be attained also because the non-profit and social orientation of multi-stakeholder co-operatives helps to gather non-market resources, such as partial or complete work donations (partially non paid or volunteer work), and other typologies of donations, which correspond to cost and price reductions and increased supply of services, hence to increased social surplus (Tortia, 2010).

Furthermore, the constraints imposed on profit distribution support the accumulation of funds that can then be used for social, instead of private, purposes (Borzaga, Depedri and Tortia, 2010). On the other hand, not all benefits reach every group in the same way, since each effect is expected to benefit mainly the patrons that actively participate in the venture. For example, literature stresses that increased employee welfare and improved working conditions are conditional to the inclusion and active participation of workers in deliberative processes regarding organisational issues and objectives (Erdal, 2011).

Despite the benefits emphasised from multiple perspectives in the literature, what is lacking is an understanding of how multi-stakeholdership can be applied in practice, or how organisations achieve the much advocated balance of interests, as opposed to contractual coordination. Our following sections address this issue.

Contract Incompleteness

Multi-stakeholder governance accounts for the internalization of those effects that derive from the specificity and originality of the activity, in terms of the knowledge, expertise and social capital involved in the production of the service, or in terms of material assets. Uncertainty and the need for flexibility is also a crucial determinant when designing coordination mechanisms (Borzaga and Tortia, 2010; Sacconi and

Degli Antoni, 2010). These immaterial elements are not captured by contractual relations and require complementary forms of coordination that acknowledge social exchange in production relationships, such as moral obligations, reciprocal commitment and embedded trust, as emphasised by institutionalism, game-theoretic and experimental approaches (Granovetter, 1985; Homans, 1961; Macneil, 1980; Poteete, Janssen and Ostrom, 2010; Fehr and Gächter, 2000; Sacconi and Degli Antoni, 2010).

The contractual approach relates contractual imperfections with the presence of asymmetric information, complexity and uncertainty (Knight, 1921; Grossman and Hart, 1986; Aghion and Holden, 2011). Social service provision is one of the main sectors of operation of social enterprises and is characterised by fragmented needs and complexity of responses. It therefore touches upon a multiplicity of interests and stakeholders.

The impossibility to write complete contracts is even more relevant in multilateral relations, in terms of raising contractual costs, but also because the immaterial aspects of the relation are difficult to monitor and essentially impossible to price (Muthusami and White, 2005). For example, reciprocating behaviour can be more difficult to assess with multiple partners.

How is reciprocating behaviour assessed? What do actors understand by reciprocating? Some degree of proximity of values and aims must be entailed (Sacchetti and Sugden, 2009). The production of the service requires that the network of patrons share fundamental values, have common aims and build the relation on a high degree of trust. Trust distribution can however change over time, according to how patrons experience their relation with each other. And this clearly adds to the problem of uncertainty.

More generally, the contractual perspective argues that the necessity to simultaneously pursue the objectives of, for example, users, producers, government and those of the community of reference, could not be achieved effectively solely through contracts only, due to the problems emphasised above. In assessing the costs of internal governance vis à vis contractual costs, the contractual approach would nonetheless suggest that, as the complexity of administered transactions increases, agency and other organizational costs increase as well, bounding the development of the enterprise (Hansmann, 1996; cfr. also Borzaga, Depedri andTortia, 2011; Giudi, 2011)

Instead we argue that unified governance that provides a deliberative space where interests, possible trade-offs and behaviours can dynamically evolve through interactions can represent a win-win solution. The internalization of contractual effects within the boundaries of the organization leads to the reinterpretation of internal relations where the interplay between individual patrons and organizational objectives is mediated by trust and commitment (Okun, 1981). Procedural fairness and transparency create the conditions for developing trust, in a way that is more similar to the working of psychological contracts than to the working of explicit contracts (Rousseau, 1995; Tortia, 2008; Leonardi, 2013).

The reduction of organizational costs is one of the main expected and desired outcomes of a governance model based on inclusion, in which trust is both an input and an output in organisational processes. That is, the existence of relations based on trust favours ex-ante the reduction of transaction costs and the implementation of implicit contracts while, at the same time, organisational processes can help to create and strengthen new relations, for example though reciprocating behaviours (Fehr and Gächter, 2000; Zamagni, 2005, 2012). Such processes can also favour the endogenous accumulation of localized social capital in a way that is not achievable by market exchanges (Sabatini et al., 2013).

Inclusion and deliberation

The internalization of external contractual effects into the objective function of social enterprises implies the existence of a deliberative space where the elaboration of complex information, knowledge and experiences can gather and evolve, such as staff teams, the assembly of members, elected and appointed bodies (Sacchetti 2013). These relations and flows have a relevant and non-codifiable tacit dimension (Polanyi,

1958, 1967). By promoting deliberative processes and communication, multi-stakeholder governance can generate a learning culture that favours enquiry and inclusion. Deliberative processes, in this respect, have been specifically advocated because of their potential to activate individual creativity and generate new knowledge (Sacchetti and Sugden, 2011).

Deliberative and inclusive processes are also expected to activate positive psychological effects. In particular they have been associated with the satisfaction of basic psychological needs such as competence (the mastering of abilities such as learning and creativity), autonomy (the feeling that an act is connected to the individual's critical judgement) and relatedness (the feeling of belonging or being connected to a group) (Deci & Ryan, 2000). Taken together, these aspects of involvement positively affect individual welfare, in terms of health (Erdal, 2011), satisfaction, and firm performance (Lawler, 1986; Arthur, 1994; Appelbaum, Bailey, Berg & Kalleberg, 2000; Guest, 2011; Wood & Wall, 2007).

Moreover, because it reinforces trust and reciprocity, deliberation has been associated with co-operative behaviour and trust (Ostrom, 1990; Sabatini et al., 2014; Sacchetti, 2013). Besides improving the work environment and answering to specific psychological needs, co-operation and trust also decrease the costs of transactions, thus boosting the production of social value. It follows that inclusive governance and deliberative practices can lead to the private provision of public and collective goods, such as trust and improved knowledge. This, in turn, can help to overcome contractual failures and to include the objectives of multiple patrons.

The Case Study

The case study was conducted in Faenza (Emilia Romagna Region in Central Italy) at the Educational Co-operative for the Faenza Families (CEFF), an organisation that comprises two social enterprises incorporated as co-operatives. They offer both employability services and labour integration for the disadvantaged. In analysing this experience we illustrate how the progressive integration of patrons, demanding and offering specific services, has been actualised by the social co-operative system. In this process contractual limitations and costs have been overcome, new social value has been produced, while the growth of organizational costs has been kept under control.

Socially oriented co-operatives, the most relevant Italian sub-category of social enterprises, can be considered a third typology of co-operative firm, besides the more traditional supply and demand side co-operatives, which historically emerged earlier. The initial examples of social co-operatives date back to the late 1970s (Borzaga and Ianes, 2006). Their origin is connected with initiatives of social activists, directed to supplement public intervention in the delivery of social and community services. This extended dimension of mutuality appeals to the systemic role of co-operatives, characterized by feedback mechanisms with the surrounding environment, for example in terms of production and accumulation of social capital, as well as pursuit of socially relevant objectives (Sabatini et al., 2014).

Methodology

The case study approach has been chosen as the preferred research method since we required mostly qualitative data that would allow us to trace the path undertaken by the organisation, and build an understanding of the motivations as well as the contextual and historical conditions that impacted on governance choices. This perspective was required since strategic choices and implications had to be observed over the years within an evolving political and economic context, and across multiple patrons. Our data collection has addressed secondary data in the form of organisational reports, as well as primary data collected by means of structured in depth interviews. Interviews took place as extended conversations guided (albeit not exclusively) by a number of questions that the interviewer had designed for each category of patrons. The scope of the questions was wide. It embraced: (i) the organisation's profile in terms of typology, mission and sector of activity;(ii) the evolution of the organisation and its critical episodes; (iii) the organisational structure and the nature of membership;(iv) the relation with institutional stakeholders (i.e. public administration, job centres); (v) the relation with other organisations;

(vi) workers' participation; (vii) the relation with users and the quality of services; (viii) the relation with the local community and the contribution of the organisation to community development; (ix) the external network and its integration with the organisation's activities.

We proceeded by contacting one of the managers at CEFF who was at the time directly involved with the research and development strategy. This first contact was aimed at explaining the research aims and modalities and also at identifying the key individuals to interview. A first meeting was scheduled during which the research was explored in depth. On the basis of the themes to be addressed, the director identified a number of key informants internal and external to the organisation. During this first face to face meeting we collected also sources of secondary data and proceeded with the first interview with the director in question. All the other interviews (eight overall) were undertaken between November 2005 and January 2006. Recent developments at CEFF were then researched with an unstructured interview undertaken in 2013 with the then R&D manager.

Each interview lasted between one and two hours, was recorded, transcribed and then utilised, together with secondary data, to extract our findings. In particular we interviewed the President, the Director, two managers (R&D; HRM), two disadvantaged workers (former drug addicts), one volunteer worker, the City Councillor with a remit on social services. The additional materials included (i) a mission document of the CEFF system, (ii) the social balance sheet; (iii) the "Carta deiservizi" (an internal document that defines the characteristics of the services offered, the delivery method, and the impacts expected. This is a form of self-regulation that operationally defines how to achieve the aims of the organisation); (iv) the organisational structure of CEFF Servizi.

The CEFF System

The CEFF system exemplifies many of the governance issues discussed above. The CEFF system is now constituted by one Type A and one Type B co-operative, but when founded, in the Seventies, the original co-operative was one, with the main aim of offering educational and recreational services for local disadvantaged families in Faenza (Emilia-Romagna, Italy). Its founder, Francesco Bandini, was at that time a volunteer in the movement Catholic Action, and later was elected Council member with the Christian Democrats. After the defeat in the local elections of the Christian Democrats in 1975, the City Council administration was won by the Left. From an analysis of the political defeat, some of the Catholic party leaders concluded that the electorate's support could be won back by re-building ties with the local community. From this aim originated the idea of addressing the recreational social needs of the local families. CEFF organised family holidays on the nearby Adriatic coast managing a number of Council "vacation houses." Later, after these houses were closed, in 1988 CEFF was transformed and later renamed CEFF Francesco Bandini following the death of its founder. The new CEFF Bandini was intended to support families in a different way, i.e. by supplementing the Council's employability services for disabled persons. CEFF became a "social-solidarity co-operative" (Borzaga & Ianes, 2006).

The long process through which the organisational structure developed was completed in 1998 with the creation of CEFF Servizi, which represented the incorporation of the protected workshops already existing since the 1980s at CEFF Bandini. CEFF Servizi was created as spin-off of CEFF Bandini and constituted as a Type B work-integration social co-operative. CEFF Servizi employs some tens of disadvantaged workers, mostly disabled, but also a significant number of ex-drug addicts. Nowadays, the two organisations represent a highly integrated system, though they also acquired over time a degree of independence. CEFF Bandini delivers social services beyond the assistance that is required by disadvantaged workers at CEFF Servizi. In parallel and complementary, CEFF Servizi is a manufacturer producing mostly intermediate goods for local client firms.

The process of creation and development of the CEFF system can be well reconciled with the theoretical insights developed in the first part of the paper. In general terms, the need to create a dedicated organization derived just from the difficulties

encountered in arranging social entrepreneurial action both within the public sector and on the basis of simple market exchanges. The creation of an independent organization in the social economy, in the words of its managers and of the City Council Councillor, allowed the implementation of more effective coordination mechanisms between different actors (volunteers, the families of the disabled persons, the industrial firms in the locality, and the social services department at the City Council).

This process allowed the reduction of contractual costs and limitations derived from imperfect information, incompleteness and diverging objectives of the different groups of patrons. Also, the implementation of integrated governance succeeded in strengthening trust among the involved actors and lowered organizational costs relative to what would have been achieved in the public sector, for example, in terms of the cost of bureaucracy and collective action. Furthermore, it allowed the creation and preservation of new organization-specific knowledge, the lowering of social costs and the production of new social and economic value deriving from the employment of otherwise unemployable persons.

Between 1989 and 2006, 82 individuals were integrated in the job market. A significant element of impact is also related to the distribution of value added. In 2004 the turnover of CEFF Bandini was €1.071 million Euros, corresponding to a total net value added of €587,000. Of this, 85% was distributed to personnel and 10% to users (by means of benefits such as lunches, integrative educational activities, short holidays, vouchers etc.).

CEFF Servizi had, in the same year, a turnover of €966,000, which corresponded to a net value added of €497,000. Twenty-one disadvantaged workers were allocated 63% of the value-added, reflecting the aims and activity of CEFF Servizi, whilst 36% went to other employees. These impacts fall entirely within the Faenza's community. Many resources are contributed directly from the local community, whose contribution, besides workers, goes also to the organisation, the State and the solidarity co-operative funds.

Table 1: **NUMBER OF INDIVIDUALS DIRECTLY INVOLVED IN THE ACTIVITIES AT CEFF (2004)**

Type	CEFF Bandini	CEFF Services	Former users working in for-profit firms	Total
Ordinary Members	91	31	-	**122**
Volunteer Members	26	6	-	**32**
Employees	15	9	-	**24**
Disadvantaged Employees	-	16	24	**40**
Users	32	-	-	**32**
Total	**164**	**62**	**24**	**250**

Impacts

In 2004 the two CEFF co-operatives employed 122 ordinary workers, 32 voluntary workers, 24 standard employees (non-members), 40 workers with employability difficulties (differentiated into active employees, and ex-employees reintegrated in the labour market). Users were 32. In total, about 250 people were involved in the activities of the CEFF system (Table 1).

Structural evolution

Over the years, CEFF has responded organically to the needs of its multiple stakeholders by dividing into two democratically governed subsystems. Crucially, by distributing substantial control powers to patrons, CEFF has prepared the social mission for multiple and varying aims. Started by a group of volunteers, over time it came to include in its governance a variegated set of different patrons (employees, the parent association of disabled workers, non-profit organisations that assist disadvantaged workers and families also outside of the working environment, the local business association, and the job centre).

The ultimate change in CEFF's rules, near the time the interviews were carried out in 2006, concerned the inclusion of workers as patrons of the organisation. This required the extension of membership rights to both ordinary employees and disadvantaged workers. Discussions about the possibility and opportunity to allow all workers, and especially the disadvantaged ones, into the membership had been going on for several years and, as a result, all workers under labour contracts who wish to become members can now do so. The long duration of these processes is a testimony to the organizational complexities and to the need to keep under control the organizational costs connected with the creation of suitable inclusion and coordination mechanisms addressed to fill contractual incompleteness by involving the main stakeholders (employees in this case).

This governance change came 30 years after the creation of CEFF. CEFF Bandini was in fact born as a volunteer run organisation (volunteers are still present on the board of directors and as practitioners), in which a key role has been played also by associations dealing with the social reintegration of disadvantaged people, and by their parents. However, eventually further steps were taken in the direction of considering workers as active and involved stakeholders (Table 2).

Complementarily, a prolonged process led to the introduction of a new quality system for manufacturing activities, as the R&D manager explained in one of the interviews, and of a renewed recruitment approach, as the HRM manager pointed out.

The crucial feature of recruitment, in particular, lies with the screening of applicants based on the degree of intrinsic and social motivation, more than on educational attainments and previous work experience. In the Italian environment CEFF has been able to innovate in their recruitment practices, shifting from the standard focus on productivity to a different focus based on pro-social values and motivations. This[3] process also shows how pro-social attitudes can be factored in the construction of contractual agreements, reducing costs derived from diverging interests between the employer and the employee.

Connections with different associations and with the social service department in the municipality were sought for and developed over time. More generally CEFF evolved its membership by searching among the actors involved in the sharing and design of common initiatives, e.g. the development of new training methodologies, production, service delivery, assistance, the creation of new collective organisations such as consortia. CEFF's extended network (which overlaps with most of the patrons included in the organisation's board) specifically included the Municipality's Social Services; SIIL – The Local Employment Agency supporting access to labour market of disadvantaged people; Il Sol.co. (consortium of co-operatives); Assindustria Faenza (Industrialist Association);Other non-profit organisations (e.g. 'In Cammino', 'Giovanni XXIII'); for-profit firms; IRECOOP (Local co-operatives association); CGM (National consortium of social co-operatives); Local Catholic Churches.

Table 2: **PATRONS INCLUDED IN THE BOARD OF DIRECTORS AT CEFF**

Internal stakeholders	External stakeholders
• Volunteers (members of the board of directors and practitioners) • Employees • Users	• The Municipality's Social Services (The Local Community) • SIIL - Local Employment Agency supporting access of disadvantaged people to the labour market • Assindustria Faenza (for-profit firms) • Other non-profit organisations eg "Giovanni XXIII" • ANPAS - Parents' association

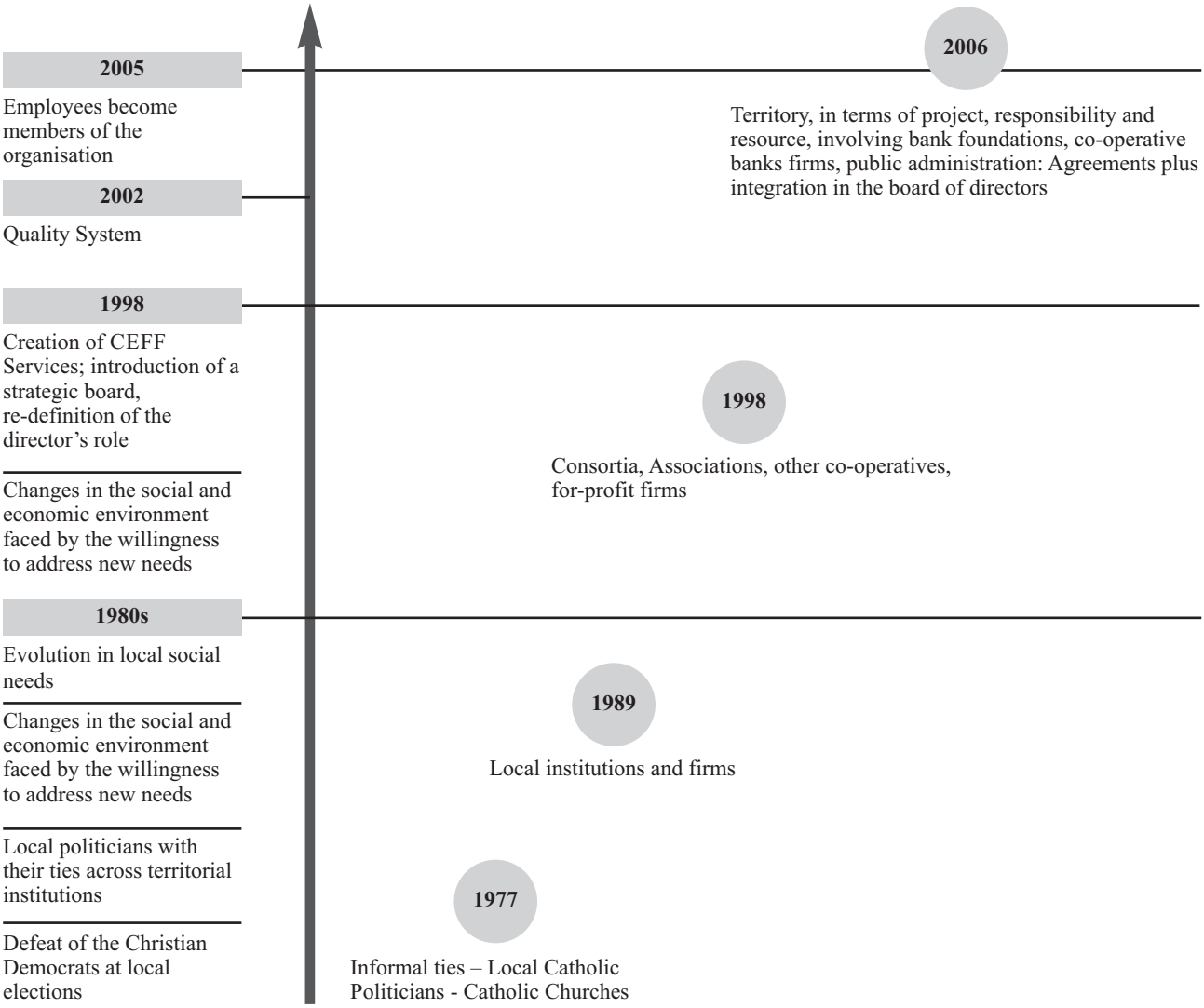

Figure 1: **Environmental Changes and Network/Governance Evolution**

Our field work did not evidence the dominance of the objectives of specific groups of patrons over others and few, if any, frictions amongst different constituencies were recorded over the years. These outcomes confirm the good quality of processes and objectives, right from the statements of aims inscribed in the Statute of the CEFF co-operatives. The social mission was constantly assessed and updated (the move from recreational activities to social services, then adding work integration) and taken as the yardstick against which to evaluate decisions (such as the inclusion of a variety of constituencies over the years). These results have been supported by crucial regulatory elements building up governance of the organization:

- Values laid down by the founders of CEFF;
- Working rules of the organisations: e.g. in terms of regulating turnover in presidential and managerial positions; in the formal and informal processes of consultation and deliberation with other members; in the transparency and formalization of procedures put in place to promote personal development and to provide a career path to individual users;
- Emergence and choice of managers who understand and share the social values of the organisation;
- Contribution and control exerted by volunteers, who also happen to have a public sector background;
- Centrality of local social capital. In particular, different forms of participation have been gradually nested over the initial core created by volunteers and social activists.

The inclusion of new patrons and the design of tailored forms of participation (both in the governance of the organisations, and in managerial models) has not endangered, but instead it has empowered strategic and operational capabilities. New organisational processes have created synergies with the existing ones. In our view, this positive result is to be ascribed to the careful evaluation of new needs, rules and governance procedures, and to the deliberative and inclusive character of the decisions taken. Long deliberative processes helped to clarify, evolve and pursue the social mission, while contributing to build a relevant patrimony of non-codified knowledge and trust. Many of the processes within the organisational boundaries would have proven unmanageable on a contractual basis. For example, the services and advice offered by the associations that were actively involved in the governance could not have been exchanged through arm's-length market relations.

The dynamic of organizational development at CEFF shows that decision makers were able to strike an effective balance between the need to innovate and foster change in the way the organisation was governed, and the risks posed by such change in the presence of delicate (though not necessarily unstable) organisational equilibrium. This balance was just struck through an open approach whereby inclusion is a progressive element of structural change. This required resources in terms of time and effort in the search for publics and adequate governance solutions allowing the overcoming of contractual failures.

Additional governance costs resulted in a more than proportional growth in social benefits. Also, the features of the involvement processes at CEFF suggest that a high degree of participation necessitates, as a precondition, a high degree of managerial independence in decision- making. This independence was granted to hired professionals who have been in charge of designing strategic regulatory codes and of implementing decisions accordingly. One reason for granting a high degree of independence to decision makers appears connected with the complexity of organisational problems. A second reason is to be found in the heterogeneity of the interests and motivations characterizing different constituencies. For example, the primary objective of business associations lies with securing an adequate level of productivity and work efficacy by disadvantaged workers. On the other hand, the charitable organisations sheltering many disadvantaged workers demand their reintegration in the social context.

Managerial independence and discretion resulted in the guarantee of an acceptable equilibrium between sharply competing ends. This is coherent with a perspective in which the managerial function is not one of pursuing exclusively or predominantly the maximization of economic returns, but much more one of designing and guaranteeing the accomplishment of appropriate organisational equilibrium that mediate between the different objectives of different constituencies (Blair and Stout 1999). The message supported by the CEFF experience is that the managerial function in socially oriented organisations is strictly connected with the ability to seek and guarantee active participation and, at the same time, with the capacity to accomplish effective decisions.

Our fieldwork also supports the view that economic aggregates such as costs, turnover, and net residuals work as parameters for assessing economic sustainability. They are not the objectives of the organisation, but they are instrumental to such objectives. Indeed throughout the history of CEFF, their relevance, though not concealable, appeared quite limited when compared with the matters arising from the complex host of social problems and governance issues that these organizations have been facing.

The CEFF system in the midst of the economic crisis

Starting from 2007 the economic crisis hit the whole Italian economy, whose GDP shrank by 5% in 2009 and shrank again by 2.1% in 2012. The unemployment rate grew to 10.7% in 2012, peaking at 12.2% in August 2013 whilst youth unemployment reached the astonishing figure of 40.1% in July, and 40.4 in September 2013. The

NEET (Youth Not in Education, Employment or Training) reached 23% in the same period (IMF and ISTAT data)[4].

The local economy in Faenza has not been an exception and all actors, both private and public, have been forced to look for ways to escape the worst consequences of the crisis. Throughout these difficult years the CEFF system has shown admirable stability and resilience, even if difficulties are being encountered with counteracting manoeuvres being activated. Overall, the system kept on relying on both the public procurement contracts and sales to the private sector. About half of the turnover has been stably obtained from public procurement for the delivery of socio-assistance and healthcare services (about 25%) and from other deliveries to the public sector (about 25%). The remaining half of the turnover is currently obtained (as before the crisis) from sales of goods and services to private actors.

The two components (public and private) show, however, different dynamics. Sales on the private markets witnessed growing instability and forced the CEFF system to look for new and more promising alternatives to the traditional delivery channels. On the other hand, public procurement bids and other contracts with the public sector showed a slow but inexorable decline. This is strictly connected with the severe crisis of Italian public finance. Social co-operatives are being used as a way to externalize and reduce public expenditure, imposing on them shrinking margins and cuts in labour costs. Overall, while the instability of the market is causing concern, the private channel appears to be the most promising direction for the development of the CEFF system.

To face the crisis on the private market the CEFF system has strengthened network ties outside its boundaries, in the search for more effective solutions to economic and financial problems. In particular CEFF has fostered networking aimed at implementing partnerships with the public sector for the reintegration of disadvantaged people, and community level networks aimed at local development initiatives. With this prospect, new sectors of activity have been envisaged and are being developed, including mainly: the production of organic goods in the agri-food processing sector, the development of fair trade channels, and the installation of eco-friendly appliances (photovoltaic panels) and waste management.

Looking more closely at the evolution of accounting figures, occupational levels at CEFF have been stable throughout the crisis, even in the presence of slightly shrinking revenues and strongly shrinking positive residuals (profits). The granting of employment stability to the whole workforce has been an explicit choice, since the co-operative is conceived as an organization informed by solidarity and common social rights, and is instrumental to the fulfilment of employees' objectives, that is to grant "employment insurance" to their workforce (Miyazaki and Neary 1983; Navarra 2010; Albanese, Navarra & Tortia, 2012).

The desire to protect employment levels may eventually come to conflict with the development plans of the organization, if the economic crisis continues. Indeed, investment levels are stalled, but this appears to be mainly due to the contextual uncertainty and to the constraints that socially oriented businesses encounter in gathering sufficient finance from intermediaries. While these organisations appear stable and less risky than other entrepreneurial forms, their ability to gather finance on the market is often more constrained than in the case of commercial companies since financial intermediaries tend to see in social businesses a low degree of financial reliability.

Conclusion: implications for theory and practice

Collective action, coordination, the evolving network of relations, and the emergence of co-interested patrons can help improve social welfare beyond the objectives of individuals or specific groups. This process passes necessarily through the conception and implementation of proper governance mechanisms that are able to coordinate the involved actors closely and in the long run, beyond what would be achieved by means of simple contractual exchanges. The internalization and coordination of complex contractual effects characterized by incompleteness and imperfect information is indeed one of the main functions

of organizational governance.

For example, by employing disadvantaged workers, social co-operatives aimed at work integration have been able to reduce social costs, to decrease unemployment, and contribute to production through the involvement of different groups of patrons, i.e. volunteers, social activists, disadvantaged workers and their families, and meso-level associations. These constituencies are involved following a process of social interaction that uncovers their needs, as well as the practical ways in which the organisation could contribute to their satisfaction. At a more fundamental level, welfare outcomes require, as a precondition, overcoming profit as the main objective, which pairs the satisfaction of the needs of non-investor stakeholders.

The idea of multi-stakeholder organisation can be broadened by understanding the organisation itself as a network of co-interested and co-motivated actors (Sacchetti, 2013). Indeed, the evolution of the organisation is favoured by the social ties of patrons. At the same time, linkages evolve together with the organisation since interconnections, like the body of knowledge and experience that they carry, are constantly incomplete. Being a privileged terrain for inclusive deliberative processes, multi-stakeholdership offers a favourable environment for the discovery of new interested patrons and for constructing new relations. These patterns can take place inside the organization, but also with actors that exist outside the organizational boundaries (Sacchetti, 2013). In co-operative firms, mutual benefit finds its preconditions in the inclusive nature of governance and its reliance on trust relations, social capital and communicative rationality, rather than directives (Sacchetti & Sugden, 2003; Zamagni, 2012).

The study shows that patterns of interaction based on the search of patrons and their involvement requires openness and a preference of decision-makers towards inclusion, social goals and reciprocating behaviours (Ben-Ner and Putterman, 1999; Sacconi, 2011; Sacchetti 2013; Zamagni, 2012). Over time, a process of discovery and on-going inclusion has given CEFF its multi-stakeholder structure. This pluralistic governance choice has allowed the enterprise not only to respond to the needs of specific patrons but also to overcome a variety of contractual imperfections. Our major conclusion in this respect is that, over time, besides and beyond the strong intrinsic motivations of the founders, the internalization of relevant contractual effects within organizational boundaries can lead to the resilience of the organisation and to the production of broad societal value.

Yet, the inclusion of different groups did more than just overcome contractual failures. Participation and other inclusive practices have created and strengthened trust, which has greatly reduced potential and actual conflict. In this way, the feared exponential growth of organizational costs has been kept at bay. Participation has also favoured the creation of novel knowledge, specific to the effective delivery of social services. Crucial social effects connected with the exclusion of disadvantaged workers have been internalized and re-addressed, thus reducing social costs.

By lowering the costs of exclusion and heightening solidarity in favour of the weakest, CEFF succeeded in increasing the welfare of many families in Faenza and of the community as a whole. On the other hand, inclusion has not compromised the effective delivery of services and efficient production of goods. The CEFF system achieved remarkable standing in production efficiency, and in product and service quality, as exemplified by the subcontracting arrangements with a number of client firms in Faenza. Finally, networking has been crucial in the development of the governance structure, both internally in terms of relations amongst directly participating stakeholders, and externally across the community and the different publics.

To conclude, we underline that the aims and process established at CEFF have not, so far, been halted by the economic crisis that hit the Italian economy over the last few years. The strengthening of network ties also in new sectors of activity allowed the CEFF system to achieve stability and resilience, the shrinking support by the public sector and the instability of the market

notwithstanding. The processes that led to the formation of this multi-stakeholder co-operative were led by forerunners in social activism, but they do not seem to be exhausted, as new patrons were involved overtime and became active in regenerating social entrepreneurship in the CEFF system.

In more general terms, we can suggest that some of the features and outcomes of multi-stakeholder co-operatives proved precious in the development of new and emerging models of socially oriented businesses, notably the social enterprise, but also to more traditional organisations as an example of inclusive governance and as a strategy to resilience and sustainability.

Notes

[1]Cfr. Law no. 381/1991 on the "Co-operativa sociale"

[2]Contrary to this, advocates of new-institutionalism have rejected the presence of multiple patrons in the board of directors because of the alleged cost-inflating features of this governance solution. Here the assumptions is that diversity of interests and perspectives would make decision-making costly and that monitoring and direct supervision would be nonetheless required (Hansmann, 1996; Ben-Ner and Van Hoomissen, 1993).

[3]This solution is clearly in line with the recruitment of workers in other non-profit organisations (Handy and Katz 1998).

[4]We are grateful to Massimo Caroli for further interviews conducted during summer and autumn 2012 concerning the development of the CEFF system during the 2007 to 2012 period.

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Co-operative Accountability. Vancity integrated reporting model

Joanne Westwood

Abstract

The paper provides a brief organizational background portrait of Vancity as a case study written from a participant observer perspective. The paper provides an action centered account of the Vancity Integrated Reporting Model and evaluates the impact of this radical new approach to accounting practice. The paper finds this model to be a particularly valuable management tool able to support a democratic governance structure facilitating the goals and mission of the co-operative and credit union model and values.

Key Words

Accounting, Credit Unions, Co-operative Banking, Corporate Social Responsibility Reporting, Ethical Banking, Integrated Management Reporting Systems, Sustainability, Wealth Management

Introduction. Vancity's vision of an integrated redefinition of wealth

Vancity is a values-based financial co-operative serving the needs of half a million member-owners through 57 branches in British Columbia. It has a vision to Redefine Wealth by using all of its $17.5 billion in assets to support the long-term needs of the people it serves, and their communities. Besides being a living-wage employer and carbon neutral, Vancity is a member of the Global Alliance for Banking on Values, an independent network of banks using finance to deliver sustainable development for under-served people, communities and the environment. It is recognized globally for its transparent reporting practices and was the first Canadian organization to join the International Integrated Reporting Council's pilot program.

Vancity's reporting process - extending and integrating the metrics

Vancity's vision requires it to extend its definition of success beyond traditional financial indicators. It has voluntarily produced externally-verified public reports documenting its social and environmental performance and impact since 1997. It first considered producing an integrated report (a report that brings annual financial and sustainability information together in one document) in 2005, and commissioned research on leading practices and implications. Following this, the organization worked on streamlining its non-financial reporting processes, including data collection and verification. It also worked to align financial and accountability reporting processes, and to strengthen the linkages between reporting, strategic planning, performance reporting and risk management. Vancity transitioned to an integrated reporting model in 2010.

For Vancity, integrated reporting was a natural progression given its vision, co-operative nature, and its integrated business strategy and organizational scorecard. Integrated reporting provides a platform for the organization to tell its story to members in a connected, consistent and credible way, and to explain how its key activities, rather than making a profit, benefit the community but benefit the community in a profitable way. Its reporting practices are driven by the board of directors who view accountability and transparency as key elements of good governance and values-based banking. The Audit Committee of the Board oversees non-financial as well as financial reporting practices.

Reporting is viewed by Vancity as a valuable management and accountability tool, and a way to build trust by demonstrating it 'walks the talk'. Processes that support the report's production include data collection and analysis, agreement on responses and approaches to issues as they arise (e.g. performance-related or specific events), independent assurance on key processes, data and information; and a common understanding of priority topics, including those that are important to members and other key stakeholders. These processes require collaboration across multiple areas of the business and help break down silos, and the outcomes can be a useful input into strategic planning and risk management.

Reporting principles and guidelines

In addition to meeting financial reporting standards, Vancity prepares its integrated annual reports in accordance with the Global Reporting Initiative's (GRI) Sustainability Reporting Guidelines, and adheres to the AA1000 principles. These are principles-based frameworks that allow organizations, including co-operatives, the flexibility to tell their story in their own way while focusing on material (the most important and relevant) performance aspects and issues.

Vancity sees the AA1000 principles of inclusivity, materiality and responsiveness as consistent with the co-operative governance model. While often perceived as principles that guide sustainability reporting, the real value is when the principles are applied more broadly to inform how an organization runs its business. The principles speak to the importance of long-term thinking and using the results of stakeholder engagement to inform strategy and decision-making. They also emphasize the importance of understanding the organization's social, environmental and economic operating context, and having systems in place to prioritize and respond to key business and sustainability risks and opportunities, including those raised by stakeholders.

One area where the AA1000 principles and the co-operative model might be interpreted differently is stakeholder engagement. While co-operatives are participatory in nature, many tend to focus primarily on member needs and expectations, especially as members are both owners and customers of the credit union. The AA1000 Stakeholder Engagement Standard 2011 encourages a multi-stakeholder approach. It defines stakeholders as "those groups who affect and/or could be affected by an organisation's activities, products or services and associated performance." It goes on to note that organisations "will have many stakeholders, each with distinct types and levels of involvement, and often with diverse and sometimes conflicting interests and concerns".

Identifying and engaging a broader set of key stakeholders and understanding their priorities and where opinions differ—both between the groups and between stakeholders and the organization—can be an extremely valuable governance tool. On the other hand, an engagement approach that focuses solely or primarily on members may be to the detriment of others, innovation or long-term value creation. A narrow understanding of its service to members also implies that a co-operative is not living up to its principles—in particular Principle 7 'Care for community'.

The Global Reporting Initiative's (GRI) Sustainability Reporting Guidelines

The GRI Guidelines provide a good foundation for social and environmental responsibility and minimizing negative externalities. The GRI Guidelines were recently updated, and GRI reports are now intended to focus on 'material aspects'. The GRI defines these as "an organization's significant economic, environmental, and social impacts, or those aspects that influence the assessments and decisions of stakeholders". Organizations are expected to be transparent about how they decided what to report, the process they use to engage stakeholders and results, and to explain the boundaries of where material impacts occur (e.g. inside or outside of the organization).

Vancity views the recent changes as positive. However, a key challenge it faced when applying the GRI's G4 Guidelines was language. Vancity believes it is important that its annual reports mirror the language, key data and information it uses in its internal management reports. In other words, it believes the key measures and targets used internally to measure success, inform decision-making and reward management and employees should be consistent with those presented to members in its annual reports. Thus, Vancity chose to translate the sustainability aspects included in the GRI's G4 Guidelines into Vancity priority (material) topics that make sense to the organization.

The GRI Guidelines are not designed to rate an organization's sustainability performance. Rather, they relate to the level of disclosure on an organization's governance approach and on its material environmental, social and economic performance and impacts. It is left up to report users and readers to make up their minds on how

sustainable the organization is. In this way, a report from a large bank, tobacco or a mining organization with risk-driven sustainability practices might receive as high, or higher, accolades than a report from a leader in sustainable business practices.

Vancity feels that reporting in accordance with these frameworks and guidelines is not sufficient to clearly differentiate it from conventional financial institutions. For example, the GRI reporting requirements do not highlight its co-operative nature, the extent to which sustainability factors are factored into decision making across the organization, or how its activities result in positive community impact. To address this gap, Vancity develops and reports additional metrics and information related to its co-operative nature, its business strategy and values-based banking.

pay and the amount of employee profit share. There is a corresponding payout range for each target based on if Vancity met, exceeded or fell short of the target. Developing the 'right' targets is challenging, and the scorecard will continue to evolve—but it is a tangible example of how Vancity is different from conventional financial institutions.

Examples of additional management indicators and targets which Vancity tracks (but that do not influence pay) include:

- Number of people assisted though financial education (impact)
- Number of people assisted in poverty reduction, access to credit and credit repair (impact)
- Estimated greenhouse gas emission reductions funded through loans (impact)

VANCITY'S 2014 ORGANIZATIONAL SCORECARD
Impact—to demonstrate if Vancity is creating the impact its vision promises
• Enhanced member well-being: at least 50% of members strongly agree Vancity's contribution to the community has a positive effect on their well-being • Community impact loans: 41% of commercial and business loans approved ($s) are for projects or to organizations with demonstrable positive community impac
Confidence—to demonstrate that what Vancity is doing is sustainable and can be done without making trade-offs
• Member growth (we will attract 27,000 members to Vancity) • Long-term profitability (return on average members' equity is 5%)
Integrity—to demonstrate that the way Vancity does business is consistent with its values and co-operative principles
• Diversity (people with a disability represent at least 4.5% of Vancity's workforce)

Measuring Vancity's difference

Vancity's organizational scorecard

Vancity's organizational scorecard includes five key targets to measure progress against three outcomes: impact, integrity and confidence. The scorecard is intended to encourage the behaviours and activities needed for Vancity to achieve it vision and transform the way it does business. Results directly influence senior management's incentive

- Percentage of suppliers that are locally based/purchases made from locally-based suppliers (impact)
- Growth in member deposits as a percentage of growth in member loans (confidence)
- Number of living wage campaign information sessions hosted (integrity)
- Tonnes of greenhouse gas emissions from operations (integrity)

Progress against the organizational scorecard and management targets is reported to the executive team and Board of Directors quarterly; to all managers at quarterly performance updates; and to members in the annual report.

Vancity's impact metrics

The intention behind the impact metrics is to help employees and members connect the work and business they do at Vancity with the positive impact it has on members' lives and their communities. Its goal is to enhance members' well-being by offering financial products, services and advice that meet their needs, such as financial literacy programs, accessible or 'green' products and services, as well as financial advice that's in our members' best interests. It also seeks to enhance members' well-being by investing in the communities in which members live and work, for example through grants and loans.

MEMBER WELL-BEING

Measures below create a composite metric for member well-being

Co-operative economy	Financial inclusion and social justice	Environmental sustainability
Activate members on local economy (tbd)	Financial literacy	Activate members on climate change
	Access to basic financial services and credit	
	Poverty reduction	
	Long-term financial goals supported	
…supported by stories		

ASSETS INVESTED IN IMPACT

Measures below roll up to show total assets invested in impact ($)

Co-operative economy	Financial inclusion and social justice	Environmental sustainability
Community-minded organizations supported	Assets invested in social impact*	Assets invested in environmental impact*
…supported by stories		

*Assets could include retail, treasury, and other assets as well as investments leveraged

Figure 1. **Vancity's evolving impact metrics**

Vancity plans to spend a couple of years testing and learning from these impact metrics before formalizing them and incorporating them into its organizational scorecard and annual reports. Over time, it hopes to understand which measures are most effective in determining how it is progressing towards its vision. For example, several of the measures rely on surveying members, and Vancity needs to determine how meaningful this is.

Vancity believes that a balance of data, narrative and stories is necessary to provide a full understanding of its performance and impact. To this end it has developed a repository of community impact stories, including videos. These stories are available to employees and members through Vancity's intranet and website, and examples are included in Vancity's annual reports. They are designed to show the breadth and depth of the impact Vancity helps create in a way that cannot be fully conveyed by numerical data alone.

Values-based banking scorecard

As a member of the Global Alliance for Banking on Values (GABV), Vancity is also supporting the development of a sustainable banking scorecard. The scorecard will be used as a tool to assess the extent to which a financial institution is operating in a way that's consistent with GABV's Principles of Sustainable Finance. The measures will also be used to communicate the results and impact of the products and services being offered by members of GABV designed to address social and environmental challenges, and to highlight the differences between values-based and conventional banking.

Member and stakeholder engagement

Vancity considers its members as its primary stakeholder. Other key stakeholders include regulators, employees and members' communities.

Like many larger co-operatives, an issue Vancity faces is the fact that many of its member-owners have become passive participants in the governance of the credit union. Members tell Vancity they don't have the desire, time or the knowledge to attend the Annual General Meeting (AGM) or vote for the Board of Directors. And in fact, some don't even realize Vancity is a co-operative or how a co-operative differs from a bank or a publicly listed company. For the members that do understand, Vancity knows from research that while many members appreciate that they have the right to vote and attend the AGM, they don't feel the need to exercise these rights.

For these reasons, Vancity proactively reaches out to members in other ways to seek their input and ensure their voices are heard. It uses tools such as surveys, on-line panels, focus groups and—more recently—community advisory committees. As needed, it conducts one-off engagements to inform initiatives, marketing and communications strategies, issues management, and product innovation etc. Vancity also engages regularly with employees and community groups, and it seeks input from its peers and thought-leaders on specific topics as part of its annual strategic planning process. For the first time in 2014, it made its Three Year Plan—the outcome of its annual planning process—available to members, community partners and peers online.

Vancity has found that its annual reports can be a meaningful platform for ongoing communication and engagement with members, employees and others. For example, it uses the report as a tool to validate existing, or identify emerging, community or broader sustainability issues members care about—issues that affect their personal well-being, or the communities in which they live and work. It also uses the report to ignite conversations about the ways Vancity might play a role in addressing these issues.

Vancity's annual reports are highly valued by employees and members, who find them educational, comprehensive, easy to read, believable and effective in validating the reasons why they choose to bank or work at Vancity. After reading the report, members stated they felt compelled to recommend Vancity to others. However, few members will voluntarily read a 60+ page printed report, and a significant opportunity exists to find creative and tailored ways to expand the readership of the report and increase awareness of what Vancity is trying to achieve and how.

For this reason, and to reduce its carbon footprint, Vancity's 2014 Annual Report will only be available

online. It will have a 'build your own report' feature that allows people to read or print only those parts they are interested in. Vancity will also produce a highlights video and a short, printed companion piece designed to get members curious about Vancity's journey toward its vision, and to encourage them to find out more by reading the annual report or Three Year Plan. Vancity also plans to explore ways to more formally gather, prioritize, communicate and respond to findings from all the engagement it does.

Communicating the co-operative difference

As co-operatives, credit union members are also shareholders. The fundamental operating principle of credit unions is democratic decision-making, meaning 'one member, one vote'. This is in stark contrast to banks and other corporations, where it is money (the amount of shareholdings) that has the control, rather than the people. Shareholder-led organizations are also under pressure to report increasingly large quarterly profits, which may lead to short term and/or poor decision making. Without this pressure, credit unions are able to take a longer-term, broader, people-focused view.

However, the outward appearance of conventional banks and credit unions make them look more similar than they really are. This means it is even more important that credit unions or values-based financial institutions effectively communicate how they are different, and how this difference translates into better lives for people and healthier communities. Yet it is the Canadian banks that are arguably producing better sustainability reports than the majority of the credit unions, even though the driver for them is regulation, reputation and risk management vs. identifying opportunities, and believing it's the right thing to do both from a business and a sustainability standpoint.

One reason could be that credit unions have historically flown under the radar and typically don't have the pressures banks and other corporations have to demonstrate that they are conducting business in a way that is socially and environmentally responsible—although this is changing. They also tend to be smaller organizations with fewer resources to dedicate to reporting efforts. Both these make it more difficult for credit unions to build the business case for enhanced reporting—and especially so if reporting is not viewed as a strategic management tool.

The benefits of an integrated approach

Vancity believes an integrated approach to management and reporting simply means a better-run business. Management and employees take a broader and longer-term view to making decisions and have a deeper understanding of the external context in which they operate, including the views of multiple stakeholders. Such an approach, which is built into the DNA of co-operatives (although not necessarily always practiced or formalized) can lead to the early identification of emerging risks and highlight opportunities for strategic differentiation. Other key benefits include:

- breaking down operating silos across the organization (e.g. between divisions and departments);
- a complete and consistent view of the business, where external reporting reflects internal reality;
- a common understanding of priority topics and stakeholder needs and expectations, which are addressed through one business strategy.

Vancity anticipates its understanding of the linkages between its sustainability and financial performance and impact will evolve and ultimately demonstrate that Vancity (and other organizations) can both have a positive impact on people and communities and be profitable. Simply put, Vancity believes that if it does the right things for its members, profitability and sustainable growth will follow.

Visit vancity.com to find out more, and to view or download a copy of Vancity's Annual Report or Three Year Plan.

Notes

[1.] An analogue article was published in Italy by IPSOA Wolters Kluver in the journal *Administration and Finance*, December 2013 issue.

SAOS Ltd Working with Agricultural Co-operatives to Deliver Strategies for Growth and Resilience in Uncertain Times

Bob Yuill

Introduction

This paper provides an insight into governance thinking at SAOS Ltd with respect to our role, the future and strategies to help our members grow their co-operatives and build resilience in the face of increasing risks and global challenges.

SAOS (Scottish Agricultural Organisation Society) is a second tier co-operative providing managing consultancy, research and governance services to co-operatives and food supply chain partners. SAOS Ltd is wholly owned by Scotland's agricultural co-operatives. All of SAOS' resources and profits are committed to promoting, developing and enabling business solutions through co-operation and partnership

In 2001 SAOS members' turnover was £855 million and in 2013 it was circa £3,300 million. There are many aspects which have led to this growth, but primarily it is driven by excellent co-op governance and management - leading competitive strategies. These strategies are derived from a deep understanding of change, member loyalty and measurement of member value provided by their co-operative businesses.

In one small sector, the Rings[1], set up in 1987 with 23 farmer members, had 4,100 members and a throughput of £21 million by 2001; today they have a throughput of £70m and a membership of 6,467.

What are the change drivers behind this growth?

The fundamental changes driving modern farming are the rise of corporate agriculture, extreme technologies, capital intensive systems, just-in-time supply chains, sophisticated consumer markets and, importantly, globalised food markets driven by World Trade Organization's (WTO) agricultural trade polic

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Most farmers see change driven by technologies. Today agriculture has fully robotic milking machines, yield mapping systems, satellite positioned cruise control tractors, satellite imaging, remote sensing, drones, breakthroughs in nutrition and disease control, and of course the great debate on genetics. But, we will need technology. Global food production has to increase by around 70% by 2050[2].

WTO agricultural trade policy is driven by the larger food exporters such as the USA, Brazil and the European Union, and changing food demand from the large populations in China and India who do not now decrease their food calorie demand when food becomes short – they simply buy on the world market and the price increases.

For example, a 7% change in world production of wheat - amounting to circa 50 million tonnes (from 760 to 810 million tonnes) has recently produced a price movement of 35 – 40%.

The brutal truths driving change are:

- Massive technological change – and the pace is increasing.
- Just in time or lean processes through our supply chains.
- Climate change.
- Globalisation of food.
- Increasing world demand for food.
- Multi-national corporations vying for an even greater role in food markets.
- London & Chicago futures speculation on food commodities – volatility is a very profitable business.

- Complex government regulation & meddling, for example the bio-fuels industry.
- Sovereign wealth funds buying tracts of land.

The benefits of an integrated approach

In reality we are in a very complex world; and an increasingly complex world –and the systems which maintain this complexity are 'brittle' at best[3] , particularly concerning food.

If you combine the complex issues surrounding climate change, capital, geopolitics, IT & machine technology – we live in very uncertain times. Complexity and uncertainty is increasing the vulnerability of farmers and their families to shocks i.e. unpredicted events that can be catastrophic to communities, to businesses, to personal strength. (Typhoon Haiyan is an example of a tragic shock event.)

Agriculture is quite used to dealing with risk – one of the largest and oldest mutual insurance organisations in the UK is The National Farmers Union Mutual Insurance Society Limited[4].

Risk is calculable, it can be shared equitably. But uncertainty is a completely different concept and is a result from the mix of complexity, leading to brittleness within our systems– the weather, our sophisticated machines, capricious bank lending, complex software systems and so on.

Agriculture no longer uses seed sowing sheets, scythes, or horse drawn implements that are simple, understood and had a design life measured in millennia.

The benefits of an integrated approach

But the outlook is not as pessimistic as many might have us believe. Within this change and uncertainty, and certainly as a result of shocks to our various systems, come opportunities for constructive and sustainable change.

Planning for uncertainty, and developing strategies for uncertainty is a wholly different concept than standard planning techniques. This is the 'market gap' (so to speak) that our co-operatives are expanding into.

Dealing with uncertainty and inevitable shocks to our systems –capital shocks, weather shocks, political turmoil – requires a different planning outlook; planning which cannot be done in isolation. The word that best encapsulates how to deal with uncertainty is resilience. There are three constructs of resilience– personal resilience, community resilience and business resilience.

Resilience is rooted in family, community, in co-operation; it's rooted to having dignity for life and dignity for the environment. It is the antithesis of externalising costs, feeding capital at the expense of all else, of the 'me-me-me' society.

It might be helpful to note that modern farming is becoming an ever more lonely day-to-day business for many if not most farmers. Not that many years ago farming was a community business. The concern that we have may, perhaps, be summed up by a quotation from Daniel Goleman from his book *Social Intelligence: The New Science of Human Relationships*[5].

> *"Self-absorption in all its forms kills empathy, let alone compassion. When we focus on ourselves, our world contracts as our problems and preoccupations loom large. But when we focus on others, our world expands. Our own problems drift to the periphery of the mind and so seem smaller, and we increase our capacity for connection - or compassionate action." (Goldman, 2007)*

The Importance of Values in Responding to the Challenges at SAOS

So how are SAOS and our 70 or so member co-ops dealing with change, planning resilience and growing?

The most fundamental change to SAOS is we now wear our values on our sleeve. We are absolutely clear and have huge pride in who we are - our co-operative values of self-help, self-responsibility, democracy, equitability, transparency, openness,

learning and concern for our communities.

We strive to be a source of innovation and we engage and harness the uniqueness, talents, beliefs, capabilities and ways of working of our colleagues. We tender a culture of our people being exceptional, valued and respected, with individual differences and talents that enhance our values.

Without this value driven core it would be nigh on impossible for us to guide, influence, advise and share risks with our members. It took SAOS a couple of years of work to develop and share an absolute clarity about who we wanted to be, and to understand the strength of our co-operative values[6]. It's difficult to believe that it took us 100 years to clearly figure this out. But, then again, we know we are entering a new paradigm.

Since the last few years there is a growing development in the relationship we have with our member co-ops, which in reality means that we are sharing the burden of governance. In many ways we take a more significant burden than individual directors, if you consider that we can be sued for wrongful advice.

A great deal of our day to day job is working with our members to research and design competitive strategy. We have found that this process is the most powerful way. It not only enhances the internal delivery capabilities of the co-operative, it also provides significant training and director development, which is fundamental to their fiduciary duties.

However, and this cannot be emphasised enough, effective co-operative strategies cannot be developed without the closest involvement by the co-op members in researching, discussing, developing and engaging strategy.

It is perhaps a little easier to figure this with a farmer's co-operative in that the farmer and his family is often motivated from a significant investment in their co-operative and their own income is dependent on the success of their co-operative. In many respects producer co-operatives are similar to worker co-operatives. Indeed in many of our co-operatives there is a coincidence of membership between employees and producers.

Examples of developing resilience strategies

The strategic development process can be illustrated by a typical case study which pulls together most of the points discussed. In the east of Scotland the weather is always fickle, and the area is highly dependent on its cereal harvest, with significant numbers of porridge eaters, cattle, sheep, pigs, broiler chickens, laying hens and of course whisky drinkers.

Farmers are therefore investing in larger, faster, sophisticated combine harvesters with outputs that are astonishing in comparison to the ones only 20 years ago. In addition to this Scottish farmers have honed the co-operative phenomenon of the Rings, a concept completely unfamiliar to those outside agriculture, which ensures that any available folks and machines within their area are working as efficiently as possible during short weather windows. (Rings are fundamental to Scottish agriculture's resilience strategy.)

The downstream problem from high capacity harvesting is that grain handling, drying, storage facilities and the logistics that surround these, have to be more than adequate to deal with the huge outputs a fleet of modern combines can generate. This was the challenge for four of our co-operatives - Aberdeen Grain, Angus Cereals, Highland Grain and East of Scotland Farmers. Please note that everything was working fine as was, a few weather related hold ups and panics now and again but over the short term the members did not need to change their co-operatives and expand capacity.

But, their resilience capability to withstand shocks to the system was declining. Limited drying capacities, long truck tipping times, limited wet grain holding, single fuel sources, small number of grain separation bins and so on.

The strategy development process commenced by raising awareness with members and also the wider community of what the future challenges are

(discussed previously), which requires detailed research and survey work. Agreeing with members what has to be done formulates the strategy, including design, changes to logistics and priorities, additional levels of investment, increased member commitment, need for new members and so on. Also, agreeing with the broader community the need for new buildings, roads and infrastructure.

The respective memberships developed an absolute clarity that in the event of a hellish year their current co-operative systems would struggle to cope. Importantly, they accept, or perhaps understand, the complete uncertainty of what kind of shock they might need to withstand. They needed to build resilience. Importantly members recognised how their own vulnerabilities to future shock events could be shared, which included sharing capital investment.

The point here is that close membership involvement, and the time and patience this takes, is the start process for building loyalty through participation in the present and the future.

Understanding the probable future, the scenarios, is the key to engaging competitive long term strategies. Traditionally too much Co-operative governance focus is on governing the past – by this I mean directors most often take inordinate amounts of time understanding what has happened, rather than taking the long view in researching and figuring what needs to be done.

Close membership involvement in strategy development is the major component of what characterises a co-operative; it elevates participation by membership and moves co-operative governance to a new level, focussing on the practical aspects of participation.

The outcome for all four Scottish grain co-ops is their members have invested heavily in state of the art expanded grain facilities which give them the confidence they require, and, also most importantly gives their markets huge confidence.

The foundation of member loyalty and increasing participation is members' absolute trust that their co-operatives will never, ever, take advantage of vulnerabilities (a million miles away from corporate pay-day loan companies and their likes). Personal, community and business vulnerabilities are more quickly exposed during times of change and uncertainty; and, are exposed immediately as a result of shocks.

A simple farming example was sprouting of Oil Seed Rape before harvest, which was a major problem due to a wet warm autumn. The general merchant trade took advantage and deducted £60/ton immediately on delivery due to sprouted rape, but Aberdeen Grain through careful marketing, and some patience, needed to only deduct £7/ton – which saved members typically around £12,000.

Nevertheless, from shocks come opportunities - opportunity to change and deal with any new equilibrium, opportunity to build competitive strategies. East of Scotland Growers for example, who pioneered new broccoli varieties with Indole-3-Carbinol or I3C for short, which helps fight cancer, had a desperate year in 2012 due to weather. So much so that if each grower was working on their own they would plan to stop and grow an easy crop like wheat instead. But, by working together they kept markets supplied, ahead of competitors, through hellish conditions and emerged stronger with higher demands for their produce in 2013.

Conclusions

The SAOS view is that in this complex world a status quo of only modest co-operative growth (if any) is no longer acceptable. Co-operatives are designed to be leaders, to be entrepreneurial and innovators of shared strategies to deal with change. We must simply forget about comparisons with investor business and begin fully delivering a co-operative democracy and economic participation in all that we do.

The starting point is accepting and dealing with change and complexity that affect co-operative members. Our co-operative values should do this in any case.

At SAOS we work closely with all co-operative members (1st & 2nd tier) to build resilient systems and resilient members, who are able to deliver the changes that they want to see and wish to invest in. This takes passionate loyal members, which requires great governance and exceptional managers. We have tools that measure loyalty and participation easily and accurately, and compare from year to year, and from co-operative to co-operative.

Our job at SAOS is delivering real and lasting commitment to co-operative values, the seven co-operative principles in equal measure, which will provide prosperity, employment, sustainability, local empowerment and most importantly resilience.

Co-operatives must never be frightened to measure their membership value proposition, and work assiduously to keep increasing member value in an ever changing world. This is what increases participation and loyalty, and delivers growth.

Notes

[1]Rings – Machinery Rings, or Rural Business Rings, are unique co-operatives where all members trade with each other through their ring. Trade involves labour and machinery, goods and services. The ring manages the trade efficiently and clears payment between demanders and suppliers deducting 2% from each transaction to pay for the management and administration infrastructure.

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Co-operative Governance Codes in the UK

Ed Mayo

The recognition of good governance as a factor in business success in recent years has gone hand in hand with the proliferation of codes of governance, designed to capture and promote best practice[1]. In the UK, the co-operative sector has worked collaboratively around the development of three such codes, relating to different types of co-operative ownership and sector. This paper gives a practitioner view on the experience at national level of governance codes.

A code of governance, simply enough, is defined as "a set of 'best practice' recommendations with regard to the behaviour and structure of the board of directors of a firm."[2]. Such codes are considered to work because, while typically voluntary or co-regulatory, they signal to the owners of firms that governance is taken seriously, while responding in a more flexible way to emerging best practice than can national legislation[3]. Set against this is an argument that as a tool for voluntary action, codes can suffer from the same weaknesses as self-regulation, in that they may be shaped by private rather than public interests, while lacking the enforcement powers to tackle egregious corporate malpractice.

The interplay between legislation and self-regulation is an important one in understanding the potential role and contribution of codes[4]. This is particularly in the context of co-operative enterprises, where state registration and regulation may, for a variety of reasons, be more prescriptive than may be the case for companies more widely.

The UK co-operative economy has a turnover of around £36.7 billion and is owned by 15.4 million adult members in the UK. The sector has grown by nearly 20 per cent since the start of the credit crunch[5]. Co-operatives UK is the national trade body that works to promote, develop and unite co-operative enterprises. Recognised by the International Co-operative Alliance as the Apex Body for the UK, the organisation serves as a trade association for co-operatives and mutuals. It works to promote co-operative businesses across all sectors of the economy – from retail and finance where co operatives are most recognised to key growth areas such as renewable energy, agriculture and education. Co-operatives UK operates a number of quality standards, to guide co-operatives in relation to good governance. These include the Code of Governance for Consumer Co-operative Societies, the Worker Co-operative Code of Governance and a standard currently under development for agricultural co-operatives.

Consumer Co-operative Code of Governance

The Code of Governance for Consumer Co-operative Societies is a self-regulation quality standard intended to ensure that co-operative businesses are well run and meet their members' needs. The code was first launched by Co-operatives UK (then the Co-operative Union) in 1996.This code has now been comprehensively revised, after a period of open consultation in the co-operative sector. The new code applies to all the major consumer retail co-operatives from 2014[6].

The code sits alongside the usual legal requirements set out in law or, from time to time, by the Financial Conduct Authority. Co-operatives working in or with subsidiaries operating in regulated sectors, such as banking or energy, also have to comply with duties set out by the regulators in those sectors, reflecting the specialist expertise that is often required.

The co-operative code is based on the UK Corporate Governance Code, with considerable overlap, for a good reason. Good governance is in many respects about the same underlying principles – such as the accountability of a Board to the owners, the role that a Board has in directing but not managing activity, the duty a Board has in relation to due diligence, risk management and so

on. The main difference is that a co-operative board has to act in accordance with the co-operative values and principles, whereas the board of an investor-owned business simply has to provide responsible leadership.

There is therefore a stronger emphasis in co-operatives on active participation. Members are encouraged to play a part in governance, whereas shareholders in listed companies simply monitor governance by the board. The co-operative board is expected to engage with active members and maintain close relations, whereas the investor-owned business board is charged only to ensure dialogue with major shareholders. There are some high profile issues that will also have a different emphasis in co-operatives. The form of executive compensation, for example, may be somewhat less contentious in a co-operative. Because there are no offers of share options to top managers as part of their remuneration package, the opportunities for inappropriate incentives or abuse are more limited.The major areas in which the new Code of Governance for Consumer Co-operative Societies has been strengthened include:

- The handling of risk: including who is responsible, how it is managed, what the appetite for taking on risk is and what the internal controls and risk management looks like.
- Board skills and composition: including the balance of newly elected and experienced board members, board evaluation and ensuring that directors have the appropriate skills to undertake their role
- Equalities: recognising the benefits of a diverse Board and removing references to any upper limit age rule
- Fraud: ensuring transparency in the democratic process, with particular reference to ensuring that election and voting procedures are free from fraud and undue influence.

Worker Co-operative Code of Governance

In 2006, a group of experienced UK worker co-operators set out to use the co-operative principles to create good co-operative businesses. Called 'The Worker Co-operative Code of Governance', and published by Co-operatives UK, the booklet sets out what anyone should expect, and should work together to achieve, as a member of a worker co-operative. The intention was for this to be a practical expression not just of co-operative values and principles, but a reflection too of the spirit of the ICA World Declaration on Worker Co-operatives, agreed in 2005[7] - to help people create and defend decent jobs, with a culture of equality and respect at work, where people benefit fairly from their own labour and take collective control of their working lives.

The code has been translated for use and promotion in Spanish, French, German, Japanese, Finish, Croatian and Maltese[8]. This code was updated in 2012, after work and consultation led by the Worker Co-operative Council, the lead membership committee of Co-operatives UK for the sector[9]. The code recognizes that there are different models of governance across worker co-operatives, although each can benefit from a close focus on participative decision-making. "Worker co-operative governance and management structures" it explains "reflect their personalities and history. Small or newly started worker co-operatives tend to operate as collectives, where management and governance structures are essentially flat and informal. As a worker co-operative grows, governance tends towards the membership electing a representative body. Similarly, management and operational decisions are often delegated to semi-autonomous teams, or individuals."

Agricultural Co-operative Code of Governance

The development of an agricultural co-operative code of governance has been some years in the planning. A review in 2009/10 by the Parliamentary Committee on Environment, Food and Farming on the failure of the co-operative, Dairy Farmers of Britain concluded that, while the enterprise had not failed because it was a co-operative, there was a need for the development of an appropriate code of governance, in order to support good governance across the sector[10]. This proposal was accepted by the UK Government, which committed to work with Co-operatives UK and its members, notably the Scottish Agricultural Organisation Society (SAOS) and the English Food and Farming Partnerships (as it was), to achieve this[11].

An exposure draft was completed in early 2014, with input from the National Farmers Union, for consultation with member co-operatives of Co-operatives UK and SAOS. The work drew on the experience not just of the two existing UK codes, in particular the Consumer Co-operative Code of Governance, but also the Dutch NCR Governance Code for Co-operatives, which was first drawn up in 2005 and revised in 2011[12].

The Co-operative Governance Wheel

While there are significant differences across the three codes, there is also recognition of shared elements that underpin each of these, in line with internationally agreed co-operative values and principles. These underlying components of the Co-operatives UK codes of governance are articulated in the Co-operative Governance Wheel.

Compliance with the Governance Codes

As a self-regulatory tool, compliance with the codes is in each case voluntary. There are, however, ways to encourage compliance on a voluntary basis. For the worker co-operative code, which includes thirty seven provisions grouped around the seven co-operative principles, compliance rests on self-assessment, with the provision by Co-operatives UK of an online governance audit, for co-operative members to work through individually or as a group. The consumer co-operative code is organized around twenty high level governance principles, spanning 163 separate provisions. The co-operatives using the code, who are relatively large retail societies, report against these, on a 'comply or explain' basis, to their own members in the Annual Report as well as to Co-operatives UK which monitors compliance with the code. The compliance model for the newer agricultural co-operative code is in development.

Reporting can shine a light on areas of compliance or non-compliance with the code. Over recent years, drawing on expert advice from its longstanding Co-operative Performance Committee, chaired by Professor John Arnold, Co-operatives UK has developed a practical framework for measuring co-operative performance, based on a set of common indicators and benchmarks based on shared data[13]

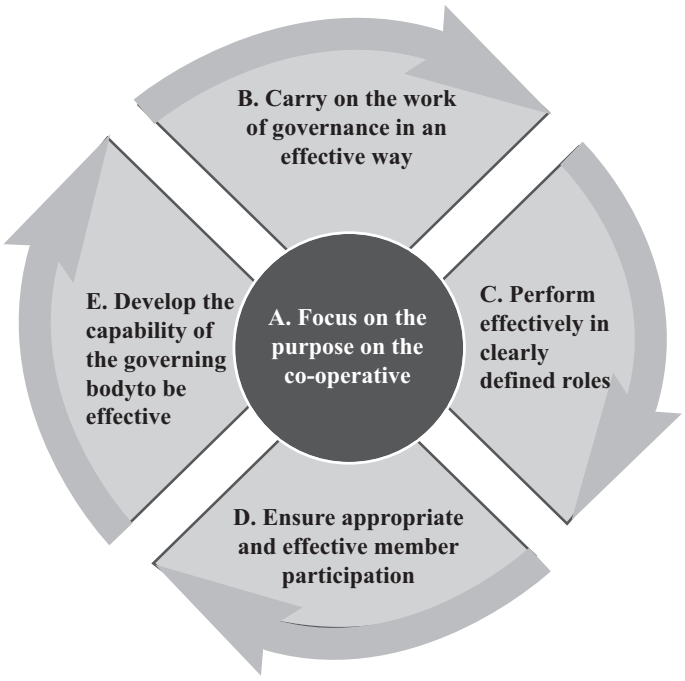

Figure 1. **Corporate Governance Wheel**

On the basis of this, Co-operatives UK provides a performance monitor report for consumer co-operative retail societies that includes governance compliance and offers a degree of assurance to directors, helping to address the accountability gap that can emerge if information flows are limited to performance data that is generated by managers.

Governance Reviews

Alongside this, Co-operatives UK conducts governance reviews for its members, where requested. One of the benefits of an expert, independent view is that those involved in any particular structure of governance can face conflicts of interest at a personal level in terms of how that structure evolves over time. The key factors that inform the approach to such governance reviews include future business strategy and the core member relationship and proposition around member value and member voice:

- In generic terms, the core purpose of any co-operative or mutual is to generate member value. As it can be the case that what members consider to be value varies, Co-operatives UK in its advice work on governance therefore recommends that co-operatives satisfy themselves that they know what it is that their members value.
- Good governance responds to the voice of members. A good headline indicator of effective member control in the governance of a co-operative is that members have a sense of control – that they are satisfied that they have a voice in how the business is run over time, in relation to the issues that matter to them.

Examples of governance practice in consumer co-operatives

Co-operative governance is more than codes or simply due processes for decision-making. Governance design encompasses the culture of decision-making, leadership and accountability and it includes the people that are involved with those processes and culture. There can be strengths and weaknesses in each of these domains. The design of governance structures even across a relatively small number of consumer co-operative retail societies in the UK shows a high degree of variation.

The Co-operative Group, the UK's largest consumer co-operative, has commissioned a major review of its own governance, led by the distinguished business leader, Lord Myners. This follows a series of weaknesses that led to the demutualization of the UK Co-operative Bank in 2013. This paper, for reasons of timing, does not consider these issues but the findings of this review will have significant implications for the governance of co-operatives in the UK and there is a commitment by Co-operatives UK to review the relevant governance code, as appropriate in this context. It seems likely that a set of fundamental weaknesses that have affected other banks over time may have come into play in relation to the Co-operative Bank – in particular, a failure to establish adequate internal risk controls and a failure of corporate governance in terms of its responsibility to assure that banking activities were properly managed by its executive officers and overseen by an effective board of directors.

With the merger of a number of smaller societies, including the creation in 2014 of the Central England Co-operative, all of the leading consumer societies with the exception of The Co-operative Group, operate a model of direct election of members to the board. Based on data reported to Co-operatives UK, the average size of the board across consumer societies is twelve (11.93 average). Co-operatives UK has in the past advised a top-level maximum of fifteen members for consumer society Boards, while recognizing that there is diverse practice around the exact number. A number of societies also operate intermediary structures that are intended to complement the governance model. The function of these appear to work best when there is a clear role that adds value – such as checking the quality and practice of member engagement by the society.

Across all societies, there is an active focus on director development, with experimentation

around different models, including specification of skills required, candidate development prior to being eligible to stand for election and ongoing director development, such as provided by the UK Co-operative College[14]. A number of societies have scope for Independent Professional Non-Executive Directors, often in order to bring in specific complementary skills to the mix of the Board.

In terms of member participation in governance, and in relation to the composition and diversity of Boards, there is an acceptance in the consumer co-operative sector of the need to ensure that currently under-represented groups are included. This has been the case in terms of ethnicity and gender, for example – with the latter being the subject of the Co-operative Women's Challenge, a cross movement initiative co-ordinated by Co-operatives UK, which promotes gender equality in representative roles, as well as more widely. Research by Co-operatives UK shows that, while there is a long way further to go, co-operative models of governance do lead the way in terms of gender equality in business. Across the co-operative sector, 37% of directorships are held by women, compared to only 20% among leading PLCs[15].

In relation to young people, Co-operatives UK led a successful campaign with its members in 2010/11 to open up membership of co-operative societies to all ages, with a change in the legislation that, from 2012, now permits members under the age of sixteen. To support its members around this, it has published a guide to societies on young member engagement and pointed to best practice models around the engagement of young people, including in governance, across the co-operative sector[17].

Conclusion

The UK has a well-developed body of practice around the field of co-operative governance. Perhaps because there is no one single legal form for co-operatives and mutual's in the UK, the value of developing codes to articulate and promote a consistent approach to good practice has been recognized relatively early on. While good governance should always add value, this paper makes no claim to assess the impact of this work in objective terms over time. Despite the overall commercial success of the co-operative sector in the UK over recent years, the headline failures in 2013 around the Co-operative Bank are certainly prompts for deeper learning.

The values of good governance on the face of it seem to be close to the traditional values of co-operatives, including self-responsibility and honesty - and there is relevant practice from across the co-operative sector, to learn from, as well as opportunities for new best practice to emerge. As the Worker Co-operative Code concludes: "we can't wait to see what kind of future you choose to build for your co-operative, and wish you every success."

Notes

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Heirs and annuitants of co-operative banks –three principles for securing the long-term future of co-operative governance

Jean-Louis Bancel and Olivier Boned

Abstract

Although co-operative banks are now both recognized and clearly defined, there remain three major challenges in terms of governance. The first is to protect the principle of democracy at local level and, by doing so, to preserve the "local" dimension that underpins the commitment members make to governance. The second is to ensure that members remain central to the governance process and are not marginalized by salaried directors. The third is to define the roles of elected board members more clearly and to provide them with greater support, through training in particular.

Key Words

Co-operative Banks, Governance, Elected Board Members

Introduction

In terms of recognition, the situation has never been so promising for co-operatives.

In a 2009 report, the International Labour Organization pointed to the resilience of co-operative banks during a period of crisis, focusing in particular on their stability and risk aversion (Birchall & Hammond Ketilson, 2009)[1] .the ILO has also conducted research into the capacity of co-operative banks to resist external crises. This study shows that, between 2007 and 2010, their assets rose by 10% and their customer base by 14%[2].

The UN's decision to declare 2012 the International Year of Co-operatives provided excellent exposure for the virtues of the co-operative model. According to the UN Secretary-General:

> *"Through their distinctive focus on values, co-operatives have proven themselves a resilient and viable business model that can prosper even during difficult times. This success has helped prevent many families and communities from sliding into poverty[3].*

The International Monetary Fund, meanwhile, recognizes the ability of co-operative banks to build strong relationships and develop trust with their members. It also recognizes their role in driving down the prices charged across the banking sector. Through its ability to create close ties with members and keep a lid on prices, the co-operative model therefore promotes better access to financial products (Fonteyne,2007). These international organizations also recognize the important stabilization role that co-operative banks play.

Yet if we fail to question the long-term future of our model, we will be little more than "annuitants" profiting from a highly favorable situation. We have a duty, for ourselves and for future generations, to continue seeking ways to improve and renew our organizations. We must never lose sight of the fact that we have inherited these organizations and, in turn, that we have a duty to pass on this value and capacity to change economic situations for the better to future generations of co-operators. It is our obligation, as responsible heirs and not profiteering annuitants, to pass on this value rather than simply act as consumers.

There are three key questions that we must ask ourselves: First, if our co-operatives are growing, how can we secure effective co-operative governance into the future? Second, how do we ensure that power remains in the hands of members rather than the techno structure? Third, how can we strengthen our model by selecting and supporting senior elected directors with the requisite skills and who are fully

accountable to members?

Growth calls local democracy into question

The second principle of the International Co-operative Alliance, "Democratic Member Control", states that:

> *"Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary cooperatives members have equal voting rights (one member, one vote)."*[5]

This principle highlights a number of core elements of the co-operative model: the "local" dimension, member involvement in decision-making and strategy, and equal voting rights (one member, one vote).

As co-operative banks grow, co-operators naturally have a reduced influence on final decision-making. Their individual power is watered down as the number of members grows. Unlike commercial organizations with shareholders, there is no "poison pill" mechanism in co-operative organizations that would enable long-standing co-operators to retain greater power than new entrants. Furthermore, as banking groups grow, the number of decision-making levels naturally increases in line with this growth.

Power tends to be transferred from local level to regional and then to national level. Power is always distributed according to the principle of subsidiarity: when something cannot be done at one level of an organization, for technical or financial reasons, it moves up to the next level, and so on. Yet this can lead to excessive concentration of power in the centre, with decisions regarding profitability, efficiency or resource-sharing regularly passed up the chain to the central decision-making body. Although this may be necessary in some cases, and especially for organisational matters in a competitive market, it is important to ensure that the local level is not stripped entirely of its responsibilities. Co-operative banks must be prepared to return or restore power to the local level, for it is at this level that the co-operative model gains its credibility. By ignoring local democracy and cutting their members out of the loop, co-operative banks will become no different from traditional banks and members will disengage from the governance process.

As a result, General Meeting attendance levels will fall and democratic expression will suffer. This will also lead to a shortfall of potential elected directors –in terms of both quantity and quality –capable of filling senior governance roles in co-operative banks. It is therefore of critical importance that we revitalize the local level, assigning meaningful tasks to local elected officials. This is the best way to ensure effective governance at all levels of the co-operative.

Governance: members vs. technostructures

The increasing size of co-operative banks poses another potential hazard. As members lose their individual power at local and regional level, they also lose power at national level. This watering-down of power will cause a loss of motivation which, in turn will see members withdraw from participating in governance. As the banking profession demands increasing levels of expertise across multiple areas of business and in a variety of technical fields, and as the size of organizations continues to grow, greater emphasis is placed on salaried professionals. Yet it is important to remember that elected board members are representatives of their members. They are elected through democratic support rather than on the basis of their technical capabilities. These board members now face competition from highly skilled directors who enjoy strong managerial credibility and possess a wealth of information.

These directors play an executive-type role and have the ability to seize control and power with relative ease. As a result, the role of elected board members is reduced to little more than rubber-stamping decisions made, or at least oriented, elsewhere. They have minimal room for maneuver. It is therefore crucial that elected representatives

remain able to define strategy and take decisions. In short, they must retain the ability to fulfill their role rather than become "non executives", as is already the case in many co-operative banks.

Responsible, senior directors

This need for senior, responsible directors requires action in two areas. First, it is important to define the position and role of these directors, to ensure that they are not excluded from the organization's governance process. Second, they need support to ensure they are fully capable of meeting their responsibilities. Training is therefore crucial in this respect.

In our view one of the key challenges is to redefine the role of the elected director within co-operative organizations, and within co-operative banks in particular. The problems that have occurred in the sector in recent years may give the impression that elected directors have failed to fulfill their counter-balancing role, especially when it comes to dangerous investments in high-risk countries. We could even go further than this and suggest that some of these problems are attributable to elected directors themselves, who have simply not been up to the task – UK The Co-operative Bank is a case in point in this respect.

The elected director's role therefore needs to be redefined in clearest possible terms. Objectively speaking, elected directors cannot intervene in all operational activities. This is outside the elected director's remit, and any attempt to do so would constitute stepping on the toes of the Managing Director. Instead, elected directors must focus on two key elements of governance: taking decisions and ensuring that these decisions are implemented. In this sense, the elected director has a dual role: strategist and controller. He/she is also responsible for upholding members' interests. As such, the elected director's role includes coordinating the organization's membership and democratic processes.

Elected directors have a mandate, which means that they are accountable to their peers, i.e. the members of the General Meeting. The General Meeting has a "sovereign" role and similar responsibilities to those of the elected directors: it defines and oversees strategic decisions. The elected director's power is therefore delegated to him/her by the members of the co-operative. This is a fundamental aspect of co-operative governance, which clearly defines the roles of each individual and entity within the organization. The elected director –the Chairman of the co-operative bank –must be a strategist with an ability to take long-term decisions. He/she is also accountable for decisions and overseeing their implementation on behalf of co-operative members.

Once the elected director's role has been defined, the question of skills then needs to be addressed. Members of the board are elected to these positions after many years of service in the co-operative or the co-operative movement in general. As such, the individuals who occupy these posts have extensive practical experience. However, in order to fulfill their decision-making and oversight responsibilities as effectively as possible, and in light of new challenges that have emerged in recent years, the importance of training cannot be over-stated. Although some dedicated courses already exist , such initiatives need to be extended. There is also a need for more regular discussions on these matters to share information about the specific situations encountered in each organization and in different countries. By sharing information in this way, we will be better placed to define the needs of future co-operative bank directors.

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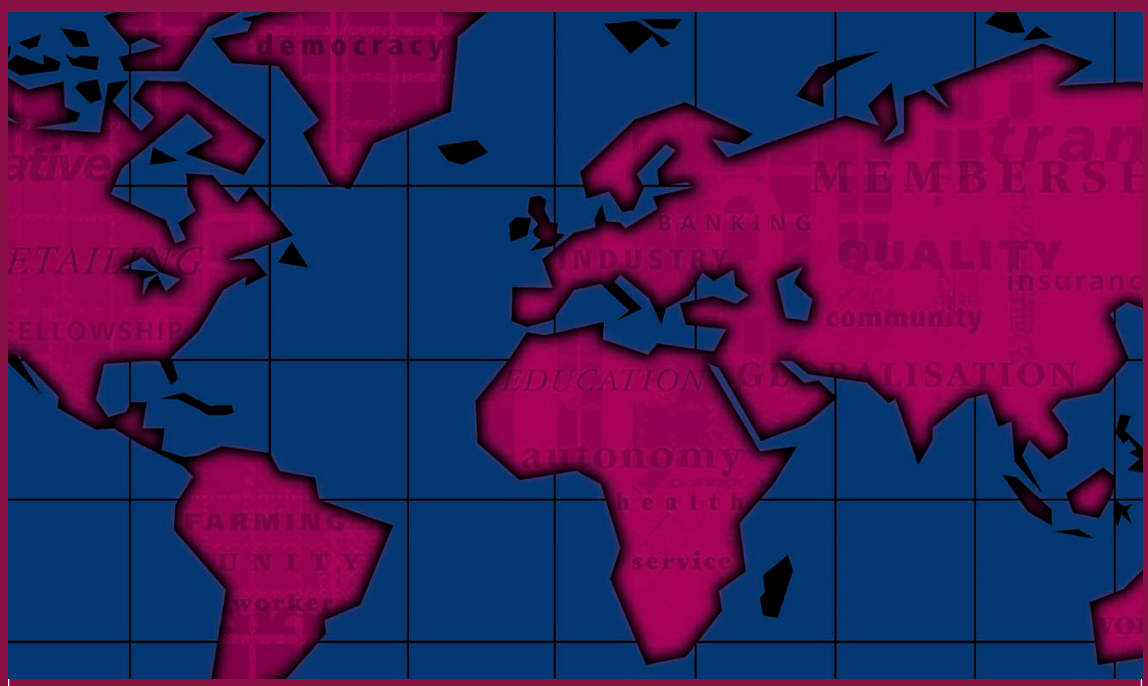

Future Issues:

Service Sector Co-operatives
Worker Co-operatives
Sustainability: Co-operative initiation
The UK Co-operative decline: Can it be reversed?
Trade Union Co-operative relation: Short term or strategic?

Developing themes:

Character, attitudes and values: Developing the Co-operative Manager
Strategies for globalisation
Resource depletion and climate change: The Co-operative response

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