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Accounting by agricultural producers and agricultural cooperatives; Issues paper (1981 July 31)

American Institute of Certified Public Accountants. Agribusiness Special Committee

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Issues Paper

Accounting by Agricultural Producers and Agricultural Cooperatives

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INTRODUCTION

1. This paper discusses issues in accounting by agricultural producers and agricultural cooperatives for which sufficient guidance is not provided by professional pronouncements and practices vary. The issues involve:

- accounting for inventories by producers,
- accounting for development costs of land, trees and vines, intermediate life plants, and animals,
- accounting for patrons' product deliveries to cooperatives,
- accounting for investments in and income from cooperatives, and
- accounting for forward and futures contracts by producers and cooperatives, including
  - Criteria for differentiating between a hedge and a nonhedge futures transaction,
  - accounting for hedging transactions of producers, and
  - accounting for hedging transactions of cooperatives.

This paper does not apply to accounting for timber production or animals raised for competitive sports.

Definitions

2. For purposes of this paper the following definitions are provided.

Agricultural Cooperatives - See paragraphs 7 through 23.

Agricultural Producers - See paragraphs 3 through 6.

Anticipatory Hedge - A hedge using forward contracts or commodity futures contracts to minimize risk due to price fluctuations for an expected transaction,

such as for a producer who is committed to growing a crop or raising livestock and wishes to fix the sales price.

Assigned Amounts - Amounts used to record products delivered by patrons and the related liability to patrons of a marketing cooperative operating on a pooling basis, where the ultimate amounts to be paid patrons are determined when the pool is closed. These amounts may be established based on current prices paid by other buyers (sometimes referred to as field prices), or the amounts may be established by the cooperative's board of directors. The assigned amounts are sometimes referred to as established values.

Cash or Spot Price - The price at which commodities available for immediate delivery are currently selling.

Cash or Spot Transactions - The purchase and receipt or sale and delivery of a commodity.

Commercial Production - When the crops produced by an orchard, vineyard, or grove provide revenues in excess of all direct and indirect costs, including costs of harvesting.

Commodity Futures Contract - An agreement to buy or sell a specified quantity of a specified commodity of a certain grade at a specified future date. The contracts are subject to the rules of organized commodity exchanges.

Cost Advance Method - A method of accounting for inventories of a marketing cooperative operating on a pooling basis. Under the method, inventories are accounted for at the amount of cash advances made to patrons.

Crops - Grains, vegetables, fruits, berries, nuts, and fibers grown by agricultural producers.

Crop Development Costs - Costs incurred to the time plantings begin to produce in commercial quantities, including the costs of land preparation, plants, planting, fertilization, grafting, pruning, equipment use costs, and irrigation.

Exempt and Nonexempt Cooperatives - A cooperative is an exempt or nonexempt cooperative depending on its federal income tax status. Both types are permitted to deduct from taxable income patronage distributed to patrons to the extent such distributions represent earnings of the cooperative derived from business done with patrons. In addition, cooperatives meeting the requirements of Section 521 of the Internal Revenue Code (exempt cooperatives) are permitted to deduct (1) limited amounts paid as dividends on capital stock and (2) distributions to patrons of income from business done with United States government or its agencies, and from nonpatronage sources.

Farm Price Method - A method of accounting for inventories at the sales prices in the nearest local market

for the quantities normally sold less the estimated costs of disposition.

Forward Purchase Contract - An agreement to buy the production from a specified acreage or to buy a specified quantity of a specified commodity at a set or determinable price for delivery at a specified future date.

Forward Sales Contract - An agreement to sell production from a specified acreage or to sell a specified quantity of a specified commodity at a set or determinable price for delivery at a specified future date.

Growing Crop - A field, row, tree, bush, or vine crop before harvest.

Harvested Crops - Agricultural products, gathered but unsold.

Hedge - The initiation of positions through use of forward contracts or commodity futures contracts opposite from the inventory position which consists of inventories held and inventories committed for or sold through open forward contracts to minimize risks due to price fluctuations.

Hedging Procedures Method - A method of accounting for inventory, commonly used by grain merchants, in which the theoretical cost of hedged inventories is determined by pricing them at market and adjusting for gains and losses on related open futures and forward contracts.

Livestock - Registered and commercial cattle, sheep, hogs, horses, poultry and small animals bred and raised by agricultural producers.

Mark-to-Market - A method of accounting for inventories, forward contracts, and futures contracts at current market prices and recognizing changes in market prices as gains and losses.

Market Order Prices - Prices for raw product established by federal or state agencies.

Net Inventory Position - The quantity of a specified commodity on hand adjusted for the quantities on open forward contracts and open futures contracts.

Patronage Earnings - The excess of a cooperatives revenues over its costs that is distributed (cash patronage) or allocated (noncash patronage) to patrons. Those earnings are normally distributed or allocated to individual patrons based on their proportionate share of total patronage.

Retains - Amounts determined on a per unit basis or as a percentage of patronage earnings that are withheld by cooperatives from distributions and allocated to patrons' capital accounts.

Recurring Land Development Costs - Costs that do not result in permanent or long term improvements to land, for example maintenance costs that occur annually or periodically.

Speculative Contracts - Commodity futures contracts entered into without offsetting actual or anticipated

ownership of or commitments to purchase or sell the commodity.

Unit Livestock Method - Accounting for livestock by using an arbitrary fixed periodic charge. For raised animals, the amount is accumulated by periodic increments from birth to maturity or disposition. For purchased animals the arbitrary fixed periodic amount is added to the acquisition cost until maturity or disposition of the animal.

Agricultural Producers

3. Farmers and ranchers are referred to in this paper as agricultural producers, a term that includes, for example, those who raise crops from seeds or seedlings, breed livestock, whether registered or commercial, and feed livestock in preparation for slaughter. The term excludes, for example, merchants and processors of agricultural products who purchase commodities from growers, contract harvesters, and others serving agricultural producers; although they are included in the term agribusiness as it is generally used. The term also excludes growers of timber and raisers of animals for competitive sports although some principles discussed in this paper may apply to such activities.

4. Agricultural producers use every form of business organization, from sole proprietorships to large publicly held corporations. They engage in numerous basic activities, for example:

. growing wheat, milo, corn, and other grains,

. growing soybeans, vegetables, sugar beets, and sugar cane,

- growing citrus fruits, other fruits, grapes, berries, and nuts,
- growing cotton and other vegetable fibers,
- operating plant nurseries;
- breeding and feeding of cattle, hogs, and sheep, including wool production,
- operating dairies,
- operating poultry and egg production facilities,
- breeding horses, and
- raising mink, chinchilla, and similar small animals.

5. Operations of agricultural producers often involve various combinations of those activities and practices and their products may further vary because of variations in temperature, soil, rainfall, and regional economics. Farm products may be used in related activities, such as feeding hay and grain to livestock, or they may be marketed directly by the producer. Producers often sell products in accordance with government programs or through agricultural cooperatives. Marketing strategies may include forward contracts or commodity futures contracts to reduce the risks of fluctuations in market prices.

6. Agricultural producers often borrow to finance crop development costs and costs of acquiring facilities and equipment.

Agricultural Cooperatives

7. About 7,500 agricultural cooperatives process, market, or purchase agricultural products or perform related

services for producers. About 70 to 80 percent of the nation's farmers are patrons of one or more cooperatives.

8. Of the 7,500 cooperatives, about 1,700 have limited or sporadic operations. According to a 1976 study by the Cooperative Program of the Economics, Statistics and Cooperatives Service, U. S. Department of Agriculture, active cooperatives provide the following services:

Supply	2,164
Marketing	1,674
Combined	1,957
Total	5,795

9. In 1976 those cooperatives sold $51.8 billion of products and had total equity of $7.7 billion and total assets of $18.6 billion. The 1979 list of Fortune's 1,000 largest industrial companies included 15 cooperatives. Farmland Industries, Inc., the largest, was 91st on the list. At least 55 cooperatives not on the Fortune list had sufficient sales to be included.

10. Section 1141 j of the Agricultural Marketing Act of 1929 contains the following definition of a cooperative association:

> .....The term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services. Provided, however, that such associations are operated for producers or purchasers and conform to one or both of the following requirements:

> First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and
>
> Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

And in any case to the following:

> Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.

11. A cooperative typically has the following characteristics:

a. Assets are usually distributed periodically to patrons on a patronage basis. However, in certain situations, assets in the amount of net of tax earnings may be accumulated by the cooperative and may or may not be allocated to patrons accounts.

b. Members control the organization in their capacity as patrons and not as equity investors.

c. Membership is limited to patrons.

d. The return that can be paid on capital investment is limited.

e. At least 50 percent of the cooperative's business

is done with its members (excluding business with the U. S. Government).

12. Virtually all agricultural cooperatives meet the definition, which is used to determine eligibility for borrowing from various banks for cooperatives and for exemption from the annual reporting requirements of the Securities and Exchange Act of 1934. Not meeting the definition, however, does not necessarily prevent an entity from being considered as operating on a cooperative basis under Subchapter T of the Internal Revenue Code.

13. The main difference between cooperatives and other corporations is that the patrons and the cooperatives operate as single economic units to accomplish specific business purposes, such as, marketing farm products, purchasing supplies, or performing services for the benefit of the patrons. The aim is to reduce costs or to maximize sales proceeds through increased bargaining power from the patrons' combined resources and buying power.

14. The patron's role as an investor is secondary and incidental to his business relationship with the cooperative. The role as investor is required so that the costs of operation may be shared by all patrons.

15. Cooperatives do business for the benefit of their patrons. In recognition of that, if certain requirements are met, the Internal Revenue Code permits cooperatives tax deductions for earnings allocated to its patrons. Earnings not allocated are taxed at corporate income tax rates. Coop-

eratives may use other terms for earnings such as margins, net proceeds, or savings.

16. Another difference between cooperatives and other business corporations is that the cooperative's bylaws usually require it to distribute assets to patrons or allocate to patrons accounts amounts equal to its earnings on the basis of their patronage. The theory of distributions to patrons is different from that of payments of dividends to stockholders in other corporations. The distribution of earnings on the basis of patronage has been termed the price adjustment theory.

17. Under the price adjustment theory, a cooperative agrees to do business at cost. In a purchasing cooperative, for example, a patron may be charged more than cost at the time of purchase; however, the cooperative normally must return to the patron all amounts received in excess of cost, including costs of operation and processing.

18. Nonexempt cooperatives are subject to federal income taxes on earnings arising from sources other than patronage, even if assets in the form of cash or noncash allocations are distributed to patrons in the amount of the earnings. Both exempt and nonexempt cooperatives are subject to income taxes on earnings if the cooperatives do not distribute or allocate to patrons accounts amounts equal to their earnings on a patronage basis.

19. Problems arise in cooperatives in predicting what total costs of finished goods derived from member product

deliveries will be in any given period. Cooperatives generally try to buy or sell at the current market price of competitors. At year end, they determine total costs and make distributions to patrons in the form of cash, certificates, or other notices of allocation based on the excess of revenues over costs.

20. The two major types of cooperatives are (1) supply cooperatives and (2) marketing cooperatives. Services related to those functions are provided by some supply and marketing cooperatives, and they are also provided by separate associations known as service cooperatives. Service cooperatives provide services such as trucking, storage, accounting, and data processing. A special type of service cooperative is a bargaining cooperative, which serves its members by negotiating on their behalf with processors.

21. Supply cooperatives obtain or produce items for their patrons, such as building materials, equipment, feed, seeds, fertilizer, and petroleum products. Marketing cooperatives provide means for agricultural producers to process and sell their products.

22. Many marketing cooperatives commingle patrons' fungible products in a pool or in pools. The excess of revenues over costs for each pool is allocated to patrons on the basis of their pro rata contribution to the pool, which may be determined by the number of units delivered, the volume of product delivered, or another equitable method.

23. The members of local cooperatives are agricultural

producers whose activities are generally centralized. The members of federated cooperatives are other cooperatives whose activities are regional. Some cooperatives have both individual producers and other cooperatives as members.

ACCOUNTING FOR INVENTORIES BY PRODUCERS

Authoritative and Other Literature

24. No authoritative or other accounting literature specifically covers accounting by producers, and available material is predominately tax oriented. Such literature includes the following concerning accounting for inventories:

- Accounting Research Bulletin 43, Chapter 4, Statement 9. Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

  Discussion

  It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may

be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

- Accounting Principles Board Statement 4, Chapter 6. .16 Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices. The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability, are reasons given to support this exception.

- Accounting Research Study No. 13, Chapter 9, Page 156. Market as the accounting basis of inventories. Exceptional cases exist in which it is not practicable to determine an appropriate cost basis for products. A market basis is acceptable if the products (1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relativly insignificant costs of disposal. The accounting basis of those kinds of inventories should be their realizable value, calculated on the basis of quoted market prices less estimated direct costs of disposal. Examples are precious metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations.

Diversity in Practice

25. The following data obtained from published financial

statements analyzed by the Agribusiness Committee illustrate the diversity in practice in accounting for growing and harvested crops and livestock:

Accounting for growing crops

Charge costs to operations when incurred

Include crop development costs in deferred charges until amortized

State costs in balance sheet at unchanging amounts substantially less than costs incurred and charge all current costs to operations when incurred

Defer all costs and write them off at harvest or, for perennial crops, over the estimated productive life of the planting

Accounting for harvested crops and livestock

Farm Price Method

Cost (FIFO) (LIFO) (Average cost)

Lower of cost and market

Unit Livestock Method

26. The committee believes that many small producers use the farm price method (market) to account for inventories of harvested crops. Large companies, particularly those whose securities are publicly held, tend to account for harvested crops at the lower of cost and market.

Pros and Cons

27. A study of accounting for inventories of producers involves a reexamination of Statement 9 of Chapter 4 of

Accounting Research Bulletin 43. That bulletin provides that inventories may be stated above cost if "...justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristics of unit interchangeability." That statement and the related discussion have been used as authority for accounting for producers' inventories at market.

28. An inquiry by the committee addressed to accountants serving a significant number of agricultural producers provided responses generally favoring accounting for harvested crops at market value. Some of the respondents believed that many producers cannot determine costs, and some believed that market was an appropriate value whether or not cost data was available. A majority of the respondents believed that users of financial statements of producers would find them less useful if inventories were valued at the lower of cost and market.

29. Other reasons given for the preference for market value were its long established use and the need to identify separately the gains and losses attributable to the production cycle and the marketing function, which is discussed in paragraph 35.

30. For most business activities, the accounting literature requires an exchange of goods or services before income is recognized. That precludes accounting for inventories of unsold goods at market, unless market value is less than cost. The principal exceptions to that rule are identi-

fied in Chapter 9 of Accounting Research Study 13 as "metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations." Those products have unique cost identification problems. Chapter 9 of Accounting Research Study 13 further states that those products to be carried at market values, are required to:

> ...(1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal.

Inability to Determine Costs

31. The first of the three conditions in ARB 43 (Statement 9) is the inability to determine costs. While many producers may not keep detailed cost records, the information made available to the committee indicates that costs are either available or can be determined with acceptable accuracy.

32. Those who favor accounting for producers' inventories at market recognize that ARB 43 requires an inability to determine appropriate approximate costs. They point out, however, that the discussion interprets the statement to apply when "appropriate costs may be difficult to obtain." They also note that APB Statement 4, Chapter 6, refers to the "difficulty in some situations of determining costs of products" as a partial justification for use of market price. Those who favor accounting for those inventories at market interpret Statement 9 as allowing that treatment on the basis that costs are difficult to determine, not that they are impossible to determine.

Availability of Market Prices

33. A major argument for accounting for inventories at market is the availability of established markets that provide quoted market prices for most agricultural commodities. However, restrictions exist that affect the ultimate realization of quoted market prices of agricultural products, including variations in grade and quantity, distance from central markets, and hazards of shipment. Thus, there could often be serious difficulties in determining the market price for a given product in a given place. Also, many products have no central market with established prices, and determining their market prices may be subjective and incapable of verification.

34. While ARS 13 does not cover inventories of agricultural products, it questions the appropriateness of accounting for inventories at market even if an established market exists. The study notes that present principles appear to allow the use of market price in accounting for inventories of precious metals if there is a fixed selling price and insignificant marketing cost regardless of whether it is practicable to determine costs. The study states:

> ...The apparent preferential treatment may have originally been considered appropriate because metals having fixed monetary values clearly demonstrated the "immediate marketability at quoted market prices and the characteristic of interchangeability" required in the cases in which it is impracticable to determine costs. Further question as to why preferential treatment was originally accorded to precious metals might now be considered academic. Silver no longer has a fixed monetary price, and gold has a fluctuating free market price for nonmonetary purposes. That raises questions

as to whether the inventory basis for gold and silver should now be considered the same as for other metals produced as by-products or joint products.

35. Some proponents of accounting for inventories of producers at market distinguish the production of a crop from its marketing, and believe delays in the disposal of a harvested crop or of livestock are principally due to the producer's desire to sell the commodities later at a higher price. They contend that in order to separate the results of the performance of the two functions, the inventories should be accounted for at market prices after they are harvested. They point out that both functions are likely to cause significant gains and losses. In response to such contentions, some claim the same argument can be made for many nonagricultural enterprises that are not permitted to recognize income at the end of production.

36. The securities of most agricultural producers are not traded publicly and their financial statements are prepared primarily for management and lenders. Advocates of the use of market prices contend that lenders are concerned with the market price of inventories to be used as collateral. Moreover, most producers are not required to use cost information for income tax purposes. Thus, some argue that determining cost for financial statements is an unproductive additional burden to the producer. Conversely, cost advocates point out that both public and nonpublic producers require long term financing, and cost basis financial statements may provide better information for those purposes.

37. Some believe it is difficult to argue persuasively for charging to expense the periodic costs of growing crops as incurred since a valuable asset is being developed. Some contend the use of a fixed amount less than cost violates existing accounting principles of accounting for assets. Others believe it is acceptable, and consistent with a market basis of accounting, to account for growing crops at net realizable value or at no value.

Issues

38. The issues are:

a. How should producers account for growing crops?

b. How should producers account for harvested crops and livestock held for sale?

* * * * * * *

Advisory Conclusions

39. The committee believes:

a. Growing crops should be valued at the lower of cost and market.

(Yes 13 No 1 Abstain 0)

AcSEC Vote

(Yes 12 No 0 Abstain 1)

b. Usually, inventories of harvested crops and livestock held for sale should be accounted for at the lower of cost and market. However, in certain circumstances the prevailing conditions for agricultural producers may justify a departure from usual accounting principles for revenue recognition. Therefore, an agricultural

producer should be permitted to account for harvested crops and livestock held for sale at market, less estimated costs of disposal, when all the following conditions exist:

- The product has a reliable market price that is readily available,
- The product has relatively insignificant and predictable costs of disposal,
- The product is available for immediate delivery.

(Yes 12 No 1 Abstain 1)

AcSEC Vote

(Yes 12 No 2 Abstain 0)

(Seven AcSEC members, six of whom voted yes and one who voted no on this issue, prefer the required use of market values for harvested crops and livestock held for sale when the above conditions exist.)

ACCOUNTING FOR DEVELOPMENT COSTS OF LAND, TREES AND VINES, INTERMEDIATE LIFE PLANTS, AND ANIMALS

Background

40. This section discusses accounting for development costs of land, trees and vines, intermediate life plants, and animals, which should be distinguished from costs incurred in raising annual crops for harvest. Accounting for the costs of growing crops is discussed in the section on Accounting for Inventories by Producers.

41. Land development generally includes making improvements needed to bring the land into a condition suitable for general agricultural use and to maintain its productive condition. Some improvements are permanent and some have a limited life. Permanent land developments include, for example, clearing, initial leveling, terracing, and construction of earthen dams. Those improvements involve changes to the grade and contour of the ground and generally have an indefinite life if properly maintained. Limited life developments usually include items such as water distribution systems and fencing and may also include the costs of wells, levees, ponds, drain tile, and ditches, depending on the climate, topography, soil conditions, and farming practices in the area.

42. Orchards, vineyards and groves generally develop over several years before they reach commercial production. Production continues for varying numbers of years, depending on influences such as type of plant, soil and climate. During development, the plants normally require care such as grafting, pruning, spraying and cultivation.

43. Intermediate life plants are those that have growth and production cycles of more than one year but not as long as those of trees and vines. They include, for example, artichokes, various types of berries, asparagus, alfalfa, and grazing grasses. Development costs of intermediate life plants include cost of land preparation, plants, and cultural care until the plant, bush, or vine begins to produce in commercial quantities.

44. The terms livestock and animals are used interchangeably and are meant to include cattle, sheep, hogs, horses, poultry and other small animals. The development of animals requires care and maintenance of the breeding stock and their progeny until their transfer from the brood herd. Animals purchased before maturity also require care and maintenance to ready them for productive use or sale. Animals are maintained and cared for during development and are ultimately identified for transfer to breeding herds, dairy herds, or other productive functions, are selected for sale, or are transferred to a feeding or other marketing operation.

Diversity in Practice

45. The committee found that costs of land developments, trees and vines, intermediate life plants and animals are accounted for in the following ways:

a) charged to operations when incurred

b) included in deferred charges

c) included in the balance sheet at fixed amounts substantially less than costs incurred with all or a majority of the current costs charged to operations as incurred

d) capitalized and amortized over the estimated productive life of the animal, tree, vine, or plant

e) carried at market values

46. The committee found that costs are generally matched

with revenues by producers of annual field crops that are planted and harvested in the same accounting period. However, when the growing cycle continues beyond the accounting period, costs often are not matched with revenues.

47. Few significant diversities of practice could be identified in the financial statements reviewed, primarily due to lack of disclosure. However, committee members are aware of the practice by agricultural producers of charging to expense land development costs based on provisions of the income tax laws.

48. In accounting for development costs of trees and vines, some agreement exists among producers with the general principle that the costs should be capitalized and depreciated over the expected productive life, but the costs to be capitalized and those to be charged to expense are not identified uniformly. Income tax concepts have had a strong influence on accounting practices for those development costs.

49. The committee found that crops from intermediate life plants have generally been accounted for the same as annual crops, with no distinctions for variations in the periods of development and productivity.

50. A review of accounting methods used by livestock producers indicated that many deduct costs of developing animals without regard to their productive lives or future use or sales value. Animals are sometimes recorded at cost and other times at market values. A few examples were found of the use of the unit livestock method and in most of those,

the annual unit cost increments were below market and probably below cost.

Pros and Cons

51. Some believe that large scale improvements that transform the land to new and better uses are permanent land improvements to be capitalized and that subsequent modifications and improvements are necessary and should be classified as period expenses.

52. Others believe it difficult, or nearly impossible, to distinguish between permanent, limited life, and recurring land development costs. Land improvements that have been made over many years by an owner tend to lose their original characteristics. Such improvements are usually accompanied by increasingly intensive use of the land over relatively long periods. Improvements of prior years are modified, improved on, or eliminated, and the resulting land configuration and use are noticeably changed. The characteristics of continuing land improvements accomplished over long periods are given as justification for classifying those costs as recurring.

53. Many believe that all direct and related indirect costs of land development, such as leveling, clearing of brush, terracing, and installation of drain tile, should be capitalized. They further believe that land development costs that waste away or diminish in efficiency through use, such as drainage tile, should be depreciated or amortized over the number of seasons that the land can reasonably be expected to produce without renovation or renewal of the particular development.

54. It is generally agreed that development costs of orchards, vineyards, and groves should be capitalized ,but there is no agreement on the specific costs that should be capitalized. Many believe it necessary to capitalize only those costs required to be capitalized by income tax laws.

55. Some believe that all direct and indirect costs for orchards, vineyards and groves incurred during the development period should be capitalized until commercial production is achieved. Others believe all such costs except annual maintenance costs should be capitalized. All agree that capitalized costs should be depreciated or amortized over the useful life of the plantings.

56. The committee found accounting practices for development costs of intermediate life plants to be inconsistent . Those who deduct expenses before revenues are realized do so for the same reason as the orchardists and vineyardists who do not want to capitalize development costs and depreciate them over the estimated productive life of the developed asset. The question of capitalization and depreciation is nearly identical for producers of intermediate life plants and for producers of trees and vines. The principal distinctions are the shorter development period and productive life. For example, orchard trees may require four to seven years before nominal production, while limited production may occur during the first year of crops such as alfalfa, some berries, and asparagus.

57. Some have objected to and resisted accumulating

development costs for growing animals, based on the difficulty and expense of accumulating such information, and, in some instances, the problem of identifying individual animals or groups and categories of animals. Instead of cost, the unit livestock method or a market value have been used for assigning amounts to the animals at each level of maturity in the belief that such accounting methods, if consistently applied, would not adversely affect income recognition.

58. Others believe that all direct and indirect development costs of raising livestock should be accumulated and capitalized until such livestock have reached maturity and have been selected for breeding or other productive purposes. Many believe that income producing livestock should be depreciated based on their expected productive life.

Issues

59. These are the issues in accounting for development costs of land, trees and vines, intermediate life plants, and animals:

a) How should permanent land development costs be accounted for?

b) How should limited life land development costs, and development costs of orchards, vineyards, groves, and intermediate life plants be accounted for?

c) How should development costs of animals held for breeding, dairy, or other working herds or groups be accounted for?

d) How should development costs of animals held for sale be accounted for?

* * * * * * *

Advisory Conclusions

60. These are the advisory conclusions:

a) Permanent land development costs should be capitalized and should not be depreciated or amortized, as they have, by definition, an indefinite useful life.

(Yes 14 No 0 Abstain 0)

AcSec

(Yes 13 No 0 Abstain 2)

b) Limited life land development costs, and development costs of orchards, vineyards, groves, and intermediate life plants should be capitalized during the development period, and depreciated over their estimated useful lives.

(Yes 14 No 0 Abstain 0)

AcSec Vote

(Yes 13 No 0 Abstain 2)

c) All direct and indirect costs of developing animals should be accumulated until the animals reach maturity and are transferred to a productive function. When animals reach maturity and are transferred to breeding or dairy herds or other productive functions, the accumulated development costs should be depreciated over the estimated productive life.

(Yes 14 No 0 Abstain 0)

AcSec Vote

(Yes 9 No 4 Abstain 2)

d) All direct and indirect development costs of animals raised for sale should be accumulated and the animals accounted for at the lower of cost and market until available for sale. Animals available and held for sale should be accounted for in accordance with the advisory conclusion in paragraph 39 b.

(Yes 14 No 0 Abstain 0)

AcSec Vote

(Yes 8 No 5 Abstain 2)

ACCOUNTING FOR PATRONS' PRODUCT DELIVERIES TO MARKETING COOPERATIVES OPERATING ON A POOLING BASIS

Background

61. Agricultural marketing cooperatives process and market the products of their patrons. There are frequently good bases for recording transfers of products between cooperatives and their patrons. For example, dairy cooperatives record transfers of products on the basis of market order prices and grain cooperatives record transfers of products on the basis of readily determined cash prices. Many cooperatives, therefore, transfer patrons' products at market prices, and the transactions are treated as purchases by the cooperatives and sales by the patrons.

62. However, cooperatives operating on a pooling basis receive products from their patrons without paying a fixed

price to the patrons. Cooperatives may assign amounts to products based on current prices paid by other buyers or on amounts established by the cooperatives' boards of directors, or they may assign no amount. The cooperatives estimate a liability to patrons equal to the assigned amount for the product delivered, and usually pay this liability on a short term basis. The excess of revenues over the assigned amounts and operating costs at the end of a pool period, which may be a week, a month, a year, or a longer period, is paid or allocated to patrons. Assets equal to that excess may be distributed to the patrons or retained by the cooperative.

63. The different accounting methods used by pooling cooperatives have been developed to satisfy provisions of their bylaws and contractual arrangements with patrons and to provided equitable methods of settlement from pool period to pool period as well as among the various classes of patrons. For pooling cooperatives accounting methods have been developed to allow the use of the single pool or multiple pool methods of accounting.

Diversity in Practice

64. Significant information about the accounting practices of patrons in the timing of recording the delivery of raw product to marketing cooperatives is scarce. Among practices noted were recognition (1) at the estimated net return, presumably at the time of delivery, and (2) at the time of sale by the cooperative to an outside party. Those two examples provide the extremes, one recognizing the delivery

to the cooperative as a sale and the other continuing to carry the product as inventory of the producer until sold by the cooperative. Diverse methods of establishing transfer prices for products delivered to cooperatives include:

- at market order price or other governmental price support,
- at market price,
- at an assigned amount determined by the cooperative's board of directors to approximate market price,
- at the amount of advances,
- at cost to the producer, or
- at no amount until the cooperative advises the producer of the expected proceeds from the ultimate disposition of the product.

65. Cooperatives that receive products from patrons and pay their patrons at or shortly after time of delivery a firm market price treat the payments as purchases. In those situations the prices are paid regardless of the amount of the cooperatives' earnings. Those cooperatives normally account for inventories at the lower of cost and market. However, pooling cooperatives estimate amounts due to patrons at time of delivery of products, and those amounts are later adjusted based on earnings of the pool. This presents a significant accounting problem. Therefore, the following paragraphs discuss only the accounting issues that result from deliveries of products by patrons to cooperatives operating on a pooling basis.

66. In cooperatives operating on a pooling basis, products delivered by patrons are commingled with other patrons' products, processed and marketed. Earnings from the sale of finished products are returned to patrons, either in cash or some form of equity, whether or not those earnings were determined on the basis of current market prices at time of delivery. Many cooperatives value patrons' products at assigned amounts (usually current market price) set by the board of directors at time of delivery. A corresponding estimated liability is recorded for amounts due to patrons. At the end of the pool period net earnings of the pool are credited to amounts due patrons on a patronage basis.

67. Some cooperatives cannot determine the market prices of patrons products when they receive them because of limited cash purchases by other processors. They are usually cooperatives that process and market a high percentage of limited specialty crops, such as walnuts, cranberries, concord grapes, prunes, or raisins. Many of those cooperatives account for inventories of goods in process and finished goods at net realizable value, determined by deducting estimated completion and disposition costs from the estimated sales value of the processed inventory, because a reliable price for the unprocessed product is not available to account for inventories at the lower of cost and market. Furthermore, many cooperatives need to determine net realizable value to comply with bylaw provisions and contractual obligations and to facilitate equitable pool settlements from pool period to pool period and among various classes of patrons.

68. A 1973 survey by the National Council of Farmer Cooperatives indicated that many marketing cooperatives use net realizable value to account for inventories. The following is an excerpt from an article on this subject prepared for the Legal, Tax, and Accounting Committee of the Council:

> The National Council of Farmer Cooperatives made a survey of the inventory valuation methods used by its marketing cooperatives. The results of this survey confirm what has been the private belief of most cooperative accountants, that the net realizable market value method is perhaps the most widely used and accepted method of inventory valuation by marketing cooperatives. This survey reflects the responses of 49 cooperatives and, in summary, indicates the following inventory methods are in use:

Method	Cooperatives	Sales (In Thousands)	% of Total Sales
Net realizable market value	24	$ 2,310,938	48%
Lower of cost and market, using field price as the established value of raw product	8	630,898	13
Net realizable market value and lower of cost and market, using field price as the established value of raw product	5	$ 802,867	17
Cost	2	53,400	1
Rev. Rul. 69-67*	7	367,469	8
Other	3	621,925	13
	49	$ 4,787,497	100%

*Note: Rev. Rul. 69-67 refers to the cost advance method.

69. The net realizable value method of accounting for

inventories permits the recognition of estimated net earnings of the pool at the end of the fiscal period in which the patrons supply their crops to the cooperative. Inventories are stated at net realizable value and the amounts due to patrons is credited with the earnings. The net realizable value method of accounting for inventories permits closing the pools at the end of the accounting period and provides equitable treatment to patrons as the cooperative transfers the inventories forward to the next period's pool at estimated market value.

70. A few marketing cooperatives receive products from patrons without assigning amounts to them. During the year, cash is advanced to patrons based on anticipated earnings. Inventories are recorded at amounts advanced plus costs of processing and patrons' products are valued at the amount of advances made to the date of the financial statements, primarily to comply with certain rulings of the Internal Revenue Service. This is commonly called the cost advance method.

Authoritative and Other Literature

71. Except for Accounting Research Bulletin 43, no authoritative literature covers accounting for inventories that result from deliveries of products by patrons to cooperatives. However, the National Society of Accountants for Cooperatives, the National Council of Farmer Cooperatives, members of public accounting firms, and others have authored literature, including the following, that is generally accepted by agricultural marketing cooperatives:

- Accounting Research Bulletin No. 3 - Valuation of Inventories in Agricultural Marketing Cooperatives, 1972, published by the National Society of Accountants for Cooperatives, discussed valuations of inventories in marketing cooperatives, particularly the use of net realizable value.

- A Touche Ross & Co. publication, Topical Index Docket, Release 76-271A discusses in some detail the various methods of inventory valuation in cooperatives. Included are detailed procedures to be used in valuing inventories at net realizable market value, such as the valuation date and the deductions to be made from the market or sales value.

- Accounting for Inventories of Agricultural Cooperatives, Robert C. Estes, for the Legal, Tax and Accounting Committee, National Council of Farmer Cooperatives, 1973. This article discusses, among other things, the net realizable market value method for valuing inventories in agricultural marketing cooperatives.

Issues

72. The issue in accounting by patrons for delivery of products to cooperatives is should the delivery of products to a cooperative be treated as a sale by the patron at the time of delivery and, if so, how should the sales amount be determined?

73. The issues in accounting by cooperatives for products received from patrons are:

a. If marketing cooperatives assign no value to products when they are received from patrons based on reliable current market prices paid by others for similar products in the same area, should the cooperatives later account for inventories at net realizable value?

b. If the boards of directors of marketing cooperatives operating on a pooling basis, with no obligation to pay patrons fixed prices, assign amounts to products received from patrons based on determinable current market prices paid by others for similar products in the same area, should the amounts assigned to products be considered cost of inventories and should inventories be accounted for at the lower of that cost and market?

c. In determining pool proceeds and transferring inventories to subsequent pools, may cooperatives account for products received from patrons at assigned amounts, but account for inventories of goods in process and finished goods at net realizable value?

d. If no amount is assigned to products received from patrons, should cooperatives account for inventories of finished goods at costs that include patrons' products at only a proportionate share of cash advances made to patrons for the period being reported?

Pros and Cons

74. A transaction is usually completed when a patron delivers his product to a cooperative. The patron's product is commingled with that of other patrons and title and indivi-

dual risk of loss have passed. Some believe no accounting is necessary at the time of delivery because the transfer price is frequently not known until some later date. Nevertheless, accrual basis accounting calls for reporting the transaction based on the best information available at the time. While greater accuracy may be achieved by waiting for the cooperative to advise the patron of the net proceeds, the handicap of not having current financial information could outweigh the benefit of greater accuracy and the lack of consistency in reporting could be confusing to the users of the financial statements.

75. For pooling cooperatives, some argue that an assigned amount for products received from patrons should not be used for financial accounting and reporting purposes because the amounts may not be reliable and the patrons may be paid more or less than that amount at the end of the pool period. However, some argue that an assigned amount permits the use of generally accepted accounting and reporting principles, including the establishment of a tentative liability due patrons and inventories stated at the lower of cost and market. The method also facilitates allocation of pool proceeds to patrons.

76. Some believe the net realizable value method of accounting for inventories is unacceptable because it anticipates cooperative earnings. Further, they believe future selling prices and disposition costs are too uncertain to base accounting on them. Alternately, those who favor the

use of the net realizable value method believe the problems of determining net realizable value do not differ from those of determining market under the lower of cost and market method. They also believe the method is acceptable in accounting for pools because it enables the cooperative to settle pools annually and to comply with bylaw provisions and contractual obligations. In essence, they claim, the inventory is transferred to the next period's pool on an equitable basis.

77. Some believe cooperatives may record products received from patrons at assigned amounts and then account for the inventories at net realizable value. That method permits closing pools at least annually on an equitable basis. Others believe if assigned amounts are used on receipt of the product, the inventories should be accounted for at the lower of cost and market.

78. Some favor the cash advance method of accounting for inventories. They believe the only product cost that should be accounted for is the total of cash advanced to patrons to the date of the financial statements, because the cooperative has no liability to pay more unless earned. Others favor the cash advance method because the Internal Revenue Service has held in several rulings that pooling cooperatives should use that method in tax computations. Others reject the cash advance method because advances to patrons are primarily determined on availability of cash, the percentage of the pool production sold to the date of the financial statements, and short term inventory loan restric-

tions rather than on the value of products received. Further, they reject the method because the amount and timing of advances are generally subject to the board of directors' action and may vary from period to period.

* * * * * * *

Advisory Conclusions

79. The advisory conclusions concerning accounting by patrons for products delivered to pooling cooperatives are:

. If title has passed and if a price is available by reference to contemporaneous transactions in the market, or if the cooperative establishes an assigned amount, a delivery to the cooperative should be recorded as a sale at that amount on the date of delivery. If there is a reasonable indication that the proceeds from the cooperative will be less than the market price or the assigned amount, the lower amount should be used.

. If title has passed and there are neither prices determined by other market buyers nor amounts assigned by the cooperative, or if such amounts are erratic, unstable, or volatile, the patron should record the delivery to the cooperative as a sale at the recorded amount of the inventory and record an unbilled receivable. If there is a reasonable indication

that the proceeds from the cooperative will be less than the receivable, the lower amount should be used. Advances from the cooperative should be treated as reductions in the unbilled receivable.

. If title has not passed, the identity of the individual patron's product is maintained by the cooperative, and the price to the patron will be based on that identified product sale, the transaction is not complete and the product should be included in the patron's inventory until it is sold by the cooperative, at which time the patron should record the sale.

. Advances are financing devices and should not be used as amounts for recording sales.

(Yes 14 No 0 Abstain 0)

AcSEC Vote:

(Yes 10 No 1 Abstain 2)

80. The advisory conclusions concerning accounting by cooperatives for products received from patrons are:

a. If pooling cooperatives do not assign amounts to products received from patrons at times of deliveries based on reliable current market prices paid by others for similar products in the same area, the cooperatives should account for inventories at net realizable value with

corresponding credits to amounts due patrons. The method used and dollar amounts involved should be disclosed

(Yes 13 No 0 Abstain 1)

AcSEC Vote:

(Yes 10 No 2 Abstain 2)

b. If the boards of directors of agricultural marketing cooperatives, operating on a pooling basis with no obligation to pay patrons fixed prices, assign amounts to products received from patrons that approximate the market prices of the products, and the assigned amounts are based on current market prices paid by others in the same area, the assigned amounts are cost and the inventories of finished goods should be accounted for at the lower of cost and market, with disclosure of the use of assigned amounts and the dollar amounts involved.

(Yes 13 No 0 Abstain 1)

AcSEC Vote:

(Yes 11 No 1 Abstain 2)

c. Cooperatives accounting for inventories at net realizable value for financial reporting, for determining pool proceeds, and for transferring inventory amounts to subsequent pools may account for products received from patrons at assigned amounts for determining estimated

amounts due to patrons and for internal accounting purposes. The method used and dollar amounts involved should be disclosed.

(Yes 13 No 0 Abstain 1)

AcSEC Vote:

(Yes 7 No 4 Abstain 3)

d. Pooling cooperatives should not use the cash advance method to account for inventories.

(Yes 13 No 0 Abstain 1)

AcSEC Vote:

(Yes 12 No 0 Abstain 1)

ACCOUNTING FOR INVESTMENTS IN AND INCOME FROM COOPERATIVES

Background

81. Member patrons of cooperatives can be producers or other cooperatives. These member patrons provide most of the capital required by cooperatives. The capital usually represents long term investments acquired through initial cash investments, retains, or noncash patronage allocations. Voting rights for those investments are usually based on one member-one vote or limited weighted voting rather than on the number or amount of securities or other evidence of equity ownership held. The investments are made primarily to obtain an economical source of supply or marketing services and not on the expectation of a return on investment. The sale of such investments other than back to the issuing cooperative is usually restricted or prohibited.

Survey of Practices

82. Investments in cooperatives are generally carried by producers at cost, at cost plus declared retains, at cost plus estimated retains, or at an amount less than cost.

83. Most cooperatives carry their investments in other cooperatives at cost, if purchased, or at face amount if received in other than a purchase transaction (retains or noncash patronage allocations). However, they usually write the investments down to estimated net realizable value if evidence indicates they will be unable to fully recover the carrying amount of the investments. That practice has been endorsed in Accounting Research Bulletin No. 2 issued by the National Society of Accountants for Cooperatives, which states:

> ....investments in cooperatives made by user patrons for the purpose of providing capital for operations of the investee cooperative should be carried at cost, if purchased, or at face value if received in transactions other than purchases such as non-cash patronage dividends. Such investments should be written down to an appropriate amount if reliable evidence indicates that their value has been permanently impaired.
>
> It should be noted that in most instances accounting for investments in other cooperatives (including banks for cooperatives and other cooperative financing organizations, such as the National Rural Utilities Cooperative Finance Corporation) on the basis outlined above results in investment carrying values equal to the equity values of the investing cooperative's interest in the investee cooperatives; therefore, it would appear that the basis outlined complies with APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock", to the extent that the intent of the opinion is applicable to

> investments of cooperatives. In the infrequent instances where the investor's share of unallocated retained earnings of an investee cooperative is material to the investor, the principles set forth in APB Opinion No. 18 should be applied.

84. A review of financial statements of cooperatives that invest in other cooperatives indicates that allocated equities are usually recognized in the cooperative investor's fiscal year within which notice of allocation is received, and the investment is carried at cost plus allocated equities. That method of revenue recognition conforms with reporting required for federal income tax purposes. It is the most practical method of reporting because many investee cooperatives issue financial statements and determine patronage allocations only at the close of their accounting years. Many cooperatives do that because they find determining patronage allocations complex and time consuming, since their operations may include both marketing and supply functions as well as several departments under each function.

85. Accounting literature gives little attention to accounting problems relating to investments in cooperatives, and diversity in practice has developed in accounting for unallocated equities. Some patrons who hold at least a 20% ownership interest recognize their interest in unallocated equities in accordance with APB Opinion 18. Others do not recognize unallocated equities, primarily because the equity ownership percentage changes based on patronage and voting is usually based on the one member-one vote principle, which does

not necessarily provide significant influence. Interpretation and application of APB Opinion 18 may in the future become more significant in financial reporting for cooperatives because the 1978 changes in the Internal Revenue Code, relating to the investment tax credit, may encourage cooperatives to reduce distributions of assets to patrons and increase unallocated net after-tax earnings for the purchase of assets.

86. The timing for reporting allocated equities also needs to be examined. Most patrons recognized their patronage allocations when they are notified, which conforms with federal income tax reporting requirements. Other patrons accrue patronage allocations based on interim financial statements of the cooperatives.

87. Presentation of patronage allocations in patron financial statements is also diverse. Some patrons recognize patronage allocations as reductions of purchase or interest costs on purchases from supply or financing cooperatives or as increases in sales for deliveries to marketing cooperatives. Other patrons recognize all patronage allocations as nonoperating income.

Relevant Accounting Literature

88. Authoritative literature on marketable investments - Statement of Financial Accounting Standards No. 12, "Accounting for Certain Marketable Securities," and FASB Interpretation No. 16, "Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable" - has little applicability to investments in cooperatives. Investments in cooperatives are usually not readily marketable, and

transfer or sale other than back to the issuing cooperative is usually restricted or prohibited. Current accounting literature supports carrying long term investments, such as nonmarketable investments in agricultural cooperatives, at cost as long as the value of the investments is not impaired. Carrying amounts are reduced when the investor becomes unable to fully recover the carrying amounts. APB Opinion 18 requires the equity method of accounting for investments in which the investor has significant influence over operating and financial policies of an investee.

89. The significance of investments by patrons results primarily from the purchasing or marketing rights and participation in the operating earnings. As such, the operations of cooperatives have many of the attributes of corporate joint ventures or partnerships.

Issues

90. The basic issue is how should patrons account for investments in cooperatives?

91. Other issues are when should patronage allocations be recognized and how should increases or decreases in allocated equities be presented in the patron's statement of operations?

Pros and Cons

92. Some argue the investment in a cooperative is in substance a long-term investment and, as such, should be carried at cost or, alternatively, at cost plus allocated equities. Some believe the investments should be discounted to their present value. The carrying amounts would be adjusted downward as required

by generally accepted accounting principles when the patron becomes unable to fully recover the carrying amounts.

93. Proponents of the discounting of investments in cooperatives believe it results in satisfactory presentation in the financial statements because allocated equities are usually not redeemed or are redeemed over a long period. However, others believe patrons contribute amounts to cooperatives not as investments but to obtain supply or marketing sources and the allocated equities represent a proportionate share of the earnings of the cooperative for the period of patronage. That is similar to accounting for equities in partnerships or corporate joint ventures in which undistributed earnings are recognized for accounting purposes on the same basis as for federal income tax reporting. Proponents of that method also believe it produces symmetry, since the investee records the issuance of securities or book credits at par or face amount rather than on the basis of discounted values. The proponents argue further that the method conforms with the underlying price-adjustment theory of cooperatives, which holds that such allocated equities are merely reductions of the cost of supply purchases or increases in the proceeds of products marketed through the cooperative and, therefore, should be reflected in the results of operations of the patrons.

94. Those who believe that unallocated losses of a cooperative should not be recognized by the patrons base their belief on the premise that operating losses may indicate

temporary rather than permanent declines in value, because they may be the result of identifiable, isolated, or nonrecurring events. Accordingly, they should not be recognized. Many investor cooperatives determine patronage allocations on the basis of financial statement reporting rather than on the basis of federal income tax reporting. Therefore, others argue that financial statement recognition by investor cooperatives of unallocated losses will cause the payment of federal income taxes by the investor cooperative that would not otherwise be payable and such taxes will not be recoverable if the losses are later allocated. That adverse effect is the result of federal income tax regulations that limit the patronage refund deduction to the lesser of the patronage refund "paid" or the patronage refund "allowable" as determined in accordance with federal income tax rules and regulations. Those who believe unallocated losses should be recognized argue that the allocated losses must be recognized for consistent reporting by patrons the same as if the investment were in a corporate joint venture or partnership rather than a cooperative. They further believe not recognizing unallocated losses permits management of earnings because patrons often serve on the board of directors of the cooperative or can influence the board of directors, which has the authority to determine the portions, if any, of the losses that will be allocated to patrons.

95. Those who believe unallocated equities should not be recognized by the patrons generally believe that APB Opinion 18 does not apply because equity ownership generally does not

convey voting control and ownership interests in unallocated equities may be temporary as a result of changes in subsequent patronage participation and the redemption of equities. However, others believe APB Opinion 18 should apply to all investments in cooperatives in which the patrons hold at least 20% or more of the equity securities, regardless of the one member-one vote requirement and the fact that ownership interests may change. They believe the patron frequently has significant influence due to patronage volume, assured representation on the board of directors, or other means.

96. Some believe patronage allocations should be recognized in the accounting period in which the supply is purchased or the product is marketed, as those transactions are the source of the patronage allocations and are adjustments of the price at which the supply is purchased or the product marketed. Others believe the accrual of estimated patronage allocations is not practical because many cooperatives do not determine patronage allocations at interim periods and the amount of the allocations usually cannot be determined from interim financial statements of the cooperatives. Further, existing federal income tax rules and regulations, as well as the bylaws of most investee cooperatives, require patronage allocations of the investee to be included in taxable income in the period the investor is notified of the patronage allocation. This tax requirement may cause adverse tax effects for investors.

97. Some believe allocated and unallocated equities should be reflected in the statement of operations as reductions of costs or increases in proceeds because such amounts

result from the transactions by which supplies are purchased, interest is paid, or products are sold. Accordingly, the proponents believe they should be reported in the same manner as the original transactions to properly report sales, cost of sales, and operating expenses. Others believe the allocations should be reported as other income rather than as increases or decreases in sales, cost of sales, or operating expenses. They believe that including the allocations in sales, cost of sales, or operating expenses could misstate gross profit or expenses.

* * * * * * *

Advisory Conclusions

98. Investments in cooperatives should be accounted for at cost, including allocated equities and retains. The carrying amount of an investment in a cooperative should be reduced when the patron is unable to fully recover the carrying value of the investment. Losses unallocated by the investee probably indicate such an inability and, at a minimum, the patron's proportionate share, based on the patron's proportionate share of the total equity of the investee cooperative, of the excess of unallocated losses over unallocated equities should be recognized by the patron unless the patron can demonstrate it is probable that the carrying amount of the investment in the cooperative can be fully recovered.

(Yes 10 No 3 Abstain 1)

AcSec Vote

(Yes 9 No 4 Abstain 1)

99. Since the primary purpose of a cooperative is to provide supply or marketing services to its members, the committee believes the patron should recognize patronage refunds in the period in which the related patronage occurs. As a result, patronage allocations should be deemed to be adjustments of cost or proceeds and accrued as soon as the amount can be reasonably estimated. The accrual should be based on the latest available reliable information, and should be adjusted on notification of allocation. Since such allocations are deemed to be adjustments of costs or proceeds, classification of the allocations in the financial statements should follow the recording of the costs or proceeds. However, if patronage refunds cannot be reasonably determined in the period in which the patronage transactions occur and if the refunds in a subsequent year have a material effect on sales, cost of sales, or expenses, the amount of the refunds applicable to prior periods should be disclosed in the financial statements.

(Yes 14 No 0 Abstain 0)

AcSec Vote

(Yes 13 No 0 Abstain 1)

ACCOUNTING FOR FORWARD AND FUTURES CONTRACTS BY PRODUCERS AND COOPERATIVES

Background

100. This section discusses criteria for differentiating between hedge and nonhedge futures transactions of producers and cooperatives and accounting for hedging transactions by producers and cooperatives.

101. Because of uncertaintities such as abnormal weather, transportation problems, or changes in supply or demand, the prices of agricultural commodities can fluctuate dramatically. Cooperatives and producers may try to reduce risk from those changes by using forward sales or forward purchase contracts or by selling or buying futures contracts. Forward and futures contracts generally allow cooperatives and producers to reduce risk of loss from adverse price changes and substantially eliminate the possibility of gains from favorable price changes.

102. Producers use forward sales and purchase contracts as hedges to assure known prices for commodities that are on hand, to be produced, or to be used in production. Forward sales and purchase contracts are an integral part of hedging by cooperatives, since the contracts assure a source of spot purchases or sales and, therefore, are considered in reaching decisions on futures contracts required for hedging.

103. Both producers and cooperatives use commodity futures contracts. Present accounting practices for those contracts vary. The variations result from numerous factors, including the type of agricultural products, geographic location, regional practices, and lack of definitive accounting guidance.

104. Hedges are classified as either buying (long) hedges or selling (short) hedges. Buying hedges are typically entered into to establish fixed costs if fixed price sales commitments have been entered into or to fix the buying price

of a commodity to be used in production or processing. Selling hedges are typically used to establish sales prices if the enterprise owns the inventory, has a fixed price purchase commitment, or intends to produce a particular commodity.

105. Forward contracts pertain to the spot market and involve acquiring or disposing of goods at fixed or determinable prices for which authoritative accounting pronouncements exist. Losses on forward purchase contracts of goods for inventory should be measured in the same way as inventory losses, as described in Statement 10 of Chapter 4 of Accounting Research Bulletin No. 43. Accounting for forward sales contracts is covered under Statement 6 of Chapter 4 of Accounting Research Bulletin No. 43, which indicates that such contracts should be taken into account in arriving at market in determining the lower of cost and market.

106. A cooperative that uses the hedging procedures method must consider open forward contracts to determine its net inventory position subject to price fluctuations and the resulting quantities to be hedged by futures contracts. Forward purchase and sales contracts used in those circumstances are discussed in this issues paper.

107. This discussion considers accounting for futures contracts by agricultural producers and cooperatives regardless of the method they use to account for their inventories. It does not include hedging transactions of other processors, suppliers, or users of agricultural products.

Authoritative and Other Literature

108. Only in recent years has authoritative literature discussed accounting questions regarding hedging transactions. Accounting for forward exchange contracts is discussed in FASB Statement No. 8. That Statement provides that gains or losses shall be deferred only for forward exchange contracts that are hedges. The rules to classify forward exchange contracts as hedges are strict and any violation changes the classification and results in immediate recognition of gain or loss. Excerpts from that statement (as modified to reflect portions of other paragraphs, which are bracketed [ ]) follow:

> There shall be the presumption that the intent of entering into a forward contract is a [(a) hedge of a foreign currency exposed net asset or net liability position, (b) hedge of a foreign currency commitment that does not meet the condition described below, or (c) speculation for which a gain or loss shall be included in determining net income for the period]. However, a forward contract shall be considered a hedge of an identifiable foreign currency commitment [and a gain or loss shall be deferred and included in the measurement of the dollar basis of the related foreign currency transaction if the gain or loss pertains to a forward contract that is intended to be a hedge of an identifiable foreign currency commitment] provided all the following conditions are met:
>
> a. The life of the forward contract extends from the foreign currency commitment date to the anticipated transaction date or a later date.
>
> b. The forward contract is denominated in the same currency as the foreign currency commitment and for an amount that is the same or less than the amount of the foreign currency commitment.

c. The foreign currency commitment is firm and uncancelable.

109. An exposure draft, dated June 30, 1981, of a proposed statement of financial accounting standards titled, Foreign Currency Translation, contains the following comments in paragraph 131 of appendix C:

> The Board believes that if a foreign currency commitment is hedged by a forward contract or by any other type of foreign currency transaction, the accounting for the foreign currency transaction should reflect the economic hedge of the foreign currency commitment. The existence of an economic hedge is a question of fact, not of form. Therefore, the Board did not require any linkage of the date of the hedging transaction with the date of the hedged commitment. However, the foreign currency transaction must be designated as, and effective as, a hedge of a foreign currency commitment. In some instances, it may not be practical or feasible to hedge in the same currency and, therefore, a hedging transaction also may be denominated in a currency for which the exchange rate generally moves in tandem with the exchange rate for the currency in which the hedged commitment is denominated.

110. In discussing Government National Mortgage Association (GNMA) futures transactions, the AICPA Industry Audit and Accounting Guide for Savings and Loan Associations on page 24 states:

> ...Associations may hedge against price risk by buying (long hedge) or selling (short hedge) futures contracts to offset transactions in the cash market. Except for recording margin deposits, no accounting entry is generally required until the futures contract is closed. Realized gains and losses on closed futures transactions should be matched to the related cash market transactions. Accordingly, if an association hedges to protect itself against sales in the cash market, the gain or loss from the futures contract should be reflected as part of the gain or loss on the loans sold in the

cash market. If an association has entered into a futures contract to hedge against sales of loans in the cash market, write-downs to market of loans held for sale may be confined to the unhedged portion of the loan inventory.

Gains or losses from futures contracts entered into to hedge against price fluctuations in originating or purchasing loans for investment should be deferred and amortized over the expected life of the related loans.

Since savings and loan associations are only permitted to engage in hedging rather than speculation in futures contracts, such contracts should be treated as closed at any time it becomes known that the expected cash transactions will not occur, and the futures contracts should be carried at market thereafter. If a futures contract is not closed at the time the transaction takes place in the cash market, the rollover of the futures contract should be marked to market and adjusted to market at each financial reporting date. Thereafter, futures contracts that do not represent positions taken as hedges against price fluctuations in originating, purchasing or selling loans should be adjusted to market at each financial reporting date.

111. In Section 5 - Commodity Transactions, of the AICPA Industry Audit Guide, Audits of Brokers and Dealers in Securities, support is given for deferral of unrealized gains or losses on hedging transactions:

In its simplest form, hedging involves the simultaneous purchase of the physical commodity to replenish inventory and entering into a contract for the sale of the same commodity for delivery at some future date. Theoretically, as physical (spot) inventory is accumulated, futures (sales) contracts are entered into to hedge against loss due to price fluctuations. As the physical inventory of the commodity is sold, the futures trade is closed by buying-in the previous sale. Any loss incurred on the futures transaction becomes part of the cost of sales and will be offset by a profit on the inventory liquidation, or vice versa.

112. Accounting Research Study No. 13, "The Accounting Basis of Inventories," discusses the rationale for and use of the hedging procedures method. As stated in the Study, the hedging procedures method is an inventory pricing method, requiring that a fully or substantially hedged position be maintained. If so, open futures contracts are an integral part of inventory valuation. The concluding paragraph of Chapter 8 states:

> I therefore recommend that the hedging procedures method be given authoritative recognition as the preferable accounting basis of the hedged portions of inventories of grain merchandisers and processors. The method should be differentiated from methods that are exceptions to the realization principle. The use of the method should, however, be appropriately explained in notes to the financial statements, with disclosure of the extent to which the resulting basis approximates the lower of cost or net realizable value. The recommendations are incorporated in the substance of recommendations set forth in Chapter 9.

113. The Study, on page 156 of Chapter 9, "Recommended Restatement of Principles," states:

> Hedging procedures. If an enterprise is engaged in the merchandising or processing of grains and follows a policy of hedging its inventory positions by entering into contracts in established commodity futures markets to buy or sell corresponding quantities of grain or grain content of converted product, the preferable accounting basis for its grain inventories is current market price adjusted to reflect gains and losses of all open commodity futures contracts at the inventory date. The use of this so-called hedging procedures method operates to approximate a lower of cost or net realizable value basis for the hedged inventory amounts.

114. The AICPA Issues Paper on Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts includes problems common to those encountered by agricultural producers and cooperatives. The advisory conclusions on the basic issues in that paper include the following:

> Changes in market values of forward and futures contracts should generally be recognized currently in the income statement. This basis of accounting (commonly referred to as "mark-to-market") should be used when (1) the forward and futures contracts are entered into for speculation, (2) forward and futures contracts represent hedges of asset positions, contemplated asset purchases or short positions, all of which are, or will be, carried at market value, or (3) the criteria for hedge accounting for specific hedging transactions discussed in paragraph 53(a) are not met. However the aggregate lower of cost and market valuation for forward and futures contracts should be followed rather than the mark-to-market method when an entity uses the lower of cost and market method for similar types of short term or other trading positions.
>
> An entity should use hedge accounting rather than the mark-to-market approach for forward and futures contracts that meet the criteria for hedges ... Hedge accounting is based on the concept of symmetry between the accounting for the forward or futures contract and that of the asset or liability being hedged.
>
> Following are the accounting principles that should be followed in various specific hedging situations:
>
> - Anticipatory hedge of an asset or liability to be carried at cost. Gains and losses on forward and futures contracts should be deferred and included in measurement of the dollar basis of the asset acquired or the liability incurred for which the hedge was intended. The gains and losses would then be amortized to income over the asset or liability holding period as an adjustment to interest income or interest expense.
>
> - Hedge of an asset carried at cost. Gains and losses on forward and futures contracts

sold to hedge against market declines for existing assets carried at cost should be deferred and recognized in income when the hedged asset is sold or recorded as an adjustment to the carrying value of the asset if the futures or forward contract is closed out before the hedged asset is sold (see paragraphs 53(d) and (e)).

- Hedge of assets carried at lower of cost and market or hedge of liabilities carried at higher of cost and market. Gains and losses on forward and futures contracts bought or sold to hedge against market declines in existing assets positions carried at the lower of cost and market or short positions carried at the higher of cost and market should be deferred and considered in determining the lower of cost and market or higher of cost and market adjustment at the end of each reporting period. Deferred gains and losses from those hedges should be recognized in income when the hedged commitment or position is honored or sold. If a hedged asset continues to be held after the forward or future contract is closed out, the deferred gain or loss should be included in the carrying amount of the asset being hedged; the asset (at its adjusted cost) will be subject to the lower of cost and market test at each subsequent reporting date.

115. Concerning other issues, the Issues Paper on Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts includes the following:

> Criteria should be established to distinguish hedge from non-hedge situations. The followimg are the recommended criteria:
>
> - At the time the forward commitment or futures contract is entered into, its purpose should be specifically identified and documented as part of the accounting records. The dollar amount and description of the asset or liability for which the hedge is intended should be specified.

- The price of the forward commitment or futures contract and the hedged assets or liabilities should have a high degree of positive correlation, that is, the tendency to move in the same direction with similar magnitude.

- For an anticipatory hedge, the anticipated transaction should reasonably be expected to be fulfilled in the ordinary course of business.

If these criteria are met, a specific hedge is entered into and hedge accounting should be followed.

- A forward or futures contract entered into as an anticipatory hedge should extend at least to the anticipated transaction date. The intended use of successive futures contracts satisfies this condition if the futures market precludes a single contract covering the entire period. However, if a forward or futures contract previously considered as a hedge of an anticipatory transaction is closed out, paired off, or otherwise terminated before the cash transaction date, the deferred gain or loss, if any, should continue to be deferred and included in the measurement of the dollar basis of the asset acquired or the liability incurred. If it becomes known that the anticipated cash market transaction will not occur, the deferred gain or loss on the forward or futures contract should be recognized immediately in income.

- If an anticipatory hedge is extended or rolled over and such extension or rollover was not previously contemplated in the original anticipatory hedge transaction (see paragraph 53(b)), the extension or rollover should be accounted for as a completed transaction. The deferred gain or loss, if any, should be recognized immediately in income.

116. While many books and articles on futures markets, hedging, and speculating are available, few discuss financial accounting for such activities. Literature reviewed by the committee that discusses accounting for hedging transactions deals primarily with the use and justification of the hedging procedures method. One study of inventory pricing practices in the grain industry states the author's conclusion that use of the hedging procedures method conforms with generally accepted accounting principles.[1/]

Criteria for Differentiating Between a Hedge and a Nonhedge Futures Transaction

Pros and Cons

117. Some consider that classification of a futures transaction as a hedge or a nonhedge should be based on the intention of the party on entering the transaction. They believe exposure to price changes for existing or anticipated inventory positions places an entity at risk and justifies classifying offsetting forward and futures contracts as hedges. Others believe specific criteria need to be met to satisfy the intention to hedge. They further believe that producers and cooperatives trading on commodity futures markets against inventories on hand are not necessarily hedging and may instead be engaging in speculation.

1/ "Inventory Pricing in the Grain Industry: A Study of Current Practice," Clyde Stevenson Rowley, Jr., Ph.D. thesis University of Wisconsin, 1970.

118. Some believe producers and cooperatives must be able to make or take delivery against a commodity futures contract to account for the transaction as a hedge. That position is based on the belief that inability to make or take delivery leaves the entity at substantial risk and that acquiring the contract is therefore speculation. Circumstances that cast doubt on the ability of producers and cooperatives to make or take delivery include these:

- The central market is so far away that delivery is not economically feasible.
- A position is taken on a commodity futures market against a growing crop or livestock on feed (anticipatory hedge).
- A position is taken on a commodity futures market by a producer committed to planting a particular crop or raising certain livestock (anticipatory hedge).
- A position is taken on a commodity futures market for a commodity that is different from that contracted, purchased, produced or sold.

119. Others believe a producer or cooperative need not be able to make or take delivery to account for a transaction on a commodity futures market as a hedge. However, they hold that the producer must identify the crop to be planted, livestock to be raised, growing crop, or livestock on feed and establish a reasonable estimate of the quantity of salable product. They also believe producers and cooperatives may

establish hedge positions for commodities not traded on organized exchanges by using different commodities that are traded, provided the price movement relationships are reasonably parallel.

Basic Issues

120. The issues are:

a. What should be the criteria to distinguish futures contracts as hedges and nonhedges?

b. What method of accounting should be followed for gains and losses on open futures contracts that do not meet the criteria of hedges?

c. What financial statement disclosures should be made for nonhedging transactions?

* * * * * * *

Advisory Conclusions

121. Futures contracts of producers and cooperatives should be considered hedges if all the following requirements are met:

a. When a commodity futures contract is entered into, its purpose should be specifically identified and documented as part of the accounting records. The commodity or livestock for which the hedge is intended should be specified and the quantity or count should be indicated. Sometimes specific identification in the accounting records is not practical; however, the entity should be able to support the purpose of the hedge.

b. The price of the futures contract and the spot price of the hedged assets should move reasonably parallel.

c. The crop to be planted, livestock to be raised, growing crop, or livestock on feed involved in an anticipatory hedge must be expected to be produced or raised.

(Yes 11 No 0 Abstain 3)

AcSec Vote

(Yes 13 No 0 Abstain 2)

122. If the criteria in paragraph 121 are not met, or the quantity of commodity in paragraph 121c is less than the related futures contracts, the transactions are considered nonhedges and mark-to-market accounting for the futures transactions should be followed.

(Yes 10 No 1 Abstain 3)

AcSec Vote

(Yes 12 No 2 Abstain 1)

123. A producer or cooperative with significant nonhedge transactions should disclose in the financial statements the quantity of its net long or short position by commodity at each financial statement date and the effect on gain or loss.

(Yes 6 No 3 Abstain 3)

AcSec Vote

(Yes 8 No 6 Abstain 1)

* * * * * * *

Accounting for Hedging Transactions of Producers

Diversity in Practice

124. Financial statements of producers whose stock is publicly traded indicate diversity in accounting for hedges. The committee infers from the disclosures reviewed that unrealized gains and losses on open futures contracts are usually deferred and considered in determining the lower of cost and market amount of inventories.

125. Accounting practices for closed futures contracts also vary. Both gains and losses are sometimes deferred until the related inventories are sold. In one instance, losses on closed futures contracts were recognized by the company as incurred, without regard to whether the related inventory was still on hand, while gains related to inventory still on hand were deferred. The committee inferred that both gains and losses on closed futures contracts were recognized immediately in cost of sales by the remaining companies.

Pros and Cons

126. Some believe deferring unrealized gains and losses on futures contracts entered into as hedges is consistent with the purpose of hedges - to minimize the risk of loss due to price changes. By hedging, the producer has offset gains or losses on the futures market with approximately equal, but opposite, gains or losses on the cash market, considering both inventories and open commitments. That position appears to be consistent with the authoritative literature cited in paragraphs

108 through 115, and is generally followed in practice. Determining market for the lower of cost and market value of inventories commonly includes considering unrealized gains and losses on futures contracts entered into as hedges.

127. Some believe deferring realized gains and losses on futures contracts entered into as hedges when the related commodity is on hand or the related commitment is still outstanding is consistent with the purpose of hedges. In such cases the the producer closes the futures contracts and sells on a forward contract or is at risk as to the physical commodity on hand or the commitment. Most, if not all, producers are exposed to such risks. Under this approach, realized gains and losses on the futures contracts are included as decreases or increases in the related inventory costs or deferred against open commitments provided that total accumulated costs do not exceed market. On disposing of the commodity or product on the cash market or closing of the related sales commitment, deferred gains and losses on closed futures contracts are recognized as part of cost of sales. If the deferred realized gains or losses relate to purchase commitments or the purchase of product to be used in production or processing, they become part of the cost of the related inventories.

128. Some recognize losses on closed futures contracts before disposing of the related commodity or closing of the related commitment. That practice results in the inventory remaining at the original cost to produce, while net realizable value and potential gross profit have presumably increased.

If a loss is recognized on closing a futures contract, the commodity or commitment that had been hedged may ultimately result in greater gross profit on disposition because of an increase in the cash market price as evidenced by the loss in the futures contract. That can result in shifting or managing income.

129. Some believe both gains and losses should be recognized on closed futures contracts originally entered into as hedging transactions because the transactions are closed and realization is complete. They argue that since commodity futures markets provide sufficient contract dates to accommodate most growing and harvesting periods, an early closing of the futures contracts terminates the hedge. They further claim that closing a position in the futures market without concurrent disposition of the commodity in the cash market results in a nonhedge transaction. Others oppose that practice because they believe it provides the possibility of shifting or managing income.

Accounting for Hedging Transactions of Cooperatives

Diversity in Practice

130. Since few cooperatives register with the Securities and Exchange Commission, the committee mailed requests for financial statements to a number of cooperatives. Disclosures in the financial statements received indicated that most of those that sell grain account for inventories through use of the hedging procedures method. Some entities trading and

processing grain account for inventories at market reduced for unrealized losses but unadjusted for unrealized gains.

131. Most financial statements received from cooperatives that sell grain disclosed their hedging policies and indicated that inventories carried at market were adjusted for unrealized gains and losses on open futures contracts and forward contracts. Some financial statements did not include such disclosures.

132. Financial statements submitted by the remaining cooperatives, primarily those that do not sell grain, did not reveal whether opportunities to hedge were available or were used.

133. A review of the financial statements of cooperatives that used the hedging procedures method indicated some of them seemed to be applying that method to their entire inventory positions when those inventory positions were less than substantially hedged. Others accounted for their hedged inventories using the hedging procedures method and accounted for the unhedged portion of their inventories at the lower of cost and market.

Pros and Cons

134. For cooperatives that account for inventories at the lower of cost and market, the pros and cons related to realized and unrealized gains on futures contracts are the same as for producers set forth in paragraphs 126 through 129.

135. However, opinions differ on recognition of unrealized gains and losses by cooperatives that price their inventories

at market. Some believe a cooperative that accounts for its substantially hedged inventory of agricultural commodities at market by the hedging procedures method is accounting for its inventory in accordance with an acceptable accounting practice. That belief is based on the premise that proper use of the hedging procedures method results in amounts that approximate cost. Proper use of the hedging procedures method requires the cooperative to be substantially hedged, that forward contracts be accounted for at market and included in the inventory position, and that unrealized hedging gains and losses on open futures contracts be considered when accounting for the inventory position. They further believe the practice achieves the intent of hedges by deferring income statement recognition of the effects of the hedges until the related inventory is sold. They also argue that pricing inventories at market but not adjusting for either unrealized gains or losses on open futures contracts and forward contracts constituting hedges would permit shifting or managing income. Yet, others believe inventories should be accounted for at market reduced only for unrealized losses on futures contracts since they believe (1) the market value approach is an accceptable inventory pricing method under Statement 9 of Chapter 4 of Accounting Research Bulletin No. 43 and (2) the modifying convention of conservatism, which calls for early recognition of unfavorable events and minimization of operating results, warrants the reduction of inventories stated at market for unrealized losses on futures contracts and forward contracts.

136. Others believe the entire inventory position should be accounted for at market using the hedging procedures method if the inventory position is less than substantially hedged. They contend that is appropriate since the market value approach is an acceptable inventory pricing method under Statement 9 of Chapter 4 of Accounting Research Bulletin No. 43. The result of accounting for the entire inventory using the hedging procedures method when it is less than substantially hedged is, in effect, to account for hedged positions at approximate cost and unhedged positions at market. Those using the hedging procedures method when less than substantially hedged may believe they are not following the hedging procedures method, but are valuing inventories at market, a practice permitted for agricultural commodities. They maintain the hedged portion simply has a different market value than the unhedged portion and it is mere coincidence that the hedging procedures method results in their inventory being stated at approximate cost, since the intent of placing the hedges was to fix prices that would naturally bring the hedged portion of the inventory to an amount more in keeping with cost.

137. Some believe that in keeping with the matching concept inherent in hedges, realized gains and losses on closed futures transactions entered into as hedging transactions should be deferred until disposal of the related inventory. That avoids the possibility of shifting or managing income. Others counter, however, that realized gains and losses on

hedges pertaining to inventory on hand or commitments outstanding should not be deferred if the hedging procedures method is used, because in using that method inventory is priced at market and adjusted for all realized and unrealized gains and losses on hedging transactions. They believe closing the futures side of the hedging transaction before disposing of the inventory negates the hedge and could be deemed to complete the revenue cycle and the futures gain or loss should be recognized regardless of whether the cooperative replaces the hedge or remains unhedged. They point out that it would be impractical, if not impossible, for an entity with a significant volume of transactions to accurately correlate specific closed futures transactions with specific inventory still held.

Issues

138. The basic issue on accounting for hedging transactions by agricultural producers and cooperatives is how should gains and losses on open and closed futures contracts entered into as hedging transactions be accounted for?

Subsidiary issues are

a. Can a producer intending to raise certain livestock or to plant a particular crop establish a position on a futures market and account for the position as a hedge?

b. Can a cooperative contractually committed to acquire a particular commodity establish a position on a futures market and account for

the position as a hedge?

c. Can a producer with growing crops or livestock on feed establish a position on a futures market and account for it as a hedge?

d. If no futures market exists for a commodity, can a producer or cooperative establish a position on a futures market for a similar commodity and account for the position as a hedge?

e. What financial statement disclosures should be made for hedging transactions?

* * * * * * *

Advisory Conclusions

139. Accounting for gains and losses on futures contracts entered into as hedging transactions depends on whether the hedged portion of the inventory is accounted for at the lower of cost and market, or at market.

Inventory Accounted for at Lower of Cost and Market

a. Producers and cooperatives, accounting for inventories at the lower of cost and market, should defer gains and losses on open and closed futures contracts acquired for hedging. Gains and losses on such contracts should be considered in determining net realizable value for calculating the lower of cost or market.

(Yes 12 No 0 Abstain 2)

AcSEC Vote

(Yes 14 No 0 Abstain 1)

Inventory Accounted for at Market

b. Producers and cooperatives, accounting for inventories at market, should recognize currently gains and losses on open and closed futures contracts acquired for hedging.

(Yes 11 No 0 Abstain 3)

AcSEC Vote

(Yes 14 No 0 Abstain 1)

140. Advisory conclusion for the subsidiary issues are:

a. A producer who intends to raise certain livestock or plant particular crops, and can reasonably expect to produce or acquire those commodities in the ordinary course of business, and has established a short position on a futures market before or while growing should account for the futures positions as hedges if the estimate of salable product is reasonably determinable and the commodities to be raised are specifically identified.

(Yes 9 No 2 Abstain 3)

AcSEC Vote

(Yes 13 No 1 Abstain 1)

b. A cooperative contractually committed to acquire a particular commodity in the ordinary course of business may establish a short position on a futures market and account for that position as

a hedge.

(Yes 9 No 2 Abstain 3)

AcSEC Vote

(Yes 13 No 1 Abstain 1)

c. A producer who has established a short position on a futures market for growing crops or livestock on feed should account for the position as a hedge if the hedged commodities are specifically identified, the cost and quantities of salable product can be reasonably estimated, and the crops or livestock are expected to be produced or raised.

(Yes 9 No 2 Abstain 3)

AcSEC Vote

(Yes 14 No 0 Abstain 1)

d. If no futures market exists for a given commodity but a producer or cooperative has established a short position on a futures market for a similar commodity traded on a commodity exchange, the producer or cooperative should account for the transaction as a hedge provided the prices of the two commodities have moved in a reasonably parallel manner.

(Yes 11 No 0 Abstain 3)

AcSEC Vote

(Yes 14 No 0 Abstain 1)

e. A producer or cooperative with significant

hedge transactions should disclose the following regarding those activities:

. The hedging policies of the producer or cooperative.

. The accounting practices for gains and losses on hedging contracts.

(Yes 13 No 0 Abstain 1)

AcSEC Vote

(Yes 14 No 0 Abstain 0)