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Agribusiness industry developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Agribusiness Industry Developments—1991

Update to AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural Cooperatives*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of agricultural producers and cooperatives with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

Agricultural producers and agricultural cooperatives continue to represent one of the U.S.'s largest industries, ranging in size from small, noncorporate family groups to publicly held multinational corporations. Despite the trend toward larger business units, most entities engaged in agriculture are relatively small and, as a result, are especially sensitive to changing economic conditions.

After three relatively profitable years, many agricultural producers are facing increasing financial strains this year. As a result, farm failures are expected to rise this year for the first time since 1987. The prices that many farmers receive for their major crops have fallen below last year's levels, and concurrently, the federal government is cutting subsidies paid to farmers as part of its efforts to reduce its deficit.

The weakness in crop prices is largely the result of declines in food exports as record harvests around the world have reduced the dependence of many countries on U.S. crops. The reluctance of many lenders to finance purchases by the Soviet Union, usually one of the industry's most substantial customers, has curtailed its ability to buy U.S. farm products. As these factors work to decrease demand, the supply of most crops is rising as a result of favorable growing conditions across the farm belt.

Auditors of entities in the agribusiness industry should consider the potential problems that these conditions may raise for agricultural producers and cooperatives. An economic downturn for the industry is likely to expose many marginal producers who have survived the past several years only because of their relatively high profitability. As they become apprehensive about a downturn, lenders are likely to tighten credit standards, particularly if land prices continue to weaken. As a result, farmers may find it increasingly difficult to obtain the financing necessary to sustain their operating capacity.

Regulatory and Legislative Developments

Environmental Matters

As described in the general *Audit Risk Alert—1991*, the Environmental Protection Agency is empowered by law to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to such a site. Agricultural producers and cooperatives commonly use chemical agents, such as herbicides and pesticides, and engage in activities, such as maintenance of underground storage tanks, that may create environmental hazards. As a result, they may face the possibility of incurring significant costs resulting from environmental cleanup activities. The general *Audit Risk Alert—1991* includes a detailed discussion of accounting for environmental cleanup costs.

Audit Issues

Economic Conditions

The strained financial condition of many agricultural producers and cooperatives, especially when viewed in combination with generally sluggish economic conditions, may give rise to going-concern issues that need to be considered by auditors. Going-concern problems are discussed in detail in the general *Audit Risk Alert—1991*.

Accounting Issues

Troublesome Accounting Areas

Agricultural producers and cooperatives use a number of specific accounting principles that have been developed in response to matters unique to the industry. These principles are described in detail in the Audit and Accounting Guide *Audits of Agricultural Producers and Cooperatives*. The following is a list of some of the areas of accounting that have given rise to troublesome issues in the past.

- *Hedging Activities*—Both agricultural producers and cooperatives enter into futures contracts as a means of hedging exposure to certain risks. Financial Accounting Standards Board (FASB) Statement No. 80, *Accounting for Futures Contracts*, describes the criteria that must be present for such contracts to qualify as hedges. Auditors should carefully consider whether the specified criteria are present as they evaluate the appropriateness of the accounting for hedged inventories. Auditors should also carefully evaluate the adequacy of disclosures in the financial statements about hedging activities in which agricultural producers and cooperatives are engaged.
- *Classification of Patronage Credits*—Agricultural cooperatives use a variety of methods to allocate equities arising from patronage. Generally accepted accounting principles (GAAP) require that patronage credits that have no fixed maturity dates and are subordi-

nated to all debt instruments be treated as equity (rather than liabilities), and that appropriate disclosure of their face value, dividend rate, negotiability, subordination arrangements, and any revolving or retirement plans be made.

Allocated equities may be paid out over a number of years. The timing of such payments is usually at the discretion of the board of directors. Such amounts should not be classified as current liabilities until the board has formally acted to revolve the equities. Auditors should carefully consider the classification of such retains.

- *Inventory Valuation*—Most cooperatives use the pool method of accounting for patrons' products that must be commingled before they are sold. Accounting periods for such pools vary from a week (for a product such as eggs) to longer than a year (two years for canned fruits and nuts). GAAP requires that when the accounting period extends beyond a year, the pooled inventories continue to be carried at cost. In the past, some cooperatives have erroneously marked such inventories up to market.
- *Integration With Other Industry Segments*—In recent years, certain underperforming cooperatives have combined or integrated their operations with those of cooperatives operating in better performing peripheral industry segments to enhance the appearance of the results of operations and financial condition. For example, a poultry-growing cooperative may integrate with a poultry-processing cooperative. Auditors should consider the appropriateness of the accounting by agricultural producers and cooperatives for investments in other entities, including the basis for combination and the adequacy of disclosure.

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This Audit Risk Alert supersedes *Agribusiness Industry Developments—1990.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1991* (Product No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter.* Additional copies can be obtained from the AICPA Order Department.

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