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**AUDIT RISK
ALERTS**

Agribusiness Industry Developments—1992

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 agricultural 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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Agribusiness Industry Developments—1992

Industry and Economic Developments

Agricultural producers and agricultural cooperatives continue to represent one of the largest industries in the United States. Farming accounts for approximately 17 percent of the gross national product and over 20 million jobs. Agricultural producers and cooperatives continue to face a number of external challenges—a sluggish economy, financial institutions with increasingly tighter lending policies, a changing work force, uncertain public policy as reflected in fluctuating laws and regulations, stricter environmental regulations, and expanding global markets. Expanding global markets pose risks to agricultural producers and cooperatives previously accustomed to doing business with only U.S. customers. Such risks include those customarily inherent in transacting business in foreign currencies (such as the risk that the value of foreign currencies will fluctuate), as well as those that stem from involvement in more complex financial instruments, and the possibility of collectibility problems from counterparties with little or no reliable credit history.

Many agricultural producers have taken a very conservative approach to operating their businesses and are drastically reducing their debt levels and decreasing their spending (for example, by prepaying debt and deferring purchases of new machinery). One indication of this conservative fiscal approach is the marked growth in farm banks, which now constitute the strongest sector of U.S. banking. Farm banks, which had been failing at a rapid rate in recent years, earned a record \$1.7 billion in 1991.

The conservative fiscal stance being adopted by many agricultural producers may actually hinder economic recovery in the Farm Belt. As farmers use cash rather than credit for purchases (if purchases are made at all), they are also turning toward renting rather than owning farm land. Although profits have been steadily increasing, the overall farm economy has remained stagnant.

Regulatory Developments

Environmental Matters

The Environmental Protection Agency is empowered by law to seek recovery from anyone who ever owned or operated a particular contami-

nated 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 significant costs resulting from environmental cleanup activities. *Audit Risk Alert—1992* includes a detailed discussion on accounting for and disclosure of environmental cleanup costs.

Audit Issues and Developments

Financing Methods

More and more agricultural producers and cooperatives are employing new and innovative financing methods to raise the capital needed for their operations. Limited partnerships, joint ventures, member-employee loan programs, deferred-payment programs, nonfarm credit financing, and employee equity participation programs are becoming increasingly important financing vehicles in the industry. The use of such financing methods may be indicative of increased audit risk. For example, the use of complex or sophisticated financial instruments may result in off-balance-sheet risks of accounting loss. The existence of such risks to the enterprise may affect the auditor's assessment of overall audit risk.

Further, management and accounting personnel may be unaware of some of the risks to their enterprises that may be inherent in such financial instruments or of requirements that information about such risks be disclosed. In auditing the financial statements of agricultural producers and cooperatives that use innovative financing methods, auditors should carefully evaluate the substance of transactions that involve such instruments as they consider the propriety of the accounting treatment of such transactions and financial statement disclosures about them.

Compensation Methods

Agricultural producers and cooperatives sometimes pay wages to their employees in the form of commodities. By doing so, the payment of Social Security and other taxes may be avoided. Such policies are currently being investigated by the Internal Revenue Service (IRS). Findings by the IRS that such payments are improper may result in the assessment of additional taxes as well as interest and penalties. Use of compensation methods that result in the avoidance of taxes may constitute illegal acts that have a direct and material effect on the determination of financial statement amounts. Statement on Auditing Standards (SAS) No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and SAS No. 54, *Illegal Acts by Clients*, provide guidance that auditors should follow in such circumstances.

Financial Guidelines for Agricultural Producers

In May 1991, the Farm Financial Statements Task Force (FFSTF), a task force composed of experts from various facets of the farming industry and sponsored by the American Bankers Association, the Farm Foundation, and the Farm Credit System, issued a set of recommendations for the preparation of financial statements and other information to be used in analyzing agricultural credit. The recommendations, entitled *Financial Guidelines for Agricultural Producers*, are intended to increase the uniformity of financial reporting by farmers. Auditors of agricultural producers and cooperatives may be asked to audit and report on financial statements prepared in conformity with the FFSTF recommendations. In doing so, auditors should recognize that the FFSTF recommendations do not constitute generally accepted accounting principles (GAAP), and they do not constitute a comprehensive basis of accounting other than GAAP as defined in SAS No. 62, *Special Reports*. Auditors who report on financial statements of an agricultural producer or cooperative prepared in conformity with the FFSTF recommendations should consider whether a qualified or adverse opinion should be issued because of departures from GAAP as described in SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 49 through 69.

Concentrations of Credit Risk

Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, establishes requirements for all entities to disclose information about financial instruments with off-balance-sheet risk of accounting loss and about significant concentrations of credit risk from an individual counterparty or groups of counterparties for all financial instruments. Some agricultural producers and cooperatives may be unaware of the types of disclosures that are relevant to their operations and that should be disclosed. For example, the requirements of FASB Statement No. 105 extend to the potential loss of cash funds in excess of \$100,000 (the FDIC insurance coverage limit) when the amount deposited by an agricultural producer of a cooperative at a single financial institution exceeds this limit. Also, since agricultural cooperatives generally serve members in a specific geographic area, there may be geographic concentrations of credit risk. Other items that might require disclosure in accordance with FASB Statement No. 105 include concentrations of credit risk resulting from multiple contracts with one customer and descriptions of customer financing arrangements. In evaluating the propriety of disclosures in the financial statements of agricultural producers and cooperatives, auditors should carefully consider whether management has complied with requirements of FASB Statement No. 105.

The Confirmation Process

Confirmation of balances is generally an important procedure in auditing the financial statements of agricultural producers and cooperatives. In November 1991, the AICPA's Auditing Standards Board issued SAS No. 67, *The Confirmation Process*, which provides guidance on the confirmation process in audits performed in accordance with generally accepted auditing standards. It defines the confirmation process, discusses the relationship of confirmation procedures to the auditor's assessment of audit risk, describes certain factors that affect the reliability of confirmations, and provides guidance on performing alternative procedures when responses are not received and on evaluating results of confirmation procedures. SAS No. 67 specifically addresses the confirmation of accounts receivable and explicitly prohibits the use of negative confirmation requests when control risk is assessed at the maximum level. This SAS is especially relevant to audits of agricultural producers and cooperatives because confirmation procedures are typically performed on balances due from supply and marketing cooperatives (to producers), patronage refunds receivable, and cooperatives' equity balances, which usually constitute a material portion of an agricultural producer or cooperative's balance sheet. SAS No. 67 is effective for audits of fiscal periods ending after June 15, 1992. *Audit Risk Alert—1992* includes further discussion of SAS No. 67.

COSO Report on Internal Control

In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework*. The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management's reporting on internal controls over financial reporting.

The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting of External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help evaluate an internal control system.

The four-volume set (No. 990002CL) costs \$50; the "Executive Summary" (No. 990001CL) is available individually for \$3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department (see order information on page 10).

Accounting Developments

Hedging Activities

Both agricultural producers and cooperatives sometimes enter into futures contracts as a means of hedging exposure to certain risks. In order

for futures contracts to qualify as hedges in accordance with FASB Statement No. 80, *Accounting for Futures Contracts*, there must be a high correlation between the price of the product being hedged and the market value of the futures contract. However, certain futures contracts do not always track price movements in certain regions of the country, especially during certain seasons or at certain points during the life of the futures contract. Auditors should consider whether management's designation of futures contracts as hedges is appropriate in light of the criteria set forth in FASB Statement No. 80.

As they evaluate the propriety of presentation and disclosure of hedging activities in the financial statements, auditors should be aware that FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, states that cash flows from hedging transactions should be classified as operating cash items in the statement of cash flows and disclosed as a separate line item if material.

Income Taxes

In February 1992, the FASB issued Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, which establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes. FASB Statement No. 109 is effective for fiscal years beginning after December 15, 1992, with earlier application encouraged. The temporary differences created by the different bases of investments for book and tax purposes may result in deferred tax assets for some agricultural producers and cooperatives. Therefore, auditors of agricultural producers and cooperatives should be familiar with the criteria for recognition of a deferred tax asset, as well as with the guidance for establishing an appropriate valuation allowance. *Audit Risk Alert—1992* includes further discussion of the provisions of FASB Statement No. 109.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

The AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Cooperatives* is available through the AICPA's loose-leaf subscription services. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of the guides as they appear in the service are printed annually.

Agricultural Cooperatives Financial Reporting Checklist

The AICPA's Technical Information Service has published a revised version of *Checklists and Illustrative Financial Statements for Agricultural Cooperatives* as a tool for preparers and reviewers of financial statements of agricultural cooperatives. Copies may be obtained by calling the AICPA Order Department.

Technical Practice Aids Publication

Technical Practice Aids is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. Several sections of *Technical Practice Aids* contain questions and answers specifically pertaining to agricultural producers and cooperatives. *Technical Practice Aids* is available both as a subscription service and in hardback form. Order information may be obtained from the AICPA Order Department.

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This Audit Risk Alert supersedes *Agribusiness Industry Developments—1991*.

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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—1992*, which was printed in the November 1992 issue of the *CPA Letter*.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 862-4272. Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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