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Agribusiness industry developments - 1993; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Agribusiness Industry Developments—1993

Complement 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 the 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 on by a senior technical committee of the AICPA.

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Industry and Economic Developments

Agriculture is one of the most productive and globally competitive sectors of the United States economy. More than 16 percent of the gross national product comes from the soil. Productivity in the agricultural sector has been increasing faster than demand, and this growth has been accomplished with fewer farmers and fewer acres under cultivation. The overall economic climate, lower farm asset values, reduced farm income, farm acreage out of production, inclement weather, and revolutionary new farming practices such as conservation tillage, have all affected agricultural producers and agricultural cooperatives.

As a result of the floods in the Midwest, many commodity products, such as corn and soybeans, have been in short supply, driving prices up. For many producers, corn and soybean production for 1993 is expected to be down approximately 22 percent and 13 percent, respectively. Due to sophisticated hedging programs that lock in prices far ahead of harvest, most producers will show little impact on their bottom line in 1993. Other producers are so diversified that price increases for some products will have little effect on earnings. Seed companies' earnings may be negatively affected in 1993, as farmers return seeds they were unable to plant due to the weather, or fail to pay for seeds that were planted but never harvested.

U.S. consumption patterns of meat and poultry have changed in recent years in response to dietary concerns. Consumers are eating more poultry and fish and less red meat. In an effort to remain profitable, the red meat industry has been closing inefficient plants and introducing product innovations. Red meat companies are also responding to changes in demand by expanding into other product areas, such as poultry, through mergers, acquisitions, and joint ventures. The poultry industry continues to experience growth as consumers demand more ground turkey, chicken nuggets, and other value-added, convenience-type poultry products. However, although the overall poultry industry is growing, the number of establishments has been declining due to mergers and acquisitions.

In the dairy industry, consumers are seeking nonfat and low-fat products. This trend is evident in the growth of yogurt products.

As consumers continue to seek lower-fat alternatives to whole milk, the production of low-fat and skim milk should continue to rise. Some dairy companies are trying to draw consumers from competing, non-dairy beverages by improving the taste of skim milk.

Auditors should be aware of practices that may expose agricultural producers and cooperatives to high levels of risk. The various risks associated with these practices may be significant, and auditors should consider whether agricultural producers and cooperatives are involved in sophisticated hedging programs, downsizing, innovative financing arrangements, or research and development projects.

Regulatory Developments

New Marketing Loan Provisions—Agricultural Producers

Marketing loan provisions provide an alternative method for repaying Commodity Credit Corporation (CCC) nonrecourse loans. CCC loans allow producers who participate in commodity programs to use their commodities as collateral for loans. Producers often take out CCC nonrecourse loans to obtain short-term financing, and most often do so at harvest or soon thereafter.

CCC nonrecourse loans provide producers with ready cash, and allow them to hold commodities until later in the marketing year when prices may be higher than traditional harvest-time lows. CCC loans serve this function regardless of relative levels of loan rates and market prices. The loan program also helps provide income support, and at times has provided price support to producers.

For the first time, marketing loan provisions are available to eligible wheat and feed grain producers, beginning with the 1993 crop year. The impetus for this action was the Omnibus Budget Reconciliation Act of 1990, which required the Secretary of Agriculture to implement marketing loan provisions for 1993–1995 wheat and feed grain crops if a General Agreement on Traffic and Trade (GATT) accord was not signed by June 30, 1992. As of August 1993, no GATT accord had been signed.

Marketing loan provisions are designed to help minimize potential loan forfeitures and accumulation of government stocks when prices are low relative to CCC loan rates. This helps keep CCC loan programs from interfering with markets, and provides additional income support to producers when prices are low.

Although marketing loan provisions were available for rice and cotton beginning in 1985 and for soybeans and minor oilseeds beginning in 1991, prices have not always been low enough for many producers to receive payments, and only rice producers have consistently received benefits. However, as of mid-1993, low wheat prices have already resulted in benefits to some wheat producers.

Producers must meet certain criteria to be eligible for marketing loan benefits. Crops eligible for marketing loan gains due to the GATT trigger provisions include wheat and feed grains (corn, grain sorghum, barley, oats, and rye). Rice has been eligible for marketing loans since the 1985–1986 crop year, cotton since 1986–1987, and soybeans and minor oilseeds since 1991–1992.

Under the wheat and feed grain provisions, a producer must participate in the commodity program for that crop, and comply with all acreage reduction requirements. The wheat or feed grain crops, except for rye, must be produced on program-permitted acreage or flex acres, and the producer must ensure that the grain meets the requirements of CCC minimum grade and quality standards.

In addition, the producer must have beneficial interest in the commodity on the date the price-support loan or loan deficiency payment is requested. This means that the following criteria must be met:

1. *Control of the commodity.* The producer must retain the ability to make all decisions affecting the commodity, including movement, sale, and the request for a loan or a loan deficiency payment.
2. *Risk of loss.* The producer must be responsible for loss or damage to the commodity.
3. *Title to the commodity.* The producer must not have sold or delivered the commodity or warehouse receipt to a buyer.

Once beneficial interest in the commodity is lost, the commodity loses eligibility for a loan or a loan deficiency payment at any time in the future. Auditors of wheat and feed grain producers should be aware of these marketing loan provisions and should carefully consider their impact on the financial statements of producers.

Environmental Matters

The Environmental Protection Agency (EPA) 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 herbicides and pesticides, and engage in activities, such as maintenance of underground storage tanks, that may create environmental cleanup activities. *Audit Risk Alert—1993* includes a detailed discussion on accounting for and disclosure of environmental cleanup costs.

Income Tax Developments

In a recent letter to the U.S. Department of Agriculture, the Internal Revenue Service (IRS) took the position that farmers who use futures or options to hedge the value of their crops must treat those instruments as capital assets for income tax purposes. According to recent studies, between 20 and 30 percent of U.S. farmers now hedge their crop prices in the futures market. Farmers' losses on such hedges have always been considered ordinary business expenses. Auditors of agricultural producers and cooperatives involved in these hedging activities should consider this IRS position when auditing the client's income tax accrual and tax payable balances.

Audit Issues

Inventory

Inventory is generally a significant asset on the balance sheet (usually the most significant current asset) of an agricultural producer or cooperative. Since an agricultural producer or cooperative is essentially a manufacturer, auditors should be aware that an agricultural producer or cooperative's inventory often has a higher inherent risk and produces greater complexities for auditors than do inventories of other businesses. AICPA Statement of Position 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives,* provides specific guidance on the generally accepted accounting principles (GAAP) relating to accounting for inventories of agricultural producers and cooperatives. Auditors of agricultural producers or cooperatives should pay special attention to the following areas of inventory accounting that may affect audit risk:

- Whether the agricultural producer or cooperative has established an adequate internal control structure over the inventory, for example, a control structure that safeguards physical quantities and provides accurate quantity and cost data
- Whether all purchases and receipts are properly authorized and recorded
- Whether payroll records are sophisticated enough that labor costs may be allocated to the appropriate inventory component
- Whether all direct and indirect costs of developing animals are accumulated until the animals' maturity, at which point the accumulated development costs are depreciated over the animals' estimated productive life

- Whether agricultural cooperatives are appropriately determining the passing of title for products received from patrons without payment of a set price to the patron
- Whether land development costs (costs incurred getting land ready for production), are being appropriately capitalized by the agricultural producer or cooperative

Auditors of agricultural producers and cooperatives may consider engaging a specialist to evaluate the quality or value of inventory. In these cases, auditors should follow the guidance of AICPA Statement on Auditing Standards (SAS) No. 11, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336). Other general guidance on auditing inventory can be found in the AICPA Auditing Procedure Study, *Audit of Inventories* (Product No. 021045).

Research and Development Costs

Some agricultural producers and cooperatives may be involved in research and development programs in attempts to create different products or improve those that exist. Auditors of these agricultural producers and cooperatives should consider whether these costs have been appropriately accounted for and disclosed. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs,* requires that research and development costs be charged to expense when incurred. FASB Statement No. 2 also requires disclosure in the financial statements of the total research and development costs charged to expense in each period for which an income statement is presented.

Derivatives and Other High-Risk Investments

Recent years have seen a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Both agricultural producers and cooperatives regularly enter into forward contracts, futures contracts, and options in order to hedge against inventory losses. These off-balance-sheet instruments are complex financial instruments whose values depend on the volatility of interest rates, foreign currency indexes, and commodity and other prices.

Accounting. Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, however, several related projects are under way.

The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* No. 107, *Disclosures about Fair Values of Financial Instruments,* and No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force. Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation,* and No. 80, *Accounting for Futures Contracts.* In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters relatd to options.

Auditing. The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more entities enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of agricultural producers and cooperatives to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311) requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the entity's financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.

2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

Service-Center-Produced Records

Many agricultural producers and cooperatives use outside service organizations to perform tasks requiring expertise or technology that does not exist within the organization. Service organizations provide various levels of services ranging from performing a specific task under the direction of an agricultural producer or cooperative to replacing entire business units or functions of the agricultural producer or cooperative. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 324), which was issued in April 1992 and superseded SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* provides guidance to auditors of agricultural producers or cooperatives and to service auditors performing procedures and reporting on the control policies and procedures at a service organization. *Audit Risk Alert—1993* contains a more detailed discussion of SAS No. 70. Also, the AICPA's Auditing Standards Division plans to issue an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* in the first quarter of 1994.

Innovative Financing Methods

In today's competitive market, many new and innovative financing methods are growing in popularity. Auditors of agricultural producers and cooperatives should be aware of such methods as limited partnerships, joint ventures, member-employee loan programs, special assessments, deferred-payment programs, nonfarm credit financing, and employee equity participation.

These financing methods could affect an audit of an agricultural producer or cooperative in a number of ways, including an increase in the following:

- Number of audit procedures, for example, reading partnership agreements, analyzing and substantiating changes in partnership or joint venture capital
- Amount of audit work performed on equity and income taxes, in the case of partnerships

- Testing of internal controls when the producer or cooperative is invested in an unaudited partnership or joint venture
- Payroll testing in instances of employee equity participation

In cases of innovative financing methods, the overall audit risk will usually increase, resulting in the need to alter the nature and increase the extent of audit procedures. If auditors do not have the proper expertise in this area, they should consider using an outside specialist for these transactions.

Compensation Methods

Some agricultural producers and cooperatives have been paying wages in the form of commodities to avoid the payment of some Social Security taxes. This policy is currently being investigated by the IRS and could result in some agricultural producers and cooperatives paying additional taxes plus interest and penalties. Auditors may consider extending their payroll auditing procedures for this type of compensation and may also consider following the progress of the IRS investigation to determine whether there is a need for a loss-contingency accrual.

Auditors should also consider whether the fair value of any services provided as compensation expense is recorded in the financial statements.

Agricultural Producers' Financial Statements

In May 1991, the Farm Financial Statements Task Force released a report, *Recommendations of the Farm Financial Standards Task Force,* the purpose of which was to standardize financial reporting for farmers. Auditors should be aware that these recommendations do not constitute GAAP, nor do they have the substantial support required to constitute a comprehensive basis of accounting other than GAAP. Auditors who report on financial statements prepared in conformity with such 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 (AICPA, *Professional Standards,* vol. 1, AU sec. 508).

Accounting Issues and Developments

Hedging Activities

Both agricultural producers and cooperatives enter into futures 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,* the following conditions must be met:

- The item or group of items intended to be hedged must contribute to the price or interest rate risk of the agricultural producer or cooperative.
- There must be a high correlation of changes in the market value of the futures contracts, and the fair value of, or interest income, or expense associated with, the hedged items shall be probable so that the results of the futures contract will substantially offset the effects of price or interest changes on the exposed items.

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 the 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.

Disposal of Business Segments

As discussed earlier, some sectors of the industry may be in the process of downsizing their operations, for example, red meat producers may be closing inefficient plants. If an agricultural producer or cooperative is accounting for the closing as a disposal of a segment, the auditor should consider whether the plant being closed meets the criteria to be considered a segment under Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.* If it is determined that the plant closing constitutes a disposal of a segment, the auditor should consider, among other things, whether management has—

- Disclosed the results of operations of the disposed segment, less applicable income taxes, as a separate component of income before extraordinary items.
- A disposal plan which includes, at a minimum, identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if the disposal is to be by sale,

and the estimated results of operations of the segment from the measurement date to the disposal date.

- Recorded an estimated loss at the measurement date, if the disposal is expected to result in a loss.
- Recognized any gain upon realization, usually the date of disposal.
- Appropriately calculated the gain or loss from the disposal, not including expenses associated with normal business activities.

The auditor should also consider whether the agricultural producer or cooperative has disclosed the following in the notes to the financial statements for the period encompassing the measurement date:

- The identity of the segment of business that has been or will be discontinued
- The expected disposal date, if known
- The expected manner of disposal
- A description of the remaining assets and liabilities of the segment at the balance sheet date
- The income or loss from operations and any proceeds from the disposal of the segment during the period from the measurement date to the date of the balance sheet date

AICPA Audit and Accounting Literature

Audit and Accounting Guide

The AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural 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.

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. *Technical Practice Aids* contains questions and answers specifically pertaining to agricultural 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 replaces *Agribusiness Industry Developments—1992.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* and *Compilation and Review Alert—1993,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099 (audit) or 060666 (compilation and review).

Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.