1995

Agribusiness industry developments - 1995/96; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Agribusiness Industry Developments—1995/96

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 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

The agricultural industry accounts for a significant portion of U.S. economic activity. During 1995, the industry is expected to produce output of $258 billion while employing 3.82 million workers. Agricultural activities include producing, processing, distributing, or merchandising a wide range of commodities such as wheat, vegetables, fruits, and nuts as well as breeding and feeding cattle, hogs, and sheep; operating dairies and poultry facilities; breeding horses; raising mink and chinchilla; and so forth. Although the industry includes all forms of business organizations, smaller farmers and ranchers generally view the sole proprietorship as the preferred form. And while most agricultural entities are small sole proprietorships, there is a continuing trend toward larger farms, incorporation, and specialization.

Based on the assumption of favorable weather conditions, 1995 was expected to be a year of overabundance for many U.S. farmers. The U.S. Department of Agriculture initially estimated that 1994-1995 corn crop would exceed 10 billion bushels — up 58 percent from flood-ravaged 1993-1994. Soybean and wheat crops were also expected to exceed 1994 levels with production topping 2.5 billion bushels and 2.3 billion bushels, respectively. These expected record harvests, along with excess supplies of inexpensive feed for livestock, were to create downward pressures on prices and, therefore, farm revenues. However, after spring downpours and a summer heat wave, the midyear assessment is that this has been a poor growing season for some corn and soybean farmers. Therefore, a meager fall harvest is expected. While weather conditions initially pushed corn and soybean prices up, mass selling by commodity traders and mutual fund managers put extreme pressure on prices. By early August, prices had fallen from previous levels by almost 10 percent.

Encouraged in part by declining feed prices, many livestock producers overbred their herds. As a result, industry analysts believe that unless there are substantial increases in prices, even the most efficient producers will have a hard time making a profit. Mitigating this situation, to an extent, is the expectation of strong exports due to a rise in global demand for agricultural products, along with the new foreign markets opened by the ratification of the General Agreement on Tariffs and Trade and the North American Free Trade Agreement. Exports to the Pacific Rim are expected to increase. China, whose consumption of U.S. farm products tripled in 1994, is likely to import in excess of $1 billion — with heavy buying of cotton and vegetable oil. Meat exports are also expected to rise along with an 11 percent increase in poultry shipments. In spite of these export gains, overall farm income for 1995 is expected to remain flat at an estimated $55 billion.

The implementation of technological advances (for example, improved varieties of seeds and animal feed and improved techniques for applying fertilizer and pesticide), which have contributed to increased productivity for many U.S. farmers, is expected to continue in 1995. Great strides have also been made in adapting information technology to farming. (Refer to the "Audit Issues and Developments" section of this Audit Risk Alert for a discussion of the audit implications of computerized accounting systems.) Technological advances adopted by the industry include crop harvesting that incorporates satellite navigation systems and electronic tags worn by cows that ration feed and record levels of milk output. Advances such as these bring new precision to agricultural activities that have historically been dependent on educated guesses and good fortune.

Technologically driven efficiencies will generate higher production levels from fewer farms. In 1992, the number of U.S. farms fell below 2 million for the first time since 1850. This decline is expected to continue in 1995 as farmers take advantage of emerging technologies. Agricultural entities failing to implement such advances are likely to be overwhelmed by competitive pressures and may well face extinction. Accordingly, auditors should be alert to conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about an entity's ability to continue as a going concern. Such conditions and events include, for example, (1) negative trends such as recurring operating losses or working capital deficiencies, (2) financial difficulties such as loan defaults or denial of trade credit from suppliers, (3) internal matters such as labor difficulties, or (4) external matters such as legal proceedings or legislation that jeopardize the entity's ability to operate. In such circumstances, auditors will have to consider whether, based on conditions and events, there is substantial doubt about the entity's ability to continue as a going concern. Refer to the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion of this matter.

The availability and pricing of agricultural commodities are subject to significant fluctuations given the unpredictability of many factors including weather conditions, governmental farm programs and policies, changes in global demand due to population growth, and the production of similar and competitive crops. It is, therefore, fairly common for agricultural entities to offset or minimize such price risks by hedging commodity transactions. This matter is discussed further in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Legislative and Regulatory Developments

The federal government has a significant impact on the agricultural industry. With various objectives such as ensuring adequate production levels and stabilizing prices, the government has established loan programs that, for example, lend funds to producers that are collateralized by security interests in their crops. These crops may ultimately be used to repay the indebtedness. Programs also exist to provide agricultural producers with income replacements and subsidies in the event of natural disasters or declining price levels. Cost-sharing programs exist whereby the government provides reimbursement for the cost of certain production-related expenses. Additionally, the Internal Revenue Code affords special treatment to many agricultural entities in areas such as the choice of accounting and valuation methods. In evaluating the entity's tax accrual, auditors should be aware that such special elections may create temporary differences between pretax accounting income and taxable income pursuant to Financial Accounting Standards Board (FASB) Statement No. 109, *Accounting for Income Taxes* (FASB, *Current Text*, vol. 1, sec. I27).

Given the recent philosophical shift in the congressional landscape, a change in the role of the federal government in the agricultural arena appears likely. With a mandate to reduce the federal budget deficit and bureaucracy, farm subsidy programs will probably face some reductions and perhaps even elimination. Auditors should be alert to the impact of such changes and the response by agricultural entities to reduced revenues and increased expenses. Testing of sales cutoff and inventory valuation, along with the evaluation of revenue recognition policies and deferred costs, may take on increased significance in such an environment.

Audit Issues and Developments

Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance

With the intent of stabilizing prices and production of domestic agricultural output, the federal government provides direct subsidies and loans, as well as sponsoring cost-sharing and income replacement programs to agricultural producers and cooperatives. Agricultural entities that receive such governmental assistance may be subject to audit requirements associated with some of those programs. Auditors of such entities should consider the guidance set forth in AICPA Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801). SAS No. 74, which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

SAS No. 74 continues to recognize three levels of audits — generally accepted auditing standards (GAAS), *Government Auditing Standards,* and certain other federal requirements — of recipients of governmental financial assistance. SAS No. 74 is applicable when the auditor is engaged to perform an audit under GAAS, and under *Government Auditing Standards,* and in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

SAS No. 74 also provides general guidance to the auditor to—

- Apply the provisions of SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.
- Perform a financial audit in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States.
- Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
- Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

Auditors of agricultural producers or cooperatives that receive governmental financial assistance should also be alert to the 1994 Revision of *Government Auditing Standards,* commonly referred to as the "Yellow Book", as issued by the Comptroller General of the U.S. The 1994 Revision provides guidance (rather than requirements) on the auditor's consideration of internal controls for the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessment. It does not establish new responsibilities for testing controls. Some of the more important changes made in the 1994 Revision deal with the following:

- Submission of peer review reports
- Commenting on the status of prior year control weaknesses and other matters
- Responsibility for detection of noncompliance with contract or grant agreement provisions
- Working paper documentation
- Communication of additional services available on controls and compliance
- Report content
- Direct reporting of irregularities and illegal acts
- Applicability of the Yellow Book to other attest engagements

The Audit Risk Alert *State and Local Governmental Developments—1995* contains a detailed discussion of the revisions to the Yellow Book.

Illegal Acts by Clients

During 1995, the Federal Bureau of Investigation initiated an investigation of a major agricultural producer and a number of its competitors to determine the extent of their possible involvement in a conspiracy to fix prices on an animal feed additive. While the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations when the financial statement effect is indirect, this event, though not suggestive of an industry-wide problem, should serve as a reminder to auditors of their responsibilities with regard to possible illegal acts by clients. Auditors should design their audits to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts. However, an audit performed in accordance with GAAS does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements (such as the alleged price-fixing scheme noted above). Auditors should, however, be aware of the possibility that such illegal acts may have occurred. Specific guidance in this area is set forth in SAS No. 54.

Going-Concern Issues

Competitive pressures and anticipated reductions in federal farm subsidies, along with declining prices, may result in increased farm failures. Auditors should be aware of their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). SAS No. 59 provides guidance to auditors in conducting an audit of financial statements in accordance with GAAS for evaluating whether there is substantial doubt about a client's ability to continue as a going-concern for a period not to exceed one year from the date of the financial statements being audited.

Continuation of an entity as a going concern is generally assumed in the absence of significant information to the contrary. Information that significantly contradicts the going-concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. SAS No. 59 does not require the auditor to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

If there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that existing conditions and events can be mitigated by management plans and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, auditors should refer to the specific guidance set forth under SAS No. 59.

Inventory

Inventory is generally one of the most significant assets on the balance sheet of an agricultural producer or cooperative. Auditors should be aware that inventories of agricultural producers or cooperatives often have higher inherent risk and produce greater complexities for auditors than do inventories of other businesses.

AICPA Statement of Position (SOP) 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 should pay special attention to the following areas of inventory accounting that may affect audit risk:

- Whether the agricultural producer or agricultural 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 to allow labor costs to be allocated to the appropriate inventory component
- Whether all direct and indirect costs of developing animals raised for a productive function are accumulated until the animals reach maturity and are transferred to a productive function, at which point the accumulated development costs are depreciated over the animals' estimated productive life
- Whether all direct and indirect costs of developing animals raised for sale are accumulated and the animals are accounted for at the lower of cost or market until they are available for sale. SOP 85-3 provides that agricultural producers should report animals available and held for sale (a) at the lower of cost or market or (b) in accordance with established industry practice at sales price, less estimated costs of disposal, when all of the following conditions exist:
    - There are reliable, readily determinable, and realizable market prices for the animals.
    - The costs of disposal are relatively insignificant and predictable.
    - The animals are available for immediate delivery.
- 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 permanent land development costs are being appropriately capitalized by the agricultural producer or agricultural cooperative

- Whether limited-life development costs and direct and indirect development costs of orchards, groves, vineyards, and intermediate-life plants are appropriately capitalized during the development period and depreciated over the estimated useful life of the land development or of the tree, vine, or plant

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 SAS No. 73, *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 may be involved in research and development (R&D) programs in attempts to create new products or improve existing product lines. Auditors of these entities should consider whether costs related to such efforts have been appropriately accounted for and disclosed. FASB Statement No. 2, *Accounting for Research and Development Costs* (FASB, *Current Text,* vol. 1, sec. R50), requires that R&D costs be charged to expense when incurred. In evaluating the adequacy of disclosure of the entity's financial statements (see SAS No. 32, *Adequacy of Disclosure of Financial Statements* [AICPA, *Professional Standards,* vol. 1, AU sec. 431]) auditors should be aware that FASB Statement No. 2 requires disclosure in the financial statements of the total R&D costs charged to expense in each period for which an income statement is presented.

Derivatives

Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, 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 losses related to the effect of changing prices and other uncertainties. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements.

It is essential that auditors understand both the economics of derivatives used by the entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should carefully evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text,* vol. 1, sec. F25), No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), the disclosure requirements set forth in those statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

The Securities and Exchange Commission (SEC) staff has indicated in public speeches and letters of comment to registrants during the past year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements cited above.

Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96*. Also, see in the "Accounting Issues and Developments" section — "Disclosures about Derivatives" of this Audit Risk Alert. The AICPA publication *Derivatives-Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Environmental Issues

Environmental remediation liability laws, written at all levels of government, have exposed agricultural producers and cooperatives to an increased vulnerability to environmental claims. The Resource, Conservation and Recovery Act, Superfund, along with various clean air and water acts, may be used to hold agricultural entities liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site, or anyone who generated or transported hazardous substances to such a site. The use of herbicides and pesticides by agricultural entities as well as the maintenance of underground storage tanks for hazardous fuel and chemical substances used in agricultural activities may create environmental cleanup issues.

The accounting literature applicable to accounting for environmental remediation liabilities includes FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text,* vol. 1, sec. C59), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text,* vol. 1, sec. C59), and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text,* vol. 1, sec. B10). In addition, guidance is included in the consensuses reached by the Emerging Issues Task Force (EITF) of the FASB in EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination,* and Issue No. 93-5, *Accounting for Environmental Liabilities.*

Auditors of publicly held agricultural producers should be aware of the SEC's Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities.
- Recognition of liabilities for costs apportioned to other potential responsible parties.
- Uncertainties in the estimation of the extent of environmental liabilities.
- The appropriate discount rate for environmental liabilities, if discounting is appropriate.
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements.

Audit Risk Alert—1995/96 contains further discussion of issues relating to environmental remediation matters. Also, refer to the "Accounting Issues and Developments" section of this Audit Risk Alert for information on AICPA Exposure Draft: *Proposed Statement of Position on Environmental Remediation Liabilities.*

Service-Center Produced Records

Many agricultural producers and agricultural cooperatives use outside service organizations to perform tasks requiring expertise or technology that do 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 agricultural cooperative to replacing entire business units or functions. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 324), provides guidance to auditors of agricultural producers or cooperatives and to service auditors performing procedures and reporting on the control policies and procedures at service organizations.

When an agricultural entity uses a service organization, the functions or processing performed by the service organization may have a significant effect on the entity's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the entity, the internal control structure of the entity may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 319), requires auditors to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of an agricultural producer or cooperative may require that auditors gain an understanding of the control policies and procedures performed by service organizations. When an agricultural producer or agricultural cooperative relies on a service organization's control policies and procedures over the processing of transactions that are material to their financial statements, those control procedures should be considered by the auditors.

One method of obtaining information about a service center's policies and procedures is to obtain a service auditor's report as described in SAS No. 70. However, the fact that an entity uses such an organization does not, in itself, require that such a report be obtained. In certain situations, the agricultural producer or cooperative may implement control policies and procedures that will make it unnecessary to obtain a service auditor's report. For example, an entity using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The agricultural producer or cooperative may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the agricultural producer or cooperative is not relying on the service organization's controls.

Other factors that may be considered in determining whether to obtain a service auditor's report include—

- Whether the transactions or accounts affected by the service organization are material to the agricultural producer or cooperative's financial statements.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) that may provide the auditors with sufficient information to plan the audit.

Interpretation No. 1 of SAS No. 70, titled "Describing Tests of Operating Effectiveness and the Results of Such Tests" and Interpretation No. 2 of SAS No. 70, titled "Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)" may also be relevant in this area. *Audit Risk Alert — 1995/96* contains additional information on these Interpretations.

Additionally, a task force of the AICPA's Auditing Standards Board has drafted an APS that provides guidance to auditors on implementing SAS No. 70. The APS provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of an entity that uses a service organization. The task force expects to issue the APS by the end of 1995.

Computerized Accounting Systems

The continuing trend by agricultural enterprises of implementing technological advances includes the computerization of in-house accounting and information systems. In the planning stage, auditors should consider the methods used by the enterprises to process accounting information since those methods will have an impact on the design of the entity's internal control structure. The extent to which computer processing is used in significant accounting applications, along with the complexity of such processing, is likely to influence the nature, timing, and extent of audit procedures. While specific audit objectives will not change, regardless of whether the processing of accounting information is automated or performed manually, the methods of applying audit procedures to gather sufficient competent evidential matter may be influenced by the method of data processing used. General guidance on how computer technologies employed by clients will affect audits can also be found in the APSs, *Auditing in Common Computer Environments* (Product No. 021059) and *Consideration of the Internal Control Structure in a Computer Environment: A Case Study* (Product No. 021055).

Agricultural Producers' Financial Statements

In July 1995, the Farm Financial Standards Council issued a revised version of *Financial Guidelines for Agricultural Producers,* the purpose of which is to standardize financial reporting for agricultural producers that do not maintain their accounting records in accordance with GAAP. Auditors should be aware that these guidelines do not constitute GAAP, nor do they have the substantial support required to constitute a comprehensive basis of accounting other than GAAP.

The guidelines set forth guidance that deviates from GAAP in accounting for—

- Raised breeding stock
- Deferred taxes
- Capital assets
- Inventories of grain and livestock
- Items held for resale
- Growing crops
- Government loan programs
- Depreciation

Auditors who report on financial statements prepared in conformity with such guidelines should consider whether, because of the GAAP departures, a qualified or adverse opinion should be issued 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

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text,* vol. 1, sec. I08). FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the entity estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) 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* (FASB, *Current Text,* vol. 1, sec. I13). Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995. (Earlier application is encouraged.) Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

Given the capital intensive nature of the agricultural industry, auditors should be alert to those events or changes in circumstances which indicate that an impairment of an asset may have occurred. For example, as agricultural producers continue toward the adoption of technologically advanced farming techniques, traditional long-lived agricultural assets may be rendered obsolete. Additionally, environmental regulations may impose restrictions upon the use of a long-lived asset used in crop cultivation, thus significantly reducing its ability to generate future cash flows. In such instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 may need to be applied.

In considering an agricultural entity's implementation of FASB Statement No. 121, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342).

Hedging Activities

Agricultural entities may enter into futures contracts as a means of reducing their exposure to certain financial risks. In order to qualify as a hedge in accordance with FASB Statement No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), (1) 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 and (2) 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 so the results of the futures contracts will substantially offset the effects of price or interest changes on the exposed items. Auditors should consider whether management's accounting for futures contracts, designated as hedges, is appropriate in light of the criteria set forth in FASB Statement No. 80.

In evaluating the propriety of presentation and disclosure of hedging activities in the financial statements, auditors should also 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* (FASB, *Current Text*, vol. 1, sec. C25), provides that the cash flows from hedging transactions be classified as operating cash items in the statement of cash flows and disclosed as a separate line item if material.

Disclosures About Derivatives

As previously discussed, agricultural producers and agricultural co-operatives regularly employ derivative financial instruments as risk management tools (hedges). Derivatives are complex financial instruments whose values are affected by the volatility of interest rates, foreign currency indices, and commodity and other prices.

In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25). FASB Statement No. 119 requires disclosures about derivative financial instruments — futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

The Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Paragraph 12 of FASB Statement No. 119 encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

FASB Statement No. 119 was effective for financial statements issued for fiscal years ending after December 15, 1994, except for organizations with less than $150 million in total assets. For those organizations, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.

The FASB Special Report, *Illustrations of Financial Instrument Disclosures,* contains illustrations of the application of FASB Statements No. 105, No. 107, and No. 119.

Risks and Uncertainties

In December 1994, the AICPA's Accounting Standards Executive Committee issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about 1) the nature of their operations and 2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about 1) certain significant estimates and 2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of agricultural producers and cooperatives include:

- Impairment of long-lived assets used in crop cultivation
- Estimates of environmental remediation liabilities resulting from the use of pesticides, herbicides, or fungicides

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of agricultural producers in accordance with paragraph 21 of the SOP include the following:

- Volume of business with a particular cooperative or governmental program
- Revenue from a particular crop or livestock
- Processing, distributing, or marketing agricultural products in a particular geographic area

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

Auditors should be alert to the requirements of the new SOP and its impact upon the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

In June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities.* The exposure draft provides that—

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 are met, and it includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the

extent the employees are expected to devote time to the remediation effort.

- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site, and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- Measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed, and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean-up laws and the need to consider various individual state and other non-United States government requirements.

Comments on the exposure draft were due by October 31, 1995.

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 loose-leaf subscription service. 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 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

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

Information Sources

Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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This Audit Risk Alert supersedes *Agribusiness Industry Developments—1994.*

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Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96,* which may be obtained by calling the AICPA Order Department at the number below and asking for product no. 022180 (audit) or 060669 (compilation and review).

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			Action Alert Telephone Line (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001	
U. S. Department of Agriculture	1301 New York Ave., NW Washington, DC 20005-4788 (800) 999-6779			

U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088 (ext. 3) (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)
Farm Financial Standards Council	c/o Mr. Steve Hofing Agricultural Education and Consulting Centrec Business Center 3 College Park Court Savoy, IL 61874 (217) 352-1190			

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