2008

Agricultural producers and agricultural cooperatives with conforming changes as of May 1, 2008; Audit and accounting guide:

American Institute of Certified Public Accountants. Agribusiness Special Committee

AICPA Member and Public Information:
www.aicpa.org

AICPA Online Store:
www.cpa2biz.com

ISO Certified

012688

Agricultural Producers and Agricultural Cooperatives – May 1, 2008

AICPA®

American Institute of Certified Public Accountants

AUDIT & ACCOUNTING GUIDE

Agricultural Producers and Agricultural Cooperatives

May 1, 2008

AICPA®

AUDIT & ACCOUNTING GUIDE

Agricultural Producers and Agricultural Cooperatives

WITH CONFORMING CHANGES AS OF
MAY 1, 2008

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

This edition of the AICPA Audit and Accounting Guide *Agricultural Producers and Agricultural Cooperatives*, which was originally issued in 1987, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The changes made are identified in a schedule in appendix F of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

0547-344

1 2 3 4 5 6 7 8 9 0 AAP 0 9 8

ISBN 978-0-87051-760-0

Notice to Readers

This Audit and Accounting Guide presents recommendations of the AICPA Agribusiness Special Committee on the application of generally accepted auditing standards to audits of financial statements of agricultural producers and agricultural cooperatives. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for agricultural producers and agricultural cooperatives. The AICPA Accounting Standards Executive Committee has found this guide to be consistent with existing standards and principles covered by Rule 202, *Compliance With Standards*, and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 and 203) of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the accounting guidance in this guide, as discussed in paragraph 7 of Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411).*

Auditing guidance included in an AICPA Audit and Accounting Guide is an interpretive publication pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive

---

* In May 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). FASB concluded that the GAAP hierarchy should reside in the accounting literature established by FASB rather than in the auditing literature established by the AICPA (for non-Securities and Exchange Commission [SEC] registrants) or the Public Company Accounting Oversight Board (PCAOB) (for SEC registrants).

FASB Statement No. 162 carries forward the GAAP hierarchy as set forth in the AICPA's Statements on Auditing Standards (SAS) No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), subject to certain modifications that FASB does not expect to result in changes to current practice. The modifications include, among other changes, the expansion of category (a) accounting principles to include, with one exception, all sources of accounting principles that are issued after being subject to FASB's due process (including, but not limited to, FASB Staff Positions and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, implementation issues, which are currently not addressed in SAS No. 69). Although certain consensus positions of the FASB Emerging Issues Task Force (EITF) have been issued after being subjected to FASB's due process, FASB decided to carry forward the categorization of EITF consensuses as presented in SAS No. 69, which is category (c).

FASB Statement No. 162 does not carry forward the exception permitted in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203), of the AICPA's Code of Professional Conduct, that allows departures from the GAAP hierarchy if the member can demonstrate that, due to unusual circumstances, the financial statements would otherwise have been misleading. Therefore, as stated in FASB Statement No. 162, an entity cannot represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in FASB Statement No. 162, and that departure has a material effect on its financial statements.

FASB Statement No. 162 is effective 60 days following the approval by the Securities and Exchange Commission of the conforming amendments included in PCAOB Auditing Standard No. 6 and conforming amendments adopted by the PCAOB on January 29, 2008. Among other significant provisions, the conforming amendments remove the GAAP hierarchy from the PCAOB's interim auditing standards.

In response to FASB's release of the exposure draft of FASB Statement No. 162 in April 2005, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 69*, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities for Nongovernmental Entities*, in May 2005, which deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The effective dates of the AICPA, FASB, and PCAOB standards will coincide. For more information, please visit the FASB Web site at www.fasb.org.

publications are issued under the authority of the Auditing Standards Board (ASB) after all members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

This AICPA Audit and Accounting Guide, which also contains attestation guidance, is an interpretive publication pursuant to AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1). Interpretive publications include recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the AICPA ASB. The members of the ASB have found this guide to be consistent with the existing SSAEs.

A practitioner should be aware of and consider interpretive publications applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in an applicable AICPA Audit and Accounting Guide, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by such guidance.

FASB Accounting Standards Codification™

On January 15, 2008, the Financial Accounting Standards Board (FASB) launched the 1-year verification phase of the *FASB Accounting Standards Codification*™ (codification). After the verification period, during which constituents are encouraged to provide feedback on whether the codification content accurately reflects existing U.S. generally accepted accounting principles (GAAP) for nongovernmental entities, the FASB is expected to formally approve the codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). The codification includes all accounting standards issued by a standard-setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

This edition of the guide has not been conformed to the new codification. AICPA Audit and Accounting Guides, as well as other AICPA literature, will be conformed to reflect the codification after the verification phase and upon formal approval by the FASB.

Defining Professional Requirements

AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, and AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional*

Standards, vol. 1), which were issued in December 2005, set forth the meaning of certain terms used in SASs and SSAEs, respectively, issued by the ASB in describing the professional requirements imposed on auditors and practitioners. The specific terms used to define professional requirements in these sections are not intended to apply to interpretive publications issued under the authority of the ASB because interpretive publications are not auditing or attestation standards. It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists.

In December 2007, the Accounting and Review Services Committee (ARSC) issued AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), which sets forth the meaning of certain terms used in Statements on Standards for Accounting and Review Services (SSARS) issued by the ARSC in describing the professional requirements imposed on accountants performing a compilation or review of a nonissuer. The specific terms used to define professional requirements in this section are not intended to apply to interpretive publications issued under the authority of the ARSC because interpretive publications are not SSARSs. It is the ARSC's intention to make conforming changes to the interpretive publications to remove any language that would imply a professional requirement where none exists.

AU section 120, AT section 20, and AR section 20, which were effective upon issuance, define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. SASs, SSAEs, and SSARSs will use the words *must* or *is required* to indicate an *unconditional requirement*, with which the auditor, practitioner, or accountant is required to comply. SASs, SSAEs, and SSARSs will use the word *should* to indicate a *presumptively mandatory requirement*. The auditor, practitioner, or accountant is required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the auditor, practitioner, or accountant may depart from a presumptively mandatory requirement provided he or she documents the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. If a SAS, SSAE, or SSARS provides that a procedure or action is one that the auditor, practitioner, and accountant *should consider*, the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

This guide has been updated as applicable for AU section 120, AT section 20, and AR section 20. Refer to the schedule of changes, appendix F, for additional information.

Recognition

Benjamin S. Neuhausen, *Chair*
Accounting Standards Executive Committee

Harold L. Monk, Jr., *Chair*
Auditing Standards Board

Agribusiness Special Committee (1987)

Donald F. Linsteadt, *Chair*
Richard M. Arndt
Lorence Bravenec
Gail N. Brown
Robert L. Burton
Virgil S. Chandler
John P. Gerst
Jerrold A. Hunt
Howard C. Lewis
Thomas B. Lund
William H. Severson

AICPA Staff

Doug Bowman
Technical Manager
Accounting and Auditing Publications

The AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Bob Beerup, Jeff Brandenburg, Joe Daughhetee, Larry Romuald, Phil Blakney, and Rick Turpen.

This guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. Relevant guidance contained in official pronouncements issued through May 1, 2008, has been considered in the development of this edition of the guide. This includes relevant guidance issued up to and including the following:

- FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*
- Revised FASB statements issued through May 1, 2008, including FASB Statement No. 141 (revised 2007), *Business Combinations*
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB Staff Positions issued through May 1, 2008
- FASB EITF consensus ratified by the FASB through May 2008
- Statement of Position (SOP) 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (AICPA, *Technical Practice Aids*, ACC sec. 10,930)
- Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes* (AICPA, *Technical Practice Aids*, PB sec. 12,150)
- SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)

- Auditing Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit," of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.04)
- SOP 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers* (AICPA, *Technical Practice Aids*, AUD sec. 14,430)
- SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50)
- Attestation Interpretation No. 6, "Reporting on Attestation Engagements Performed in Accordance With *Government Auditing Standards*," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101 par. .56–.58)
- Public Company Accounting Oversight Board Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards")

Users of this guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this guide. In determining the applicability of a pronouncement, its effective date should also be considered.

The changes made to this edition of the guide are identified in the schedule of changes, appendix F. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

This edition of the guide includes SOP 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives* (AICPA, *Technical Practice Aids*, ACC sec. 10,390). In using this guide, readers should refer to the material in the SOP (appendix B), as it is an integral part of this guide.

Auditing Guidance Included in This Guide

Risk Assessment Standards

In March 2006, the ASB issued SAS Nos. 104–111 (the "risk assessment standards"). Collectively, the risk assessment standards establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by fraud or error) in a nonissuer financial statement audit; design and performance of tailored audit procedures to address assessed risks; audit risk and materiality; planning and supervision; and audit evidence. The most significant changes to existing practice that the auditor will be required to perform are as follows:

- Obtain a more in-depth understanding of the audited entity and its environment, including its internal control.

- Perform a more rigorous assessment of the risks of where and how the financial statements could be materially misstated (defaulting to a maximum control risk is not acceptable).
- Provide a linkage between the auditor's assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The statements are effective for audits of financial statements for periods beginning on or after December 15, 2006. Early adoption is permitted. See appendix E in this guide for a more detailed comparison between the risk assessment standards and the superseded standards. This guide has been conformed to the new risk assessment standards.

For additional guidance on the risk assessment standards, please refer to the AICPA Audit Guide *Assessing and Responding to Risk in a Financial Statement Audit* (product no. 012456), and the AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526).

Defining Professional Requirements

As previously stated, this guide has been conformed, as applicable, to the standards found in AU section 120, AT section 20, and AR section 20, which were effective upon issuance (December 2005, except for AR section 20, which was issued in December 2007). These new standards define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. Refer to the schedule of changes, appendix F, for additional information.

Preface

Purpose and Applicability

This guide applies to financial reporting and auditing in the agricultural producers and agricultural cooperatives industries. It is intended

- to provide background information on the nature and characteristics of the agricultural industry.
- to assist agricultural producers and cooperatives in applying generally accepted accounting principles (GAAP).
- to assist the independent auditor in applying generally accepted auditing standards (GAAS) and knowledge of GAAP to determine whether GAAP have been applied by management, which has the primary responsibility for financial statements.

GAAS and accounting principles are applicable to all types of agribusiness. The general application of these standards and principles is not discussed herein; rather, this guide focuses on the special problems inherent in auditing and reporting on the financial statements of agricultural producers and agricultural cooperatives.

This guide contains some suggested auditing procedures, but detailed internal control questionnaires and audit programs are not included. The nature, timing, and extent of auditing procedures are matters of professional judgment and should be responsive to the assessed risks of material misstatement. This guide also includes information regarding statutory rules and regulations applicable to the industry and illustrations of the form and content of financial statements of agricultural producers and agricultural cooperatives and the independent auditor's reports thereon.

Statement of Position 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives* (AICPA, *Technical Practice Aids*, ACC sec. 10,390) included as appendix B to this document, and the accounting provisions of this guide do *not* apply to personal financial statements of agricultural producers or statements prepared on a comprehensive basis of accounting other than GAAP (for example, the income tax or the cash basis of accounting). They also do not apply to growers of timber; growers of pineapple and sugarcane in tropical regions; raisers of animals for competitive sports; or merchants or noncooperative processors of agricultural products that purchase commodities from growers, contract harvesters, or others serving agricultural producers.

Public Accounting Firms Registered With the Public Company Accounting Oversight Board

Subject to the Securities and Exchange Commission (SEC) oversight, Section 103 of the Sarbanes-Oxley Act authorizes the Public Company Accounting Oversight Board (PCAOB) to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers, as defined by the act, and other entities when prescribed by the rules of the SEC.

Effective Date

The provisions for this guide shall be effective for audits of financial statements for periods ending on or after December 31, 1987.

Agribusiness Special Committee

References to Professional Standards

In citing the professional standards, references are made to the AICPA *Professional Standards* publication. In those sections of the guide where specific PCAOB auditing standards are referred to, references are made to the AICPA's *PCAOB Standards and Related Rules* publication. Please refer to appendix D of this guide for a summary of major existing differences between AICPA standards and PCAOB standards. Additionally, when referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, SAS No. 54 is referred to as AU section 317.

Applicability of Requirements of the Sarbanes-Oxley Act of 2002

Publicly held companies and other *issuers* are subject to the provisions of the act and related SEC regulations implementing the act. Their outside auditors are also subject to the provisions of the act and to the rules and standards issued by the PCAOB.

Presented is a summary of certain key areas addressed by the act, the SEC, and the PCAOB that are particularly relevant to the preparation and issuance of an issuer's financial statements and the preparation and issuance of an audit report on those financial statements. However, the provisions of the act, the regulations of the SEC, and the rules and standards of the PCAOB are numerous and are not all addressed in this section or in this guide.

Definition of an Issuer

The act states that the term *issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Issuers, as defined by the act, and other entities when prescribed by the rules of the SEC (collectively referred to in this guide as *issuers* or *issuer*) and their public accounting firms (who must be registered with the PCAOB) are subject to the provisions of the act, implementing SEC regulations, and the rules and standards of the PCAOB, as appropriate.

Nonissuers are those entities not subject to the act or the rules of the SEC.

Guidance for Issuers

Management Assessment of Internal Control

As directed by Section 404 of the act, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange

Act of 1934, other than registered investment companies and certain other entities (for example, 11-K filers), to include in their annual reports a report of management on the company's internal control over financial reporting.

Companies that are *large accelerated filers* or *accelerated filers,* as defined in Exchange Act Rule 12b-2, are required to comply with these rules for fiscal years ending on or after November 15, 2004. Foreign private issuers that are large accelerated filers or accelerated filers and that file their annual reports on Form 20-F or 40-F must comply with the rules for the first fiscal year ending on or after July 15, 2006. *Nonaccelerated filers* including foreign private issuers that are not accelerated filers are required to comply with the rules for the first fiscal year ending on or after December 15, 2007. See the SEC Web site at www.sec.gov/ for further information.

The auditor's attestation on the effectiveness of the issuer's internal control over financial reporting is currently required for large accelerated filers and accelerated filers. For nonaccelerated filers, the auditor's attestation is required for annual reports for fiscal years ending on or after December 15, 2009.

The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. The SEC's definition of internal control encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Select SEC Developments

The SEC posted an Interpretive Release, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* on June 20, 2007, to provide guidance for management regarding its evaluation and assessment of internal control over financial reporting. This guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. This guidance describes a top-down, risk-based approach to this principle. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. This guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation.

The SEC also posted a Final Rule, *Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting*, on June 20, 2007, that provides, among other significant provisions, that a company performing an evaluation in accordance with the aforementioned interpretive guidance also satisfies the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15. Among other rule changes, the SEC defined the term *material weakness* and revised the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to require the auditor to express an opinion directly on the effectiveness of internal control over financial reporting and not on management's evaluation process.

In a subsequent Final Rule, *Definition of the Term Significant Deficiency*, posted August 3, 2007, the SEC defined the term *significant deficiency* for the purpose of implementing Section 302 and Section 404 of the act. By including a definition of *significant deficiency* in SEC rules, in addition to the definition of *material weakness*, the SEC has enabled management to refer to its rules and guidance for information on the meaning of these terms rather than referring to the auditing standards. Readers should refer to the SEC Web site at www.sec.gov for more information.

Guidance for Auditors

The act mandates a number of requirements concerning auditors of issuers, including mandatory registration with the PCAOB, the setting of auditing standards, inspections, investigations, disciplinary proceedings, prohibited activities, partner rotation, and reports to audit committees, among others. The PCAOB continues to establish rules and standards implementing provisions of the act concerning the auditors of issuers.

Applicability of GAAS and PCAOB Standards

Specifically, the act authorizes the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports for entities subject to the act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of *issuers,* as defined by the act, and other entities when prescribed by the rules of the SEC.

For those entities not subject to the act or the rules of the SEC, the preparation and issuance of audit reports remain governed by GAAS as issued by the Auditing Standards Board.

Select PCAOB Developments

On May 24, 2007, the PCAOB adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), and an independence rule relating to the auditor's provision of internal control-related nonaudit services. Auditing Standard No. 5 supersedes PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. The SEC approved the standard on July 25, 2007 and it is effective for audits of internal control over financial reporting required by the act for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval.

Auditing Standard No. 5 is principles-based and is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements and, at the same time, eliminate procedures that are unnecessary. It focuses the auditor on the procedures necessary to perform a high quality audit and makes the audit scalable so it can change to fit the size and complexity of any company. Readers should refer to the PCAOB Web site at www.pcaob.org for more information.

Major Existing Differences Between GAAS and PCAOB Standards

The major differences between GAAS and PCAOB standards are described in both part I of volume one of the AICPA *Professional Standards* and in part I of the AICPA publication titled *PCAOB Standards and Related Rules*. Please refer to appendix E of this guide for a summary of major existing differences between AICPA standards and PCAOB standards.

TABLE OF CONTENTS

PART I—Agricultural Producers

Chapter 1

Introduction

1.01 Agriculture ranks among the largest industries in the United States and, until recent times, was the country's principal occupation and employer. Although the number of people involved in agricultural production is still large, that number has been steadily shrinking as a result of increased farm productivity, a growth in the size of individual farms and ranches, and the population shift toward urban centers. Despite the trend toward larger business units, however, entities engaged in agriculture still range from small noncorporate family groups to publicly held multinational corporations.

1.02 For purposes of this guide, the term *agricultural producers* includes farmers and ranchers who grow or raise agricultural or horticultural products for sale or for use in the production of other agricultural or horticultural products. In their transactions with agricultural cooperatives, they may be referred to as *members* or *patrons*.

1.03 Audits of agricultural producers are designed and conducted in the same manner as audits of other enterprises, giving due consideration to the size and nature of the organization and internal control. The auditing procedures suggested herein are presented to provide guidance on matters that are unique or significant to the industry, but they may not apply to all situations and are not intended to replace or limit the use of judgment in determining the nature, timing, and extent of audit procedures to be applied in a particular audit.

1.04 Sample financial statements, whose form and content are currently acceptable, are illustrated in appendix A.

Chapter 2

Background Information

2.01 Organizations ranging from small proprietorships to large public companies engage in a variety of farming and ranching activities, including the following:

- Growing wheat, milo, corn, and other grains
- Growing soybeans, vegetables, sugar beets, and sugarcane
- Growing citrus fruits, other fruits, grapes, berries, and nuts
- Growing cotton and other vegetable fibers
- Operating nurseries
- Breeding and feeding cattle, hogs, and sheep, including wool production
- Operating dairies
- Raising fish and shellfish
- Operating poultry and egg-production facilities
- Breeding horses
- Raising mink, chinchilla, and similar small animals

Agricultural producers may be involved in one or more activities, and their practices and products may vary because of differences in temperature, soil, rainfall, and regional economics.

2.02 Agricultural producers primarily market their products directly to existing commercial enterprises, consume them in a related activity, such as the feeding of raised hay and grains to livestock, or market them through agricultural cooperatives. Agricultural cooperatives may act as agents and account for the separate products of each producer, or they may commingle the patrons' products and either market them in the form in which the products were received or process them before sale. Producers also sell some products through governmental programs. Prices of most agricultural products are determined by economic forces, but some product prices are established by federal and state regulatory agencies. Agricultural producers may use forward sales contracts, commodity futures contracts, or options to reduce the risks associated with fluctuating commodity prices.

2.03 Agricultural producers conduct their operations in various manners. Some agricultural producers manage the entire productive activities of their farms and ranches. Others conduct agricultural operations as tenants under cash or crop-sharing rental agreements. Terms of crop-sharing agreements usually provide for a portion of the crop to be sold for the account of or delivered to the landowner. The extent of the landowner's participation in costs, profits, and management depends on the terms of each agreement.

2.04 The daily activities of farmers and ranchers who produce market crops may also create additions to fixed assets. Examples include the addition of raised animals to a breeding herd and the construction of buildings, fences, and various types of land improvements by using the producer's equipment and employees.

2.05 Federal and state income tax laws have significantly affected the operations and accounting practices of agricultural producers. Some accounting practices have been partially justified based on their acceptance for income tax purposes, but these practices may not be in accordance with generally accepted accounting principles. Economic decisions and productive activities of many agricultural producers have also been influenced by government subsidy and credit programs.

Chapter 3

Financial Reporting Information Systems, Internal Control, and Other Accounting Considerations[*]

Financial Reporting Information Systems

3.01 More attention has been given to financial reporting information systems and practices in the agricultural industry in recent years because of the increased size and complexity of operating units as well as the greater number of formally educated and trained agricultural producers and managers. Many large private entities and publicly held corporations engaging in agricultural production have sophisticated financial reporting information systems. However, many producers maintain elementary accounting records that are used for both tax and financial accounting. There are numerous sources of accounting forms and systems designed for agricultural producers. In addition, many producers use cash basis accounting. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors about the effect of IT on internal control and on the auditor's understanding of internal control and assessment of the risks of material misstatement. In performing audits of entities that choose to outsource their computer processing functions, the independent auditor should consider the factors listed in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).[1]

> *Considerations for Integrated Audits*
>
> Paragraph .01 of AU section 324, *Service Organizations* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of appendix B, "Special Topics," of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), regarding the use of service organizations.

Internal Control

3.02 As in other small businesses, internal control of many small agricultural operations is weak because they typically have small or part-time accounting staffs and little or no segregation of duties. However, involvement

---

[*] Refer to the preface of this guide for important information related to the requirements and standards of the Public Company Accounting Oversight Board and for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

[1] For more information on AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), refer to the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, As Amended*.

of the owner or manager in the operations frequently provides some control, particularly over access to assets and authorization of transactions.

3.03 Large agricultural operators are likely to have adequate controls over critical functions, such as sales, costs of production, inventories of products and supplies, purchases and disbursements, equipment use, and personnel utilization.

Cost Accounting and Cost Allocations

3.04 Accounting for the cost of agricultural products is similar to accounting for the cost of manufactured products. However, agricultural producers are faced with significant problems of cost identification and determination because the same personnel and equipment are often used in the production and sale of products, administration, and construction and production of assets. In addition, producers may raise diverse crops and animals, which further complicates the process of cost allocation.

3.05 Certain production costs, such as those for seed, planting, feed, and fertilizer, may be allocated directly to a particular product. Other production costs may be accumulated by department or function and allocated on systematic and rational bases to various products through cost or support centers. For example, costs may be accumulated for machinery and equipment used for more than one agricultural activity and allocated to the activities based on usage records. Departments providing goods or services for more than one product are often called cost centers or *support centers* and may be established for the purpose of accumulating indirect costs and direct costs for activities such as irrigation and pest and disease control.

3.06 Production overhead includes all production costs that are common to various products, support centers, and other cost objectives. These costs should be accumulated for each period and allocated to products based on direct labor hours, machinery and equipment use, or another basis that correlates with the use of resources.

3.07 If overhead and support center costs are estimated in advance and allocated on an interim basis, under- or overapplied costs may result. Under- or overapplied costs should be allocated to cost of goods sold, inventories, and growing crops.

3.08 Costs should be allocated when one raised product is used in the development of another. For example, grain or hay raised by the producer may be used to feed livestock. The costs of producing the grain or hay should be accumulated and allocated to the cost of producing the livestock.

3.09 Matching costs and expenses with related revenues is important to the design of the accounting system of the agricultural producer. Costs of resources that are expected to provide future benefits should be deferred as assets on the balance sheet. Costs without expected future benefits should be charged to expense as incurred.

3.10 Questions frequently arise about the accounting treatment of costs incurred for replanting, costs attributable to prior crops, double-cropping costs, and costs of crops that take over one year to mature. These items, which do not apply to orchards, vineyards, and groves, are discussed as follows.

Partial Replanting

3.11 Partial replanting occurs for a variety of reasons, including damage from insects, crop disease, and drought. Costs of replanting may include land preparation, irrigation, seed, and labor. If those costs are considered normal costs and, when combined with other capitalized costs, do not exceed estimated net realizable value, they should be included as part of the growing or harvested crop's cost. If the costs are abnormal or excessive, they should be charged to operations. (See "Normal Costs Versus Abnormal or Excessive Costs," paragraphs 3.17–.18.)

Complete Replanting

3.12 Complete replanting of a field may occur at some point during the crop year for various reasons, including economic considerations. Generally, the costs incurred with respect to the crop removed should be charged to expense, and the cost of the new planting should be capitalized as the cost of the new crop. However, some costs incurred for an earlier planting may benefit a replanted crop and be appropriately considered costs of the new crop. Examples of such items include deep plowing, estimated residual value of earlier fertilizing, and seedbed preparation.

Double-Cropping

3.13 A parcel of land may be used for more than one crop in the same growing season. For example, winter wheat might be planted in the fall and harvested in early summer of the following year. Immediately following the wheat harvest, soybeans may be planted and harvested that fall. As a result, certain costs may be allocated to more than one crop. For example, the same land preparation or fertilizer costs may benefit both crops and should be allocated to each crop, either on the basis of the relative values of the two crops or on another logical basis.

Extended-Period Crops and Methods

3.14 Some crop costs, such as soil preparation, are incurred prior to planting and should be deferred and allocated to the growing crop. Other cultural practices, such as clearing the residue of harvested crops, cannot be performed or completed until after harvest, which may be in a succeeding year; those costs should be estimated, accrued, and allocated to the harvested crop. Some crops require more than one year to mature, and the costs should be deferred until harvest.

3.15 It is not uncommon for assets to be constructed by using labor and materials from the farm or ranch rather than by employing an outside contractor. When this occurs, the costs of materials, labor, machinery and equipment, and related overhead applicable to such assets should be capitalized. Ordinarily, the costs of constructed assets includes only the direct construction costs and allocated overhead costs. The overhead rate used in capitalization should generally not be higher than the rate used for product costing. Other general and administrative expenses should not be capitalized. The amount of costs capitalized for internally constructed assets generally should not be more than the estimated external purchase price of such assets.

3.16 The interest costs related to construction or production of major assets should be capitalized in accordance with Financial Accounting Standards Board Statement No. 34, *Capitalization of Interest Cost*.

Normal Costs Versus Abnormal or Excessive Costs

3.17 In order to record assets at amounts that do not defer losses to future periods, the producer should distinguish normal costs from abnormal costs. (Accounting Research Study No. 13, *The Accounting Basis of Inventories*, contains discussions of *abnormal costs* and *normalizing direct costs* that may be useful in distinguishing normal costs from abnormal costs.) Identification of abnormal costs involves consideration of the producer's performance, which can be measured by various statistics, such as utilization rates, per-acre crop yields, and insecticide application rates. Regional averages, the experience of others producing the same or similar products in a comparable area, and the opinions of specialists may be used to determine the level of performance that represents an acceptable standard of achievement under ordinary operating conditions.

3.18 Identification of abnormal costs of agricultural assets may require a general knowledge of the normal loss rate of animals, trees, or vines. No separate accounting is necessary for normal losses. When abnormal losses occur in a particular year, the undepreciated costs of lost animals, trees, or vines should be charged to current operations. The complexity and subjectivity associated with determining normal loss rates may require, in the auditor's judgment, using the work of a specialist to obtain appropriate audit evidence. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance in this area.

Chapter 4

General Auditing Considerations for Agricultural Producers[*]

Overview

4.01 In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This chapter of the guide provides guidance, primarily on the application of the standards of fieldwork. Specifically, this chapter provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding the entity and its environment, including its internal control) and general auditing considerations for agricultural producers.

4.02 For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, was superseded by PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"). The new standard is effective for all audits of internal control required by Section 404(b) of the act for fiscal years ending on or after November 15, 2007. Earlier application is permitted.

4.03 PCAOB Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements. This chapter is not intended to provide guidance to auditors on how to comply with the requirements of PCAOB Auditing Standard No. 5 although it highlights, as appropriate, significant differences between GAAS and PCAOB standards.

Planning and Other Auditing Considerations

4.04 The objective of an audit of the financial statements of an agricultural producer is to express an opinion on whether its financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to agricultural producers.

---

[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

Audit Planning

4.05 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

4.06 Paragraph .03 of AU section 311 states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Integrated Audits*
>
> Paragraph .01 of AU section 311, *Planning and Supervision* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 9 of PCAOB Auditing Standard No. 5 regarding planning considerations.

Audit Risk

4.07 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

4.08 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. Paragraph .23 of AU section 312 states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be *at the maximum*. This assessment may be in qualitative terms such as *high*, *medium*, and *low*, or in quantitative terms such as *percentages*.

4.09 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Planning Materiality

4.10 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

4.11 In accordance with paragraph .27 of AU section 312 (AICPA, *Professional Standards*, vol. 1), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark, for example total assets, total pool values, or revenues, as a step in determining materiality for the financial statements taken as a whole. Auditors may also consider Farm Financial Standards Council's "Sweet Sixteen" ratios which are made up of liquidity, solvency, profitability, repayment capacity, and financial solvency. Auditors are reminded that volatile markets for agricultural commodities can cause both revenues and assets to fluctuate significantly from year to year.

> *Considerations for Integrated Audits*
>
> Paragraph .03 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended) states when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of PCAOB Auditing Standard No. 5 regarding materiality considerations.

Tolerable Misstatement

4.12 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 (AICPA, *Professional Standards*, vol. 1) defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

4.13 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

4.14 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 (AICPA, *Professional Standards*, vol. 1) provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Auditor's Communication With Those Charged With Governance

4.15 AU section 380, *The Auditor's Communication with Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), provides a framework for effective two-way communication between the auditor and those charged with governance, and identifies certain specific matters that the auditor must communicate to those charged with governance. The auditor must communicate matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

4.16 For purposes of AU section 380, *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, the term *those charged with governance* encompasses the term *board of directors* or *audit committee* used elsewhere in GAAS. For purposes of AU section 380, *management* means the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

4.17 Note that AU section 380 does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role. In some cases, all of those charged with governance are also involved in managing the entity. Matters communicated in accordance with AU section 380 to person(s) with management responsibilities need not be communicated again with those same person(s) in their governance role. Paragraph .22 of AU section 380 provides that, when all of those charged with governance are involved in managing the entity, the auditor should consider whether communication with person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. Paragraph .18 of AU section 380 presents matters the auditor may consider in determining whether communication with subgroups of those charged with governance adequately fulfills the auditor's responsibility under this professional standard.

4.18 As provided in paragraph .49 of AU section 380, matters that may contribute to effective two-way communication include discussion of the purpose of communications, the form in which communications will be made, the person(s) on the audit team and among those charged with governance who will communicate regarding particular matters, the auditor's expectation that the communication will be two-way, the process for taking action and reporting back on matters communicated by the auditor, and the process for taking action and reporting back on matters communicated by those charged with governance. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of the matters to be communicated. The importance of effective two-way communication is evidenced by the statement in paragraph .63 of AU section 380 that if, in the auditor's judgment, the two-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements.

4.19 Paragraph .23 of AU section 380 identifies the following matters that the auditor should communicate with those charged with governance:

- the auditor's responsibilities under GAAS,
- an overview of the planned scope and timing of the audit, and
- significant findings from the audit.

The communication of internal control related matters is addressed in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and in paragraphs 4.59–.61 of this guide. The communication about fraud related matters is addressed in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), and in chapter 13 of this guide. Appendix A of AU section 380 contains a list of other AU sections that contain requirements for auditor communication with those charged with governance. Nothing in AU section 380 precludes the auditor from communicating any other matters to those charged with governance.

Use of Assertions in Obtaining Audit Evidence

4.20 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

4.21 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

4.22 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows:

> "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures."

4.23 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Paragraph .05 of AU section 314 states that, throughout this process, the auditor should also follow the guidance in AU section 316. See chapter 13 for additional guidance pertaining to AU section 316.

4.24 This section addresses the unique aspects of agricultural producers that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

Risk Assessment Procedures

4.25 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

4.26 In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Discussion Among the Audit Team

4.27 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Entity and Its Environment

4.28 Paragraph .03 of AU section 314 states that obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with GAAS. In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests).

4.29 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies (see the following section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (*a*)–(*d*).

4.30 Factors that may be particularly relevant to the auditor when obtaining an understanding of an agricultural producer and its environment include

1. the relationship of the producer's fiscal year-end to the harvest cycle of the producer's major crops. For example, a producer with a fiscal year ending on June 30 whose major crop is rice will have a growing crop for the auditor to consider at year-end; however, the auditor for a similar producer with a fiscal year ending on December 31 would not have that same concern.
2. the existence of share-crop arrangements. When such arrangements exist, the auditor should consider terms of the share-crop agreement including the party having title to the growing or harvested crops, the possibility of inventory and accounting distortions because of planting schedules and different fiscal years, and the landowner's right to participate in management decisions, including the planting and sale of crops.
3. special conditions affecting the producer's crops, plants, and animals, such as diseases and unfavorable weather conditions. For

example, yields expected for a tree-fruit crop may be adversely affected to such a degree by weather conditions that accumulated costs may exceed inventory values. When these costs are increased by growing and harvest costs yet to be incurred, they may exceed anticipated crop revenues.

4. government regulations affecting the producer. For example, the producer may be adversely affected by changes in the farm program or by local restrictions on the use of herbicides, pesticides, or fungicides.
5. the need for the services of a specialist to evaluate the quality of the producer's crops, plants, or animals. For example, in some instances the auditors may not possess the knowledge or experience to evaluate the health of plants and animals, estimate crop quality and expected yields, or recognize the existence of disease or infestations. See AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1).
6. availability of specialized information. Information regarding subsidy programs, historical crop yields, and general information regarding local area conditions is available from the Department of Agriculture's Agricultural Stabilization and Conservation Service, university extension services, and other sources.

4.31 To assist in obtaining an understanding of an agricultural producer, numerous publications are available that contain detailed descriptions of most production operations. Such publications are available from U.S. government agencies, state agricultural universities, agricultural extension services, and commodity and trade organizations. (See appendix C, "Information Sources.")

Understanding of Internal Control[1]

4.32 Paragraph .40 of AU section 314 states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

a. evaluate the design of controls relevant to an audit of financial statements.

b. determine whether they have been implemented.

4.33 The auditor should use the understanding to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

4.34 Obtaining an understanding of controls is different from testing the operating effectiveness of controls. The objective of obtaining an understanding of controls is to evaluate the design of controls and determine whether they

---

[1] For additional nonauthoritative guidance pertaining to internal control and the recently issued auditing standards on risk assessment, refer to Technical Questions and Answers (TIS) section 8200.05–.16 (AICPA, *Technical Practice Aids*) issued in March and April 2008.

have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

4.35 Paragraph .41 of AU section 314 defines internal control as "a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of five interrelated components:

a. The control environment

b. Risk assessment

c. Information and communication systems

d. Control activities

e. Monitoring

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components.

4.36 Internal control that is appropriate for agricultural producers is similar to that appropriate for entities engaged in manufacturing. Controls normally exist over the producer's major transaction cycles, such as purchasing, sales, and payroll. In addition, the producer normally maintains controls over production activities that provide reasonable assurance that costs are appropriately allocated to inventories and self-constructed assets.

Use of Information Technology

4.37 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. AU section 314 states that, in obtaining an understanding of internal control sufficient to assess the risk of material misstatement, the auditor should obtain an understanding of how an entity's use of IT and manual procedures may affect controls relevant to the audit. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, authorize, record, process, and report transactions or other financial data. Paragraph .119 of AU section 314 provides guidance to auditors in auditing the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically.

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

4.38 As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

4.39 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.

b. relate the identified risks to what can go wrong at the relevant assertion level.

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

4.40 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

4.41 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks. Examples include environmental liabilities or special repayment terms.

Designing and Performing Further Audit Procedures

4.42 AU section 318 provides guidance about implementing the third standard of field work, as follows:

> "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

4.43 To reduce audit risk to an acceptably low level, the auditor (1) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (2) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

Overall Responses

4.44 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

4.45 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level. In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach. Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

Tests of Controls

4.46 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

> *Considerations for Integrated Audits*
>
> Paragraph .30 of AU section 312 (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended) states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 6–8 and appendix B paragraphs B1–B5 of PCAOB Auditing Standard No. 5 regarding tests of controls.

4.47 Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion. Paragraphs .106–.108 of AU section 314 discuss the identification of controls at the relevant assertion level likely to prevent or detect a material misstatement in a class of transactions, account balance, or disclosure.

4.48 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures,[2] the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

4.49 Tests of the operating effectiveness of controls ordinarily include procedures such as inquiries of appropriate entity personnel; inspection of documents, reports, or electronic files; observation of the application of specific controls; and reperformance of the application of the control by the auditor. Note that since inquiry alone is not sufficient, the auditor should use a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls.

4.50 In designing tests of controls, the auditor should consider the need to obtain audit evidence supporting the effective operation of controls directly related to the relevant assertions as well as other indirect controls on which these controls depend.

> *Considerations for Integrated Audits*
>
> Paragraph .97 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 54 of PCAOB Auditing Standard No. 5 for discussion on the extent of tests of controls.

4.51 In the case of an automated application control, because of the inherent consistency of IT processing, audit evidence about the implementation of the control, when considered in combination with audit evidence obtained regarding the operating effectiveness of the entity's IT general controls (and in particular, security and change controls), may provide substantial audit evidence about its operating effectiveness during the relevant period.

---

[2] Paragraph .06 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), discusses the use of risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, that the auditor uses to support assessments of the risks of material misstatement of the financial statements.

4.52 Generally, IT processing is inherently consistent; therefore, the auditor may be able to limit the testing to one or a few instances of the control operation. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor should perform tests to determine that the control continues to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls are effective. Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may test the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

4.53 To test automated controls, the auditor may need to use techniques that are different from those used to test manual controls. For example, computer-assisted audit techniques may be used to test automated controls or data related to assertions. Also, the auditor may use other automated tools or reports produced by IT to test the operating effectiveness of general controls, such as program change controls, access controls, and system software controls. The complexity and other factors associated with designing and performing such tests of controls may require, in the auditor's judgment, using the work of a specialist to obtain appropriate audit evidence. AU section 336 provides guidance in this area.

4.54 Refer to paragraphs .23–.49 of AU section 318 for additional guidance on tests of controls.

Substantive Procedures

4.55 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

4.56 Refer to chapter 6 for specific guidance on the more significant audit procedures that the independent auditor may consider in the audits of agricultural producers.

Evaluating Misstatements

4.57 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 (AICPA, *Professional Standards*, vol. 1) states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. AU section 312 further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

4.58 For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 (AICPA, *Professional Standards*, vol. 1) and AU section 326, respectively.

Identifying, Evaluating, and Communicating Control Deficiencies

4.59 In an audit of the financial statements of a nonissuer, paragraph .04 of AU section 325 states that the auditor is not required to perform procedures to identify deficiencies in internal control, or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risk, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

4.60 The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses (as defined in AU section 325). The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatements does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of misstatement.

4.61 Control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under AU section 325 must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication. AU section 325 provides additional guidance and establishes further requirements for communicating internal control related matters identified in an audit.

Chapter 5

*Inventories**

Accounting for Inventories[1]

5.01 Inventories of agricultural producers include growing crops, developing animals to be held for sale, harvested crops, livestock held for sale, and secondary products, such as calves from dairy herds and wool from sheep.

5.02 Financial Accounting Standards Board Statement No. 151, *Inventory Costs—an amendment of ARB No. 43, Chapter 4*, amends Accounting Research Bulletin (ARB) No. 43 chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities.

5.03 Growing crops and developing animals to be held for sale should be valued at the lower of cost or market. Inventories of harvested crops and livestock held for sale may be valued at the lower of cost or market or, in accordance with established industry practice, at sales price less estimated costs of disposal, when all the following conditions exist:

1. The product has a reliable, readily determinable, and realizable market price.
2. The product has relatively insignificant and predictable costs of disposal.
3. The product is available for immediate delivery.

5.04 For the purpose of this section, *market* means *net realizable value* as defined in statement 6 of chapter 4 in ARB No. 43 and discussed later in this section of the guide. A reliable market price should be found in an established market for products that are comparable to the product being valued and that do not vary significantly because of differences in grade or variety.

5.05 The product should be located sufficiently close to the marketplace to make delivery practical without significant costs or time delays. These circumstances affect the amount and predictability of market prices. In addition, the marketing procedures should be well established so that transportation and other disposal costs, which should be relatively small, can be estimated with reasonable accuracy.

Net Realizable Value

5.06 Inventories of harvested crops and livestock held for sale and commonly referred to as valued at market are actually valued at net realizable

---

[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

[1] The Financial Accounting Standards Board (FASB) recently ratified Emerging Issues Task Force Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty." The issue is effective for new arrangements entered into, or modifications or renegotiations of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006. For additional information refer to the FASB Web site at www.fasb.org.

value. Thus, whether harvested crops and livestock held for sale are valued at market or at the lower of cost or market, it is necessary to determine the net realizable value of those inventories. At times, net-realizable-value calculations are required for growing crops and developing animals. For these categories, costs to complete, including direct costs, production overhead, and costs of disposal, should be estimated and deducted from the anticipated sales prices to determine the net realizable value for the growing crops and developing animals and to compare it to costs incurred.

5.07 Determining net realizable value requires estimating selling prices and related costs of disposal in the ordinary course of business. The entity's involvement with derivative instruments and hedging activities may also need to be considered. Disposal costs include handling, packing, transportation costs identified with sale of the specific product, and selling expenses such as commissions and other types of direct sales expense.

5.08 Sources of market information for agricultural commodities are numerous. They include quoted daily prices for traded commodities such as grains and livestock. For other commodities, information may be available from local dealers, crop-reporting services, commercial lending institutions, county extension services, and trade publications. The reputation and credibility of the information source should be considered. The market data should be adjusted to the local price because there are usually significant variations between the local and central market prices, reflecting, at the least, the freight differential. In addition, prices of most agricultural products will depend on their grade classifications, which should be considered in determining net realizable value.

5.09 Any estimate of net realizable value by the producer should be based on the most reliable evidence available at the balance sheet date. However, if a material variation from that amount exists prior to the date the financial statements are issued, AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), states that all information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. AU section 560 provides additional guidance and establishes requirements regarding the evaluation of subsequent events by the independent auditor.

> *Considerations for Integrated Audits*
>
> Paragraph .01 of AU section 560, *Subsequent Events* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 93–97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for direction with respect to subsequent events in audit of internal control over financial reporting.

An Overview of the Audit of Inventories

5.10 Audit objectives include (*a*) obtaining reasonable assurance that inventory quantities represent all agricultural products and animals belonging to the producer and (*b*) determining that an acceptable valuation method has been properly and consistently applied.[2] If a cost method is used to value inventories, cost should not exceed net realizable value. Adequate disclosure related to inventories should be made.

5.11 Audit procedures for inventories generally are similar to those performed in the audit of manufacturing entities. Unique audit risks may require modification of those procedures, as described here:

1. When no documents exist to evidence title to raised products, reviews of cost records, yield statistics, and supporting documents may indicate the nature and extent of the farming activity and thus provide that evidence.
2. When there is a lack of documentary evidence to support the ownership of raised livestock, the number of animals represented as produced for a period may be tested for reasonableness by applying normal productivity rates to the productive animals in the breeding herd. Inspection of records evidencing real estate ownership may provide additional support for ownership of crops and livestock on the land, as may tenant lease agreements.
3. Inventories of agricultural products are often stored in public warehouses. In addition to using the relevant assertions associated with inventory stored in public warehouses (existence, rights and obligations, and valuation and allocation, for example) in designing and performing further audit procedures, the auditor should apply the additional audit procedures set forth in paragraph .14 of AU section 331, *Inventories* (AICPA, *Professional Standards*, vol. 1), that the auditor considers necessary in the circumstances, if such inventories represent a significant portion of current or total assets.

---

[2] The level of the auditor's responsibility for performing procedures or achieving objectives can be described in two ways—with the terms *assurance* or *risk*. Assurance is the complement or converse of risk. AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), discusses reducing audit risk to a low level. The term *reasonable assurance* is used in this guide to describe the high, but not absolute, level of assurance that is intended to be obtained by the auditor.

Chapter 6

Specific Accounting Principles and Auditing Considerations[*]

Field and Row Crops

Background and Unique Characteristics

6.01 Field and row crops with cycles of less than one year are generally classed as annuals. These crops include wheat, barley, milo, corn, soybeans, sugar beets, tobacco, cotton, crops raised for seed, tomatoes, lettuce, beans, cabbages, and melons.

6.02 Field and row crops are usually planted from seeds or are transplanted from beds and develop to the point of harvest within several months. In certain areas, when weather conditions permit, two and sometimes three different crops can be raised and harvested sequentially from the same field during one year. These practices are referred to as *double-* and *triple-cropping*.

6.03 Good management of field and row crops demands careful protection from spoilage. The delicate nature of some crops requires quick handling from harvest to storage because the product may become worthless in a short period of time. Current methods of harvesting and handling usually prevent spoilage from becoming a significant problem.

6.04 In recent years hybridization has resulted in plant varieties that carry substantially improved growth, maturation, and yield characteristics compared with older varieties. The development of improved varieties has occurred simultaneously with improvements in both cultural techniques and harvesting equipment. These innovations have increased yields per acre, reduced per-unit costs, and enhanced the general economic value of those plantings.

Accounting Principles

6.05 Costs of growing crops should be accumulated until the time of harvest, subject to lower of cost or market adjustments. Harvested crops held for sale should be reported at the lower of cost or market or in accordance with established industry practice at market if certain conditions described in paragraph .039 of Statement of Position (SOP) 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives* (AICPA, *Technical Practice Aids*, ACC sec. 10,390), exist. (See appendix B for SOP 85-3.)

6.06 Cost centers may be established by field, crop, ranch, or other geographic area. To adequately allocate costs to inventories, each cost center should be charged with direct material and labor and an allocation of indirect costs. Where there are multiple crops, records should be maintained to provide a basis for allocation of total costs to the separate crops.

6.07 Most costs related to producing field and row crops benefit only the current-year crop (for example, furrows and beds constructed for annual plantings). However, certain costs may be expended for resources benefiting more

[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

than one crop year and should be allocated to the appropriate years. For instance, in the production of rice crops the engineering and grading costs for *borders* (ridges used to retain water) may benefit several years. Such costs are properly included in property and equipment and amortized over their useful lives.

6.08 Generally, farming procedures undertaken after the current year harvest benefit the crop of the succeeding year. There may be instances, however, where additional costs such as costs of special tillage, chopping, or burning are required after harvest of a particular crop to overcome a physical or noxious condition. Those costs should be estimated and accrued as costs of the harvested crop.

6.09 In some agricultural operations a field or row crop is raised for use in the development of another product, such as grain or hay used by the producer to feed livestock. The costs involved in the production of the field or row crops for the producer's own use should be identified as part of the maintenance costs of the livestock and accounted for in the same manner as other maintenance costs, as described in "Accounting Principles for Breeding Animals," paragraphs 6.47–.53.

Auditing Considerations

6.10 When obtaining an understanding about the agricultural producer and its environment, the auditor should inquire about the farming procedures and become familiar with the overall operation and any unusual events and practices.

6.11 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. For harvested and growing field and row crops, the auditor may perform the following audit procedures:

1. Physically observe and review crop maturity and quality.
2. Confirm the existence of harvested crops stored in outside warehouses. AU section 331, *Inventories* (AICPA, *Professional Standards*, vol. 1), provides guidance and sets forth requirements for inventories held in public warehouses.
3. Review and test the capitalized costs of growing and harvested crops for reasonableness.
4. Determine that capitalized costs of crops do not exceed market.

6.12 When records of ownership are inadequate or nonexistent, determining the ownership of harvested crops can present special audit risks. In those situations, evidence of crop ownership may be provided by a review of direct crop costs, harvesting and handling expenses, and applicable leases and tenant agreements.

6.13 Unique audit risks also may be encountered in reviewing the quality of harvested crops. When inventories include harvested crops, relevant considerations include whether the stored commodity is of acceptable variety and quality. Assessing the value of a commodity can be a demanding procedure. In addition to market conditions, the value will be influenced by physical condition, variety, and quality.

6.14 The physical state of the product may be affected by obvious conditions, such as mold, decay, or other evidence of physical spoilage, or by deterioration discernible only to those experienced and technically qualified. For instance, seed held in storage for long periods may suffer loss of germination potential that can only be detected by laboratory tests. Other damage may include insect infestations that require microscopic examination to determine the type and extent of deterioration.

6.15 The variety of a stored commodity may have a material influence on value. For instance, recent technical advances in hybridization have resulted in the development of varieties and strains of agricultural products far superior to the varieties they replaced. As a consequence, stored seeds of an old variety may have only a fraction of their former value. There have even been instances where inventories of plants and trees growing in nursery farms were obsolete before they were ready for market.

6.16 Quality, though similar to condition, is distinguishable from it. For instance, two groups of seeds may be in good condition and of the same variety but may have distinctive quality differences. One group may pass germination tests with high percentages, whereas the second group may have low percentages or undesirable germination qualities.

6.17 In reviewing the quantity, condition, quality, and relative value of agricultural products, the auditor may conclude that the use of a specialist with expertise in evaluating farm products is required. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance and sets forth requirements for using the work of a specialist, other than a specialist employed by the auditor's firm who participates in the audit, in which case AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), provides applicable guidance.

6.18 Inventories of crops grown for seed present different risks for the auditor to consider when assessing the risks of material misstatement and designing an performing further audit procedures in response to those risks. Although the commodity may be corn or some other grain, seed crops are significantly different from crops of the same product sold in the general market. Consequently, audit evidence related to market prices for seed crops is more relevant and reliable than general market prices.

Orchards and Vineyards

Background and Unique Characteristics

6.19 Orchards and groves produce such commodities as citrus, walnuts, almonds, pecans, peaches, pears, apples, apricots, cherries, and avocados. There are many varieties and subvarieties of each. The term *vines*, for purposes of this section, refers primarily to grape vines, of which there are several hundred varieties.

6.20 Each variety and type of tree or vine requires a period of development to reach a stage of maturity at which it produces in commercial quantities. During this development period there are substantial expenditures for labor and material to shape and train the tree or vine into an efficient form. For instance, the lower limbs of fruit or nut trees are held apart to spread the tree and develop a wider and more open crown to improve productivity. In addition, trees are pruned and shaped in the early growth stages to encourage a lower profile. Such practices can limit the height of the tree and alter its shape to accommodate mechanical picking or more rapid picking from vehicles.

6.21 During the development period, trees and vines require grafting, pruning, spraying, cultivation, and similar care. Occasionally, row crops are grown between the rows of developing trees or vines to provide a supplemental source of revenue until the trees or vines reach maturity.

6.22 Although fruits, nuts, and grapes can be grown in most parts of the nation, different varieties may produce more effectively in particular geographic areas. As a result, the crop development periods and cultural cycles vary significantly in different geographic areas.

6.23 Trees and vines require several years of development before production occurs in commercial quantities. The costs of labor and materials to shape and train trees and vines constitute a significant portion of the costs incurred during the development years. During the last two or three years of the development period, it is not unusual for trees and vines to produce fruit or nuts in less than commercial quantities. Once the trees and vines have matured adequately, production generally continues for a number of years, depending upon the plant, soil, climate, and other influences. The productive lives of trees and vines with the same general classification may vary, depending on the particular variety.

6.24 The products of trees and vines require careful handling after harvest. They must be skillfully graded due to wide variations in quality. Then, because of the perishable nature of the products they can be downgraded or become worthless if not stored so that they are protected against temperature variations and insects.

Accounting Principles

6.25 Trees and vines may be planted and brought to production by the producer or on a contract basis. The young trees and vines are usually purchased as nursery stock and transplanted into the orchard or vineyard in the desired pattern. Cultural costs during the development period, including stakes and wires, grafting, and labor for pruning and forming, should be capitalized. Net proceeds from sales of products before commercial production begins should be applied to the capitalized cost of the plants, trees, or vines.

6.26 The productive lives of the trees or vines can usually be estimated by considering such factors as the geographical area (influence of water, humidity, and temperature), variety or classification of the plant, type of rootstock used, grafting and pruning practices, plant-spacing intervals, and picking or harvesting methods. The best sources of data regarding these factors are grower and commodity associations and the local agricultural extension service.

6.27 Not all plants in a developing orchard, vineyard, or grove will survive to a productive stage. Normal losses do not generally require an adjustment to reduce the capitalized cost of an orchard or grove. However, the capitalized cost of trees or vines lost through abnormal events, such as unusual disease, frost, or flood, should be written off in the year of the loss and the costs to replant should be capitalized. (The distinction between normal and abnormal is determined on the basis of the procedures discussed in "Normal Costs Versus Abnormal or Excessive Costs" in paragraphs 3.17–.18 of this guide.)

6.28 Each orchard, vineyard, or grove may be considered a cost center, and all costs incurred prior to the time of commercial production should be accumulated in the property accounts. When production in commercial quantities begins, the accumulated costs should be depreciated over the estimated useful life of the particular orchard, vineyard, or grove.

6.29 Operators of orchards and vineyards should account for costs of growing and harvested crops in the same manner as other agricultural producers, as discussed in "Field and Row Crops," paragraphs 6.01–.18 of this chapter. Growing costs include annual maintenance cost of the orchard or vineyard, such as cultivation, spraying, fertilizing and pruning; annual depreciation of the orchard or vineyard; and normal tree and vine replacement.

Auditing Considerations

6.30 Audit procedures for orchards and vineyards are similar to those performed for other types of property, plant, and equipment and may include

1. considering the relative health and conditions of the trees or vines.
2. reviewing the estimated remaining productive lives of the trees or vines. This may require an annual inspection of the orchard or vineyard, and, when questions arise, the auditor may need to consult a specialist.
3. testing total capitalized costs of orchards and vineyards to determine whether such costs are recoverable. Appropriate comparisons when performing such tests include prevailing costs for similar orchards and vineyards and with data obtainable from state agricultural universities, agricultural extension services, and commodity and trade organizations.

6.31 In testing the recoverability of accumulated costs of growing crops, relevant considerations include prospective yield, weather conditions, expected market price, and ability to economically harvest and transport the crop to the marketplace. It is not uncommon for the net realizable value of a growing crop to be less than the accumulated costs. The auditor may perform the following audit procedures:

1. Testing the accumulation of costs of growing crops for accuracy of classification.
2. Comparing accumulated costs with market prices and estimated disposition costs.
3. Considering the physical condition of the inventory in reviewing its net realizable value. The use of a specialist may be advisable. AU section 336 provides guidance and establishes requirements applicable to the auditor using the work of a specialist, other than a specialist employed by the auditor's firm who participates in the audit, in which case AU section 311 provides applicable guidance.

Intermediate-Life Plants

Background and Unique Characteristics

6.32 Intermediate-life plants include perennial plants and vines that have growth cycles of more than one year. Such plants include artichokes, asparagus, various types of bush berries, kiwifruit, alfalfa, and grazing grasses. Those plants produce for more than one year, depending on the type of plant and the geographic area, but not as long as trees and vines.

Accounting Principles

6.33 Accounting principles for intermediate-life plants are similar to the principles applicable to orchards and vineyards.

6.34 Intermediate-life plants may be developed by the agricultural producer or developed by others on a contract basis. Costs of intermediate-life plants developed by the producer include costs of land preparation, plants, preparation of planting beds, stakes and wires, cultural care during the development period, and overhead. Accumulated costs for these plants and vines, whether acquired on a contract basis or self-developed, should be capitalized.

6.35 When production in commercial quantities begins, the capitalized costs should be depreciated over the estimated productive life of the plantings. Regional differences, climate and soil conditions, and cultural practices may affect the productive capacity and life of intermediate-life plants and should be considered when establishing depreciable lives. The capitalized costs should be classified with property, plant, and equipment; financial statement disclosure of the costs and estimated useful lives should be made.

6.36 After the development period, annual maintenance costs become a portion of the cost of the current-year crop, along with harvesting costs, depreciation of the plants, and allocated overhead costs. Annual maintenance costs include cultivation, spraying, pruning, and fertilizing. The harvested crop held for sale should be reported at the lower of cost or market or in accordance with established industry practice at market if certain conditions described in paragraph .039 of SOP 85-3 (appendix B), exist.

Auditing Considerations

6.37 Audit procedures for intermediate-life plants are similar to those performed for other types of property, plant, and equipment, and may include

1. physically observing the condition of the plants.
2. testing accumulated costs for properly capitalized amounts.
3. comparing accumulated costs to prevailing costs for similar plants.
4. testing accumulated costs for recoverability. If there is a question about future productive capability of the plants, it may be necessary to consult a specialist. (For example, unusually heavy rainfall or inadequate drainage may have drowned all or a substantial portion of an alfalfa planting [an intermediate-life plant]).
5. testing the useful lives or depreciation rates used in accounting for the plants. Actual or anticipated production declines may lead to a revision of useful lives or depreciation rates.

Breeding and Production Animals

Background and Unique Characteristics

6.38 Breeding herds consist of mature and immature male and female animals, either of registered or commercial grade, that are maintained for their progeny. Registered herds are used to preserve or improve the desirable characteristics of the animals, and commercial herds provide animals for consumption. Registered animals are bred and retained on the basis of the demand for particular characteristics and their ability to reproduce animals with the same desirable attributes. The values of registered animals may be comparatively higher and significantly greater than those of commercial-grade animals.

6.39 Production animals provide a service or primary product other than their progeny. Examples are dairy cows (milk), poultry (meat and eggs), and sheep (meat and wool).

6.40 In many areas of the country, commercial-grade cattle are maintained on large grazing areas or on open ranges, such as land rented from the Bureau of Land Management, the U.S. Forest Service, or various state agencies. Range conditions and infrequent observation may result in a higher percentage of unbred females and lower calf-survival rates than those for animals confined in smaller areas and more closely observed.

6.41 Horses are still used by agricultural producers, particularly by those who raise cattle and sheep. Some have extensive programs for breeding, raising, and training the saddle horses used in their operations.

6.42 Dairy herds are used primarily for the production of milk that is often unprocessed when sold to a cooperative or other buyer. Calves are a secondary product of dairy operations and may be retained as replacement animals. Animals not selected as herd replacements, along with those later culled from the productive dairy herd, are usually sold for slaughter.

6.43 The marketing of milk is controlled in most states. In some jurisdictions the producer owns rights called *milk quotas* or *can contracts* that entitle the producer to sell the processor a stated quantity of milk per period. Those rights are separate from the milk-producing herd in some states, and in others they remain with the herd. If the rights are separate, they have a market value and may be purchased and sold.

6.44 Poultry operations may include the raising of birds for meat, the production of eggs for human consumption, and the raising of breeder pullets. Chicken and turkey operations are similar. There are usually three separate phases of poultry operations: brooder, meat, and eggs. All phases might be found in one integrated operation, or an operation might be limited to one phase. Examples are turkey operations that raise meat birds or chicken operations that raise broilers as the principal source of revenue. In either operation, hatchlings may be purchased from other producers.

6.45 Other examples of single-phase operations are brooder-chicken farms that produce layer pullets (young hens) and egg-laying units where the sale of eggs is the principal source of income. Income from the sale of older or *spent* hens for meat is nominal and incidental to an egg-laying operation.

6.46 Poultry operations can utilize the following: complex and costly brooder facilities; large flocks of breeder chickens and laying hens; extensive specialized buildings; feed mills and storage facilities; rooms for washing, candling, and packaging eggs; cold storage; transportation equipment; and manure-handling and manure-processing equipment. Around-the-clock intensive care of the flocks requires employees to be on duty or nearby at all times. Therefore, it is common for employee housing to be a significant part of the overall operating facilities.

Accounting Principles for Breeding Animals

6.47 Whether breeding animals are of registered or commercial grade, their purpose is to produce young animals. Thus, accounting for livestock operations usually requires accumulation of the annual maintenance costs of the breeding herd as a means of establishing the cost of young animals. Included in the total to be allocated to the animals produced are costs of feed, veterinary care, medicines, labor, land and pasture rent, and depreciation of the herd and facilities. Costs of maintaining raised animals prior to maturity or disposition are capitalized as an additional cost of the animals. Costs of raising the young animals should be accumulated and allocated on a rational basis. Not all young animals survive to maturity or disposition; normal losses of young animals are usually not expensed directly because total annual maintenance costs are assigned to the survivors. The accumulated costs of animals lost through causes considered abnormal should be written off in the period in which the abnormal losses occur. (See "Normal Costs Versus Abnormal or Excessive Costs" in paragraphs 3.17–.18.)

6.48 Regardless of the size or quality of the herd, the accounting principles applicable to accumulating costs remain the same. The accounting system ordinarily should track accumulated costs of replacement animals as well as costs of animals culled.

6.49 When males are maintained for the breeding herd, the ownership and maintenance costs usually constitute a separate cost center. When artificial insemination is used, the costs of the semen and insemination process are direct costs. Practices of the producer will usually dictate the accounting methods to be used.

6.50 As the animals mature and costs are accumulated, the accounting considerations may vary depending on the future use of each animal. The usual alternatives include the following:

- Transfer to the breeding herd, in which case the costs would be accumulated until the animal is mature and the breeding process is begun. The costs then become part of the depreciable cost of the breeding herd.
- Sale of young animals to another breeder or feeder, in which case the costs would be accumulated until the animal is sold. A gain or loss equal to the sale proceeds, less the accumulated costs and the expenses of sale, would then be recognized.
- Retention until fattened and sold, in which case the costs of production, care, and feeding to date of sale are accumulated and charged to cost of sales.

6.51 Some producers raise feed for their animals. Costs of producing the feed should be considered a cost of the animals and capitalized or accounted for as a production cost based on classification of the animals.

6.52 The total capitalized costs of raised breeding animals, including interest required to be treated as a cost under Financial Accounting Standards Board (FASB) Statement No. 34, *Capitalization of Interest Cost*, should generally not exceed the estimated external purchase price of such animals.

6.53 Generally, breeding animals are fixed assets and their costs should be depreciated over their useful lives. Immature animals are not considered to be in service until they reach maturity, at which time their accumulated costs become subject to depreciation. The same general accounting principles apply to all livestock, which includes cattle, hogs, sheep, and goats. Animals with short productive lives, such as poultry, may be classified as inventory.

Auditing Considerations for Breeding Animals

6.54 Major audit objectives for breeding animals include establishing the existence and proper valuation of the animals. Procedures the auditor may perform include

1. physically observing the animals.
2. reviewing and testing the applicable acquisition and accounting records.
3. reviewing the reasonableness of the useful lives of the animals, the depreciation rates, and salvage values. The reasonableness of useful lives should be reviewed in light of the experience of similar operations in the same geographical area.
4. observing and performing counts of animals. Special audit risks exist where animals are left on grazing areas or open ranges. In those situations, the auditor may need to perform or observe counts at interim periods or may decide to use the services of a specialist. (See AU section 336.) Test counts should be used only in those circumstances where controls and periodic independent observations have conclusively proven the integrity of the accounting system and related controls.
5. considering the use of a specialist where it is necessary (*a*) to identify breeds; (*b*) to read brands, tattoos, ear tags, earmarks, and other special identification marks; or (*c*) to evaluate the quality of the animals.

Additional procedures are described in the section of this guide dealing with auditing considerations applicable to animals held for sale. (See "Auditing Considerations," paragraphs 6.69–.70.)

Accounting Principles for Production Animals

6.55 Production animals generally are fixed assets subject to depreciation procedures described for breeding animals. The principles are similar to group depreciation methods applicable to other fixed assets.

6.56 When milk-marketing rights remain with the producing herd, it may be necessary to allocate acquisition costs between the animals and the rights. The costs allocated to the animals should be depreciated over their estimated useful lives. Costs allocated to the marketing rights should be accounted for in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets*.[†]

6.57 The accounting principles for poultry operations are much the same as those for livestock, although the operating cycles are much shorter. The production costs of chickens raised for an egg-laying unit should include the initial

[†] The Financial Accounting Standards Board (FASB) has proposed an exposure draft, *Not for Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition, an amendment of FASB Statement No. 142*. Refer to the FASB Web site at www.fasb.org for more information on the status of this exposure draft.

cost of the birds (or, if hatched, the costs of eggs and hatching expenses), the costs of materials and labor, and allocated indirect costs during the prematurity period. These costs, less estimated salvage value of the chickens, should be amortized over the egg-laying period. Due to the short productive life of poultry, the cost of flocks may be classified as inventory.

6.58 Costs attributed to eggs produced for human consumption consist of the costs for maintaining the production flock, applicable overhead, and depreciation of the production flock and the facilities.

6.59 Some production animals produce more than one product. For example, sheep produce lambs, wool, and meat; dairy cattle produce milk, calves, and meat. The primary products are lambs and milk, whereas the secondary products are usually wool and calves. Costs may be allocated as either joint products or by-products depending on the estimated relative values of each. In most instances the meat, or slaughter value, of the production animal is considered salvage. The method of accounting is determined by the amounts anticipated to be received for each product. Those amounts are affected by the breeding, production, and marketing practices of the producer.

Auditing Considerations for Production Animals

6.60 Audit procedures for production animals with extended productive lives are similar to those for breeding animals and other fixed assets. Procedures the auditor may perform include

1. testing capitalized costs.
2. reviewing the reasonableness of depreciation policies, including lives, depreciation rates, and salvage values.
3. testing depreciation calculations.
4. applying other procedures described in the sections of this guide dealing with auditing considerations applicable to breeding animals and animals held for sale [paragraphs 6.54 and 6.69–.70].

Animals Held for Sale

Background and Unique Characteristics

6.61 Animals held for sale include all the progeny of the breeding herds except those retained for the expansion or replacement of existing herds. In some operations, young animals are purchased and maintained until they develop further and are sold. Animals held for sale are usually not retained beyond the time they reach optimal size or weight because their value usually does not increase thereafter and may even decrease.

6.62 In this section, cattle operations are described in more detail than other animal-feeding operations because they have the longest operating cycle; however, the same principles apply to operations with shorter operating cycles. A calf will usually be kept with its mother from birth until the time it is weaned. These young animals, referred to as *weaners*, will then be placed on pasture for a period of months or sent to a feedlot.

6.63 Young feeder animals bought by producers in the spring of the year are often kept on large grazing areas or open ranges, where they are subject to the same physical conditions described for breeding herds, until the fall, when they are transferred to feedlots. Cattle feeders may transfer raised cattle to feedlots or purchase young cattle to be placed in feedlots.

6.64 Some feed producers and breeders supply young animals and chicks to other producers who raise the animals to maturity, and they provide breeding animals and dairy cows on a rental basis. Terms of the agreements under which these arrangements are made generally provide for sharing the income from the use and sale of the animals. These arrangements provide a source of capital for the producers and reduce their risk of loss; consequently, they are used extensively in cattle, hog, poultry, and dairy operations.

6.65 Agricultural producers also engage in farming for oysters, abalone, and catfish. The major differences between these operations and the ones already described usually relate to the length of the operating cycles, ease of identification of the operating cycles, ease of identification of the productive group (breeding versus held for sale) for costing purposes, the nature of certain costs, and the environment in which they live.

Accounting Principles

6.66 Animals held for sale are inventories of the producer and should be accounted for at the lower of cost or market, or under certain circumstances at sales price less estimated cost of disposal as explained in paragraph .062 of SOP 85-3 (appendix B).

6.67 The costs of raised or purchased animals kept in grazing areas or open ranges are determined in the manner discussed in the section of this guide dealing with breeding animals (paragraphs 6.38–.60).

6.68 Costs during the period the cattle are held in feeding pens should be readily determinable. The cattle are in a controlled environment for a relatively short period of time, usually not over six months, and are typically segregated into pens by expected date of slaughter. Accordingly, costs can frequently be aggregated by pens. The purchase price (or transferred cost, if applicable), labor and yard expenses (including depreciation of equipment and pens), veterinary supplies, and feed represent the total costs of the animals at the time of slaughter.

Auditing Considerations

6.69 Animal-feeding operations present special audit risks resulting from the lack of documents to evidence the ownership of raised animals. Evidence of ownership of raised animals may be obtained by performing tests that apply the usual productivity rates to the number of breeding animals. However, possession of the animals does not necessarily establish ownership. In some cases, the presence of animals without proof of ownership or purchase records may indicate the existence of a leasing or profit-sharing arrangement. Records of feed consumption may provide an indication of the total number of animals in the possession of the producer. Moreover, the management representation letter should contain an affirmation of ownership for the recorded number of animals. Refer to chapter 12 for additional discussion of representation letters.

6.70 In addition, as part of gaining an understanding of the five components of internal control discussed in chapter 4, the auditor should review the adequacy of the accounting system and related controls. Since risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion, they must be supplemented by further audit procedures. In audits of entities with animals held for sale, audit procedures that may be performed include the following:

1. Observing test counts or total counts of animals held for sale, depending on the adequacy of controls
2. Testing the costs capitalized for the animals
3. Obtaining reliable estimates of the weight and quantity of the animals for valuation purposes
4. Testing the net realizable value of the animals by reference to quoted market prices while taking into consideration local market prices that may differ from regional prices

Land Development Costs

Background and Unique Characteristics

6.71 The following discussion of land development costs is limited to development costs applicable to the creation of productive assets possessing identifiable value and expected to create future income. These costs generally include costs of changes to make land suitable for general agricultural use, but they may also include improvements to land already used for agricultural production. Examples of land development activities are clearing brush, removing rocks, and leveling.

6.72 Land improvement and development costs generally fall within two broad classifications, permanent and limited-life, described as follows:

1. *Permanent land development costs* include the costs of initial land surveys, titles, initial clearing, and initial leveling.
2. *Limited-life land development costs* are those that will lose value as time passes or as the land and its improvements are used. Costs identified as limited-life improvements include water distribution systems, fencing, and drainage tile. The useful lives of those improvements are reasonably determinable.

Regional Differences

6.73 The nature and treatment of costs often vary in different areas of the country. For example, regional differences affect the frequency of brush removal, the useful lives of water wells, salinity control requirements and practices, and types of water conveyance systems. In some regions, deep-ripping of the soil is an initial cost that is usually not repeated. In other areas deep-ripping is required at three-to-five-year intervals.

Accounting Principles

6.74 Land development costs other than those of a recurring nature represent additions to fixed assets and should be capitalized. Permanent land development costs should not be subject to depreciation or amortization because they have an indefinite useful life. Limited-life development costs should be capitalized and depreciated over the estimated useful life of the particular improvement.

Auditing Considerations

6.75 The main audit objectives for land development costs are to obtain evidence that costs have been properly capitalized and properly classified as permanent or limited-life and that the useful lives and salvage values assigned are reasonable. Accordingly, the auditor may perform the following audit procedures:

1. Testing the capitalized costs by reference to cost accounting records
2. Reviewing the capitalized assets for proper classification
3. Reviewing the reasonableness of depreciation policies

Research and Development Activities

6.76 In accordance with FASB Statement No. 2, *Accounting for Research and Development Costs*, all costs related to the research and development of new and improved products should be expensed as incurred. Those costs would include the development of improved animal bloodlines or hybrid plants, trees, and vines. When this type of research and development is conducted through use of productive fields, groves, or herds, it is inappropriate to allocate costs to such newly developed breed, seed, tree, or vine types. The provisions of FASB Statement No. 2 apply when costs related to research and development of new breeds of animals or new varieties of agricultural crops are accumulated and identified. Emerging Issues Task Force Issue No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities," establishes the required accounting treatment of nonrefundable advance payments for goods and services to be used or rendered in future research and development activities pursuant to an executory contractual arrangement.

Investments in and Transactions With Cooperatives

Investments in Cooperatives

6.77 *Background.* Investments in both supply and marketing cooperatives may consist of common or preferred stock acquired for cash and patronage allocations withheld under various capital plans. Cooperatives may issue patronage allocations through qualified notices of allocation (a taxable distribution to the patron) or through nonqualified notices of allocation (a distribution not taxable to the patron until redeemed by the cooperative). *Per-unit retains* issued by marketing cooperatives are another method of financing. (A detailed history and description of agricultural cooperatives can be found in part II of this guide.)

6.78 *Accounting principles.* Agricultural producers (patrons) should account for investments in agricultural cooperatives at cost, including allocated equities and *retains*. The carrying amount of those investments should be reduced when the cooperatives allocate losses to the patron or if the patron is unable to recover the full carrying amount of the investment.

6.79 Losses incurred by a cooperative that are not allocated to the patron may indicate such an inability on the part of the patron. At a minimum, the excess of unallocated losses over unallocated equities should be recognized by the patron on the basis of the patron's proportionate share of the total equity of the investee cooperative, or any other appropriate method, unless the patron demonstrates a likelihood that the carrying amount of the investment in the cooperative can be fully recovered.

6.80 Other relevant guidance to consider when accounting for investments in agriculture cooperatives include Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, and FASB Interpretation No. (FIN) 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*. Refer to chapter 12 for additional discussion of FIN 46(R).

6.81 *Auditing considerations.* Audit procedures for investments in cooperatives are similar to those performed for other investments. Relevant factors that may be considered when evaluating the carrying amount of investments include the basis of records of disbursements, notices of allocation, and the financial condition of the cooperatives. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on auditing investments in debt and equity securities and investments accounted for under Accounting Principle Board Opinion No. 18, *Equity Method*. In addition, the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing AU section 332.

Transactions With Cooperatives

6.82 *Background of supply and manufacturing cooperatives.* Supply and manufacturing cooperatives produce or purchase goods and materials for their members. Products are generally sold to members at prices that approximate those charged at the same level of distribution by other suppliers of similar products. To the extent that sales proceeds exceed costs of goods sold and all other operating costs, the cooperatives may distribute patronage refunds. These refunds are generally based on the volume of business conducted with the cooperative and may vary by product line.

6.83 *Accounting principles for supply and manufacturing cooperatives.* Patronage refunds, in cash or equities, should either be accrued on notifications by the distributing cooperative or accrued as soon as it is probable that

1. a refund applicable to the period will be declared.
2. one or more future events confirming the receipt of the refund are expected to occur.
3. the amount of the refund can be reasonably estimated.
4. the accrual can be made consistently from year to year.

6.84 Classification of the refunds in the financial statements should follow the recording of the costs or proceeds, or the refunds should be presented separately.

6.85 *Auditing considerations for supply and manufacturing cooperatives.* The primary objective in testing producers' transactions with supply and manufacturing cooperatives is to determine that the conditions for accrual as stated at "Accounting Principles for Supply and Manufacturing Cooperatives" (paragraphs 6.83–.84) existed at the balance sheet date. Audit procedures to evaluate the reasonableness of patronage refunds to be received may include

1. reviewing records of refunds from previous years and considering the estimates provided by the cooperative.
2. confirming patronage refunds receivable with the cooperative.
3. examining patronage refund notifications.
4. reviewing, if available, information regarding the issuing cooperative's financial position, results of operations, and cash flows.

6.86 *Background for marketing cooperatives.* Marketing cooperatives provide sales outlets for the products of their members and patrons. The products may be sold in a processed or unprocessed condition. For certain products there are readily determinable bases for recording exchange transactions between the cooperative and the member. Deliveries to dairy cooperatives can be recorded at market-order prices and deliveries to grain cooperatives at readily available market prices.

6.87 When marketing cooperatives operate on a pooling basis, products are usually delivered to the cooperatives for processing and sale. The identity of the product is lost upon delivery because it is commingled with products of other patrons on a multiple- or single-pool basis. The pools are *closed* (accounted for) at weekly, monthly, annual, or longer intervals. Proceeds from the sale of pooled products, less processing, marketing, and other costs of the cooperative, are returned to members of the pool, but generally some funds are retained to provide capital for the cooperative. Some processed products may not be sold for a long period of time after delivery; however, the producer generally receives advances against final settlement.

6.88 *Accounting principles for marketing cooperatives.* The major accounting considerations encountered in transactions between patrons and marketing cooperatives involve the timing and method of recording the sale of products delivered. If control over the future economic benefits relative to the product has passed, ordinarily evidenced by the transfer of title, and if a reliable market price is available or the cooperative assigns a price to be paid for the product, the producer should record the delivery of product as a sale at the specified price at date of delivery. If the prior performance of the cooperative or unfavorable market conditions indicate that proceeds from the cooperative will be less than the specified price, the lower amount should be used in recording the sale.

6.89 When there is no established market price (a price determined by other market buyers or amounts assigned by the cooperative) or market prices are erratic, unstable, or volatile, the producer should treat the delivery to the cooperative as a sale at an amount equal to the accumulated cost of the product and should establish an unbilled receivable. If there are indications that the expected net proceeds will be less than cost, the unbilled receivable should be recorded at estimated net realizable value. Advances from the cooperative should be treated as reductions of the unbilled receivable and should not be used as amounts for recording sales. Variances from the amount recorded as an unbilled receivable should be recognized when reasonably determinable.

6.90 If the ultimate sales proceeds vary materially from the estimates made in the year of delivery, the financial statements should disclose the amount of current-year revenues that represent an adjustment of revenues from prior years (see FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, paragraph 22).[‡]

6.91 When a cooperative segregates the product delivered by the producer and accounts for it separately, and title has not been transferred, an agency relationship is created. In those situations, the producer should carry the product as inventory and record a sale only when the product has been sold by the cooperative.

6.92 Marketing cooperatives often deduct per-unit retains from the estimated proceeds due producers. Per-unit retains are based on the quantity of product delivered by the producer and are a method of financing for the cooperative. For producers, the retains represent investments in the cooperative. Producers should record the per-unit retains at face value and, if the retains are not to be redeemed in the current year, they should be classified as noncurrent.

6.93 Accruals of patronage refunds from marketing cooperatives should follow the principles stated in paragraphs 6.83–.84 of this guide.

6.94 When a producer is economically dependent on a cooperative for sale of all or a significant portion of annual production, the extent of such transactions should be disclosed in the financial statements.

6.95 *Auditing considerations for marketing cooperatives.* The primary audit objective in testing producers' transactions with marketing cooperatives is to obtain evidence regarding the propriety of the amount recognized as a sale at the time the product is delivered to the cooperative. Audit procedures may include

1. for products with reliable market prices, testing the reasonableness of sales amounts by reference to quoted prices adjusted for estimated marketing and distribution costs to be deducted by the cooperative.

[‡] On Janaury 29, 2008, the Public Company Accounting Oversight Board (PCAOB) adopted PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and an accompanying set of amendments to the PCAOB's interim auditing standards. Among other significant provisions, this auditing standard and related amendments update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with the requirements of FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*. Auditing Standard No. 6 states that the correction of a material misstatement in previously issued financial statements (that is, a *restatement*) is recognized in the auditor's report through the addition of an explanatory paragraph. Furthermore, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. The first statement in the explanatory paragraph distinguishes restatements from adjustments to prior-period financial statements resulting from changes in accounting principle. Previously, the auditor's responsibilities for reporting on most restatements were the same as for reporting on changes in accounting principle.

Auditing Standard No. 6 and the amendments, if approved by the Securities and Exchange Commission (SEC), will become effective 60 days after SEC approval. Refer to the PCAOB Web site at www.pcaob.org for more information.

2. confirming receivables from the cooperative.
3. examining cash receipts from the cooperative.
4. inspecting correspondence from the cooperative.
5. inspecting bills of lading and weight tickets.

Government Loans and Agricultural Programs

Loan Programs

6.96 Under various stabilization programs, producers of certain crops or products may receive federal agency loans that are collateralized by security interests in negotiable warehouse receipts. The producer is not required to repay the loans but may relinquish title to the stored crop or product to satisfy the obligation. Because the producer has title to the product until a decision is made to liquidate the obligation by transfer of title to the lender, the loan should be shown in total as a current liability and the inventory recorded as an asset. Conditions may exist where the net realizable value of the commodity is less than the loan and accrued interest. In those cases the net realizable value of the commodity should be equal to the loan, including accrued interest. Paragraph .14 of AU section 331 discusses controls and auditing procedures for goods stored in public warehouses.

Income Replacement and Subsidy Programs

6.97 Income replacement and subsidy programs are designed to bring income from commodities to certain predetermined levels and include

- deficiency payments, which are subsidy payments resulting from low prices for designated commodities.
- disaster payments, which may be made to producers when disasters prevent planting or reduce yields on crops.
- other programs, which are available to producers to encourage production, provide indemnity for certain types of losses, and reimburse producers for withholding land from production.

Existing programs change periodically, and it may be necessary to know their current status on a particular audit engagement. Information regarding these programs can be obtained from offices of the Agricultural Stabilization and Conservation Service, United States Department of Agriculture.

6.98 All of the previously listed payments, while different in nature, constitute additional income and should be recorded when the amount of and right to receive the payment can be reasonably determined.

Cost-Sharing Programs

6.99 Under cost-sharing programs, the government reimburses producers or shares the cost of certain expenditures with them. Such programs include reimbursement for weed control and cost-sharing of expenditures for ditch lining, earthen dams, and prevention of soil erosion.

6.100 Reimbursements of costs for capital expenditures should be accumulated and applied against the total fixed asset costs. Direct payments by the government agency should be accounted for as if the producer had received the payment and made the expenditure. Reimbursements of expense items should be applied to reduce the recorded amount of the expenses. The payments should be recorded in the period when the original expenditure occurred, unless it is not practicable to estimate the amount of the reimbursement or determine eligibility for the benefit.

Income Taxes

6.101 Most agricultural producers receive special treatment under income tax laws, including the right to elect to use the cash method of accounting, the right to use certain inventory valuation methods that are not in accordance with generally accepted accounting principles, and the right to currently deduct certain expenditures for items of a capital nature. As a consequence, many transactions affect the determination of pretax accounting income in one period and the computation of taxable income in another reporting period. Those transactions create temporary differences that require the recognition of deferred tax liabilities and assets in the financial statements.

6.102 The provisions of FASB Statement No. 109, *Accounting for Income Taxes*, are applicable to agricultural enterprises. FASB Statement No. 109 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.

6.103 In accordance with the provisions of FASB Statement No. 109, the following basic principles are applied in accounting for income taxes at the date of the financial statements:

a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

6.104 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. This interpretation is effective for fiscal years beginning after December 15, 2006.[||]

[||] FASB issued FASB Staff Position (FSP) FIN 48-1, *Definition of* Settlement *in FASB Interpretation No. 48*, which provides guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.

FASB also issued FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*. This FSP applies to nonpublic enterprises subject to the provisions of FASB Interpretation No. (FIN) 48 unless that nonpublic enterprise (*a*) is a consolidated entity of a public enterprise that applies U.S. GAAP or (*b*) has issued a full set of U.S. GAAP annual financial statements prior to the issuance of this FSP using the recognition, measurement, and disclosure requirements of FIN 48. This FSP defers the effective date of FIN 48 for nonpublic enterprises included within this FSP's scope to the annual financial statements for fiscal years beginning after December 15, 2007. When effective, FIN 48 should be applied as of the beginning of the enterprise's fiscal year.

The AICPA has also issued a 13 page nonauthoritative practice guide entitled *Practice Guide on Accounting for Uncertain Tax Positions Under FSP FIN 48*, which is free to all AICPA members.

PART II—Agricultural Cooperatives

Chapter 7

Introduction

History

7.01 The genesis of the modern cooperative movement is generally attributed to the first consumer cooperative organized in 1844 by a small group of laborers in Rochdale, Lancashire, England. The following principles were developed in that first cooperative: (1) sale for cash and not on credit, (2) charges that matched prevailing local prices, (3) refunds in proportion to purchases, (4) limited interest on capital investments, (5) one vote for each member, and (6) regular and frequent meetings.

7.02 The emergence of the cooperative movement in the United States came in 1875, when the so-called Rochdale principles were formally adopted at a convention of the National Grange (an organization of farmers). By 1900, a substantial number of these farmer-owned organizations were in operation, and although most of them were small they were beginning to exert an influence on the agricultural economy of the nation. Since that early beginning, cooperatives have grown in size and number.

7.03 Congress has encouraged the development of agricultural cooperatives through favorable legislation, including

- special rules that soften or nullify the effect of antitrust laws and
- recognition of the cooperative's nonprofit nature by allowing patrons' qualifying distributions to be excluded from taxable income of the cooperative.

Organizational Characteristics and Functions

7.04 Agricultural cooperatives engage in a variety of activities that include

- food processing and distribution,
- oil production and refining,
- manufacturing,
- transportation, and
- research.

7.05 Cooperatives are not identified by any particular activity but rather by their form of organization. The basic characteristics of cooperatives are summarized as follows:

1. Most agricultural cooperatives are organized as corporations, but they may or may not issue capital stock. Cooperatives differ from other corporations in that the net earnings of cooperatives are allocated to patrons on a patronage basis rather than to members on the basis of equities held. Dividends paid on stock or membership capital are usually limited.

2. Cooperatives are owned and controlled by their members, generally based on the one-member-one-vote principle or limited-weighted voting, regardless of the amount of stock or membership capital owned.
3. To be recognized as a cooperative for federal income tax purposes, an organization must operate on a cooperative basis. To qualify as a tax-exempt cooperative, to borrow from the banks for cooperatives, and to qualify for exemption from registration under the federal securities acts, a cooperative must meet quantitative requirements relating to the value of business done with members.
4. Except for a few large organizations, cooperatives do not have substantial amounts of nonpatron capital. Typically, cooperatives are organized with small amounts of original capital, and equity is accumulated by retaining allocated earnings and issuing qualified or nonqualified written notices of allocation to patrons.* Capital may also be accumulated by retaining after-tax patronage and nonpatronage earnings.
5. The federal income tax status of agricultural cooperatives is an important characteristic. Section 521 of the Internal Revenue Code (IRC) provides a limited tax exemption for certain cooperatives.

Because of the requirements necessary to maintain exempt status under section 521, many cooperatives operate as nonexempt cooperative organizations. The rules for taxation of both exempt and nonexempt cooperatives are set forth in Subchapter T of the IRC, Sections 1381–1388. The requirements for exempt status under Section 521, and some of the provisions of Subchapter T are outlined in chapter 8 of this guide.

* Some agricultural cooperatives may have retained allocated equities, which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and as such may have to be classified as liabilities. However, in accordance with FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

Chapter 8

Background Information

Types of Cooperative Organizations and Services

8.01 Agricultural cooperatives may be classified by their operational characteristics in the following manner:

1. Marketing cooperatives market agricultural products for patrons in unprocessed and processed condition. Products typically marketed include milk, fruits, vegetables, nuts, livestock, poultry, eggs, grain, wool, and cotton. Marketing cooperatives range in size from small country grain elevators to very large organizations with nationally advertised brands. Most marketing cooperatives take title to patrons' products and process or pack them for sale to wholesale or retail customers. Other cooperatives act as agents for their patrons on a commission or brokerage basis.
2. Bargaining cooperatives negotiate with packers and processors, provide market information, and act as intermediaries between their patrons and packers and processors.
3. Supply or purchasing cooperatives purchase, manufacture, distribute, and provide feed, petroleum products, fertilizer, chemicals, farm supplies, and services of various kinds to their patrons. Supply cooperatives range in size from very small local retail units to large regional manufacturing and wholesale organizations. Most small retail cooperatives purchase the equipment and supplies sold to their patrons from large regional cooperatives or other trade sources. Many large regional cooperatives operate manufacturing facilities for the production of various products and supplies. The facilities may be operated independently or in association with other large regional cooperatives.
4. Service cooperatives provide artificial insemination, breeding of livestock, data processing, equipment leasing, insurance, financing, and other services to agricultural producers.

8.02 Large regional cooperatives, as well as many small cooperatives, may engage in both marketing and supply activities. Grain marketing cooperatives, for example, often sell feed, fertilizer, and farm supplies to patrons.

Relationships With Members and Patrons

8.03 The members of a cooperative are usually its patrons. (As defined in the glossary, the terms *members* and *patrons* are often used interchangeably.) There is a unique relationship between the cooperative and its members and patrons. The cooperative performs marketing, supply, or other services for its patrons and usually agrees to distribute to them, on a patronage basis, any revenues in excess of costs that it derives from performing those services. In some nonexempt cooperatives a patron must also be a member to receive a distribution.

8.04 An underlying concept of cooperative ownership and operation is the equitable treatment of patrons. This is particularly significant for cooperatives claiming exempt status under Section 521 of the Internal Revenue Code (IRC). Cooperatives may be denied tax-exempt status if they do not deal with member and nonmember patrons on an equitable basis. Equitable treatment in the allocation of net earnings among patrons is also important for *nonexempt* cooperatives, because it is generally required in order to maintain cooperative status under the federal income tax laws. Cooperatives' eligibility to borrow from various banks for cooperatives may also be affected by inequitable treatment of patrons. In addition, failure to treat patrons equitably may subject a cooperative to litigation by patrons.

8.05 After cooperatives have provided supplies or other services or performed marketing functions for their patrons, they generally allocate revenues in excess of costs from those activities on a patronage basis. This excess is referred to as *net margins*, *net proceeds*, *net savings*, or *net earnings*. In the discussion that follows, the more frequent use of the terms *earnings* or *net earnings* is not intended to imply preferability. Regardless of the terminology used, allocation of earnings must be made on an equitable and consistent basis.

8.06 Generally, the earnings of cooperatives are classified as either *patronage* or *nonpatronage*. The excess of revenues over costs resulting from transactions for or with patrons is *patronage* source earnings.

8.07 *Nonpatronage* earnings result from transactions other than those with or for patrons. Examples are nonpatronage income from investments in securities, rental income from nonpatronage activities, and income earned on sales or purchases made on a nonpatronage basis. It is sometimes difficult to distinguish between patronage and nonpatronage earnings, especially when patronage and nonpatronage activities overlap. However, distinguishing between the two types of earnings is very important because of the tax treatment of patronage source income.

8.08 Allocations of net earnings to patrons are called *patronage refunds, patronage dividends*, or *patronage distributions*. These allocations may be made in cash or in a combination of cash and *equity certificates*. Equity certificates, such as revolving-fund certificates and capital certificates, are credited to the individual patron's account and are usually revolved (paid) over a period of years. Revolvement practices may be defined in governance documents such as bylaws or may be specified by the board policy. Revolvement may be linked to the date of issue (for example, revolvement on a FIFO basis) or may be linked to some other benchmark, such as the patron's attained age, the patron's retirement from farming, etc. Bylaws frequently spell out that revolvement is strictly at the discretion of the board of directors. The proportion of refunds to be distributed as cash and equity certificates and the revolving period of these certificates are specified in the cooperative's bylaws or determined by its board of directors.[*]

---

[*] Some agricultural cooperatives may have retained allocated equities, which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and as such may have to be classified as liabilities. However, in accordance with FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

Related-Party Transactions

8.09 The underlying concept of cooperatives is ownership and control by members and patrons with and for whom cooperatives conduct their operations. It is common for patrons, officers, and directors to own or have interests in enterprises that transact business with the cooperatives. Accordingly, cooperatives are involved in related-party transactions as a result of their normal activities. When related-party transactions are material, disclosure should be made in accordance with Financial Accounting Standards Board Statement No. 57, *Related Party Disclosures*.

Federal Income Taxes and Cooperative Operations

8.10 IRC Section 521 provides a limited exemption for associations of farmers organized and operated as cooperatives for either (1) marketing the producers' products and returning the net earnings to them on the basis of either quantity or value of the products furnished or (2) purchasing supplies and equipment for use by the members or other persons and returning the net earnings to them on the basis of the purchases made.

8.11 Before 1951, cooperatives described in IRC Section 521 were not subject to income taxes. Income taxes, if any, were paid at the patron level. In 1951, legislation was passed to ensure that cooperative earnings would be currently taxable to either the cooperatives or the patrons. However, court decisions have generally held that, under the 1951 Act, noncash allocations of patronage were not taxable to the patron even though they were deductible by the cooperatives.

8.12 Subchapter T of the IRC (Sections 1381–1388) was enacted in 1962 to resolve this situation. It provided the first statutory recognition for the patronage distributions of nonexempt cooperatives and continued the tax treatment previously available to exempt cooperatives with respect to nonpatronage distributions and dividends on capital stock. The principal change introduced by Subchapter T was to limit deductions for cooperative distributions to amounts that patrons individually consent to recognize as income for tax purposes.

8.13 The criteria necessary for an organization to qualify under Section 521 follow:

1. The organization must be a farmers' cooperative.
2. It must market the products of members and other producers or purchase supplies and other equipment for members and other persons.
3. Margins must be returned to all patrons (members and nonmembers alike) on a patronage basis.
4. Dividends on capital stock may not exceed the legal rate of interest in the state of incorporation or 8 percent per year, whichever is greater.
5. Substantially all (85 percent) voting stock must be owned by the producers that market their products or purchase their supplies and equipment through the cooperative.
6. Reserves must be required by state law or for a necessary purpose.

7. The value of marketing and purchasing transactions with members must exceed that of such transactions with nonmembers. Also, purchasing for persons who are neither members nor producers can't exceed 15 percent of total purchasing activity.

8.14 If a cooperative is exempt under Section 521, it obtains two deductions in addition to those allowed cooperatives in general:

1. Limited amounts paid as dividends on capital stock during the taxable year.
2. Amounts of nonpatronage earnings paid or allocated on a patronage basis to patrons within eight-and-one-half months after the close of the taxable year.

8.15 IRC Sections 1381–1388 and related regulations prescribe the tax treatment for cooperatives. In general, these sections apply to all cooperatives except rural electric and telephone cooperatives, although certain portions apply only to exempt cooperatives.

8.16 IRC Sections 1381–1388 impose a tax on all cooperative net earnings that are not distributed to patrons in cash or qualified written notices of allocation. These sections enable exempt and nonexempt cooperatives to avail themselves of tax deductions for patronage distributions and also permit exempt cooperatives to deduct distributions of nonpatronage income and dividends on capital. The tax treatment for the recipients is also covered in these sections.

8.17 For patronage distributions to be treated as qualified allocations, at least 20 percent of the distribution must be paid in cash. The noncash portion of the allocation must be in the form of a qualified written notice of allocation and must be furnished to the patron within eight-and-one-half months after the end of the fiscal year of the cooperative. The patrons must agree, either in writing or through bylaw consent, to include the amount of the qualified written notice of allocation, together with the cash received, in taxable income in the year of receipt.

8.18 Cooperatives may issue nonqualified written notices of allocation and recognize income tax at the cooperative level. Upon redemption of nonqualified notices of allocation, the issuing cooperatives are entitled to a current tax credit for taxes paid in the year of origination of the nonqualified notices of allocation or a deduction for the amount of the nonqualified notices redeemed, for the year of origination or the year of redemption, whichever provides the issuing cooperative the greater tax benefit.

8.19 Per-unit retains withheld from patrons of marketing cooperatives are generally based on units of products delivered or on some other unit or percentage basis rather than on earnings. They may be issued on a qualified or nonqualified basis. Qualified per-unit retains are deductible by the cooperative for income tax purposes but nonqualified per-unit retains are not. The rules governing the issuance of per-unit retains are similar to those applicable to patronage refunds, except a minimum payment of 20 percent in cash is not required for per-unit retains issued on a qualified basis.

8.20 Many marketing cooperatives, for processing and marketing purposes, commingle agricultural products into a pool. The products are treated as a unit, and each pool patron receives an equitable share of net earnings from the pool. Some pools may be held open beyond the end of the fiscal year. In those instances earnings for patronage-refund purposes are recognized in the year the pool is closed (IRC Section 1382[e]).

Regulatory Commissions

8.21 Most cooperatives do not issue to third parties the type of debt and equity instruments that are subject to the registration provisions of the Securities Act of 1933. The specific exemptions given to farmer cooperative organizations are found in Section 3 of the act and include any security issued by an agricultural cooperative exempt from tax under IRC Section 521. However, certain securities of nonexempt cooperatives are subject to the provisions of the Securities Act of 1933.

8.22 The Securities Exchange Act of 1934, on the other hand, exempts substantially all agricultural cooperatives from its Section 12(g) registration provisions, related annual and periodic reporting, and proxy and insider trading requirements.

8.23 Cooperatives are, to some extent, exempt from antitrust prosecution by the Federal Trade Commission under the Capper-Volstead Act. As cooperatives grow in size and influence, there are continuous challenges to this exemption from the monopoly and restraint-of-trade rules contained in the Sherman and Clayton Acts. Section 2 of the Capper-Volstead Act gives the secretary of agriculture the power to prevent cooperatives from using monopoly power for *undue price enhancement.*

Market Orders and Government Support Programs

8.24 Marketing cooperatives may be affected by federal and state market orders and support programs for products such as milk, fresh fruits and vegetables, grains, dried fruits, and nuts. Marketing orders are usually initiated by the producers of an agricultural commodity in an attempt to stabilize the market and assure an adequate return. If the secretary of agriculture or the appropriate state agencies agree it is needed, an order legally obligating commodity handlers to comply with specified trade practices and sales restrictions is issued.

8.25 Market orders may restrict the quality, size, or grade of the commodity to be marketed. Specific provisions of market orders vary. Some orders apply to the entire U.S. production of a commodity, whereas others apply only to production in certain areas. Some orders limit the absolute quantity that can be marketed, whereas others limit only the quantity in certain markets (fresh or processed, for example) or the amount that can be marketed at certain times of the year.

8.26 Cooperatives may participate in government support programs (the Commodity Credit Corporation) on behalf of their members. This participation requires special segregation of sales proceeds, inventories, interest expense, and other amounts for the commodities covered by the programs.

Chapter 9

General Auditing Considerations for Agricultural Cooperatives[*]

Overview

9.01 In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This chapter of the guide provides guidance, primarily on the application of the standards of fieldwork. Specifically, this chapter provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and general auditing considerations for agricultural cooperatives.

9.02 For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), was superseded by PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"). The new standard is effective for all audits of internal control required by Section 404(b) of the Sarbanes-Oxley Act for fiscal years ending on or after November 15, 2007. Earlier application is permitted.

9.03 PCAOB Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements. This chapter is not intended to provide guidance to auditors on how to comply with the requirements of PCAOB Auditing Standard No. 5 although it highlights, as appropriate, significant differences between GAAS and PCAOB standards.

Planning and Other Auditing Considerations

9.04 The objective of an audit of the financial statements of an agricultural cooperative is to express an opinion on whether its financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to agricultural cooperatives.

---

[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

Audit Planning

9.05 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

9.06 Paragraph .03 of AU section 311 (AICPA, *Professional Standards*, vol. 1) states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Integrated Audits*
>
> Paragraph .01 of AU section 311, *Planning and Supervision* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 9 of PCAOB Auditing Standard No. 5 regarding planning considerations.

Audit Risk

9.07 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions and disclosures, and at the overall financial statement level.

9.08 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. Paragraph .23 of AU section 312 (AICPA, *Professional Standards*, vol. 1) states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be "at the maximum." This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages.

9.09 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Planning Materiality

9.10 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

9.11 In accordance with paragraph .27 of AU section 312 (AICPA, *Professional Standards*, vol. 1), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark, for example total member equity, as a step in determining materiality for the financial statements taken as a whole. Auditors may also consider Farm Financial Standards Council's "Sweet Sixteen" ratios which are made up of liquidity, solvency, profitability, repayment capacity, and financial solvency. Auditors are reminded that volatile markets for agricultural commodities can cause both revenues and assets to fluctuate significantly from year to year.

> *Considerations for Integrated Audits*
>
> Paragraph .03 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of PCAOB Auditing Standard No. 5 regarding materiality considerations.

Tolerable Misstatement

9.12 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 (AICPA, *Professional Standards*, vol. 1) defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

9.13 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

9.14 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 (AICPA, *Professional Standards*, vol. 1) provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Auditor's Communication With Those Charged With Governance

9.15 AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), provides a framework for effective two-way communication between the auditor and those charged with governance, and identifies certain specific matters that the auditor must communicate to those charged with governance. The auditor must communicate matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

9.16 For purposes of AU section 380, *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, the term *those charged with governance* encompasses the term *board of directors* or *audit committee* used elsewhere in GAAS. For purposes of AU section 380, *management* means the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

9.17 Note that AU section 380 does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role. In some cases, all of those charged with governance are also involved in managing the entity. Matters communicated in accordance with AU section 380 to person(s) with management responsibilities need not be communicated again with those same person(s) in their governance role. Paragraph .22 of AU section 380 provides that, when all of those charged with governance are involved in managing the entity, the auditor should consider whether communication with person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. Paragraph .18 of AU section 380 presents matters the auditor may consider in determining whether communication with subgroups of those charged with governance adequately fulfills the auditor's responsibility under this professional standard.

9.18 As provided in paragraph .49 of AU section 380, matters that may contribute to effective 2-way communication include discussion of the purpose of communications, the form in which communications will be made, the person(s) on the audit team and among those charged with governance who will communicate regarding particular matters, the auditor's expectation that the communication will be 2-way, the process for taking action and reporting back on matters communicated by the auditor, and the process for taking action and reporting back on matters communicated by those charged with governance. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of the matters to be communicated. The importance of effective 2-way communication is evidenced by the statement in paragraph .63 of AU section 380 that if, in the auditor's judgment, the 2-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements.

9.19 Paragraph .23 of AU section 380 identifies the following matters that the auditor should communicate with those charged with governance:

- The auditor's responsibilities under generally accepted auditing standards
- An overview of the planned scope and timing of the audit
- Significant findings from the audit

The communication of internal control related matters is addressed in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and in paragraph 9.58–.60 of this guide. The communication about fraud related matters is addressed in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), and in chapter 13 of this guide. Appendix A of AU section 380 contains a list of other AU sections that contain requirements for auditor communication with those charged with governance. Nothing in AU section 380 precludes the auditor from communicating any other matters to those charged with governance.

Use of Assertions in Obtaining Audit Evidence

9.20 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.

(continued)

Categories of Assertions—continued

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Under-standability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

9.21 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

9.22 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows:

> "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures."

9.23 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Paragraph .05 of AU section 314 states that, throughout this process, the auditor should also follow the guidance in AU section 316. See chapter 13 for additional guidance pertaining to AU section 316.

9.24 This section addresses the unique aspects of agricultural cooperatives that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

Risk Assessment Procedures

9.25 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

9.26 In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Discussion Among the Audit Team

9.27 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Entity and Its Environment

9.28 Paragraph .03 of AU section 314 states that obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with GAAS. In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests).

9.29 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies (see the following section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (*a*)–(*d*).

9.30 Factors that may be particularly relevant to the auditor when obtaining an understanding of agricultural cooperatives include

- the method of accounting for unprocessed products delivered by patrons of marketing cooperatives, including the basis for assigned amounts if they are used.
- the valuation of inventories of finished products in marketing cooperatives operating on a pooling basis.
- the board of directors' intentions regarding redemptions of equities and retains.[†]
- the existence of forward and futures contracts and other derivatives.
- the methods of allocation of gains and losses to various pools.

[†] Some agricultural cooperatives may have retained allocated equities which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and as such may have to be classified as liabilities. However, in accordance with FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

- timing and amounts of advances against estimated pool proceeds.
- the need for services of a specialist to evaluate the quality of the cooperative's inventories (see AU section 336, *Using the Work of a Specialist* [AICPA, *Professional Standards*, vol. 1]).
- the method of allocating units for a marketing cooperative with more than one business activity.
- government and tax regulations that affect cooperatives' activities.

To assist in obtaining an understanding of an agricultural cooperative, numerous publications are available from U.S. government agencies, state agricultural universities, agricultural extension services, and commodity and trade organizations. (See appendix D, "Information Sources.")

Understanding of Internal Control[1]

9.31 Paragraph .40 of AU section 314 states that the auditor should obtain an understanding of the 5 components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

a. evaluate the design of controls relevant to an audit of financial statements.

b. determine whether they have been implemented.

9.32 The auditor should use the understanding to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

9.33 Obtaining an understanding of controls is different from testing the operating effectiveness of controls. The objective of obtaining an understanding of controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

9.34 Paragraph .41 of AU section 314 defines internal control as "a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of 5 interrelated components:

a. The control environment

b. Risk assessment

---

[1] For additional nonauthoritative guidance pertaining to internal control and the recently issued auditing standards on risk assessment, refer to Technical Questions and Answers (TIS) section 8200.05–.16 (AICPA, *Technical Practice Aids*) issued in March and April 2008.

c. Information and communication systems

d. Control activities

e. Monitoring

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components.

9.35 Agricultural cooperatives usually establish controls that are similar to those of other commercial enterprises. Controls normally exist over the cooperative's major transaction cycles, such as marketing, purchasing, production, and payroll. Also, internal control usually provides reasonable assurance that transactions and activities undertaken by the cooperative are understood and authorized by those charged with governance.

Use of Information Technology

9.36 An entity's use of IT may affect any of the 5 components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. AU section 314 states that, in obtaining an understanding of internal control sufficient to assess the risk of material misstatement, the auditor should obtain an understanding of how an entity's use of IT and manual procedures may affect controls relevant to the audit. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, authorize, record, process, and report transactions or other financial data. Paragraph .119 of AU section 314 provides guidance to auditors in auditing the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically.

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

9.37 As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

9.38 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.

b. relate the identified risks to what can go wrong at the relevant assertion level.

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

9.39 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

9.40 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks, for example inventory valuation in grain marketing.

Designing and Performing Further Audit Procedures

9.41 AU section 318 provides guidance about implementing the third standard of field work, as follows:

> "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

9.42 To reduce audit risk to an acceptably low level, the auditor (1) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (2) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

Overall Responses

9.43 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

9.44 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level. In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach. Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

Tests of Controls

9.45 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

> *Considerations for Integrated Audits*
>
> Paragraph .30 of AU section 312 (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended) states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 6–8 and appendix B paragraphs B1–B5 of PCAOB Auditing Standard No. 5 regarding tests of controls.

9.46 Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion. Paragraphs .106–.108 of AU section 314 discuss the identification of controls at the relevant assertion level likely to prevent or detect a material misstatement in a class of transactions, account balance, or disclosure.

9.47 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures,[2]

---

[2] Paragraph .06 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), discusses the use of risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, that the auditor uses to support assessments of the risks of material misstatement of the financial statements.

the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

9.48 Tests of the operating effectiveness of controls ordinarily include procedures such as inquiries of appropriate entity personnel; inspection of documents, reports, or electronic files; observation of the application of specific controls; and reperformance of the application of the control by the auditor. Note that since inquiry alone is not sufficient, the auditor should use a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls.

9.49 In designing tests of controls, the auditor should consider the need to obtain audit evidence supporting the effective operation of controls directly related to the relevant assertions as well as other indirect controls on which these controls depend.

> *Considerations for Integrated Audits*
>
> Paragraph .97 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 54 of Auditing Standard No. 5 for discussion on the extent of tests of controls.

9.50 In the case of an automated application control, because of the inherent consistency of IT processing, audit evidence about the implementation of the control, when considered in combination with audit evidence obtained regarding the operating effectiveness of the entity's IT general controls (and in particular, security and change controls), may provide substantial audit evidence about its operating effectiveness during the relevant period.

9.51 Generally, IT processing is inherently consistent; therefore, the auditor may be able to limit the testing to one or a few instances of the control operation. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor should perform tests to determine that the control continues to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls are effective. Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may test the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

9.52 To test automated controls, the auditor may need to use techniques that are different from those used to test manual controls. For example, computer-assisted audit techniques may be used to test automated controls or data related to assertions. Also, the auditor may use other automated tools or reports produced by IT to test the operating effectiveness of general controls, such as program change controls, access controls, and system software controls. The complexity and other factors associated with designing and performing such tests of controls may require, in the auditor's judgment, using the work of a specialist to obtain appropriate audit evidence. AU section 336 provides guidance in this area.

9.53 Refer to paragraphs .23–.49 of AU section 318 for additional guidance on tests of controls.

Substantive Procedures

9.54 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

9.55 Refer to chapters 10 and 11 for specific guidance on the more significant audit procedures that the independent auditor may consider in the audits of agricultural cooperatives.

Evaluating Misstatements

9.56 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 (AICPA, *Professional Standards*, vol. 1) states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management. AU section 312 (AICPA, *Professional Standards*, vol. 1) further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

9.57 For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 (AICPA, *Professional Standards*, vol. 1) and AU section 326, respectively.

Identifying, Evaluating, and Communicating Control Deficiencies

9.58 In an audit of the financial statements of a nonissuer, paragraph .04 of AU section 325 states that the auditor is not required to perform procedures to identify deficiencies in internal control, or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risk, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

9.59 The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses (as defined in AU section 325). The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatements does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of misstatement.

9.60 Control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under AU section 325 must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication. AU section 325 provides additional guidance and establishes further requirements for communicating internal control related matters identified in an audit.

Chapter 10

Special Accounting and Auditing Considerations[*]

Accounting by Marketing Cooperatives Operating on a Pooling Basis

Background and Unique Characteristics

10.01 Because specific product identification is not practical for marketing patrons' products that must be commingled and processed before they are sold, cooperatives generally have adopted the *pool* method of accounting for these products. Under that method, cooperatives take title to the patrons' products on delivery, commingle products of like kind and grade, and sell the finished products for their own account. Records of sales, payments for products, and costs are maintained for each pool. When the pool is closed, the net proceeds are distributed to members of the pool, based on the amounts assigned to the products provided by each patron.

10.02 Accounting periods for pools vary from a week to longer than a year, based on the production and marketing cycle. Short pool periods are used for products such as eggs, which have a short production and marketing cycle. Longer pool periods are often necessary for such products as canned fruits and vegetables that require more than one year to process and market.

10.03 Both single- and multiple-pool methods of accounting are used by marketing cooperatives to allocate net proceeds to pools:

10.04 *Single-pool method.* Net proceeds from operations are allocated to patrons on a proportional basis, usually based on the amounts assigned to the products delivered to the cooperative.

10.05 *Multiple-pool method.* Products received are accounted for in separate product pools. Net proceeds of the separate pools are allocated to patrons of those pools usually based on the amounts assigned to the products delivered to the cooperative.

Accounting Principles

10.06 Overhead allocations to product lines are unnecessary when the single-pool method is used. This allows the management of marketing cooperatives with several departments, such as canning, freezing, or fresh shipping, more flexibility in determining alternative levels of production.

10.07 The following example illustrates pool settlement under multiple- and single-pool methods:

---

[*] Auditors of issuers should refer to the preface of this guide for important information related to the requirements and standards of the Public Company Accounting Oversight Board.

	Unprocessed Product Assigned		Net Proceeds Allocated to Patrons			
			Multiple-Pool		Single-Pool	
Product	*Amounts*	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
A	$ 5,000	50	$ 700	70	$ 500	50
B	2,000	20	100	10	200	20
C	3,000	30	200	20	300	30
Total	$10,000	100	$1,000	100	$1,000	100

In this example, the allocation of net proceeds to patrons under the multiple-pool method was determined by the separate accounting for the operations of each product (each product is a separate pool); therefore, the percentages differ from the unprocessed product percentages. Under the single-pool method, the net proceeds from total operations are allocated on the basis of the value of the unprocessed product and the percentages are the same as the unprocessed product percentages.

10.08 If the production and marketing cycle extends beyond one year, marketing cooperatives may have substantial inventories of finished goods on hand at the end of the fiscal year. Marketing cooperatives often transfer (in effect, *sell*) such inventories to the succeeding year's pools, thus allowing the current pools to be closed on an annual basis. This method is often used when the type and quantity of products delivered by members do not vary materially from year to year. Other cooperatives hold the pools open beyond one year and do not close them until substantially all the pooled inventories have been sold.

10.09 Accounting for overall losses is a difficult problem for both single- and multiple-pool operations. In addition, multiple-pool operations may be faced with the problem of disposing of losses from individual pools. Accounting for those losses is addressed in the "Accounting for Losses" and "Departmental and Functional Accounting" sections that follow in paragraphs 10.12–.19.

10.10 Although the preceding paragraphs relate primarily to marketing cooperatives, supply cooperatives encounter similar problems in allocating earnings to members, particularly if both manufacturing and distribution are involved. Patrons of supply cooperatives buy goods and services at approximately the same prices that would be paid to other suppliers. Earnings are determined periodically and allocated to patrons on the basis of the business done by each patron with the cooperative.

Auditing Considerations

10.11 When obtaining an understanding about the agricultural cooperative and its environment, the auditor should inquire about the allocation procedures for pool proceeds and any unusual events and practices. The auditor may perform the following procedures when auditing the determination and allocation of pool proceeds:

1. Obtain an understanding of controls over the system of recording sales, cost of sales, and expenses.
2. Review pool closings and allocations of pool proceeds, including advances, made during the year, as well as those made after year-end but before the date of the auditor's report.

3. Test the pool closings and allocation of pool proceeds to patrons for

   - clerical accuracy.
   - compliance with the board of directors' actions.
   - compliance with the cooperative's bylaws.
   - compliance with tax regulations.
   - compliance with established accounting policies.
   - consistency of application from pool period to pool period.

Accounting for Losses

Background

10.12 A cooperative may incur an overall loss in a given year. The disposition of losses may be made based on bylaws or the board of directors' action.

Accounting Principles

10.13 Cooperatives use a number of different methods for disposing of an overall loss, including

1. allocating the loss to patrons on the basis of current patronage. The loss may offset the patrons' equities, future patronage allocations, or future cash contributions.
2. allocating the loss to all equities without considering current patronage. However, patrons with substantial equities and decreasing patronage may be treated inequitably if this method is used.
3. charging the loss to unallocated retained earnings. This method is equitable when the loss is attributable to nonpatronage business.
4. offsetting the loss against amounts available for patronage allocation in subsequent years before making any such allocation to patrons. This method may be acceptable if the patrons are substantially the same from year to year.

Auditing Considerations

10.14 The auditor may perform the following procedures in reviewing the disposition of overall operating losses of cooperatives:

1. Reading those sections of the bylaws and articles of incorporation describing the procedures for disposition of losses.
2. Reviewing the board of directors' minutes to determine policies or actions for allocation of losses.
3. Reviewing the method of allocating losses to determine that the method is in accordance with the cooperative's bylaws or board actions.
4. Testing the mathematical accuracy of allocated losses.
5. Reviewing allocations made during the year under audit and those made after the balance sheet date up until the report date.

Departmental and Functional Accounting

Background and Unique Characteristics

10.15 Cooperatives operating on a functional or departmental basis may have net earnings from one function or department and operating losses from another. It is a common practice for losses from one function or department to be absorbed by profits from another function or department before earnings to patrons are allocated. Some cooperatives distribute departmental earnings to patrons and charge departmental losses to unallocated retained earnings. The method of accounting for functional or departmental earnings and losses, and the basis for making allocations to patrons, may be provided for in the bylaws or by actions of the board of directors.

Accounting Principles

10.16 To allocate earnings to patrons equitably, cooperatives usually account for revenues and costs by function (supply or marketing) or departments within the function.

10.17 Expenses common to one or more functions or departments should be allocated on a reasonable and consistent basis. In addition, one department of a cooperative may handle several commodities, and departmental revenues and expenses may have to be allocated among them.

10.18 Cooperatives may incur a loss in one department or function and realize earnings in another. Methods of accounting for these departmental and functional losses include

1. offsetting the losses of unprofitable departments against profitable ones, and allocating the remaining profit to the patrons of the profitable departments by using the allocation method adopted by the cooperative.
2. recovering the loss from the patrons of that department or function on the basis of bylaw provisions or a marketing agreement.
3. subtracting the loss from net nonpatronage income. Offsetting patronage losses against nonpatronage income may not eliminate the income tax due on the nonpatronage income of a nonexempt cooperative.
4. charging the loss to unallocated retained earnings, and allocating income from profitable departments or functions to patrons on the basis of the cooperative's allocation methods.
5. offsetting the losses against patronage allocation for subsequent years prior to making departmental and functional allocations to patrons.

Auditing Considerations

10.19 When auditing the functional or departmental results and the allocation of net earnings to patrons, the auditor should obtain an understanding of controls over the generation of information on a functional or departmental basis, including sales, direct costs, and the allocation of common costs by department and commodity. Additionally, the auditor may perform the following procedures:

1. Reviewing the allocation of overhead costs for consistency and compliance with governing documents and board actions.
2. Reviewing the methods for allocating departmental losses for compliance with governing documents and board actions.
3. Reviewing allocations, including the basis for the allocations, made during the year under audit and those made after the balance sheet date up until the report date.

Chapter 11

Specific Accounting Principles and Auditing Considerations*

Inventories[1]

Background and Unique Characteristics

11.01 Inventory methods of cooperatives encompass a wide range of practices. Supply cooperatives generally have a reliable purchase price for inventories on hand. Many marketing cooperatives have a known or determinable market price on which to base amounts to be paid for patrons' products. However, some marketing cooperatives operating on a pooling basis do not have a reliable market price on which to value and account for receipt of patrons' products.

11.02 Financial Accounting Standards Board (FASB) Statement No. 151, *Inventory Costs—an amendment of ARB No. 43, Chapter 4*, amends the guidance in Accounting Research Bulletin (ARB) No. 43 chapter 4, "Inventory Pricing" to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities.

Accounting Principles

11.03 Selecting a method to account for product inventories depends on the financial information available, marketing agreements, bylaws, and actions of the board of directors. A discussion of accounting for product inventories at lower of cost or market and net realizable value follows. Paragraphs .083–.086 in Statement of Position 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives* (AICPA, *Technical Practice Aids*, ACC sec. 10,390) discuss accounting by pooling cooperatives for products received from patrons.

11.04 *Net-realizable-value method.* Some marketing cooperatives operating on a pooling basis cannot determine the market price of patrons' products when received because a reliable price for the products is not available. Such cooperatives usually process and market a high percentage of limited specialty crops. Many of those cooperatives account for inventories of goods in process and finished goods at net realizable value, determined by deducting estimated completion and disposition costs from the estimated sales price of the processed inventory. Furthermore, many processing cooperatives use net realizable value for product inventories in order to comply with bylaw provisions and contractual

---

* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

[1] Emerging Issues Task Force (EITF) Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty" addresses the accounting treatment for transactions involving the sale of inventory to an entity from which the selling entity also purchases inventory to be sold in the same line of business. The EITF excludes inventory purchase and sales arrangements that (*a*) are accounted for as derivatives under Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and (*b*) involve exchanges of software or exchanges of real estate.

obligations and to facilitate equitable pool settlements from pool period to pool period and among various classes of patrons. If inventories are accounted for at net realizable value, there should be a corresponding effect on earnings and amounts due patrons. The entity's involvement with derivative instruments and hedging activities may also need to be considered.

11.05 The calculation of net realizable value for product inventories requires the determination of sales dates, sales prices, and the estimated costs of completion and disposal. The sales prices may be based on comparable sales or published market prices.

11.06 *Lower of cost or market method.* Inventories of supply, manufacturing, and other service cooperatives present no unusual accounting problems and are usually accounted for at the lower of cost or market on a first in, first out (FIFO), last in, first out (LIFO), or average-cost basis.

11.07 Marketing cooperatives, such as grain and dairy cooperatives, that receive products from patrons and pay their patrons a firm market price at time of delivery or shortly thereafter, regardless of the amount of the cooperative's earnings, should treat the payments as purchases. Those cooperatives have established costs and can determine inventories at the lower of cost or market, with cost determined on a FIFO, LIFO, or average-cost basis.

11.08 Boards of directors of marketing cooperatives that operate on a pooling basis with no obligation to pay patrons fixed prices may assign to patrons' products amounts that approximate estimated market. These assigned amounts are cost and should be charged to cost of production and credited to amounts due patrons. Inventories are then accounted for at the lower of cost or market. However, some cooperatives may value the inventories at net realizable value to facilitate determination of pool proceeds.

Auditing Considerations

11.09 Tests of inventory quantities and quality are generally the same as those applied in the audits of other commercial entities. To test the calculation of lower of cost or market or net realizable value, the auditor may perform the following procedures:

1. Testing inventory costs by
   - comparing amounts paid to patrons or assigned to patrons' products with market prices paid by others or prices established by the board.
   - reviewing additional processing and packaging costs for reasonableness and consistency.
   - reviewing variances between actual and standard costs for reasonableness and consistency.
2. Testing net realizable value, which is calculated in essentially the same way as market for inventories valued at the lower of cost or market, by
   - reviewing price lists and actual sales at and subsequent to the valuation date.
   - testing sales prices by referring to available prices for similar products of other processors.

- reviewing marketability of various groups of finished-product inventories on the basis of existing market conditions.
- reviewing open orders to determine future sales prices.
- determining that disposal costs include normal shipping, storage, selling, and production overhead costs.
- testing computation of completion and disposal costs for reasonableness and consistency.

3. Testing the lower-of-cost-or-market calculations by comparing net realizable values with cost and determining that write-downs have been consistently recognized on a line-by-line, a commodity-by-commodity, or an overall basis.
4. Reviewing the mix of finished goods to be packed from those inventories if bulk and in-process inventories are to be valued at net realizable value, comparing the projected mix with prior experience for reasonableness, and considering a write-down of any excess inventory quantities.

11.10 The auditor may consider the following examples in the audit of product-delivery transactions between patrons and cooperatives operating on a pooling basis:

1. Reviewing the reasonableness of the amounts assigned to patrons' products by comparing the amounts with values for products obtained from established markets, bargaining-association contracts, and federal and state crop-reporting services.
2. Selecting patron statements on a test basis and
   - reviewing approval of patrons' product prices.
   - testing the accuracy of extensions and footings.
   - comparing the amounts due patrons with subsequent payments.
   - comparing quantities delivered by patrons with weight tickets.
   - comparing deductions for freight and other expenses with approved deduction schedules.
3. Comparing statements to determine that patrons receive similar treatment and terms.
4. Confirming directly with patrons the quantity of products delivered, payments received, and equity balances.
5. Determining whether retains are recorded correctly as an element of equity if per-unit retains are deducted from patrons' products payments.[†]

[†] Some agricultural cooperatives may have retained allocated equities which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and as such may have to be classified as liabilities. However, in accordance with FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments*

(continued)

6. Determining whether payments to patrons are made in accordance with written agreements and whether all parties have complied with all the terms.
7. Determining whether payments to nonmembers are made in accordance with established policies and rates.

Investments in Other Cooperatives

Background and Unique Characteristics

11.11 Agricultural cooperatives may join and invest in one or more other cooperatives to purchase farm-related products, to process and market farm products, or to obtain financing. The investments are long-term in nature and are an extension of the cooperative's own productive facilities and capital. In most instances, voting rights accompanying these investments are based on the one-member-one-vote principle or are limited to weighted voting based on patronage rather than on the amount of the investment. The sale of such investments to parties other than the issuer is often restricted or prohibited. Accordingly, such investments are made primarily to obtain the benefits offered by the cooperative rather than for investment or capital-appreciation purposes.

11.12 Investments in agricultural cooperatives may include initial cash commitments for common and preferred stock, subsequent per-unit retains under base capital or revolving capital plans, patronage refunds, and other allocated equities. An investor cooperative may also be required to invest in some form of interest-bearing debt instrument.

11.13 To borrow from regional banks for cooperatives, investments in such banks are required. The extent of the investment is usually based on the amount and terms of the loans. Investments in the banks for cooperatives may also include capital stock received as patronage refunds.

Accounting Principles

11.14 Investments in other cooperatives should be accounted for at cost, including allocated equities and retains. For this purpose, *cost* means the amount of any cash investment and the face amount of all written notices of allocation in the form of per-unit retains, capital equity credits, revolving fund certificates, and certificates of equity.

11.15 The carrying amount of an investment in a cooperative should be reduced if the patron is unable to recover the full carrying value of the investment. Losses unallocated by the investee may indicate such an inability, and, at a minimum, the excess of unallocated losses over unallocated equities should be recognized by the patron, based on the patron's proportionate share of the total equity of the investee cooperative or any other appropriate method, unless

---

(footnote continued)

of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

the patron demonstrates a likelihood that the carrying amount of the investment in the cooperative can be fully recovered. Factors to consider in making the determination include

- whether the unallocated losses resulted from identifiable, isolated, and nonrecurring events.
- whether the investee cooperative has been profitable over a long period of time and suffered only occasional losses that were offset by unallocated earnings or equities.
- whether the investor has ceased or will cease to patronize the investee cooperative on a permanent basis or for an extended period of time.

11.16 Patrons should recognize patronage refunds either on notification by the distributing cooperative or when the related patronage occurs if it is then probable that (1) a patronage refund applicable to the period will be declared, (2) one or more future events confirming the receipt of a patronage refund are expected to occur, (3) the amount of the refund can be reasonably estimated, and (4) the accrual can be consistently made from year to year. The accrual should be based on the latest available reliable information and should be adjusted on notification of allocation.

11.17 Classification of the allocations in the financial statements should follow the recording of the costs or proceeds, or the allocations should be presented separately.

11.18 When a cooperative allocates all earnings to patrons (on a tax or book basis) and there are no unallocated earnings (on a book basis), the principles set forth in Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, are not applicable. In those infrequent instances where the investor's share of unallocated retained earnings of an investee cooperative is material to the investor, the equity method of accounting should be applied in a manner that gives consideration to the voting rules or statutory rights applicable to the cooperative.

11.19 Other relevant guidance to consider when accounting for investments in agriculture cooperatives include ARB No. 51, *Consolidated Financial Statements*, and FASB Interpretation No. (FIN) 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*. Refer to chapter 12 for a discussion of FIN 46R.

Auditing Considerations

11.20 AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on auditing investments in debt and equity securities and investments accounted for under APB Opinion No. 18. In addition, the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* provides practical guidance for implementing AU section 332. For investments in cooperatives the auditor should analyze the investment accounts for the period and examine the documentation supporting the transactions, including securities on hand.

11.21 An investor will normally receive notification of amounts allocated by the investee cooperative, and the auditor should consider direct confirmation with the investee cooperative. If patronage refunds are accrued before notices of allocation have been received, the accrual should be tested for reasonableness and consistency. The auditor should consider reviewing the estimated amount with the investee cooperatives.

11.22 The auditor should review the issuer's accounting for qualified and nonqualified allocations and determine whether these allocations were made in proper form and within the prescribed time limit.

11.23 In evaluating the carrying amounts of investments in other cooperatives, the auditor should consider the investor's continued participation in the investee cooperative and recent reliable financial information about the investee. Where the carrying amounts are material to the financial position of the investor cooperative and possible disclosure may be necessary, a more detailed review of the operations and financial status of the investee cooperative should be considered. If the carrying amount of an investment has been or should be reduced, the auditor should review financial information and obtain support showing that the investor cooperative will be unable to fully recover the carrying amount of the investment.

Equities and Members' Investments†

Background and Unique Characteristics

11.24 The composition of the equity section of a cooperative's balance sheet distinguishes it from other balance sheets. Generally, its equities arise from investments by members and nonmembers and from patronage allocations. In addition, cooperatives may accumulate unallocated retained earnings arising from after-tax earnings on nonpatronage business.

Accounting Principles

11.25 Various forms of allocated equities arising from patronage are used by cooperatives. A brief description of those commonly used follows:

1. *Retained patronage allocations*. Retaining patronage earnings through methods such as the issuance of qualified or nonqualified written notices of allocation is a major form of financing by cooperatives.
2. *Per-unit retains*. Per-unit retains are used in marketing cooperatives in accordance with debt agreements, bylaws, or board of directors' authorizations. These amounts are determined without regard to earnings and may be based on a rate per ton or on a percentage of the dollar amount of raw product delivered. Amounts are withheld from payments to patrons for deliveries of raw products and are credited to the account of each patron.

11.26 If the retained patronage allocations and per-unit retains have no fixed maturity dates and are subordinated to all debt instruments, they should be treated as equity with appropriate disclosure of face value, dividend rate, negotiability, subordination agreements, and any revolving or retirement plan.

11.27 Allocated equities are usually paid, or revolved, over a number of years. The timing may be specified in the cooperative's bylaws, but it is usually

† See footnote † in paragraph 11.10.

at the discretion of its board of directors. The amounts should not be classified as current liabilities until the board has formally acted to revolve the equities.

11.28 In addition to allocated equities, cooperatives may issue common and preferred stock. Common stock is often issued to establish members' voting rights, whereas preferred stock may be sold to members and nonmembers on a nonpatronage basis. Cooperatives may also issue preferred stock as a form of earnings distribution. Limited amounts of dividends on preferred stock are tax deductible by exempt cooperatives, but they are not tax deductible by nonexempt cooperatives. Disclosure of a cooperative's equity is similar to that required for other corporate entities.

11.29 Certain transactions of cooperatives may result in unallocated equities. For example, cooperatives may derive earnings from nonpatronage business and account for these earnings as other corporations do. Nonpatronage earnings are frequently not allocated and are classified as retained earnings in the equity section. In addition, a cooperative may elect at times not to allocate patronage earnings or losses.

Auditing Considerations

11.30 The following procedures may be performed when auditing a cooperative's equity account:

1. Procedures for patronage allocations and per-unit retains are

   - becoming familiar with bylaws, board policies, and other governance documents regarding revolvement practices.
   - examining, on a test basis, individual records of patrons' equity and test allocations and revolvements for compliance with bylaws and board minutes.
   - considering whether allocation and revolvement provisions comply with statutory requirements.
   - confirming balances in various equity classifications with patrons.
   - reviewing allocations that are due to be retired within a year, including an evaluation of potential reclassification as liabilities.
   - ascertaining that unallocated equities are indeed unallocated, including an evaluation of potential disclosures for any special provisions or restrictions.
   - examining, on a test basis, member additions and deletions for compliance with the by-laws and applicable cooperative policies.

2. Procedures for common and preferred stock that may be performed include

   - considering compliance with statutory requirements, bylaw provisions, and articles of incorporation.
   - reviewing minutes of the meetings of members and of the board of directors for approval of changes in capital structure.

- reviewing provisions of stock issuance for possible redemption requirements, including an evaluation of potential reclassification as a liability.

Current and Deferred Income Taxes

Background and Unique Characteristics

11.31 The various exemptions and deductions available to cooperatives have been discussed in prior sections of this guide. The applicable federal income tax provisions are found in Sections 521 and 1381–1388 of the Internal Revenue Code (IRC). State income tax laws may also have applicable provisions.

11.32 Accounting for current and deferred income taxes of cooperatives is affected by several factors. These include whether patronage allocations are issued on a qualified or nonqualified basis, whether patronage allocations are based on book earnings or tax earnings, the classification of earnings as patronage or nonpatronage, and the status of the cooperatives as exempt or nonexempt.

11.33 Cooperatives may issue patronage allocations on a qualified or nonqualified basis. Generally, patronage distributions are considered qualified when at least 20 percent of the distribution is paid in cash and the balance distributed as qualified written notices of allocation within the required time period. Qualified patronage allocations are deductible for federal income tax purposes in the year for which they are issued and are fully taxable to the patrons in the year received. When cooperatives issue nonqualified notices of allocation, they are not currently deductible for federal income tax purposes, and the patrons do not recognize taxable income until payment is received.

11.34 Because of the tax treatment afforded tax-exempt cooperatives, accounting records should provide the patronage information necessary to determine that the cooperative has maintained its tax-exempt status. If the cooperative is nonexempt, the accounting records should identify patronage and nonpatronage income to facilitate the determination of patronage allocations and taxable income. Also, it is essential that records be maintained to provide information for determining the costs associated with patronage and nonpatronage income.

11.35 The manner in which a patronage allocation is made is usually specified in the bylaws, resolutions of the board of directors, and marketing or other agreements. Whether allocations are based on book or tax earnings is usually controlled by bylaw provisions or action of the board of directors. Thus, both exempt and nonexempt cooperatives may have temporary differences as a result of differences in the accounting treatment of deductions and patronage allocations for financial and tax-reporting purposes.

Accounting Principles

11.36 As stated above, cooperatives are subject to income taxes as required under the reference sections of the IRC. When temporary differences exist, taxable income at the cooperative level may give rise to deferred taxes.

11.37 Generally, deferred tax accounting is not required for tax-temporary differences associated with patronage and nonpatronage earnings of exempt cooperatives and patronage earnings of nonexempt cooperatives when those earnings are allocated to patrons through use of qualified notices of allocation.

In those circumstances, the liability for income taxes, current and deferred, follows the allocation of earnings and is the responsibility of the recipient patron.

11.38 For temporary differences related to nonqualified written notices of allocation of exempt and nonexempt cooperatives, nonpatronage earnings of nonexempt cooperatives, and patronage earnings not allocated as patronage refunds, FASB Statement No. 109, *Accounting for Income Taxes*, applies.

11.39 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting for interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006.[‡]

11.40 Accounting for deferred income taxes of a cooperative is affected by several factors. One such factor is whether or not patronage is allocated on a book or tax basis; other factors include the impact of patronage versus nonpatronage earnings and the use of nonqualified written notices of allocation.

Auditing Considerations

11.41 When reviewing a cooperative's tax liability, the auditor may perform the following procedures:

1. Reviewing marketing and other contracts between the cooperative and its patrons and nonpatrons.
2. Reviewing the bylaws and articles of incorporation for their effect on patronage deductions.
3. Determining that a bylaw consent effective under IRC Section 1388(c) or (h) has been adopted and that notice has been given to new members. (If no bylaw consent is in effect, individual written consents from patrons or qualified checks issued in accordance with tax regulations should be reviewed.)
4. Reviewing the accounting methods used by the cooperative to determine earnings subject to patronage distributions.
5. Reviewing the minutes approving the per-unit retain and annual patronage distribution to members.
6. Determining that allocations of patronage distributions and per-unit retains are made pursuant to written obligations in effect prior

[‡] FASB issued FSP FIN 48-1, *Definition of* Settlement *in FASB Interpretation No. 48*, which provides guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.

FASB also issued FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*. This FSP applies to nonpublic enterprises subject to the provisions of FIN 48 unless that nonpublic enterprise (*a*) is a consolidated entity of a public enterprise that applies U.S. GAAP or (*b*) has issued a full set of U.S. GAAP annual financial statements prior to the issuance of this FSP using the recognition, measurement, and disclosure requirements of FIN 48. This FSP defers the effective date of FIN 48 for nonpublic enterprises included within this FSP's scope to the annual financial statements for fiscal years beginning after December 15, 2007. When effective, FIN 48 should be applied as of the beginning of the enterprise's fiscal year.

The AICPA has also issued a 13 page nonauthoritative practice guide entitled, *Practice Guide on Accounting for Uncertain Tax Positions Under FSP FIN 48*, which is free to all AICPA members.

to the delivery of agricultural products or purchases of goods and services by patrons (see IRC 1388).

7. Determining that patronage distributions, per-unit retains, and payments in cash claimed as deductions for the previous year were paid or issued with proper notice to patrons during the eight-and-one-half-month period after year-end.
8. Inquiring whether an exempt cooperative has engaged in activities that could result in the loss of its exempt status.
9. Determining that appropriate records are maintained for each patronage allocation unit and that separate earnings allocations are made on the basis of business transacted within each allocation unit.

PART III—Other Matters

Chapter 12

Other Accounting Principles and Auditing Considerations[*] Applicable to Agricultural Producers and Agricultural Cooperatives

Use of Derivative Instruments and Hedging Activities

Background

> The following section provides a discussion about the economic uses of derivative instruments and hedging activities. Refer to Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, for accounting guidance on these topics.

12.01 Forward contracts can be used to reduce the risk of loss from price fluctuations of products to be sold or materials to be purchased.

12.02 Both agricultural producers and agricultural cooperatives enter into marketing agreements with buyers, merchandisers, processors, and suppliers to assure a sales market or source of goods at a specific or determinable price. These agreements, called *forward contracts*, usually relate to the delivery of a fixed quantity of product or the delivery of all the product of a designated number of acres. These agreements usually also lock in a delivery date or period for delivery. Terms of the contracts vary by product type and the geographical area of the country.

12.03 A fixed-quantity contract requires the delivery of a fixed quantity of the specified product by a particular date. The price may be fixed at the time the contract is executed, established at the date of delivery, or established at a later date by basing it on a defined relationship to a quoted market price. The contract may provide for deferred payment of all or part of the contract amount.

12.04 An acreage contract requires the delivery of all the crop produced on a specified number of acres. The price may be fixed on a per-unit basis or may vary with quoted market prices in the same manner as fixed-quantity contracts and may be similarly deferred. Payment may be deferred as well.

12.05 Forward contracts may provide protection against the risk of loss from price variations that can result from the impact of the many factors that influence the supply and demand for agricultural products and supplies. However,

[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

forward contracts do not provide protection to the producer or cooperative if it is unable to meet its delivery obligation under the contract or if a supplier fails to perform in accordance with its commitment.

12.06 Trading in futures contracts for agricultural commodities has been possible through long established commodity exchanges. In recent years, the options markets have provided an alternative to the futures market for hedging transactions.

12.07 A producer or cooperative holding grain in inventory might hedge the risk of loss by selling futures contracts for an equivalent quantity of the same grain on a commodity futures market for delivery in the desired month of sale. Hedging with futures contracts reduces the risk of loss from unfavorable price changes and also effectively eliminates the possibility of gain from later favorable price changes.

12.08 As an alternative to the futures contract, the holder of the grain might purchase a put option covering an equivalent quantity of grain that would give the holder of the put the right to sell the grain to the writer of the put at the strike price and during the time specified in the contract. If the grain price had fallen by the exercise date, the put would be exercised at the higher strike price. If the grain price had risen by an amount greater than the contracted strike price, the put holder could benefit by allowing the option to expire and selling the grain at the higher market price.

12.09 A producer or cooperative may wish protection against a prospective increase in the cost of materials or supplies. This protection may be provided by purchasing futures contracts for the quantities expected to be needed at the contract delivery dates. For example, a producer with large numbers of animals to feed might buy grain futures contracts in amounts and for delivery dates that coincide with projected needs.

12.10 As an alternative, the producer might acquire a call option giving the holder the right to purchase the specified quantity of grain at the contract strike price during an option term that includes the date on which the grain was expected to be needed. If the price of the grain on the market had fallen below the strike price by more than the cost of the call, the holder could allow the call option to expire and benefit by purchasing the grain at the lower current market price. If the market price had risen, the right to purchase the grain at the lower strike price would be exercised.

12.11 In economic (not accounting) terms, hedges are classified as either buying (long) hedges or selling (short) hedges. Buying hedges may be used, for example, to fix the cost or assure the availability of a commodity when producers or cooperatives have entered into fixed-price sales commitments or to fix the purchase price of commodities to be used in production or processing. Examples of uses of selling hedges would be to establish sales prices when producers or cooperatives hold inventory for sale or to provide protection when fixed-price purchase commitments have been made.

12.12 Not all commodities that producers and cooperatives may wish to hedge are traded on futures exchanges. However, a substitute commodity that is traded on a futures exchange may be used to establish an economic hedge if there is a clear economic relationship between the prices of the two commodities and high correlation is probable. Those transactions are referred to as *cross hedges.*

12.13 A producer may establish an economic hedge position for the future sale of a crop before it is harvested and, at times, before it is planted.

12.14 Usually, deliveries are not made against futures contracts. Rather, the contracts are closed by buying or selling an offsetting number of contracts on the futures exchange when the underlying commodity is purchased or sold.

12.15 Some agricultural cooperatives also use interest-rate swaps to hedge the uncertain future cash flows associated with variable-rate debt.

Accounting for Derivative Instruments and Hedging Activities

12.16 FASB Statement No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. See the discussion of fair value measurements later in this chapter. If certain conditions are met, a derivative may be specifically designated as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (*b*) a hedge of the exposure to variable cash flows of a recognized asset or liability or of a forecasted transaction, or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. Certain forward contracts that otherwise meet the definition of derivatives are excluded from the scope of FASB Statement No. 133 under the "normal purchases and normal sales" provision as described in paragraph 10(b) of that statement. Paragraphs 44–47 of FASB Statement No. 133, as amended, contains extensive disclosure requirements.[†] Refer to the full text of the statement and related amendments when considering accounting and reporting issues related to derivative instruments and hedging activities. FASB established the Derivatives Implementation Group (DIG) to assist the board and its staff in providing implementation guidance regarding FASB Statement No. 133. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org.

12.17 FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year

---

[†] In March 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. In response to constituents' concerns that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, does not provide adequate information about how derivatives and hedging activities affect an entity's financial position, financial performance, and cash flows, FASB issued FASB Statement No. 161 to enhance disclosures about an entity's derivative and hedging activities and to improve financial transparency. This statement has the same scope as FASB Statement No. 133 and, accordingly, applies to all entities. FASB Statement No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early adoption is encouraged. FASB Statement No. 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. Refer to the FASB Web site at www.fasb.org for the full text of the statement.

that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this statement may also be applied upon adoption of this statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this statement.

Auditing Considerations

12.18 To determine the existence and proper reporting of marketing agreements, the auditor may perform the following audit procedures:

1. Obtaining an understanding of normal purchasing and marketing methods
2. Inquiring and obtaining written representations from management and owners
3. Reviewing transactions subsequent to the balance sheet date for undisclosed agreements
4. Reviewing open contracts and confirming details with other parties
5. Obtaining and evaluating the facts required for making a judgment about (*a*) the need to decrease the carrying amount of existing inventories or (*b*) the need to recognize a loss resulting from open marketing agreements

12.19 AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on auditing investments in debt and equity securities, investments accounted for under APB Opinion No. 18, and derivative instruments and hedging activities. The companion AICPA Audit Guide to AU section 332, titled *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical implementation guidance for all types of audit engagements. The suggested auditing procedures contained in the guide do not increase or otherwise modify the auditor's responsibilities described in AU section 332. Rather, the suggested procedures in the guide are intended to clarify and illustrate the application of the requirements of AU section 332.

Considerations for Integrated Audits

Paragraph .11 of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), which states that the auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion. If there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

Asset Retirement Obligations

12.20 With rapid change in production technology, asset retirement obligations have become a significant consideration for agricultural producers and cooperatives. FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. As used in FASB Statement No. 143, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of a promissory estoppel. FASB Statement No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. See the discussion of fair value measurements later in this chapter. If a reasonable estimate of fair value cannot be made in the period the asset retirement obligation is incurred, the liability shall be recognized when a reasonable estimate of fair value can be made. Upon initial recognition of a liability for an asset retirement obligation, an entity shall capitalize an asset retirement cost by increasing the carrying amount of the related long-lived asset by the same amount as the liability. An entity shall subsequently allocate that asset retirement cost to expense using a systematic and rational method over its useful life.[1]

12.21 FASB Interpretation No. (FIN) 47, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*, clarifies the term conditional asset retirement obligation as used in FASB Statement No. 143.

Fair Value Measurements

12.22 FASB Statement No. 157, *Fair Value Measurements*, issued in September 2006, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements. Rather, it changes current practice by establishing a single definition of fair value. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, issued in February 2007, creates a fair value option under which an organization may irrevocably elect

---

[1] AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures contained in financial statements.

For further guidance, see the AICPA Practice Aid *Alternative Investments—Audit Considerations (A practice aid for auditors)*. This practice aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist (that is, that are not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System). Alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions, because of the lack of a readily determinable fair value for these investments and the limited investment information generally provided by fund managers.

fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date as those changes occur. Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts. Refer to the FASB Web site at www.fasb.org for the full text of the statements.

12.23 Except for application to certain nonfinancial assets and nonfinancial liabilities, FASB Statement No. 157, as amended by FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. This statement shall be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, except as provided in paragraph 37 of the statement. FSP FAS 157-2 delays the effective date of FASB Statement No. 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value at least once a year, to fiscal years beginning after November 15, 2008. Paragraph 12 of FSP 157-2 requires entities that have not fully applied the provisions of FASB Statement No. 157 to make certain disclosures in their interim and annual financial statements. FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157.

Disclosures

12.24 Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period. FASB Statement No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Organizations should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an organization should either (*a*) report the aggregate carrying amount for both fair value and nonfair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the nonfair-value carrying amounts. Refer to the FASB Web site at www.fasb.org for the full text of the statements.

Fair Value Accounting—Agricultural Producers and Agricultural Cooperatives

12.25 FASB Statement No. 159 permits all entities to elect the fair value option for many financial instruments and certain other items, including held-to-maturity securities, at specified election dates. Prior to FASB Statement Nos. 157 and 159, agricultural producers and agricultural cooperatives were already required to report derivatives, hedging activities, and available-for-sale securities and trading securities at fair value.

12.26 In addition to the aforementioned financial assets, FASB Statement No. 157 also affects the definition of fair values used to measure certain *nonfinancial* assets and liabilities, including asset retirement obligations discussed earlier in this chapter and impairment write-downs discussed in chapter 13.

Consolidation of Variable Interest Entities

12.27 FIN 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51* establishes requirements applicable to accounting for investments in agricultural cooperatives and other entities.[2] Agricultural producers involved in cash or crop-sharing agreements[3] whereby

---

[2] FASB issued the following FASB Staff Positions (FSPs) associated with the issuance of FASB Interpretation No. (FIN) 46(R)s:

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003)."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003)."
3. FSP FIN 46(R)-3, "Evaluating Whether, as a Group, the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003)."
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003) Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21."
5. FSP FIN 46(R)-5 "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003). (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) For entities to which FIN 46(R) has been applied, the guidance in this FSP is applied in the first reporting period beginning after March 3, 2005, in accordance with the transition provisions of FIN 46(R). Restatement to the date of the initial application of FIN 46(R) was permitted but not required. Early application was permitted for periods for which financial statements have not yet been issued. For entities to which FIN 46(R) has not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of FIN 46(R).
6. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)." An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of FIN 46(R) beginning the first day of the first reporting period beginning after June 15, 2006.
7. FSP FIN 46(R)-7, "Application of FASB Interpretation No. 46(R) to Investment Companies."

FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 replaced FSPs FIN 46-2, FIN 46-5, and FIN 46-8, respectively, with the effective dates and transition periods applied accordingly. For additional assistance, refer to Technical Question and Answers (TIS) section 1400.29, "Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*" (AICPA, *Technical Practice Aids*).

[3] Refer to paragraph 2.03 for more information on these arrangements.

the landowner controls both the producer and the entity operating the land, may also be subject to provisions of FIN 46(R). FIN 46(R) addresses consolidation by business enterprises of entities, which have one or more of the following characteristics: (1) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders, (2) the equity investors do not have the characteristics of a controlling financial interest or (3) the equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest. An entity subject to consolidation according to the provisions of this interpretation is referred to as a variable interest entity (VIE). FIN 46(R) governs how entities should assess interests in other entities in determining whether to consolidate that entity. FIN 46(R) requires an assessment of every relationship between an enterprise and another legal entity. Legal entities include grantor trusts, limited liability corporations, partnerships, corporations, and other trusts. Broadly stated, an entity that must determine consolidation in accordance with FIN 46(R) is known as a VIE and an entity that is required to consolidate a VIE is known as a primary beneficiary. There are many possible relationships an enterprise may have with other legal entities that are VIEs. For example, a company may participate in joint ventures with outside investors that may be VIEs. Swap agreements and derivative instruments between entities, even if used for hedging purposes, need to be evaluated. Management needs to evaluate equity method investments, leases, trust accounts, and loans as potential relationships with a VIE that may trigger consolidation.

12.28 FIN 46(R) changes prior practices by requiring a company to consolidate a VIE if that company either is subject to a majority of the risk of loss from the VIE's activities or is entitled to receive a majority of the VIE's residual returns, or both.[4]

Audit Documentation

12.29 Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides guidance and sets forth requirements about the content, ownership, and confidentiality of audit documentation.

12.30 The auditor **must** prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusion reached. Paragraph .03 of AU section 339 states that audit documentation

a. provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally acceptable auditing standards.

b. provides that principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

---

[4] For additional assistance, refer to Practice Alert 05-1, *Auditing Procedures With Respect to Variable Interest Entities* (AICPA, *Technical Practice Aids*, PA sec. 16,280).

Other purposes of audit documentation include, among other things, assisting the audit team to plan and perform the audit, assisting members of the audit team responsible for supervision to direct and supervise the audit work, retaining a record of matters of continuing significance to future audits of the same entity, and enabling an experienced auditor to conduct inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements.

12.31 Paragraph .10 of AU section 339 states that the auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand

- the nature, timing, and extent of auditing procedures performed to comply with generally accepted auditing standards and applicable legal and regulatory requirements;
- the results of the audit procedures performed and the audit evidence obtained;
- the conclusions reached on significant matters; and
- that the accounting records agree or reconcile with the audited financial statements or other audited information.

12.32 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or workpapers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.

12.33 Audit documentation includes, for example audit programs, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.

12.34 Paragraph .23 of AU section 339 also states that the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Among other things, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. This will ordinarily result in a report date that is close to the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements (report release date).[5] Delays in releasing the report may require the auditor to perform additional procedures to comply with the requirements of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1).[‡] Paragraph .36 of AU section

[5] In many cases, the report release date will be the date the auditor delivers the audit report to the entity.

[‡] The Professional Issues Task Force has issued Practice Alert 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290). The practice alert

(continued)

339 lists the audit documentation requirements contained in other statements on auditing standards.

> *Considerations for Integrated Audits*
>
> Paragraph 6 of PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), states that the auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. Relevant financial statement assertions are described in paragraphs 28–33 of PCAOB Auditing Standard No. 5.

Auditing Fair Value Measurements and Disclosures†

12.35 Financial statements of agricultural producers and cooperatives contain a number of significant fair value measurements and disclosures. For example, fair value of investments in nonpublicly-traded entities, such as other cooperatives, joint ventures, limited liability companies, and family limited partnerships are common to both agricultural producers and cooperatives. In addition, as investment strategies increasingly include investing in more complex and higher-risk securities, the values of securities may not be readily available through market quotations. Such securities are often valued at amounts determined by the cooperatives and producers' management. Auditing the valuation of investments in nonpublicly-traded entities and certain securities is an area that requires a high degree of judgment to ensure that the valuation procedures are reasonable and underlying support is appropriate. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures.

12.36 AU section 328 provides overall guidance on auditing fair value measurements and disclosures. It does not, however, provide guidance on auditing specific assets, liabilities, components of equity, transactions, or industry-specific practices. That guidance may be developed in the future for inclusion in this guide. Auditors may also refer to other standards, such as AU section 332, and related interpretations, such as Auditing Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, vol. 1, AU sec. 9328 par. .01–.04) and Auditing Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA *Professional Standards*, vol. 1, AU sec. 9332 par. .01–.04).

12.37 AU section 328 provides that the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate.

(footnote continued)

provides guidance to auditors of nonissuers and their firms regarding application of certain provisions of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), primarily relating to dating the auditor's report. Practitioners and AICPA member firms should incorporate the guidance contained in the alert as soon as practicable. The alert is currently available on the AICPA's Web site: www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf.

12.38 When testing management's significant assumptions, the valuation model, and the underlying data, the auditor evaluates whether:

1. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information.
2. The fair value measurement was determined using an appropriate model, if applicable.
3. Management used relevant information that was reasonably available at the time.

Auditors should perform this evaluation even if the fair value estimate is made by a valuation specialist.

Representation Letters

12.39 Paragraph .05 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), states that written representations should be obtained from management for all financial statements and periods covered by the auditors report. Paragraph .09 of AU section 333 states that the management representation letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Paragraph .09 of AU section 333 states that the written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of the report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report. If comparative financial statements are reported on, the representations obtained at the completion of the most recent audit should address all periods being reported on.

12.40 Additionally, paragraph .12 of AU section 560 states that the auditor generally should obtain a letter of representations as to whether any events have occurred subsequent to the date of the financial statements being reported on by the independent auditor that, in the officer's (or other appropriate person's) opinion, would require adjustment or disclosure in the financial statements.

12.41 Paragraph .06 of AU section 333 identifies the matters to which specific representations should relate, including an acknowledgement by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter.

12.42 The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. Paragraph .17 of AU section 333 provides examples of additional representations that may be appropriate. Paragraph .16 of AU section 333 provides an illustrative representation letter.

Considerations for Integrated Audits

Paragraph .05 of AU section 333, *Management Representations* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 75–77 of PCAOB Auditing Standard No. 5 for additional required written representations to be obtained from management.

State License Regulations

12.43 Producers and other agribusiness entities involved in the production, purchase or resale of grain (or other commodities) may be regulated or have specific reporting requirements by the state(s) in which they do business. For example, some states regulate and monitor grain merchandising license compliance by requiring certain financial statement disclosures or maintenance of specific financial ratios in order to retain a grain dealer or warehouse license. Auditors should obtain an understanding of state grain or commodity regulations and reporting requirements that apply to the entity. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides guidance and establishes additional requirements for gaining a sufficient understanding of the entity and its environment, including its internal control.

Chapter 13

Consideration of Fraud in a Financial Statement Audit*

13.01 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1).

> *Considerations for Integrated Audits*
>
> Paragraph .01 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 14–15 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), regarding fraud considerations in addition to the fraud considerations set forth in AU section 316 (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended).

13.02 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Additionally, three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

13.03 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's

* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[1]

13.04 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements established in paragraphs .14–.18 of AU section 316. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives or pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

13.05 Most agricultural cooperatives and producers exhibit the classic small business attributes. For example, top management (Chief Executive Officer [CEO], general manager) tends to dominate the entity, increasing the likelihood of override of controls. Basic controls may be in place, but segregation of duties is often lacking. Internal audit function is rarely present. Most agricultural cooperatives and farming operations are not publicly owned and therefore are not subject to the Securities and Exchange Commission and the requirements of the Sarbanes-Oxley Act. Generally, there is no audit committee and the board of directors lacks financial expertise. Management often lacks an understanding or appreciation of accounting and financial reporting standards. Likewise, the accounting staff may lack sophistication and an understanding of current accounting developments. At the same time, agricultural cooperatives and producers are becoming engaged in more and more complex financial transactions, such as those involving derivatives and significant estimates. Producers are becoming more diversified, adding vertical integration to the business by additional processing of the commodity beyond the traditional harvest point. The expanding agricultural entrepreneur likely began farming a much smaller acreage with fewer crops. As operations expand the accounting and financial expertise often lags behind.

13.06 The agriculture industry operates on a yearly cycle due to distinct planting, growing and harvesting seasons. Both cooperatives and producers operate in this seasonal environment. A high demand exists for seasonal and temporary employees. Such employees are likely to be compensated less than full-time employees and less likely to receive the full complement of benefits enjoyed by full-time employees. Such employees are less likely to be committed to the cooperative and more likely to misappropriate assets.

---

[1] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), to discuss the potential of the risks of material misstatement.

Examples of Fraud Risk Factors

13.07 The following are examples of fraud risk factors that may be present in agricultural cooperatives and producers:

Part 1: Fraudulent Financial Reporting

A. *Incentives/Pressures*

- Performance-based compensation incentives.
- Pressures to provide returns to members of cooperatives or nonactive family members of agricultural producers.
- Pressure to keep cooperative members and lenders satisfied by reporting consistent financial results from year to year despite the inherent volatility of the agricultural industry. Competition, supply and demand factors, weather, and government programs all result in uncertain and unpredictable sales volumes, crop yields, commodity prices and profitability levels.
- Pressure to report favorable financial results to stave off pressures to merge.
- Pressure to report adequate earnings to finance capital acquisitions (for example, different types of handling and storage facilities necessary for the identity preservation needed to capture the premiums of specialty crops, expansion of business through additional vertically integrated processing).
- Pressure to report adequate earnings in order to obtain future financing.
- Pressure to meet financial targets to obtain business licensure.
- Rapid developments in technology (biotechnology, chemicals, genetically modified organisms, animal genetics) that make inventories obsolete.
- Desire to cover up losses resulting from the rejection of genetically modified crops by key markets.
- Potential losses on unhedged or imperfectly hedged commodity market positions.
- Global or local trends in the agricultural economy that could result in reduced profitability, such as high degree of competition, market saturation in a mature market, declining margins, or weather patterns that harm yields or infringe on key planting or harvesting periods that threaten the viability of members (collectibility of receivables, future sales opportunities).
- Government programs may significantly alter farmer planting and marketing decisions, thereby resulting in reduced sales, reduced margins and financial statement volatility. Government

subsidies are a major component of some operations. Some producers and cooperatives may engage in fraudulent activities to receive yet more subsidies. For example, they may attempt to collect government payments for nonplanting while continuing to plant, grow and harvest a crop. Another possibility would be to change the amount of acres of a crop planted and reported to another crop due to change in pricing structure.

B. ***Opportunities***

- Small business characteristics such as domineering management, inadequate segregation of duties, or absence of internal audit and audit committee.
- Complex marketing and hedging activities.
- Complex and numerous deferred tax issues.
- Significant related party transactions. In a cooperative, the members of the board of directors also are members and customers of the cooperative. Virtually all customers also are member/owners. Therefore, most revenue-generating transactions are conducted with related parties. It is presumed that these transactions are routine, bona fide arms-length business transactions. It is thus difficult to identify any related-party activity that actually deserves enhanced scrutiny. In the case of agricultural producers, transfer prices of commodities between producers and related processing entities may be manipulated to achieve desired results.
- Valuation of agricultural products is highly subjective and often requires specialized knowledge.
- Valuation of nonpublicly-traded investments are based on significant estimates that involve subjective judgments.
- Use of estimates in a number of key areas when preparing financial statements of agricultural producers and cooperatives (see paragraph 13.30 for a list of significant estimates used in the industry).
- Grain marketing cooperatives usually also operate as public warehouses. Commodities handled by the warehouse (for example, wheat or corn) are fungible and cannot be specifically identified or differentiated as to ownership. Commodities owned by the warehouse are commingled in bulk storage with commodities owned by depositors. This results in the opportunity to overstate inventory and profitability by suppressing the storage obligation to depositors.

- Complex organizational structures involving joint ventures, subsidiaries, or limited liability companies.

C. *Attitudes/Rationalizations*

- Desire to report adequate earnings to justify a distribution to members.
- Cover up bad decisions or poor management.

Part 2: Misappropriation of Assets

A. *Incentives/Pressures*

- Employees uncertain about continued employment in light of financial stress on the cooperative.
- Seasonal or temporary employees with less commitment to the cooperative, lower pay and absence of benefits.
- Lower wage scale in relation to other industries.

B. *Opportunities*

- Inventory items of small size with high value (for example, agricultural chemicals).
- Inventories consisting of fungible commodities, easily convertible to cash.
- Commingling of company-owned assets with assets owned by third-party depositors in a public warehouse.
- Commingling of assets or liabilities within related party entities.
- Agricultural supply businesses (equipment dealerships, fertilizer and chemical companies) frequently offer deferred billing arrangements to buyers of their products. Producers and cooperatives may use these arrangements to manipulate their financial results by not recognizing liability for such products in the proper period. If a cooperative sells products to its members under deferred billing arrangement, customer account statements are often not provided during the deferred billing periods. This makes it possible to obscure or distort accounts receivable aging problems or lapping schemes.
- Inventory stored at remote, rural, poorly secured locations.
- Numerous remote sites with few employees, inadequate segregation of duties, and inadequate supervision by top management.
- Supplier rebate programs that are handled outside the routine accounting process and change from year to year.

- Inherent conflicts of interest wherein employees with access to inventories also use those products in their own outside activities (for example, farming or custom chemical and fertilizer application).

C. ***Attitudes/Rationalizations***

- Unreasonable reliance on fundamental integrity of the agricultural community in general. Many members of the agricultural community consider it to be a close-knit community with a high level of moral and ethical standards. Therefore, inadequate attention may be paid to internal controls, written documentation of transactions and agreements, or follow-up on unusual or unexpected items.
- Small losses cost less than the cost of controls to prevent them.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

13.08 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risk of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35–.42 of AU section 316) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs .20–.27 of AU section 316.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs .28–.30 of AU section 316.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs .31–.33 of AU section 316, the appendix to AU section 316, and paragraphs 13.08 and 13.18–.19.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .34 of AU section 316.)

13.09 Omnibus 2006 amends paragraph .35 of AU section 316 with the addition of a footnote in the heading titled "Identifying Risks That May Result in a Material Misstatement Due to Fraud." The footnote addresses the auditor's responsibility to assess the risk of material misstatement at the financial statement level based on the entity and its environment.

13.10 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

13.11 Developing expectations and evaluating the results of analytical procedures may be difficult because of the inherent volatility of many businesses in which agricultural cooperatives and producers are involved. For example, the timing and volume of crop input sales as well as production yields can vary greatly from one year to the next due to weather as well as the general state of the agricultural economy. Local, national and world supplies of commodities affect an individual producer's market. The impact of these variables may be localized or widespread. For example, deterioration in accounts receivable aging when compared to the prior year may indicate nothing more than the fact that farmers' planting season came earlier in the year due to more favorable weather conditions. Therefore, when developing expectations and evaluating the results of analytical procedures, the auditor should obtain an understanding of both global and localized variables that impact the ratios and relationships being examined.

13.12 It is also important to understand the business practices of the audit client in comparison to other entities in similar lines of business. For example, different grain marketing cooperatives may follow differing practices for handling grain quality and moisture discounts, and may follow different practices for drying and blending grain. These practices will affect quantity shrinks and overruns as well as margins per unit. Changing government regulations may affect various practices as well, affecting environmental, labor, marketing, or other practices.

13.13 Unusual or unexpected relationships for agricultural cooperatives include the following:

- Inconsistent quantity shrinks or overruns in relation to industry peers, individual cooperative history, or blending/drying/operating practices
- Inconsistent unit margins in relation to industry peers, individual cooperative history, or blending/drying/operating practices
- Inconsistent unit sales in relation to general or local economic conditions or to local weather conditions
- Inconsistent reported profits in relation to economic and weather conditions
- Bad debt expense as a percent of sales more or less than industry peers or individual cooperative history
- Bad debt reserve as a percent of receivables more or less than industry peers or individual cooperative history
- Recorded receivables too high or too low in relation to sales
- Aging of receivables inconsistent with timing of peak season
- Total inventory out of line in relation to sales
- Inventory turnover or days sales in inventory inconsistent with peers, historic trends, or current economic conditions
- Operating expenses out of line in relation to gross income
- Payroll expenses per employee out of line with industry peers and historic trends

13.14 Agricultural producers may experience similar and other unusual or unexpected relationships, such as

- quality and net realizable value of the product harvested is unusual when compared to industry peers.
- debt ratios indicating tendency towards a more leveraged environment.
- inconsistent inventory levels relative to acreage harvested and collections prior to the end of the year.
- "repair" or "supply" line items out of line with historical trends for the producer.
- repairs as a percentage of gross revenue increasing, possibly indicating financial pressures preventing upgrading of equipment.
- inventories of commodities relative to acreage planting indicating yields above the norm for the geographic area or crop.
- unexpected or unusually high "cullage" rates, compared to prior years or industry standards, may indicate the misappropriation of inventory.
- change in revenue per acre or revenue per unit harvested may be the result of poor marketing results or may indicate misappropriation.
- unusual results when compared to Farm Service Agency records of historical yields.
- deferred expenses for growing crops recorded at inappropriately high values per acre due to financial results pressures.

13.15 The agricultural producer's mix of receivables, inventories and collections may vary drastically from year to year. Comparisons of beginning of the year receivables to receivables at the end of the year often are not meaningful. The same is true with inventories. However, the sum of receivables, inventories and postharvest collections should bear similar relationships to total acreage harvested from year to year, taking into account weather and price variables. The auditor should be familiar with the weather patterns in the geographic area of the clients in order to properly evaluate the relationships in year-to-year comparisons. The auditor should also obtain an understanding of the relationship of the local market price to national and world supply and the dependency, if any, of the client's market to national and world demand.

13.16 Auditors may also make inquiries of management to determine any unusual or unexpected relationships with customers, suppliers, board members, other members of management, and key employees.

Considering Fraud Risk Factors

13.17 As indicated in item (*c*) in paragraph 13.08, the auditor may identify events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes or rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors.* Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

13.18 AU section 316 provides fraud risk factor examples that have been written to apply to most enterprises. Paragraph 13.07 provides a list of fraud risk factors specific to the agricultural producers and cooperatives industry. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud[2]

13.19 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements established in paragraphs .19–.34 of AU section 316. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

13.20 For example, in addition to their susceptibility to misappropriation, inventories of cooperatives and producers may be subject to fraudulent financial reporting involving the valuation and allocation assertion. Although the availability of reliable purchase or market prices may alleviate this concern, determination of net realizable value or lower-of-cost-or-market can be subjective and will often involve managerial estimates.

13.21 Equipment and other fixed assets are also vulnerable to misappropriation, but like inventory they can pose a risk of fraudulent financial reporting involving the valuation and allocation assertion. In particular, natural competitive pressures and changes in production technology make careful evaluation of possible impairment losses in accordance with Financial Accounting Standards Board (FASB) Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, a critical management responsibility in the cooperative and producer environment. Given the broad range of factors that can influence this determination, estimation of any loss is likely to be highly subjective. The presentation and disclosure assertion may be relevant as well since impairment losses are reported in part according to management's plans for the underlying assets' use or disposition. For example, the producer may have a line of equipment unique to the harvesting of a particular crop. The market for the crop may have disappeared from the local area due to the closure of a processing plant. The producer will be sustaining the burden of switching to another crop, needing to acquire another line of equipment. The existing equipment may be idled, with no local or regional market for disposal of the equipment. The creditor's collateral may be impaired, even though the equipment is in good working condition. Apart from the possibility of such losses, there is generally a need to consider the impact of any asset retirement obligations that may exist with

---

[2] Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

respect to property, plant, and equipment. Depending on the nature of the obligation, FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, provides guidance for producers and cooperatives to estimate a fair value of the related liability for accrual and capitalization (and thus subsequent depreciation) purposes. Accordingly, rights and obligations becomes another assertion of possible audit concern in this area. See the discussion of fair value measurements in paragraphs 12.22–.26.

13.22 Valuation and allocation will again be an assertion of primary auditor interest in the area of cooperative investments, as will presentation and disclosure. Concern here is likely to center on carrying values and the effects of investee losses and unallocated equities. In this regard, management's interpretation and application of the relevant authoritative literature (for example, Accounting Principles Board Opinion No. 18) is particularly important. The timing and recognition of patronage dividends may pose similar concerns. Another important consideration is management's discretion in displaying patronage refunds since presentation choices (for example, reductions of costs and expenses) made without adequate supporting disclosure may distort operating results.

13.23 The unique characteristics of cooperatives give rise to concern for the presentation and disclosure assertion in another financial statement area, specifically patrons' equities. In addition to determining that classifications are consistent with the underlying economic realities, the auditor should ascertain that allocated equities have been determined in accordance with the cooperative's bylaws and any statutory requirements. The existence of due dates or interest obligations may indicate that the patronage allocations should be reclassified and reported as debt. Such findings are important considerations for the auditor in developing further audit procedures related to both the valuation and allocation and rights and obligations assertions.[†]

13.24 In the case of agricultural producers, integrated livestock and row crop operations are particularly challenging to audit due to financial characteristics unique to the operations. Crops raised may be fed to the livestock, hiding crops diverted by employees. Thus, with respect to key assertions, the auditor will want to emphasize both the existence and completeness of these inventories, as well as their classification—presentation and disclosure assertion. Records of units harvested compared to livestock pounds sold may indicate feed conversion ratios out of line with industry standards. Each agricultural producer uses land for unique purposes depending upon crop rotation, geographic limitations, soil type, weather conditions, and livestock integration. It is this uniqueness that makes auditing agricultural producers particularly difficult. The auditor may consider using information gathered from sources other than internal records to determine which crops were raised on which ground, to determine expectations for quantities harvested. Comparisons with the producer's

---

[†] Some agricultural cooperatives may have retained allocated equities which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and as such may have to be classified as liabilities. However, in accordance with FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

historical results may be the better indicator of current problems. *Common size* financial information (classification on a per acre or per unit harvested) may also disclose anomalies.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

13.25 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph .41 of AU section 316). Due to the nature of agriculture, improper revenue recognition is possible related to crop revenue.

13.26 Agricultural cooperatives and producers are increasingly using derivatives and other complex contracts for marketing agricultural commodities and for hedging associated risks. Some of these contracts include embedded derivatives or derivative-like features. In some cases, neither top management nor the accounting staff fully understand these contracts, related risks and the associated accounting ramifications. Improper accounting for such activities can easily result in income being moved between fiscal periods.

13.27 Significant year-end revenue accruals may be based on estimates and management judgments. As provided in paragraph .54 of AU section 316, the auditor should develop auditing procedures based on the auditor's understanding of the entity and its environment, including the composition of revenues, specific attributes of the revenue transactions, and unique industry considerations. Quantity, quality and value of year-end commodity inventories, particularly those stored in bulk form, are subject to numerous estimates. The misstatement of inventory does not directly affect revenue, but it has a direct effect on cost of sales and periodic earnings. For example, the value of the inventory of livestock will depend upon the health of the animals, weight and estimated costs of disposal for animals of market size. The auditor should consider whether specialized skills are needed to evaluate the various factors that affect the value of inventory. If specialized skills are needed to evaluate the estimates provided by management, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional (see AU section 336, *Using the Work of a Specialist* [AICPA, *Professional Standards*, vol. 1]). Commodities in storage are also subject to manipulation by management. Merely computing the volume of grain in storage is not sufficient to establish the bona fides of the value. Grain placed at the top of the bin may be of high quality, hiding substandard grain subject to substantial dockage.

13.28 In addition to timing of revenue recognition, timing and consistency of expense recognition can be used to manipulate results of operations. For example, the decision to expense or capitalize certain expenditures can be made inconsistently from one year to the next for the purpose of smoothing net income. Expense accruals and allowances can likewise be used to manipulate net income.

A Consideration of the Risk of Management Override of Controls

13.29 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Key Estimates

13.30 The following significant estimates are common in agricultural cooperatives and producers:

- Allowances for uncollectible accounts.
- Inventory valuation allowances for obsolescence.
- Inventory valuation allowances for quality and foreign substances (for example, weed seed).
- Valuation allowances for discounts in commodity inventories of substandard quality, resulting in reduced carrying values.
- Receivables for rebates to be received in the future from suppliers based on past purchases of products such as herbicides and pesticides.
- Environmental remediation liabilities.
- Future settlements of customer complaints.
- Volume discounts to be credited to customers in the future, based on past sales.
- Potential impairments of long-lived assets, particularly plant and equipment.
- Fair value of investments in privately held entities such as other cooperatives, joint ventures, or limited liability companies. See the discussion of fair value measurements in paragraphs 12.22–.26.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

13.31 Paragraphs .43–.45 of AU section 316 establish requirements and provide guidance concerning the auditor's evaluation of the entity's programs and controls that address identified risks of material misstatement due to fraud. It is important for the auditor to remember that most agricultural producers and cooperatives are small and so generally lack many of the programs and controls that their larger corporate counterparts would be expected to have in place. In particular, they tend to exhibit the same vulnerabilities typical of small businesses, for example, lack of segregation of duties and limited expertise in the key areas of finance, accounting, and internal auditing. Moreover, because their operations are usually directed by a single individual (that is, a CEO or the general manager), they are often at greater risk of management override of whatever controls do exist.

13.32 Thus, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in service. Following are some examples of programs and controls an entity might implement to create a culture of honesty and ethical behavior, and that help to prevent, deter, and detect fraud, some of which are likely to be found only within more sophisticated or control-conscious agricultural producers and cooperatives:

- An effective, functional board of directors has established and maintains a strong control environment by setting an appropriate tone at the top.
- With respect to cooperative boards in particular, the directors demonstrate an understanding of the somewhat different challenges confronting the organization as compared to those in the investor-owned corporation. The cooperative exists to provide economic benefits to its members rather than to generate a return on the owners' investment. The absence of profit maximization as the primary charge to the governing board may alleviate some of the related pressure that often leads to fraud. Although the cooperative directors remain responsive to the desires of the member-users, they balance these concerns with the more important goal of maintaining high standards of ethical behavior, especially when those desires conflict.
- The board has developed a meaningful and carefully considered entity-wide code of conduct and has conveyed its philosophy and guidance to employees at all levels. Additionally, the board has emphasized the significance of this code through formal training and active enforcement.
- With respect to the cooperatives' codes, they describe appropriate policies covering all significant aspects of cooperative operations, especially those of particular relevance in this setting—conflicts of interests, external employee activities, and relationships with patrons and suppliers.
- The board has demonstrated its commitment to maintaining a strong control environment by taking an aggressive stance toward fraud prevention. Specifically, the board uses a proactive approach that includes identifying and eliminating (or at least reducing) opportunities for fraud throughout the organization.
- In cooperatives, this commitment is further evidenced by the board having hired management with the competence and expertise necessary to carry out its policies. These individuals share the board's concern for high ethical standards and they exhibit a zero-tolerance attitude toward fraud.
- Management in both agricultural producers and cooperatives implement and monitor control activities to address specific concerns, particularly controls (for example, physical security) designed to deter and detect misappropriation of inventories and equipment. Within the cooperative setting, key controls include scrutiny of related party transactions given the ownership by and patronage with members that characterizes this environment.
- Consistent with the Committee of Sponsoring Organizations of the Treadway Commission's internal control framework, producers and cooperatives emphasize the risk assessment and monitoring components with respect to those fraud-related vulnerabilities

that are particularly acute in the agricultural industry. Specifically, directors and managers follow technological developments that could render inventories and equipment obsolete, study global or local economic trends that could threaten the viability of customers and members, and review operating results and key performance indicators that could reveal fraud (for example, especially those pertaining to production and payroll).

- Agricultural entities with public ownership have formed audit committees that meet the requirements of the Sarbanes-Oxley Act of 2002, particularly with respect to composition and function. This latter dimension includes the creation of a system to gather and respond to fraud-related tips and complaints.
- Cooperatives maintain detailed records of varieties and tons delivered to the elevator, with detailed reconciliation to sales and other transfers out of the elevator. State commodity licensing agencies periodically audit the reports.

13.33 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment[3]

13.34 Paragraphs .46–.67 of AU section 316 establish requirements and provide guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph .50 of AU section 316).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs .51–.56 of AU section 316). Procedures that the auditor of an agricultural cooperative or producer may perform include

- review any reports filed with the Farm Services Agency regarding land under the control of the producer (owned or leased) for additional evidence of acreage in production and expected yield.

---

[3] Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), states that, to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04–.07 of AU section 318. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

- obtain data in the form of expected or historical results from the field personnel of chemical and fertilizer suppliers for comparison to recorded amounts.
- devote special attention to cut-offs between fiscal periods.
- use more substantive tests (for example, inspection, confirmation, analysis, and vouching of details) in lieu of analytical procedures.
- perform substantive procedures at year-end rather than at an interim date.
- devote special attention to identifying and understanding various contracts used to market commodities and hedge related risks.
- confirm with external parties the existence and significant terms of derivatives and other complex contracts.
- identify significant balances based on estimates. Scrutinize carefully the underlying information and methods used by management in developing the estimates. Details may be confirmed with outside parties.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs .57–.67 of AU section 316 and paragraph 13.35*b*).

Evaluating Audit Evidence

13.35 Paragraphs .68–.78 of AU section 316 establish requirements and provide guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

13.36 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

13.37 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. Paragraphs .75–.78 of AU section 316 establish requirements and provide guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

13.38 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.[4]

b. consider the implications for other aspects of the audit (see paragraph .76 of AU section 316).

c. discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.[5]

d. if appropriate, suggest that the client consult with legal counsel.

13.39 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

13.40 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to those charged with governance. The disclosure of possible fraud to parties other than the client's senior management and those charged with governance ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose to parties outside the entity may exist:

---

[4] See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), for guidance on auditors' reports issued in connection with audits of financial statements.

[5] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

a. To comply with certain legal and regulatory requirements

b. To a successor auditor when the successor makes inquiries in accordance with AU section 315, *Communications Between Predecessor and Successor Auditor* (AICPA, *Professional Standards*, vol. 1)

c. In response to a subpoena

d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance

Because potential conflicts between the auditor's ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs .79–.81 of AU section 316 with parties outside the client. See paragraphs .79–.82 of AU section 316 for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

13.41 Paragraph .83 of AU section 316 establishes requirements and provides guidance regarding certain items and events that the auditor should document.

Practical Guidance

13.42 The AICPA Practice Aid *Fraud Detection in a GAAS Audit* (Revised Edition) provides a wealth of information and help on complying with the provisions of AU section 316. This practice aid is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1).

Appendix A

Illustrative Financial Statements[*]

Illustrative Financial Statements of an Agricultural Producer[†]

The following financial statements illustrate one currently acceptable form of financial reporting for an agricultural producer accounting for inventories of growing crops, harvested crops, and cattle at the lower of cost or market. A separate statement of income, with supporting calculations, illustrates one method of reporting when inventories of harvested crops are carried at net realizable value. Other forms of financial statements are acceptable, and more or less information may be appropriate, depending on the circumstances. The amounts shown on the illustrative financial statements may not necessarily indicate customary relationships between accounts.

The notes to the illustrative financial statements are representative of the basic type of disclosure for an agricultural producer. Additional disclosures such as information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, accounting changes, off-balance-sheet risks, concentrations of credit risk, and other matters that are not unique to agricultural producers may be required by generally accepted accounting principles (GAAP).

These illustrative financial statements do not and are not intended to include items that should be accounted for under the requirements of Financial Accounting Standards Board (FASB) Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, and No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. Practitioners should refer to the applicable FASB statements and related amendments for guidance on reporting derivative and related financial instruments and hedging activities.

---

[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

[†] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. FASB Statement No. 150 affects the issuer's accounting for three types of freestanding financial instruments. One type is mandatorily redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets. A second type, which includes put options and forward purchase contracts, involves instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets. The third type of instruments that are liabilities under this statement is obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuers' shares. FASB Statement No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. In addition to its requirements for the classification and measurement of financial instruments in its scope, FASB Statement No. 150 also requires disclosures about alternative ways of settling the instruments and the capital structure of entities, all of whose shares are mandatorily redeemable.

Please refer to FASB Statement No. 150 and FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, for the effective date information.

Independent Auditor's Report

The Stockholders and Board of Directors
Grain and Cattle Producer, Inc.

We have audited the accompanying balance sheets of Grain and Cattle Producer, Inc., as of August 31, 20X2 and 20X1, and the related statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Grain and Cattle Producer, Inc., as of [at] August 31, 20X2 and 20X1, and the results of its operations and its

---

[1] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), replaces this sentence with the following sentence, "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

Auditing Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit of a nonissuer in accordance with both generally accepted accounting standards and PCAOB auditing standards. The Auditing Standards Board also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA Web site at www.aicpa.org/members/div/auditstd/index.htm for more information.

[2] This optional wording may be added in accordance with Auditing Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which addresses how auditors of nonissuers may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Firm Signature*]
Certified Public Accountants

City, State
October 18, 20X3

Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB), the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraph 85 of PCAOB Auditing Standard No. 5, *Audit of Internal Control Over Financial Reporting That is Integrated With An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for direction about reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of PCAOB Auditing Standard No. 5 for an illustrative example of a combined audit report.

If the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), X Company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

When performing an integrated audit, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraph 89 of PCAOB Auditing Standard No. 5 for direction about the report date in an audit of internal control over financial reporting.

Exhibit A-1

Grain and Cattle Producer, Inc.

Balance Sheets

	August 31, 20X2	August 31, 20X1
Assets		
Current assets		
Cash and cash equivalents	$112,000	$195,000
Receivables (notes 1 and 2)	510,000	475,000
Inventories (note 1)		
Feed and supplies	75,000	70,000
Grain	265,000	245,000
Cattle	410,000	445,000
Deposits and prepaid expenses	90,000	65,000
Total current assets	1,462,000	1,495,000
Investment (note 1)	54,000	47,000
Property and equipment, net (notes 1 and 3)	5,288,000	4,837,000
Total assets	$6,804,000	$6,379,000
Liabilities and Stockholders' Equity		
Current liabilities		
Notes payable (note 4)	$200,000	$200,000
Accounts payable and accrued expenses	247,000	267,000
Deferred tax liability, net (note 5)	17,722	13,514
Current maturities of long-term debt	250,000	200,000
Total current liabilities	714,722	680,514
Deferred tax liability, net (note 5)	192,278	159,486
Long-term debt (note 4)	3,020,000	2,925,000
Total liabilities	3,927,000	3,765,000
Stockholders' equity		
Common stock $100 par, authorized and issued 5,000 shares	500,000	500,000
Retained earnings	2,377,000	2,114,000
	2,877,000	2,614,000
Total liabilities and stockholders' equity	$6,804,000	$6,379,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-2

Grain and Cattle Producer, Inc.

Statements of Income[3] and Retained Earnings

	Years Ended August 31,	
	20X2	*20X1*
Revenue		
Grain	$2,365,000	$1,810,000
Cattle	1,110,000	1,378,000
Interest	15,000	17,000
Other	14,000	22,000
Total revenue	3,504,000	3,227,000
Costs and expenses		
Grain	1,395,000	1,090,000
Cattle	910,000	1,025,000
Interest expense	375,000	355,000
General and administrative expense	280,000	275,000
Total costs and expenses	2,960,000	2,745,000
Income before provision for taxes on income	544,000	482,000
Provision for taxes on income (note 5)	251,000	227,000
Net income	293,000	255,000
Retained earnings, beginning of year	2,114,000	1,889,000
Dividends paid	(30,000)	(30,000)
Retained earnings, end of year	$2,377,000	$2,114,000
Basic earnings per share	$ 58.60	$ 51.00
Dividends per share	$ 6.00	$ 6.00

The accompanying notes are an integral part of the financial statements.

[3] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement No. 130, *Reporting Comprehensive Income*, which establishes standards for the reporting and display of comprehensive income and its components. The statement requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The statement does not require a specific format for that financial statement but requires that an enterprise display an amount representing total comprehensive income for the period in that financial statement. The statement does not apply to an enterprise that has no items of other comprehensive income in any period presented.

Exhibit A-3

Grain and Cattle Producer, Inc.

Statements of Cash Flows

	Years Ended August 31, 20X2	20X1
Cash flows from operating activities:		
Net income	$ 293,000	$ 255,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	190,000	175,000
Deferred income tax	37,000	38,000
Gain on sale of property and equipment	(6,000)	(2,000)
Change in assets and liabilities:		
Decrease (increase) in receivables	55,000	(50,000)
Decrease (increase) in inventories	10,000	(70,000)
Increase in deposits and prepaid expenses	(25,000)	(15,000)
(Decrease)/Increase in accounts payable and accrued expenses	(20,000)	33,000
Net cash provided by operating activities	534,000	364,000
Cash flows from investing activities:		
Sale of property and equipment	90,000	72,000
Additions to property and equipment	(725,000)	(210,000)
Note receivable	(90,000)	—
Net cash used in investing activities	(725,000)	(138,000)
Cash flows from financing activities:		—
Repayment of notes payable	—	(50,000)
Issuance of long-term debt	345,000	—
Repayment of long-term debt	(200,000)	(200,000)
Allocated retains Central Supply Cooperative	(7,000)	(5,000)
Dividends	(30,000)	(30,000)
Net cash provided by (used in) financing activities	108,000	(285,000)
Net decrease in cash and cash equivalents	(83,000)	(59,000)
Cash and cash equivalents at beginning of year	195,000	254,000
Cash and cash equivalents at end of year	$ 112,000	$ 195,000
Supplemental disclosure of cash flow data:		
Cash paid during the years for:		
Interest (net of amounts capitalized)	$ 250,000	$ 225,000
Income taxes	$ 259,000	$ 220,000

The accompanying notes are an integral part of the financial statements.

Grain and Cattle Producer, Inc.
Notes to Financial Statements
Years Ended August 31, 20X2 and 20X1

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of operations. The company is an agricultural producer principally involved in breeding cattle and growing wheat and corn. The company sells primarily to domestic wholesale and retail distributors.

Use of estimates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash equivalents. The company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Receivables. Receivables from cattle and grain sales are based on contracted prices. The company provides an allowance for doubtful accounts which is based upon a review of outstanding receivables, historical collection information, and existing economic conditions. Normal trade receivables are due 30 days after the date of sale. Trade receivables past due more than 120 days are considered delinquent. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

Inventories. Cattle inventories are stated at the lower of cost (first-in, first-out method) or market. Costs of raised cattle include proportionate costs of breeding, including depreciation of the breeding herd, plus the costs of maintenance through the balance sheet date. Purchased cattle are carried at purchase cost plus costs of maintenance through the balance sheet date.

Harvested grain inventories are stated at the lower of cost (first-in, first-out method) or market. Growing crops are valued at the lower of cost or estimated market.

Investment. The investment in Central Supply Cooperative (Central) represents equities allocated to Grain and Cattle Producer, Inc. (the Company), by Central as of Central's most recent fiscal year-end, plus an accrual at the Company's fiscal year-end for anticipated patronage allocations. The accrual is based on the expected percentage (1 percent in both 20X2 and 20X1) of Central's total patronage applied to Central's interim operating results. Patronage refunds are credited to operating expenses.

Property and equipment. Property and equipment are stated at cost. Breeding animals are carried at purchase costs or inventory transfer amounts equal to the lower of accumulated animal maintenance costs or market. Depreciation is provided over the estimated useful lives of the assets on a straight-line basis (see note 3). Renewals and betterments are charged to property accounts. Costs of maintenance and repairs that do not improve or extend asset lives are charged to expense.

Long-lived assets. Long-lived assets to be held and used are tested for recoverability whenever events or changes in circumstances indicate that the related carrying amount may not be recoverable. When required, impairment losses on assets to be held and used are recognized based on the fair value of the asset and long-lived assets to be disposed of by sale are reported at the lower of carrying amount or fair value less cost to sell.[4]

Income taxes. Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in FASB Statement No. 109, *Accounting for Income Taxes*.[‡] As changes in tax laws or rate are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Basic earnings per share. Basic earnings per share of common stock were computed by dividing income available to common stockholders, by the weighted average number of common shares outstanding for the year. Diluted earnings per share are not presented because the Company has issued no dilutive potential common shares.

---

[4] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement No. 157, *Fair Value Measurements* and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. See chapter 12, paragraphs 12.22–.26 of this guide for discussion regarding FASB Statement Nos. 157 and 159.

[‡] FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition.

FSP FIN 48-1, *Definition of* Settlement *in FASB Interpretation No. 48*, amends FIN 48 and provides guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. The AICPA has also issued a 13 page nonauthoritative practice guide titled, *Practice Guide on Accounting for Uncertain Tax Positions Under FSP FIN 48*, which is free to all AICPA members.

In December 2007, FASB issued FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*. This FSP applies to nonpublic enterprises subject to the provisions of FIN 48 unless that nonpublic enterprise (*a*) is a consolidated entity of a public enterprise that applies U.S. generally accepted accounting principles (GAAP) or (*b*) has issued a full set of U.S. GAAP annual financial statements prior to the issuance of this FSP using the recognition, measurement, and disclosure requirements of FIN 48. This FSP defers the effective date of FIN 48 for nonissuing enterprises included within this FSP's scope to the annual financial statements for fiscal years beginning after December 15, 2007. When effective, FIN 48 should be applied as of the beginning of the enterprise's fiscal year.

2. Receivables

Receivables are composed of the following:

	August 31,	
	20X2	20X1
Note secured, due January 20X3, interest at 12%	$90,000	
Grain receivables	100,000	$110,000
Livestock receivables	298,000	320,000
Price-later receivables	50,000	65,000
Other	10,000	15,000
Less: Allowance for doubtful accounts	(38,000)	(35,000)
	$510,000	$475,000

3. Property and Equipment

Property and equipment are stated at cost. A summary of the Company's facilities is shown below.

	August 31,		
	20X2	20X1	Useful Lives
Land	$3,678,000	$3,214,000	
Buildings and land improvements	840,000	800,000	5-40 years
Machinery and equipment	560,000	515,000	3-15 years
Feedlot facilities	285,000	270,000	10-25 years
Breeding herd	1,025,000	978,000	8 years
	6,388,000	5,777,000	
Less accumulated depreciation,	1,100,000	940,000	
Property and equipment, net	$5,288,000	$4,837,000	

Depreciation charged against income for the years ended August 31, 20X2 and 20X1, amounted to $190,000 and $175,000, respectively.

Note: FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* requires certain disclosures if an impairment loss is recognized for assets to be held and used. An example of such a disclosure is shown below:

> *Recently adopted environmental legislation has placed certain restrictions on the use of agricultural machinery and equipment owned and operated by the company. This circumstance has called into question the recoverability of the carrying amounts of these assets. As a result, pursuant to FASB Statement No. 144, an impairment loss of $X,XXX has been recognized for this equipment and included as a component of income before income taxes under the caption "General and Administrative expense." In calculating the impairment loss, fair value was determined by reviewing quoted market prices for current sales of similar equipment.*

4. Long-Term Debt and Short-Term Borrowings

Long-term debt. The long-term debt, which is collateralized by real estate, outstanding as of August 31, 20X2 and 20X1, is summarized below.

	August 31, 20X2	August 31, 20X1
Payable in annual principal installments of $200,000 with final installment of $125,000 in 20Y6; interest at 11%	$2,925,000	$3,125,000
Payable in annual principal installments of $50,000 with final installment of $45,000 in 20X8; interest at 14.5%	345,000	
	3,270,000	3,125,000
Less amount due within one year	250,000	200,000
Balance, due after one year	$3,020,000	$2,925,000

Maturities of long-term debt for each of the five fiscal years subsequent to August 31, 20X2, are as follows.

20X3	$ 250,000
20X4	250,000
20X5	250,000
20X6	250,000
20X7	250,000
Total	$1,250,000

The debt agreements contain a number of restrictive covenants on the payment of dividends including, among other things, a limit of 75 percent of the net earnings over $100,000 per year.

Short-term borrowings. The Company had a short-term line of credit with First National Bank of up to $300,000 in 20X2 and $250,000 in 20X1. The average interest rates were 17 percent and 18 percent for the years ended August 31, 20X2 and 20X1, respectively.

5. Income Taxes

The provision for income taxes consist of the following:

	Years Ended August 31, 20X2	20X1
Current		
Federal	$197,000	$175,000
State	17,000	14,000
Total current	214,000	189,000
Deferred		
Federal	28,000	30,000
State	9,000	8,000
Total deferred	37,000	38,000
Total	$251,000	$227,000

The net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes are reflected in deferred income taxes. Significant components of the company's deferred tax liabilities as of August 31, 20X2 and 20X1 are as follows:

	Years Ended August 31, 20X2	20X1
Current deferred tax assets/(liabilities)		
Inventory valuation methods	$ 5,523	$ 1,986
Capitalized costs	(23,245)	(15,500)
Total current deferred tax liability	$(17,722)	$(13,514)
Noncurrent deferred tax assets/(liabilities)		
Accelerated depreciation	(175,462)	(142,435)
Other, (net)	(16,816)	(17,051)
Total noncurrent deferred tax liability	$(192,278)	$(159,486)

A reconciliation of the income tax provision with amounts determined by applying the federal statutory rate to income before income taxes is as follows:

	Years Ended August 31, 20X2	20X1
Federal statutory income tax rate	34.0%	34.0%
State and local income tax	4.8	4.6
Nondeductible expenses	4.6	5.1
Other	2.7	3.4
Effective tax rate	46.1%	47.1%

6. Fair Value of Financial Instruments[5]

The carrying amount of the company's current maturities of long-term debt approximate their fair value. The fair value of net long-term debt, which is based upon borrowing rates currently available to the company for debt issues with similar terms and maturities, is $2,895 (20X1, $2,640).[6,7]

---

[5] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement Nos. 157 and 159. See chapter 12, paragraphs 12.22–.26 of this guide for discussion regarding FASB Statement Nos. 157 and 159.

[6] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment of FASB Statement No. 107*, which amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria:

a. The entity is a nonpublic entity.

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

[7] AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures. Please refer to paragraphs 12.35–.38 of this guide for a discussion of auditing fair value measurements and disclosures.

Exhibit A-4

Grain and Cattle Producer, Inc.

Statements of Income

The presentation in exhibit A-5 illustrates the statements of income of Grain and Cattle Producer, Inc., with grain inventories valued at net realizable value.[8] The amounts included in the statement are based on the following cost and market amounts.

	20X2	*20X1*	*20X0*
Ending inventory at cost	$ 265,000	$ 245,000	$ 180,000
Ending inventory at net realizable value	$ 290,000	$ 263,000	$ 200,000
Cost of grain sold, with inventory stated at cost	$1,395,000	$1,090,000	
Adjusted for the change in the cost of inventories:			
for 20X2 ($265,000 less $245,000)	20,000	—	
for 20X1 ($245,000 less $180,000)	—	65,000	
Costs incurred for grain production	1,415,000	1,155,000	
Beginning inventory at net realizable value	263,000	200,000	
Ending inventory at net realizable value	(290,000)	(263,000)	
Cost of grain sold, with inventory stated at net realizable value	$1,388,000	$1,092,000	

[8] Paragraph 039 of SOP 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives* (AICPA, *Technical Practice Aids*, ACC sec. 10,390) [appendix B], provides the criteria necessary to value inventories of producers at sales price less estimated costs of disposal.

Exhibit A-5

Grain and Cattle Producer, Inc.

Alternative Statements of Income[9]

	Years Ended August 31,	
	20X2	*20X1*
Revenue		
Sales of grain	$2,365,000	$1,810,000
Sales of cattle	1,110,000	1,378,000
Interest	15,000	17,000
Other	14,000	22,000
Total revenue	3,504,000	3,227,000
Costs and expenses		
Grain	1,388,000	1,092,000
Cattle	910,000	1,025,000
Interest expense		375,000
General and administrative expense	280,000	275,000
Total costs and expenses	2,953,000	2,747,000
Income before income taxes	$ 551,000	$ 480,000

[9] This statement of income assumes grain inventories are accounted for at net realizable value.

Illustrative Financial Statements of Agricultural Cooperatives[10]

The following financial statements of cooperatives are included for illustrative purposes only and are not intended to establish reporting requirements. Furthermore, the dollar amounts shown are illustrative only and may not indicate any customary relationship among accounts. These financial statements do not include all the accounts and transactions that might be found in practice. The notes indicate the subject matter generally disclosed. In addition to the illustrative notes that are presented, some of which are peculiar to cooperatives, financial statements of cooperatives should include any other appropriate disclosures, such as information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, accounting changes, off-balance-sheet risks, concentrations of credit risk, and other matters that are not unique to agricultural cooperatives. Certain disclosures included in the illustrative financial statements may not be required for nonpublic companies.

In the illustrative cooperative financial statements, it is assumed that the distribution of patronage proceeds or margins in cash and allocated equities is in accordance with appropriate action of the board of directors prior to the issuance of the financial statements. It is further assumed that amounts shown as allocated equities do not have attributes of debt, such as fixed due dates or interest bearing, that would suggest that those instruments be treated as liabilities.[11]

The financial statements for Midstate Marketing Cooperative (exhibits A-7–A-11) have been prepared on the basis of charging cost of production for patrons' raw product deliveries, and valuing inventories of finished goods and goods in process at the lower of cost or market. However, for illustrative purposes certain statements for Midstate are presented (1) as if no value had been assigned to patrons' raw product deliveries and inventories of finished goods and goods in process had been valued at net realizable value (exhibits A-13 and A-14) and (2) as if cost of production had been charged for patrons' raw product deliveries and inventories of finished goods and goods in process had been valued at net realizable value (exhibit A-13). The above three methods are acceptable in accordance with paragraphs 083–085 of SOP 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives* (AICPA, *Technical Practice Aids*, ACC sec. 10,390) [appendix B].

In the accompanying illustrative statements of amounts due to patrons (exhibits A-9, A-14, and A-16) and the illustrative statements of net operations (exhibits A-8, A-13, and A-15), net proceeds are classified as to patronage and nonpatronage. For Midstate Marketing Cooperative (exhibit A-8) and Central Supply Cooperative (exhibit A-18), margins before income taxes are comparable with earnings of other corporate entities before income taxes.

---

[10] The staff of the SEC may require a different financial statement format in filings with the SEC depending on the particular circumstances.

[11] Some agricultural cooperatives may have retained allocated equities which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under FASB Statement No. 150, and as such may have to be classified as liabilities. However, in accordance with FSP FAS 150-3, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

Midstate Marketing Cooperative, as an agricultural marketing cooperative, differs from agricultural supply cooperatives and nonagricultural cooperatives because it receives agricultural products from its patrons, processes and markets those products, and returns to its patrons the patronage earnings in cash and allocated equities. Therefore an illustrative statement of amounts due to patrons is included showing an analysis of the distribution of the cooperative's patronage proceeds.

Exhibit A-6

Midstate Marketing Cooperative

Balance Sheets||

	April 30, 20X2	April 30, 20X1
Assets		
Current assets		
Cash and cash equivalents	$2,890,000	$6,360,000
Accounts receivable (notes 1, 2, and 4)	13,120,000	9,600,000
Inventories (notes 3 and 4)	35,050,000	30,980,000
Prepaid expenses and other current assets	1,170,000	1,370,000
Total current assets	52,230,000	48,310,000
Investment and other assets		
Investment in Bank for Cooperatives	6,200,000	5,340,000
Trademarks	1,600,000	2,000,000
Other assets	370,000	190,000
Total investments and other assets	8,170,000	7,530,000
Property, plant, and equipment (note 4)		
Land	1,130,000	1,130,000
Buildings and improvements	10,970,000	10,860,000
Machines and equipment	25,280,000	19,760,000
Total property, plant, and equipment	37,380,000	31,750,000
Less accumulated depreciation	(13,670,000)	(12,170,000)
Net property, plant, and equipment	23,710,000	19,580,000
Total assets	$84,110,000	$75,420,000
Liabilities and Patrons' Equities		
Current liabilities		
Notes payable to bank (note 4)	$17,480,000	$16,950,000
Accounts payable and accrued expenses	8,100,000	7,480,000
Salaries, wages, and related payroll taxes	1,560,000	1,080,000
Due to patrons	10,260,000	8,910,000
Deferred tax liability, net (note 5)	500,895	458,797
Current portion of long-term debt	2,890,000	2,890,000
Total current liabilities	40,790,895	37,768,797
Deferred tax liability, net (note 5)	1,799,105	1,541,203
Long-term debt (note 4)	13,210,000	16,100,000
Patrons' equities		
Allocated equities	26,360,000	19,710,000
Unallocated equities	1,950,000	300,000
	28,310,000	20,010,000
Total liabilities and patrons' equities	$84,110,000	$75,420,000

The accompanying notes are an integral part of the financial statements.

|| See footnote || in exhibit A-5.

Exhibit A-7

Midstate Marketing Cooperative

Statements of Operations[11]

	Years Ended April 30,	
	20X2	*20X1*
Net sales	$129,630,000	$110,110,000
Expenses		
Cost of sales (including proportionate share of assigned value of patrons' raw products received)	84,630,000	70,200,000
Selling, general, and administrative expense	19,380,000	18,900,000
Interest expense	5,090,000	4,750,000
Total expenses	109,100,000	93,850,000
Proceeds before provision for taxes on income	20,530,000	16,260,000
Provision for taxes on income (note 5)	1,250,000	900,000
Net proceeds	$19,280,000	$15,360,000
Patronage	17,630,000	14,100,000
Nonpatronage	1,650,000	1,260,000
	$19,280,000	$15,360,000

The accompanying notes are an integral part of the financial statements.

[11] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement No. 130, which establishes standards for the reporting and display of comprehensive income and its components. The statement requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The statement does not require a specific format for that financial statement but requires that an enterprise display an amount representing total comprehensive income for the period in that financial statement. The statement does not apply to an enterprise that has no items of other comprehensive income in any period presented.

Exhibit A–8

Midstate Marketing Cooperative

Statements of Amounts Due to Patrons[||]

	April 30, 20X2	April 30, 20X1
Amounts due to patrons at beginning of year	$8,910,000	$9,070,000
Assigned value of patrons' raw products (approximates market at date of receipt)	56,500,000	51,500,000
Net patronage proceeds	17,630,000	14,100,000
Total	83,040,000	74,670,000
Less:		
Amounts paid to patrons in cash	58,830,000	53,240,000
Amounts retained as:		
Per-unit retains	5,650,000	5,250,000
Equity credits	8,300,000	7,270,000
Total	72,780,000	65,760,000
Amounts due to patrons at end of year	$10,260,000	$ 8,910,000

The accompanying notes are an integral part of the financial statements.

[||] See footnote || in exhibit A-5.

Exhibit A-9

Midstate Marketing Cooperative

Statements of Patrons' Equities[||]

	Allocated			
	Equity Credits	*Per-Unit Retains*	*Total*	*Unallocated Equities (Deficit)*
Balance, April 30, 20X0	$8,730,000	$5,210,000	$13,940,000	$ (960,000)[12]
Patronage proceeds	7,270,000	—	7,270,000	—
Refund of prior years' allocated equities	(6,750,000)	—	(6,750,000)	—
Per-unit retains	—	5,250,000	5,250,000	—
Nonpatronage proceeds	—	—	—	1,260,000
Balance, April 30, 20X1	9,250,000	10,460,000	19,710,000	300,000
Patronage proceeds	8,300,000	—	8,300,000	—
Refund of prior years' allocated equities	(7,300,000)	—	(7,300,000)	—
Per-unit retains	—	5,650,000	5,650,000	—
Nonpatronage proceeds	—	—	—	1,650,000
Balance, April 30, 20X2	$10,250,000	$16,110,000	$26,360,000	$1,950,000

The accompanying notes are an integral part of the financial statements.

[||] See footnote || in exhibit A-5.

[12] Central Supply Cooperative, a patron of Midstate Marketing Cooperative, did not record its proportionate share of its investee's unallocated loss because of the assumption that the interim financial statements and projections reflected nonpatronage proceeds sufficient to offset the loss.

Exhibit A-10

Midstate Marketing Cooperative
Statements of Cash Flows

	Years Ended April 30, 20X2	20X1
Cash flows from operating activities:		
Net proceeds	$19,280,000	$15,360,000
Adjustments to reconcile net proceeds to net cash provided by operating activities:		
Depreciation and amortization	3,500,000	3,200,000
Provisions for losses on accounts receivable	50,000	(10,000)
Deferred income taxes	300,000	160,000
Change in noncash current assets and liabilities:		
Accounts receivable	(3,570,000)	660,000
Inventories	(4,070,000)	(1,100,000)
Prepaid expenses and other current assets	200,000	(250,000)
Accounts payable and accrued expenses	620,000	580,000
Salaries, wages, and related payroll taxes	480,000	(220,000)
Amounts due to patrons	1,350,000	400,000
Net cash provided by operating activities	18,140,000	18,780,000
Cash flows from investing activities:		
Property, plant, and equipment additions	(7,230,000)	(5,440,000)
Investments and other assets	(1,040,000)	(520,000)
Net cash used in investing activities	(8,270,000)	(5,960,000)
Cash flows from financing activities:		
Repayment of long-term debt	(2,890,000)	(2,890,000)
Increase in notes payable to bank	530,000	1,000,000
Per-unit retains	5,650,000	5,250,000
Patronage distributions	(9,330,000)	(6,830,000)
Payment of prior years' retains	(7,300,000)	(6,750,000)
Net cash used in financing activities	(13,340,000)	(10,220,000)
Net Change in cash and cash equivalents	(3,470,000)	2,600,000
Cash and cash equivalents at beginning of year	6,360,000	3,760,000
Cash and cash equivalents at end of year	$2,890,000	$6,360,000
Supplemental disclosure of cash flow data:		
Cash paid during the years for:		
Interest (net of amounts capitalized)	$5,500,000	$5,250,000
Income taxes	$1,300,000	$ 800,000

The accompanying notes are an integral part of the financial statements.

Midstate Marketing Cooperative

Notes to Financial Statements

Years Ended April 30, 20X2 and 20X1

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of operations. Midstate Marketing Cooperative is an agricultural cooperative association operating on a pool basis, and it is organized for the purpose of processing and marketing fruits and vegetables delivered by its patrons who are principally agricultural producers located in the Midwestern region of the United States. Deliveries from nonmember growers may also be accepted on a patronage or nonpatronage basis. Patrons are credited for the assigned amounts (as determined by the board of directors) of raw products delivered. Net proceeds or losses from patronage business are allocated to patrons on the basis of their participation in the total established value of the related pool.

Use of estimates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Equity requirements, as determined by the board of directors, are retained from amounts due to patrons and credited to patrons' equity.

Unallocated equities arising from nonpatronage business and certain nonrecurring revenues and expenses, less income taxes, are not allocated to patrons.

Cash equivalents. The cooperative considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Accounts receivable. Receivables from fruits and vegetables sales are based on contracted prices. The company provides an allowance for doubtful accounts which is based upon a review of outstanding receivables, historical collection information, and existing economic conditions. Normal trade receivables are due 30 days after the date of sale. Trade receivables past due more than 120 days are considered delinquent. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

Inventories. The cooperative's inventories are stated at the lower of cost or market using the first-in, first-out method (FIFO). Raw products received from members are included as an element of cost at their assigned amounts.

Investments. The investment in the Bank for Cooperatives consists of class C stock at cost and the cooperative's share of the bank's allocated surplus. Patronage refunds are credited to interest expense.

Trademarks. Purchase costs of trademarks are capitalized and amortized over 10 years.

Property, plant, and equipment. Property, plant, and equipment are stated at cost. Depreciation is computed principally by using the straight-line method over the estimated useful lives of the related depreciable assets. Expenditures for betterments and renewals that extend useful lives are capitalized. Gains and losses on retirements and disposals are included in net proceeds.

Long-lived assets. Long-lived assets to be held and used are tested for recoverability whenever events or changes in circumstances indicate that the related carrying amount may not be recoverable. When required, impairment losses on assets to be held and used are recognized based on the fair value of the asset and long-lived assets to be disposed of by sale are reported at the lower of carrying amount or fair value less cost to sell.[13]

Patrons' equities.[||] In accordance with its bylaws, the cooperative allocates patronage proceeds to patrons, as determined for income tax purposes, in cash and equity certificates in proportions determined by its board of directors.

Income taxes. The cooperative, as a nonexempt cooperative, is taxed on nonpatronage proceeds and any patronage proceeds not paid or allocated to patrons. Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in FASB Statement No. 109.[‡] As changes in tax laws or rate are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

2. Accounts Receivable

Receivables are composed of the following:

	April 30,	
	20X2	20X1
Fruit receivables	$7,485,000	$5,530,000
Vegetable receivables	6,110,000	4,500,000
Other	25,000	20,000
Less: Allowance for doubtful accounts	(500,000)	(450,000)
	$13,120,000	$9,600,000

3. Inventories

A summary of inventories follows.

	April 30,	
	20X2	20X1
Finished goods	$28,040,000	$22,820,000
Goods in process	4,320,000	5,560,000
Materials and supplies	2,690,000	2,600,000
Total	$35,050,000	$30,980,000

---

[13] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement Nos. 157 and 159. See chapter 12, paragraphs 12.22–.26 of this guide for discussion regarding FASB Statement Nos. 157 and 159.

[||] See footnote || in exhibit A-5.

[‡] See footnote ‡ in exhibit A-3.

4. Notes Payable to Bank and Long-Term Debt

Notes payable to the bank consist of short-term loans from the Bank for Cooperatives. Following is a summary of such borrowings during the years ended April 30, 20X2 and 20X1.

	April 30,	
	20X2	*20X1*
Borrowings as of April 30	$17,480,000	$16,950,000
Average interest rate on year-end borrowings	17.5%	13%
Average borrowings during the year	$19,500,000	$16,500,000
Average interest rate on borrowings during the year	15.75%	14.5%
Maximum borrowings during the year	$20,060,000	$25,000,000

Long-term debt consists of notes payable to the Bank for Cooperatives, which bear interest at 12.5 percent. Payments are due in varying installments through 20X8. Aggregate annual principal payments applicable to long-term debt for years subsequent to April 30, 20X2 are as follows.

Year Ending April 30,	
20X3	$2,890,000
20X4	2,890,000
20X5	2,890,000
20X6	2,270,000
Thereafter	2,270,000
Total	$13,210,000

Essentially, all accounts receivable and inventories are pledged as collateral under the short-term agreement.

The long-term notes are secure. I hope your weed by property, plant, and equipment with a net book value of $18 million and by the investment in the Bank for Cooperatives.

The debt agreements with the Bank contain a number of restrictive covenants, including limitations on equipment purchases and prior approval of the Bank on revolvement of retained equities.[#]

[#] See footnote † to the foreword to the Illustrative Financial Statements of Agricultural Cooperatives for the discussion of FASB Statement No. 150. FASB Statement No. 150 may have a significant impact on debt covenants by reducing the cooperative's reported capital.

5. Income Taxes

The provision for income taxes consists of the following:

	Years Ended April 30,	
	20X2	*20X1*
Current		
Federal	$790,000	$470,000
State	160,000	100,000
Total current	950,000	570,000
Deferred		
Federal	250,000	270,000
State	50,000	60,000
	300,000	330,000
Total deferred	$1,250,000	$900,000

The net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes are reflected in deferred income taxes. Significant components of the cooperative's deferred tax liabilities as of April 30, 20X2 and 20X1 are as follows:

	Years Ended April 30,	
	20X2	*20X1*
Current deferred tax assets/(liabilities)		
Inventory valuation methods	$22,105	$28,203
Capitalized costs	(523,000)	(487,000)
Total current deferred tax liability	$ (500,895)	$ (458,797)
Noncurrent deferred tax assets/(liabilities)		
Accelerated depreciation	(1,762,289)	(1,523,152)
Other, (net)	(36,816)	(18,051)
Total noncurrent deferred tax liability	$(1,799,105)	$(1,541,203)

A reconciliation of the income tax provision with amounts determined by applying the federal statutory rate to income before income taxes is as follows:

	Years Ended August 31	
	20X2	*20X1*
Federal statutory income tax rate	35.0%	35.0%
Qualified patronage distributions	(34.3)	(31.7)
State and local income tax	10.0	9.8
Other (net)	(4.6)	(7.6)
Effective tax rate	6.1%	5.5%

6. Fair Value of Financial Instruments[14]

The carrying amount of the cooperative's current portion of long-term debt, approximates its fair value. The fair value of net long-term debt, which is based upon borrowing rates currently available to the Company for debt issues with similar terms and maturities, is $13,125 (20X1, $15,843).[15,16]

---

[14] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement Nos. 157 and 159. See chapter 12, paragraphs 12.22–.26 of this guide for discussion regarding FASB Statement Nos. 157 and 159.

[15] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement No. 126, which amends FASB Statement No. 107 to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria:

a. The entity is a nonpublic entity.

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

[16] AU section 328 contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures. Please refer to paragraphs 12.35–.38 of this guide for a discussion of auditing fair value measurements and disclosures.

Exhibit A-11

Midstate Marketing Cooperative

Statements of Operations[17]

	Years Ended April 30,	
	20X2	*20X1*
Net sales	$129,630,000	$110,110,000
Product inventory, ending	35,596,000	31,218,000
Product inventory, beginning	(31,218,000)	(24,200,000)
Gross proceeds	134,008,000	117,128,000
Cost and expenses		
Processing and packing	32,110,000	25,080,000
Selling, general, and administrative expenses	19,380,000	18,900,000
Interest expense	5,090,000	4,750,000
	56,580,000	48,730,000
Proceeds before income taxes	77,428,000	68,398,000
Income taxes (note 4)	1,250,000	900,000
Net proceeds	$76,178,000	$67,498,000
Patronage	$74,528,000	$66,238,000
Nonpatronage	1,650,000	1,260,000
	$76,178,000	$67,498,000

[17] In this example, no charge to cost of production has been made for patrons' raw product deliveries, and inventories of finished goods and goods in process have been valued at net realizable value.

Exhibit A-12

Midstate Marketing Cooperative
Statements of Amounts Due to Patrons[||,18]

	Years Ended April 30,	
	20X2	20X1
Amounts due to patrons at beginning of year	$11,748,000	$11,270,00
Net patronage proceeds	74,528,000	66,238,000
	86,276,000	77,508,000
Less:		
Amounts paid to patrons in cash	58,830,000	53,240,000
Amounts retained as:		
Per-unit retains	5,650,000	5,250,000
Equity credits	8,300,000	7,270,000
	72,780,000	65,760,000
Amounts due to patrons at end of year	$13,496,000	$11,748,000

[||] See footnote || in exhibit A-5.

[18] The amounts due to patrons at the end of the year are the same as shown in the financial statements in which cost of production has been charged for patrons' raw product deliveries and inventories of finished goods and goods in process have been valued at the lower of cost or market, except for the difference in valuing those inventories at the end of the year. The amounts due patrons are reconciled as follows:

Amounts due to patrons, with inventories valued at the lower of cost or market	$10,260,000	$8,910,000
Add adjustments of inventories to net realizable value	3,236,000	2,838,000
Amounts due patrons, with inventories valued at net realizable value	$13,496,000	$11,748,000

Inventories. Product inventories are stated at estimated net realizable values, determined by reducing sales value for completion, direct distribution, and selling costs. Supply inventories are stated at the lower cost or market using the first-in, first-out method (FIFO).

Inventories consist of the following:

	April 30,	
	20X2	20X1
Finished goods	$30,844,000	$25,102,000
Goods in process	4,752,000	6,116,000
Materials and supplies	2,690,000	2,600,000
Total	$38,286,000	$33,818,000

Exhibit A-13

Midstate Marketing Cooperative
Statements of Operations[19]

	Years Ended April 30,	
	20X2	20X1
Net sales	$129,630,000	$110,110,000
Expenses		
Costs of sales (including proportionate share of assigned value of patrons' raw products received)	84,232,000	69,562,000
Selling, general, and administrative expense	19,380,000	18,900,000
Interest expense	5,090,000	4,750,000
Total expenses	108,702,000	93,212,000
Proceeds before income taxes	20,928,000	16,898,000
Provision for taxes on income (note 5)	1,250,000	900,000
Net proceeds	$19,678,000	$15,998,000
Patronage	$18,028,000	$14,738,000
Nonpatronage	1,650,000	1,260,000
	$19,678,000	$15,998,000

[19] In determining net proceeds in this example, charges to cost of production, in the amounts of $56,500,000 and $51,500,000 for 20X2 and 20X1, respectively, have been made for patrons' raw product deliveries, with corresponding credits to amounts due to patrons. Inventories have been valued at net realizable value.

Exhibit A-14

Midstate Marketing Cooperative
Statements of Amounts Due to Patrons[||,20]

	April 30, 20X2	April 30, 20X1
Amounts due to patrons at beginning of year	$11,748,000	$11,270,000
Net patronage proceeds	18,028,000	14,738,000
Assigned value of patrons' raw product	56,500,000	51,500,000
Total	86,276,000	77,508,000
Less:		
Amounts paid to patrons in cash	58,830,000	53,240,000
Amounts retained as:		
Per-unit retains	5,650,000	5,250,000
Equity credits	8,300,000	7,270,000
	72,780,000	65,760,000
Amounts due to patrons at end of year	$13,496,000	$11,748,000

[||] See footnote || in exhibit A-5.

[20] The amounts due to patrons at the end of the year are the same as shown in the financial statements in which cost of production has been charged for patrons' raw product deliveries and inventories of finished goods and goods in process have been valued at the lower of cost or market, except for the difference in valuing those inventories at the end of the year. The amounts due patrons are reconciled as follows:

	April 30, 20X2	April 30, 20X1
Amounts due to patrons, with inventories valued at the lower of cost or market	$10,260,000	$8,910,000
Add adjustments of inventories to net realizable value	3,236,000	2,838,000
Amounts due patrons, with inventories valued at net realizable value	$13,496,000	$11,748,000

Inventories. Product inventories are stated at estimated net realizable values, determined by reducing sales value for completion, direct distribution, and selling costs. Supply inventories are stated at the lower cost or market using the FIFO.

Inventories consist of the following:

	April 30, 20X2	April 30, 20X1
Finished goods	$30,844,000	$25,102,000
Goods in process	4,752,000	6,116,000
Materials and supplies	2,690,000	2,600,000
Total	$38,286,000	$33,818,000

Exhibit A-15

Central Supply Cooperative

Balance Sheets||

	May 31, 20X2	May 31, 20X1
Assets		
Current assets		
Cash and cash equivalents	$2,650,000	$2,819,000
Accounts receivable (notes 1, 2, and 4)	6,573,000	6,298,000
Inventories (notes 3 and 4)	15,520,000	14,686,000
Advances on grain purchases and margin deposits	1,240,000	1,610,000
Prepaid expenses and other current assets	1,195,000	1,306,000
Total current assets	27,178,000	26,719,000
Investments and other assets		
Investment in Midstate Marketing Cooperative	1,357,000	1,020,000
Investment in Bank for Cooperatives	1,274,000	1,160,000
Investment in Farm Fertilizers, Inc.	980,000	908,000
Other assets	126,000	192,000
	3,737,000	3,280,000
Property, plant, and equipment (note 4)		
Land and land improvements	1,248,000	1,736,000
Buildings and improvements	10,753,000	9,726,000
Machinery and equipment	20,154,000	17,622,000
Automobiles and trucks	1,197,000	1,173,000
	33,352,000	30,257,000
Less accumulated depreciation	(10,165,000)	(8,247,000)
Net property, plant, and equipment	23,187,000	22,010,000
Total assets	$54,102,000	$52,009,000

(continued)

|| See footnote || in exhibit A-5.

Exhibit A-15, continued

	May 31, 20X2	May 31, 20X1
Liabilities and Patrons' Equities		
Current liabilities		
Notes payable to bank (note 4)	$7,084,000	$6,473,000
Accounts payable and accrued expenses	10,994,000	11,045,000
Salaries, wages, and related payroll taxes	2,230,000	1,985,000
Patronage refunds payable	874,000	619,000
Deferred tax liability, net (note 5)	126,200	177,500
Current portion of long-term debt	560,000	1,230,000
Total current liabilities	21,868,200	21,529,500
Deferred tax liability, net (note 5)	1,400,800	1,176,500
Long-term debt (note 4)	8,978,000	10,208,000
Commitments and contingencies (note 6)		
Patrons' equities		
Preferred stock, 6% noncumulative, $100 par value: Authorized, 100,000 shares		
Issued and outstanding, 54,840 and 37,380 shares	5,484,000	3,738,000
Common stock, voting, $100 par value:		
Authorized, 25,000 shares		
Issued and outstanding, 5,070 and 5,020 shares	507,000	502,000
Allocated equities	13,650,000	13,632,000
Unallocated equities	2,214,000	1,223,000
Total patrons' equities	21,855,000	19,095,000
Total liabilities and patrons' equities	$54,102,000	$52,009,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-16

Central Supply Cooperative
Statements of Operations

	Years Ended May 31,	
	20X2	20X1
Revenues		
Farm supply sales	$71,681,000	$67,391,000
Farm marketing sales	37,939,000	32,963,000
Other	1,055,000	978,000
	110,675,000	101,332,000
Costs and expenses		
Costs of raw materials, operations, and distribution	98,509,000	91,589,000
General and administrative expense	3,149,000	2,913,000
Interest expense	2,785,000	2,610,000
	104,443,000	97,112,000
Margins before provision for taxes on income	6,232,000	4,220,000
Provision for taxes on income (note 6)	650,000	545,000
Net margins	$5,582,000	$3,675,000
Net patronage margins to be distributed as follows:		
Cash	$874,000	$619,000
Preferred stock	1,746,000	1,238,000
Allocated equities	1,747,000	1,238,000
	4,367,000	3,095,000
Nonpatronage margins to unallocated equities	1,215,000	580,000
	$5,582,000	$3,675,000

The accompanying notes are an integral part of the financial statements.

Exhibit A-17

Central Supply Cooperative
Statements of Patrons' Equities||

	Allocated			
	Preferred Stock	*Common Stock*	*Allocated Equities*	*Unallocated Margins*
Balance, May 31, 20X0	$2,500,000	$500,000	$15,268,000	$ 793,000
Patronage margins	1,238,000		1,238,000	
Refund of prior years' allocated equities			(2,874,000)	
Net nonpatronage margins				580,000
Preferred stock dividends				(150,000)
New memberships, net		2,000		
Balance, May 31, 20X1	3,738,000	502,000	13,632,000	1,223,000
Patronage margins	1,746,000		1,747,000	
Refund of prior years' allocated equities			(1,729,000)	
Nonpatronage margins				1,215,000
Preferred stock dividends				(224,000)
New memberships, net		5,000		
Balance, May 31, 20X2	$5,484,000	$507,000	$13,650,000	$2,214,000

The accompanying notes are an integral part of the financial statements.

|| See footnote || in exhibit A-5.

Exhibit A-18

Central Supply Cooperative
Statements of Cash Flows

	Years Ended May 31, 20X2	20X1
Cash flows from operating activities:		
Net margins	$5,582,000	$3,675,000
Noncash items included in net margins:		
Depreciation and amortization	2,937,000	2,537,000
Provisions for losses on accounts receivable	110,000	25,000
Deferred income taxes	173,000	120,000
Change in noncash current assets and liabilities:		
Receivables	(385,000)	(81,000)
Inventories	(834,000)	129,000
Advances on grain purchases and margin deposits	370,000	(87,000)
Prepaid expenses and other current assets	111,000	(58,000)
Accounts payable and accrued expenses	(51,000)	29,000
Salaries, wages, and related payroll taxes	245,000	(146,000)
Net cash provided by operating activities	8,258,000	6,143,000
Cash flows from investing activities:		
Acquisitions of investments and other assets	(457,000)	(175,000)
Acquisitions of property, plant, and other equipment	(4,723,000)	(5,044,000)
Proceeds from sales of property, plant, and equipment	609,000	4,078,000
Net cash used in investing activities	(4,571,000)	(1,141,000)
Cash flows from financing activities:		
Increase in notes payable to bank	611,000	157,000
Repayment of long-term debt	(1,900,000)	(1,175,000)
Patronage refunds and other equity paid in cash	(2,572,000)	(3,811,000)
Proceeds from issuance of common stock	5,000	2,000
Net cash used in financing activities	(3,856,000)	(4,827,000)
Net change in cash and cash equivalents	(169,000)	175,000
Cash and cash equivalents at beginning of year	2,819,000	2,644,000
Cash and cash equivalents at end of year	$2,650,000	$2,819,000
Supplemental disclosure of cash flow data:		
Cash paid during the years for:		
Interest (net of amounts capitalized)	$2,919,000	$2,733,000
Income taxes paid	$715,000	$428,000

The accompanying notes are an integral part of the financial statements.

Central Supply Cooperative

Notes to Financial Statements

Years Ended May 31, 20X2 and 20X1

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of operations. Central Supply Cooperative is an agricultural cooperative association organized to provide a supply source for members and to market farm products delivered by members. The Cooperative's members are located primarily in the Midwestern region of the United States.

Use of estimates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash equivalents. The cooperative considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Accounts receivable. Receivables from farm supply and farm marketing sales are based on contracted prices. The cooperative's receivables consist primarily of large groups of smaller-balance homogeneous accounts that are collectively evaluated for impairment. The company provides an allowance for doubtful accounts which is based upon a review of outstanding receivables, historical collection information, and existing economic conditions. Normal trade receivables are due 30 days after the date of sale. Trade receivables past due more than 120 days are considered delinquent. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

Inventories. Grain inventories are carried at market.

Sunflower-seed inventory is stated at the lower of cost or market, FIFO.

Supplies and materials are stated at the lower of cost or market, first-in, FIFO.

Investments. The investment in Midstate Marketing Cooperative (Midstate) represents equities allocated to the cooperative by Midstate as of Midstate's most recent fiscal year-end, plus an accrual to the cooperative's fiscal year-end for anticipated patronage allocations. The accrual is based on the cooperative's expected percentage (5 percent in both 20X1 and 20X2) of Midstate's total patronage applied to Midstate's interim operating results. Patronage refunds are credited to cost of raw materials, operations, and distribution.

The investment in the Bank for Cooperatives consists of class C stock at cost and the cooperative's share of the bank's allocated surplus. Any patronage refunds received from the bank are credited to interest expense.

The investment in Farm Fertilizers, Inc. (FFI), represents allocated equities for which notification has been received by the cooperative. The patronage earnings of FFI vary substantially from year to year, and FFI does not make interim operating results available to the cooperative. Accordingly, patronage allocations for which notification has not been received cannot be reasonably determined. Patronage refunds are credited to cost of raw materials, operations, and distribution.

Property, plant, and equipment. Property, plant, and equipment are stated at cost. Depreciation is computed principally by using the straight-line method over the estimated useful lives of the related depreciable assets. Expenditures for betterments and renewals that extend useful lives are capitalized. Gains and losses on retirements and disposals are included in net margins.

Long-lived assets. Long-lived assets to be held and used are tested for recoverability whenever events or changes in circumstances indicate that the related carrying amount may not be recoverable. When required, impairment losses on assets to be held and used are recognized based on the fair value of the asset and long-lived assets to be disposed of by sale are reported at the lower of carrying amount or fair value less cost to sell.[21]

Patrons' equities.[||] In accordance with its bylaws, the cooperative allocates patronage margins to its patrons, as determined for income tax purposes, in cash, preferred stock, and certificates of equity in proportions determined by its board of directors.

New members are issued one share of common stock. At any time a member ceases to be active, such shares are redeemed at par value.[**]

Income taxes. The cooperative, as a nonexempt cooperative, is taxed on nonpatronage proceeds and any patronage proceeds not paid or allocated to patrons. Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in FASB Statement No. 109.[‡] As changes in tax laws or rate are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

2. Accounts Receivable

Receivables are composed of the following:

	May 31,	
	20X2	20X1
Farm Supply receivables	$3,788,000	$3,798,000
Farm Marketing receivables	3,500,000	3,100,000
Other	35,000	40,000
Less: Allowance for doubtful accounts	(750,000)	(640,000)
	$6,573,000	$6,298,000

---

[21] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement Nos. 157 and 159. See chapter 12, paragraphs 12.22–.26 of this guide for discussion regarding FASB Statement Nos. 157 and 159.

[||] See footnote || in exhibit A-5.

[**] See footnote † to the foreword to the Illustrative Financial Statements of Agricultural Cooperatives for the discussion of FASB Statement No. 150. In a situation described above such common stock meets the definition of a mandatorily redeemable financial instrument under FASB Statement No. 150 and as such may have to be reclassified as a liability.

[‡] See footnote ‡ in exhibit A-3.

3. Inventories

A summary of inventories follows.

	May 31, 20X2	May 31, 20X1
Grain	$8,211,000	$8,105,000
Sunflower seed	3,101,000	3,020,000
Supplies and materials	4,208,000	3,561,000
Total	$15,520,000	$14,686,000

Grain purchased from patrons is included as an element of cost of sales, based on the spot-market price of the grain at date of receipt. The value of grain received from patrons amounted to $ 16,427,000 and $ 15,845,000 for the years ended May 31, 20X2 and 20X1, respectively.

4. Notes Payable to Bank and Long-Term Debt

Notes payable to the bank consist of short-term loans from the Bank for Cooperatives. A summary of such borrowings during the years ended May 31, 20X2 and 20X1 follows.

	May 31, 20X2	May 31, 20X1
Borrowings as of May 31	$7,084,000	$6,473,000
Average interest rate on year-end borrowings	15.6%	14.7%
Average borrowings during the year	$8,562,000	$7,679,000
Average interest rate on borrowings during the year	14.9%	14.2%
Maximum borrowings during the year	$9,500,000	$8,650,000

Long-term debt consists of the following:

	May 31, 20X2	May 31, 20X1
Bank for Cooperatives, 12% due in varying installments through 20X9	$6,049,000	$6,367,000
Commercial bank loans, at prime, 16% at May 31, 20X2 and 14.5% at May 31, 20X1 due in varying installments through 20X8	3,489,000	5,071,000
	9,538,000	11,438,000
Less current maturities	560,000	1,230,000
Total	$8,978,000	$10,208,000

Aggregate annual principal payments applicable to long-term debt for the 5 years subsequent to May 31, 20X2 are as follows.

Year Ending May 31,	
20X3	$ 560,000
20X4	601,000
20X5	892,000
20X6	1,802,000
20X7	2,186,000
Thereafter	3,497,000
Total	$9,538,000

Inventories and accounts receivable are pledged as collateral under the short-term agreements with the Bank for Cooperatives. Property, plant, and equipment with book value of $12 million, along with the investment in the Bank for Cooperatives, are pledged under the long-term agreements with the Bank for Cooperatives and a commercial bank. The long-term agreements require maintenance of $5 million of working capital and agreement with the banks on revolvement of allocated equities and assumption of additional long-term debt.[||] Additionally, the agreements require the cooperative to invest in class C stock of the Bank for Cooperatives in amounts determined by that bank.

5. Income Taxes

The provision for income taxes consist of the following:

	Years Ended May 31,	
	20X2	*20X1*
Current		
Federal	$365,000	$305,000
State	112,000	95,000
Total current	477,000	400,000
Deferred		
Federal	139,000	116,000
State	34,000	29,000
Total deferred	173,000	145,000
Total	$650,000	$545,000

The net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes are reflected in deferred income taxes. Significant components of the company's deferred tax liabilities as of April 30, 20X2 and 20X1 are as follows:

[||] See footnote || in exhibit A-5.

	Years Ended May 31, 20X2	Years Ended May 31, 20X1
Current deferred tax assets/(liabilities)		
Inventory valuation methods	$53,800	$47,500
Capitalized costs	(180,000)	(225,000)
Total current deferred tax liability	$ (126,200)	$ (177,500)
Noncurrent deferred tax assets/(liabilities)		
Accelerated depreciation	(1,355,000)	(1,135,000)
Other, (net)	(45,800)	(41,500)
Total noncurrent deferred tax liability	$(1,400,800)	$(1,176,500)

A reconciliation of the income tax provision with amounts determined by applying the federal statutory rate to income taxes is as follows:

	Years Ended May 31, 20X2	Years Ended May 31, 20X1
Federal statutory income tax rate	34.0%	34.0%
Qualified patronage distributions	(24.2)	(21.7)
State and local income tax	2.3	2.9
Other (net)	(1.7)	(2.3)
Effective tax rate	10.4%	12.9%

6. Commitment and Contingencies

The cooperative has signed agreements to purchase machinery and equipment costing approximately $7 million to modernize its grain-handling facilities. These purchases are to be financed by additional long-term debt with the Bank for Cooperatives.

7. Fair Value of Financial Instruments[22]

The carrying amount of the cooperative's current maturities of long-term debt, approximate their fair value. The fair value of net long-term debt, which is based upon borrowing rates currently available to the company for debt issues with similar terms and maturities, is $8,695 (19X1, $9,987).[23,24]

---

[22] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement Nos. 157 and 159. See chapter 12, paragraphs 12.22–.26 of this guide for discussion regarding FASB Statement Nos. 157 and 159.

[23] These illustrative financial statements have not been updated to reflect the accounting and reporting requirements of FASB Statement No. 126, which amends FASB Statement No. 107 to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria:

a. The entity is a nonpublic entity.

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

[24] AU section 328 contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures. Refer to paragraphs 12.35–.38 of this guide for a discussion of auditing fair value measurements and disclosures.

Appendix B

Statement of Position 85-3 Accounting by Agricultural Producers and Agricultural Cooperatives

Accounting by Agricultural Producers and Agricultural Cooperatives

April 30, 1985

Issued by
Accounting Standards Division
American Institute of Certified Public Accountants

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

TABLE OF CONTENTS

Accounting by Agricultural Producers and Agricultural Cooperatives

Introduction

.001 This statement discusses accounting by agricultural producers and agricultural cooperatives that intend to present financial statements in conformity with generally accepted accounting principles. The issues discussed are—

- Accounting for inventories by producers
- Accounting for development costs of land, trees and vines, intermediate-life plants, and animals
- Accounting by patrons for product deliveries to cooperatives
- Accounting by cooperatives for products received from patrons
- Accounting for investments in and income from cooperatives

This statement does not apply to personal financial statements of agricultural producers or statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, for example, the income tax or the cash basis of accounting. This statement also does not apply to growers of timber; growers of pineapple and sugarcane in tropical regions; raisers of animals for competitive sports; or merchants or noncooperative processors of agricultural products that purchase commodities from growers, contract harvesters, or others serving agricultural producers.

Definitions

.002 For purposes of this statement, the following definitions apply.

Advances. Generally used in marketing and pooling cooperatives to denote amounts paid to patrons prior to final settlement; for example, amounts paid to patrons on delivery of crops.

Agricultural cooperatives. See paragraphs .006 through .022.

Agricultural producers. See paragraphs .003 through .005.

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

Cash advance method. A method of accounting for inventories of a marketing cooperative operating on a pooling basis. Under this method, inventories are accounted for at the amount of cash advances made to patrons. (This is sometimes referred to as the "cost advance method.")

Commercial production. The point at which production from an orchard, vineyard, or grove first reaches a level that makes operations economically feasible, based on prices normally expected to prevail.

Crop development costs. Costs incurred up to the time crops are produced in commercial quantities, including the costs of land preparation, plants, planting, fertilization, grafting, pruning, equipment use, and irrigation.

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

Exempt and nonexempt cooperatives. Cooperatives classified according to their federal income tax status. Both types are permitted to deduct from taxable income patronage distributed or allocated on a qualified basis to patrons to the extent that the distributions represent earnings of the cooperative derived from business done with or for the patrons. In addition, cooperatives meeting the requirements of Internal Revenue Code section 521 (exempt cooperatives) are permitted to deduct (1) limited amounts paid as dividends on capital stock and (2) distributions to patrons of income from business done with the U.S. government or its agencies and income from nonpatronage sources.

Farm price method. A method of accounting for inventories at the sales prices in the nearest local market for the quantities that the producer normally sells less the estimated costs of disposition.

Futures contract. A standard and transferable form of contract that binds the seller to deliver to the bearer a standard amount and grade of a commodity to a specific location at a specified time. It usually includes a schedule of premiums and discounts for quality variation.

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

Grove. Fruit or nut trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit or nuts.

Harvested crop. An agricultural product, gathered but unsold.

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

Market order prices. Prices for raw products established by federal or state agencies.

Marketing cooperative. A cooperative that markets the products (crops, livestock, and so on) produced by its patrons.

Member and nonmember (of a cooperative). A member is an owner-patron who is entitled to vote at corporate meetings of a cooperative. A nonmember patron is not entitled to voting privileges. A nonmember patron may or may not be entitled to share in patronage distributions, depending on the articles and bylaws of the cooperative or on other agreements.

Net realizable value. Valuation of inventories at estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

Orchard. Fruit trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit.

Patron. Any individual, trust, estate, partnership, corporation, or cooperative with or for whom a cooperative does business on a cooperative basis, whether a member or nonmember of the cooperative association.

Patronage. The amount of business done with a cooperative by one of its patrons. Patronage is measured by either the quantity or value of commodities received from patrons by a marketing cooperative and the quantity or value of the goods and services sold to patrons by a supply cooperative.

Patronage allocations. Patronage earnings distributed, or allocated, to individual patrons on the basis of each patron's proportionate share of total patronage. Such allocations, which include notification to the patron, may be made on a qualified or nonqualified basis.

Patronage earnings. The excess of a cooperative's revenues over its costs arising from transactions done with or for its patrons. Generally a significant portion of those earnings is allocated to the cooperative's patrons in the form of cash, allocated equities, or both.

Pools. Accounting control centers used for determining earnings and patronage refunds due to particular patrons.

Open pools are accounting control centers that are not closed at the end of each accounting period. Open pools are sometimes used by marketing cooperatives for crops that may not be sold for two or more years after their receipt from patrons.

A single pool cooperative determines net proceeds or patronage refunds on the basis of overall operating results for all commodities marketed during an accounting period.

A multiple pool cooperative determines net proceeds or patronage refunds on the basis of separate commodities, departments, or accounting periods.

Progeny. Offspring of animals or plants.

Raised animals. Animals produced and raised from an owned herd, as opposed to purchased animals.

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

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

Supply cooperative. A cooperative that supplies to its patrons goods and services used by them in producing their products.

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

Vineyards. Grapevines planted in patterns for commercial cultivation and production.

Written notice of allocation. Any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice to the recipient that states the dollar amount allocated to the patron by the cooperative and the portion that constitutes a patronage dividend.

Agricultural Producers

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

.004 Agricultural producers use every form of business organization, from sole proprietorship to a large publicly held corporation. They engage in numerous activities, for example:

- Growing wheat, milo, corn, and other grains
- Growing soybeans, vegetables, sugar beets, and sugarcane
- Growing citrus fruits, other fruits, grapes, berries, and nuts
- Growing cotton and other vegetable fibers
- Operating plant nurseries
- Breeding and feeding cattle, hogs, and sheep, including animals for wool production
- Operating dairies
- Operating poultry and egg production facilities
- Breeding horses
- Raising mink, chinchilla, and similar small animals

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

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

Agricultural Cooperatives

[.006–.008] [Paragraph deleted to remove outdated information.]

.009 Section 1141(j) of the Agricultural Marketing Act of 1929, as amended, contains the following definition of a cooperative association:

> The term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services. Provided, however, that such associations are operated for producers or purchasers and conform to one or both of the following requirements:
>
> First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and
>
> Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.
>
> And in any case to the following:
>
> Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an

amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.

.010 A cooperative typically has the following characteristics:

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

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

c. Membership is limited to patrons.

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

e. At least 50 percent of the cooperative's business is done on a patronage basis.

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

.012 The main difference between cooperatives and other business enterprises is that cooperatives and their patrons operate as single economic units to accomplish specific business purposes, such as the marketing of farm products, the purchase of supplies, or the performance of services for the benefit of the patrons. The aim is to reduce costs, increase sales proceeds, and share risks through the increased bargaining power that results from the patrons' combined resources and buying power.

.013 The patron's role as an investor is secondary and incidental to his business relationship with the cooperative.

.014 If certain requirements are met, the Internal Revenue Code permits cooperatives tax deductions for earnings allocated to their patrons. Earnings not so allocated are taxed at corporate income tax rates. Cooperatives may use other terms for earnings, such as "margins," "net proceeds," or "savings."

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

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

.017 Both exempt and nonexempt cooperatives are subject to federal income taxes on patronage earnings that are not distributed in cash or allocated on a qualified basis. Nonexempt cooperatives are subject to income taxes on earnings arising from sources other than patronage.

.018 Cooperatives generally try to buy or sell at the current market price. Periodically, they determine total costs and make distributions to patrons in the form of cash, certificates, or other notices of allocation based on the excess of revenues over costs.

.019 The two major types of cooperatives are supply cooperatives and marketing cooperatives. *Supply cooperatives* obtain or produce such items as building materials, equipment, feed, seeds, fertilizer, and petroleum products for their patrons. *Marketing cooperatives* provide means for agricultural producers to process and sell their products.

.020 Services related to those functions are provided by some supply and marketing cooperatives; they are also provided by separate associations known as *service cooperatives,* which provide such services as trucking, storage, accounting, and data processing. A special type of service cooperative is a *bargaining cooperative,* which serves its members by negotiating with processors on their behalf.

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

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

Accounting for Inventories of Crops by Agricultural Producers

.023 Previously existing accounting literature does not specifically cover accounting by agricultural producers, and available material is predominantly tax oriented. Accounting Research Bulletin (ARB) No. 43, chapter 4, provides the following information about accounting for inventories:

> **STATEMENT 9**
>
> Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.
>
> *Discussion*
>
> It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon

> for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

.024 Accounting Principles Board (APB) Statement No. 4, chapter 6, paragraph 152, states the following:

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

Statement of Position 93-3, *Rescission of Accounting Principles Board Statements* [section 10,560], rescinds APB Statement No. 4. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses matters similar to those in APB Statement No. 4. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.025 Accounting Research Study (ARS) 13, chapter 9, page 156, states—

> *Market as the Accounting Basis of Inventories*
>
> Exceptional cases exist in which it is not practicable to determine an appropriate cost basis for products. A market basis is acceptable if the products (1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal. The accounting basis of those kinds of inventories should be their realizable value, calculated on the basis of quoted market prices less estimated direct costs of disposal. Examples are precious metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations.

Paragraph 67 of FASB Concepts Statement No. 5 also discusses measurement of assets at current market value. [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Diversity in Practice

.026 Published financial statements reveal several ways that agricultural producers account for growing crops:

- Charging costs to operations when they are incurred
- Including crop development costs in deferred charges and amortizing them

- Stating costs on the balance sheet at unchanging amounts substantially less than the costs incurred and charging all current costs to operations when they are incurred
- Deferring all costs and writing them off at harvest or, for perennial crops, over the estimated productive life of the planting

Agricultural producers report harvested crops using the farm price method, at cost (LIFO, FIFO, or average cost), and at the lower of cost or market.

Some producers use the farm price method (market) to account for inventories of harvested crops. Other agricultural producers, particularly those whose securities are publicly held, account for harvested crops at the lower of cost or market.

Pros and Cons

.027 A study of accounting for producers' inventories involves an examination of chapter 4, statement 9, of ARB No. 43, which has been used as authority for accounting for producers' inventories at market.

.028 Some accountants believe that many producers cannot determine costs, and some believe that market is an appropriate valuation, whether or not cost data are available. Many accountants believe that users of producers' financial statements would find them less useful if inventories were valued at the lower of cost or market.

.029 Other reasons for the preference for market value are its long established use and the need to identify separately the gains and losses attributable to the production cycle and the marketing function, which is discussed in paragraph .035.

.030 For most business activities, the accounting literature requires an exchange of goods or services before income is recognized. That precludes accounting for inventories of unsold goods at market unless market value is less than cost. The principal exceptions to that rule are identified in chapter 9 of ARS 13 as "metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations." Those products have unique cost identification problems. Chapter 9 of ARS 13 further states that carrying products at market is acceptable if those products "(1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal."

.031 The first of the three conditions in ARB No. 43, statement 9, is the inability to determine costs. While many producers may not keep detailed cost records, costs usually either are available or can be determined with acceptable accuracy.

.032 Accountants who favor accounting for producers' inventories at market recognize that ARB No. 43 requires an *inability* to determine appropriate approximate costs. They point out, however, that the discussion interprets the statement to apply when "appropriate costs may be *difficult* to obtain" [emphasis added]. They also note that APB Statement No. 4,[1] chapter 6, referred to

---

[1] Statement of Position 93-3, *Rescission of Accounting Principles Board Statements* [section 10,560], rescinds APB Statement No. 4. [Footnote added to reflect conforming changes necessary due to the issuance of recent authoritative literature; Footnote renumbered, August 2008, for editorial purposes.]

the "difficulty in some situations of determining costs of products" as a partial justification for the use of market price. Thus, they interpret statement 9 as allowing the use of market if costs are difficult to determine, not only if they are impossible to determine.

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

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

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

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

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

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

Division Conclusions

.038 All direct and indirect costs of growing crops should be accumulated and growing crops should be reported at the lower of cost or market.

.039 An agricultural producer should report inventories of harvested crops held for sale at (a) the lower of cost or market or (b) in accordance with established industry practice, at sales price less estimated costs of disposal, when all the following conditions exist:

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

Accounting for Development Costs of Land, Trees and Vines, Intermediate-Life Plants, and Animals

.040 Development costs of land, trees and vines, intermediate-life plants, and animals are different from costs incurred in raising crops for harvest, which were discussed in the previous section, "Accounting for Inventories of Crops by Agricultural Producers."

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

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

.043 Intermediate-life plants have growth and production cycles of more than one year but less than those of trees and vines. They include, for example, artichokes, various types of berries, asparagus, alfalfa, and grazing grasses. Development costs of intermediate-life plants include the cost of land preparation, plants, and cultural care until the plant, bush, or vine begins to produce in commercial quantities.

.044 The terms *livestock* and *animals* are used interchangeably and are meant to include cattle, sheep, hogs, horses, poultry, and other small animals.

The development of animals requires care and maintenance of the breeding stock and their progeny until their transfer from the brood herd. Animals purchased before maturity also require care and maintenance to ready them for productive use or sale. The animals are ultimately identified for transfer to breeding herds, dairy herds, or other productive functions, are selected for sale, or are transferred to a feeding or other marketing operation.

Diversity in Practice

.045 Development costs of land, trees and vines, intermediate-life plants, and animals are accounted for in the following ways:

- Charged to operations when they are incurred
- Included in deferred charges
- Included on the balance sheet at fixed amounts substantially less than the costs incurred, with all or a majority of the current costs charged to operations as they are incurred
- Capitalized and amortized over the estimated productive life of the animal, tree, vine, or plant
- Carried at market values

.046 In the case of annual field crops that are planted and harvested in the same accounting period, producers generally match costs with revenues. When the growing cycle continues beyond the accounting period, costs often are not matched with revenues.

.047 Few significant diversities of practice are apparent in the financial statements primarily because of lack of disclosure. However, some agricultural producers charge land development costs to expense based on provisions of the income tax laws.

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

.049 Crops from intermediate-life plants have generally been accounted for in the same way as annual crops, with no distinctions for variations in the periods of development and productivity.

.050 Many livestock producers charge the costs of developing animals to expense without regard to their productive lives or future use or sales value. Animals are sometimes reported at cost and other times at market values. Some producers use the unit livestock method, and in many instances, the annual unit cost increments are below market and probably below cost.

Pros and Cons

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

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

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

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

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

.056 Accounting practices for development costs of intermediate-life plants are inconsistent. Producers who deduct expenses before revenues are realized for intermediate-life plants and orchardists and vineyardists who do not want to capitalize development costs and depreciate them over the estimated productive life of the developed asset are motivated by the same reasons. The question of capitalization and depreciation is similar for producers of intermediate-life plants and for producers of trees and vines. The principal distinctions are in development period and productive life. For example, orchard trees may require four to seven years before nominal production, while limited production may occur during the first year of such crops as alfalfa, some berries, and asparagus.

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

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

Division Conclusions

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

.060 Limited-life land development costs and direct and indirect development costs of orchards, groves, vineyards, and intermediate-life plants should be capitalized during the development period and depreciated over the estimated useful life of the land development or that of the tree, vine or plant.

.061 All direct and indirect costs of developing animals should be accumulated until the animals reach maturity and are transferred to a productive function. At that point the accumulated development costs, less any estimated salvage value, should be depreciated over the animals' estimated productive lives.

.062 All direct and indirect development costs of animals raised for sale should be accumulated, and the animals should be accounted for at the lower of cost or market until they are available for sale. 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.

Accounting for Patrons' Product Deliveries to Marketing Cooperatives Operating on a Pooling Basis

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

.064 However, cooperatives operating on a pooling basis may receive products from their patrons without paying a fixed price to the patrons. A cooperative may assign amounts to products based on current prices paid by other buyers or on amounts established by the cooperative's board of directors, or it may assign no amount. The cooperative estimates a liability to patrons equal to the assigned amount for the delivered product, and it usually pays this liability on a short-term basis. The excess of revenues over the assigned amounts and operating costs at the end of a pool period, which may be a week, a month, a year, or longer, is paid or allocated to patrons. Assets equal to that excess may be distributed to the patrons or retained by the cooperative.

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

Diversity in Practice

.066 Significant information about the accounting practices of patrons in recording the delivery of raw products to marketing cooperatives is scarce. Among the practices used are recognition (1) at the estimated net return, presumably at the time of delivery, and (2) at the time of sale by the cooperative to an outside party. Those two examples provide the extremes, one recognizing the delivery to the cooperative as a sale and the other continuing to carry the product as inventory of the producer until it is sold by the cooperative. Transfer prices for products delivered to cooperatives are established in diverse ways:

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

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

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

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

.070 A 1973 survey by the National Council of Farmer Cooperatives indicated that many marketing cooperatives use net realizable value to account for inventories. An excerpt from an article on this subject prepared for the council's legal, tax, and accounting committee appears below.

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

Method	*Cooperatives*	*Sales (In Thousands)*	*% of Total Sales*
Net realizable market value	24	$2,310,938	48%
Lower of cost or market, using field price as the established value of raw product	8	630,898	13
Net realizable market, value and lower of cost or market, using field price as the established value of raw product	5	802,567	17
Cost	2	53,400	1
Rev. Rul. 69-67[2]	7	367,469	8
Other	3	621,925	13
	49	$4,787,197	100%

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

.072 Some marketing cooperatives receive products from patrons without assigning amounts to them. During the year, cash is advanced to patrons on the basis of anticipated earnings. Inventories are recorded at amounts advanced plus costs of processing, and patrons' products are valued at the amount of

[2] Note: Rev. Rul. 69–67 refers to the cash advance method. [Footnote renumbered, August 2008, for editorial purposes.]

advances made to the date of the financial statements. This is commonly called the "cash advance method."

Authoritative Literature

.073 The primary source of authoritative guidance for accounting for inventories that result from deliveries of products by patrons to cooperatives has been ARB No. 43.

Pros and Cons

.074 A transaction is usually completed when a patron delivers his product to a cooperative. The patron's product is commingled with that of other patrons, and title and individual risk of loss have passed. Some accountants believe that no accounting is necessary at the time of delivery because the transfer price is frequently not known until some later date. Nevertheless, accrual basis accounting calls for reporting the transaction according to the best information available at the time. While greater accuracy may be achieved by waiting for the cooperative to advise the patron of the net proceeds, the handicap of not having current financial information could outweigh the benefit of greater accuracy, and the lack of consistency in reporting could be confusing to the users of the financial statements.

.075 Some accountants argue that pooling cooperatives should not use an assigned amount for products received from patrons for financial accounting and reporting purposes because the amounts may not be reliable and the patrons may be paid more or less than that amount at the end of the pool period. Others argue that the use of an assigned amount permits the establishment of a tentative liability due patrons and allows inventories to be stated at the lower of cost or market. The method also facilitates allocation of pool proceeds to patrons.

.076 Some accountants believe that the net realizable value method of accounting for inventories is unacceptable because it anticipates cooperative earnings. Further, they believe that future selling prices and disposition costs are too uncertain to base accounting on them. Alternatively, those who favor the use of the net realizable value method believe that the problems of determining net realizable value do not differ from those of determining market under the lower of cost or market method. They also consider the method to be acceptable in accounting for pools because it enables the cooperative to settle pools annually and to comply with bylaw provisions and contractual obligations. In essence, they claim, the inventory is transferred to the next period's pool on an equitable basis.

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

.078 Some accountants favor the cash advance method of accounting for inventories. They believe that the only product cost that should be accounted for is the total of cash advanced to patrons to the date of the financial statements, because the cooperative has no liability to pay more unless more is earned. Others favor the cash advance method because the Internal Revenue Service has held in several rulings that pooling cooperatives should use that method in tax computations. Others reject the cash advance method because advances to patrons are primarily determined on availability of cash, the percentage of the pool production sold to the date of the financial statements, and short-term inventory loan restrictions rather than on the value of products received. Further, they reject the method because the amount and timing of advances are generally subject to the board of directors' action and may vary from period to period.

Division Conclusions

Accounting by Patrons for Products Delivered to Pooling Cooperatives

.079 If control over the future economic benefits relating to the product has passed, which ordinarily is evidenced by the transfer of title, and if a price is available by reference to contemporaneous transactions in the market, or if the cooperative establishes an assigned amount, a delivery to the cooperative should be recorded as a sale by the patron at that amount on the date of delivery. If there is a reasonable indication that the proceeds from the cooperative will be less than the market price or the assigned amount, the lower amount should be used.

.080 If control over the future economic benefits relating to the product has passed, which ordinarily is evidenced by the transfer of title, and there are neither prices determined by other market buyers nor amounts assigned by the cooperative, or if such amounts are erratic, unstable, or volatile, the patron should record the delivery to the cooperative as a sale at the recorded amount of the inventory and should record an unbilled receivable. If there is a reasonable indication that the proceeds from the cooperative will be less than the receivable, the lower amount should be used.

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

.082 Advances are financing devices and should be treated as reductions in the unbilled receivable and should not be used as amounts for recording sales.

Accounting by Pooling Cooperatives for Products Received From Patrons

.083 If the boards of directors of agricultural marketing cooperatives operating on a pooling basis with no obligation to pay patrons fixed prices (pooling cooperatives) assign amounts that approximate estimated market to unprocessed products received from patrons, the assigned amounts are cost and should be charged to cost of goods sold and credited to amounts due patrons. The inventories should be accounted for at the lower of cost or market or, as described more fully in paragraph .084, at net realizable value. When assigned amounts are used, they should approximate estimated market of unprocessed products delivered by patrons (an example of inventories at lower of cost or market is provided in the appendix [paragraph .107], column A). The method used and the dollar amounts assigned to members' products should be disclosed.

.084 If the boards of directors of pooling cooperatives assign amounts to products received from patrons, the cooperatives should use those assigned amounts in determining the estimated amounts due patrons. Such cooperatives may use net realizable value for determining pool proceeds, transferring inventory amounts to subsequent pools, or for other purposes (an example is provided in the appendix [paragraph .107], column B). The method used and the dollar amounts assigned to members' products should be disclosed.

.085 If the boards of directors of pooling cooperatives do not assign amounts that approximate market to unprocessed products received from patrons, the cooperatives should account for inventories at net realizable value (an example is provided in the appendix [paragraph .107], column C). Because amounts that approximate estimated market are not assigned to products received from patrons, cost of goods sold will not include a charge for unprocessed products under this method.

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

Accounting for Investments in and Income From Cooperatives

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

Diversity in Practice

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

.089 Most cooperatives carry their investments in other cooperatives at cost if they are purchased or at face amount if they are received in other than purchase transactions (retains or noncash patronage allocations). However, they usually write the investments down to estimated net realizable value if evidence indicates they will be unable to recover the full carrying amount of the investments. That practice has been endorsed in Accounting Research Bulletin 2, issued by the National Society of Accountants for Cooperatives, which states—

> Investments in cooperatives made by user patrons for the purpose of providing capital for operations of the investee cooperative should be carried at cost, if purchased, or at face value if received in transactions other than purchases such as non-cash patronage dividends. Such investments should be written down to an appropriate amount if reliable evidence indicates that their value has been permanently impaired.
>
> It should be noted that in most instances accounting for investments in other cooperatives (including banks for cooperatives and other cooperative financing organizations, such as the National Rural Utilities Cooperative Finance Corporation) on the basis outlined above results in investment carrying values equal to the equity values of the investing cooperative's interest in the investee cooperatives; therefore, it would

appear that the basis outlined complies with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to the extent that the intent of the opinion is applicable to investments of cooperatives. In the infrequent instances where the investor's share of unallocated retained earnings of an investee cooperative is material to the investor, the principles set forth in APB Opinion No. 18 should be applied.

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

.091 Diversity in practice has developed in accounting for unallocated equities. Some patrons who hold at least a 20 percent ownership interest recognize their interest in unallocated equities in accordance with APB Opinion No. 18. Others do not recognize unallocated equities, primarily because the equity ownership percentage changes according to patronage and because voting is usually based on the one-member-one-vote principle, which does not necessarily provide significant influence. Interpretation and application of APB Opinion No. 18 may become more significant in financial reporting for cooperatives because 1978 changes in the Internal Revenue Code, relating to the investment tax credit, may encourage cooperatives to reduce distributions of assets to patrons and increase unallocated net after-tax earnings for the purchase of assets.

.092 Most patrons recognize their patronage allocations when they are notified, which conforms with federal income tax reporting requirements. Other patrons accrue patronage allocations on the basis of the cooperatives' interim financial statements.

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

Authoritative Literature

.094 Authoritative literature on marketable investments—FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,* and FASB Interpretation No. 16, *Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable*—has

* FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, amends certain parts of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. [Footnote added to reflect conforming changes necessary due to the issuance of recent authoritative literature; Footnote renumbered, August 2008, for editorial purposes.]

little applicability to investments in cooperatives. Investments in cooperatives are not equity securities and usually are not readily marketable, and transfer or sale, other than back to the issuing cooperative, is usually restricted or prohibited. Current accounting literature supports the carrying of long-term investments, such as nonmarketable investments in agricultural cooperatives, at cost if the value of the investments is not impaired. Carrying amounts are reduced when the investor becomes unable to recover the full carrying amounts. APB Opinion No. 18 requires the equity method of accounting for investments in which the investor has significant influence over an investee's operating and financial policies.

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

Pros and Cons

.096 Some accountants argue that the investment in a cooperative is in substance a long-term investment and, as such, should be carried at cost or at cost plus allocated equities. Others believe that the investments should be discounted to their present value. The carrying amounts would be adjusted downward as required by generally accepted accounting principles when the patron becomes unable to recover the full carrying amounts.

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

.098 Accountants who believe that a cooperative's unallocated losses should not be recognized by the patrons base their contention on the premise that operating losses may indicate temporary rather than permanent declines in value because they may result from identifiable, isolated, or nonrecurring events. Accordingly, they should not be recognized. Furthermore, because many investor cooperatives determine patronage allocations on the basis of financial statement reporting rather than federal income tax reporting, some accountants argue that financial statement recognition by investor cooperatives of unallocated losses will cause the payment of federal income taxes by the investor cooperative that would not otherwise be payable and such taxes will not be recoverable if the losses are later allocated. That adverse effect is the result of federal income tax regulations that limit the patronage refund deduction to the lesser of the patronage refund "paid" and the patronage refund "allowable," as determined in accordance with federal income tax rules and regulations.

.099 Those who believe that unallocated losses should be recognized argue that patrons must recognize allocated losses for consistent reporting, much as if the investment were in a corporate joint venture or partnership rather than a cooperative. They further contend that failure to recognize unallocated losses permits manipulation of earnings because patrons often serve on the cooperative's board of directors or can influence the board of directors, which has the authority to determine the portions, if any, of the losses that will be allocated to patrons.

.100 Accountants who believe that unallocated equities should not be recognized by the patrons generally contend that APB Opinion No. 18 does not apply because equity ownership generally does not convey voting control and because ownership interests in unallocated equities may be temporary, being subject to changes in patronage participation and the redemption of equities. However, others argue that APB Opinion No. 18 should apply to all investments in cooperatives in which the patrons hold at least 20 percent of the equity securities, regardless of the one-member-one-vote requirement and the fact that ownership interests may change. They believe that the patron frequently has significant influence due to patronage volume, assured representation on the board of directors, or other means.

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

.102 Some accountants argue that allocated and unallocated equities should be reflected in the statement of operations as reductions of costs or increases in proceeds because such amounts result from the transactions by which supplies are purchased, interest is paid, or products are sold. Accordingly, the proponents believe that the equities should be reported in the same manner as the original transactions to report sales, cost of sales, and operating expenses. Other accountants believe that the allocations should be reported as other income rather than as increases or decreases in sales, cost of sales, or operating expenses; they argue that including the allocations in sales, cost of sales, or operating expenses could misstate gross profit or expenses.

Division Conclusions

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

.104 Patrons should recognize patronage refunds either—

a. When the related patronage occurs if it is then probable that (1) a patronage refund applicable to the period will be declared, (2) one or more future events confirming the receipt of a patronage refund are expected to occur, (3) the amount of the refund can be reasonably estimated, and (4) the accrual can be consistently made from year to year or

b. On notification by the distributing cooperative.

The accrual should be based on the latest available reliable information and should be adjusted on notification of allocation.

.105 Either (1) the classification of the allocations in the financial statements should follow the recording of the costs or proceeds or (2) the allocations should be presented separately.

Effective Date and Transition

.106 The Accounting Standards Division recommends application of this statement to financial statements prepared for fiscal years, and interim periods in such fiscal years, beginning after June 15, 1985. Accounting changes to conform to the recommendations of this statement should be made prospectively for transactions or activities occurring on or after the effective date of this statement. Application for earlier years, including retroactive application, is encouraged for all transactions or activities regardless of when they occurred. Disclosures should be made in the financial statements in the period of change in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*, which supersedes APB Opinion No. 20, *Accounting Changes*.[†]

[†] [Footnote deleted, August 2007, for editorial purposes; Footnote renumbered, August 2008, for editorial purposes.]

.107

Appendix

Accounting by Pooling Cooperatives for Products Received From Patrons

The following illustrates the statement of net earnings prepared under each of two possible methods of accounting for inventories (columns A and B), the statement of net proceeds prepared under the net realizable value method (column C), and the respective statements of amounts due patrons, if such latter statement is included in the financial statements. (See paragraphs .083, .084, and .085.) Column A demonstrates the lower of cost or market method with patrons' raw product being charged to cost of production at assigned amounts. Column B demonstrates the net realizable value method with patrons' raw product being charged to cost of production at assigned amounts. Column C demonstrates the net realizable value method when no amounts are assigned to patrons' raw product; therefore, there is no charge to cost of production for patrons' raw product. The assumed facts are as follows:

Sales	$ 129,630
Beginning inventory	
Net realizable value	31,128
Lower of cost or market	28,380
Assigned value of patron's raw product received	56,500
Ending inventory	
Net realizable value	35,596
Lower of cost or market	32,360
Income taxes	1,250
Other costs and expenses	56,580
Amounts paid to patron's, retains, and non-patronage earnings	74,430
Amounts due patrons at beginning of year	
Lower of cost or market method	8,910
Net realizable value method	11,748

Statements of Net Earnings (columns A and B)
Statement of Net Proceeds (column C)

	Inventories Valued At		
	Lower of Cost or Market—A	Net Realizable Value—B	Net Realizable Value—C
Sales	$ 129,630	$ 129,630	$ 129,630
Costs and expenses (I)	109,100	108,702	52,202
Earnings before income taxes	20,530	20,928	—
Proceeds before income taxes	—	—	77,428
Income taxes	1,250	1,250	1,250
Net earnings	$ 19,280	$ 19,678	
Net proceeds			$ 76,178
I. Beginning inventory	$ 28,380	$ 31,218	$ 31,218
Assigned value of patrons' raw product received	56,500	56,500	—
Ending inventory	(32,360)	(35,596)	(35,596)
Other costs and expenses	56,580	56,580	56,580
	$ 109,100	$ 108,702	$52,202

Statement of Amounts Due Patrons

	Inventories Valued At		
	Lower of Cost or Market—A	Net Realizable Value—B	Net Realizable Value—C
Amounts due patrons at beginning of year	$ 8,910	$ 11,748	$ 11,748
Net earnings	19,280	19,678	—
Net proceeds	—	—	76,178
Assigned value of patrons' raw product received	56,500	56,500	—
	84,690	87,926	87,926
Less amounts paid to patrons, retains, and non-patronage earnings	74,430	74,430	74,430
Amounts due patrons at end of year	$ 10,260	$ 13,496	$ 13,496

Under the two inventory methods presented, the difference in amounts due patrons at the end of the year results from the difference in the ending inventory valuations, illustrated as follows:

Inventories of finished goods and goods in process at:	
Net realizable value	$ 35,596
Lower of cost or market	(32,360)
	3,326
Amounts due patrons at end of year on lower of cost or market basis	10,260
Amounts due patrons at end of year on net realizable value basis	$ 13,496

Accounting Standards Executive Committee (1983–1984)

ROGER CASON, *Chairman*
HAROLD E. ARNETT
JOSEPH S. BURNS
DONALD C. ELLWOOD
MARVIN A. GOLDMAN
VAUGHN L. HERSEY, JR.
JOHN W. HOYT
HOWARD B. LEVY
PAUL B. LUKENS
RONALD J. MURRAY
SANDRA S. SCHMIDT
WALTER P. SCHUETZE
JAMES O. STEPP
RONALD L. WOLF
LESTER I. WOLOSOFF

PAUL ROSENFIELD, *Director*
Accounting Standards

Agribusiness Special Committee (1983–1984)

DONALD F. LINSTEADT, *Chairman*
RICHARD M. ARNDT
LORENCE L. BRAVENEC
GAIL N. BROWN
ROBERT L. BURTON
VIRGIL S. CHANDLER
JOHN P. GERST
JERROLD A. HUNT
HOWARD C. LEWIS
WILLIAM H. SEVERSON
BILL F. SIMS
MICHAEL W. SMITH
DENNIS M. SWENSON
O. RAY WHITTINGTON

PATRICK L. MCNAMEE
Manager, Accounting Standards

Appendix C

Information Sources

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. 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 the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

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

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) lines.

General information, including electronic versions of documents and e-mail alerts may also be obtained by visiting the Web sites for the organizations named in the table that follows:

Organization	*General Information*	*Fax/Phone Services*	*Internet Web Site*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* 220 Leigh Farm Rd. Durham, NC 27707-8110 (888) 777-7077 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077.		www.aicpa.org Copies of AICPA publications referred to in this document may also be obtained from the online AICPA store at www.cpa2biz.com.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (800) 748-0659 Copies of printed and bound FASB publications referred to in this document may be obtained directly from FASB by calling the FASB Order Department. FASB Statements also are available as downloadable PDF documents at no charge.	*24 Hour Access* (203) 847-0700	www.fasb.org	

(continued)

Organization	*General Information*	*Fax/Phone Services*	*Internet Web Site*	*Recorded Announcements*
U.S. Government Accountability Office	*Government Accountability Office* 441 G Street, NW Washington, DC 20548 (202) 512-3000		*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 www.gpoaccess.gov/index.html www.gao.gov	
U.S. Department of Agriculture	1400 Independence Ave., SW Washington, DC 20250 (202) 720-2791		www.usda.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 100 F Street, NE Washington, DC 20549-0001 (202) 551-4040 (202) 551-8090 (800) SEC-0330		www.sec.gov	*Information Line* (202) 942-8088 (202) 551-6020 (tty)
Farm Financial Standards Council	Carroll Merry Farm Financial Standards Council N78 W14573 Appleton Ave #287 Menomonee Falls, WI 53051 (262) 253-6902	(262) 253-6903	www.ffsc.org	

Appendix D

Major Existing Differences Between AICPA Standards and PCAOB Standards

At the time of this writing, the following major differences existed between AICPA standards and final Public Company Accounting Oversight Board (PCAOB) standards approved by the Securities and Exchange Commission (SEC):

- **Risk Assessment Standards**. In March 2006, the Auditing Standards Board (ASB) issued eight Statements on Auditing Standards (SAS) Nos. 104–111, collectively referred to as the risk assessment standards. These standards are applicable to nonissuers and are effective for audits of financial statements for periods beginning on or after December 15, 2006. These standards provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. SAS Nos. 104–111 make significant changes to numerous AU sections in the auditing literature. These standards and their changes do not apply to audits conducted in accordance with PCAOB standards.

- **Audit of Internal Control**. In connection with the requirement of section 404(b) of the Sarbanes-Oxley Act that an issuer's independent auditor attest to and report on management's assessment of the effectiveness of internal control, PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements,* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), establishes requirements and provides direction that apply when an auditor is engaged to audit the internal control over financial reporting and to perform that audit in conjunction with the audit of an issuer's financial statements. There were also several conforming amendments to PCAOB Auditing Standards resulting from the adoption of PCAOB Auditing Standard No. 5.

- **Independence Matters**. Rule 3600T requires compliance with Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, and Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), and Interpretations 99-1, 00-1, and 00-2 of the Independence Standards Board. Also, to the extent that a provision of the SEC's independence rules or policies are more restrictive—or less restrictive—than the PCAOB's interim independence standards, a registered public accounting firm shall comply with the more restrictive requirement.

- **Independence Matters**. The PCAOB has adopted ethics and independence rules concerning independence, tax services, and contingent fees. See PCAOB Rules 3501, 3502, 3520, 3521, 3522, 3523, and 3524.
- **Audit Committee Preapproval of Nonaudit Services**. Rule 3525 requires registered public accounting firms who are performing a nonaudit service related to internal control over financial reporting to (1) describe to the audit committee of the issuer the scope of the service, (2) discuss with the audit committee the potential effects of the service on independence, and (3) document the substance of these discussions.
- **Concurring Partner**. Rule 3400T requires the establishment of policies and procedures for a concurring review (generally the SEC Practice Section [SECPS] membership rule).[1]
- **Communication of Firm Policy**. Rule 3400T requires registered firms to communicate through a written statement to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, at a minimum, matters that relate to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional firm personnel periodically that compliance with those principles is mandatory (generally the SECPS membership rule).
- **Affiliated Firms**. Rule 3400T requires registered firms that are part of an international association to seek adoption of policies and procedures by the international organization or individual foreign associated firms consistent with PCAOB standards.
- **Partner Rotation**. Rule 3600T requires compliance with the SEC's independence rules which include partner rotation.
- **Continuing Professional Education (CPE) Requirements**. Rule 3400T requires registered accounting firms to ensure that all of their professionals participate in at least 20 hours of qualifying CPE every year (generally the SECPS membership rule).

Please note that in the time since publication, these differences might have been eliminated and others might have arisen.

---

[1] Firms that were not members of the AICPA's Securities and Exchange Commission (SEC) Practice Section (SECPS) as of April 16, 2003 do not have to comply with this requirement.

Appendix E

Comparison of Key Provisions of the Risk Assessment Standards to Previous Standards

This appendix discusses the key provisions of each of the risk assessment related Statements on Auditing Standards (SASs) and provides a summary of how each of the SASs differs, if at all, from the previous AICPA generally accepted audit standards.

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of *reasonable assurance*.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risks of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • SAS No. 105 emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter.*

SAS No. 106, *Audit Evidence*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence,* defined in SAS No. 106, replaces the term *sufficient, competent evidential matter.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risks of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor's opinion on the financial statements.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

Key Provisions	*How the SAS Differs From Previous Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SAS No. 107 states that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risk of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, it is no longer acceptable to "default" to maximum control risk.

Key Provisions	*How the SAS Differs From Previous Standards*
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

Key Provisions	*How the SAS Differs From Previous Standards*
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the auditee. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing IT skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should establish a written understanding with your auditee regarding the services to be performed for each engagement.

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the auditee. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of auditee acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risks of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar to (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risks of material misstatement" and design and perform further audit procedures responsive to the assessed risks.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.

(continued)

<table>
<tr><th>Key Provisions</th><th>How the SAS Differs From Previous Standards</th></tr>
<tr><td>• SAS No. 109 states the auditor should assess the risks of material misstatement at both the financial statement and relevant assertion levels.</td><td>• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance.
• SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.</td></tr>
<tr><td>• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.</td><td>• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements.
• The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.</td></tr>
<tr><td>• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.</td><td>• Previous standard did not include the concept of "significant risks."
• Significant risks exist on most engagements.
• The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.</td></tr>
</table>

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risks of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risks of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affects individual financial statement assertions, so you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risks of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risks of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risks of material misstatements. — Agreeing the financial statements, including their accompanying notes, to the underlying accounting records — Examining material journal entries and other adjustments made during the course of preparing the financial statements

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • Ordinarily sample sizes for nonstatistical samples are comparable to sample sizes for an efficient and effectively designed statistical sample with the same sampling parameters.

Appendix F

Schedule of Changes Made to the Text From the Previous Edition

As of May 1, 2008

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Terms Used to Define Professional Requirements

The 2008 editions of the AICPA Audit and Accounting Guides, including this guide, have been updated to conform with AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1), and AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), in which professional requirements are categorized as either *unconditional requirements* or *presumptively mandatory requirements*, each of which is associated with specific wording such as *must* or *is required* or *should*. These standards distinguish *professional requirements* set forth in the standards from *explanatory material* contained in the standards, the latter of which requires only the auditor, practitioner, or accountant's "attention and understanding." Whether the auditor, practitioner, or accountant performs the suggested procedures or actions in the engagement (as stated in the explanatory material) depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard.

Because interpretive publications (including AICPA Audit and Accounting Guides, for example) are recommendations, the publications cannot establish requirements. Paragraph .06 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), states, "The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance."

An interpretive publication, such as this guide, should state the requirement of the standard and then give recommendations on the application of the requirement in the specific circumstances. The terms *must*, *is required*, or *should* may be used in an interpretive publication only when it is clear that the requirement originated in a standard. Otherwise, the user may be uncertain whether a requirement or a recommendation is intended. The following conventions were used to conform the AICPA Audit and Accounting Guides to these standards, which define professional requirements:

- Terms to replace the use of *must*, *should*, and *is required* consist only of those explanatory material terms included in AU section 120, AT section 20, and AR section 20: *could*, *may*, and *might*, and these variations of those terms: *could consider*, *may consider*, and *might consider*.

- When referring guide users to interpretive publications, which consist of interpretations of the Statements on Auditing Standards (SASs), appendixes to the SASs, auditing guidance in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position (SOPs), or to nonauthoritative knowledge sources, if an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used; if not, *should* or *should consider* are used.
- Specific auditing procedures generally are explanatory in nature (the standards generally do not include specific audit procedures). As such, explanatory material terms (*could*, *may*, *might*, *could consider*, *may consider*, or *might consider*) are used, unless the specific audit procedure is the established way or only way of achieving a generally accepted auditing standard objective for this industry, in which case *should* is used.
- If the recommendation is that the auditor consult or familiarize himself or herself with other sources of information, such as Securities and Exchange Commission (SEC) regulations, income tax laws, and industry developments including regulatory, economic, and legislative developments, then the following considerations were used in developing which terms to use in the guides:
    - — If the purpose of the recommendation is for the auditor, practitioner, or accountant to develop the required understanding of the entity and its environment for risk assessment purposes, and an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used within the recommendation; if not, *should* or *must* is used depending upon the associated standard requirement.
    - — If the purpose of the recommendation is for the auditor, practitioner, or accountant to perform the engagement in accordance with AICPA *Professional Standards*, and the knowledge is available *only* from the source cited (such as SEC regulations, income tax law, and the like), then *should* is used. If the knowledge is available from other sources as well, *explanatory material* terms are used.
- The guides contain guidance for management, which includes best practices for the industry. Because the recommendations are best practices, the terms *ordinarily should* or *generally should* are used.

Reference	Change
Notice to Readers and Preface	Updated.
Paragraph 1.03	Revised to reflect the appropriate use of terms used to define the professional requirements of auditors, practitioners, and accountants in AU section 120, AT section 20, and AR section 20 of AICPA *Professional Standards*.
Paragraph 3.01	Revised for clarification; Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Former footnote 2 in paragraph 3.01	Deleted.
Paragraphs 3.09 and 3.18	Revised to define professional requirements.
Paragraphs 4.02–.03	Added to reflect the issuance of PCAOB Auditing Standard No. 5.
Former paragraph 4.05 and former footnote † in former paragraph 4.05	Deleted.
Paragraph 4.06	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraph 4.08	Revised for clarification.
Former footnote 1 in paragraph 4.08 and former paragraph 4.11	Deleted.
Paragraph 4.11	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraphs 4.15–.19	Added for clarification.
Paragraphs 4.23 and 4.28	Revised to define professional requirements.
Paragraph 4.30	Revised for clarification; Revised to define professional requirements.
Footnote 1 in heading before paragraph 4.32	Added to reflect the issuance of Technical Questions and Answers (TIS) section 8200.05–.16.
Former paragraphs 4.32–.33 and former footnote † in former paragraph 4.32	Deleted.
Paragraphs 4.34 and 4.37	Revised to define professional requirements.
Paragraph 4.46	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.

Reference	Change
Former paragraph 4.48	Deleted.
Paragraph 4.50	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraph 4.53	Revised for clarification; Revised to define professional requirements.
Paragraphs 4.59–.61	Added for clarification.
Paragraph 5.09	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraph 5.11	Revised for clarification; Revised to define professional requirements.
Paragraph 6.11	Revised for clarification; Revised to define professional requirements.
Paragraph 6.13	Revised to define professional requirements.
Paragraphs 6.17–.18	Revised for clarification; Revised to define professional requirements.
Paragraphs 6.30–.31	Revised to define professional requirements.
Paragraph 6.37	Revised for clarification.
Paragraph 6.48	Revised to define professional requirements.
Former footnote ‡ in paragraph 6.56	Deleted.
Paragraphs 6.59–.60	Revised to define professional requirements.
Paragraphs 6.69–.70	Revised for clarification.
Former footnote 1 in paragraph 6.69	Deleted.
Paragraph 6.76	Revised to reflect the issuance of EITF Issue No. 07-3.
Paragraphs 6.80–.81	Revised to define professional requirements.
Footnote ‡ in paragraph 6.90	Added.
Paragraphs 9.02–.03	Added to reflect the issuance of PCAOB Auditing Standard No. 5.
Former paragraph 9.05 and former footnote † in former paragraph 9.05	Deleted.
Paragraph 9.06	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraph 9.08	Revised for clarification.
Former footnote 1 in paragraph 9.08	Deleted.

Reference	Change
Former paragraph 9.11	Deleted.
Paragraph 9.11	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraphs 9.15–.19	Added for clarification.
Paragraphs 9.23 and 9.28	Revised to define professional requirements.
Paragraph 9.30	Revised for clarification; Revised to define professional requirements.
Footnote 1 in heading before paragraph 9.31	Added to reflect the issuance of Technical Questions and Answers (TIS) section 8200.05–.16.
Former paragraphs 9.31–.32	Deleted.
Paragraph 9.33	Revised for clarification.
Paragraph 9.36	Revised to define professional requirements.
Paragraph 9.45	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Former paragraph 9.47	Deleted.
Paragraph 9.49	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraph 9.52	Revised to define professional requirements.
Paragraphs 9.58–.60	Added for clarification.
Former footnote * to title of chapter 10	Deleted.
Paragraphs 10.11 and 10.19	Revised for clarification; Revised to define professional requirements.
Paragraphs 11.09 and 11.19–.22	Revised to define professional requirements.
Paragraph 11.30	Revised for clarification; Revised to define professional requirements.
Paragraph 11.34	Revised to define professional requirements.
Footnote ‡ in paragraph 11.39	Revised.
Former footnote † in paragraph 12.16	Deleted.
Footnote † in paragraph 12.16	Added.
Paragraph 12.16	Revised for clarification.
Paragraph 12.18	Revised to define professional requirements.

Reference	Change
Former footnote 1 in paragraph 12.18	Deleted.
Paragraph 12.19	Revised to define professional requirements; Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Former paragraph 12.20 and former footnote ‡ in former paragraph 12.20	Deleted.
Paragraphs 12.22–.26	Revised to reflect the issuance of FASB Statement Nos. 157 and 159; Revised to reflect the issuance of FSP FAS 157-2.
Paragraph 12.27	Revised to define professional requirements.
Former paragraphs 12.31–.33	Deleted.
Paragraphs 12.29–.31	Revised for clarification; Revised to define professional requirements.
Paragraph 12.34	Revised for clarification; Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraphs 12.36–.37	Revised for clarification.
Paragraph 12.38	Revised to define professional requirements.
Paragraphs 12.39–.41	Added for clarification.
Paragraph 12.42	Added for clarification; Added to reflect the issuance of PCAOB Auditing Standard No. 5.
Paragraph 12.43	Revised to define professional requirements.
Paragraph 13.01	Revised to reflect the issuance of PCAOB Auditing Standard No. 5.
Former paragraph 13.02	Deleted.
Paragraph 13.07	Revised for clarification.
Paragraph 13.15	Revised to define professional requirements.
Former footnote † in paragraph 13.21	Deleted.
Paragraphs 13.21–.22	Revised to define professional requirements.
Paragraph 13.23	Revised for clarification; Revised to define professional requirements.
Paragraph 13.24	Revised to define professional requirements.
Paragraph 13.27	Revised for clarification; Revised to define professional requirements.

Reference	Change
Paragraph 13.30	Revised for clarification.
Paragraphs 13.31–.32	Revised for clarification; Revised to define professional requirements.
Paragraphs 13.34–.35 and 13.37	Revised to define professional requirements.
Paragraph 13.40	Revised for clarification.
Former footnote 6 in paragraph 13.40	Deleted.
Paragraph 13.41	Revised to define professional requirements.
Former paragraphs 13.42–.44	Deleted.
Former Appendix A	Deleted.
Appendix A	Material under the heading "Illustrative Financial Statements of an Agriculture Producer" revised for clarification; Former footnote ‡ under the heading "Illustrative Financial Statements of an Agricultural Producer" deleted; Footnotes 1 and 2 revised for clarification; Material under the heading "Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting" revised to reflect the issuance of PCAOB Auditing Standard No. 5; Former footnote ‖ under the heading "Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting" deleted; Footnote 3 revised for clarification; Footnote 4 added for clarification; Former footnote # in exhibit A-3 deleted; Footnote ‡ in exhibit A-3 revised for clarification and revised to reflect the issuance of FSP FIN 48-2; Former footnote 4 deleted; Former footnote # in exhibit A-3 deleted; Footnote 5 added for clarification; Footnotes 6 and 7 revised for clarification; Footnote 11 revised for clarification; Former footnote # in exhibit A-10 deleted; Footnotes 13 and 14 added for clarification; Footnotes 15 and 16 revised for clarification; Former footnote # in exhibit A-18 deleted; Footnote 21 added for clarification; Footnote 22 added for clarification; Footnote 23 revised for clarification; Footnote 24 added for clarification; Former Footnote # in exhibit A-18 deleted.
Appendix C	Updated.
Appendix D	Updated.
Appendix E	Updated.

Glossary

abnormal costs. Those costs above normal costs (which can be defined as an acceptable standard of achievement under ordinary operating conditions).

advances. Generally used in marketing cooperatives to denote amounts paid to patrons prior to final settlement. For example, amounts paid to patrons on delivery of crops.

agricultural cooperatives, exempt and nonexempt. Cooperatives classified according to their federal income tax status. Both types are permitted to deduct from taxable income the patronage earnings distributed or allocated on a qualified basis to patrons to the extent that the distributions represent earnings of the cooperative derived from business done with or for the patrons. In addition, cooperatives meeting the requirements of Internal Revenue Code section 521 (exempt cooperatives) are permitted to deduct (1) limited amounts paid as dividends on capital stock and (2) distributions to patrons of income from business done with the U.S. government or its agencies as well as income from nonpatronage sources.

annual. A crop that completes its life cycle, from seed to mature plant, in one growing season.

anticipatory hedge. The use of commodity futures contracts or options to minimize risk from price fluctuations for an expected transaction. For example, a producer who is committed to growing a crop or raising livestock and wishes to fix the sales price may use an anticipatory hedge. Anticipatory hedges are sometimes referred to as forecasted transactions. As defined in Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, a forecasted transaction is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

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

base capital plan, revolving capital plan.[*] Plans designed to require capital investment by cooperative members in proportion to each member's

---

[*] Some agricultural cooperatives may have retained allocated equities which are usually repaid to cooperative patrons over a specific number of years. These retained allocated equities may meet the definition of mandatorily redeemable financial instruments under Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and as such may have to be classified as liabilities. However, in accordance with FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for non-public entities are deferred indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. Readers should be alert to further developments.

current use of the cooperative. A base capital plan is usually funded over a specific period of time with an established amount of investment required each year. Capital investment is evidenced by the issuance of capital certificates (qualified or nonqualified written notices of allocation) in lieu of cash payments to members. These certificates are typically redeemed in series according to year of issue, with the earliest years first. The revolving cycle is determined by the board of directors on the basis of current capital requirements.

bed. An area of ground prepared for seeding or planting.

breeding herd. A group of animals used for breeding purposes.

broiler chickens. Chickens produced for slaughter.

capital certificates (revolving fund certificates, capital-retain certificates).* A type of patrons' equities withheld by cooperatives from distributions of net earnings, credited to the patron's account, and usually revolved (paid) over a specific number of years.

cash advance method (cost advance method). A method of accounting for inventories of a marketing cooperative operating on a pool basis. Under this method, inventories are accounted for at the amount of cash advances made to patrons.

cash or spot price. The price at which commodities available for immediate delivery are currently selling.

commercial herd. A breeding herd used to produce standard-quality animals without emphasis on any particular breed or bloodlines.

commercial production. The point at which production from an orchard, vineyard, or grove first reaches a level that makes operations economically feasible based on prices normally expected to prevail.

commodity. An agricultural product, such as wheat or sugar.

consent. Refers to the patron's agreement to report noncash distributions from cooperatives for income tax purposes. Consents are required in order for the cooperative to deduct patronage distributions for income tax purposes.

cover. The purchase (or sale) of a futures contract for a particular commodity to offset a previously established short (or long) position.

crop. Grains, vegetables, fruits, berries, nuts, and fibers grown by agricultural producers. The term is also used to refer to a calf crop.

crop development costs. Costs incurred up to the time crops begin to be produced in commercial quantities, including the costs of land preparation, plants, planting, fertilization, grafting, pruning, equipment use, and irrigation.

crop year. Generally the period from the harvest of a crop to the corresponding period in the following year. When used in connection with commodity markets, the term assumes a more specific meaning. For example, the U.S. crop year for wheat begins on July 1 and for cotton begins on August 1.

---

* See footnote * to *base capital plan, revolving capital plan.*

crossbreed. An animal that is the product of two different breeds. Sometimes used to denote generations, as in first cross, second cross, and so on.

cross hedge. The use of a commodity traded on a commodity futures market to hedge a commodity for which there is no such market. The practice is acceptable if there is a clear economic relationship between the two commodities, such as when the futures price of the substitute commodity moves in tandem with the cash price of the commodity being hedged, and provided high correlation is probable.

deep-ripping. To split open the ground in a field at a depth greater than normal plowing so that air, water, and chemicals can penetrate.

feeder. A young animal cared for and fed for a period of time and ultimately destined for slaughter.

feedlot. The enclosed area in which animals are cared for and fed until fattened and ready for slaughter.

forward purchase contract. An agreement to buy production from a specified acreage or to buy a specified quantity of a commodity at a set or determinable price for delivery at a specified future date.

forward sales contract. An agreement to sell production from a specified acreage or to sell a specified quantity of a commodity at a set or determinable price for delivery at a specified future date.

fumigation. To destroy insects by application of smoke, a chemical, or gas vapor. It can be applied to produce in storage. It also includes treatment of soil, often to considerable depth, to kill diseases, nematodes, or viruses.

futures contract. A standard and transferable form of contract that binds the seller to deliver to the bearer a standard amount and grade of a commodity at a specific location at a specified time. It usually includes a schedule of premiums and discounts for quality variation.

futures market. A federally designated commodity exchange organized to provide the facilities and rules for trading certain commodities swiftly and economically, by using uniform contracts for delivery or receipt of commodities of a specified grade at a specified time.

grade. The classification of a commodity or an animal by quality, size, or ripeness. Standards of uniformity are usually designated by a governing group, such as the U.S. Department of Agriculture or a recognized trade association.

grafting. Inserting a living portion of a plant into the limb or trunk of another tree or vine to change the variety of species.

grove. Fruit or nut trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit or nuts.

growing crop. A field, row, tree, bush, or vine crop before harvest.

harvested crop. An agricultural product, gathered but unsold.

hatching eggs. Eggs used for production of poultry. Hatching eggs, as distinguished from market eggs, must be fertile.

hedge. Any action taken to reduce the risk of loss from price fluctuations of products to be sold or materials to be purchased. A hedge may be accomplished by the use of forward or commodity futures contracts. As used in this Guide, the words *hedge* and *hedging* pertain to the use of commodity futures contracts and options bought and sold on established markets.

hedging-procedures method. A method of accounting for inventory, commonly used by grain merchants, in which the approximate cost of hedged inventories is determined by pricing quantities on hand at market and by adjusting for gains and losses on related open futures and forward contracts.

hybrid. Any new or different variety of animal, plant, tree, or vine produced by crossbreeding or pollinizing two or more varieties within a general species.

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

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

market-order prices. Prices for raw products established by federal or state agencies.

marketing cooperative. A cooperative that markets the products (crops, livestock, and so on) produced by its patrons.

marketing pool. A method of accounting for business done between patrons and their marketing cooperative whereby the cooperative usually takes title to the raw product on delivery, commingles products of like kind and quality, performs whatever processing and packaging are required, sells the finished product, and maintains records of sales and payments for product and expenses. When the pool is closed, the cooperative distributes net earnings, less previous advances, to the pool patrons on the basis of the amount or value of product delivered.

member and nonmember (of a cooperative). A member is an owner-patron of a cooperative who is entitled to vote at corporate meetings. A nonmember patron is not entitled to voting privileges. A nonmember patron may or may not be entitled to share in patronage distributions, depending on the articles and bylaws of the cooperative or on other agreements.

net inventory position. The quantity of a specified commodity on hand that is adjusted for the quantities on open forward and futures contracts.

net proceeds, net margins, net savings, net earnings. Used to denote the excess of marketing or sales proceeds over costs of operations and income taxes. They normally represent the amount available for distribution to patrons on a patronage basis.

net realizable value. Valuation of inventories at estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

nonpatronage income. Earnings other than those from business done with or for patrons on a patronage basis.

nonqualified written notice of allocation. A nonqualified written notice of allocation is similar to a qualified written notice of allocation, except that no portion of the nonqualified notice is paid in cash at the time of notification and the patron is not required to report it for income tax purposes until redemption.

normal costs. Those costs that conform to an acceptable standard of achievement under ordinary operating conditions.

open contract. An unliquidated (or open) futures contract.

option. A contract allowing, but not requiring, its holder to buy (call) or sell (put) a specific or standard commodity or financial or equity instrument at a specified price during a specified time period. The principal difference between an option and a futures contract is that the exercise of a futures contract is mandatory.

orchard (see grove). Fruit trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit.

patron. Any individual, trust, estate, partnership, corporation, or cooperative with whom or for whom a cooperative does business on a cooperative basis, whether a member or nonmember of the cooperative association.

patronage. The amount of business done with a cooperative by one of its patrons. Patronage is measured by either the quantity or value of commodities received from patrons by a marketing cooperative and the quantity or value of the goods and services sold to patrons by a supply cooperative.

patronage allocations.* Patronage earnings distributed, or allocated, to individual patrons on the basis of each patron's proportionate share of total patronage. Such allocations, which include notification to the patron, may be made on a qualified or nonqualified basis.

patronage earnings.* The excess of a cooperative's revenues over its costs arising from transactions done with or for its patrons. Generally, a significant portion of those earnings is allocated to the cooperative's patrons in the form of cash, allocated equities, or both.

patron equities.* Funds invested by the members of a cooperative, in the form of either cash or reinvested noncash patronage distributions, that represent ownership in the cooperative rather than debt. These investments may be represented by capital stock, membership certificates, capital certificates, patronage certificates, revolving-fund certificates, or other similar instruments.

per-unit retain.* A form of financing used by marketing cooperatives and usually based on tonnage or quantities of product delivered by patrons. Typically it involves withholding cash from the amounts advanced to patrons at time of delivery. These withheld amounts are ultimately distributed in the form of written notices of allocation, and they differ from patronage refunds because they are not determined on the basis of net earnings. There is no 20-percent cash payment requirement in order for written notices of allocation to be tax deductible.

per-unit retain certificate. A written notice of allocation to the recipient that states the dollar amount of a per-unit allocation.

---

* See footnote * to *base capital plan, revolving capital plan.*

pooling cooperative. A marketing cooperative that receives its members' agricultural products without obligation to pay a fixed price and commingles those products into single or multiple pools for processing and marketing purposes. Pool periods may vary from a week to a year or longer, depending on the product involved. Generally profits or losses are allocated to patrons upon closing of the pool.

pools. Accounting control centers used for determining earnings and patronage refunds due to particular patrons.

Open pools are accounting control centers that are not closed (that is, accounted for) at the end of each accounting period. Open pools are sometimes used by marketing cooperatives for crops that may not be sold for two or more years after their receipt from patrons.

A *single-pool* cooperative determines net proceeds or patronage refunds on the basis of overall operating results for all commodities marketed during an accounting period.

A *multiple-pool* cooperative determines net proceeds or patronage refunds on the basis of separate commodities departments.

progeny. Offspring of animals or plants.

pruning. Cutting away unwanted portions of trees or vines to shape them and to encourage forms of growth that will enhance production and harvest.

pullet. A hen less than one year old.

qualified check. A check or other instrument redeemable in money that is paid as part of a patronage refund or other payment to a distributee who has not given consent with respect to such patronage refund or payment. Imprinted on the check is a statement explaining that endorsing and cashing the check within ninety days constitutes consent by the payee to include in gross income the dollar amount of the written notice of allocation.

qualified per-unit-retain certificate. Any per-unit-retain certificate that the distributee has agreed to recognize for income tax purposes.

qualified written notice of allocation. A written notice of allocation of a patronage distribution from a cooperative to a patron when the distributee has consented to report the distribution for income tax purposes and the cooperative also distributes a cash payment, or a qualified check, equal to 20 percent or more of the total patronage distribution. The term also includes a written notice of allocation that may be redeemed in full for cash within ninety days of its issuance.

raised animals. Animals produced and raised from an owned herd, as opposed to purchased animals.

recurring land development costs. Costs that do not result in permanent or long-term improvements to land (for example, maintenance costs that occur annually or periodically).

registered herd. Animals with characteristics and genealogical information that make them an established breed, with records maintained for each successive generation.

retained earnings (retained margins, earned surplus, unallocated capital reserves, undistributed margins). These terms refer to unallocated earnings of cooperatives on which income taxes have been paid.

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

revolvement.* A colloquial term referring to a plan for redeeming retained allocated equities previously issued to the cooperative patrons.

rootstock. A variety or type of root used to develop trees, vines, or plants by grafting the rootstock onto a different species or variety to produce a tree or vine with the best attributes of the combined varieties. Different rootstocks are usually used to obtain disease or virus-resistant trees or vines.

speculative contracts. Commodity futures and options contracts entered into without offsetting actual or anticipated ownership of or commitments to purchase or sell the commodity.

stated value. The value assigned to a commodity delivered by patrons that approximates the amount the commodity would have sold for on the open market.

summer fallow. The practice of plowing soil so that it will lay open to air and water without the need to support growth for a season.

supply cooperative. A cooperative that supplies to its patrons goods and services used by them in producing their products.

unit-livestock method. Accounting for livestock by using an arbitrary fixed periodic charge. For raised animals the amount is accumulated by periodic increments from birth to maturity or disposition. For purchased animals the arbitrary fixed periodic amount is added to the acquisition cost until maturity or disposition of the animal. The use of this method is inappropriate under generally accepted accounting principles.

vineyard. Grape vines planted in patterns for commercial cultivation and production.

warehouse receipt. A warehouse-issued certificate that lists goods and produce stored and that must be surrendered to receive delivery of the goods. It may be negotiable or nonnegotiable.

written notices of all allocation. Any capital stock, revolving-fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice to the recipient that states the dollar amount allocated to the patron by the cooperative and the portion that constitutes a patronage refund.

---

* See footnote * to *base capital plan, revolving capital plan.*

For additional **Audit and Accounting Guides** log onto the AICPA Store at www.cpa2biz.com – or to automatically receive an annual update immediately upon its release – call 1-888-777-7077.

Additional Publications

Audit and Accounting Guides – 2008 Industry Guides

With conforming changes as of March 1, 2008.

- Common Interest Realty Associations (012578)
- Construction Contractors (012588)
- Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies (012738)
- Employee Benefit Plans (012598)
- Federal Government Contractors (012608)
- Life & Health Insurance Entities (012638)
- Not-for-Profit Organizations (012648)
- State and Local Governments (012668)

With conforming changes as of May 1, 2007.

- Agricultural Producers and Agricultural Cooperatives (012687)
- Brokers and Dealers in Securities (012707)
- Casinos (2006) (012716)
- Entities With Oil and Gas Producing Activities (012657)
- Government Auditing Standards and Circular A-133 Audits (012747)
- Health Care Organizations (012617)
- Investment Companies (012627)
- Property and Liability Insurance Cos. (012677)

Audit and Accounting Guides – 2008 General Guides

- Analytical Procedures (012558)
- Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (2007) (012527)
- Auditing Revenue in Certain Industries (012518)
- Personal Financial Statements (2007) (012757)
- Prospective Financial Information (012728)
- Service Organizations: Applying SAS No. 70, as Amended (012778)

To order log on to the AICPA Store at **www.cpa2biz.com**
Call AICPA at **1-888-777-7077** or fax to **1-800-362-5066**