

7-1940

Audits of Agricultural Cooperatives

Walter L. Bradley

Follow this and additional works at: <https://egrove.olemiss.edu/jofa>



Part of the [Accounting Commons](#)

Recommended Citation

Bradley, Walter L. (1940) "Audits of Agricultural Cooperatives," *Journal of Accountancy*. Vol. 70: Iss. 1, Article 5.

Available at: <https://egrove.olemiss.edu/jofa/vol70/iss1/5>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Audits of Agricultural Coöperatives

BY WALTER L. BRADLEY

IN WHAT respect does the audit of an agricultural coöperative differ from the audit of a commercial institution of comparable size and importance? This question, which should interest both accountants and managers of agricultural coöperatives, is the key to the understanding of what a successful audit of this type should include. The answer lies in the fact that when the normal commercial audit program has been fully applied to an agricultural coöperative, the audit is still only half completed.

Agricultural coöperatives are usually set up under the provisions of special statutes of the respective states in which they are formed. There, if properly organized and operated, they are entitled to certain rights and privileges which do not pertain to a commercial organization. An audit of the circumstances relating to these special features assumes, therefore, an importance equal to the examination of financial and operating data. This second phase of the examination is sometimes aptly called an audit of "membership and patronage."

Coöperative management should be fully informed as to what is involved in an audit of coöperatives, what responsibility it can reasonably expect the public auditor to assume, and what it should expect in his report. A realization of these factors will emphasize the importance of having the work done by competent professional auditors. It is of equal importance that the public accounting profession be aware of the special requirement of such an engagement.

At the outset there should be a clear understanding of the distinction between agricultural coöperatives and the so-called consumer coöperatives. The

former function in a definite field of their own. They are the creatures of specific legislation, and the statutory rights which they enjoy are theirs because of their important service to agriculture. Therefore the special features which this article will discuss do not appropriately apply to the audits of consumer coöperatives.

In its initial phase, an audit of an agricultural coöperative conforms to the requirements of an audit of a commercial enterprise of equal importance or magnitude. However, despite the similarity of the program of examination to be followed, circumstances attending an audit of an agricultural coöperative often impose upon the auditor additional responsibilities such as a more detailed report, the use of special terminology and forms of operating statements, and in many instances offers of financial counsel. These variations, while important, are not the most fundamental differences. They merit elaboration, however, and will be discussed later at greater length.

The second phase in an audit of this type, having to do with organization, membership, and patronage, constitutes the most important addition to the usual audit procedure, for it is only on the basis of conformance to statutory requirements in the matter of organization and adherence to required practices in operation that the particular rights and benefits inherent to this type of organization can be rightfully obtained and retained. As the discussion advances, it will be found that there are two fundamental requirements coincident to the enjoyment of these rights. These embrace not only matters of organization, but the manner of operation.

The history of agricultural coöpera-

tives is replete with instances wherein a coöperative entity was properly set up to qualify for its special rights, but lost those rights because of nonconformance to the requirements in its mode of operation. Let me, therefore, answer in advance the question which may come to the minds of many readers, that the responsibility which we are herein settling upon the auditing profession should rather fall upon legal counsel, and not upon the auditors. *Since compliance in performance* constitutes the acid test of the coöperative's right to enjoy the special benefits conferred by statutes, the auditor has a favored opportunity to observe the extent of compliance, or noncompliance, which is not available to legal counsel, or others, who have not had occasion to observe in detail the actual day-to-day functioning of the institution as reflected in its records of account. It seems fair to expect the auditor to be informed of his special responsibilities in this type of audit, and that he be held responsible for reporting on these essential factors. The penalties involved in noncompliance are often so severe, both with respect to their effect on the corporate charter, and the financial position of the coöperative, that it would constitute gross negligence on the part of the auditor if he did not give due consideration to these requirements in his program of examination and in his report.

AUDITOR'S RESPONSIBILITY

Let me briefly discuss the elements which must be especially considered. There is, first, the matter of corporate organization. The auditor should ascertain that the certificate of incorporation, and the by-laws conform to the requirements of the coöperative law of the state in which it may be organized, and if it be a large coöperative organized in one state and authorized to do business in other states, that the requirements applicable to coöperatives in those other states have been met. It is

entirely possible that the auditor may not feel competent to pass judgment on a purely legal matter. If there be doubts in his mind, the opinion of competent legal counsel should be furnished him, in order that he may be satisfied in this important regard. The coöperative laws of the several states are uniform in many fundamental respects. Minor variations in the definition of members and in the statutory requirements with respect to reserve funds and distribution of margins may appear. The auditor should, therefore, be familiar with the coöperative laws applicable to the operations of the enterprise which he is auditing.

Next, it is his responsibility to determine whether or not the coöperative is actually operated so as to conform to the special requirements of the certificate of incorporation and by-laws, as prescribed. Bearing in mind the two fundamental requirements, compliance with which is necessary to safeguard the special rights and privileges in the premises, there must be not only proper organization, but complete conformance in the day-to-day conduct of the business of the enterprise.

The auditor's responsibility also extends to a determination as to whether the organization, in its charter and by-law provisions, conforms to, or conflicts with, other special statutes, both federal and state, relating to the special rights of agricultural coöperatives, and under which they enjoy the rights to exemption from federal capital-stock taxes and federal corporation-income taxes; the exemption from certain state franchise taxes in states where such exemptions apply; the right to borrow funds from the banks for coöperatives; and the conformation and qualification under blue-sky laws with respect to the sale or other disposition of corporate securities, or in some instances, perhaps, the requirements of registration of securities with the Securities and Exchange Commission.

RIGHTS OF COÖPERATIVES

There often appear to be conflicts between the rights and privileges granted to these coöperatives under the coöperative laws of the several states. An outstanding example will be discussed later.

The principal benefits which accrue to the agricultural coöperative embrace its right to exemption from federal income and capital-stock taxes, and the right to use and borrow from the bank for coöperatives. There are three principal federal statutes in which the definition of agricultural coöperatives can be found, and conditions prerequisite to the enjoyment of special benefits outlined. The most important and all-inclusive of these is found in section 101, paragraph 12 of the internal-revenue code under which the requirements for exemption from the federal taxes, as mentioned, are outlined. Let me quote from statutes as follows:

"The following organizations shall be exempt from taxation under this chapter:

"Farmers', fruit growers', or like associations organized and operated on a coöperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the state of incorporation or 8 per centum per annum, whichever is greater on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dis-

solution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by state law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph."

It will be observed that so far as this federal statute is concerned, the only requirement with respect to organization is that the association shall be organized and operated on a coöperative basis. In its application, this has the effect of accepting the coöperative statutes of the several states. It follows, therefore, that the definition of who shall constitute members of a coöperative shall be those who are entitled to membership under the laws of the particular state involved. But it will also be noted, that this federal statute further qualifies its definition of a coöperative association by imposing the following limitations:

That its volume of business conducted with nonmembers shall not exceed the value of the volume of business done with members, and that the value of the volume of business done with nonproducers of agricultural products shall not exceed 15 per cent of the value of all of its business. This statute covers both marketing and purchasing coöperatives.

Coöperative associations are also defined in another section of federal legislation, namely, in the agricultural-marketing act, as it applies to the administration of farm credit. Chapter 7 of title 12, section 1141j of the U. S. Code defines coöperative associations as follows:

"(a) 'Coöperative association' defined—As used in this subchapter, the term 'coöperative 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 the mutual benefit of the members thereof as such 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 coöperative 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."

Compliance with these provisions is necessary in order to qualify agricultural coöperatives with the right to borrow money from the federal banks for coöperatives.

Another definition of what consti-

tutes an agricultural coöperative association is found in the so-called "Capper-Volstead act," which is section 291 of chapter 12, title 7, of the U. S. Code.

"Persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers, may act together in associations, corporate or otherwise, with or without capital stock, in collectively processing, preparing for market, handling, and marketing in interstate and foreign commerce, such products of persons so engaged. Such associations may have marketing agencies in common; and such associations and their members may make the necessary contracts and agreements to effect such purpose; *provided however*, That such associations are operated for the mutual benefit of the members thereof, such as producers, 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, or

"Second: That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

"Third: That the association shall not deal in products of nonmembers to an amount greater in value than such as are handled by it for members."

It will be observed that the Capper-Volstead act differs from the other acts in that it was made applicable only to marketing coöperatives, whereas the provisions of the farm-credit act and the internal-revenue laws cited above, apply equally to both marketing and purchasing coöperatives.

The section of the internal-revenue law cited, which states the requirements for exemption, is the most all-inclusive, and it follows that if a coöperative organization can conform to its provisions, it will properly qualify as an agricultural association entitled to the rights conferred by the farm-credit act. Let me review those principal qualifications. First, that it shall do at least 50

per cent of its business with members, and at least 85 per cent of its business with agricultural producers. Incidentally, most of the state statutes which define the terms of membership in an agricultural coöperative, limit the rights to such membership to agricultural producers.

The regulations pertaining to the revenue act also provide that substantially all of the membership stock shall be owned by producers of agricultural products, who are patrons. This does not apply to holders of nonvoting preferred shares.

The applicable section of the federal-revenue act does not cover an essential feature of coöperative organization, which is found in both the farm-credit act and the Capper-Volstead act, to the effect that each member shall be entitled to but one vote, irrespective of the number of shares held. This is also, almost uniformly, a requirement of the coöperative statutes of the several states.

All of the federal acts cited, and also most of the state statutes, place a definite limitation on the rate of return on capital, or membership stock; and most of the state statutes limit the participation of such shares in liquidation to the par value thereof.

Let me next point out that the federal tax statute quoted requires, in the instance of marketing coöperatives, that it shall turn back to the patrons the proceeds of sales, less the necessary marketing expenses on the basis of either the quantity or value of the products furnished by them, or in the instance of purchasing coöperatives, that such supplies and equipment shall be turned over to patrons at actual cost, plus necessary expense. It follows that no enterprise can accurately gauge in advance just what its cost of doing business may be. The general practice, therefore, has been for marketing organizations to make returns to growers, after deducting a predetermined burden of expense, and for a purchasing coöperative to add to its cost of purchases

a predetermined margin to cover its costs of doing business. Actual compliance with the statute with respect to doing business at cost, therefore, involves utilization of the "patronage dividend."

The federal-revenue act has been supplemented, by provisions of the regulations of the Commissioner of Internal Revenue applicable thereto, to provide a further condition that any undistributed margins, when distributed, must be to all patrons on a basis proportionate to their patronage. It makes it very clear that nonmember patrons must be treated in this matter just exactly the same as members.

The regulations cited also require that proper permanent records of the individual's patronage be available. The regulations further provide that a coöperative may accumulate and maintain a reserve which may be required by state statute or reserve for expenditure for any necessary purpose, and still retain its right to exemption. Furthermore, the regulations provide that the coöperative association must establish that it has no net income for its own account other than that reflected in the authorized contingent reserve or surplus; and further, that where a coöperative association is engaged in both marketing and purchasing activities, it may be entitled to exemption if, as to each of these functions, it meets the requirements of the internal-revenue code.

Where a coöperative organization has, in its form of organization and in the conduct of its business affairs, conformed to these fundamental requirements, it is entitled to the rights and benefits granted by these special statutes. But conformance in both matters of organization and performance are requisite.

EXEMPTION FROM TAXATION

In the matter of exemption from federal taxation, there is another essential preliminary which must be met in order

that the rights to this exemption may be enjoyed by the coöperative. It is not enough that it qualify as a matter of organization and operation; it must actually apply to the Commissioner of Internal Revenue for such exemption, and make an affirmative showing as to its right to exemption. This requirement has been too generally overlooked.

There have been instances wherein coöperatives have operated for a number of years, complacently certain of their rights to exemption from taxes, and have accumulated substantial surplus and reserves which, to a qualified coöperative, would be exempt from taxes, only to find ultimately that they had overlooked the formality of making application for exemption and the affirmative showing necessary to prove their rights to it. They discover too late that a technical noncompliance has deprived them of the exemption and necessitated the assessment of substantial taxes, penalties, and interest against them.

These instances have sometimes been caused because of variations between the definition and requirements of coöperatives, according to the state statutes under which they were formed and the provisions of the federal law granting specific privilege or immunity. A marked instance of this variation may be found in the Pennsylvania coöperative law, under the terms of which a coöperative organization may distribute patronage dividends to patron stockholders at double the rate paid to nonstockholder patrons. A coöperative which makes a distribution of patronage dividends in conformance with this statute would still be an agricultural coöperative according to the laws of the State of Pennsylvania, and would be obliged to forfeit its right to tax exemption and other benefits under the federal statute. Failure to detect any such discrepancy and to actually obtain the exemption on the basis of the affirmative showing required has, in many in-

stances, subjected coöperative organizations to relatively heavy liability for taxes, penalties, and interest. The liability in such cases is not contingent. It is vitally actual, even though it may not be known or recognized prior to the audit. The illustration merely serves to emphasize the responsibility of the auditor in this regard, in order that he may intelligently reveal the full extent of the coöperative's liability.

ACCOUNTING SYSTEM AND RECORDS

Another responsibility of the auditor of an agricultural coöperative involves a thorough survey of the accounting system, records, and procedure, to ascertain that the coöperative is in a position to comply with the special requirements.

Among the first of these requirements are patronage records to reflect the volume of patronage, either marketing or purchases, by each patron. It is probably up to the individual coöperative to determine whether these patronage records shall reflect the volume of patronage on the basis of dollar value without regard to commodities, on the basis of dollar value according to commodities, or on the basis of unit value according to commodities. A study of the by-laws of a large number of coöperatives indicates that the basis of determining the volume of patronage is not entirely uniform, and that patronage dividends have been paid by coöperatives according to one of the three bases outlined above, or a combination thereof. The provisions of the federal statute are not entirely clear in this matter, nor do the statutes of the several states offer much specific guidance or regulation. The federal statute refers to "turning back to patrons the proceeds of sales, less the necessary marketing expenses on the basis of either the quantity or the value of the products furnished by them," or, "turning over supplies and equipment purchased for patrons at actual cost plus necessary expenses." Apparently,

considerable leeway may be granted the coöperative in determining whether to make patronage refunds on a unit basis, a dollar basis according to commodities, or a dollar basis irrespective of commodity. The essential thing is that the coöperative shall be in a position to know who its patrons are, and the respective volume of patronage accorded from each patron, so that if, as, and when distribution of patronage dividends may be made, they may be made ratably to all patrons alike. To this end, patronage records are necessary.

There must be an adequate record of membership, either as reflected in the stock records or otherwise, depending on whether the coöperative is a stock corporation or a membership corporation without capital stock. The membership records should indicate all those who are qualified members in accordance with the by-laws of the association and the statutes of the respective state applicable.

The system survey should also establish the adequacy of cost records maintained by the association in all instances where the by-laws require that the patronage dividend shall be paid on a unit basis according to margins realized in any one commodity.

The important thing to be stressed as a result of this discussion of audit of membership and patronage is that constant compliance *in performance* is an essential prerequisite to the continued enjoyment of the particular advantages accruing to an agricultural coöperative. It is not enough that exemption from taxes may have been obtained in the past. Coöperative management, in many instances, is under constant pressure to enlarge the scope of its operations beyond the limitations prescribed for its acceptable activities. The obligation rests with the coöperative to maintain its privileged position once it has been obtained, and to maintain it through effective control of its operations within the circumscribed limits

upon which its preferment is predicated. To this end, the auditor must be alert.

DETAIL IN REPORT

Let me briefly revert to the initial phase of auditing an agricultural coöperative, involving the verification of financial data, and the report thereof. We have indicated that there may possibly be requirements for greater detail in the report. It must be borne in mind that there are large coöperatives and small coöperatives, but even in the large institutions the directors are not usually in as close daily contact with the business enterprise as the directors of the usual commercial enterprise of like moment would be. And further, in many instances, the coöperative itself does not furnish its directors with as much in the way of operating reports and other financial data as may be available to the directors of commercial enterprises. This is especially true among the smaller coöperative units. It therefore follows that the auditor may do well to include in his report of audit a considerably greater amount of explanatory comment and detailed data than he otherwise would furnish.

It also follows that the coöperative may require of its auditor more in the way of financial counsel. This may be particularly helpful in respect to the type of coöperative organization to be utilized, a financial plan, and the use of certain types of capital securities, or certificates of beneficial interest, in order to meet its capital needs and still conform to the requirements of coöperatives with respect to distribution of margins. The coöperative may depend upon the auditor for guidance in obtaining and maintaining a balanced financial structure, the determination and recommendations with respect to amounts available for patronage dividends, and the computation of amounts to be credited to the statutory or other reserves.

TERMINOLOGY

There are also the questions of terminology peculiar to coöperatives and the most effective form for presenting operating statements. In this respect the auditor's report of a coöperative enterprise may vary greatly from that usually followed in commercial practice. The coöperative is, by its very nature, a nonprofit organization. Accordingly, the word "profits" should not be applied. Some coöperative managers utilize the word "savings" instead of "profits," but we believe the more generally accepted and appropriately descriptive term is that of "margins," and accordingly the surplus account, as distinguished from the statutory contingent or other reserves, should be known as "undistributed margins." In the instance of a purchasing coöperative, supplies purchased for patrons should not be referred to as "sales to patrons," but rather are generally referred to as "purchases for patrons," and the cost of such purchases as "cost of patrons' purchases." The difference between patrons' purchases and the cost thereof, which in commercial language would be known as "gross profit," should be reflected as "gross margin." This use of special terminology may be considered of little consequence, and yet it is relatively important in that it permits the telling of the story of the coöperative's operations in terms which the farmer coöperator understands and which are, accordingly, more effective.

FORM OF STATEMENT

The form in which the operating statement should be presented cannot be uniformly proscribed in an article such as this, inasmuch as the functions performed by the different types of agricultural coöperatives vary greatly. There are marketing agencies which, for practical purposes, operate on the so-called "purchase-and-sale" plan, under

which they acquire inventories from patrons for which they make advances to patrons at the time. These products are, in turn, sold to customers, with an ultimate adjustment to patrons for any net margins accruing in excess of advances made. There are as well marketing coöperatives, found principally in the livestock field and in certain produce marketing operations, wherein the unit of revenue accruing to the coöperative is not the gross sale price at which the coöperative may have disposed of the patrons' produce, but is in fact only the fee or commission which the coöperative may have assessed against the patron for the services rendered. In these instances, the basis of computing each patron's portion of any net margins to be distributed is based, not on the total value of produce marketed through the institution, but rather according to proportionate contributions of commissions or fees.

The general philosophy to be reflected in the arrangement of information in the operating statement of an agricultural coöperative should be to reflect not profits, but rather net cost of service. In the instance of a marketing coöperative, this means the return to patrons of all proceeds, less cost of doing business and required additions to the reserves; and, in the instance of purchasing coöperatives, the actual cost of supplies furnished, plus the net cost of doing business, and required additions to reserves.

With coöperative management fully informed as to what it should reasonably expect from an audit, and a public accounting profession universally enlightened as to its duties and responsibilities, the profession should find itself in a position to render an essential service to agriculture, and make a genuine and distinctive contribution by helping to correct or eliminate costly errors of the past.