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Missouri State Auditor

AGRICULTURE

Grain Regulatory Services Program

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YELLOW SHEET

Findings in the audit of the Department of Agriculture, Grain Regulatory Services program

According to department officials, grain producers suffered losses valued at over \$32 million when two licensed grain dealers became insolvent in February 2009. The Director of the Department of Agriculture subsequently requested an audit of the Grain Regulatory Services program (GRS). Our audit objectives were to (1) evaluate GRS examination policies and procedures, including the regulatory efforts taken in relation to two recent grain dealer failures, and (2) evaluate and compare Missouri's grain dealer and warehouse laws, regulations, and procedures to those of other states and the federal government.

GRS Examinations of Failed Licensees

Better execution of GRS examination procedures during 2008 GRS examinations would have detected irregularities occurring at two licensed grain dealers. For the 2008 GRS examinations of these entities, improper execution of examination procedures by GRS auditors prevented the earlier detection of one insolvency and precluded further regulatory action to reduce the losses from the other pending insolvency.

GRS examination procedures did not always adhere to established requirements. During the September 2008 examination of the Martinsburg dealer, the GRS did not verify that detailed information (such as dates, grain type and quantity, and producer name) on canceled checks and producer settlements was in agreement with information on scale tickets obtained at the time the dealer delivered the grain for sale. Had the required procedures been performed properly, the GRS would have determined the dealer had not truthfully disclosed obligations for the current and previous examinations, and had not paid for grain within 30 days as required for a Class IV dealer license. If the GRS had discovered the fraud during the September 2008 examination, the loss to producers may have been limited. The GRS also did not perform examinations of the Martinsburg dealer in accordance with established frequency intervals.

During the April and September 2008 examinations of the Gallatin dealer, the auditors noted large negative grain equities (about \$699,000 and \$639,000, respectively), but the GRS did not require additional bonding to be provided by the dealer, and the auditors improperly considered owner assets that were not related to the operation of the grain dealer.

GRS Examination Procedures

GRS confirmations were not effective in disclosing unrecorded obligations at both the Martinsburg and Gallatin dealers because producers did not return confirmation forms notifying the GRS of unrecorded obligations. GRS examination procedures could be enhanced by requiring auditors to review additional licensee sales revenue records including bank deposits and settlement sheets of the purchasing elevator or grain terminal. GRS procedures do not require the review of bank deposits that were made immediately prior to the time of the examination. GRS procedures do not require the auditor to reconcile, on a test basis, the quantities of grain



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recorded as sold on the licensee's daily position record and individual producer settlements to settlements from the purchasing grain entity. GRS regulations do not require licensees to utilize pre-numbered contracts, settlement sheets, or receipts for direct farm-to-market transactions. The GRS has assigned few licensees to accelerated examination frequencies and is often unable to conduct those examinations within the assigned frequency.

Other Regulatory Concerns

The GRS does not require licensees to submit audited financial statements and does not require more frequent submission of financial reports from licensees with financial solvency concerns. Missouri state law provides the GRS the authority to impose additional financial reporting requirements upon licensees as needed. The bonding amounts required of licensees by the GRS may be too low to adequately protect grain producers. In addition, the GRS has not imposed adequate additional dealer bonding for licensees with financial solvency concerns. The bonds for the Martinsburg and Gallatin dealers provided producers with only about 1 percent and 12 percent of the value of their claims, respectively. State requirements for minimum net worth of licensees are low and outdated. The GRS should consider the benefits of an indemnity fund, including the additional financial protection afforded grain producers, and consult with the General Assembly regarding the establishment of an indemnity fund.

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Department of Agriculture

Grain Regulatory Services Program

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SUSAN MONTEE, JD, CPA

Missouri State Auditor

Honorable Jeremiah W. (Jay) Nixon, Governor
and
Dr. Jon Hagler, Director
Department of Agriculture
Jefferson City, Missouri

At the request of the Director of the Department of Agriculture, we have audited the Department of Agriculture Grain Regulatory Services program (GRS). The scope of our audit included, but was not necessarily limited to, the years ended June 30, 2009 and 2008. The objectives of our audit were to:

1. Evaluate GRS examination policies and procedures, including the regulatory efforts taken in relation to two recent grain dealer failures.
2. Evaluate and compare Missouri's grain dealer and warehouse laws, regulations, and procedures to those of other states and the federal government.

Our audit determined that better execution of GRS examination procedures would have detected irregularities sooner, and may have reduced producer losses resulting from the failure of two licensed grain dealers in early 2009. The audit also identified additional areas where the department's grain related regulation efforts need improvement.

We conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a basis.

A handwritten signature in cursive script that reads "Susan Montee".

Susan Montee, JD, CPA
State Auditor

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Department of Agriculture

Grain Regulatory Services Program

Introduction

Background

According to department officials, grain producers suffered losses valued at over \$32 million when two licensed grain dealers became insolvent in February 2009.

Organizational information

The Grain Regulatory Services program (GRS), a functional unit within the Grain Inspection and Warehousing Division of the Missouri Department of Agriculture, licenses and regulates grain dealers and warehouses. The Missouri Grain Dealer Law, Sections 276.401 through 276.582, RSMo, establishes licensing requirements for grain dealers. The Missouri Grain Warehouse Law, Chapter 411, RSMo, establishes licensing requirements for grain warehouses. These laws set forth the duties and responsibilities of the GRS and its regulatory authority over grain dealers and warehouses.

As of June 30, 2009, the GRS licensed 175 warehouses with storage capacity totaling about 114 million bushels and 258 grain dealer companies that reported grain purchases totaling about \$5.7 billion in 2008. There were also 49 warehouses licensed under federal law for which the GRS has no oversight authority. Although licensed separately, all federal and state licensed grain warehouses are operated in conjunction with state licensed grain dealers.

The GRS conducts examinations of dealers and warehouses to measure and verify grain in storage, verify the accuracy of settlements to sellers of grain, and analyze records to ensure licensees are financially sound and operated in compliance with state law. As of December 31, 2009, the GRS employed a program administrator, 11 auditors, and 3 administrative staff.

Grain dealers are licensed under one of six classifications. All dealers are required to issue payment to grain sellers upon demand, or if demand is not made, within certain contractual or maximum timeframes. State law requires the GRS conduct at least one annual examination of each Class I-III dealer and authorizes the GRS to examine Class IV-VI dealers.

The following table lists the dealer classes, the number of dealers in each group as of June 30, 2009, whether the class may offer credit sales, and the maximum number of days dealers have to make payment if payment is not demanded.

Class	Number	Credit Sales Contract Allowed	Timeframe for Payment (days)
I	188	Yes	180
II	15	No	180
III - VI	55	No	30
Total	258	N/A	N/A



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Common grain
marketing methods
and terms

Only Class I dealers may purchase grain under credit sales contracts wherein payment and/or pricing of the grain is deferred to a later date. Class I dealers must execute formal written contracts if payment for grain is not made within 180 days. Class II-VI dealers may not issue any type of credit sales contracts.

Class II dealers are those dealers who also maintain a warehouse license, but are not Class I dealers. Class II dealers must make payment within 180 days or upon demand by the seller. Class III dealers have physical storage facilities, but no warehouse license to store grain for others. Class I-III dealers must maintain an office and office hours. Class IV dealers are principally truckers who also buy or sell grain. The only grain transactions of Class V dealers are sales of grain from their own farming operations. Class VI dealers are any dealers not classified as Class I-V dealers. Class III-VI dealers must make payment for grain within 30 days or upon demand by the seller.

According to a GRS publication¹, the most common methods available to producers to market their grain are cash sale, forward price contract, grain bank, storage, and warehouse receipt. Class I dealers may offer delayed pricing, deferred payment, and minimum price contracts. There are many variations of these common methods such as hedge-to-arrive, basis, minimum/maximum, market plus, and others that allow producers additional flexibility when marketing grain.

Cash sale - Sale of a commodity for timely payment. Also known as spot sale. Transaction is covered by grain dealer security.

Forward price contract - Contract with an agreed upon price for future delivery of a specified quantity of grain. All classes of dealer may offer this type of contract. Transaction is covered by grain dealer security.

Grain bank - Grain deposited for storage to be withdrawn at a later date by the depositor. Transaction is covered by warehouse security.

Storage - Grain deposited and held until sold or removed by the depositor. Transaction is covered by warehouse security.

Warehouse receipt - A storage transaction with a negotiable warehouse receipt issued to the depositor. The warehouse receipt may be used as collateral to obtain financing. Transaction is covered by warehouse security.

¹ "Are Your Grain Transactions Protected?", Department of Agriculture Grain Regulatory Services, <<http://mda.mo.gov/grains/pdf/grsbrochure.pdf>>. Accessed January 15, 2010.



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Delayed pricing - A transaction where a producer delivers grain but can choose a later date for pricing and payment. Title transfers to the buyer at the time of delivery or completion of a valid delayed pricing contract. Transaction is not covered by any security.

Deferred payment - An agreement where a producer delivers grain, the purchase price is established and documented, and payment is deferred to a specific future date. Title transfers to the buyer at time of delivery or pricing. Transaction is covered for 12 months from date of transaction by grain dealer security.

Minimum price - A conditional grain sales transaction establishing an agreed upon minimum price where the seller may participate in subsequent price gains, if any. The minimum price is covered by the grain dealer security for 12 months from date of contract; subsequent price gains are not covered.

Other terms

Other terms used in the regulation of grain dealers and in this report are also defined below. The definitions were adapted from various sources including state statutes, state regulations, GRS publications, discussions with GRS officials, and accounting standards and guidance.

Audited financial statements - financial statements that have been audited by a certified public accountant (CPA) in accordance with auditing standards generally accepted in the United States of America. An audit of an entity's financial statements and records results in the auditor expressing a written opinion concerning whether the financial statements are fairly presented in accordance with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting.

Reviewed financial statements - financial statements that have been reviewed by a CPA in accordance with Statements on Standards for Accounting and Review Services (SSARS). This involves inquiry and analytical procedures that provide the CPA with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting.

Examination - The review and testing of grain related records by a GRS field auditor.

Scale ticket - A depositor's proof that a commodity has been delivered. The scale ticket should be filled out completely at time of delivery including weight, grade, discount factors, and type of marketing transaction.



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Grain obligation - Liability of grain dealer for grain delivered but not yet paid for.

Daily position record - The grain dealer record showing, by kind and quantity, all movements of grain in and out of the facility, total grain held, storage obligations, and total company-owned grain for each kind of grain in the facility.

Producer settlement sheet - A report from the grain dealer to the producer listing each individual shipment with the related scale ticket number, quantity in bushels, discount factors, net bushels and price due the producer with inspection, and dealer transportation and marketing fees.

Elevator/terminal settlement sheet - The report from an elevator or grain terminal to a grain dealer listing each individual shipment with the related scale ticket number, quantity in bushels, discount factors, net bushels and price due the grain dealer with inspection or other fees.

Negative grain equity - A grain dealer marketing position in which grain related liabilities exceed grain related assets.

Current loss position - The excess of the grain dealer's current obligations (those expected to be liquidated within 1 year) over current assets (those resources reasonably expected to be realized as cash within 1 year). Also known as negative working capital.

Net worth - Total assets less total liabilities.

Positive confirmation - Written request by the auditor sent to a party having financial dealings with the client about the accuracy of an item. A response is required whether the particular item is correct or incorrect.

Negative confirmation - Written request by the auditor sent to a party having a financial relationship with the client about the accuracy of an item. A response is required only when the particular item is incorrect.

Insolvencies and Fraud

Missouri grain producers suffered losses exceeding \$32 million when two grain dealers failed in February 2009. The GRS had performed examinations of these entities preceding the failures, but those examinations were not effective in disclosing the pending insolvencies and the fraud or alleged criminal acts of the entities.

Martinsburg dealer

The owner of a Class IV dealership located in Martinsburg, Missouri, operated the grain dealer business and a farm as sole proprietorships, and a grain trucking business as a limited liability company. A Class IV dealer is primarily engaged in trucking and also buys and sells grain, and must pay



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for grain within 30 days or upon demand of the seller, if sooner. In 2008, the GRS conducted two examinations of the dealer (a regular examination in June 2008 and a special examination related to the release and replacement of a letter of credit in September 2008). The GRS identified no concerns during those examinations. However, in January 2009, the GRS received complaints from area competitors, lending institutions, and a producer about the dealer's business practices and in February 2009 the GRS began another examination. After beginning the examination, the GRS became aware of large amounts of unpaid grain obligations even though the dealer indicated no unpaid obligations existed. On February 18, 2009, the GRS suspended the dealer's license and on February 20, 2009, the GRS obtained approval from the Twelfth Judicial Circuit, Audrain County, Missouri, to act as trustee and receiver of the dealer, take possession of and liquidate grain-related assets, and pay claimants. The GRS collected \$297,000 from the letter of credit previously posted by the dealer and \$235,730 from other assets obtained by the GRS as trustee. The GRS received claims for unpaid grain from about 180 grain producers totaling about \$51.4 million. However, because producers had no written contracts guaranteeing higher than market price, the GRS valued the claims at \$27.4 million based upon the market price received by the dealer at the time of delivery.

The GRS investigation determined the dealer entered into verbal delayed price and deferred payment agreements with producers in violation of state law. Section 276.461, RSMo, only allows Class I dealers to enter into credit sales agreements and requires those agreements to be in writing; no similar provision exists for Class IV dealers. The investigation also determined the dealer violated other provisions of the Missouri Grain Dealer Law including under-reporting grain obligations by \$4.8 million on its December 31, 2007, financial statements; and falsely reporting to GRS auditors that no outstanding grain obligations existed during the June 2008, September 2008, and February 2009 examinations. The GRS estimated the amounts owed on those dates were at least \$13 million, \$16 million, and \$27 million, respectively. The dealer concealed the fraudulent activities by providing false records to the GRS auditors, including altered copies of checks and producer settlement sheets, another violation of state law.

Federal and state prosecutors, aided by the GRS investigation, alleged the dealer operated a Ponzi scheme offering producers inflated prices for their grain, agreeing to pay for the grain at a later date, selling the grain to elevators at the current market prices, and using those proceeds to pay producers with previous agreements. Prosecutors also alleged the dealer, in some instances, told producers their grain was being hauled to a grain elevator for storage and stored under delayed price or deferred payment contracts when the grain was actually sold upon delivery at spot prices. The federal indictment alleged the scheme to defraud began in or about October 2002. The owner of the dealership was indicted in federal court for mail



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fraud, wire fraud, and interstate transportation of stolen property, and in November 2009 pleaded guilty to mail fraud. In February 2010, the owner was sentenced to 9 years in federal prison and ordered to forfeit real estate and business related assets. The forfeited assets are to be sold by federal authorities and the proceeds distributed to victims of the fraud. On April 8, 2010, the GRS distributed checks totaling \$579,334, just over 2 percent of valid claims, to producers based upon the producers' pro rata shares of payout from the dealer's letter of credit and grain related assets, and interest earned while the GRS held the monies. In June 2010, the owner pleaded guilty to five state criminal charges and was sentenced to 10 years on one count of felony stealing and 7 years each on four counts of filing false statements with Department of Agriculture officials.

Gallatin dealer

The owner of a Class I grain dealership and warehouse located in Gallatin, Missouri, operated the dealership and warehouse business as a sole proprietorship. The owner was also the sole proprietor of a livestock auction and a farming operation. The GRS conducted regular examinations of the dealer in April 2007, October 2007, April 2008, and September 2008. The GRS examinations reported multiple and repeated deficiencies related to inaccurate and inadequate recordkeeping, grain shortages, missing scale tickets, and invalid contracts. In February 2009, the dealer notified the GRS the dealership was insolvent, had sold all grain assets and storage grain, and surrendered his licenses. The dealer also reported keeping separate records on over \$1 million of previously undisclosed grain obligations.

In March 2009, the circuit court of Daviess County, Missouri appointed the GRS to act as trustee and receiver, take possession and liquidate the dealer's grain-related assets, and pay claimants. The GRS collected the dealer's bond of \$223,000, the warehouse bond of \$184,000, and other assets and interest totaling about \$10,000. The GRS received 92 valid warehouse claims totaling about \$1.5 million and 49 valid dealer claims totaling about \$1.8 million. Six claims totaling about \$1.2 million were withdrawn by the claimants in exchange for property of the dealership's owner. The pro rata payouts determined by the GRS for producer claims from the dealer bond and the warehouse bond were 12.4 percent and 12.1 percent of claims, respectively. Additionally, distribution of the other assets and interest increased the pro rata payout slightly. The GRS distributed \$417,006 to claimants in August 2009. As of June 2010, the GRS has accumulated an additional \$50,000 from the sale of some additional seized assets and a few small voluntary payments from the owner of the dealership. GRS officials indicated a future pro rata payout will be made of those monies. A total of 26 counts of state criminal charges for stealing grain; theft/stealing over \$25,000; withholding, altering, or providing false records or documents; and violation of the Missouri Grain Dealer Law were filed by the Daviess County Prosecuting Attorney against the owner of the dealership and remain pending as of May 2010.



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Producer responsibilities

According to a GRS publication,² producers should be aware of the types of transactions allowable for the class of grain dealer with which they conduct business, as well as the timeframes required for payment, and require written contracts before entering into credit sales transactions. As noted above, the Martinsburg dealer entered into prohibited credit sales transactions with willing producers, some of whom were paid or promised prices far in excess of market prices. As a result, those producers should have been aware that the transactions carried significant risk. Yet no producers contacted the GRS with concerns about the dealer's marketing practices from 2004 until January 2009. Also, at least three producers had received requests from the GRS related to the June and September 2008 examinations of the dealer to confirm amounts owed them. In these instances the producers were owed more than the reported amount, but the producers did not return the confirmation. In addition, producers apparently did not always require the Martinsburg dealer to provide them with copies of scale tickets for delivered grain or failed to recognize the type of marketing transaction noted on the scale ticket was not the type of transaction the dealer indicated. The GRS also indicated one of the confirmations sent during the September 2008 examination of the Gallatin dealer was not returned by a producer who was owed more than the reported amount. The GRS has taken action to make producers more aware of the risks by including on the dealer's license whether the dealer is allowed to enter into credit sales contracts and providing similar information on confirmations sent to producers.

Third insolvency

On February 16, 2010, subsequent to the end of our fieldwork, another licensed grain dealer notified the GRS that it was unable to pay for grain delivered on the 3 preceding business days. The GRS suspended the dealer's license, seized the grain related assets and negotiated the sale of those assets. Following court approval, the GRS distributed the amounts owed to the producers in April 2010. No grain producers lost monies due to this insolvency. The dealer's website indicated this insolvency was precipitated by changes in the federal bio-diesel blenders tax credit program which created significant liquidity issues for the dealer.

Scope and Methodology

To evaluate GRS examination policies and procedures, including regulatory efforts taken in relation to two recent grain failures, we reviewed policies and procedures, examined work papers generated during GRS examinations of seven dealers (including the two failed dealers) and other pertinent documents, and interviewed various personnel of the GRS.

² "Are Your Grain Transactions Protected?", Department of Agriculture Grain Regulatory Services, <<http://mda.mo.gov/grains/pdf/grsbrochure.pdf>>. Accessed January 15, 2010.



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To evaluate and compare Missouri's applicable laws, regulations and procedures to those of other states and the federal government, we identified the states of Iowa, Kansas, Indiana, and Illinois as having comparable grain industries based on discussions with GRS personnel. We reviewed related laws and regulations of those states as well as federal and Missouri state laws and regulations. In addition, we gathered information on indemnity funds in other states from a study compiled by the Association of Grain Regulatory Officials, and obtained crop production and average market pricing statistics from the National Agricultural Statistics Service for Missouri.

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Management Advisory Report - State Auditor's Findings

1. GRS Examinations of Failed Licensees

Better execution of Grain Regulatory Services program (GRS) examination procedures during 2008 GRS examinations would have detected irregularities occurring at two licensed grain dealers. The subsequent failure of these dealers resulted in large losses to grain producers with unpaid grain sales or storage grain with the dealers. The owners of both dealers were charged with criminal offenses. For the 2008 GRS examinations of these entities, improper execution of examination procedures by GRS auditors prevented the earlier detection of one insolvency and precluded further regulatory action to reduce the losses from the other pending insolvency. While the examination work papers for both dealers were reviewed by a GRS supervisor, the supervisory reviews were not effective in disclosing the problems.

1.1 Martinsburg dealer examinations

GRS examination procedures did not always adhere to established requirements. During the September 2008 examination of the Martinsburg dealer, the GRS did not verify that detailed information (such as dates, grain type and quantity, and producer name) on canceled checks and producer settlements was in agreement with information on scale tickets obtained at the time the dealer delivered the grain for sale. For ten checks reviewed by the GRS, the original scale tickets issued by the buying elevator ranged from 3 months to almost 9 months before the check date. In addition, producer names and grain type and quantity recorded on producer settlements differed from information on the scale tickets. Existing GRS procedures require, on a test basis, information from the canceled check be compared to information recorded on the producer settlement and the original scale ticket. If discrepancies are identified, GRS supervisors are to be notified immediately. Had the required procedures been performed properly, the GRS would have determined the dealer had not truthfully disclosed obligations for the current and previous examinations, and had not paid for grain within 30 days as required for a Class IV dealer license. According to GRS officials, records were not available to determine whether similar deficiencies existed during the June 2008 examination.

Work paper documentation

Work paper documentation required by the GRS for the procedure described above was not sufficient to enable the supervisor to determine whether the procedure was performed properly. Adequate documentation would require key information (such as dates, producer name, and grain quantities and type) on various documents and/or specific test attributes be documented. In addition, the GRS provides a minimum of 6 months on-the-job training with an experienced auditor to new auditors. GRS auditors generally receive no further formal training. To ensure examination procedures are properly performed, the GRS should provide periodic training to auditors and require further test details be documented in the examination work papers.

Increased losses

If the GRS had discovered the fraud during the September 2008 examination, the loss to producers may have been limited. According to the



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felony complaint filed in the state's criminal case, the total outstanding obligations at that date were about \$16 million, about \$11.4 million less than the final total claim amount of \$27.4 million.

Additional examinations

The GRS did not perform examinations of the Martinsburg dealer in accordance with established frequency intervals. Based upon GRS established examination planning procedures, the dealer should have been subjected to an annual examination frequency. The following table lists the dates examinations were performed and the interval between examinations for the 5 year period ended June 2008.

Examination date	Interval from prior examination
June 2008	26 months
April 2006	17 months
November 2004	17 months
June 2003	12 months

If the GRS had performed the examinations of this dealer in accordance with the assigned examination frequency, two additional examinations would have been performed during the 5-year period. The GRS should ensure grain dealers are subjected to examinations in accordance with the assigned frequency.

1.2 Gallatin dealer examinations

During the April and September 2008 Gallatin examinations, the auditors noted large negative grain equities (about \$699,000 and \$639,000, respectively), but the GRS did not require additional bonding to be provided by the dealer, and the auditors improperly considered owner assets that were not related to the operation of the grain dealer.

GRS examination procedures require auditors to examine financial records of the licensee to determine whether resources are or will be available to meet the licensee's payment obligations when large negative grain equities are identified. For both 2008 examinations, the auditors concluded that sufficient resources were available after considering assets of the other ventures of the owner of the licensed entity. For the April 2008 examination, the auditors obtained a summary report of the assets and liabilities for all ventures of the owner. This report showed total assets exceeded total liabilities by about \$3.4 million, but the work papers do not indicate which assets and liabilities related only to operations of the grain dealer. Based on discussions with GRS staff and review of the December 31, 2007, financial statements of the owner of the Gallatin dealer, many assets were real estate and not readily convertible to cash to satisfy current obligations. In addition, many of the assets did not relate to operations of the grain dealer. Information from the dealer's bank noting account balances, letter of credit, and outstanding loans were obtained during the examination, but there is no indication in the work papers these



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amounts were compared to the summarized assets and liabilities of the grain dealer. For the September 2008 examination, the auditors noted only that the owner indicated he intended to meet his obligations and expected a cash inflow of about \$500,000 from other ventures in the near future.

Section 276.436, RSMo, allows the GRS to impose additional bonding up to the amount of the licensee's current loss position. Furthermore, while the state Grain Dealer Law and Grain Warehouse Law allow the GRS to take possession of grain assets of insolvent dealers and warehouses, respectively, state law does not provide the authority for the GRS to take possession of non-grain related assets. Consequently, since net assets in other ventures are not available to the GRS upon failure of the licensed entity, the GRS should not have considered those assets in an analysis related to negative grain equities.

Following the April 2007 examination, the GRS required the dealer to provide additional bonding of \$100,000 as a result of violations and concerns about the ability of the dealer to pay for current grain obligations. However, subsequent to the 2008 examinations that identified additional violations and continuing concerns about the ability to pay current obligations, the GRS took no further action to increase the dealer's bond and did not place the dealer on a more frequent examination schedule.

Recommendations

The GRS:

- 1.1 Ensure auditors are properly trained, work papers are properly documented, and grain dealer examinations are performed in accordance with required examination frequencies.
- 1.2 Develop specific and detailed examination procedures to be performed in instances where large negative grain equities are detected. In this regard, the GRS should develop procedures to ensure only grain related assets are considered when determining the ability of the dealer to pay current obligations and require auditors to consider whether additional bonding should be required.

Auditee's Response

The Director of Agriculture requested an audit of the Department's Grain Regulatory Services (GRS) program after the two largest grain failures in Missouri history. The purpose of the audit was to analyze these specific cases and further evaluate audit processes to better serve the citizens of Missouri. In certain instances, the audit determined that departmental procedures were not properly executed. The Department acknowledges these shortcomings. More importantly, the audit revealed that even with perfect execution, the procedures the Department has relied on for the past five decades are inadequate to regulate today's grain dealer and warehousing businesses, and insufficient for early detection of deliberate misrepresentation or criminal misconduct. As such, the Department concurs



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with the main findings of the audit and is updating its procedures to directly address these historical, procedural shortcomings.

1.1 GRS acknowledges that auditors could have better executed audit procedures and concurs that existing audit procedures were insufficient to handle class IV dealers of this type. Applicable audit instructions were originally designed for facilities which use scale tickets and maintain a numerical file of those tickets. When auditing businesses that do not have scale tickets, such as a dealer (without a scale) utilizing direct farm-to-terminal transactions, existing procedures called for auditors to trace transactions to the dealer's transaction register. In the past, any file containing customer settlements in its entirety has been accepted as the dealer's transaction register. This procedure was insufficient in this case.

GRS administration has provided additional instruction to grain auditors to ensure they are aware of handbook requirements and has revised the audit guidelines. The new procedures include a checklist specifically tailored for grain dealer-only facilities and require GRS auditors to report the status of the pre-numbering of source documents and describe the record keeping system for farm-to-market/third party transactions. In addition, the GRS auditor is now required to examine the settlement sheet provided to the dealer by the terminal. Finally, a new audit function requires grain revenue tracing of bank deposits backwards to the grain records of the dealer. This procedure will help detect unreported transactions.

GRS has implemented increased and expanded training for auditors and supervisors to include quarterly professional development sessions. The sessions will include education on best practices for detecting discrepancies, updates on grain trading practices, and information sharing from other states as well as internally.

Work Paper Documentation

GRS concurs that the work paper documentation process and subsequent supervisor review process were inadequate. As mentioned above, GRS has developed a new dealer-only checklist that will generate the necessary work paper documentation to allow supervisors to determine whether procedures were performed properly. GRS has also revised the supervisory review process to include tracking information generated by the new audit procedures.

Increased Losses

It is impossible to ascertain the extent to which losses could have been reduced if these discrepancies would have been detected



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earlier, particularly in cases where there are deliberate misrepresentations. Nonetheless, GRS concurs that discrepancies could have been detected sooner had procedures been more rigorous and better executed.

Additional Examinations

GRS concurs that examinations were not performed in accordance with established frequency intervals. As a class IV dealer, examinations of the Martinsburg dealer were not statutorily required. However, GRS strives to conduct annual examinations of all class IV dealers regardless of statutory requirements. In this case staff shortages due to budget reductions, illness of the business owner, and a clean audit history contributed to extended periods between audits. In the future GRS will tightly adhere to established intervals for class IV dealer examinations.

- 1.2 *As recommended in the State Auditor's finding, a new audit guideline has been established to require that only grain-related assets can be considered when determining the ability to pay current obligations. The guideline calls for grain-related assets to be defined as those assets used to establish and maintain licenses and determine bonding levels.*

GRS concurs that the entirety of the Gallatin dealer principle's assets were incorrectly included in the determination of solvency. GRS plans to implement new requirements that require dealers and warehouses to submit audited financial statements if they comingle funds between grain-related and non grain-related ventures.

2. GRS Examination Procedures

GRS examination procedures do not include the use of positive producer confirmations, reviews of licensee sales revenues, or the use of pre-numbered documents for licensees. Additionally, the GRS usually does not assign licensees to accelerated (more frequently than annual) examination schedules and for those licensees assigned to accelerated examination frequencies the GRS is often unable to meet the assigned frequency.

2.1 Producer confirmations

GRS confirmations were not effective in disclosing unrecorded obligations at both the Martinsburg and Gallatin dealers because producers did not return confirmation forms notifying the GRS of unrecorded obligations. GRS staff determined, based on their review of claims and related receivership information, at least three confirmations sent to producers during the June 2008 Martinsburg examination and one sent during the September 2008 Gallatin examination should have reported unrecorded grain obligations, but the producer did not return the confirmation to the GRS.



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GRS examination procedures require auditors to send confirmations to producers on most examinations. The GRS utilizes negative confirmations which require the producer return the confirmation form to the GRS only if the information on the form is not correct. Consequently, for negative confirmations, auditors must assume the information is correct if the forms are not returned and no auditor follow up is required. A positive confirmation would request the producer to reply to the confirmation whether the information is correct or incorrect and requires auditors to follow up on unreturned confirmations with a second mailing or telephone call. The GRS should consider utilizing positive confirmations to improve the effectiveness of the confirmation procedure in disclosing unrecorded obligations.

2.2 Sales revenue records

GRS examination procedures could be enhanced by requiring auditors to review additional licensee sales revenue records including bank deposits and settlement sheets of the purchasing elevator or grain terminal.

Bank deposits

GRS procedures do not require the review of bank deposits that were made immediately prior to the time of the examination. By reviewing these bank deposits and comparing items comprising the deposit to individual producer accounts, the GRS auditors could have determined the Martinsburg dealer had outstanding obligations that were not recorded.

Elevator settlement sheets

GRS procedures do not require the auditor to reconcile, on a test basis, the quantities of grain recorded as sold on the licensee's daily position record (DPR) and individual producer settlements to settlements from the purchasing grain entity. In its investigations as receiver, the GRS determined the Gallatin dealer had not recorded certain grain purchases and the subsequent grain sales to terminal elevators on the DPR to conceal unrecorded grain obligations from GRS auditors. The auditors may have discovered unrecorded and withheld obligations and/or grain-out transactions that were not recorded on this dealer's DPR by comparing grain sales per the terminal elevator settlement sheets to the dealer's DPR.

Adopting these procedures for future examinations may help provide additional assurance about the accuracy of grain obligation records. In addition, comparison of terminal elevator settlement sheets to producer settlement sheets could reveal unusual pricing differences.

2.3 Pre-numbered documents

GRS regulations do not require licensees to utilize pre-numbered contracts, settlement sheets, or receipts for direct farm-to-market transactions. Both the Martinsburg and Gallatin dealers used unnumbered settlement sheets and contracts and neither issued receipts or bills of lading for direct shipments.



2.4 Examination frequencies

The use of pre-numbered documents and accounting for the numerical sequence of those documents is an important control to help ensure the population of records is complete. GRS examination procedures require auditors ensure scale tickets and warehouse receipts issued are pre-numbered as specifically required by state law. The lack of pre-numbered settlements sheets, contracts, and receipts for direct farm-to-market transactions helped the dealers to conceal obligations from the GRS. Section 276.406.2(3), RSMo, provides the GRS with the authority to require records it deems necessary to ensure compliance with grain purchasing and sales regulations.

The GRS has assigned few licensees to accelerated examination frequencies and is often unable to conduct those examinations within the assigned frequency. GRS officials indicated additional audit staff would allow the GRS to assign more licensees to accelerated examination frequencies and to ensure those examinations are performed as planned.

The GRS has assigned most licensees to an annual examination frequency and relatively few licensees to an accelerated examination frequency. State law requires annual examinations of Class I, II and III dealers and warehouses and allows the GRS to examine Class IV, V, and VI dealers. GRS procedures are to assign licensees to one of seven audit frequencies (annual, semi-annual, quarterly, monthly, 18 months, 2 years, 3 years) after considering the requirements of state law and the GRS's perceived risk of licensee insolvency or non-compliance with licensing requirements. Approximately 2,300 examinations were performed between January 1, 2005, and July 22, 2009, and only about 300 (13 percent) were examinations of licensees assigned to an accelerated examination frequency (more frequently than annually).

For those licensees assigned an accelerated examination frequency, the GRS was often unable to conduct examinations of those licensees within the assigned frequency. Of the examinations of licensees assigned an accelerated frequency between January 1, 2005, and July 22, 2009, only 108 were conducted within the assigned frequency.

Performing GRS examinations within the required timeframes is necessary to ensure licensees are in compliance with laws and regulations and have no solvency problems, and to adequately protect the financial interests of grain producers.

Recommendations

The GRS:

- 2.1 Use positive confirmations of producer accounts in future examinations.



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- 2.2 Establish additional examination procedures to review sales revenue records.
- 2.3 Consider establishing additional regulations requiring the use of pre-numbered documents.
- 2.4 Perform examinations in accordance with established timeframes.

Auditee's Response

- 2.1 *GRS agrees that although the producer confirmations were conducted according to procedure, the practice of relying on negative confirmations was not effective in uncovering unrecorded obligations. Audit guidelines have been changed to implement positive confirmations which require a producer response regardless of the accuracy of his/her individual status with the dealer.*

The program has also increased the minimum number of confirmations mailed to producers in each case to increase the likelihood of discovering any obligations. In cases where discrepancies are discovered, additional confirmations may be mailed to dealer customers in order to obtain an adequate sample.

- 2.2 *GRS concurs that the examination procedures would be enhanced by reviewing sales records via bank deposits and reconciling licensee records with elevator settlement sheets.*

GRS has developed a new guideline that requires auditors to trace bank deposits back to the grain records of the dealer which should help detect unreported transactions. The new procedures also call for auditors to reconcile the records of grain sold by the licensee on a test basis with the settlement sheet of the purchasing entity.

- 2.3 *GRS agrees to evaluate additional regulations requiring the use of pre-numbered documents. A checklist for grain dealer-only facilities now requires GRS auditors to report the status of the pre-numbering of source documents and describe the record keeping system for farm-to-market/third party transactions.*

- 2.4 *GRS concurs that performing examinations within the required timeframes is an important part of insuring licensees are in compliance. As indicated earlier, staff shortages resulting from budget reductions forced GRS to prioritize statutorily required annual examinations over those that were established internally. GRS has begun to address the staffing issue by adding one additional auditor and in the future will adhere to internal timelines once established.*



3. Other Regulatory Concerns

The GRS does not require licensees to submit audited financial statements and the GRS does not obtain timely financial information from licensees with financial solvency concerns. The bonding amounts required of licensees by the GRS are too low to provide adequate protection to producers and statutory requirements for minimum net worth of licensees are relatively low and outdated. Missouri, unlike many other states, has not established an indemnity fund to help protect grain producers.

3.1 Audits of licensees' financial statements

State law does not require licensees to submit audited financial statements, but allows licensees to submit either reviewed or audited financial statements. Licensees annually submit financial statements including a balance sheet and income statement that summarize the licensee's assets and liabilities and results of operations. The GRS uses the data in the financial statements to establish the licensee's required bond amount and to evaluate the solvency of the licensee for purposes of determining the examination frequency and scope.

The financial statements of most licensees are reviewed but not audited by a certified public accountant (CPA). Of 258 licensee financial statements received in 2008 by the GRS, only 97 (38 percent) were audited. The financial statements of the Martinsburg and Gallatin dealers were reviewed, instead of audited by a CPA. The most recent financial statements submitted by these dealers materially understated grain liabilities. Had those financial statements been audited, it is more likely the understatements would have been detected. The State of Illinois requires audited financial statements from state-licensed grain dealers and warehouses.

To provide more assurance about the accuracy of financial data, the GRS should consider requiring audited financial statements for all licensees and for the owner, if a sole proprietorship. While state law allows licensees to submit either audited or reviewed financial statements, the law also allows the GRS to require any additional information or verification considered necessary with respect to the financial resources of the applicant.

3.2 Timely financial reports

The GRS does not require more frequent submission of financial reports from licensees with financial solvency concerns. The State of Iowa requires licensees with financial solvency concerns to remit financial information monthly to the state regulatory agency. Missouri state law provides the GRS the authority to impose additional financial reporting requirements upon licensees as needed. To better monitor licensees with solvency concerns, the GRS should develop regulations requiring licensees to submit more frequent financial information.

3.3 Licensee bonding

The bonding amounts required of licensees by the GRS may be too low to adequately protect grain producers. In addition, the GRS has not imposed adequate additional dealer bonding for licensees with financial solvency



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concerns. The bonds for the Martinsburg and Gallatin dealers provided producers with only about 1 percent and 12 percent of the value of their claims, respectively.

Statutory requirements

State law requires licensees to post a surety bond to protect the financial interests of producers selling grain to the dealers or storing grain with warehouses. Upon failure of the licensed entity, the GRS uses the bonds to partially satisfy the claims of grain producers. The law requires the GRS to establish a dealer bond between 1 and 5 percent of the dealer's annual grain purchases up to a maximum \$300,000, and a warehouse bond based on licensed warehouse capacity. For dealers with low net worth the law requires additional bonding. For dealers with net worth equal to at least five times the amount of bond otherwise required, the law allows the dealer to request a minimum bond of \$20,000. State law allows the GRS to impose additional bond amounts when financial concerns exist.

Bonding amounts imposed

The GRS generally bases the dealer bond amount on 1 percent of grain purchases and imposes additional bonding for net worth deficiencies. For dealer bonds that exceed 1 percent of grain purchases (absent a net worth deficiency) it is often because the bond amount was established in previous years when the dealer had higher annual grain purchases and the GRS decided to retain the higher the bond amount due to financial concerns about the entity. As of April 2010, 2 dealers have bonding in excess of the \$300,000 statutory maximum; 23 dealers have bonds of \$300,000; and the remaining 233 dealers have bonds below \$300,000. Based on our analysis of the most recent financial statements submitted by licensees, eight licensees were at risk for insolvency for each of three GRS solvency measures. However, the GRS has imposed the minimum bonding in five of these cases. In addition, in each of the eight instances, the bond is significantly below the respective licensee's working capital deficit. To better protect grain producers, the GRS should impose additional dealer bonding for licensees with financial solvency concerns, as allowed by state law.

3.4 Net worth requirements

State requirements for minimum net worth of licensees are low and outdated. State law allows warehouses to choose whether to be licensed under state law or federal law. State law requires licensed warehouses to maintain a net worth equal to the greater of \$10,000 or 15 cents per bushel licensed capacity. Federal law requires warehouses maintain a minimum net worth of 25 cents per bushel licensed capacity. Most Missouri grain warehouses are licensed under state law and are consequently subject to the lower Missouri warehouse minimum net worth requirement.

For dealers, the minimum net worth required by state law varies by dealer class and size. Class I dealers must maintain net worth of 2 percent of annual grain purchases with a minimum of \$50,000. The requirement for Class II, III, IV, V, and VI dealers varies between small dealers (less than \$400,000 in annual grain purchases) and large dealers (\$400,000 or more in



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annual grain purchases). Small dealers must maintain net worth of 5 percent of annual grain purchases with a minimum of \$10,000 and large dealers must maintain net worth of 1 percent of annual grain purchases with a minimum of \$20,000. The Class II-VI dealer net worth requirements have not changed since 1981 other than the establishment of the \$10,000 minimum. According to an insurance fund study prepared by the Association of Grain Regulatory Officials,³ seven of eight states⁴ reporting net worth information had higher minimum net worth requirements than Missouri. The minimum requirements ranged from \$25,000 to \$90,000. In addition, most states reporting also indicated an additional net worth requirement based upon storage capacity and/or grain purchases ranging from 10 cents to 25 cents per bushel.

An increase in the minimum net worth requirements would provide greater protection to grain producers against the potential failure of grain dealers and warehouses. The GRS should consider seeking legislative changes to increase minimum net worth requirements.

3.5 Indemnity fund

According to a report,⁵ 14 states (including 5 contiguous states) and a Canadian Province have established indemnity funds. These funds are financed by a fee imposed on grain purchases, that provides for the full or partial payment of valid claims upon licensee failure. The fee is usually imposed only on the original sale by the producer and not on subsequent dealer to dealer or dealer to terminal elevator sales. The report summarized the indemnity fund laws of states and noted much variation exists among states operating indemnity funds.

- Fees ranged from .2 cents to 1 cent per bushel, or .0004 percent to .002 percent of the grain sale value.
- Some states collect additional fees from grain dealers and warehouses.
- While all states place a cap on the indemnity fund balance and suspend fees when that cap is reached, the amount of the cap ranged from \$1 million to \$15 million.
- The percentage of losses covered by the fund ranged from 75 percent to 100 percent.
- Some states established maximum claim amounts ranging from \$100,000 to \$300,000.

³ Insurance Fund Study, State of Origin, as of June 2009, Association of Grain Regulatory Officials.

⁴ States reporting higher minimum net worth requirements were Idaho, Illinois, Iowa, Michigan, Ohio, Oklahoma, and Washington.

⁵ Insurance Fund Study, State of Origin, as of June 2009, Association of Grain Regulatory Officials.



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- One state only covered credit sales transactions while another state did not cover credit sales transactions.

Based on 2008 corn, soybean, wheat, rice and sorghum crop production and average market pricing statistics obtained from the National Agricultural Statistics Service for Missouri, a fee of .2 percent of the market value of first sales, totaling \$3.96 billion, would generate about \$7.9 million. If the fee was set at 1 cent per bushel, the fee would generate about \$6.6 million. For an individual producer selling 50,000 bushels of soybeans with a value of \$487,000, the fee would be \$974 under the first method and \$500 under the second method. Both production and market price vary significantly from year to year and therefore potential revenues would also vary significantly under any funding mechanism. GRS officials indicated that for the 20 years preceding 2009, the total loss to producers due to grain dealer and warehouse insolvencies was about \$3 million.

The GRS should consider the benefits of an indemnity fund, including the additional financial protection afforded grain producers, and consult with the General Assembly regarding the establishment of an indemnity fund.

Recommendations

The GRS:

- 3.1 Require audited annual financial statements for all licensees.
- 3.2 Require licensees with financial solvency concerns to remit more frequent financial information.
- 3.3 Re-evaluate the sufficiency of bonding requirements and impose additional dealer bonding for licensees with financial solvency concerns.
- 3.4 Consider seeking legislative changes to increase minimum net worth requirements for grain dealers and warehouses.
- 3.5 Consider the benefits of an indemnity fund and if deemed beneficial consult with the General Assembly regarding establishment of such a fund.

Auditee's Response

- 3.1 *GRS concurs that the financial statements of most licensees are reviewed as opposed to audited, and that if the financial statements of the dealers in question had been audited instead of reviewed, outstanding obligations may have been detected. GRS is developing guidelines that require audited financial statements or additional financial information when the circumstances warrant.*



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- 3.2 *GRS concurs that requiring more frequent submission of financial reports from licensees with solvency concerns may be a useful tool. GRS will develop procedures that require more frequent submission of financial statements when a specific set of conditions are met.*
- 3.3 *GRS concurs that in certain cases of financial solvency concerns, additional bonding may be necessary. As indicated in the State Auditor's Findings, the program has historically used increased bonds when warranted. GRS agrees to better utilize their authority to increase bonds in certain cases as a way to mitigate solvency concerns. GRS has previously sought, and will again consider seeking legislative changes to increase the minimum bonding requirements.*
- 3.4 *GRS concurs that existing state requirements for minimum net worth of licensees may be low and outdated. GRS agrees to consider seeking legislative changes to increase minimum net worth requirements.*
- 3.5 *GRS agrees with the conceptual benefits of an indemnity fund and will consult with the General Assembly and the industry to gauge support for the establishment of such a fund.*