The Non-Price Risks of Credit Sale Contracts: Know Your Grain Buyer

Producers use a variety of contracts to market grain, including cash or spot purchase contracts, forward contracts, and deferred price contracts, more broadly termed "credit sale contracts." Credit sale contracts (CSCs) are common tools for producers and grain marketing firms, and they serve the important functions of managing grain movements and cash flows. They are contracts by which the sale price of grain is paid – and in some cases determined – at a date in the future. CSCs are commonly known by other names, including deferred payment contracts, deferred price contracts, price later, basis-only, and minimum price contracts. Importantly, for each of these, title of the grain passes to the buyer when the contract is signed, thus establishing the seller as an unsecured creditor of the buyer and creating a potential for counterparty risk to the seller.

The nature and degree of this counterparty risk hinges on the financial stability of the grain buyer. A grain buying firm facing cash flow constraints or other financial challenges may offer CSCs and resell the newly owned grain as a way to generate cash to pay other nearby obligations. However, without additional cash inflow, the firm is at risk of not having the cash to pay the grain seller's CSC when the time comes. While this is not common, there have been isolated cases in Iowa and producers selling grain should be aware of this potential. The Grain Warehouse Bureau of the Iowa Department of Agriculture and Land Stewardship (IDALS) monitors the financial condition of grain dealers authorized to issue CSCs in Iowa, but losses associated with CSCs are not covered by the Grain Indemnity Fund. More information from IDALS on the Grain Indemnity Fund is available, www.iowaagriculture.gov/grainWarehouse/GrainIndemnityFund.asp.

One step producers can take to evaluate and potentially avoid this risk is to perform a summary evaluation of the financial position of the grain-buying firm offering the CSC. The basic financial metrics that can lend insight to the financial position of the firm are working capital (or working capital to sales ratio), the long-term debt to equity ratio, long-term debt to net fixed assets ratio, and profits to sales ratio (return on sales). Taken together, these give grain sellers information about the grain buyer's ability to meet its future payment obligations and a more accurate picture of the non-price risk associated with the CSC.

More information about the counterparty risk associated with CSCs and also a guide to evaluating a company's financial condition is available for download from the Iowa State University Extension and Outreach Store: "Evaluating a Company's Financial Position before Selling Grain on Deferred Price Contracts" (FMR 1893), https://store.extension.iastate.edu/product/15305. The publication includes an accompanying spreadsheet calculator that will compute the financial metrics for cooperative and non-cooperative grain marketing firms based on user-entered financial information.

For more information about cooperatives, visit the Ag Decision Maker Cooperatives webpage, www.extension.iastate.edu/agdm/cooperatives.html.

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