Lecture X: Accounting for Farm Businesses and Pro Forma Statements

Charles B. Moss[1]

[1]Food and Resource Economics Department
University of Florida

January 10, 2018

1. Accounting Issues for the Farm Firm
   - FFSC Substantive Goals
   - Standards Overload
   - Methods of Valuation

2. Pro Forma – What Could Be

Accounting Issues for the Farm Firm

Farm Financial Accounting Standards Council (FFSC) is an independent organization which grew primarily out of the farm financial crisis of the mid 1980s. The role of the guidelines issued by the council are intended to:

1. Promote uniformity in financial reporting for agricultural producers by presenting methods for financial reporting which are theoretically correct and technically sound;
2. Present standardized definitions and methods for calculating financial measures which may be used in the measurement of financial position and financial performance of agricultural producers; and
3. Identify alternatives for development of a national agricultural financial database.

Substantive Goals

1. *Universal Financial Reports*. This section contains suggested procedures and concepts for constructing farm financial statements for the purposes of financial reporting and financial analysis (i.e., the balance sheet, the income statement, the statement of cash flows, and the statement of owner equity).
2. *Universal Financial Criteria and Measures*. This section contains material regarding the definitions, computations, interpretations, and limitations of some of the most widely used measures of financial position and financial performance.
3. *Universal Information Management*. This section contains suggestions for collecting and using standardized farm financial data for the benefit of agricultural producers and those that serve them.

Standards Overload

Over the years, the FASB [Financial Accounting Standards Board], the SEC, and the AICPA [American Institute of Certified Public Accountants] have been criticized for imposing too many accounting standards on the business community. This *standards overload* problem has been particularly burdensome for small businesses that do not have the economic resources to research and apply all the pronouncements issued by these authoritative bodies. Those who contend that there is a standards overload problem base their arguments on two allegations: (1) not all GAAP requirements are relevant to small business financial reporting needs; and (2) even when GAAP requirements are relevant, they frequently violate the pervasive cost-benefit constraint....

Standards Overload – Continued

Critics of the standard-setting process for small businesses also assert that GAAP were developed primarily to serve the needs of the security market. Many small businesses do not raise capital in these markets: therefore, it is contended that GAAP were not developed with the small business needs in mind.
Some consequences of the standards overload problem to small business are as follows:

1. If a small business omits a GAAP requirement from audited financial statements, a qualified or adverse opinion may be rendered.
2. The cost of complying with GAAP requirements may cause a small business to forgo development of other, more relevant information.
3. Small CPA [Certified Public Accountant] firms that audit smaller companies must keep up to date on all the same requirements as large international firms, but they cannot afford the specialists that are available on a centralized basis in the large firms (Schroeder et al. 2011, p. 14).

- The FFSC prescribes a minimum set of four statements for the farm firm:
  1. Balance sheet,
  2. income statement,
  3. statement of cash flows, and
  4. statement of [change in] owner's equity.
- The council states that these statements should be prepared according to GAAP.

Methods of Valuation

1. *Historical Cost/Historical Proceeds Method*. For an asset: the amount of cash, or its equivalent, paid to acquire the item, commonly adjusted for depreciation or other allocation. For a liability: the amount of cash, or its equivalent, received when the obligation was incurred – sometimes adjusted for amortization or other allocations.
2. *Current Market Value Method*. The amount of cash, or its equivalent, that could be obtained by selling an asset in an orderly liquidation.
3. *Net Realizable Value Method*. The amount of cash, or its equivalent, into which an asset is expected to be converted in the due course of business, less any direct costs necessary to make that conversion.
4. *Discounted Future Cash Flows Method*. For an asset: the present value of future cash inflows into which an asset is expected to be converted [See Chapter 5] in the due course of business, less present values of cash outflows necessary to obtain those inflows. For a liability: the present value of future cash outflows expected to be required to satisfy the liability in the due course of business.

Relevance and Reliability

- *Relevance*. To be relevant, information about an item must have feedback value and/or predictive value for users and must be timely. Information is relevant if it has the capacity to make a difference in the decisions of owners, investors, creditors, or other interest parties.
- *Reliability*. To be reliable, information about an item must be representationally faithful, verifiable, and neutral. Information is reliable if it is sufficiently consistent in its representation of the underlying resource, obligation, or effect of events; and sufficiently free of error and bias to be useful to owners, investors, creditors, and others in making decisions.

Areas of Contention

1. **Balance Sheet Format – Capital Asset Presentation**: The valuation debate here centers around the valuation of farmland and equipment. As discussed throughout the FFSC report, farmland prices have a tendency to increase over time (the only real exception being the farm financial crisis of the mid 1980s).
2. **Raised Breeding Stock**: If breeding stock is purchased, little debate occurs – the asset is carried at its purchase price. The issue is that breeding livestock (particularly heifers in cow-calf operations) may be kept from this year's production.
3. **Deferred Taxes**: Often the tax code allows for special tax benefits on certain transactions. For example, Section 179 or Additional First Year Depreciation has allowed producers to write-off a larger portion of some equipment purchases in the first year.

Areas of Contention – Continued

4. **Accounting for Inventories of Grain and Livestock**: The traditional accounting approach is to value work-in-progress inventories at cash cost (except in those cases where the market value of those inventories is less than the historical cost).
7. **Growing Crops**: Again, following GAAP, growing crops should be valued at the accumulated cost of production. While it may be appropriate to value these assets at a lower market value, many of these crops may not be in a marketable form at the date of valuation (i.e., there is not market value on a field of growing wheat).
8. **Government Loan Programs**: Prior to the implementation of the Food Security and Rural Investment Act of 2002 U.S. farm programs operated through the non-recourse loan program.

Pro Forma – What Could Be

- The preceding parts of this chapter have examined accounting presentations of history – what has happened.
- Sometimes *pro forma* (Latin for – *as a matter of form*) financial statements are prepared to depict what the consequences of a financial proposal will be.
- Assume that the Texas wheat farmer has an opportunity to purchase his grandfather's 320 acres for \$ 1,500 an acre (a pretty good deal since the market value of crop land in Texas was \$ 1,670 in 2010).
  - The purchase price of a quarter section would be \$ 480,000.
  - We assume that the farmer proposes to finance the new acreage with \$ 15,000 of cash and a loan of \$ 465,000.
  - Normally, the lender would require more down payment, but given that the wheat farmer already has equity in farmland, the additional loan may be secured based on the other farmland.

Construction of a *pro forma* Income Statement

- Income will increase by \$ 15,120 which was the amount that the farmer was paying his grandfather in wheat (i.e., 2,880 bushels of wheat).
- The harvesting expense remains unchanged as well as the cropping expenses.
- The gross margin is higher with the purchase (\$ 181,472 versus \$ 166,352), but the real estate interest also increases (from \$ 32,486 to \$ 70,486).
- In net, the farmer is far worse off buying the land, his income would decline from \$ 34,989 to \$ 12,109.

Pro forma Income Statement

Item	Without Purchase	With Purchase
Sales	226,800	241,920
Cost of Goods Sold		
Planting Cost	41,888	41,888
Harvest Expense	18,560	18,560
Gross Margin	166,352	181,472
Depreciation	84,256	84,256
Interest	47,106	85,106
Net Income	34,989	12,109

Similar pro forma balance sheets and statements of cash flow could be computed; however, it is fairly easy to see that purchasing the land would leave the farmer worse off. It is a case where using someone else's equity in farmland benefits the farmer.