



Farm financial standards:

An overview of the recommended guidelines

by Freddie L. Barnard

After two years of work, the multidisciplinary Farm Financial Standards Task Force (FFSTF) has completed initial guidelines for reporting and analyzing the financial information of agricultural producers.

The work centers on the crucial need for an industry manufacturing diverse products across a broad geographical area to have common accounting guidelines on which to base financial viability.

The FFSTF endorses Generally Accepted Accounting Principles (GAAP) as the basis for farm financial statements and has worked to develop recommendations that are generally consistent with GAAP.

Although there are deviations from GAAP, which are noted in the report, the FFSTF recommendations are not intended to change GAAP, nor should they be construed as a replacement for or alternative to GAAP.

It is important to recognize that the recommendations summarized below will very likely change over time as

new issues surface.

Financial statements

A minimum set of financial statements should include a balance sheet, income statement, statement of owner equity and statement of cash flows. Rather than specific forms, the task force has recommended general guidelines to allow sufficient uniformity of reporting for ratio analysis and comparative analysis.

Balance sheet: Separate balance sheets for business and personal items are preferable. Assets and liabilities should be segregated into current and non-current categories. The three-category balance sheet is acceptable, however, in cases where the segregation is more informative to the user. Both cost and market value information are needed, however, it is acceptable to use alternative balance sheet formats for the presentation of these capital asset values. The balance sheet should include a section for owner equity that contains at least a valuation equity component and a retained earnings/contributed capital component.

Income statement: At a minimum, the format for an income statement should include a calculation of gross revenues and net farm income on an accrual-adjusted basis. A charge for unpaid family labor and management should *not* be included on the income statement. Non-farm earnings should be separately identified.

The calculation for determining profitability ratios for an ongoing farming operation should be made with Net Farm Income From Operations (NFIFO), which is net farm income excluding gains and losses from

the disposal of farm capital assets.

Statement of owner equity: A statement of owner equity was recommended to reconcile the equity amount shown at the beginning and end of the period. The statement should include at least a valuation equity component and a retained earnings/contributed capital component.

Statement of cash flows: A statement of cash flows should be included in financial statements for agriculture. The cash flow activities resulting from operating, investing and financing decisions are shown separately on the GAAP formatted statement of cash flows.

Other recommendations include: guidelines for asset valuation; reporting investments in other entities, investments in cooperatives, capital leases and perennial crops; calculating and reporting deferred taxes; and treatment of proceeds from government loan programs.

Financial criteria

Five financial criteria were recommended: liquidity, solvency, profitability, financial efficiency and repayment capacity. To determine the extent to which each criterion can be met 16 measures have been recommended, each specific to a criterion. (See chart at right).

Guidelines were recommended for the calculation and interpretation of each financial measure, but a numerical standard was not established. Comparisons to other businesses with similar characteristics were seen as more meaningful than comparisons to a numerical standard.



Freddie L. Barnard is an associate professor of agricultural economics at Purdue University, West Lafayette, Ind., and coordinator of the Financial Criteria and Measures Subcommittee of the Farm Financial Standards Task Force.

Liquidity measures the ability of a farm business to meet financial obligations as they come due in the ordinary course of business, without disrupting the normal operation of the business.

Solvency measures the amount of borrowed capital, leasing commitments and other obligations used by a business relative to the amount of owner's equity invested in the business. It helps gauge the firm's ability to repay all financial obligations if all assets are sold, and the ability to continue operations as a viable business after a financial adversity.

Profitability: Net Farm Income From Operations (NFIFO) does not include the gains or losses from the sale of farm capital assets. Net farm income includes the results of such transactions. NFIFO is used to calculate the profitability ratios because

C3-58

including the gain or loss from the sale of a farm capital asset can distort the result.

Financial efficiency measures the intensity with which a business uses its assets to generate gross revenues and the effectiveness of production, purchasing, pricing, financing and marketing decisions.

Asset turnover ratio (gross revenue ÷ average total farm assets) measures capital efficiency. The other ratios, all of which reflect the composition of gross revenues or value of farm/ranch production, are operating expense ratio, depreciation expense ratio, interest expense ratio and NFIFO ratio. All are calculated by dividing the component by gross revenue or value of farm/ranch production, i.e. interest expense divided by gross revenue.

Repayment capacity measures the

borrower's repayment capacity of term debts and capital leases. The recommended measures, which both include nonfarm income, enable the analyst to evaluate the borrower's repayment capacity, regardless of the source of funds used to make payments.



THE 16 RECOMMENDED MEASURES FOR DETERMINING FINANCIAL CRITERIA

LIQUIDITY:

Current ratio = total current farm assets ÷ total current farm liabilities

Working capital = total current farm assets - total current farm liabilities

SOLVENCY:

Debt/asset ratio = total farm liabilities ÷ total farm assets

Equity/asset ratio = total farm equity ÷ total farm assets

Debt/equity ratio = total farm liabilities ÷ total farm equity

PROFITABILITY:

Rate of return on farm assets = (NFIFO* + farm interest expense - value of operator and unpaid family labor and management) ÷ average total farm assets

Rate of return on farm equity = (NFIFO - value of operator and unpaid family labor and management) ÷ average total farm equity

Operating profit margin ratio = (NFIFO + farm interest expense - value of operator and unpaid family labor and management) ÷ gross revenue

FINANCIAL EFFICIENCY:

Asset turnover ratio = gross revenue ÷ average total farm assets

Operating expense ratio = operating expenses (excluding interest and depreciation) ÷ gross revenue**

Depreciation expense ratio = depreciation expense ÷ gross revenue

Interest expense ratio = interest expense ÷ gross revenue

NFIFO ratio = NFIFO ÷ gross revenue

REPAYMENT CAPACITY

Term debt and capital lease coverage ratio = [(NFIFO + total nonfarm income + depreciation expense + interest on term debts + interest on capital leases) - total income tax expense - withdrawals for family living] ÷ annual scheduled principal and interest payments on term debts and capital leases

Capital replacement and term debt repayment margin = [(NFIFO + total nonfarm income + depreciation expense) - total income tax expense - withdrawals for family living] - payments on prior period unpaid operating debt - principal payments on current portions of term debts - principal payments on current portions of capital leases - total annual payment on personal debt

*Net Farm Income From Operations = net farm income excluding gains and losses from disposal of farm capital assets

**Gross revenue or value of farm/ranch production