GETTING BETTER INFORMATION FROM FARMERS

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INTRODUCTION

Nearly every lender would like to get more accurate and useful information on his farm borrowers. As farms become larger and more complex, financial progress becomes more difficult to measure. In today's economic climate, it is necessary but difficult to separate true earnings from inflationary gains. Detailed accounting reports could provide much of the information desired. They are, however, not available on many farm operations. There are, however, a few things that can be done to improve the quality of financial information for teaching purposes. In this discussion, we will outline a few points that we believe can be starting points for obtaining better financial information.

Measurements of Financial Progress

There are many ways of measuring a farmer's financial progress. From a lender's standpoint, probably the fact loans are repaid on schedule is an adequate indication that financial progress is being made. However, when loan repayments are delayed or loan requests increase greatly, more information would be useful. There are probably three pieces of historical information that would be useful for both borrower and lender.

Earned Net Worth Change

Earned net worth change is the amount of profits that are plowed back into the business. Profits can be plowed back into the business by accumulation of assets or by repayment of debt. The earned net worth change figure is probably one of the best measures of repayment capacity.

Inflationary Gains

Inflationary gains--particularly in land--have been an important asset to many farmers. Because of these gains, they have been able to refinance, or use the increased equity as a basis for expanding and borrowing additional funds. Although not a measure of earnings capacity, it is useful to know the amount of gains available. More importantly, however, is to separate inflationary gains from earned net worth change.

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[1]Extension Economist, Farm Management, Department of Ag Economics, University of Missouri-Columbia (November 1980).

Cash Removed from Business

Farm profits can be returned to the business in terms of increased assets or reduced debt. Or, they can be removed from the business for family living, income tax, or non-farm purposes. To determine financial progress it is necessary to look not only at net worth change, but wherever possible to determine the amount of cash removed from the business. Obviously the less cash removed the more is plowed back and the greater the earned net worth change.

The first two factors--earned net worth change and inflationary gains can be obtained from properly constructed balance sheets. The cash removed figure is a little more difficult to get at, but can be computed from cash flow figures if accurate balance sheets are on an accounting-year basis.

Three Steps to Getting Better Information

We'd like to propose three basic steps that will help you as lenders obtain better information. These are not new and many of you are already doing these things but for the ag lender community as a whole, we still have a long way to go. These steps will permit getting at least two of the factors that we have outlined and well on the road to getting the third measure of financial progress. The three major steps are:

1. Use of good balance sheet form.
2. Obtain the balance sheet on calendar year or on farmer's accounting-year basis.
3. Have the farmer prepare his own balance sheet.

I. Good Balance Sheet Structure

A balance sheet that is properly constructed can be valuable both to the lender and the farmer. A balance sheet should give lenders a good picture of the farmer's business and, over time, show how the business changes. Secondly, a balance sheet should better help the farmer understand his financial business. Frequently, in the past, lenders have obtained information from the farmer, for their own use. The purpose of financial reports is designed to communicate. For the lender and farmer to properly communicate--both must understand the financial statement and obtain similar types of impressions about the business' financial condition.

A. Three Categories of Assets and Liabilities

Farm balance sheets should contain three categories of assets and liabilities--current, intermediate and long-term. Farm businesses are different from other businesses because in land, they have an asset that does not depreciate or wear out but has inflated tremendously in value over the last several years. Because of this asset, having three categories is a very sensible method of categorizing assets and liabilities.

(1) Current Assets

Current assets include those assets that are readily marketable--crops, feed, and market livestock. They can be sold without affecting productivity in the business.

(2) Intermediate Assets

Intermediate assets include basically breeding livestock and machinery. These are productive assets that are necessary to keep the farm productive and that will be around for several years.

(3) Long Term Assets

Long term assets are basically buildings and land are those that have a high value and intend to inflate over time.

(4) Current Liabilities

Current liabilities, of course, are those liabilities against the current assets--accounts payable, annual notes; and, also should include principal payments due on intermediate and long-term debts, as well as accrued interest and taxes.

(5) Intermediate Liabilities

Intermediate liabilities are basically one to seven year notes, due on breeding livestock and machinery.

(6) Long-term Liabilities

These, naturally, are those liabilities against the long-term assets--buildings and land--frequently running up to 30 years in length.

Placing Value on Assets

A key factor in preparing a good balance sheet is the way in which the assets are evaluated. There is always a compromise between extreme accuracy and a realistic approach. Our suggestions here are midway between these two. A proper procedure for placing value on assets is necessary to be able to arrive at earned net worth change. Traditionally current assets are priced at current conservative market value at the time the balance sheet is prepared. For many other businesses these figures are on a cost of production basis. However, since current farm assets are easily marketable, using current values usually presents no problem.

Machinery presents a problem with most farm balance sheets. A very easy and desirable way to evaluate machinery is to use the book value which could simply be the depreciated value from the income tax records. Farmers, however, feel this under-states its value. There are a number of issues here. But our solution is to also note either the cost basis (the price paid for the machinery) or an estimate of the current market value. However, for determining a farmer's earned net worth basis, the more desirable figure is the tax depreciated book value.

In order to compute earned net worth change, building and land values would be held constant. But the big gains for many farmers is in inflated land values. A reasonable way to solve the problem is to record the cost basis (the amount that the individual paid for the land) and also the current market value. In this way, both earned net worth and inflationary gain would be calculated.

<u>Arrive at Net Worth Change</u>

By evaluating the assets in the manner described above--value in the machinery at book value and the land and buildings on a cost basis, it is then possible to compute a net worth change between years.

<u>Separate Inflationary Gains</u>

If dual values on machinery, that is both the book value and current market value, and on land, both cost basis and current market value are recorded. Then it is possible to separate inflationary gains from total or net worth change.

The issues reviewed here on placing a value on assets are, of course nothing new to lenders. These are well known. We are reviewing them here only as a common basis for discussion, and as goals toward which we should be headed. We sometimes lose sight of these objectives and get distracted. We need to keep our thinking and our objectives in working with farmers on these balance sheet goals.

B. Obtain Balance Sheet on Calendar Year Basis

The second major step in getting better information from farmers is to obtain the farmer's balance sheet on the basis of the farmer's accounting year--which usually is the calendar year. This means taking the balance sheet on January 1.

Getting the balance sheet on an accounting year offers a number of advantages. One is that the balance sheet will be taken the same time every year. This may also be true if you take it at loan renewal time--but not always. When taken on an accounting year, the interval between balance sheets will be exactly one year.

Probably the most important reason for getting farm balance sheets on an accounting year basis is that it then makes it possible to reconcile the balance sheet with the farmer's cash flow record. The balance sheet provides a beginning and end to the record. This makes it possible for the farmer to calculate profit and/or loss. Using cash flow information, profit and loss sheets on farms can be very straight forward--income minus expenses, plus or minus inventory changes, minus depreciation, equals profit. A crucial element in this formula is inventory changes. These can be obtained from the balance sheet if it is on an accounting year basis. Depreciation, of course, is available from tax records so profit and loss figures can easily be obtained on farm records.

We believe that getting farm balance sheets on a calendar year basis will lead to more and better financial information in the future. We also believe it will encourage farmers to keep better records and consequently help them provide more accurate and more detailed information down the road.

C. Have Farmer Prepare His Own Balance Sheet

One of the problems in obtaining balance sheets on a calendar year (or an accounting year) basis, is that for most farmers the accounting year coincides with the calendar year. This would mean that lenders who obtain balance sheets through an interview with the farmer would have to bring in each farmer about January 1. This is just not physically possible and still be able to get good information. Having the farmer recall the situation on January 1, some months later would result in extremely poor information.

The solution is to ask the farmer to prepare his own balance sheet. This certainly is not a new idea but one that needs to be expanded. Traditionally lenders have taken an upside-down balance sheet (as one lender pointed out). This is, the lender completes the sheet and the farmer looks at the balance sheet upside down because he is sitting across the desk. It seems rather ironic that we are willing to inverview a farmer and have him recall from memory the details on assets and liabilities and then have him sign it as accurate.

Certainly a much more desirable way would be to have the farmer complete the balance sheet on his own. We think that there are several advantages. First, potentially the balance sheets will be more accurate. Secondly, the farmer learns more about his business. Thirdly, you will be able to use your time more efficiently at loan renewal time by visiting about the farmer's problems rather than spending time writing down the details of his financial situation.

A number of lenders have asked farmers to complete their own balance sheets with varying degrees of success. It is important to use the right approach to have patience and use tact in adapting this method. We'd like to suggest several steps:

1. Adopt a proper balance sheet form that communicates well between you and the farmer. It should be relatively easy to complete.

2. Select a group of farm borrowers that would be pre-disposed to this type of thinking--the young, the aggressive, the high leveraged and the new clients.

3. Send out, ahead of time, before the end of the year, last year's balance sheet and a blank form or two with a letter of instruction. In the letter, ask him to complete this balance sheet to the best of his ability as of January 1. In the letter, briefly explain the advantage to the farmer and how this will help you to serve him better.

4. Offer to help in completing the balance sheet the first year. You could do this through meetings or individual counseling sessions.

5. Have the farmer bring in the completed balance sheet soon after the first of the year. Be prepared to help him with the details in completing this balance sheet especially the first year.

6. After a year or two experience has shown that the farmers can and will do a reasonably good job of completing it. Some will do an exceptional job.

Problems and Disadvantages

Having the farmer complete his own balance sheet, of course, brings with it some problems and some difficulties. It requires not only changes on the part of the farmer, but also requires changes on the part of the lender on some traditional lending procedures.

A common argument against this approach is that some lenders feel it is necessary to have a current balance sheet at the time of loan renewal. Certainly, when loan renewal and the balance sheet are many months apart, the data becomes quite cold. The question to ask here is--do you need a balance sheet to determine the farmer's financial progress, or do you need a current collateral record? Possibly all that may be needed is an updated collateral record. In some cases lenders have allowed space in the margins to update the balance sheet at the time of loan renewal. It is certainly true that on some operations it might be useful to update the balance sheet more than once a year. This is particularly true for large cattle feeders or for those who are engaged in trading activities of cattle and grain.

A second concern is that farmers won't, or can't, complete it. Many of your clients feel very comfortable in dealing with you and assume that part of the service you are providing is gathering the information you need. Their attitude toward this new appraoch depends a great deal on how you yourself approach it. You must approach this method with a positive attitude and the idea that it benefits both you and the farmer. You will get better information and the farmer will get a better understanding of the financial information condition of his business.

Another concern is the accuracy of the information. This is a questionable argument. The client who spends time at home completing the balance sheet will certainly come up with some items that he would not recall sitting at your desk. It is, however, necessary that we provide help and training in showing the farmer how to complete his balance sheet. Also we must not be confused between accuracy and honesty--it is still necessary for you to verify the accuracy of the balance sheet. The balance sheets are not audited of course--but neither are those you take verbally. In some cases, at least some items, will need to be verified. With both methods there will be areas where you will have questions that you need to check.

SUMMARY

We believe that the key to getting better information from farmers starts with three important steps:

1. Adapt a good balance sheet--one that gives you the necessary information, is relatively easy to complete, and helps the farmer understand his financial condition.

2. Obtain the balance sheet on a calendar year basis. This will encourage better farm records and in the long run give you more accurate financial information.

3. Have the farmer complete his own balance sheet. This will save you some time, provide you with better information, and teach the farmer more about his financial business.