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AGRICULTURAL ACCOUNTING STANDARDIZATION

presented by

Mette Ching

Canadian Farm Business Management Council

75 Albert St., Suite 1110

Ottawa, Ontario,

K1P 5E7

ABSTRACT

The Canadian Farm Business Management Council (CFBMC) recognized a need for standardization of agricultural accounting practices. In response to this need CFBMC in conjunction with representatives from the accounting profession, farm management specialists, farm organizations, and lending agencies has been working on the development of model financial statement for major farm commodities.

Presently, comparability of farms and bench marking performance factors is challenging because accountants use a wide variety of presentation styles. While professional accountants are bound by GAAP (Generally Agreed Accounting Principles) and the guidelines contained in the Canadian Institute of Chartered Accountants Handbook, statements are often qualified to the extent that historic cost information has been used for capital assets and estimated market values used for inventory items.

The development of a series of model financial statements was prioritized with DAIRY being the first. It was chosen because it combined challenges which are inherent in a combination of the other sectors. The other model statements in order of anticipated publication are GRAINS & OILSEEDS; BEEF COW & BEEF FEEDER, POULTRY, SWINE, & HORTICULTURE. The Canadian Institute of Chartered Accountants has been contracted to publish and market the model statements cooperatively with the CFBMC.

INTRODUCTION

The Canadian Farm Business Management Council (CFBMC) recognized a need for standardization of agricultural accounting and financial reporting practices within Canadian agriculture. In response to this need, CFBMC in conjunction with representatives from the accounting profession, farm management specialists, farm organizations, and lending agencies has been working on the development of model financial statement for major farm commodities.

As farming becomes more complex, capital intensive, and sophisticated, farmers are demanding more information from their records. An increasing number of farmers are keeping more comprehensive financial and production records with the aid of computerized systems. Many of the financial systems combine the traditional cash journal and full double entry accrual. Leading edge farm managers are having their accountant prepare full accrual financial reports in order to discuss their annual performance with partners, creditors and other professionals. These leading edge farmers include farm family corporations, and larger partnerships and larger proprietors. The accountants can easily adjust back to a cash basis for operations using the cash method of tax reporting.

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Educational and promotional programs are in the initial stages to encourage farm operators, farm management advisor, lenders, and accountants to adopt the standardized approach. The benefits of clearer communications, and opportunities for comparisons between farms, counties, and provinces are obvious. Trial use of the new statements indicates that, after initial conversion, there are no added costs for the preparation of the new reports. Software companies have already indicated an interest in the standardized approach.

FINANCIAL AGRICULTURAL STUDIES

Since 1986, four comprehensive U.S. and Canadian studies have been done, involving agricultural accounting and financial reporting standards. These studies include:

*Banker initiated studies:

- U.S.-*Financial Guidelines for Agricultural Producers*, published by the Farm Financial Standards Task Force in 1991.
- Canada - *Farm Accounting Standardization Manual*, published by the Farm Accounting Standardization Review Committee, Farm Credit Corporation in 1991.

* Accountant initiated studies:

- U.S. - *Audits of Agricultural Producers and Agricultural Cooperatives*, an AICPA Audit and Accounting Guide published in 1987.
- Canada - *Accounting and Financial Reporting by Agricultural Producers*, a CICA Research study published in 1986.

Such studies recognized the development of common standards to be in the long-term best interest of the industry.

Standardization enhances or promotes:

- * The ability of producers to analyse and interpret financial information, and to conduct comparative benchmark analysis;
- * The accurate measurement of contribution margins;
- * Participation in commodity-based performance groups using common financial and production standards;
- * The production and delivery of farm management programs;
- * The analysis and interpretation of farm financial statements by third-party users, including financial institution and government agencies; and
- * An element of universality in computer software development.

Barriers to adoption:

Throughout North America, a wide variety of industry practices continue to exist. Some of the apparent reasons standardization in agriculture has not been widely adopted to date:

- * Cash basis accounting for tax purposes have impeded agricultural producer acceptance of standardization.
- * The agricultural industry encompasses single and multiple enterprise-based farms of varying sizes, which often present unique accounting issues.
- * Record-keeping limitations tend to inhibit the development of accounting information to comply with GAAP.
- * Financial institutions often measure a producer's assets on a market value basis, and producers commonly record inventories and productive assets at market.
- * Professional accountants often default to accounting treatments contrary to GAAP where accounting information appears impractical to obtain.
- * The accounting profession, in both Canada and the U.S., has initiated studies promoting cost-based recommendations on valuation issues in accordance with GAAP, but these recommendations have not gained wide acceptance.
- * The lack of motivation to adopt GAAP or standardization remains another significant part of the challenge. Many industry stakeholders apparently have not capitalized on the potential business management opportunities that would evolve from adoption of standardized financial accounting and reporting.

The Committee believes a significant portion of the diversity of accounting and financial reporting standards in agriculture stems from variations in the method of valuing inventories and the treatment of productive assets. It also believes, that the achievement of *standardized accounting and financial reporting* depends on the development of *commodity-base model financial statements*. This would dictate development of practical cost-based solutions to the valuation of and accounting for inventories and productive assets.

A Series of Model Financial Statements

The Committee appointed Task Forces to prepare a series of model financial statements for the following commodity groups: Dairy, Grain and Oilseed, Poultry, Beef, Hogs and Horticulture. It believes all commodity-based model financial statements in the series should have the following minimum characteristics:

- * The initial model for each commodity group should represent a general-purpose financial statement.
- * The model must, in all material respects, comply with GAAP, including the requirements of the CICA Handbook.
- * The model should provide some basic measurement of operational efficiency (e.g., a contribution margin, percentages for variable expenses, etc.).
- * The model should provide sufficient detail to facilitate appropriate analysis.
- * The model must be practical with use of most manual, or computerized record keeping systems, capable of producing double-entry, accrual basis records.
- * The initial model for each commodity group should be prepared on a single enterprise basis.
- * The legal form of business structure; proprietorship, partnership, or corporation, should not limit or impede comparability of data among producers.
- * The various models developed should retain, to the greatest extent possible, the same basic format and terminology for all commodity groups.
- * Each model should include detailed practical solution concerning such issues as the costing of inventories and/or productive assets, the amortization of productive assets, etc.

The title *Standards for Success* attaches to all commodity-based model financial statements in the series. The release of the *Standards for Success* series will provide the stakeholders with a practical solution for standardization and bench marking within Canadian agriculture.

Model Financial Statements-Other considerations

Within each commodity group, the following require consideration:

- * Development of enterprise-based management purpose model financial statement formats, in addition to and compatible with each general-purpose model.
- * Periodic review and required updating for each commodity group.
- * Development of commodity-based benchmark analysis software, keyed to the commodity-based general-purpose or management-purpose model financial statements.
- * Develop software certification to ensure compliance with national accounting and financial reporting standards.
- * Establish a method for periodic production of regional standard costs and standard cost methodology, to assist in costing inventories and productive assets.

Ultimately, one basic premise determines the degree of acceptance of *Standards for Success* by Canadian agricultural producers. That premise is that a significant number of progressive producers seek identification and implementation of improvements leading to optimal performance. A key element to the long-term efficiency of most commodity groups in Canadian agriculture is comparative benchmark analysis. *Standards for Success* provides direction, and enables the meeting of this challenge.

COMMON ACCOUNTING ISSUES

The Agricultural Accounting Standardization Committee and its commodity Task Forces recognize GAAP as the underlying basis for accounting and financial reporting by agricultural producers. GAAP define and describe the attributes of information provided in financial statements, such as, understandability, relevance, reliability and comparability, all of which make the information useful to managers and other users.

In the interest of consistency, the Committee agreed to harmonize certain accounting and financial reporting practices for each of the model financial statements. The accounting and financial reporting practices are briefly summarized under the following headings:

- *Inventories
- *Productive assets
- *Income and expense classifications
- *Statement of cash flow
- *Contribution margin
- *Economic dependence

INVENTORIES

One of the more controversial issues faced by the Committee relates to the varied inventory valuation practices followed by the agricultural industry. These varied practices often represent the single most significant impediments to comparability of financial information among producers within certain commodity groups.

In the Committee's opinion, valuation at the lower of cost and market, remains the only reasonable basis of determining a meaningful and consistent measurement of income. This applies to all inventories, including growing crops, market and breeding livestock, harvested crops, and productive output such as milk, eggs, wool etc. This conclusion was reached based on the following:

- * This valuation method provides the most useful information to the producer as a basis for improved management decisions.
- * Users are familiar with and understand the lower of cost and market valuation as it is used in other business sectors.
- * The information prepared on a timely basis is also relevant for user decision-making purposes, and
- * The costs of using this basis are reasonable.

The AICPA Audit and Accounting Guide, *Audits of Agricultural Producers and Agricultural Cooperatives*, and the CICA Research Study, *Accounting and Financial Reporting by Agricultural Producers* support the above opinion with respect to growing crops and developing animals held for sale. However both studies acknowledge those inventories of harvested crops and livestock held for sale may be valued at the lower of cost and market or, at sales price less estimated costs of disposal (referred to as "net farm price" by the CICA Research Study Group) when **all the following three conditions exist:**

- * The product has a reliable, readily determinable and realizable market price;
- * The product has a relatively insignificant and predictable costs of disposal; and
- * The product is available for immediate delivery.

Net farm price valuation of harvested crops, livestock held for sale, and certain inventories of productive output (e.g., milk and eggs) can be supported **when all three conditions** exist.

The Committee suggests these conditions infer that there is absolute certainty, **as at the balance sheet date**, concerning the full realization of the net farm price - a situation which is highly unlikely to occur in practice. Alternatively, the application of the net farm price method has support when it produces a financial outcome not materially different from the lower of cost and market method. **Full disclosure of the conditions permitting the adoption of the net farm price method, is recommended in the notes to the financial statements.**

Another issue in inventories is the debate concerning the merits of using full absorption costing, versus direct costing in valuing inventories. Full absorption costing includes all direct, variable and fixed costs as components in the determination of the cost of inventories. In *Model Financial Statements* any financial statements and sample inventory costing templates, apply the principle of **direct costing** using the following general guidelines:

- * Classify all direct costs in the statement of contribution margin as "variable expenses".
- * Classify all variable, semi-variable and fixed costs relating to **primary sources of production output** that generally vary with productive levels or productive life in the schedule of contribution margin as "variable expenses".
- * Classify all variable, semi-variable and fixed costs relating to the **facilitation of primary sources of production output** that generally vary with time, as opposed to production, as "other expenses" in the statement of income.

The Committee endorses, this simpler and more practical costing method. It facilitates the measurement of a meaningful contribution margin, which represents a key management performance measure. Practical considerations often impede the allocation of fixed costs in multi-enterprise farms.

PRODUCTIVE ASSETS

Productive assets include plants, trees, vines, and livestock. The Committee endorses the capitalization of productive assets on the basis of cost, and the systematic amortization of cost, net of residual value. Productive assets, with a productive life cycle of one year or less, become classified as inventories.

Many productive assets originate or develop through on-farm production. The model financial statements contain recommendations concerning the development of standard costs, the removal of such costs from period costs, and the subsequent amortization of the resultant capitalized amounts. In removing standard costs from period costs, the model financial statements generally deduct such costs from variable expense, notwithstanding such costs may contain an element of fixed overhead.

When applicable, the model financial statements describe the method of valuing productive assets as well as the method employed in amortizing the cost to operations.

INCOME AND EXPENSE CLASSIFICATION

The model financial statements classify expenses as "variable" and "other". While this classification often represents a matter of individual preference, the Committee has applied certain guidelines for consistency purposes. These guidelines define "variable expense" as those expenses reasonably considered to vary with production. All remaining expenses, except management salaries and income taxes, represent "other expenses".

Some of the practices or conventions in income and expense classifications include:

- * **The recognition of amortization and maintenance costs related to production equipment and productive assets (e.g. breeding herds, orchards) as "variable expenses".** Such assets represent primary sources of production output. The amortization and /or maintenance of such assets generally varies with production levels or productive life, and practical considerations often dictate the amortization of such assets over time, rather than in proportion to production.
- * **The recognition of amortization and maintenance costs related to buildings, other equipment, paved surfaces, marketing board quotas, etc., as "other expenses".** Such assets simply facilitate production from primary source assets. The amortization and/or maintenance of such assets generally varies more with time than production levels.
- * **The classification of financing costs related to all capital assets within "other expenses".** The Committee considers it impractical to record financing costs related to production equipment or productive assets as variable expenses. It may be appropriate to record financing costs related to current assets as variable expenses.
- * **The recognition of land rent and property taxes as "other expenses".** The rationale for this classification is maintenance of a contribution margin which allows comparability among farms with diverse land holding arrangements.

* **The categorization of gains or losses on the disposition of capital assets as a "variable" or "other" item depends on the classification of the related amortization expense.** Such gains or losses effectively represent adjustments to the related amortization expense.

* **The presentation of management salaries within corporate farms as a separate line item, immediately before the provision for income taxes.** Management salaries usually represent salaries or wages paid to shareholders. The segregation of management, administration, and production activities would provide the best measurement for consistency of these expenses. It is a challenge and a goal which would enable comparative performance analysis among family farm corporations, partnerships and proprietorships.

STATEMENT OF CASH FLOW

A set of financial statements prepared in accordance with GAAP includes a cash flow statement that classifies cash flows during the period between operating, investing and financing activities. Cash flows from an enterprise's operating activities may be presented using either the direct or indirect method of reporting.

The Committee endorses the use of the **direct method of reporting cash flows** from operating activities. This method discloses major classes of gross cash receipts and gross cash payments and is easy to obtain from the accounting records of the enterprise. In addition, it is readily understood by both the producer and other users. It provides information that may also be useful in estimating future cash flows, which is not available under the indirect method.

The statement of cash flow also allows a choice in the presentation of dividends as either an operating or financing activity. The majority of farming operations are owner-operated enterprises and the payment of dividends usually forms part of the owner's remuneration package. The Committee suggests that payment of dividends under these circumstances, correctly classifies them as an operating activity.

CONTRIBUTION MARGIN

The Committee recommends the inclusion of a schedule of contribution margin within the model financial statements of all commodity groups. Such ancillary information significantly enhances decision-making capabilities and represents a prerequisite to benchmarking.

ECONOMIC DEPENDENCE

Factors including supply management programs, tariff protection, export controls, contracts with third parties and limited market outlet sources, often create conditions of economic dependence within agricultural sectors. Where appropriate, the model financial statements incorporate examples of economic dependence notes.

CONCLUSIONS

The Committee and the Task Forces have worked very hard to take all concerns into account. The basic concepts and model statements are done. The **Dairy, and Grain & Oilseeds** models are in the final edit process before publication. The **Beef Cow & Beef Feeder** models are at the final review stage, and the **Poultry** models are at first review stage. They are all expected to be published to be used for the 1998 fiscal year. That leaves the **Swine and Horticulture** models to be finalized in the 1998 fiscal year.

The next challenge is the practical application of the model financial statements and communicating the benefits to Canadian commercial farms, and other industry stakeholders. Model financial statements provide farm managers with a means of accurately reporting the results of business activities and ensuring comparability to other farms. This process leads to improvements in management information and competitiveness for Canadian producers.

