Choosing the Right Accounting Method and Tracking The Right Production Details

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About your speaker

• Has worked with accounting software for the agriculture industry for 21 years.

• Has been involved in product support, product design and product development. I currently do most of the training on our software products in a classroom, online and at a customer site.

• I am also involved in consulting to help customers implement their software product and to help use it to get valuable management information out of the system.

• Was recently named President of the American Society of Agricultural Consultants (ASAC).
Uses for Accounting Information

- Government and regulatory bodies such as the IRS
- Lenders, Owners and Investors
- Senior Management
- Segment, Division or Department Managers
Common Accounting Methods Used In Agriculture

• Cash Basis

• Cash Basis with Year End Accrual Adjustments

• Accrual Based Records – Inventories valued at market value

• Accrual Based Records – Inventories valued at cost and revenue is matched with expenses for producing
Cash Based Accounting

• Primary use for this type of accounting method is compliance

• Secondary use is for lending

• Okay for simple operations not looking to grow

• Identifying costs for a single production period is difficult and therefore not as useful cost analysis or marketing information

• Business growth dependent on knowledge of operator

• Not usually a good method for accurate balance sheet reporting or analysis
Cash Based Accounting with Accrual Adjustments

- Companies using this method are still usually a single owner or manager

- Accrual adjustments are usually performed only to produce a year-end balance sheet (sometimes more often)

- Inventories are usually value at market value and not cost.

- Allocation of revenue and costs to enterprises (profit center) is sometimes performed

- Ability to get true cost of production still difficult

- Can start to look at some important business ratios
Accrual Based Records – Inventory Usually Value at Market

• Companies using this method are still usually a single owner or manager

• Comprehensive financial statements prepared more than just annually

• Inventories are usually value at market value and not cost but sometimes an attempt to value at cost is made.

• Allocation of revenue and costs to enterprises (profit center) is often performed

• Cost of production can be obtained

• Introduction of production factors is often used here
Accrual Based Records – Inventory Valued at Cost

• Companies using this method are usually characterized by profit seeking and have growth on their agenda.

• Maintain financial information by management segments (Machinery Cost Center, Labor Cost Center, Production Cost Center)

• As costs are accumulated and accrued on balance sheet those costs eventually become value of finished goods inventory so inventory is valued at cost.

• Revenue is matched with the cost of producing that revenue on the Income Statement.
Which Method Is Right For My Company?

• Base your decision on the long term goals of the owners and managers

• Sometimes the complexity of the operation can drive the decision as to which method to use.

• In some cases regulatory reporting might drive the use of which method to use.
How Does Business Structure Changes Your Reporting Needs

- Land Company
- Operating Company
- Equipment Company
Reporting Needs For Taxes Versus Lending and Management

- Many farms are setup with a business structure designed to reduce taxes and enhance government receipts.

- Looking at one company by itself doesn’t always give you the best look at your operation.

- Consider a system that allows for combining information across companies for looking at ratios and analysis profitability.
What Management Details Do I Need?
Commonly Tracked Management Details

- Enterprises (Profit Centers) – Areas of your business that general financial activity

- Cost Centers – Track costs where they occur.

- Production Centers (Fields, Farms, Livestock Confinement Bldg) – Location where your production occurs.

- Production Year, Production Series

- Tracking costs to the Asset used in a particular activity such as a combine, tractor, etc.

- Projects – Harvesting, Planting, Building a new Barn
Ways Accounting Systems Track Management Details.

- Older accounting software products use the account number to track this information:

  6001.00  Labor Expense
  6001.01  Labor Expense – Corn
  6001.02  Labor Expense – Soybean
  6001.03  Labor Expense – Wheat
  6001.04  Labor Expense – Dairy

  6005.00  Fuel Expense
  6005.01  Fuel Expense – Corn
  6005.02  Fuel Expense – Soybean

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Ways Accounting Systems Track Management Details.

• Use of the account numbering system leads to an unmanageable chart of accounts.

• Usually provides less flexibility in reporting

• Tracking multiple management details means even a larger account number with multiple segments to it.
Ways Accounting Systems Track Management Details.

Newer accounting software usually will track each management detail in a separate field.

<table>
<thead>
<tr>
<th>Account</th>
<th>6001 Labor Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost\Profit Center (Enterprise)</td>
<td>Corn Production</td>
</tr>
<tr>
<td>Field</td>
<td>Becker South</td>
</tr>
<tr>
<td>Production Year</td>
<td>2016</td>
</tr>
<tr>
<td>Associated Asset</td>
<td>JD 4956 Combine</td>
</tr>
</tbody>
</table>
Ways Accounting Systems Track Management Details.

- Using separate fields to track these attributes leads to more flexibility in reporting. The transactions can be filtered for any combination of those details.
  
  - Example: Can run a report on Corn Production for 2016 or as easily look at all transactions tagged to the JD 4956 Combine

- Adding a new management detail such as a new profit center, field or piece of equipment doesn’t mean adding additional accounts to your chart of accounts
Know what Cost Is Versus An Expense
Identifying Costs and Expenses

- Production Costs are costs incurred by a business when manufacturing a good or producing a service.

- An Expense is referred to the ongoing expense of operating a business
Allocating Costs and Expenses to Production Details

• Most costs can be directly applied to a specific profit\cost center, field, group of livestock and/or production year.

• An expense is usually something that should be applied across multiple areas of your operation and isn’t a direct cost of production but should be considered when looking at total profitability.
Pitfalls to Avoid When Allocating Costs

• Some systems allow you to Distribute Costs and Expenses on a Per Acre, Per Head, Per Unit of Production or Percentage Basis. This is usually a good method for Expenses but not for Costs.

• Purpose of applying costs directly to management details (areas of your operation) is to be able to track variances and figure out what activities you might need to make management decisions on.
Add Value to Your Management Reporting by Combining Financial Details with Production Information
Reasons for Using Production Information in an Analysis

• For the management of costs at a particular production factor such as costs per acres or cost per head. These are the factors that budgeting and cost management are often decided on but still doesn’t provide good information for marketing decisions.

• Making marketing decisions. For grain farms this is usually cost per bushel, pound or ton. For dairies it might mean the cost per cwt of milk and for livestock operations it might mean cost per pound versus cost per head.
Combining Financial Reporting with Production Information

• Production details can be tracked within the accounting software and then used in an analysis.

• Production details can come from an outside source. There is a big movement to be able to integrate information in production tracking software with accounting data. So, your accounting product needs to have a way to store that information. Gets rid of double entry of information.

• The last option is to push your accounting information to another source where it can be combined with production information. (Think spreadsheets!!)
So Many Details, Do I Need to Track All of Them?
It’s a Management Decision

• Don’t get bogged down in tracking details that nobody is going to use or make a management decision on.

• There is no prescription for the details you need to capture from one entity to another.

• Think about all the spreadsheets that you use. Is there duplication that you can get rid of by bringing the information all into the same system?

• Keep a focus on management goals and whether these tools can help with decisions about efficiencies and growth.