GAAP Accounting for Farmers
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Outline of topics

• Why GAAP financial statements
• Types of CPA prepared financial statements
• Conversion from current reporting basis to GAAP
• Specific GAAP accounting issues
Why GAAP for farmers

• Creates a common reporting language…right now, farmers are providing financial information that is inconsistent.
  • Methods of valuation of assets and liabilities
  • Completeness of information
  • Disclosure
  • Basis of accounting for reporting operating results
    • Cash
    • Tax
    • Modified Accrual
    • GAAP
    • Market
Why GAAP for farmers

• Builds credibility with stakeholders
  • Bankers
  • Major vendors such as input suppliers
  • Customers that buy your grain or livestock or produce
  • Landowners
  • Equipment dealers
  • Investors
  • …most of all – its better information for the owners and management team to run their business
Why GAAP for farmers

- Tax vs. FBFM Accrual – 5 year analysis

![Bar chart showing Schedule F Income vs. Accrual Income for years 2002 to 2006 with a 5 year average.](chart.png)

 Courtesy of University of Illinois – Paul Ellinger, Freddie Bernard, Christine Wilson
Why GAAP for farmers
Tax vs. FBFM accrual: Economic depreciation constant

Schedule F Adj Depreciation
Accrual Adjusted
5 Year Average
Why GAAP for farmers

Conclusions reached in University of Illinois Study comparing accrual basis operating statements to tax reporting:

- Average annual difference 59%
- 52% when 3 or 5 year averages used
- Depreciation, crop inventory changes and prepaids are major differences
- Impacts profitability-based financial ratios
# Why GAAP for Farmers

## Balance Sheet - 100 acre farm

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Tax</th>
<th>FBFM</th>
<th>GAAP</th>
<th>GAAP - ex</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory</strong></td>
<td>$ -</td>
<td>$ 200,000</td>
<td>$ 200,000</td>
<td>$ 200,000</td>
</tr>
<tr>
<td><strong>Prepaids</strong></td>
<td>-</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Cap Prod Costs</strong></td>
<td>-</td>
<td>-</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Equipment</strong></td>
<td>-</td>
<td>250,000</td>
<td>250,000</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>Land</strong></td>
<td>10,000</td>
<td>1,000,000</td>
<td></td>
<td>1,000,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$ 10,000</td>
<td>$ 550,000</td>
<td>$ 575,000</td>
<td>$ 1,825,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES &amp; EQUITY</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A/P</strong></td>
<td>$ -</td>
<td>$ 50,000</td>
<td>$ 50,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td><strong>Accrued vacation</strong></td>
<td>-</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Accrued payroll</strong></td>
<td>-</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Deferred tax</strong></td>
<td>-</td>
<td>-</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Unrealized loss on open contracts</strong></td>
<td>-</td>
<td>-</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td>10,000</td>
<td>465,000</td>
<td>265,000</td>
<td>1,515,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$ 10,000</td>
<td>$ 550,000</td>
<td>$ 575,000</td>
<td>$ 1,825,000</td>
</tr>
</tbody>
</table>
## Why GAAP for farmers

### Example reconciliation - Tax to GAAP

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income - tax basis</td>
<td>$50,000</td>
</tr>
<tr>
<td>Excess tax depreciation</td>
<td>50,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>200,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>100,000</td>
</tr>
<tr>
<td>Capitalized production costs</td>
<td>25,000</td>
</tr>
<tr>
<td>Unrealized losses</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>(85,000)</td>
</tr>
<tr>
<td><strong>Net income - GAAP basis</strong></td>
<td><strong>$315,000</strong></td>
</tr>
</tbody>
</table>
Types of financial statements

• What is a financial statement prepared in accordance with GAAP?
  • Requires all the basic financial statements plus footnotes
    • Balance Sheet
    • Income Statement
    • Statement of Changes in Equity
    • Statement of Cash Flows
  • Footnotes would include important information about accounting policies and methods, debt, lease commitments, hedging activities, and any other material information that would be important to the user
Types of financial statements

• What are some common exceptions to/departures from GAAP?
  • Land is reported at fair value
  • Depreciation of equipment is on a tax basis
  • Certain financial statements are excluded
  • Footnotes are excluded
  • Excluding related entities from the report that are required to be included
  • Equipment reported at appraised value

All of these exceptions are OK if your users accept them!!
Types of financial statements

• CPAs provide a level of assurance to the users of financial statements
  • Audited financial statement is the highest level of assurance, and generally the most expensive
    • Observe inventory
    • Send out confirmations of balances such as accounts receivable, investments, cash, debt, accounts payable, open contracts
    • Review internal controls, assess fraud risk, and design procedures to address fraud risks identified
    • Review technology systems and controls
    • Verify other balances through various audit procedures
Types of financial statements

• Reviewed financial statements provide limited assurance to the users
  • Procedures performed by CPA firm will be analysis of balances and ratios, and inquiry of management and accounting staff
    • Reasonableness
    • Completeness
  • Other substantive procedures could be performed by the CPA
Types of financial statements

- Compiled financial statements provide the least amount of assurance to the users
  - Relying heavily on the representations of management
  - Expand work where considered necessary due to unusual or unexplained balances
  - Many times CPA firms are simply helping the user ensure the financial statements are presented in accordance with GAAP and all required disclosures are present.
Types of financial statements

- CPAs can also prepare Compiled or Reviewed financial statements with Agreed Upon Procedures
  - AUP are procedures designed to test specific balances that represent a higher level of risk to the user – the procedures are agreed upon between all parties prior to initiation.
  - A separate narrative type report is issued explaining the procedures done, and the results or conclusions reached.
    - Eg: Observe and recompute inventory value
    - Eg: Confirm accounts receivable balances
    - Eg: Perform testing of amounts reported on borrowing base certificate
    - Eg: Verify contract terms and acres under management
Conversion to GAAP basis financial statements

• Several issues arise when we are converting to GAAP basis financial statements
  • An accurate Operating Statement for a period is dependent on accurate beginning balances
    • Inventory – grain
    • Inventory of inputs such as fertilizer, chemicals, seed, feed
    • Open purchase and sales contracts and mark to market
    • Accruals such as accounts receivable, accounts payable
    • Equipment and capitalization policy
    • Cutoff of transactions at the prior year-end

We recommend going through the exercise of preparing a balance sheet one year before GAAP basis financial statements will be required
Conversion to GAAP basis financial statements

• Reporting entity challenges
  • Multiple entities exist including farming proprietorships – what is the reporting entity?
  • What does GAAP allow in terms of Combined or Consolidated financial statements
    • Individuals generally cannot be combined with entities even though the bank as a user may want to see the combined cash flow
    • Proprietorships can be combined – this is a subset of the Individual’s overall activities…very important to segregate proprietorship accounts from personal accounts
  • Rights and obligation issues
    • Legal title to assets may be with individual personally even though they have previously reported it being owned by an entity, that is using the asset for collateral
Conversion to GAAP basis financial statements

• Level of effort and scrutiny by CPA firm may be challenging for farming operation
  • Big concern is capturing all of the transactions and relevant information for disclosure – completeness assertion
  • Work papers and documentation requirements will seem overwhelming
  • All legal agreements, debt agreements will be requested by CPA firm
  • Identification of weaknesses in your systems will feel like criticisms when they are intended to help you to improve the financial soundness of your operation
  • Disclosures will seem excessive
Specific GAAP Accounting Issues

- Inventory accounting
  - Driven by FASB ASC Topic 905, formerly, Statement of Position (SOP 85-3)
    - Market value accounting allowed under certain conditions
      - Immediate marketability at quoted market prices that cannot be influenced by producer
      - Characteristics of unit interchangeability
      - Relatively insignificant costs of disposal
    - Must take into account costs to deliver to market including trucking, etc.
    - Discounts for below market grade must be accounted for
    - Impairments for significant disease (aflatoxin as an example)
  - Is market value below the cost to produce?
Specific GAAP accounting issues

• Open contracts and mark to market accounting
  • Sales contracts to deliver commodities within a certain time period
    • Market value, net of any direct costs, of those contracts is compared to the contract value, and the gain or loss is recognized on the balance sheet
  • Board positions or open market positions also must be marked to market
  • Open purchase contracts to purchase inventory, feed, or other supplies must be evaluated to determine if these should be accrued, or, if there could be a mark to market adjustment needed
    • Eg. Open p.o. for livestock is at a price that well exceeds the market as of the balance sheet date
Specific GAAP Accounting Issues

- Land improvements on tenant ground
  - Drainage tile
  - Irrigation pivot
  - Timber cleared
  - Drainage ditch cut
  - Soil fertilization
- Is this an asset that is depreciated or is this simply amortized over the term of the lease?
- What if the lease is year to year?

Answer to this question is determined after reviewing the contractual agreement and understanding the terms.
Specific GAAP Accounting Issues

- Production costs
  - Capitalize into an inventory account or into a pre-production costs account
    - Full absorption of costs should be followed...labor, materials, equipment costs associated with the production process
    - Production costs that have a life of more than one year should be amortized over the estimated useful life (example would be Lime applied to a field that will provide benefit for 2-3 years)
  - Significant supplies, inputs that are purchased and stored have to be recognized into inventory – these should not be written off
Specific GAAP Accounting Issues

• Tax liabilities
  • Entity level – generally pass through entities will not have federal tax liabilities, but may have state or local tax liabilities
  • Current tax liabilities likely exist for farmers who deferred the recognition of crop insurance proceeds for tax purposes – a current tax liability is one that is due in the next 12 months.
  • Deferred tax liabilities arise from items that are reported into income or expense for GAAP accounting purposes, but are treated differently for tax purposes in the current period
    • Eg. Crop insurance proceeds received in 2012 was revenue for GAAP purposes, but was not reported on the tax return until 2013.
    • Eg. Depreciation deductions in recent years have been much higher for tax purposes due to Section 179 limits being higher, and Bonus Depreciation
Specific GAAP Accounting Issues

• Tax liabilities, Deferred, (continued)
  • Eg. Prepaid chemicals, fertilizer, seed are deducted for tax purposes, but recognized as inventory for GAAP purposes
  • Eg. Inventory on hand – marked to market for GAAP purposes, but all the costs of that inventory production were deducted in current year.

• A Deferred Tax Asset is created where a tax benefit from an item reported will be realized in a future tax reporting period – example is Accrued Vacation to Employees – it was expensed on the books but we generally can’t deduct this for tax until paid – so a benefit will be realized in the future

• A Deferred Tax Liability is created where a tax liability will be realized in the future from an item reported – an example is inventory marked to market – once that is sold, there will be a tax liability recognized
Specific GAAP Accounting Issues

• Conclusions on Deferred Taxes….What does it all mean?
  • What it means, is the tax effect of every transaction must be recognized….so crop insurance proceeds of $100,000 are really saddled with a tax liability
    • Deferred tax liability is computed based on an assumed rate of tax that will be paid on that amount in the future
      • Depends on your tax bracket when that amount is recognized on your return
      • In the period you recognize the tax liability, this is an estimate
  • If you have a Loss Carryforward on your tax return, then you have a future tax benefit that will allow income earned in the future to be free of tax liability, so again, we would recognize the tax effect of that on the GAAP basis financial statements

Remember, two things in life are guaranteed…Death and Taxes
Specific GAAP Accounting Issues

• Value of land or equipment recently purchased
  • Is the value on the books after amortization or depreciation, where applicable, above market?
  • Used equipment
  • Land recently purchased at premium prices
Specific GAAP Accounting Issues

• Capitalization of significant purchases and repairs
  • GAAP requires that an improvement that extends the useful life beyond one year should be capitalized and depreciated over that life
    • Applies to significant repairs
    • Self-constructed or self-repaired assets
      • Capitalize direct and indirect costs including shop and labor costs
Specific GAAP Accounting Issues

- Commitments, Concentrations, and Risks that may need to be disclosed
  - Grain inventory that is not priced – does this represent significant risk?
  - Crops that are in the ground that have no crop insurance
  - Concentrations on certain markets or customers for the sale of crops
  - Lease commitments for equipment or land
  - Long-term leases at high cash rent values - does this represent a significant risk?
  - Verbal contracts
  - Environmental or regulatory issues that may result in additional investments or fines
Specific GAAP Accounting Issues

- **Resources available**
  - Farm Financial Standards Council (FFSC) Financial Guidelines for Agricultural Producers
  - FFSC Managerial Accounting Guidelines for Agricultural Producers
  - Farm Financial Ratios – provides analytical tools unique to production Ag
  - SOP 85-3
  - AICPA accounting guide for agriculture producers
  - Industry business practices
Thank You

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