



Consolidated Financial Statements

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Farm and ranch business statements are unique in that personal and other non-farm income, assets, and liabilities are often comingled with the business items. In addition, very few farm and ranch businesses use accrual accounting; rather, they report on a cash basis and adjust for accrued items. Several issues have been identified which require special attention when preparing farm or ranch financial statements. These are:

1. defining personal and business assets and liabilities
2. non-farm income
3. withdrawals
4. credit card debt
5. savings and investments

This fact sheet will examine the five issues noted above. The methods used to identify and account for these items should be consistent for the reporting entity from year to year, and should be comparable to other farm or ranch businesses that use combined personal and business financial reporting.

Defining Personal and Business Assets and Liabilities

Some assets are easily recognized as business or personal. For example, farm or ranch machinery and livestock are obviously business, while household consumer goods are definitely personal. Other assets are not so easily classified. Cash from non-farm earnings (personal or other non-farm business) is often comingled with cash from the farm or ranch business in a single checking account. A savings account, a house which is located on the farm, or an investment in another entity could be either a business asset or a personal asset.

The Farm Financial Standards Council (FFSC) encourages a move to farm/ranch financial reporting which conforms to Generally Accepted Accounting Practices (GAAP) and which completely separates personal items from farm or ranch business statements¹. The FFSC also recognizes that statements are likely to contain both farm/ranch and personal items for some time into the future. Some guidelines are given for

classifying assets and liabilities as farm or non-farm. When cash from personal and farm or ranch business sources are comingled in a single checking account, all of it may be considered a business asset. This is because it will be impossible to determine the source of the cash and all of it is available to pay farm or ranch expenses. Cash which is maintained in separate farm and personal accounts is easier to classify, and transfers between the accounts may be recorded as contributed capital (personal to farm) or withdrawals (farm to personal).

An asset should be classified as business or personal, depending upon the owner's intent to use the asset for business or personal purposes. This provides the basis for the following paragraphs about classification of assets as business or personal.

Marketable securities may be farm or non-farm, depending upon the intent of the owner. When excess cash from the farm or ranch business is invested in marketable securities to earn income until it is needed for seasonal expenses or to carry the farm or ranch through a low income year, the owner's intent is to hold the securities as farm assets. If, however, the intent is to use the marketable securities as a source of income after retirement, to pay for children's college expenses, or for other personal use, these are personal assets. Marketable securities that are intended for personal use, may be used as collateral for a farm/ranch business loan, but this does not make them a farm asset. Moving the asset from personal to farm and later back to personal would distort the statements and violate the principle of consistency in reporting.

Accounts receivable, prepaid farm expenses, cash investment in growing crops and farm inventories and other farm assets should clearly be classified as farm or ranch business assets. Non-farm current assets could include accounts receivable and inventories in a non-farm business. Again, the intent of the owner must be used to determine whether these assets are farm or personal. The farmer or rancher may intend to invest in some non-farm enterprise for diversification, or they may consider the holding to be personal, even though the farm or ranch provided financing. In the latter case, a withdrawal should be recorded in the farm/ranch records.

A savings account may be classified as farm or non-farm according to the intent of the owner. Like marketable securities, a personal savings account may be used to secure farm or ranch debt without changing the classification to a farm asset.

¹ Financial Guidelines for Agricultural Producers: Recommendations of the Farm Financial Standards Council (Revised), July 1995.

Household items are consumer goods which may be current assets or non-current assets depending on their useful life. This type of asset is very difficult to value, is very seldom used as collateral for a loan, and is often retained by the owner who declares bankruptcy or who faces a foreclosure. If included on the balance sheet, these items should be listed as personal assets.

Houses and associated land also pose a problem of classification when farm and non-farm items are commingled on the financial statements. A house which is the residence of the farm or ranch owner should be classified as personal if it is located off the farm/ranch property. But a house located on the property may be considered an integral part of the farm or ranch business and real estate base, thus making it farm property. Or, it may be distinguishable and classified as non-farm/personal property. The classification should probably be based on whether the land on which the house is situated is legally separate from the other farm/ranch property. For example, the documents showing ownership of the house and a few acres surrounding it may be filed with the county clerk or other local authority separately from documents concerning the land used in the farm enterprises. This part of the farm or ranch might be considered a personal holding. But, in some cases, the owner would not consider selling the land separate from the house and surrounding acreage, or the entire property may be used to secure a farm or ranch loan. In these cases, the house and acreage are a farm asset. The classification again depends on the intent of the owner and the interest of lenders.

Liabilities should be classified as personal or business, according to the use of funds which resulted from the liability. Assume that the farmer or rancher purchases a vehicle which will be used exclusively for the farm or ranch enterprise and he (she) borrows the amount of the total purchase price. This seems to be a farm debt regardless of whether it will be repaid from farm revenues or personal income. Conversely, assume that a vehicle is purchased for personal use only and that the owner has no income outside the farm or ranch business. This is clearly a personal liability and the payments on the debt should be recorded as withdrawals from the farm/ranch business.

London Case Example

The Londons place cash from all sources into a single checking account. Since all of the cash is available to finance the farm business, it is classified as a farm asset. They maintain liquidity by investing in securities which are also considered farm assets. In contrast, their family savings account is intended for personal use and is classified as non-farm. Julie also inherited some stock which is held personally and classified as non-farm. Their non-current assets include several line items which are clearly farm assets and some which they consider to be personal. The cash value of Jack's life insurance policy is classified as non-farm as are the family auto, a rent house and shares of stock in State Bank. The State Bank stock could, alternatively, have been classified as an investment in other entities.

Non-Farm Income

In the changing structure of today's farm economy, farm and ranch operations increasingly rely on non-farm income

to supplement farm earnings. Not including this income may, in many instances, seriously understate total earnings on an income statement. However, "non-farm" or "off-farm" income should not be confused with "personal" income.

Non-farm income includes income which is earned separately from the farm or ranch operation but that is available to the business operation and that contributes to business owner equity in the form of retained earnings. It includes income that is derived from the business assets listed on the balance sheet.

The income statement should not include income derived from personal assets not listed on the balance sheet, or income that is not available to the business operation. The purpose of the income statement is to report business-related income, not to be an exhaustive listing of all "personal" income of the owners that is available or intended for personal use only.

If personal income is included that is not related to assets on the balance sheet, the reconciliation of changes in owner equity is extremely difficult and the linkage between the balance sheet, income statement, and statement of cash flows becomes weak and difficult to trace. Where disclosure of wage earnings and other personal income not intended for use in the business is considered to be important, it may be best to list it as a footnote to the income statement rather than to include it in net income to be reconciled to other statements.

Thus, off-farm or non-farm income should include such things as interest earned on farm or ranch business accounts, rents, royalties, mineral leases, capital gain/loss on the sale of off-farm assets (if the assets are listed on the balance sheet), and earnings from other entities, businesses and real estate. Wages may be included depending on the use and availability of the wage income. The key factor on what to include in non-farm income is to maintain consistency among what is being reported on the balance sheet, the income statement, and the statement of cash flows.

There is a practical limitation to reporting income from non-farm business entities on the income statement. If other business entities are substantial, income statements should be constructed for those entities and reported separately. Not all farm and non-farm business income and assets can be combined and still maintain the ability to reconcile changes in cash and equity accounts. The combined process becomes so cumbersome that the operation needs to have separate "business only" financial statements.

Recognizing the difficulty of all the issues surrounding the combined reporting of farm/ranch and personal income, the FFSC encourages movement toward a clear separation of business and personal income. The FFSC continues to examine the multi-faceted issue of how to report personal assets, personal income, and withdrawals.

Withdrawals

In the strictest sense, withdrawals are: 1) cash funds or assets removed from business asset accounts; and, 2) the withdrawal or consumption of income listed on the income statement. Withdrawals may or may not be the same thing as family living expenditures. If any family living or any personal expenses are paid from personal funds or from income which has never been contributed into a business asset account, they are not withdrawals. The term withdrawal is used rather loosely in the industry at this time, but generally it means

funds or assets removed from the business and converted to personal use for family living, personal investment, or purchase of personal assets.

When personal income is reported on the income statement (such as wages), the interpretation of withdrawals must be extended. In this case, withdrawals could be more than the cash or assets directly removed from business accounts. It could include income reported that never entered into a business account. An example would be part or all of a wage paycheck that is cashed or deposited directly into a personal account for family living or personal use. In this case, the definition of "withdrawal" must be extended to include the removal of any income listed on the income statement for personal consumption, regardless of whether or not cash was transferred or removed.

The concept and reporting of withdrawals is closely linked to the definitions and assumptions associated with business/personal assets/liabilities on the balance sheet, and with farm/non-farm/personal income reported on the income statement. An assumption or decision on reporting in one affects the other. For this reason, the FFSC continues to study withdrawals and how they are to be defined and reported.

Credit Card Debt

Credit card debt is usually thought of as a personal liability. However, credit cards are increasingly being used to finance purchases for farm use as well, and such debt should be classified as a farm liability. As with checking accounts, farm/ranch and personal debt may be comingled in a single credit card account. This makes it difficult to determine the amounts to be classified as farm/ranch versus personal. The original amount of credit card financing for farm or ranch purposes may be determined by recording the transactions as they take place. But when a payment is made on the outstanding balance, does it reduce the personal portion, the farm/ranch portion, or part of each? Since interest on a farm business liability is tax deductible, the farmer or rancher would likely prefer that all payments are applied to the personal portion until such time that the personal portion is paid off. In contrast, the IRS would probably prefer that the payments be applied

to the farm debt first. The best way to identify personal and business credit card debt is to use separate accounts. In many (perhaps most) cases, the farmer or rancher would be well advised to seek other financing for the farm or ranch operation which would carry a lower interest rate.

Credit card debt incurred to finance the farm or ranch operation should be included on the balance sheet as part of accounts payable, a farm liability. When the credit card debt is for personal use, it should be classified as a non-farm liability and entered on the balance sheet as non-farm notes and interest.

Savings and Investments

Savings accounts may be farm/ranch assets or personal assets. As discussed earlier, the classification depends upon the owner's intent. If the savings account is used to invest idle farm cash until it is needed, it should be classified as a farm account. On the other hand, if the savings account is to be used only for personal interests such as retirement or college funds, it should be classified as personal. The movement of cash from (to) the farm or combined checking account into (from) a savings account must be recorded so that the cash account can be reconciled in the statement of cash flows.

Short-term investments in marketable securities may be treated in the same manner as savings accounts. Long-term investments in other entities are non-current assets.

Summary

The FFSC recommends that farm/ranch business financial statements be prepared without including personal assets, liabilities, and net earnings. A set of personal financial statements should then be prepared which includes the net equity of the owners in the farm/ranch along with other personal holdings. Income from all sources completes the presentation of the financial position of the owners. The personal financial statements may be considered an extension of the farm/ranch statements since the information is simply added to the business data.

The Oklahoma Cooperative Extension Service

Bringing the University to You!

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; family and consumer sciences; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and research-based information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

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