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Farm Financial Standards Task Force: Progress and Recommendations

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Over the past couple of decades, the financial character of farm businesses has become more complex and the amount of debt capital used by individual businesses has increased. This has created an environment where appropriate and accurate financial analysis of farms has become increasingly important to both borrowers and lenders. The extreme importance of accurate representation of the financial position and performance became increasingly clear during the farm financial crisis of the mid-1980's.

In an effort to deal with this issue, a variety of lenders and others working in the agricultural finance area have developed financial statements and measures of performance. This development has not been coordinated, and thus, has resulted in a wide array of statement formats, data requirements and ways of calculating performance measures. Lenders have become concerned that the information they are collecting may not measure performance as accurately as they would like and that their measures may have different meaning than similar measures used by others. This has become particularly important as institutions merge or try to participate in nationwide programs such as Farmer Mac (Federal Agricultural Mortgage Corporation). At the same time borrowers have become frustrated with the different forms, data requirement and performance definitions used by various lenders; and by apparent lender inability to accept and use the data required by a competitor.

It is clearly time for the agricultural finance industry to set some standards, agree to operate by an established set of rules and agree to enough similarity in their forms and methods of analysis that they can clearly understand what each other is doing and communicate about loans with similar language. It is the intent of the Farm Financial Standards Task Force to provide the basic building blocks for such a development. I am going to start my discussion today with some background on the Task Force itself and the process it used. Although a few of you served on the Task Force, I am sure that many of you may have heard about it but do not know exactly what has been involved.

Task Force Creation

The Farm Financial Standards Task Force was established in late 1988 by the Executive Committee of the Agricultural Bankers Division of the American Bankers Association. Stanley O. Forbes, Sr. Vice President of Sovran Bank in Virginia, who was then Vice President of the Agricultural Bankers Division, served as the Chairman of the Task Force. Mr. Forbes and Leslie Miller, who was then Agricultural Bankers Division Manager, were the driving forces behind the Task Force.

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About 45 members of the United States Agricultural Finance community were asked to serve on the Task Force. Included were representatives from the groups listed below. There were two to five members from each group except commercial banks and academicians, which had about 10 each.

Commercial Banks	USDA
Farm Credit System	Academicians
FmHA	Accountants
Insurance Companies	Regulators (FCA, FDIC, USCC)
Input Suppliers	

Objectives

The basic objective of the Farm Financial Standards Task Force was to identify universally acceptable farm financial standards. With this overall objective were five sub-objectives:

1. To develop a set of standardized farm financial statement formats that could be used by all farm lenders.

2. Identify financial ratios common to all areas of the country.

3. Identify standard methods of calculating ratios.

4. Review and identify calculation standards for farm financial software.

5. Review and comment on proposed underwriting standards for Farmer Mac.

As a representative of the Task Force, I presented testimony on the Farmer Mac Underwriting Standards. The testimony was required before the Task Force had flushed out its ideas and recommendations. Thus, the testimony focused on a basic review of the proposed underwriting standards and a plea for Farmer Mac to give serious consideration to incorporation of the Task Force recommendations in the guidelines used for documenting loans to be included in loan pools.

Task Force Process

The first meeting of the committee was held in St. Louis in January 1989. This meeting provided an opportunity for the members of the Task Force to get to know each other and discuss a number of the issues. Much discussion of important issues took place. There was a considerable amount of apparent agreement. Part of the apparent agreement was by design. American Bankers Association asked Dave Kohl to act as moderator for the program. His encouragement, and the structure of the meeting, pushed towards identification of agreement rather than disagreement. Also, many of the issues were discussed at a fairly superficial level because of the limited amount of time available for any particular issue. However, there was considerable agreement and certainly sufficient agreement for the group to believe that, with some work, a set of standardized financial statements could be developed. Some of the areas where possible disagreement likely existed, or where further study was required, were also identified.

Following that first meeting, the group was divided into three topic area committees. A coordinator was assigned to each of the three basic areas of work; (1) universal financial reports, (2) universal financial criteria and measures, and (3) universal information management. The Universal Information Management committee was assigned the task of considering the development of a national agricultural financial data base, including ideas about software development, and thinking about the marketing of Task Force results. The assignments of the other topic area committees come naturally from the Task Force objectives. Each of the topic area committees was divided into subcommittees. Three subcommittees were assigned to work on universal financial reports. Two subcommittees were assigned to each of the other two topics.

The three topic area committees operated slightly differently but within the same basic structure. Since I worked with the Universal Financial Reports committee, I will report the process that we used.

The topic area coordinator and the chairman of the three subcommittees served as steering committee to develop procedures, identify issues, interpret reactions, and prepare drafts. Our first activity was to specify a series of issues that were identified during the discussions in St. Louis or by the steering committee as areas for discussion. A document explaining the issues and identifying some of the pros and cons was developed. Members of each subcommittee were asked to provide their reactions, opinions and suggestions on these issues. They were also encouraged to raise other important issues. The committee members' reactions were summarized by the steering committee and draft statements on the issues were prepared. These draft statements were sent to subcommittee members for their reaction and opinion. From the responses, a comprehensive draft statement was developed for consideration by the entire Task Force.

The entire Task Force met in November 1989 to review and discuss the drafts prepared by each of the three topic area committees. Some sections of these drafts were ratified as developed by the topic area committees. In other cases, specific revisions were suggested and agreed upon. In some cases, the general character of modifications were voted upon with instructions to the coordinators and subcommittee chairmen to develop revised wording. A coordinated final draft which incorporated all three topic area reports into a comprehensive document was developed by the coordinators. This draft of the final Task Force report was distributed to all Task Force members for review and comment within the last week. Task Force members will have 30 days for comment. Comments received will be considered by Task Force leaders and revisions made to the report if appropriate. From that process will emerge an exposure draft. The exposure draft will be distributed to the general public for a 45-60 day comment period. If there are substantive concerns with the document, modification will be considered by the Task Force leadership, and a final Task Force report prepared. If no substantive comments are received or the Task Force leadership believes that the comments received should not result in a change in the distributed document, it will stand as the final report of the Task Force. It is expected that the official standards, as developed by the Task Force, will be published in about three months.

Task Force Results

The final standards as developed by the Task Force represent a middle ground set of recommendations. They do not suggest that an organized shoe box would be acceptable. But, neither do they incorporate everything that the accountants and economists could dream up. The standards represent considerable Task Force member compromise. No one got everything they wanted or preferred. The diverse membership on the committee forced careful consideration of a wide variety of points-of-view.

The result is a comprehensive, reasonable and workable standard for today. It is a comprehensive, in that it provides a consistent and complete system that accurately reflects the financial condition and performance of a farm business. The system provides a sound basis for financial analysis of the business and analysis of loan requests that should be valuable to both the farmer and the lender. It is reasonable in that it requires items that farmers can logically be expected to provide. It recognizes that most farmers are cash basis tax filers and starts from that data base. It is workable in that it provides for flexibility in adoption. It does not specify an absolute format and allows alternatives where more than one procedure or standard could be appropriate.

The Standards - Universal Financial Reports

The standards for the universal financial reports use Generally Accepted Accounting Principles (GAAP) as a base. The Financial Accounting Standards Board (FASB) statements on financial accounting concepts were adopted as the basic set of ideas to be followed. As a general principle, the Task Force agreed to accept GAAP practices except for cases where we explicitly decided to deviate for a specific reason. Remember, however, that current accounting practices may be only one procedure that is consistent with GAAP. In some cases, the developed standards are consistent with GAAP but different from current accounting practice.

There were three basic reasons for deviating from GAAP:

1. To improve the financial record. For example, both farmers and lenders need market value balance sheets and defendable market values can be developed for practically all farm assets. Better measures of the financial condition of the business come from market value data. Thus, the market value balance sheet was acceptable as the primary balance sheet.

2. To improve business analysis. This is frequently driven from 1. above. For example, market value data provide a better basis for measuring the financial performance of a farm business than do cost data. Similarly, for government program loans, we recommend valuing the commodity at the higher of the loan or the realizable value, not the loan plus interest which is irrelevant in some circumstances.

3. To make it user friendly. The standards developed had to be something that farmers and lenders could live with and use. The recent decisive kill of "capitalization of preproductive expenses" by farm groups, at least partially based on the complicated bookwork and accrual accounting required, indicated a line that we had better not cross if we expected acceptance of the standards once they were developed. Several methods of handling raised breeding stock are allowed. Also there is no cost of goods sold section of the income statement.

The basic standards require four pieces of information or statements: (1) balance sheet, (2) income statement, (3) statement of cash flows, and (4) reconciliation of owner equity (reconciliation of income statement and balance sheet). Standards for each of these statements were specified and an example set of forms indicating one way that the standards could be met were provided.

As you might guess from my earlier comments, the universal financial report standards specify that the market value balance sheet will be the primary balance sheet. However, it is not the simple market value balance sheet that many are now using because it requires inclusion of deferred taxes (contingent tax liability). Also, it requires disclosure of the cost (book value) of capital items.

The income statement includes nonfarm income but requires that it be listed separately from farm business income. There is no cost of goods section to the income statement and Value of Farm Production may be used or not as the user sees fit.

One important point that needs to be understood for using these standards is that the level of financial reporting required of each borrower remains the decision of the lender. The Task Force developed a system that would provide an accurate assessment of financial position, financial performance and comparative statistics. To provide a complete and accurate picture of a business you need the complete set of reports. But, a lender may decide that a complete set of information is not required for some loans. This is a part of the lender decision on analysis and documentation. The existence of standards does not interfere with that decision.

<u>The Standards - Universal Financial Criteria and Measures</u>

Standards for universal financial criteria and measures include ratios in five familiar categories:

1. Liquidity
2. Solvency
3. Profitability
4. Repayment Capacity
5. Financial Efficiency

A set of ratios and the proper definitions for those ratios are defined for each category. It was not the intent of the Task Force to imply that all of these ratios should be used in an analysis or that a lender would need to calculate the same ones for all loans, but to say that "if you use these ratios, this is the definition that should be used". The inclusion of a ratio in the set means that a significant number of the Task Force believed it to be useful, at least in some circumstances.

To assist users, interpretation of the ratios and a listing of the limitations connected with each is provided in the report.

The Standards - Universal Information Management

The universal information management committee dealt with two issues. First, they conceptualized a computer management information system utilizing the standards developed by the other two committees. This system would accumulate a data set to help lenders evaluate loans in a manner very similar to that prepared by Robert Morris and Associates (RMA) for (primarily) nonfarm loans.

In its current design, the database system would be available nationwide 24 hours per day and available to most anyone with an interest. Data entry (additions to the database) would be free. Users of the data would be charged a fee. Hard copy printouts would be made available to those without computer access on a fee or subscription basis.

The second activity of the universal information management committee was to consider the uses of the financial standards in software products and educational materials. They conceptualized a computer software certification program that would certify that software products were consistent with standards established by the Task Force.

The Future

The primary issue at this point in time is adoption. The Task Force has developed a good set of standards that could improve the performance of the agricultural finance industry. It could help meet an industry need. In order to achieve its potential, it must be adopted by most lenders.

The ball is in your court! At this point, the burden falls on the lenders to modify their forms and procedures to be consistent with the standards. They will become "industry standards" only if they are used by the industry. This will take some effort on everyone's part. Like the members of the Task Force, lenders are going to have to give up their little pet procedures and use a set of statements and procedures that others can understand and use. Whenever forms or procedures are changed, the Task Force Standards should be part of the decision making process. Major lenders should lead the way by making sure they conform as soon as possible.

Land grant institutions and extension can help. We can teach the principles. We can use the standards in our courses and extension programs. We can help develop forms and analysis procedures. However, we only have a carrot - and it is a fuzzy carrot at that. We can not offer money. We can only offer knowledge, improved analysis, etc. As lenders, you have the stick and a carrot. You can require appropriate financial statements. You have a good reason for requiring a set of data that are comparable to data provided by other businesses and comparable to data that are available for comparison. In your role as financial advisors, you can also point out that an accurate financial reporting system will provide better data for management decisions.

The other need we have at this point in time is a continuing nonaligned entity to give the standards continuing life. We need something equivalent to FASB to continue the work of the Task Force. Without such an entity, there is a strong chance that little of a concrete nature will result from the efforts of the Task Force. People will let the report languish on their desk, adopt a few ideas that solve current problems but make little effort to treat the report as standards rather than a set of ideas for consideration. In a short time the Task Force Standards would be forgotten.

The entity should not be aligned with any specific lender so that the standards can become industry standards and avoid the perception of being the suggestions of one lender for the rest of the industry. We owe the American Bankers Association, and especially Stan Forbes and Leslie Miller, a big vote of thanks for their tremendous efforts in getting this off the ground and for starting the process with broad industry representation. However, the results of their efforts will be more durable if the effort now passes to a nonaligned entity - maybe a FFSB or FAFSB (Farm Financial Standards Board) or a FSBA (Financial Standards Board for Agriculture).

There are many things that such an entity could do:

1. Correct inconsistencies in current standards. The standards were developed by a committee - in a relatively short period of time. I find it hard to believe we won't find some inconsistencies or places where the current recommendations do not fit as well as perceived.

2. Handle new issues. There are many potential issues that the Task Force chose not to deal with. New tax laws and government programs may generate new issues. Changes in GAAP principles or practice may need to be addressed.

3. Adapt to changing times. As written, the current standards expect some changes to occur over time. Also, as the world turns, we need the financial standards to adapt to the changes that occur.

4. Software (and possibly printed material) certification. This could be one way of effecting the software certification program conceptualized by the information management group of the Task Force.

The major problem in establishing such a nonaligned entity is funding. Although it would not take a lot of money, a national group would need to meet periodically and distribute findings to the industry. Participation on such an entity could be burdensome for individuals selected to serve. The possibilities for support are somewhat limited but there are a few:

1. Copyright and sell forms and publications. This approach conflicts with the desire to get as wide adoption of the standards as possible and with the Task Force approach to focus on ideas and standards rather than forms. Further there is serious question whether sufficient funds could be generated by this procedure.

2. Assessment on lenders. An assessment of one-tenth of a basis point per dollar of outstanding loan volume on institutional lenders (FCS, FmHA, commercial banks and insurance companies) would generate far more money than is needed (over $1 million). However, it would be a very cumbersome procedure to obtain a small amount of money.

3. Foundation support. Such entities as the Farm Foundation or the Kellogg Foundation might be willing to support such an activity in the short run. Long term support would be more questionable.

4. Legislative appropriation. A small amount of money is needed, the activity should contribute to a more stable and efficient agriculture and it might contribute to avoiding repetition of the financial problems experienced during the 1980's. Thus, legislative appropriation could be justified. However, in times of large budget deficits bringing about such a result would require lobbying efforts by all commercial lenders and others with a direct interest. You would have to give it some priority. An effort would also have to be made to avoid development of a large bureaucratic institution.

I am sure I have not identified the best funding mechanism. The Task Force could use your ideas. It would be a shame not to make the effort to fan the spark that the Task Force has generated. Without a continuing entity, the effort is likely to drift into oblivion.

Summary

I believe the Farm Financial Standards Task Force has made a good start on meeting a very real need of the farm finance industry. The standards are appropriate and workable. It is now up to you as lenders to adopt them and provide the support necessary to improve them and give them continuing life.

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