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VALUATION IN FARM ACCOUNTS

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are intended to provide staff and postgraduate students working in the Department of Accounting and Finance with a means of communicating new and partly developed ideas in order to facilitate discussion and the interchange of ideas. They are not to be taken as necessarily completed works or final expressions of opinions.

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VALUATION IN FARM ACCOUNTS

by H B DAVEY & E DELAHUNTY

In this paper a marketing viewpoint is taken of farm accounts; the different users of farm accounts are determined, a normative statement is made of the needs of each user group and then the most appropriate valuation technique for each is identified.

Users of Farm Accounts

The primary user of farm accounts is the farmer himself. Frequently the farmer makes little use of the accounts other than to satisfy the demands of the Inland Revenue Department. Occasionally the farmer, (or his management adviser), will try to use the accounts to disclose weaknesses in management as shown by below average gross margins, to determine the most profitable enterprises and plan to change enterprises to increase profitability either by improving weak enterprises or intensifying the more profitable. As they soon discover, accounts prepared within the rules of the Income Tax Act, 1976, do not provide a good base for management planning. Dual purpose accounts, such as those recommended in "Management Accounting for the New Zealand Farmer",[1] tend to be lengthy, confusing to find the right information, and with an unsatisfactory valuation base.

The estate planner, usually either the accountant himself or a lawyer, will use the accounts as a list of assets essential in calculating the

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1. "Management Accounting for the New Zealand Farmer", R404 Ed. D.V.Smith, N.Z. Society of Accountants, 1977.

size of the estate for death duty purposes. Accounts are prepared for the farm as an entity, and not the farmer, so all assets subject to estate duty may not be disclosed. Historical cost valuations are clearly useless for estate planning purposes.

The Inland Revenue Department is more interested in the income section of farm accounts to give the basis on which income tax liability is worked out. Even here the Income Tax Act treats many items in a different way to the proper accounting treatment (e.g. capital development expenditure treated as a deduction from income, the value of consumer stores such as hay and gasoline omitted, livestock valued at standard and treated as trading stock).

Lending institutions, on occasions, will require a set of farm accounts annually if the farmer is heavily committed with mortgages. When first approached for a loan, a lender may flatly reject an application from a farmer with accounts showing he has little equity whereas if the farmer's equity is high the lender is more likely to view the application favourably.

Other government departments, especially the Ministry of Agriculture and Fisheries and Treasury, will use farm accounts in rural credit surveys, whereby the need for the release of further government funds to farmers is assessed. They also use farm accounts for major economic planning such as likely income of overseas funds and the increase in physical output.

Potential buyers of farms will ask for copies of past accounts to assess the profitability of the farm and to assess the asking price.

Each of these farm account users will now be considered in more detail.

The Farmer

The value of livestock and plant and equipment is where most farmer interest lies.

If the farmer is breeding his own replacements he has little concern about the value of his livestock. When he has a buy-in policy the cost of replacement livestock may turn his thoughts to alternative farming policies. If the cost of good two-tooths has risen to the high thirties or low forty dollar mark, as it did a couple of seasons ago, then buying old ewes, with a flow through of more replacements needed in future, can occur. Similarly, the price of livestock when diversification is considered is most important. A drop in deer prices has encouraged more farmers into deer farming. In goat farming, too, the high price of angora goats has forced would-be goat farmers into thinking again, perhaps they have bought cheaper breeds and bred-up by using angora sires.

The farmer is typically interested in the second hand value of his existing machinery in order to calculate how much he will need to find if he were to replace. If the plant is essential to his farming operations then the farmer may wish to replace with a similar, or better machine. Whether the machine be new or second hand depends largely on the availability of funds. If the plant is not essential then only the realisable value will be relevant. With the prolonged period of high inflation many farmers are finding the gap between the sale value of existing plant and it urgent replacement increasingly difficult to surmount. To avoid this problem, some farmers have embarked on a replacement programme, whereby a major item or essential plant is renewed each year.

Although the historic cost balance sheet is useless, the CCA [2] adjusted balance sheet should be of worth when looking at many plant and equipment items. There is a well established second hand market in plant and machinery so replacement cost should be verifiable and useful.

The Estate Planner

From 1 April 1983 an estate of less than $350,000 is not levied for death duty. Even at this level many farmers will find they have a substantial death duty problem unless some action is taken to avoid it.

For estate duty purposes a valuation should tend to be over-optimistic and should also tend to anticipate likely moves in prices in the forseeable future. By doing this, the plan for the farmer should be such that either any excess over the standard exemption will be minimised or cash will be available to pay the duty. Valuation should be based on optimistic current sale prices, and increased by an estimate of likely inflation in the future. Thus the valuation will be a guestimate based on informed judgements.

A common problem faced by accountants when advising clients over estate planning matters is that the client, familiar with the historic cost valuations of his balance sheet is often unwilling to accept the value to which the estate has risen (except when selling). Thus, at times, it will be necessary to almost coerce the client into considering the actual

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2. CCA is Current Cost Accounting for which CCA-1 is the NZ Society of Accountants Current Cost Accounting Standard No. 1 (Information Reflecting the Effects of Changing Prices). March 1982.

position of the estate. With ever increasing rates of inflation, the market value quickly overhauls the optimistic valuation and, with the farmer still alive, a revised plan is needed all too soon.

The Inland Revenue Department

This department has need for information that conforms to the Income Tax Act, 1976. Historical cost information is all that is required for items for which depreciation can be claimed apart from odd items like motor cars where specified costs form the base on which tax deductible depreciation is calculated. The provision of extra information of a CCA-1 type will make the Inland Revenue Department's job more difficult and may well lead to increasing the costs of investigations.

Money Lending Institutions

Short term finance for farmers is provided by banks or by stock-and-station agents. They take, as security, a chattels transfer over livestock and/or plant and machinery. When making a loan the current market value of the secured assets is important; if a valuation is required the valuer would be from a stock and station agency, who could well be the lender! Once the short term loan has been made, seldom is a revaluation required but accounts do give some assurance to the lender that the farmer still has the secured assets on his farm.

Long term finance is secured by a mortgage over land. In making the approach to a lender a balance sheet showing a substantial equity in the property may encourage the lender to adopt a sympathetic attitude.

Almost invariably the lender will insist on a current valuation by his own valuer; this valuation will generally be a forced sale value and probably below a CCA valuation. The lender will want to be sure the loan will generate enough extra income to repay the loan.

Other Government Departments

These departments are involved in projections of future overseas earnings from farming and the need for incentives should earnings be falling. They also use rural credit surveys, for which farm accounts reflect the change, as a basis for recommendation to the government on the need to release further funds into the farming industry through greater lending by the Rural Bank. These users will be better served by CCA data even though in many cases it will be indicative only.

Potential Farm Buyers

To most farm-buyers farm accounts give an indication of stocking rates and income levels. There is a list of machinery on hand, perhaps with the year of purchase stated, which will enable the buyer to make further enquiries and assess the level of a reasonable offer based on net realisable value. Any land valuation is little more than an educated guess by a valuer of what a knowledgeable buyer might be prepared to pay a willing seller.

Conclusion

The accountant has traditionally tried to provide multi-purpose information in a single format, i.e. in the conservatively based, verifiable income statement and balance sheet. In the past this has generally been considered to be able to satisfy whatever demands are

made from it. It is a relatively recent phenomenon whereby the accountant has talked of providing management advice and services to his farmer client.

If it is accepted that different users do in fact need different forms of asset valuation on which to base their advice or services, then it will fall primarily on the accountant to provide this information. Thus the accountant must be prepared to look beyond the traditional historical cost model and be more sympathetic to alternative valuation methods. A final plea may be made in the form of a question. Are we providing information merely for the Inland Revenue Department or are we trying to provide management advice and to genuinely help our client carry out his/her business activity?

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