ACCOUNTING COSTS VS. ECONOMIC COSTS

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I am going to be critical of enterprise costs budgets and I hope I don't offend anyone. We like to tell farmers and ranchers that they need to calculate their costs of production but haven't done a very good job of telling them how to do it. If they don't know how to do it they won't do it.

Last month we had a cattle futures hedging seminar in Salmon. The 50 ranchers there were asked if they would be interested in hiring a consultant to figure their costs for them. They about unaminously raised their hands. They were then asked if they would be willing to pay $500 for this service and again the majority raised their hands. These ranchers have access to enterprise budgets but they want to know their own costs.

Our cost of production budgets are often useless to farmers because of the economic costs hidden in them. Farmers are not economists; they don't need to put an economic value on all factors of production (except when negotiating contracts with processors). Farmers are interested in accounting costs and cash flow. Even those few that want to look at economic costs probably don't want some economist telling them that they should use x% return to management and y% return to equity, especially when interest rates fluctuate widely.

Some growers that I know are critical of Idaho's crop budgets. They say that the budgets greatly overestimate their costs because the budgets show losses and yet they have to pay income tax each year. Harlan Hughes said that during the bad dairy years in Wisconsin, when farmers were dumping milk and killing calves, the Farm Business Association records showed that they were making money. This is as reported to the IRS: receipts minus cash expenses and depreciation and adjusted for inventory.

I think that 'economic cost' budgets that show huge losses are misunderstood by farmers and may damage our credibility. My idea is that we are stopping short when

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1/ Talk given at the Western Farm Management Extension Committee Annual Meeting, Reno, Nevada, January 6 - 8, 1982.

we present a budget. The budget should be viewed as research data and not be presented as a final product. We should explain how a grower can use his own records to determine his own costs of production. This is what is important to him - his own costs. I know that some potato growers can produce for half the cost of some of their neighbors.

I also think that there is a lot of confusion due to what I call the different levels of costs:

(1) Cash Production Costs (seed, fertilizer, chemicals, seasonal labor, etc.)

(2) Above + Cash Overhead Costs (interest, rent, taxes, insurance, office expenses, etc.)

(3) Above + Depreciation

(4) Above + Economic Costs (returns to family labor, management, and equity)

Economists have alienated some growers by only looking at (4). Many growers have trouble thinking about anything past (1). I will now express my opinion on each of these costs.

<u>Cash Production Costs</u>

Growers can usually determine their direct costs of production quite easily. They may have to look into their records to find out what they paid for seed, fertilizer, chemicals and other inputs. The only help that we can offer in this category is to make sure the farmer doesn't omit any inputs and perhaps to offer some input price projections for the coming crop year.

<u>Cash Overhead Costs</u>

Allocating cash overhead costs is where we can help a great deal. Most farmers have an accounting system that groups expenses into general categories. For example, most growers will know the total amount spent on diesel fuel but they don't know how much was burned up for each crop. Fuel, in this case, is an overhead cost until the total fuel bill is allocated among the crops.

In addition to fuel, full-time labor and repair or shop expenses are some other costs that may need to be allocated. This is where we can use our research-type budgets. From these budgets we can tell the farmer, for example, that an acre of potatoes requires 4.5 times as much fuel, 3 times as much labor, and 4 times as much equipment maintenance and repair as does an acre of grain. The farmer can then use these ratios to allocate some of what I have called cash overhead expenses.

Some other allocation method may be better for some other overhead expenses such as real estate taxes, interest on borrowed money, insurance, utilities, office expenses, etc. I think ratios based on each crop's gross revenue or expected gross revenue might be a good method of allocating these costs. This is what many businessmen do.

There may be other, much better methods of allocating cash overhead costs. My point is that after the crops have been harvested the grower has dollar totals for a number of cost categories. He needs to allocate these costs among his crops. If he picks costs directly out of one of our budgets the totals won't match.

Depreciation Costs

In some cases we have also put inaccurate economic costs into the depreciation portion of our budgets. I am talking about machinery complements valued at the current replacement costs. No farmer replaces all of his depreciable assets each year. You can argue that he must eventually replace everything at an even higher costs. My argument is that he doesn't actually incur the higher depreciation costs until he buys the new equipment.

I also think that farmers should, and in many cases are, holding the equipment longer because of the drastic increases in new equipment prices. At some new equipment price it is cheaper to keep and repair the old equipment. I think that we are at that point now.

This is especially true for the farmers with good shops. Some can repair and use a potato harvester, for example, until metal fatigue damages the frame - up to 20 years perhaps. Replacing the harvester every five years instead would give the grower a much higher total equipment costs.

Some farmers feel that it takes several years just to get a piece of equipment working right. I know of one potato grower that has a 15 year old harvester that he continually repairs and improves. He can dig faster and bruise less potatoes with that machine than with a new one. He is much better off with that harvester on both the revenue and cost side. He gets a higher price for his better-quality potatoes and digs when others can't. One year he was the only one in his area to finish digging before the crop froze in. He said that his harvester made him $100,000. that year.

I will put aside the issue of replacement and now talk about enterprise budget depreciation methods. I think that we should choose the method of depreciation that most accurately depicts the actual loss in value. Which method is this: straight line, sum of the years digits, or declining balance? What about asset life? What about the new ACRS method?

My opinion is that the "Agricultural Engineer's Yearbook" figures on remaining farm value are the best we have now. I also think we need some research in this area. We should provide this information to farmers that want to determine their costs of production. If they use the depreciation figures allowed under the Economics Recovery Act I think their actual depreciation costs will be overestimated.

Economic Costs

My idea of economic costs in this category are the imputed returns for family labor, management, and equity that we seem compelled to put into our budgets.

My opinion is that there is no such thing as unpaid labor and management. The salary that the farmer draws is his family labor and management cost, just as though an absentee owner were paying him to run the farm. Instead of including a management charge in enterprise costs we could allocate the farmer's drawing and call it management salary or family living expenses.

Return to equity is another problem. What rate of return do you use and why? You already know that a 4 - 5% return is about average and that money-market rate returns are earned by only a few farmers. Everyone knows that it is about impossible to make money farming at 100% debt at today's interest rates.

Farmers, too, know this and don't expect to earn money market rates and most aren't even familiar with the term 'opportunity costs'. They know that the major portion of their return is in the increase in farm land value. They also know that they can have a money-losing year and still increase their net worth.

There is another point I'd like to make. I've asked a number of farmers, some with net worth well over a million dollars, if they would consider selling out, investing in the money market and living off a huge amount of interest. Not one has ever said he would do that. A typical answer is, "I don't know what I would do with my time if I didn't farm."

The point is that farmers don't expect all of their returns to be monetary. Their way of life is more important to them than pockets full of money. One old rancher told me that he just wants to be able to keep what he has, work it, and have enough money for groceries and a comfortable house for his wife.