Business point

CASH GOES OUT...

Heading into spring, with planting just around the corner, most growers have locked up many of their input needs for the 2012 crop. Some have even begun thinking about locking in what appear to be favorable prices for the 2013 crop.

Such foresight often can save an operation a lot of money, but it also exposes the operation to grain market price risks. Growers increasingly are considering locking in input costs for crops they've yet to grow. Inputs such as fertilizer, herbicides, fungicides, fuel, seed and so on are major investments. Agreeing to pay a certain level for them without an offsetting income guarantee can be risky.

There are some tax implications of purchasing inputs ahead of time as well. In this article, we'll offer a few tips, suggestions and "heads up" statements to help Pioneer customers formulate some strategies to deal with input purchase risks.

Supply paradigm changes

It's becoming common to prepay inputs in the March-to-September period a year ahead of the growing year. In the past, farmers acquired inputs without fanfare. Supply and availability of these inputs was never a question. Your suppliers always had the product you needed and it was always available.

In today's global economy, other regions in the world compete for the same inputs we use in the United States. We're "managing" the growing and marketing of more than one crop at a time. During the growing season, it's entirely possible you're managing three crops simultaneously:

1. Marketing the unsold crop from the prior year
2. Growing and marketing the current year's crop
3. Acquiring inputs and marketing next year's crop.

Costs precede income

You may even purchase inputs 18 months in advance of the crop's harvest, possibly 30 months in advance of its sale. This produces exposure to many months of input price variation, commodity price variation, interest rate variability, weather patterns, etc. It all creates risk at the producer level.

We typically don't think of cash rent as one of the typical prepaid inputs since we usually pay it in the same calendar year as the growing crop. But cash rent exposure remains year after year, and it may be increasing.

Cash rent leases negotiated late summer and early fall bind the producer the same way as purchased inputs even if the cash rent isn't due until March 1. If a grower is fortunate, cash rent isn't due until later in the growing season. This lessens the period of exposure. A significant input cost, cash rent can have profound effect on an operation's breakeven level.

Editor's note: *Kent Vickre and Dwight Raab write a tax and finance column for each issue of Pioneer* GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Raab is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*

If you lock in input costs early, you're exposed to grain market price changes. What can you do?

BEFORE IT COMES IN

An additional risk — one every grower fears — is the risk that we pulled the trigger too early on pricing inputs. In some years, the decision to postpone pricing inputs has been the better decision.

An offset strategy

No matter when you choose to lock in your inputs, you should think about an offsetting sale of the crop. Once you've priced and/or paid for inputs, you're exposed financially: You've paid to produce a crop that you haven't yet grown and probably have no idea of your income for that crop.

The longer the period from input purchase to sale of the crop, the greater the risk that you might have paid a high price for the inputs and might have to take a low price for your crops.

To mitigate some of this uncertainty — especially if you're exposed for more than 18 months — consider forward marketing a portion of your expected crop production.

This can help cover part or all of your input costs. Typically, when inputs are expensive, crop prices are relatively high as well. This is a general rule of thumb: Always monitor grain prices before making marketing decisions.

A plan to sell enough of the coming year's crop to cover these input expenses is a worthy way to attempt reducing the risks associated with the period of exposure.

The IRS angle

The IRS states that for the prepaid expenses to be deductible, there must be a reason other than avoiding the tax bite. The IRS says there must be a "business purpose" for the transaction.

Many reasons would qualify as a business purpose, including (1) to lock in a price, (2) to secure sufficient quantity or (3) to gain a cash discount. There may be other limitations on the deductibility of your prepaid expenses. Consult your tax adviser for specifics.

A third-party angle

It's probably wise to consider the stability of the people who provide these inputs. Prepaying inputs can mean writing them a check for inputs a few months ahead of taking actual delivery.

If you do this without a contract in place, you could be an unsecured creditor. This puts you at risk if the supplier goes out of business. Make sure you're comfortable with the stability of the business before entering into such an agreement.

A tax note

You completed your 2011 tax plans long ago and possibly claimed prepayments for any crop inputs for the 2012 growing season that you purchased before Dec. 31. This is a legitimate 2011 tax deduction, but keep in mind the expenses apply to your 2012 crop.

Suppose you locked in $50,000 in fertilizer costs in December 2011. If you use an accrual accounting system, this expense should be applied to your 2012 ledger — even if you claim it on your 2011 taxes.

They should be classified as a Prepaid Expense in the Current Assets section of your Dec. 31, 2011, balance sheet.

You could have transactions in three tax years for one crop: Input purchases in 2011, crop production in 2012 and sales of grain in 2013. Taxes aren't a good gauge for monitoring the farm's finances. Accrual accounting, which considers all expenses and incomes from a crop year, offers a better measurement.

So, in an era where avoiding the tax bite is a high priority, make sure you understand the impact 2011 (or 2013) transactions can have on 2012 finances.