

Case Study: Pre-Succession Plan

Retiring farmers can benefit from a Farm Business Assessment.

Following is the third in a series of fictional Case Studies prepared to illustrate the process and benefits of completing a Farm Business Assessment as offered through the Agricultural Policy Framework (APF) under Renewal's Canadian Farm Business Advisory Services program. The situation presented is common in the industry across Alberta. Due to fluctuations, commodity prices may not be accurate. This Case Study illustrates how a Farm Business Assessment is conducted, the type of analysis that results, and how the work done can assist you in making decisions about your business. The purpose of this Case Study is not to recommend a particular course of action. Individual results may vary.

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The Wheat Farm (retiring farmers)

Bill and Edna Wheat Sr., run a cash crop farm in central Alberta near the town of Prosperity. The operation focuses on the production of wheat, canola and barley grown in rotation on a continuous cropping basis. They own ten quarters of land and cash rent another two. Bill works full time on the farm and Edna is a homemaker. Together they have pension income of about \$15,000 per year.

The farm was originally homesteaded by Bill's grandfather in 1910, and was transferred in the 1940's to his father. In 1972 Bill and Edna took over the farm and since then the farm expanded to its present size. They now operate with their son Tyler and his wife Chrystal who own one quarter section and rent another. Bill and Edna also have two other adult children who have careers away from the farm.

The two Wheat families run the 14 quarters involved as one unit, however each has their own assets and debts, as well as income and expenses. Bill and Edna own most of the farm equipment (Tyler and Chrystal own one tractor) and operate out of their yard where all the buildings are located. Tyler and Chrystal live in nearby Prosperity where Tyler works full time as a Sales Representative for a crop protection company and Chrystal works part time in a bank. They are both 32 years old.

Bill and Edna are in there 60's and are thinking seriously about transitioning into

retirement. They find they need to slow down a bit so Tyler and Chrystal have been taking up the slack. Tyler and Chrystal would like to take over the farm, and have developed a plan. Bill and Edna would like to see that happen as well, and are willing to help. Both families feel that the time is right for them to make serious plans.

Thinking about options for this change, Bill, Edna, Tyler and Chrystal met with their accountant to discuss some tax aspects. Their accountant told them about the Canadian Farm Business Advisory Services (CFBAS) program, and Farm Business Assessment (FBA) available through Agriculture and Agri-Food Canada. He explained that the FBA is valued at \$2,500 but costs the producer only \$100 and the information they gain will help them evaluate their options. He explained that under the program they can look at each of their situations independently, and suggested that they access the program to develop a plan that would be satisfactory to both parties. On this advice, both families decided to apply to the program and arranged meetings with an approved CFBAS consultant from their area.

Note: In Case Study #2 Tyler and Chrystal's side of the transition was considered. Bill and Edna's part will be the subject of this Case Study. Visit Ropin' the Web at www.agric.gov.ab.ca/renewal to review previous Case Studies.

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Goals

Prior to the first meeting Bill and Edna's consultant, Joe Analyst asks them to provide information about their operation, goals and other basic financial information including their assets and debts. At the first meeting on the farm, Joe collects additional information necessary to complete the financial review. A significant amount of time was spent discussing what they wanted to achieve for themselves personally and for their farm business. Following is a list of goals they identify.

Personal Goals

Bill and Edna have now reached a point where they have financial stability and sufficient assets to fund their retirement. The heritage of the farm and future of their children is important to them and they are willing to provide assistance to family who wish to carry on with the farm operation.

Specific personal goals are as follows:

- While still healthy and able to work, Bill realizes he needs to slow down. He would like to stay involved in the farm, but with more time off and less responsibility.
- They would like to continue to live on the farm and have a new house with less space and easier upkeep.
- Both Bill and Edna would like to have more time and money available to use for travel and pursuit of other personal interests.

- They need to be financially secure. Ideally, they would like their various sources of income to cover their personal expenses and debt payments, retaining the value of their assets for their estate and distribution to their heirs. They want to be sure to have sufficient funds to cover additional care in their older age.
- In this planned business change, they want to be sure they treat all their children fairly, including those who have decided not to pursue farming careers.

Goals for Their Business

As retiring farmers personal goals are much more important than business goals. Their business goals are very simple:

- Within the next year – to finalize arrangements to transfer over farm operations to their son and his wife, build their new home and re-establish residence.
- Within the next 3 years – to complete the transition in all respects into the new reduced farming operation and do comprehensive Succession and Estate plans.
- Within 5 years – to reduce investment in equipment and other operating assets and begin phasing into full retirement.

Because Bill and Edna's financial situation overall is strong and they have made the decision to move toward retirement, they personally have few concerns about their own ability to make the transition. They are more concerned about the impact of their decisions on their children.

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The Status Quo Assessment (Farm Financial Assessment)

Working from the information the Wheat's provided, Joe Analyst completes a Status Quo assessment of their operation. The purpose is to gain information about where the operation is currently, and what they can expect financially if no changes are made. The results are summarized below.

Before Change: Statement of Assets and Debt

Wheat (Sr.) Farm Asset/ Debt Summary			
Assets (Jan 1, 2007)		Liabilities (Jan 1, 2007)	
Current Assets		Current Liabilities	
Cash in bank	46,000	Operating loan	
Cash saved	0	CWB Advance	49,600
Crops for sale	230,000	Acc. interest	23,596
Feed & sup.	10,000	Cur. port. term debt	<u>70,438</u>
Total	<u>286,000</u>	Total	<u>143,634</u>
Intermediate Assets		Intermediate Debt	
Mach & equip	700,000	Combine loan	77,506
RRSPs	<u>80,000</u>	Tractor loan	
Total	<u>780,000</u>	Total	<u>77,506</u>
Long Term Assets		Long Term Debt	
Land	1,980,000	Mortgage loan	330,333
Buildings	<u>120,000</u>	House loan	<u>36,351</u>
Total	<u>2,100,000</u>	Total	<u>366,684</u>
Total Assets	<u><u>3,166,000</u></u>	Total Debt	<u><u>587,824</u></u>
		Net Worth	2,578,176

Financial Ratios (Jan 1, 2007)	
Current Ratio	1.99
Debt to Equity Ratio	0.23
Equity Ratio	0.81

Definitions

Current portion term debt - is the portion of the Intermediate and Long Term Debt that is due within the next 12 months. This amount is in addition to the Intermediate and Long Term Debt shown. In this case, it includes 22,039 of the Combine loan, 18,697 of the Tractor loan, 13,556 of the Mortgage loan and 16,146 of the House loan.

Current liabilities - is debt that is normally due within the upcoming 12 months.

Intermediate debt - is the portion of the debt that is due beyond 12 months and within 10 years

Long term debt - is the portion of the debt that is due beyond 10 years

Income side accrual adjustments - are adjustments to cash income to arrive at an estimate of income earned in the period being considered.

Expense side accrual adjustments - are adjustments to cash expenses to arrive at an estimate of expenses incurred in the period being considered.

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Joe explains that the ratios and financial indicators for the present Asset/Debt Summary all appear to be strong. The Current Ratio of 1.99 suggests that there should be sufficient resources to meet financial obligations within the next 12 months. Their overall financial situation is very good as well, as evidenced by their Debt to Equity and Equity ratios. With their significant Net Worth, they should have adequate resources to fund their retirement and provide some assistance to their children who wish to take over the operation.

Before Change: Income and Expense Summary

Wheat (Sr.) Farm Income/Expense Summary				
Income (Jan 1 - Dec 31, 2007)			Expenses (Jan 1 - Dec 31, 2007)	
Income			Expense	
Crop sales			Cropping expense	256,170
wheat	31,350	x 4.00	Overhead expense	19,500
canola	24,000	x 8.00	Operating interest	2,052
barley	36,700	x 3.00	Term interest	37,013
			Total Cash Expense	314,735
		<u>427,500</u>		
Other income			Non Cash Expense	
Gov't programs		15,000	Depreciation	59,711
Custom work		1,000	Exp. side acc. adj.	<u>-2,226</u>
Other		<u>4,000</u>	Total Non Cash Expense	57,485
Total		<u>20,000</u>		
Total Cash Income		447,500	Total Accrued Expense	372,220
			Net Accrued Farm Income	75,280
			Pension income	15,000
			Living costs	30,000
			Income tax	15,000
Inc. side accrual adjustments		<u>-0</u>	Debt Service Capacity	142,004
			(Net acc. Farm inc. + depreciation	
			+ term interest + non farm income	
			- living costs - income tax)	
Total Accrued Income		447,500		

Profitability Ratios:	
Debt Service Ratio:	1.32
Return on Assets: (see Note)	2.66%
Return on Equity: (see Note)	1.72%
Max. operating loan required:	81,290

Payments	
Principal	70,438
Interest	<u>37,013</u>
Total	107,451

Closing Financial Ratios:	
Current Ratio	3.48
Debt to Equity Ratio	0.18
Equity Ratio	0.85

Note: Return on Assets and Equity as shown assume returns after Living Costs and Income Tax.

The Income Expense Summary provides further insight about what Bill and Edna could expect financially if they continue without making changes.

1. Farm operations should continue to be profitable.
2. They should be able to continue to service their debt, and meet their present financial requirements.
3. Over time, they should continue to build equity as debt is reduced and their surplus is reinvested into the farming operation.

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The Action Plan

Both families would like to see the transition to Tyler and Chrystal take place. Joe Analyst explores alternatives with them to determine the best way in which this could be done. In addition to Bill and Edna's goals, Tyler and Chrystal make sure they have enough to meet their financial needs, and that the plan is fair to their other two adult children.

The plan they decided on involves Tyler and Chrystal taking over the operation, but for Bill and Edna to continue to be involved for the next few years providing additional labour during busy seasons, and management advice as required.

Some of the features of the plan are as follows:

- Tyler and Chrystal will purchase the home quarter for \$300,000, using bank financing. Bill and Edna will use the money to build a new home on an adjoining quarter they will keep.
- Tyler and Chrystal will rent the remaining nine quarters of land owned by Bill and Edna, however, three of the quarters (the land they will inherit eventually) will be rent-free. The rent on the remaining six quarters will be slightly reduced.
- Tyler and Chrystal will rent Bill and Edna's equipment line for \$45,000 per year. As items need to be replaced, Tyler and Chrystal will purchase the new items, and the trade-in or sale amount will return to Bill and Edna. The amount of rent will decrease annually as items are replaced.
- Bill and Edna will continue to farm the half section they rent. They will pay Tyler and Chrystal \$10,000 per year back for equipment usage as long as they continue to do so.
- Bill and Edna will assist Tyler and Chrystal in farm operations as they are able, but will now spend more time and money traveling and pursuing other personal interests. They expect that with this change their living costs will increase from past levels.
- Bill and Edna's new home will be built on land that the two non-farming children will eventually inherit. When Bill and Edna are no longer able to live on their own, rental income from the home will provide them with an additional source of income. When their estate is finally settled, the extra property value will provide additional benefit to these two children to offset the benefit Tyler and Chrystal will be receiving now relative to the rental benefit, unpaid help and access to equipment.

Operations Projected for Two Years - based on change

After Change Statement and Projection (Year 1)

Income (Jan 1 - Dec 31, 2007)		Expenses (Jan 1 - Dec 31, 2007)	
Income		Expense	
Crop sales		Cropping expense 67,600	
wheat 22,000 x 4.00	88,000	Overhead expense 8,500	
canola 17,000 x 8.00	136,000	Operating interest 0	
barley 14,000 x 3.00	42,000	Term interest 36,631	
Total	266,000	Total Cash Expense 112,731	
Other income		Non Cash Expense	
Land rent (840 ac x \$40/ac)	33,600	Depreciation 59,711	
Equipment rent	45,000	Exp. side acc. adj. -5,805	
Other	4,500	Total Non Cash Expense 53,906	
Total	83,100	Total Accrued Expense 166,637	
Total Cash Income	349,100	Net Accrued Farm Income -7,936	
		Pension income 15,000	
		Living costs 30,000	
		Income tax 5,000	
		Debt Service Capacity 68,406	
		(Net acc. Farm inc. + depreciation	
		+ term interest + non farm inc.	
		- living costs - income tax)	
Inc. side accrual adjustments	-190,399		
Total Accrued Income	158,701		
Profitability Ratios:		Payments	
Debt Service Ratio:	0.95	Principal 35,595	
Return on Assets: (see Note)	-0.24%	Interest 36,631	
Return on Equity: (see Note)	-1.49%	Total 72,226	
Max. operating loan required:	0		
Closing Financial Ratios:		Note: Return on Assets and Equity	
Current Ratio	2.42	as shown assume returns after	
Debt to Equity Ratio	0.14	Living Costs and Income Tax. Before	
Equity Ratio	0.88	those items, returns would be higher.	

After Change Statement and Projection (Year 2)

Income (Jan 1 - Dec 31, 2008)			Expenses (Jan 1 - Dec 31, 2008)	
Income			Expense	
Crop sales			Cropping expense	67,600
wheat	5,500	x 4.00	Overhead expense	8,500
canola	4,300	x 8.00	Operating interest	0
barley	6,400	x 3.00	Term interest	23,528
			Total Cash Expense	99,628
		<u>75,600</u>		
Other income			Non Cash Expense	
Land rent (840 ac x \$40/ac)	33,600		Depreciation	51,520
Equipment rent	43,071		Exp. side acc. adj.	<u>-782</u>
Other	<u>4,500</u>		Total Non Cash Expense	50,736
Total	<u>81,171</u>			
Total Cash Income	156,771		Total Accrued Expense	150,366
			Net Accrued Farm Income	6,407
			Pension income	15,000
			Living costs	40,000
			Income tax	5,000
			Debt Service Capacity	51,455
Inc. side accrual adjustments	1		(Net acc. Farm inc. + depreciation + term interest + non farm inc. - living costs - income tax)	
Total Accrued Income	156,772			
Profitability Ratios:			Payments	
Debt Service Ratio:	1.35		Principal	14,522
Return on Assets: (see Note)	-0.39%		Interest	<u>23,528</u>
Return on Equity: (see Note)	-1.33%		Total	38,050
Max. operating loan required:	0			
Closing Financial Ratios:			Note: Return on Assets and Equity as shown assume returns after Living Costs and Income Tax. Before those items, returns would be higher.	
Current Ratio	3.71			
Debt to Equity Ratio	0.13			
Equity Ratio	0.88			

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Comments About the Results

Year one is the transition year, so expenses and payments are higher than they will be in the long term, as assets are being sold and debt reduced over time. Year two shows a typical year after transition and shows all expected revenues and expenses for a full year.

1. Bill and Edna's financial position is projected to remain strong going forward, even with the financial concession being made to Tyler and Chrystal.
2. As equipment is sold, funds will become available to retire the remaining debt Bill and Edna have outstanding. It is anticipated that by the time they fully retire from farming activities, in possibly another 10 years, most of the remaining equipment will be sold, and all debt will be retired.
3. Adequate funds should be available going forward for Bill and Edna to increase personal expenditures as planned.

Summary

As illustrated in the "Beginning farmer" Case Study and in this "Retiring farmer" Case Study, the projections done show that the transition plans are feasible, both for Tyler and Chrystal to expand into the farm operation, and for Bill and Edna to phase down. On the basis of the reviews done, Bill and Edna, as well as Tyler and Chrystal decide to proceed with the plan. Some additional things Bill and Edna will work into their plan include:

- Immediately access the Specialized Business Planning Service (SBPS) under the Canadian Farm Business Advisory Services Program to develop a detailed Succession Plan to work out the details (including tax and legal issues) about exactly how this transition of the farm might best take place.
- Within the next two years, develop a full estate plan to deal with all matters pertaining to their estate and eventual transfer of their remaining assets to their children. As part of this, they will update their wills, and obtain appropriate tax and legal advice on those issues as well.

Working through the Farm Business Assessment program provides both Bill and Edna, and Tyler and Crystal with the numbers they need to decide if they can proceed with a plan to the transfer of the farm operation, and areas where they need more information. They will now move to the next step in the process, which is to develop a detailed Succession Plan.

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Case Study: Pre-Succession Plan – Fall 2007, was developed by Larry Lindquist, a Farm Business Assessment Consultant under the Canadian Farm Business Advisory Services Program.

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