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Texas Agricultural Extension Service
The Texas A&M University System

Financial Management: The Key to Farm-Firm Business Management

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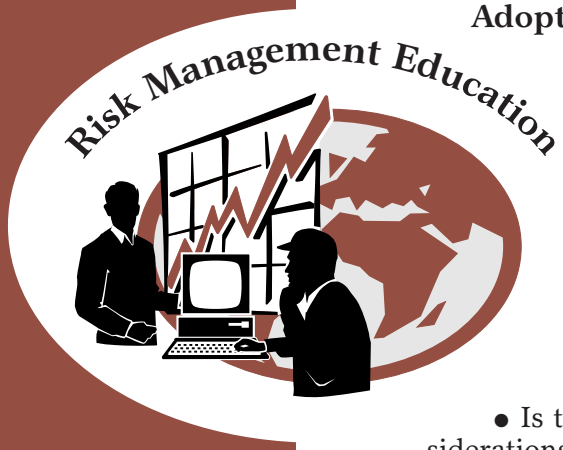
Most farmers and ranchers prefer to concentrate on production rather than planning, recordkeeping and marketing. A production management focus may have been adequate during periods of inflation and favorable commodity prices, but the disinflationary economy of the 1980s demonstrated the serious flaw in this one–dimensional approach. The reduction of the government farm program safety net, advances in biotechnology and information technology, and the increasing globalization of competition will continue to strain traditional approaches to management as we move into the 21st Century.

Those who succeed will manage their operations as farm/ranch businesses, with more emphasis on recordkeeping, planning, profitability analysis, and repayment-based financing, and with better production and business monitoring and controls. While the production aspects of an operation can not be neglected, there will be a need for a better balance between the key performance areas.

More emphasis must be placed on justifying the purchase of inputs based on economic analysis rather than simply whether or not the practice(s) will increase output. Successful producers will need to obtain more information about financial analysis, marketing, analysis of alternative enterprises, and the "bottom line" contribution of each existing enterprise.

This shift applies equally to lending institutions. Lenders will have to be involved in more in-depth financial and risk analysis, not just in the business of marketing capital. "Equity/collateral" and "character" lending protect the lender, but if the producer can not generate sufficient profits and cash flow to service debt, the lender is doing a disservice to the producer by providing capital that may end up actually increasing risk, thereby jeopardizing the producer's operation and equity.

Adopting Analytical "Tools" to Plan for Profit



As a result, agricultural producers and their lenders must adopt some of the basic analytical and planning tools used in business. To start with, a producer should ask and honestly answer the following questions:

- Is this an efficient production system?
- Can commodities be produced below the average cost of production?
- Is there a marketing plan based on adequate market analysis and the breakeven price for each commodity being produced?
- Is there an accurately prepared business plan based on economic considerations?

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- Is the operation large enough to provide the required family living withdrawal? If not, is there sufficient off-farm income?
- Have the risks involved in the business been adequately analyzed and compensated for?
- Is there an adequate system for obtaining management information and monitoring business performance?

Questions like these should be addressed continually, and not just during an initial planning process.

Developing Financial Management Skills

It should be obvious that answering these questions will require a thorough analysis of the operation and may require financial and marketing management skills the producer may not yet possess or practice. Many producers are going to have to embark upon an intensive educational program to gain the essential farm/ranch business management skills and the confidence to use them successfully.

Producers who want to succeed need to develop a farm/ranch business plan, which outlines in detail how they plan to generate a profit and manage business risks. They should start by outlining specific business/personal goals and objectives and preparing complete inventories of resources available. That is, they can not prepare a meaningful plan unless they specifically outline what they wish to accomplish and the basic "resources" available to accomplish this "objective."

The resource inventory should cover all areas of the business and include such items as farm/ranch maps by productive capacity, soil analysis, water resources, machinery, labor available, management capabilities, detailed crop/livestock production history, analysis of market information, and complete financial statements.

The Planning Process

The data obtained in the first step of the planning process provide the basis to begin developing and comparing alternative production, marketing and financing plans. The goals indicate business and personal priorities and help establish performance objectives. Data on the physical resources (including the land, labor, tangible working assets, and capital), the institutional considerations, and the managerial capacity (strengths and weaknesses) suggest the range of enterprises, production systems, and marketing tools to consider in preparing a comprehensive whole farm/ranch plan.

The next task is to develop a long-run plan that the operator will follow over a period of several years. The concept of a long-run plan involves the integration of production, management, marketing, and financing activities that will be required to accomplish the operator's goals. This plan may involve a significant adjustment from the current business structure in order to accomplish the established objectives. Such an adjustment also must be considered in the planning process. At a minimum, the plan should include:

a. A complete resource inventory and a specific outline of goals and objectives.

b. Five-year crop/livestock rotation plan. Enough years should be included in the plan to move through any transition in production and financing that may cause significant fluctuations in the year-to-year cash flows.

c. Needed immediate (first planning year), intermediate (1 to 5 years), and long-term (5 to 10 years) capital improvements.

d. Required operating and long-term capital.

e. Physical production plan by commodity and whole farm/ranch. A calendar of events by month and by year, outlining all of the required production practices and resources, should be prepared for each commodity and for the whole farm/ranch.

f. A long-term strategic assessment based on both historical data and current outlook information. This should include an assessment of government farm programs, the general economic outlook (e.g., inflation, interest rates, taxes), specific industry/commodity outlook (trends and cycles), and technological developments.

g. Individual enterprise budgets and a consolidated whole farm/ranch cash flow projection by month for at least the first year, and by year for the following years.

h. A marketing plan for the contemplated enterprises. The marketing plan should include sensitivity analysis for at least three price levels: expected, pessimistic and optimistic.

Although the items mentioned above are listed separately, they are actually part of an integrated planning process. For example, the resource inventory should help to identify potential farm/ranch enterprises. A budget

forecast for current and potential enterprises, using the three alternative price scenarios, should identify the most potentially profitable alternatives as well as focus attention on the areas of greatest uncertainty. Scarce resources such as capital, land and labor should be allocated to the most profitable enterprises. A 5-year crop/livestock rotation plan would increase the probability of sustaining maximum economic yields. By combining operating and long-term capital requirements into a multi-year cash flow projection, a producer can better evaluate the financial feasibility of short-, intermediate- and long-term plans. Balance sheets and projected income statements will be needed to evaluate net worth, profitability, economic efficiency and financial structure.

If not being done already, detailed enterprise and whole farm/ranch records should be kept from the time the plan is implemented. Financial statements and cash flow projections with "what if" analysis should be prepared and adjusted as often as necessary to analyze risks and to keep the plan on track. Successful business management requires ongoing monitoring and control.

Financial Statements

A farm/ranch recordkeeping system should facilitate the preparation of financial statements and the monitoring of business performance. Properly prepared balance sheets, income statements, and cash flow projections will be needed to help the manager keep the business on track by comparing actual performance to the plan and taking action when it is needed. Farm businesses have failed simply because it was too late before the farmer or his lender recognized problems or took corrective action.

Financial Analysis of a Farm or Ranch Operation

High among any business' goals should be (1) profitability, (2) liquidity, (3) solvency, and (4) efficiency. Yet, some managers who are very capable in the technical and production aspects of their businesses are completely in the dark when it comes to measures of business status and performance. They leave their recordkeeping to bookkeepers, or worse, use the "shoebox" record system. The only "business analysis" they do is to sign their tax forms or prepare "required" financial information for their lenders.

Effective managers should be able to determine the financial position and performance of the business at any time. They must be able to evaluate where the business is, has been, and is going. This aids in the control of the business operation over time.

A sound basis of profitability, liquidity, solvency, and efficiency allows a farmer or rancher to develop sound operating plans and arrange for credit needs. The basic tools needed to conduct farm/ranch business analysis are adequate records and properly prepared, complete financial statements.

Farm and Ranch Financial Statements

The most useful coordinated financial statements to use for summarizing a farm's or ranch's financial position, and for demonstrating managerial ability, are the balance sheet, income statement, and cash flow statement. These financial statements allow a producer to systematically analyze financial progress, plan operations for the year ahead, and demonstrate credit worthiness to lenders. To be most useful, these statements should be compared over several years. If not available from previous years, there is no better time to start preparing these statements than now.

The Balance Sheet

The balance sheet, also referred to as the statement of financial position or net worth statement, is a summary of all assets and liabilities of the farming or ranching operation at a specific point in time. At a minimum, a balance sheet should be prepared as of the last day of the fiscal year.

The Income Statement

The income statement reflects the profitability of a farm/ranch business over a period of time, usually from the beginning to the end of the tax year. For accurate analysis, it is critical that income be calculated on an accrual basis. This does not imply, however, that farmers/ranchers should not use the more flexible cash basis for tax accounting. It does mean that cash basis income accounting for management purposes can give a very distorted and inaccurate picture of business performance, and can produce lags of up to 2 years in recognizing developing profitability problems.

The Cash Flow Statement

A projected cash flow statement is a listing of all anticipated cash inflows and outflows for a specified future period. It includes farm/ranch and non-farm income, and all projected cash outflows, including operating expenses and capital outlays, family living expenses, borrowing transactions, and tax payments.

Using and Analyzing Financial Statements

Farmers and ranchers need to use the information provided by the balance sheet, income statement and cash flow statement in order to measure and understand business performance. Only by analyzing the components of all three financial statements and their interrelationships can a clear picture of financial position and performance be developed.

There are three warnings that reinforce the importance of using all three statements. The first is that a business can be going broke and still be generating a positive cash flow for a period of time by deferring expenses, restructuring or refinancing debts, selling off assets (including inventories), and by not replacing capital assets as they wear out (i.e., living off of depreciation). Second, in the long run, unless 1) the operator is generating enough off-farm income, 2) assets are appreciating faster than the business is losing money, and/or 3) the operator is inheriting sufficient money (assets) to offset losses, a business has to be profitable to survive. Finally, many farmers and ranchers have failed even though the business was profitable because they were consuming more than the business was earning.

After a careful review of all factors involved, the farmer/rancher may decide that something needs to be done. Unfortunately, there is no single prescription that will work for every operation. Just like a medical problem, any solution will depend on a specific diagnosis based on the business and the individuals involved. Carefully prepared, used and analyzed, financial statements will provide financial management warning indicators in sufficient time to make needed adjustments. Good financial analysis does not guarantee success, but it definitely improves the odds.

Partial funding support has been provided by the Texas Wheat Producers Board, Texas Corn Producers Board, and the Texas Farm Bureau.

Produced by Agricultural Communications, The Texas A&M University System

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department of Agriculture. Chester P. Fehlis, Deputy Director, Texas Agricultural Extension Service, The Texas A&M University System.

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