

## Risk Management Series

# Financial Management: The Key to Farm-Firm Business Management

Jose G. Pena and Danny Klinefelter\*

Most farmers and ranchers still prefer to concentrate on production rather than planning, recordkeeping and marketing. However, the escalation in input costs, the ability to access capital, and greater volatility in commodity markets make financial and risk management skills very important. Reductions in 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 further 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 monitoring of production and business processes. While production can not be neglected, it should be balanced with attention to other key performance areas.

The purchase of inputs should be based on economic analysis, not just increased output. Successful producers will need 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 undertake more in-depth financial and risk analysis. “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 and jeopardizing the producer’s operation and equity.

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 break-even price for each commodity being produced?
- Is there an accurately prepared business plan based on economic considerations?
- Does the business have sufficient equity and liquidity to handle adversity or a cyclical downturn?
- 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

\*Professors and Extension Economists–Management, The Texas A&M System.

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***

Answering these questions will require a thorough analysis of the operation and may require financial and marketing management skills the producer does not yet possess or practice. Many producers will need 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 that 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 skills available, management capabilities, detailed crop/livestock production history, analysis of market information, and complete financial statements.

## ***The Planning Process***

With the data obtained in the first step of the planning process, a producer can 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 plan the operator will follow for several years. A long-term plan integrates the production, management, marketing and financing activities that will be required to accomplish the operator’s goals. This plan may require a significant change in the current business structure. At a minimum, the plan should include:

- A complete resource inventory and a specific outline of goals and objectives.
- A 5-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.
- Capital improvements needed immediately (first planning year), in the intermediate term (1 to 5 years), and long term (5 to 10 years).
- Capital needed for operating the business and for the long term.
- A physical production plan by commodity and for the 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.
- 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.
- 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.
- 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 alternatives with the greatest potential profitability and those whose profitability is most uncertain. 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 keep the plan on track. Successful business management requires continuous monitoring and control.

### ***Financial Statements***

A farm/ranch recordkeeping system facilitates 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. This is done by comparing actual performance to the plan and taking action when necessary. Farm businesses have failed simply because the farmer or his lender recognized problems and took corrective action too late.

### ***Financial Analysis of a Farm or Ranch Operation***

High among any business’s goals should be profitability, liquidity, solvency and 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 are able to determine the financial position and performance of the business at any time. They can evaluate where the business is, has been, and is going, which helps them control the business operation over time. They can 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 creditworthiness 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-adjusted 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 profitability problems that may be developing.

### **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 both 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 should use the information provided by the balance sheet, income statement and cash flow statement 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 not replacing capital assets as they wear out (i.e., living off of depreciation).
- Second, 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 in the long run.
- Third, 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. Like a medical problem, the solution will depend on a specific diagnosis based on the business and the individuals involved. Financial statements that are carefully prepared and analyzed will help the manager see warning signs in time to make needed adjustments. Good financial analysis does not guarantee success, but it definitely improves the odds.

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