Business Basics for Beginners

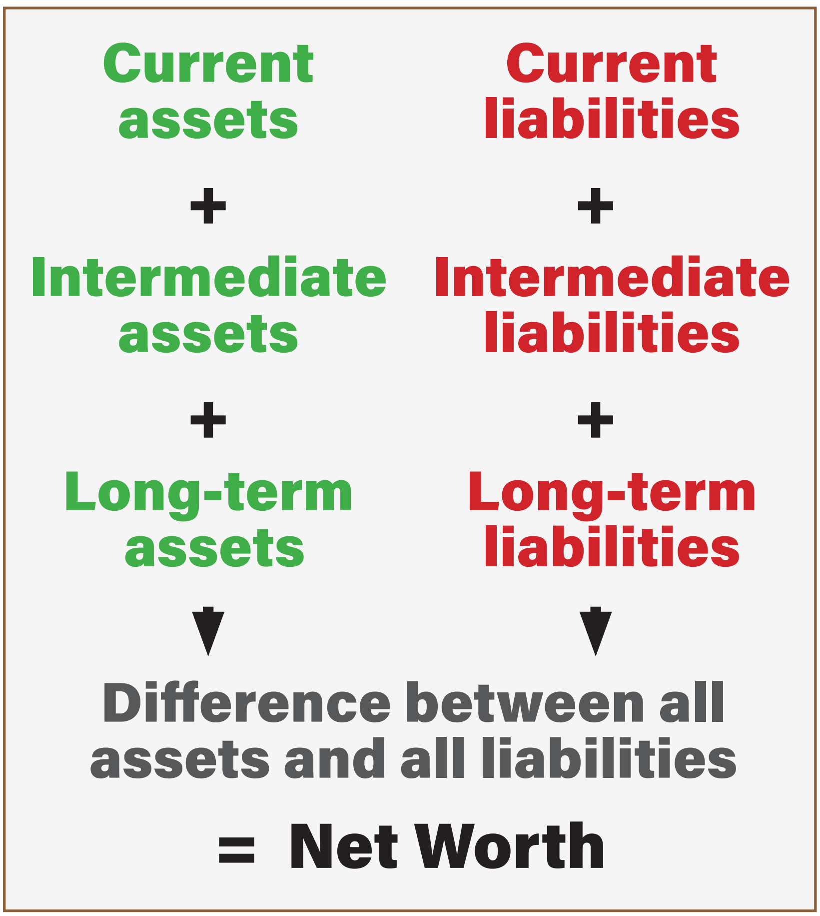
Informed approach to finance is essential for success.

by Barb Baylor Anderson, field editor

If you're just getting started in the Angus business, consider the decisions you must make to get off on the right foot. A financial plan is one of them. Informed financial management provides a solid foundation for making the best choices regarding purchases, sales, cash flow and more.

"There are three critical areas of any business — production/ services, marketing and finance," says Frank Wardynski, Michigan State University Extension educator, who also manages a small beef herd in the Upper Peninsula. "To have a successful business, you must be good in all of these areas."

The right approach to financial success begins with separating business finances from personal finances. Wardynski says producers should maintain different checkbooks and credit cards for each, as well as independent accounting systems.



Define system

"Organization is important. Not everyone has an organized mind, but you can find a way to keep things in order that works for you," he says. "I spend an hour a month on finances with my accounting system and more time in January when I develop my balance sheet for analysis."

Once your finances are separated, Wardynski's next tips involve recordkeeping. He advises producers to record every business transaction and stay current with recordkeeping. Decide if you want to record transactions on a daily, weekly or monthly basis; and keep a written record of every transaction, including feed receipts and animal bills of sale. A ledger recording can include date, record number, vendor, amount, transaction type, accounts affected or other descriptions.

"It doesn't have to be fancy. I keep my records on paper and then plug them into my accounting software," he says. "I also have two paper files — accounts payable and those entries that need to be logged. Accounts payable are bills due, while receipts go in the folder to be logged."

Once those are paid and recorded, Wardynski suggests having a file folder for each month of the year. Receipts and paid bills can be permanently filed in their respective month's folder.

"Not everyone gives a receipt, so I write my own for my file when needed," he adds.

Next, determine what accounting system will work for you, and seek expert help for any questions you may have in setting it up. If you prefer to manage finances by hand in a farm records book, Wardynski says one is offered by Michigan State University Extension. Computer recordkeeping software includes Quicken, Quickbooks and Peachtree. Farm-specific systems include Finpak, PC Mars and AgManager.

"Try to pick a system where the entries correspond with your Schedule F for taxes," he says. "A

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good system will have an annual summary that provides a look at all of your monthly income and expenses, so you get a good look at cash flow. You can see how much to save and spend. And, if you enter your crops and cattle as enterprises, it helps you know what is profitable."

Balancing act

Once you are tracking finances, you can manage them with a farm balance sheet at the end of the year. Most farmers work on a cash accounting, calendar-year system.

"A balance sheet is an important tool for year-end financial analysis," he says.

The most comprehensive balance sheets can be broken down into seven main areas:

1. Current assets are items you own that can be turned into cash during the year, such as your checking account, growing crops, accounts receivable, grain storage, hay that will be fed, hedging accounts and livestock held for sale. Wardynski does not include items like headgates or cattle chutes, for example, that are not major assets.
2. Current liabilities are what are owed in the next 12 months. Current liabilities include delivery on an unpaid product, operating loans and short-term loans with payments that are due periodically during the current year.
3. Intermediate assets are owned items that have a longer, perhaps five- to 10-year life span. This might include breeding livestock, machinery and titled vehicles.
4. Intermediate liabilities cover the loans or payments on intermediate assets. In cases where principle and interest are due, financial software can manage these more easily.
5. Long-term assets generally cover land and buildings that have a 15-plus year life.
6. Long-term liabilities are what is owed on long-term assets.
7. The last section is a total of all assets and all liabilities.

Net worth

"Once the balance sheet is complete, assets minus liabilities provide your net worth and value of the farming enterprise. It is a good annual snapshot that can be used to calculate various financial ratios that can indicate the financial stability of the business," he says.

The current ratio equals current assets divided by current liabilities. A stable current ratio falls into the 1-1.5 range and is an indicator of net worth over time that can be used for year-end financial analysis and shared with bankers when loan applications are completed.

"Calculating these financial measures is critical to liquidity, or your ability to meet financial obligations during the course of the year when due," Wardynski says.

Also key is the working capital ratio, which is current assets minus current liabilities. A working capital in the range of 20% to 50% is considered stable. Solvency is the ability to meet long-term financial obligations, which can be gauged with the debt-to-asset ratio, equity-to-asset ratio and debt-to-equity ratio. Debt-to-asset and equity-to-asset ratio should be in the range of 30% to 70%.

"These ratios help you evaluate your current position, compare year-to-year finances for a change in net worth and monitor any big changes in specific categories. You should be able to identify reasons for change, such as expansion, equipment sales, loan restructuring, as well as calculate the amount of debt you can safely add to buy more cows, for example," he says.

Wardynski encourages producers even mid-year to go back to Jan. 1, and develop a beginning-year balance sheet, which can be compared to the year-end balance sheet developed in December. Bring in an expert to develop and analyze balance sheets if assistance is needed.

"Now you have everything you need to calculate farm profitability," he says. "Net cash income plus the change in net worth minus depreciation equals net farm income. You have a full picture of your finances at the end of the year."

Wardynski notes computer software can generate summary sheets that list all income and expenses to calculate net farm income, as well as provide more detail, like quantity and price per unit. A summary sheet can also show beginning and ending inventories and inventory change of value during the year. Finally, a good program will generate performance measures for liquidity, solvency, profitability, repayment capacity and efficiency.

"Remember, these are just numbers Try to separate out the emotion. Look at your finances to strategically plan for the future. Do you need to find an off-farm job to supplement cash flow or are you ready for expansion? Know what might stabilize your situation," he says. AJ