A Financial Checkup

Assess the fiscal health of your farm or ranch by monitoring these financial vital signs.

by Kindra Gordon

In the beef industry, cattlemen like to measure birth weights, weaning weights, conception rates, quality grades and a host of other production parameters. However, when it comes to balance sheets and income statements, cattlemen's enthusiasm for crunching numbers often wanes.

But, the long-term viability of a farm or ranch — and the ability to overcome volatility in markets and weather — really hinges on an operation's business plan.

"The farm business planning process helps producers look five, 10 and 20 years into the future versus focusing on one production year to the next," says Duane Griffith, an Extension farm management specialist with Montana State University.

He adds that the key to an ag operation's ability to survive depends on how well it manages different forms of risk — be it production, marketing, human, financial or legal. Of this, Griffith uses the common mantra, "If you can't measure it, you can't manage it."

The prospect of financial planning can still be daunting, so Griffith and other financial advisors suggest staying motivated about farm business planning by keeping your eye on the prize: working toward a better future for your farm or ranch.

Griffith also points out that the difference between a farm that takes time to develop a financial plan and one that doesn't is as simple as one that is in business 20 years from now — because it had a plan in place — and one that is no longer operating.

Where to start

To begin developing a farm business plan, Griffith suggests first addressing several key points:

1) Assess the current situation.
2) Determine where you want to be.
3) Identify, select and test alternatives.
4) Monitor implementation.

Griffith says this process can be as straightforward as asking yourself and family members involved in the operation about the current status of the farm business, the interests and skills of those involved, and expectations and goals for the future.

He emphasizes that, once in place, the plan should serve as a guide for decision-making on production, marketing and even human resources on the farm or ranch. Additionally, the planning process should be revisited regularly by asking such questions as, "With no changes, would your current business be satisfactory five years from now?" or "Would the business fulfill your personal and business goals?" If the answer to any of these questions is no, you should take time to identify and test alternatives.

Put financials on paper

Along with taking inventory and setting goals in the farm business, Griffith says another crucial element for farm business planning is to have complete financial statements. He says these should include four components:

1) beginning and ending balance sheets;
2) cash-flow statement;
3) accrual adjusted income statement; and
4) statement of owner equity.

Unfortunately, Griffith says, one or more of these four components are frequently overlooked in agriculture. "Many farmers and ranchers don't do an income statement because they are not required to." He adds, "Farmers and ranchers often substitute tax records, but they do not measure business performance. They only measure the amount of taxes owed."

As an example of the financial information that can be missed when one or more of these four basic financial statements is not prepared, Griffith shares these points:

- ►All cash inflows are not income. For instance, operating loan proceeds from lenders are not claimed as income. They show up on the cash-flow statement, but not on the income statement.
- ►All cash outflows are not expenses. For example, loan principal payments are not claimed as expenses. Again, they show up on the cash-flow statement, but not on the income statement.
- ► You can have noncash expenses, such as depreciation. This is an expense that shows up on the income statement, but not on the cash-flow statement. Noncash income would be reflected on accrual statements.
- ► Outflow from a cash flow statement and expenses on an income statement tell you different things. Every dollar of expense goes to decreasing net worth; whereas, outflow does not necessarily decrease net worth.

Griffith says, "If you are not measuring these things because you don't complete an income statement, you don't know where your business is financially. These items make a difference to financials. How can you expect to do a management plan and

improve without that information?"

Additionally, he says these statements cannot be prepared individually without reference to or interaction with one another. Use them to look at net income, withdrawal, debt load, operating loan carryover, etc.

Griffith admits it will not be easy to put many of these financial statements together the first time through. And, he estimates it can cost between $3,000 and $5,000 to have them prepared by an accountant. However, he believes the information they provide is well worth it.

"These financials will tell you whether or not your operation has the potential to survive in the long run; whereas, the annual balance sheet or cash-flow projection to renew the operating line of credit at best only gives brief glimpses of business position and performance," Griffith says.

Several public domain spreadsheets for tracking financial analysis are available online at *www.montana.edu/extensionecon/farmmgt/software.html.*

Monitor human resources

A final key area to track in monitoring the business viability of your farm or ranch relates to the family itself. This includes both family living expense and family communication.

Griffith says this, too, is an area that is frequently overlooked, with many families not knowing what their annual living expense is or taking time to enhance family relationships with communication.

"It can be a challenge for farm families to generate adequate income for family living," Griffith says. He notes that the average family living expense for a North Dakota farm family of four is estimated to be about $40,000 (with the national average about $47,500).

How do farms generate that income? Griffith says many have been forced to do it through a job off the farm. And, he says, as family living expense increases, it puts more pressure on farm resources. As an example, if living expenses increase while off-farm income and farm profit margins remain the same, the farm needs to add 80 acres per year (if receiving a $20-per-acre profit) or 16 cows per year (if receiving a $100-per-cow profit) to generate that income.

As a result, Griffith says farms and ranches of the future will be forced to get bigger. "The pressure is family living, which means fewer farms, but bigger farms," he explains.

If farms stop getting bigger, Griffith says the alternative is that they can't generate enough income to keep up with their standard of living, and they'll be forced to move off the farm anyway. "If you have to keep up with family living, we have to let farms get bigger."

Griffith reiterates that decisions like these go back to having a business plan in place. "Maybe rather than getting bigger, you can get better by marketing calves at different times of year, etc. But, if you want your farm or ranch to be here 20 years down the road, you've got to monitor things like family living expense and evaluate all of your opportunities for maximizing profits from your resource base," he says.

Additionally, Laurence Crane, an economist with National Crop Insurance Services (NCIS), says tracking family living expense is a critical indicator for operations that plan to bring another family or individual back into the family business.

"You need to know how the income will be generated to cover their family living expense, or it will fail," Crane says. He adds, "It is amazing how many families don't talk this through" — which brings up the final point of communication.

Crane says, "A huge part of the business planning approach is acknowledging human resources and communication on the farm. It is worthwhile to take time for human needs such as communication, respect and recognition of everyone's contribution."

As an example, he says, a divorce — be it a husband and wife, two brothers, or a father and son that split because of poor communication or lack of respect — affects many things. For instance, if a wife whose off-farm job provided the cash-flow income for the farm or ranch leaves, the whole operation could fail without her contribution.

"Recognize that," Crane says, "because in a lot of instances, though that person isn't on the farm daily, they are the one keeping the farm going, but they often get the least recognition."

In conclusion, he says, "The business planning model is an effective way to organize decisions for the farm or ranch. It helps emphasize that all decisions are interrelated. Business planning needs to be a total package."