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RightRisk™

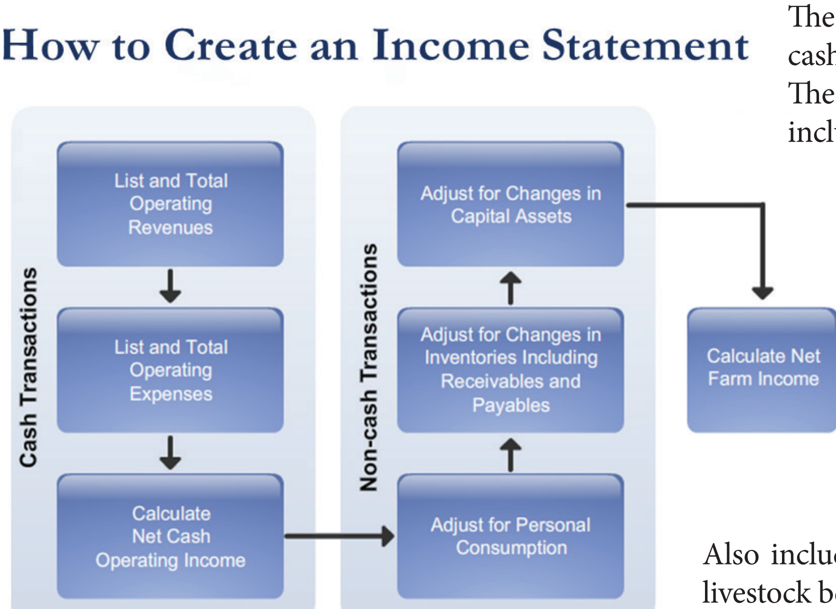
RightRisk News

How Much Risk is Right for You?

Was Your Farm Profitable Last Year?

Your checking account balance shows a bit of cash remaining, but your Schedule F shows a big loss! What do these numbers mean? Did your farm make any money last year? How can you tell? January is a great time of year to analyze your finances from the previous year and to develop a road map – cash flow budget – for the new year. You are likely already finalizing your financial reports and preparing information to take to your tax preparer. You may also be preparing documents for a lender. Given you are already compiling all these financial details, why not analyze the data and use it for making management decisions?

Let's return to the question – did your farm make money last year? The income statement is the financial document used to answer this question. A farm income statement is a summary of revenue and expenses for a specific accounting period, often one year. It is sometimes called a profit-and-loss statement (P&L) because it provides a measure of farm profitability.



Preparing an Income Statement

The income statement is divided into three parts: cash revenues, cash expenses, and adjustments. The revenue section of the income statement includes all cash income generated during the accounting period. It is derived from sales of livestock, livestock products, crops, government payments, tax credits and refunds, crop insurance proceeds, and other miscellaneous income sources. Total receipts from sales of both raised livestock and market livestock purchased for resale should be included, but not the original cost of feeder livestock purchased in the previous year. Also include total cash receipts from sales of breeding livestock before adjustments for capital gains.

Do not include on the income statement proceeds from outstanding USDA marketing loans in cash income; noncash income such as profits or losses on futures contracts and options; sales of land, machinery, or other depreciable assets; loans received; or income from nonfarm sources in income.

Expenses include operating expenses, those expenses resulting from the operation of the farm. They include feed purchases, feeder livestock purchases, cash rent, chemicals, purchased feed, fertilizers, fuel, labor, repair, maintenance, supplies, and more. The expense section of an income statement does not include purchases of capital assets, such as machinery and equipment, because such costs are accounted for in depreciation.

Income from operations is found by subtracting total operating expenses from gross revenues. This is a measure of the returns to normal farm operations. However, this income measure can be a misleading indicator of financial performance because it excludes production not sold, inputs used but not paid for during the year, and other transactions where cash changed hands at a time different from when a sale or purchase was made.

Farm Income Statement

A. Cash Farm Receipts
B. Cash Farm Expenses
C. Income from Operations (= A – B)
D. Changes in Value of Inventories
E. Depreciation
F. Gains or Losses from Capital Sales
G. Changes in Accounts Payable
H. Changes in Accounts Receivable
I. Net Farm Income (= C + D + E + F + G + H)

Not all farm income is accounted for by cash sales. Changes in inventory values can either increase or decrease net farm income for the year. Changes in the value of inventories of feed and grain, market livestock, and breeding livestock can result from increases or decreases in the quantity of these items on hand, changes in their unit values, or both. Adjusting for inventory changes ensures that the change in farm products is counted in the year when they are produced rather than the year they are sold. Changes in the market values of land, buildings, machinery, and equipment (except for depreciation) are not included in the income statement, unless the assets are actually sold. Accounts receivable and unpaid patronage dividends are included, however, because they reflect income that has been earned but not yet received.

The depreciation method used for the income statement is economic depreciation and differs from the depreciation method used for tax purposes. Accelerated tax depreciation methods overstate the cost of assets in the early years of ownership. While depreciation is listed as an expense and subtracted from income, it is retained by the firm for capital replacement and, as such, is part of the total funds available to the firm. Economic depreciation is found by subtracting the salvage value of the equipment from the purchase price and dividing by the estimated useful life. This method is also known as the straight line method of depreciation.

Personal expenses are not included when calculating net farm income calculations. Examples of personal items excluded from net farm income are personal income tax, self-employment tax, the personal use of a business automobile or truck, personal expenditures for family members who are also farm employees, and the household portion of the telephone, electricity, and other utility bills.

Net farm income equals net cash income adjusted for household consumption, changes to inventories (including receivables and payables), and changes in the value of capital assets. Examples here include fertilizer purchased but not used and supplies used but not yet paid for. Net farm income is also referred to as farm profit.

What does an income statement tell you?
The income statement allows the manger to evaluate farm profitability. Using information from the income statement, several ratios can be calculated to further understand the farm's current financial situation.

1. Rate of Return on Farm Assets (ROA) is computed by dividing the return to farm assets (income from operations minus owner withdrawals for unpaid labor and management) by the average farm asset value for the year. This ratio expresses the return per dollar of farm assets. A ratio above 0.05 indicates the farm is in a strong financial situation.

2. Rate of Return on Farm Equity (ROE) is computed by dividing the return to farm equity (income from operations minus farm interest expense minus owner withdrawals for unpaid labor and management) by farm average equity. This ratio measures the return on the owner's share of the capital invested. An ROE ratio above 0.10 is considered strong, while an ROE ratio below 0.05 is considered weak.

3. The Operating Profit Margin Ratio is computed by dividing return on farm assets by gross revenue. This measure expresses operating profit as the return per dollar of gross revenue. An operating profit margin ratio above 0.25 indicates the farm is in a strong position, while an operating profit margin below 0.10 indicates a weak position.

Farm Profitability or Net Farm Income
The cash balance in a bank account and taxable profits or losses shown on the Schedule F are not accurate indicators of farm profitability. An accurate, up to date income statement is the only method for estimating net farm income. The income statement accounts for all outputs and inputs for the specified period:

(1) receipts and expenses, regardless of cash basis or accrual basis;
(2) changes in inventories;
(3) changes in assets due to purchases and sales;
(4) tax accrued;
(5) family living expenses; and
(6) adjustments in accounts payable and accounts receivable.

The income statement measures net farm income and returns to unpaid operator and family labor, return to operator's management and risk, and return to investment and owner's equity.

Highlighted Course

Producing quality, up-to-date financial statements is a key to success in any agricultural business. These statements allow analyses of alternatives and sound management decisions. Producing accurate, well-organized financial statements benefit operations of all sizes and scales.

The academic professionals at RightRisk have developed an online course entitled *Getting on Track: Better Management through Basic Financial Statements*. The interactive course relies on an example couple looking at several alternative enterprises for their operation and how they learn to use financial statements to make decisions.

To access the course see: http://RightRisk.org > Courses >
Getting on Track: Better Management Through Basic Financial Statements.

~ Other RightRisk News ~

News Release - December 1 | RightRisk

Federal Reserve Beige Book Summary on the Ag Sector

ECONOMIC ACTIVITY was about flat or up slightly since the previous report, down from the modest average pace of growth in the prior Beige Book period. Five Districts reported slight or modest gains in activity, and the rest experienced either no change or slight-to-modest declines. Interest rates and inflation continued to weigh on activity, and many contacts expressed greater uncertainty or increased pessimism concerning the outlook . . .

For more see: RightRisk.org\News

December 1 | Social Media Post
Evaluating Pasture, Rangeland, Forage – Rainfall Index Coverage

December 6 | Social Media Post
Understanding Financial Performance

December 8 | Social Media Post
RURALTAX.org

December 13 | Social Media Post
Limited Liability Company

December 15 | Social Media Post
Multi-Temporal Risk Analyzer | RightRisk

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Risk Scenario Planning

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Evaluating Lease Arrangements

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