



Financial Management: The Key to Farm-Firm Business Management

Curriculum Guide

I. Goals and Objectives

- A. Explain the need for an increased emphasis on recordkeeping, planning, profitability analysis, repayment based financing and better monitoring and controls.
- B. Define and outline the structure, use and preparations of a balance sheet, income statement and cash flow statement.
- C. Outline the purpose, scope and use of the various analytical tools used to plan for profit.
- D. Initiate a system for using and analyzing financial statement.

II. Descriptions/Highlights

- A. High among any set of business goals are 1) profitability, 2) liquidity, and 3) solvency. Yet some managers who are very capable in the technical and production aspects of their business are completely in the dark when it comes to measures of business status and performance. They leave their record keeping to a bookkeeper or, worse, use the "shoebox" record system, i.e. storing all receipts and paperwork in a box each year. The only business analysis they do is to fill out their tax forms at the end of the year.

The functions of management include the management of human resources, a financial management aspect, a production aspect and a marketing program.

Effective managers want to be able to determine the position of a business at any time. They also want a basis for evaluating where the business has been and for projecting where the business is going. This aids their control of the business operation over time.

- B. Agricultural producers and their lenders are going to have to adopt some of the basic analytical and planning tools used in business. To start with, a series of basic questions needs to be asked and answered honestly on a continuing basis:

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? Is the operation sufficiently large 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?

- C. The first step in the planning process is to outline specific business/personal goals and objectives and prepare a complete inventory of resources available. That is, a meaningful plan can not be prepared unless owners or management specifically outline what they wish to accomplish and the basic "resources" available to accomplish these objective(s). 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 inventory, labor availability, management capabilities, detailed crop/livestock production history, analysis of market information and complete financial statements.
- D. 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), institutional considerations, and 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.
- E. 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 to keep the business on track by comparing actual performance to the plan and taking action when needed. Too many farm businesses have failed simply because it was too late before the farmer or his lender recognized problems or took corrective action.
- F. 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.
- G. 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 two years in recognizing profitability problems that may be developing.
- H. A projected cash flow statement is a listing of all anticipated cash inflows and outflows for a specified future period and includes farm/ranch and/or non-farm transactions, all projected cash outflows (including operating expenses and capital outlays), family living expenses, borrowing transactions and tax payments.
- I. Farmers and ranchers need to utilize the information provided by the balance sheet, income statement and cash flow statement in order to understand how well their business is doing. Only by analyzing the components of all three financial statements and their interrelationships can a clear picture of financial position and performance be determined.

III. Potential Speakers

- A. Extension economists
- B. Local banker or financial advisor

IV. Review Questions

- A. What is the concept of management?

Answer: The efficient organization and skillful operation for the use of all farm resources to accomplish the total farm goals and objectives.

- B. What are the components of a business firm?

Answer: Human resources, financial management aspect, production aspect and marketing aspect.

- C. What are the basic analytical tools available to analyze business performances?

Answer: The basic tools needed to analyze financial position and performance are: balance sheet, income statement, statement of cash flows and visit with lender(s).

V. For More Details

John B. Penson, Jr., Danny A. Klinefelter and David A. Lins. Farm Investment and Financial Analysis. Prentice-Hall, Inc., Englewood Cliffs, New Jersey 07632. 1982.

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Peter J. Barry, Paul N. Ellinger, C.B. Baker and John A. Hopkin. Financial Management in Agriculture. Interstate Publishers, Inc., Danville, Illinois. 1995.

Donald D. Osburn and Kenneth C. Schneeberger. Modern Agriculture Management. Reston Publishing Co., Inc., Reston, Virginia. 1978.

John B. Penson, Jr. and Clair J. Nixon. Understanding Financial Statements in Agriculture. Agri-Information Corporation, College Station, Texas. 1983.

Danny A. Klinefelter. Being Prepared to Borrow. Texas Agricultural Extension Service, Bulletin L-5071. 1993.

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! Financial Management

- ☞ Introduction to:
 - ✓ Concept of management
 - ✓ The planning process
- ☞ Changing agricultural finance environment
- ☞ Financial management

! Whole Farm Business Planning

- ☞ The efficient organization and skillful operation for the use of all farm resources to accomplish the total farm goals and objectives.
- ☞ The key to success is: MANAGEMENT
- ☞ Doing a good job with production - not enough
- ☞ Farm-firm business management required
- ☞ Integrating production technology with appropriate business management

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! Farm Business Firm

- ☞ Human resource
- ☞ Financial management aspect
- ☞ Production aspect
- ☞ Marketing

! Analyzing Your Financial Situation

- ☞ Balance sheet
- ☞ Income statement
- ☞ Statement of cash flow
- ☞ Visit with lender(s) to review position

! A Balance Sheet Shows

- ☞ What a business owns
- ☞ What it owes
- ☞ Investment of owners
- ☞ It tells you where you are

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! Uses of a Balance Sheet

- ☞ Tell you how much you're worth: that is, how much would be left if all your assets were sold and your debts were paid off.
- ☞ Tells you something about your ability to bear risk; that is how serious the effect of an unexpected loss would be.
- ☞ Show what collateral you have available to secure loans.
- ☞ Provide values of year-end inventories which are essential in order to accurately measure profit ability on the income statement.
- ☞ Provide year-to-year comparative information to indicate trends in the financial position and financial structure of the business.
- ☞ Provide information to use in estate planning.
- ☞ Allow to see, when used in conjunction with the income statement, how much of the change in financial positions is due to reinvested earnings (losses) how much is due to inflation (deflation) in asset values.



! Preparing an Income Statement

- ☞ Income Statement - a summary of revenues and the expenses associated with generating those revenues.
- ☞ $\text{Revenues} - \text{Expenses} = \text{Net Farm Income}$

! Use of an Income Statement

- ☞ Summarizing revenues and expenses
- ☞ Determining profit or loss
- ☞ Explaining changes in owner equity
- ☞ Calculating financial measures
 - ✓ Profitability
 - ✓ Financial efficiency
 - ✓ Repayment capacity
- ☞ Supporting loan applications or refinancing loans



! Statement of Cash Flows

- ☞ Summarizes all cash inflows and outflows for the business by month, quarter, or year
- ☞ Cash Flow Statement Enables Farmer to:
 - ✓ Identify periods where there are cash surpluses or deficits
 - ✓ Analyze sources and uses of cash
 - ✓ Plan/project cash flow into the future
 - ✓ Inform lenders of borrowing needs
 - ✓ Plan repayment schedule
 - ✓ Monitor cash flow variances by comparing projections to actual

! Two Types of Analysis

- ☞ Comparative statement analysis
- ☞ Financial ratio analysis
- ☞ The purpose of both types of analysis is to:
Find, Locate and Isolate



Financial Ratio Analysis

Types of ratios:

Liquidity:

Measures ability to meet obligations when due without disrupting normal operations

Solvency:

Measures borrowed capital in relation to owner's equity capital invested in business

Profitability:

Measures amount of profit from use of labor, management and capital

Repayment Capacity:

Measures ability to repay debts from both farm and non-farm income

Financial Efficiency:

Measures degree of efficiency in use of labor, management and capital