Farm Financial Vital Signs

Here's what to monitor to evaluate the fiscal health of your cattle operation.

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 market and weather volatility — 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, a Montana State University Extension farm management specialist.

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."

That said, 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 being one that is still in business in 20 years because it had a plan in place or being one that is no longer operating.

Getting started

To begin developing a farm business plan, Griffith suggests first examining several key factors:

- Assess the current situation;
- Determine where you want to be;
- Identify, select and test alternatives; and
- Monitor implementation.

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

He emphasizes that once in place, the plan should serve as a guide for decision making in the areas of 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 one or both of these questions is "No," you should take time to identify and test alternatives.

Put financials on paper

Along with the inventorying and goal setting in the farm business, Griffith says another crucial element for farm business planning is to have complete financial statements. He says this 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 says. "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 are not prepared, Griffith shares these points:

All cash inflows are not income. For instance, operating loan proceeds from lenders are not

The difference between a farm that takes time to develop a financial plan and one that doesn't is as simple as being one that is still in business in 20 years because it had a plan in place or being one that is no longer operating.

claimed as income, and they show up on the cash flow statement but not the income statement.

All cash outflows are not expenses. For example, loan principal payments are not claimed as expenses, and again, they show up on the cash flow statement but not the income statement.

You can have non-cash expenses, such as depreciation. This is an expense on the income statement but not the cash flow statement. Non-cash income is 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 and operating loan carryover among others.

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.

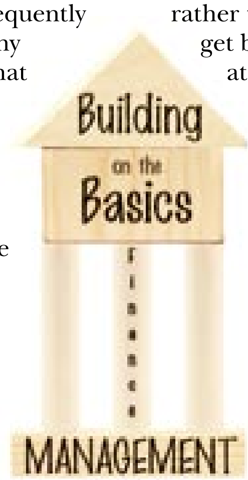
However, he believes the information they provide is well worth the expense. "These financials will tell you whether or not your operation has the potential to survive in the long run. Whereas the annual balance sheet or cash flow projection to renew the operating line of credit at best only gives brief glimpses of business position and performance," says Griffith.

Several public domain spreadsheets for tracking financial analyses are available online at *www.montana.edu/extensionecon/softwaredownloads.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 area includes both family living expense and family communication.

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



"It can be a challenge for farm families to generate adequate income for family living," says Griffith. He adds, the average family living expense for a North Dakota farm family of four is estimated to be approximately $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, the increase puts more pressure on farm resources. For example, if living expense increases while off-farm income and farm profit margins remain the same, the farm needs to add 80 acres/year (if $20/acre of profit) or 16 cows/year (if $100/cow of 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."

If farms stop getting bigger, Griffith says the alternative is that farmers and ranchers 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," he says.

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, 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," says Crane. He adds, "It is amazing how many families don't talk this through."

The final point is the importance 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." **HW**