

FARM Library

Financial and Risk Management Database

Improving farm management skills one topic at a time

Financial Tune-Up

It's common for producers to take their tractors and combines into the shop on an annual basis for a tune-up but it seems less common for them to take the time for a financial tune-up of their business. While the equipment is worth a lot of money, the financial health of the business could be worth even more.

So what's needed for a good Financial Tune-Up? The answer really depends on where you're currently at. The financial literacy of operations varies as much as cost of production or even the weather. You may need to start at Step 1, you may already be ready for Step 3 or ready to repeat Step 4.. The important thing is to honestly evaluate where you are and get started at the appropriate place because if you try and get accrual records without having accurate books, you'll end up with meaningless data.

One of the unique perspectives gained from Nebraska Farm Business, Inc. is the dual approach of looking at cash basis tax records and financial management records which are really different. Having accurate records is really important for both purposes and sometimes the things we do to advance record-keeping for management can have unintended consequences to the records needed for tax prep. With that in mind, it's important we work these steps in order to keep a good balance between the two.

Step 1: Balanced records

There's a principle often used in computer science of "garbage in, garbage out" referring to a computer's ability to process a lot of flawed information into undesired output that is meaningless because the original information wasn't any good. It certainly applies to financial records. Some producers just try and record those transactions that they THINK are important but to truly manage your business (or do your best for tax management) you need to include all transactions. If you're only recording partial information, it's a little like running your tractor without the oil pressure gauge. You can put some oil in periodically and it probably will be enough but you really won't know without monitoring that gauge. You can base your need to refill on your past experience but what if a hole develops in a line? Your experience will tell you that you are fine, but the hole changes the facts. Sometimes we see that with financial records

KEEPING GOOD RECORDS

Good Records don't have to be computer records. It may be hard for a 10,000 head feedlot to even imagine not using a good computer program to track the millions of dollars going in and out of their accounts but it's not impossible. Good records could be a hand-kept book, an excel spreadsheet, or in many different types of computer programs. The best way for you to get good books may be to have someone else do it. Many accountants will process your statements for you but remember they are not mind readers and you will be ultimately responsible for making sure everything is coded correctly.

Finding the right way for you to keep your records is important and one good start is to talk with those professionals working with your operation such as your accountant or financial consultant.

too. Many times it's similar to the past, but there are instances when you've put in a lot of information but it's just not enough causing a problem bigger than ever expected.

What does it mean to have balanced records?

Balanced records are reconciled to the bank statements. This means after you have accounted for outstanding checks and deposits (transactions that are recorded in your books but did not clear the statement) your account balance matches the banks. Many times, people assume that the bank must be right and it's not worth checking but the reality is banks make mistakes too and you'll never know if you don't check. In fact just this week, we caught a \$1,500 error for a client by taking the step to reconcile. While it doesn't happen to individual producers very often, we do enough accounts in our office that we catch a mistake at least once a year.

It also makes sure you have included EVERY transaction including automatic deposits and withdrawals that are easy to forget. We can't stop at just the farm checking account, each bank account should be reconciled including loan accounts. While it's not at all recommended, sometimes income gets applied directly to loans or there are transactions such as rollover interest that must be tracked to be deducted. It's also important to have accurate splits on principle vs interest for both management and taxes.

Step 2: Meaningful records

Once you have ensured you have included all transactions in your books, the next step is to make sure they are meaningful records. Think again about your tractor. The fuel gauge would tell you the tank is full even if you filled it with gas instead of diesel but it doesn't make it right. In fact, you'll quickly have a costly mess on your hands. In the same way, it's important that you have categorized everything right or the information you get out will be meaningless.

Meaningful records would mean that you have done things like:

1. Split the coop bill to accurately measure your chemical, fertilizer, repair and fuel expenses even though they are often really hard to navigate.
2. Split irrigation fuel & repairs from other fuel & repairs so they can be allocated correctly to the irrigated ground.
3. Split grain sales by type (separate corn from soybeans from wheat, etc)
4. Split breeding livestock income from feeding livestock income. This one is really important for both tax and management purposes.
5. Include quantities on sales of grain and livestock so you have information needed to reconcile quantities.
6. Be sure personal expenses are recorded as personal expenses and are clearly separated from farm expenses.

There are many examples like these that pertain to different operations but the main goal is to get the information recorded in a way that it is ready to be used for a tax return and for management decisions. This step could also be taken to another level by splitting major costs (seed, feed, fertilizer, vet cost, chemicals, etc) by crop or livestock enterprise. This extra step will continue to add additional meaning to your management records. I often caution productions from getting too carried away by this extra step though. If you are simply splitting an expense per acre (such as utilities or farm insurance) it is easier to do it at year-end rather than with each monthly payment. Those extra splits are often the straw that breaks the desire to keep up the

good work. Until you are prepared to put in the time, focus on those expenses that are materially different between enterprises, such as seed or chemicals, to get the largest impact for the time spent.

Step 3: Make Accrual Adjustments

Once you have meaningful records, we can move forward with looking at your operation from an accrual standpoint. This is usually where people give up because we've moved past what is

CASH VS. ACCRUAL

Cash Income is a measure of the cash transactions that happen through the year, mostly what went in and out of your checking account.

Accrual income is a measure of the true earnings of the business. It is not uncommon for your cash income to include grain/livestock sales from the previous year and input purchases for the next year's production. The accrual adjustments takes all those transactions out so we can see the actual earnings for that production year.

required for a good tax return but it's really where we can start to gain some true management knowledge. Unfortunately, it seems the requirement and deadline of having to do a tax return makes it more important than what we can learn from a management prospective and that's really not true. We report a "net income" number on the tax return but it really has little tie to the true profitability of the business. Approximately 97% of farm tax returns are reported on a cash basis and we invest a lot of time and money in making that cash basis income be where we want it. We may prepay or defer

expenses or defer or add grain and livestock sales to get the cash basis income just right but it really doesn't tell us if we made money. It just says that we are recognizing income.

Accrual income takes all the things we do for income tax purposes and puts it back into the right production year. There are usually management reasons we do some of these things too (discounts for early purchase, carry in the grain market, etc) but it's usually easier to understand if we think about undoing the tax stuff.

Some accrual examples:

1. In 2017 you may be planting seed that was purchased in 2016 but it is still a 2017 production cost, so the accrual adjustment would be to reduce 2017's cash net income by the cost of that seed.
2. In the same manner if you purchased your 2018 seed in November of 2017, it would be included in your 2017 cash net income, so we'd need to increase net income to take that out.
3. The crop that you harvest in 2017, may be sold in 2018 but it should still be attributed to the 2017 crop year. So the adjustment we would make is to increase 2017's cash income by the value of the grain you have on hand as of December 31st, 2017 (or your year end).
4. You may also have included in your 2017 cash net income, sales of grain raised in 2016. To get to 2017's true earning, you have to reduce your cash income by the value placed on that grain on December 31st, 2016. You may have actually sold that grain for more or less than the value on December 31st, but we consider that a marketing gain/loss and let that

be 2017's income. There is no right or wrong here, but just a need to be consistent in how you treat that.

Depending on your operation, you may need to make one or two adjustments or you may be making a lot of adjustments. You could keep track of all of this with a simple spreadsheet or using a program like FINPACK from the Center for Farm Financial Management at the University of Minnesota. This is the program used by Nebraska Farm Business to evaluate the accrual income of farms in the program. It is a comprehensive program that could be confusing for first time users but it really is a great farm management tool.

Getting to an accurate accrual income is very important. Just like having complete, reconciled records, we need to make sure we are accounting for all accrual adjustments as accurately as possible.

Balance Sheet

In order to ensure the adjustments are accurate, we need two good "book-end" balance sheets. These need to be as of the beginning and end of your fiscal year (typically December 31st each year). If you start with balance sheets that are dated differently (say December 5th and January 20th) there will be missing pieces. You may have prepaid additional items between December 5th and the end of the year that are in your cash basis records or you may have liquidated a lot of grain after January 1st that would be missing from a January 20th balance sheet. The balance sheets provide the information to make the accrual adjustments. For example, if your beginning balance sheet showed \$100,000 of corn on hand, you sold \$250,000 of corn in 2017, and the ending balance sheet showed \$75,000 of corn you would have a -\$25,000 adjustment (\$100,000 beginning - \$75,000 ending) to your cash sale of \$250,000 so your accrual corn sales would be \$225,000 (\$250,000 cash sales - \$25,000 adjustment).

NATURAL YEAR END

In some cases, it may make sense to have a different year-end than you have for tax purposes. If you have a "natural" break, you may consider that for your balance sheet dates. For example, if you are a cash grain operation with a 6/30 fiscal year end, you may want to evaluate your accrual income on a calendar year basis. On June 30th, you have to make estimates on growing crop, what irrigation/harvesting costs will be, etc. On 12/31, most of that is cleaned up and easier to differentiate between what belongs with each production year. Be sure you can sort your cash basis accounting by the calendar year before making this switch.

Quantities

One of the reasons it is so important to record quantities sold during the year is to give you information to reconcile bushels. This step can seem pretty silly until you find a grain bin you forgot you filled or bushels sitting in the elevator that your forgot you had to sell. It sometimes seems hard to imagine forgetting an entire grain bin, but it happens with a lot of regularity and it makes a big difference. For example, if you left 20,000 bushels of corn off your balance sheet, even at just \$3.00 we have inaccurately reported accrual income by \$60,000! That inaccuracy will throw all the gauges off and could cause you to make poor decisions.

By reconciling bushels, we are just making sure we accounted for everything. It will likely not always work out perfectly. Remember, you're estimating inventory (both beginning and ending), estimating yields (even with a yield monitor you can't be 100% accurate) and for livestock operations estimating feed usage. Even though we can't be 100% accurate, we can be sure we're close.

Accrual Accounting Records

There are many good accounting programs that will allow you to keep your records on a cash or accrual basis. What we find in practice is that it is very hard to keep up with the daily tasks of accrual adjustments and it's very easy to mess up good cash basis books that are required for an accurate tax return. Rather than altering cash basis accounting, we prefer to keep the records on a cash basis and make the accrual adjustments at year end in a separate program, at least until you've gotten very comfortable with all the adjustments. If you are in a livestock feeding operation or dairy operation, you may want to do this semi-annually or quarterly. These industries "turn over" more rapidly than a cash grain operation or beef cow-calf operation and may need to look at the numbers more often.

Once we have the accrual adjustments done, we can get down to generating meaningful data. Using the accrual adjustment income, ending balance sheet and production information, you can generate the 21 Standard Financial Ratios, earned net worth, accrual net farm income, cost of production per acre/head, etc. A program like FINPACK can do all this automatically but you can also calculate ratios and cost of production in a spreadsheet. It's important that you are consistent in how you calculate the ratios and that you include all costs in a cost of production. For example, your cost of production for corn consists of more than seed, fertilizer, chemicals, crop insurance and cash rent. There are utilities, depreciation, fuel insurance, etc that all have to be paid by the farm. In addition, we need to allocate a share of family living that must be covered to truly get a good cost of production number. By cheating these costs to make your break-even look better, you are just causing a long-term problem of not being able to service all your obligations.

<u>Example:</u>	Corn
Beginning Inventory	30,000 bu
+ Purchases	
+ Raised	61,000 bu
= Total Sources	91,000 bu
Sales	71,430 bu
+ Seeded	
+ Fed	
+ Gifted	
+ Ending Inventory	25,000 bu
= Total Uses	91,430
Total Sources - Total Uses = Discrepancy	430 bu

Step 4: Evaluate your business based on accurate, accrual input information.

Financial Ratios

The Farm Financial Standards Committee have established 21 financial ratios. No one ratio is the perfect indicator as to the financial health of the business but they really work together to give a dashboard of financial health.

How often do you look at the gauges on your tractor's dash and see something alarming? Hopefully not very often but if you do see your temperature gauge creeping into the red it's important information. You will likely shut the tractor down until you can figure out what is causing the reading. In the same way, checking your financial ratios each year will hopefully end in a quick glance that everything is okay and you can keep doing what you're doing. These ratios are really just quick indicators to tell us that something is a little off and that we need to stop or slow down until we figure out what is going on. If you ignore the ratios' warning, eventually there will be obvious signs of trouble (not getting refinanced, foreclosure, burning through equity, etc) just like waiting for smoke to come out from the hood of your tractor means you waited too long and likely caused major damage.

There are generally accepted goals or levels for each ratio but your bank may differ from our standard. (Link to benchmarking sheet). It's important to understand that these standards are established for all farms. That include cotton and tobacco farms, fruit and nut growers, rain-fed farms in the Eastern corn belt, and livestock operations. We really see many of these ratios vary depending on many factors in your operation. For example, the national standard for Operating Expense Ratio is 70% but rarely does our average Nebraska ratio beat that mark. As a heavily irrigated, livestock intense state we won't be able to attain a ratio as low as a farm that can get the same yield without the \$30/ac cost for irrigation fuel and the additional depreciation cost for pivots, wells, etc. In the same manner when a livestock feeding operation's costs include the purchase cost of the animals, even the most efficient feeders will not have a lower than 70% operating expense ratio. The ratios will also be different for different operations. For example, the solvency ratios (debt-to-asset, etc) have less value to operations who do not carry debt than an operation which is highly leverage which will place great importance on those ratios. We will also expect an asset turnover ratio to be different for a dairy operation than a cash grain operation.

With all these differences, it's important to know where your "normal" is and what the trend is of these numbers. For example, a current ratio of 2 is considered very good. It means you can pay the debts coming up in the next 12 months (operating loan and payments on term notes) 2 times with the asset you have to sell in the next 12 months. But if that ratio was 4 the year before and we're projecting it to be 1 at the end of the year, it's still indicating a problem. For some reason, the operating is "bleeding" working capital and it's important to know why.

- It could be that you have used cash to purchase intermediate or long term assets such as equipment or land. That would cause your current ratio and working capital to decrease but wouldn't be a continual decline in the future or could be "fixed" by terming out some current debt to be more aligned with the asset purchase.
- It could also mean that you are spending significantly more on family living than you are making or that your farm has been having negative net farm incomes. These issues are of

more serious nature because if they are not corrected, the "bleeding" will just keep getting worse.

- It may also be caused by the value of a bushel of corn dropping from \$6 per bushel to \$3 per bushel. You may have done nothing wrong, but if we're headed to a current ratio of 1, you need to be looking for adjustments in your operation.

Each of the financial measures tells the story of your operation and it's important that we learn from those stories. To hear the stories, you have to know what the ratios mean, how they're calculated and what has been happening in your business.

We are used to reading gauges in all kinds of vehicles and equipment, measuring rainfall and temperatures and using that information to make informed decisions but we aren't as used to using our financial measurements to improve the health of your business. These can be early indicators to a problem in your operation if you take the time to review them. You wouldn't take just one look at your gauges in your tractor and assume they will never change. In the same way, we hope the financial ratios stay in a good place but if you don't look, they could be blinking red and before long you could have smoke coming from under the hood of your financial health when it's too late to do anything to save the engine.