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YOUR PLANS FOR PROFIT

INCOME STATEMENT

BALANCE SHEET

CASH FLOW

EXTENSION SERVICE
UNIVERSITY OF NEBRASKA COLLEGE OF AGRICULTURE COOPERATING WITH THE
U.S. DEPARTMENT OF AGRICULTURE AND THE COLLEGE OF HOME ECONOMICS.
E. F. FROLIK, DEAN; J. L. ADAMS, DIRECTOR

A FINANCIAL MANAGEMENT SERIES FOR NEBRASKA FARMERS & RANCHERS

EC 71-846	YOUR PLANS FOR PROFIT
EC 71-847	YOUR BALANCE SHEET
EC 71-848	YOUR INCOME STATEMENT
EC 71-849	CASH FLOW PLANNING WITH THE AID OF YOUR INCOME TAX RETURN
EC 71-850	CASH FLOW PLANNING WITH THE AID OF YOUR RECORD BOOK AND BUDGETING
EC 71-851	ESTIMATING YOUR FAMILY LIVING EXPENSES
EC 71-852	CASH FLOW PLANNING FORM
EC 71-853	BALANCE SHEET
EC 71-854	INCOME STATEMENT

THIS SERIES WAS DEVELOPED THROUGH THE COOPERATION OF THE FOLLOWING SUBCOMMITTEES:

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YOUR PLANS FOR PROFIT

An Introduction to a Series of Financial Management Circulars

by

Larry L. Bitney, Extension Economist (Farm Management)

Why Is Financial Management Becoming More Important?

Primarily because capital is becoming more important as a resource on farms and ranches. The basic resources from which you can derive profit are land, labor, and capital. Following are some reasons why capital is increasing in importance in relation to the other resources.

More Inputs Are Purchased

Many of the items which you now buy for use in producing crops and livestock formerly were farm-raised, or not used at all in farming. A common example is the tractor which was substituted for horses. This forced farmers to buy their "fuel" instead of raising it. More recent developments which have caused farmers to purchase more of their inputs are fertilizer, herbicides, insecticides, and irrigation. Thus, the portion of gross farm income which is committed to cash expenses continues to increase. The "built-in shock absorbers" which farmers have had in the past are gradually disappearing.

Substitution of Capital for Labor

Generally it is difficult to hire good, dependable, farm labor at prices which most farmers feel they can afford to pay. This fact has been instrumental in the decisions of farmers to invest increasing amounts of capital in labor-saving machinery and equipment. Also, some items of equipment save enough labor to make them desirable investments, even with fairly low labor prices. In addition to new types of machines, the present ones are constantly being made larger so that one man can accomplish more. Livestock enterprises have also been automated to save labor. This also means more capital invested.

Farm Size Increasing

In addition to capital becoming more important in relation to the other resources used in agricultural production, the capital needs **per farm** are increasing in an absolute sense as farms become larger.

The Result — You Need More Capital

The trends cited above are expected to continue in the future. As a result, more total capital will be needed for agricultural production, and the decreasing number of farms will cause the capital requirements per farm to rise faster than the total.

Where Will the Capital Come From?

Farmers have basically two sources of capital: 1) Owned and 2) borrowed. A third source which public corporations use is sale of stock, but this alternative is not utilized by most Nebraska farmers.

In the past, much of the capital needed for agricultural production was owned. Farmers re-invested profits in their businesses. The goal of most farmers was to get out of debt.

But, the structure of agricultural production changed — and is continuing to change. With today's capital requirements, most farmers have found it necessary to borrow substantial portions of their total capital requirements. In addition to the reasons cited earlier for increased capital needs, the pressures for growth of individual farm units has been, and will be, great. The farmers who are not growing are getting behind. This rapid growth requires capital faster than it can be generated by the farm business. Thus, it must be borrowed.

The increasing use of borrowed capital is borne out by the following table:

Year	Total Farm Debt (Billion Dollars)	Debt as a % of Assets
1950	12.4	9.4%
1960	24.8	12.2%
1970	58.1	18.6%
1980	120-140 (estimated)	30 % (estimated)

Changing Attitude Toward Borrowed Capital

Borrowed capital should be viewed as a resource. If it makes you more than it costs, it is profitable to use. The fact that your debt is increasing each year is not necessarily a problem, provided your assets are increasing as fast or faster. The problem is – you need to know what your net worth is each year. And if you are to use borrowed capital profitably, it must earn more on your farm than the interest which you pay. Thus, you must determine your true net income, and the return to capital.

Using this resource (borrowed capital) is not without risks. But, you can minimize these risks through better business practices on your part.

A New Approach to Financial Management is Necessary for Two Reasons

The first reason is you – with an increasing total volume of credit, and a larger percentage of your assets borrowed, your margin for error is reduced. A loss which you could take in stride if your debts were equal to 10% of your assets might bankrupt you if your debts were 50% of your assets. Thus, the need for you to plan and carefully evaluate each move becomes increasingly important as the proportion of your total capital which is borrowed increases.

The second reason is your creditor – as his claim against your business increases, he also wants to make sure that you "make the right decisions." He has a vested interest in your business. It is no longer sufficient to discuss your past performance and your plans for the future in a general conversation. He needs to see them on paper. Thus, when your creditor asks you to fill out a new form, it's not because he's losing faith in you, but because he wants to insure your success as a farmer, and his success as a creditor. As farm numbers decline, his farm loans become fewer, but much larger. Thus, the potential damage to his business from one of his farm loans going bad increases greatly. As a result, he is interested in doing the best job that he can as your financial advisor. But he needs good information on which to base his advice.

Three Basic Tools

There are many different "tools" available for you to use in financial management. Some are simple, some are very sophisticated, some are computerized. The following three "tools" are considered basic to good business and can greatly increase your financial managements skills:

1. The Income Statement
2. The Balance Sheet
3. The Cash Flow Plan

Following is a brief description of each of these tools and how they fit together as a team for better financial management.

The Income Statement

See Extension Circular EC 71-848 for instructions on how to prepare and interpret your income statement. EC 71-854 is the income statement form.

The income statement is also called a "profit & loss statement," or an "operating statement." It is a measure of your "true" net income for a single year.

On the surface, it seems like it should be fairly simple to measure income – receipts minus expenses. But, in a farm business you have productive assets like machinery which you buy in one year, but lasts several years. Thus, a depreciation charge must be made for each year over the life of the machine. Also, your business does not stop and start at the close of one year and at the beginning of the next. Inventories of grain, livestock, supplies, and growing crops are "carried over." Thus, an expense in one year might not be recovered until the next year.

The income statement provides a procedure for you to determine your net cash income and then adjust it for inventory change, depreciation, and unrealized changes in the value of real estate. Anything short of this does not give you a true reading of your financial performance in a single year.

To complete the income statement, you need a record of cash income and expenses, a depreciation record, and an annual inventory. You already have the first two of these for income tax purposes. The inventory figures can be "lifted" from your balance sheet which is described next.

The Balance Sheet

See Extension Circular EC 71-847 for instructions on how to prepare and interpret your balance sheet. EC 71-853 contains the balance sheet form.

The balance sheet is also commonly called a "net worth statement," a "property statement," or a "financial statement." It is a picture of your financial position at one point in time. A series of balance sheets over the years will show your growth in net worth. They will show how much of the income shown on your income statements has been reinvested in the business. That which has not been reinvested has either been used to pay personal income and social security taxes or for family living expenses.

The balance sheet should be prepared at the same time each year – at the close of your tax year (December 31 for most farmers) if the inventories are to also be used for preparation of your income statement. The balance sheet is a summary of everything owned (assets) and everything owed (liabilities).

The Cash Flow Plan

See Extension Circular EC 71-849 or EC 71-850 for instructions on how to prepare and interpret your cash flow plan. EC 71-852 contains the cash flow form.

The previous two "tools" show what you have done in the past. They give some indication of what you can do in the future, and what the financial condition of your business is. But the cash flow shows what you plan to do in the future. It is often called a projected cash flow.

A cash flow plan shows the sources, amounts, and the timing of your expected cash income and expenses. It shows when you will need credit, how much you will need, and when you should be able to make loan payments.

Normally, your cash flow plan will be for one year in the future. But, if you are anticipating a major change in your farming operations, you may want to project your cash flows for a longer period to see if you will be able to pay off an investment in machinery, buildings, or land.

Your cash flow plan helps your creditor serve you better. Sometimes it is necessary for him to make prior arrangements to cover a large loan. If he can anticipate the credit needs of his customers, he can give better service. Also, it takes many of the surprises out of lending money if he can see your anticipated credit needs for the year at the beginning of the year.

Two circulars provide instructions for filling in your cash flow form:

EC 71-849 Cash Flow Planning with the aid of your Income Tax Return.
Use this one if your records are limited, you don't have much time, and you are not planning major changes in your farming or ranching operations.

EC 71-850 Cash Flow Planning with the aid of your Record Book and Budgeting.
Use this one if you are making a major change in your farming or ranching operations or if you

would just like to develop a more detailed plan. This alternative will require more time, but it will give you more information about your business.

The projected cash flow shows what you plan to do at the time you fill out the form. If new events cause you to change your plans, the projected cash flow can be altered to reflect the change. Show the new cash flow plan to your creditor to see if he will go along with the changes. Thus, the cash flow plan does not "lock you in" to a certain plan. But it does provide a means for you to evaluate your plans, or changes in your plans, and to communicate them to your creditor.

Estimating Your Family Living Expenses (EC 71-851)

At least an estimate of your family living expenses is required in completing the cash flow form. Recognizing that most farm families do not keep records of personal spending, the circular named above is provided to help you estimate your family living expenses. Records are necessary, of course, if you want to determine exactly what your family spends for personal consumption.

Summary

The tools described in this circular can be your basis for skilled financial management. The income statement – to show your financial earnings in a single year; the balance sheets – to show your financial position at one point during each year as well as your financial progress; and the cash flow plan – to show your estimated cash income and expenses as well as your credit needs for the year ahead.

Each of these three tools can stand alone – or be a member of the "team." The balance sheet has been the most widely used of these three tools. But, the capital structure of today's farms and ranches make it advantageous for you, the manager, to have the additional information provided by the income statment and the cash flow plan.

The forms and instruction circulars described in this circular are available from your local County Extension Office.