15 THINGS YOU SHOULD KNOW ABOUT FARM FINANCES

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TABLE OF CONTENTS

Running a farm means managing everything from the ground up—both in the fields and in the office. Successful, profitable farm operations are rooted in careful budgeting, execution of and monitoring your budget, and excellent recordkeeping.

1. Why is Budgeting Important to a Farm Operation?

Your budget is a quantitative operational plan that identifies your goals and objectives and the resources you need to meet them. It identifies sources and outflows of funds, financing/capital needs, and expected profits for the period. A good budget uses historical data as a reference, anticipating costs and revenues based on this knowledge as well as an understanding of other internal and external factors that affect the operation.

A budget is a farm operation's plan of action. Without a budget, it's difficult—if not impossible—to effectively plan expenditures and match them to revenues to maintain profitability. A budget is also a tool for operational performance evaluation, allowing farmers to analyze and model the financial effects of various yields, input costs, prices, expansion models, and other factors. A comprehensive, detailed budget helps you control expenditures and prevent unplanned or unnecessary spending.

2. Why Are Good Financial Records Important to a Farm Operation?

Comprehensive, organized, and accurate financial records are essential to constructing a budget that accurately reflects your historical finances and helps guide your decision making for future profitability. This can enable you to become a proactive—rather than reactive—farm operations manager.

3. What Should a Farm Operation Look For When Selecting an Accounting Software Program?

Using a farm accounting system like AgManager can help you get the information you need to make major financial decisions on issues like expanding operations or production, adopting new technology, or taking on new partners. A good software program should help you identify and analyze trends in your operation and in the markets, allowing you to accurately assess the potential rewards and risks of major financial decisions and ongoing operational choices.

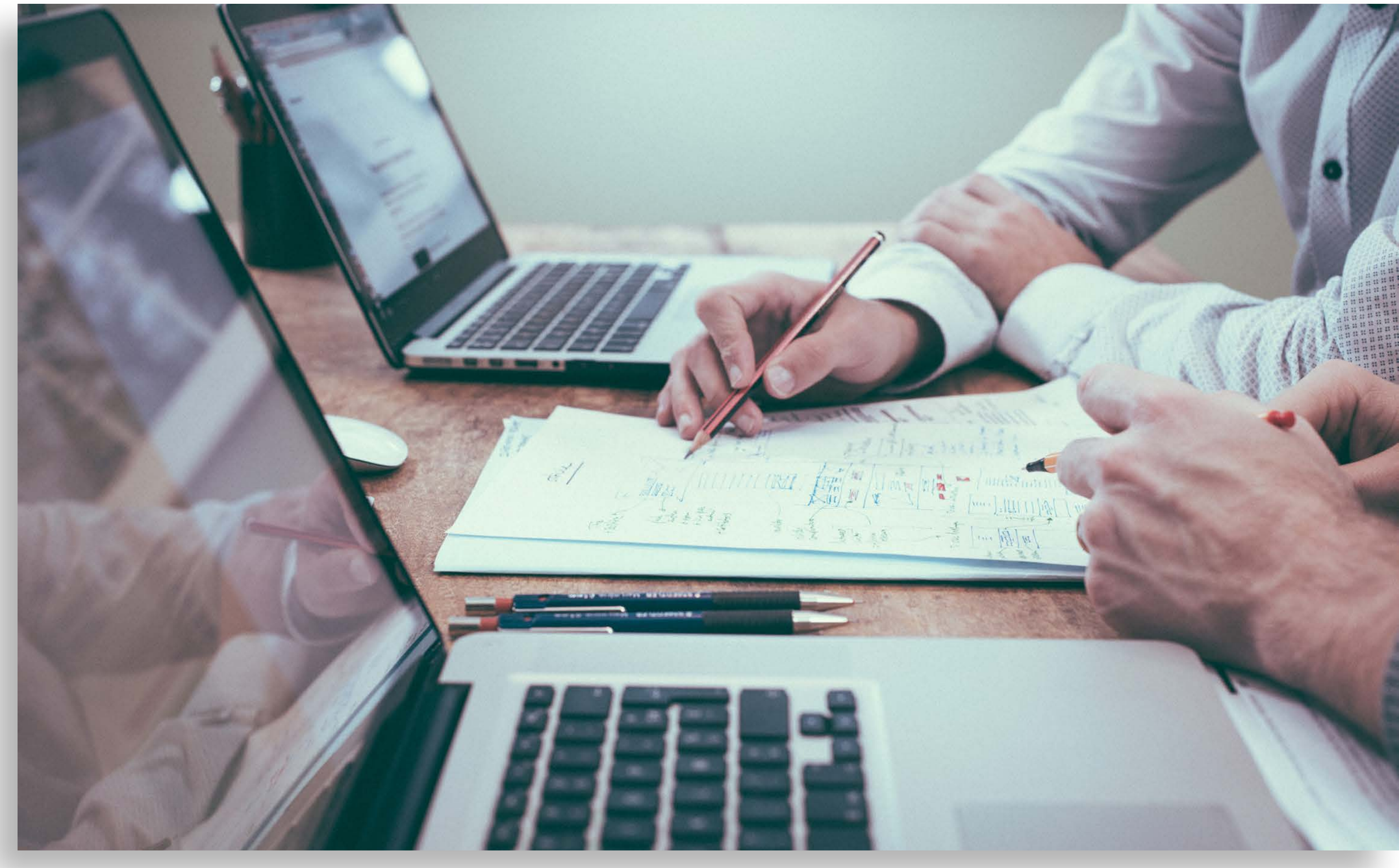
4. What's the Difference Between Entity and Managerial Accounting?

Entity-level or "financial" accounting gives a big-picture view of agricultural accounting, providing insight into how a farm is performing in both operations and capital management. It uses generally accepted accounting principles (GAAP) to evaluate past performance, looking at standard financial statements, balance sheets, income statements, and cash flow. It's generally used by entities like investors or shareholders, creditors, regulators, auditors, and government offices to evaluate a farm's financial health.

Managerial accounting, on the other hand, shows how an operation is positioned in real time and breaks down numbers and projections related to commodity, equipment activity, farm, and field, expressing quantities in bushels, gallons or units, per-head, or counter weight information. This can be used to assess progress, set goals, make plans, and evaluate outcomes.

5. What Will My Farm Operation Need to Prepare for a Meeting with a Potential Lender?

Before you meet with a potential lender, prepare a proposal or business plan that includes basic financial statements like a balance sheet (or net worth statement), operating statement (or profit and loss report), and cash flow statements. Be prepared to provide income tax returns from previous years, too. A good agricultural accounting software program can help aggregate and analyze past performance data and project future revenue and expenses. This can help give you a good foundation to successfully persuade a lender to invest in your operation.



6. What Are Some Basic Financial Process Guidelines?

Farms and businesses use basic accounting processes to record, report, and analyze financial information and determine the profitability of their operations. Standard financial processes and procedures are typically based on the basic accounting cycle: identifying, recording, and analyzing transactions, preparing and reviewing reports, and implementing reconciliation and review protocols. Hiring a specialized agricultural accountant can help farms of all sizes streamline their financial processes and maximize profitability.

7. What Are Some Financial "Don'ts" That Every Operation Should Know?

One common mistake is not paying enough attention to financial management from the outset. **Don't wait** to get your bookkeeping and accounting systems in place; keeping track of revenue and expenses is vital to building a successful enterprise from the ground up.

Don't hesitate to consult with a professional agricultural financial management and accounting firm to set up systems that will help your farm keep accurate records going forward. **Don't forget** to look at the big picture in addition to the day-to-day operations; an agricultural consultant can help you develop long-term goals and concrete measures to achieve them.

8. What are the Benefits of Working with a Professional Accounting & Consulting Firm that Specializes in Farm Operations?

A financial consultant can help analyze your business' financial health, establish a financial plan (budget), identify a plan of action to meet short- and long-term goals, and analyze your actual results on a defined schedule to determine if your operation is on target. A professional accounting and consulting firm that specializes in working with farmers understands the unique challenges that farm owners face and the special rules that apply to farms and has experience with the nuances and unpredictability of the industry. This helps the consultant understand and address your particular financial issues and formulate concrete actions and benchmarks to help your operation thrive.

A financial consultant can also assist in preparing presentations to prospective lenders to obtain funding during difficult times or when your operation is poised to expand. An accounting and consulting firm that specializes in farm operations knows the intricacies of the processes, procedures, and regulations related to agricultural lending.

9. What Can the History of My Operation Tell Me About the Future?

Analyzing the historical trends exhibited by a business is one of the best ways to predict future performance. These trends often forecast an operation's future successes, challenges, and opportunities. A historical performance analysis, or HPA, analyzes five years of financial results, including both income statement and balance sheet information, and gives a comprehensive picture of the business. Looking at five years' worth of data helps minimize the distortion that cash flow timing presents. It attempts to allocate expenses into the most appropriate production year, pull revenues back into the correct production year, and separate true operational costs from financing activities. This analysis allows you to get the most accurate view of your operation's year-by-year performance and create the most effective plan for future success.

10. How Do I Identify the Profitability of Each of My Crops or Livestock Areas?

To determine what are or can be your most profitable crops or best land use, you must capture and measure profitability. Accurate managerial accounting allows you to capture the direct and indirect expenses and the general, administrative, and finance costs associated with each crop alternative, reflected by each individual yearly production cycle. Specialized farm accounting software can help you analyze this data to understand your farm's profitability. Then, a skilled agricultural financial consultant can help you identify and target areas for improvement based on this analysis and develop a concrete, step-by-step plan to increase profitability.

11. How Do I Determine if My Farm Operation is Ready for an ERP Solution?

Enterprise resource planning software (ERP) is a complete package that integrates all the functionality of disparate business management systems into one unified application. It unites your payroll, accounts payable and receivable, accounting, inventory management, balance sheets, customer databases, and more. Having one integrated system allows you to streamline your operations, making your farm financials both more efficient and more accurate. While you may think that you can "get by" with separate, smaller solutions, doing a lot of data entry, invoicing, and reporting by hand, this not only wastes time but also sets you up for disaster. Mistakes or oversights in transferring data or errors in calculations can lead to issues with customers, fines, or loss of funding. The sooner you implement an ERP, the faster you can minimize these kinds of risks and focus your energy on growing your business.

12. What Ratios are Important for My Farm Operation to Understand and Monitor?

There are five main efficiency ratios that are important for you to understand and monitor to ensure your farm operation stays profitable and successful.

- **The asset turnover ratio** (gross revenues divided by average total assets) measures how efficiently farm assets are being used to generate revenue. An asset turnover ratio of 60% or higher is considered to be an efficient use of assets.
- **The operating expense ratio** (total operating expenses divided by gross revenues) shows the proportion of income being used to cover operating expenses (excluding the principal and interest on loans); the lower the percentage, the better.
- **The interest expense ratio** (total interest expense divided by gross revenues) should be less than 20%; more than this may indicate the farm is carrying a heavier debt load than it can sustain.
- **The depreciation expense ratio** (depreciation expense divided by gross revenues) expresses the amount of income that is required to maintain the capital being used by the farm operation. The lower the percentage, the better. Under 5% is considered strong, and a percentage higher than 15% means that the farm may be wearing out its capital too quickly.
- **The net farm income from operations ratio** (net income from operations divided by gross revenues) is the percentage of income left following the payment of all expenses. The higher the percentages, the better; 20 percent or more is considered to be strong. A net income-to-operations ratio of less than 10% can indicate that the farm is spending too much on expenses or interest or not producing enough income.

These financial ratios measure your progress over time, helping ensure that you continue to meet your lender's requirements and to allowing you to benchmark against your peers.

13. What are Internal Controls and Segregation of Duties, and Why are These Things Important to My Farm Operation?

Internal controls are the processes, checks, and balances that safeguard your assets. They help prevent fraud, ensure reliable financial reporting, and enable your farm to stay in compliance with applicable laws and regulations. One aspect of an effective system of internal controls is segregation of duties. This is the practice of requiring more than one person to complete a task. In addition to helping reduce risk, segregation of duties eliminates the pitfall of having a single indispensable person with complete oversight and knowledge of your operations.

14. What Makes Agricultural Accounting Different from Business Accounting?

Agricultural accounting services encompass basic business accounting services like bank statement processing, bill payment, payroll processing, balance sheets, reconciliation, and reporting. In addition, agricultural accounting encompasses specialized aspects that are not encountered in other industries, including special valuation rules for inventory, hedging transactions, dealing with cooperatives, and recording non-current farm assets. A skilled agricultural accounting firm should have not only business accounting experience but also extensive, in-depth knowledge of the industry and its unique requirements.

15. Why Consult with an Agricultural Accounting Consultant?

Every farm business owner should understand the basics of financial management and the importance of accurate recordkeeping. Learning the basics of accounting and debt and asset management will help you make your farm more efficient and profitable.

AgriSolutions' training courses address asset and debt management and help participants understand a wide variety of other farm accounting principles. We offer multiple levels of agricultural accounting services to ensure you have the on-demand, real-time information you need for tax, lending, and day-to-day operations management of your farm enterprise. Our skilled professionals can answer all your farm financial questions, from general inquiries to questions about specific situations your organization is facing.

Schedule a Consultation

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