AGRICULTURAL ECONOMICS

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Cornhusker Economics

Financial Analysis

With financial times like we are experiencing; it may seem like the worst time to invest more money into services that are not "required" but without solid financial information, you cannot make good, informed decisions. And with times like this, you need good choices.

Accrual vs Cash Income

The basis for a good financial analysis is getting to your accrual income. Accrual income is different than cash income, which is what most farmers and ranchers use to file their tax returns. The reason the vast majority of producers use this for taxes is because it's easy to control how much income is shown. This flexibility makes it not good for management decisions because it's so variable.

Accrual income shows the actual earnings of the business. It's sometimes easiest to think about it in terms of a crop-growing season. It's not uncommon that the income and expense for one crop is spread out over three years. Year 1 often has some prepaid expenses, Year 2 has most of the other growing costs and maybe some sales, and Year 3 has remaining sales. The accrual calculations take all those transactions and put them back into the same year.

Financial problems tend to show up faster on an accrual basis than on a cash basis. For example, 2021 and 2022 were unusually profitable years. Most producers deferred income, prepaid expenses, and purchased equipment to keep their taxable income lower than their actual earnings (accrual income). Even though 2023 and 2024 saw significantly deteriorated profits, most producers' tax returns will not show a difference as the prior year's earnings that were deferred have not been taxed yet. In other words, most producers will still have cash flow and taxable income and won't "feel" the decline in profitability as sharply as their accrual income actually was.

These "red flags" highlighted by accrual income allows producers to make changes to their operation as soon as they are indicated rather than waiting for all their cash reserves to disappear and multiple years of loss occurs.

Measuring your earned net worth increase or decrease from your annual balance sheets will give some insight into your accrual earnings but a net worth decrease could occur with farm profitability if family living is more than earnings. At the same time, you could have a net worth increase due to inheritance or other non-farm sources and be experiencing farm losses.

Getting accrual income requires more information than a tax return does. The beginning and ending balance sheets need to match the accounting records, creating bookends for the year. In other words, if your accounting records are from January 1st – December 31st, we need the balance sheets to both be dated December 31st. The balance sheets also need to include detailed loan information. Once we have these balance sheets prepared, most banks are happy to use our information to help speed up renewal time as well.

Cost of Production

Once you see "red flags" a whole farm look at accrual income doesn't give us enough information to know "Why"? We really need to dig into your costs per production unit. That may be per acre, per pound, per head, etc. A whole farm analysis could tell us your accrual fertilizer costs were $200,000 but until we add in how many acres, do we know if that cost is a part of the problem? For example, if you farm 500 acres, that fertilizer cost is likely a part of the problem but if you farm 2,000 acres, it's not unless you're under-fertilizing and not getting the yield you could.

Getting good cost of production information requires more detail in your records than a tax return does. We need to have some costs broken down by enterprise. Major costs like Seed, Fertilizer, Chemicals, and Feed make the most difference in the cost of production. For example, most times we see a significant difference in the cost of fertilizer applied to corn vs soybeans. Other costs like utilities, overhead insurance, and depreciation may be better split per unit after the fact. If you allocate the fertilizer evenly, you're distorting your costs per bushel which doesn't give you good information to build a marketing plan or a production plan for the following year.

Benchmarking

Benchmarking has certainly been the buzzword in farm finances for a few years now and for good reason. Benchmarking allows you to compare to others to know if your costs are in line with your peers but it also works to compare to your history. Both ways to benchmark are important. For example, let's go back to our fertilizer example. If you spent $200,000 on fertilizer and farmed 1,300 acres, your per-acre cost is $153. Without benchmarking to peers, you wouldn't know if that's a reasonable cost or not.

At the same time, there are measures that may make more sense to benchmark to yourself. For example, your debt-to-asset ratio may be 70%. The average would show something closer to 30% so benchmarking to your peers would look like you're in a bad place. 70% isn't a good debt-to-asset ratio anytime but if you are beginning your farming career and had an 80% ratio last year it's an improvement and maybe not something to panic over. When starting out, high debt-to-asset ratios are common and making annual improvements to the number is the goal. Focusing on improving your number may be more important than how you compare to a peer group that likely includes established operations.

Making Informed Decisions

Informed decisions take time and investment in good records, but they can be the difference between a successful operation and one that struggles to keep up. Here are a couple of real examples that made a difference for operations we work with.

> *I was once working with a farm to put together a cash flow. I always ask what their capital purchase plans are for the year. The answer was, "I really need $40,000 to build a fertilizer trailer." I put that in and finished up the rest of the cash flow and the result wasn't great. The producer leaned forward and said, "If I use some used parts and things I have around here, I bet I can do the fertilizer trailer for $25,000. What does that look like?" The answer was better but still not great. At the end of year, I was back with that farm and he didn't do the fertilizer trailer at all.*

He used his cash flow based on his actual costs to make an informed decision that went against his gut feeling. It would be nice for a numbers person like me to always have every decision based solely on numbers but that's not reasonable either. In this case, the numbers helped him see the difference between what would be nice to have and what he really needed.

> *I was working with another operation whose costs were just too high and it was causing consecutive annual losses. Their costs for seed, fertilizer, chemicals, and crop insurance were higher than their projected gross income and that didn't consider the other costs of doing business. The input decisions were recommended by an agronomist, so I challenged the producer to go back with the numbers and ask the agronomist to re-evaluate. Whether it was different inputs, a different crop, or abandoning those fields, a change was needed.*

They were able to come up with a better plan that gave the operation a chance at financial success because they had the information to make a good decision.

These same sorts of decisions can be applied to your marketing plan, family living spending, and many other decisions you make. The investment in a financial analysis can seem like a painful task of gathering information but the information it provides gives you invaluable information about your operation, especially when you don't want to see it. I was once told a producer didn't want to do the analysis anymore because the information made it hard to sleep at night. While not knowing maybe helped him sleep then, the problems that were being highlighted by the analysis didn't go away and eventually caught up to him.

If you are interested in a financial analysis, you can find more information at our website www.nfbi.net or by calling 402-464-6324.

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