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**Better Business Management Through
Financial Management**

By

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Better Business Management Through Financial Management¹

While most farmers and ranchers recognize the importance of strategic planning, recordkeeping and analysis, financial management, and marketing, their preference is to concentrate on the production aspects of their business. Focusing on production management may lead to continued business success if all aspects of the business meet or exceed expectation. However, economic forces can alter the rate of inflation, cause commodity prices to fluctuate, and policy changes can influence the level of governmental support of change the agricultural operating environment. Additionally, changes in the business environment caused by advances in information and biotechnology and increasing global competition will continue to indicate that a production focus to business management is insufficient for sustainable success of today's farms and ranches.

Continued success of the farm or ranch will require that managers adopt more business management practices. This will require more emphasis on keeping and analyzing business and financial records, using that analysis for strategic planning and for conducting profitability and repayment analyses. The production aspects of a farm or ranch will still require attention to detail, but that attention should also include monitoring and control of the production aspects of the business. The process of monitoring and controlling production can only be achieved through a complete analysis of the business. A complete analysis of the farm or ranch business will include an analysis of the enterprises that comprise that business. Successful managers will need to know that each input contributes to the overall profit of the operation, not just contributing to greater production. An economic analysis of benefits obtained versus the cost of achieving those benefits should become as common an activity as feeding the livestock or planting the crops. Successful producers will commit to balancing their time between analysis of the markets, financial analysis, planning for the future, as well as performing the production tasks of their operation. Thus, future success will depend on the manager's ability to balance priority aspects of the business.

Tools of Business Analysis

The adoption and use of basic analytic tools is the only avenue by which the path to success can be followed. The first step along the path to success is for the producer to ask and honestly answer the following questions:

- Is my production efficient? Do I achieve all I can from my resources?
- What is MY cost of production?
- Do I have a marketing plan? Does that plan include market analysis and account for the breakeven price needed for what I produce?
- Have I prepared an appropriate business plan?

¹ This information has been adapted for use in South Dakota from *Financial Management: The Key to Farm-Firm Business Management* authored by Jose Pena, Danny Klinefelter, and Gerald Warmann; RM5-10.0:8-98

- Does the business provide adequate income for family living?
- Do I have a risk management plan?
- Is the record system up to date and providing the necessary management information?

Management Analysis

The answer to the questions listed above can only be achieved through an analysis of not only the production practices, but also through an analysis of management practices. To obtain the necessary answers, producers will need to possess financial and marketing management skills. If the producer discovers that they do not have the necessary skills, they need to participate in management education workshops. While they are participating in these workshops to gain the necessary knowledge they need, farmers and ranchers can rely on outside sources to assist them in the analysis of their business. These outside sources might be accountants, lenders, or other agricultural professionals such as the Cooperative Extension Service.

Professionals assisting farmers and ranchers are encouraging the development of farm/ranch business plans. These business plans outline the risks of the business, the management of those risks, and the how the business will generate a sufficient level of profit. Most business plans start by having farmers and ranchers specify what their goals are for the business as well as the farm/ranch family. Business plans should also identify what resources are available to help achieve those goals. The inventory of resources will include both personal resources (special skills or knowledge) and business resources (soil types, production history, available markets, and financial resources).

The Planning Process

The resource inventory developed for the first step of developing a business plan provide the foundation for deciding what production enterprises, which marketing tools to use, and for comparing alternative production, marketing and financing plans. The specified goals indicate what level of performance needs to be achieved.

Once the enterprises, tools and alternatives have been identified, a long-range plan for the operation can be developed. This plan may indicate that no or few changes are anticipated, or it could indicate a significant shift from current business practices. If the plan indicates changes to the operation are necessary, the implications or results of those changes should be incorporated into the long-range plan. SDSU Extension Economics utilizing FINPACK financial analysis and planning computer software can assist producers in developing the long-range plan for their operation by assessing the financial impacts of any, or no, changes to the operation.

The development of a long-range plan will include:

- a. An understanding of the goals to be achieved.
- b. A listing of the resources that will be utilized
- c. An enterprise production plan. This plan will include which enterprises can be considered in the plan and any production history that would influence the prediction of production performance in the future. If changes to the current operation are being considered, predicted performance will have to account for how quickly those changes could be implements and what the performance improvement will be over time. Enterprises should be developed to determine is production efficiency can be

improved and what financial performance may be expected (breakeven cost of production needs to be specified).

- d. A marketing plan for the enterprises being considered. The marketing plan should include an assessment of fundamental market factors, market outlook, and which marketing tools may be used to achieve price objectives.
- e. A plan for capital investment that would detail which, when, and at what cost, capital improvements are anticipated.
- f. A financial plan detailing how much and when operating and term debt would be utilized.
- g. An analysis of factors that may influence future decision making such as any anticipated changes in government farm programs, the economy, specifically the agricultural sector (e.g., inflation, interest rates, taxes), and technological developments.

Farms and ranches that desire to be successful in the future will implement a process of assessment and control. Managers of these operations will find that this aspect of their business will be a continuous process as things don't always occur as planned. As part of the assessment and control process, detailed records will need to be kept and used. Financial statements (Balance Sheet, Income Statement, and historic Cash Flow Statement) should be prepared on at least an annual basis. The financial statements will be needed for credit applications and for evaluating net worth, profitability, economic efficiency and financial structure. In addition, projections of enterprise and financial performance should be done so that "what if" analysis can be conducted and the operation adjusted as often as necessary.

Financial Analysis

Success of any business is usually measured by financial measures in the areas of (1) profitability, (2) liquidity, (3) solvency, and (4) efficiency. While most farm and ranch operators are very skilled in the technical and production aspects of their businesses, they are unfamiliar or uncomfortable with financial measure of business success. Many times the records of the operation are the responsibility of the spouse or a bookkeeper or an accountant. For some managers, the extent of the "business analysis" they do is to sign their tax forms or assist in the inventory numbers included in the financial information provided to their lenders.

Good business and financial management includes an analysis of the profitability, liquidity, solvency, and efficiency of the business. Using good business management and accurate production and financial statements enables the farmer or rancher to determine the financial position and performance of the business at any time. Modern managers are able to evaluate where the business is, has been, and is going. Many times businesses failure can be traced back to the manager not having adequate information in order to be able to recognize a problem, or an opportunity, in time to take action in a timely manner.

Financial Statements

The most common and predominately used financial statements are the Balance Sheet, Income Statement, and Cash Flow Statement. These statements are helpful for summarizing a farm's or ranch's financial position, for demonstrating managerial ability, and allow for analyzing financial progress and for forward planning.

Balance Sheet

The balance sheet is sometimes referred to as the statement of net worth or the statement of financial position. The balance sheet is a summary of all assets and liabilities of the business at a specific point in time. For comparisons over time, it is most useful if the balance sheet is prepared on or about the same date every year.

Income Statement

It is useful to prepare an income statement at least once every year. This statement details the profitability of a business over a specified period of time by detailing the income generated, the expenses incurred and the resultant net business income earned. The most common period of time used for developing the income statement is the business year – the same period of time on which income taxes are calculated.

Cash Flow Statement

The cash flow statement details all sources of cash income and all uses of cash for a specified time period. The time period should correspond to the same time period used for the balance sheet and income statements. The cash flow statement may also detail non-business income, family living expenses, borrowing transactions, and tax payments.

Using and Analyzing Financial Statements

Farmers and ranchers need to use the information provided by the balance sheet, income statement and cash flow statement in order to measure and understand business performance. Only by analyzing the components of all three financial statements and their interrelationships can a clear picture of financial position and performance be developed. Other fact sheets in this series provide more detail on the individual financial statements and their use in managing the business.

Test Yourself on Financial Management for Better Business Decisions²

Indicate whether each of the following statements is true (T) or false (F).

- T F 1. Planning is more useful when uncertainty about future trends and events is less than normal.
- T F 2. Short-range planning is more important than long-range planning.
- T F 3. Because all farmers and ranchers face the same environmental trends, their plans are likely to be very similar.
- T F 4. Planning is often put off because it requires you to face up to reality, resolve conflicts among family members and admit that you don't have all the answers.
- T F 5. Strategic planning takes a long-range view in order to anticipate changes in agriculture, rather than reacting to them day by day.
- T F 6. Planning will help guarantee success.
- T F 7. Identifying goals is an important part of the planning process that should be done after your plan is developed. so you will know which goals are feasible.
- T F 8. Planning will reduce risk.
- T F 9. Because everything is so unpredictable in agriculture, a long-range plan should look ahead no more than one year.
- T F 10. Planning involves predicting future events that will affect your farm business.
- T F 11. After you have developed your plan for the next five years. you should consider revising it before the end of the first year.
- T F 12. It is not necessary to write out your goals as long as you have them in mind.
- T F 13. Your most important resource is not your land. capital or labor, but your management ability .

² This assessment exercise is taken from *Business Management in Agriculture*, a video tape based educational program. *Business Management in Agriculture* was financed and produced by the Cooperative Extension Service, United States Department of Agriculture, Washington D.C., and Farm Credit Bank of St. Paul, Minnesota.

- T F 14. The first step in analyzing the strengths and weaknesses of your business is to compare your past performance with your goals.
- T F 15. Opportunities and threats resulting from changes in your environment suggest what you can and should do to have a successful business in the future.
- T F 16. As you develop your long-range plan, you should specify all the decisions to be made over the next five years.
- T F 17. It is better to be cautious and not commit yourself to decisions until you have all the information you need.
- T F 18. Once you have planned what you should do, implementation is automatic.
- T F 19. Evaluating your plan by comparing what actually happened with what was planned is important so you can explain to your lender why the loan cannot be paid on schedule.
- T F 20. Doing a thorough job of planning should reduce the possibility that future events will catch you by surprise.

Test Yourself on Financial Management for Better Business Decisions

Answer Key

- T F 1. Planning is more useful when uncertainty about future trends and events is less than normal.

Comment: False. Planning is more important when conditions are dynamic. Strategic planning involves anticipating future possibilities while current decisions are being made and thinking through what business adjustments will be made depending on what happens in the future.

- T F 2. Short-range planning is more important than long-range planning.

Comment: False. Both are important, but long-range planning is needed to determine the direction for short-range planning. It is important to consider long-range possibilities in the development of your short-range plans.

- T F 3. Because all farmers and ranchers face the same environmental trends, their plans are likely to be very similar.

Comment: False. Plans for any two farm operations will not be the same because of differing goals, resources and perceived opportunities.

- T F 4. Planning is often put off because it requires you to face up to reality, resolve conflicts among family members and admit that you don't have all the answers.

- T F 5. Strategic planning takes a long-range view in order to anticipate changes in agriculture, rather than reacting to them day by day.

- T F 6. Planning will help guarantee success.

Comment: False. Planning cannot guarantee success, but it should improve your chances of achieving your goals by making you aware of resources you have available, strengths and weaknesses of your past performance, and opportunities and threats posed by your environment. Planning can also help keep you on track and help convince your lender that your business is a good credit risk.

- T **F** 7. Identifying goals is an important pan of the planning process that should be done after your plan is developed so you will know which goals are feasible.

Comment: False. Identifying goals is the first step in the planning process. Your goals determine the direction the planning process will take and are needed to carry out other steps in the process.

- T **F** 8. Planning will reduce risk.

Comment: False. Planning will help you assess risk and develop approaches to cope with it.

- T **F** 9. Because everything is so unpredictable in agriculture, a long-range plan should look ahead no more than one year.

Comment: False. Even though everything is changing in agriculture, agriculture involves long-term production processes, making it important that plans extend for more than one year. A planning period of at least five years is needed so that you can anticipate future conditions, whatever they may be.

- T **F** 10. Planning involves predicting future events that will affect your family business.

Comment: False. Planning does not predict the future. It recognizes, however, that there are probabilities associated with future events and bases a plan on these probabilities. The purpose of planning is to identify and better understand how future events and trends might affect your farm business.

- T** F 11. After you have developed your plan for the next five years, you should consider revising it before the end of the first year.

Comment: True. A strategic plan is a flexible plan that should be revised when new information indicates it should be. The plan should be reconsidered at least once a year.

- T **F** 12. It is not necessary to write out your goals as long as you have them in mind.

Comment: False. It is important to have your goals in writing so that relationships (competitive/complementary) can be examined, priorities can be set, cooperation among family members can be encouraged and so there will be a written reminder to motivate your everyday decision-making.

- T** **F** 13. Your most important resource is not your land, capital or labor, but your management ability .
- T** **F** 14. The first step in analyzing the strengths and weaknesses of your business is to compare your past performance with your goals.
- T** **F** 15. Opportunities and threats resulting from changes in your environment suggest what you can and should do to have a successful in the future.
- T** **F** 16. As you develop your long-range plan, you should specify all the decisions to be made over the next five years.

Comment: False. Your plan should include only those decisions that need to be made now. However, you should consider what effects your decisions will have on the business over the next five years.

- T** **F** 17. It is better to be cautious and not commit yourself to decisions until you have all the information you need.

Comment: False. You will never have all the information you need to make a decision. Although you should consider all information available and proceed cautiously, acting promptly is important in order to take advantage of opportunities and remain competitive.

- T** **F** 18. Once you have planned what you should do, implementation is automatic.

Comment: False. If it were automatic, the job of management would be much easier. Seeing that your plan is carried out involves important challenges of motivating other people, acquiring necessary resources, dividing jobs into smaller tasks, scheduling work and monitoring progress.

- T** **F** 19. Evaluating your plan by comparing what actually happened with what was planned is important so you can explain to the lender why the loan cannot be paid on schedule.

Comment: False. The most important reason for evaluating your plan is to help managers improve planning skills.

- T** **F** 20. Doing a thorough job of planning should reduce the possibility that future events will catch you by surprise.

Comment: True. You may be disappointed, but you should not be surprised.