Business point

Risk raises records

Editor's note: *Kent Vickre and Chuck Cagley write a tax and finance column for each issue of Pioneer* GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Cagley is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*

FBFM

IOWA FARM BUSINESS ASSOCIATION

Farmers will face additional risks in the next few years for three primary reasons, according to "Farm Economics Facts & Opinions" (FEFO 07-13), by Gary Schnitkey, University of Illinois professor of Agricultural and Consumer Economics.

1. Price variability likely will be higher the next several years. Standard deviation estimates for price variability of corn and soybeans indicate they'll double for the 2007 crop.
2. Federal commodity programs won't provide as much downside price protection. A continuation of the concepts in the 2002 Farm Bill would cause loan rates and target prices to be significantly below expected prices.
3. In periods of high prices, crop revenue must fall further before growers can collect insurance payments.

With a likely increase in price volatility and dramatically higher production costs and cash rents, growers will find few substitutes for good financial planning. A few farmers may have sufficient financial resources to follow the same "do it as I have in the past" philosophy. However, most of us will need to do an even better job of financial planning to avoid some significant losses.

This suggests a need for an even greater knowledge and understanding of your business. You'll need to monitor and manage more than ever. It takes us back to good historic cash-flow information for basing cash-flow projections.

The road to red ink

Most sole-proprietor farmers use a single-entry farm accounting system. Too many are still on what we call the "good intentions system" of keeping records: We post only the income and expense items of the business. This system will continue to meet minimal accounting needs, but many farmers are going to find they need to improve and add to this system.

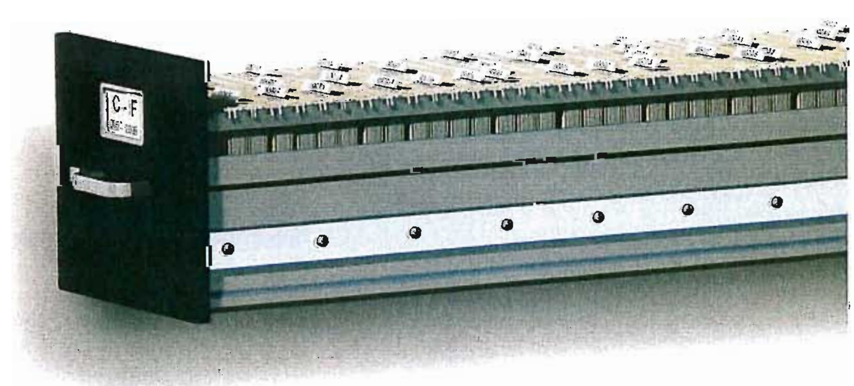
Large-volume businesses, highly leveraged expanding operations and multi-operator organizations are just a few of the businesses that will benefit from a monthly reconciliation of records. Surprisingly, it's not just those on manual record books. All too many operators using a computer fail to reconcile.

Many farm management association field staffers refer to this reconciliation procedure as "cash-flow accounting." In this system, the words "cash flow" refer to historical data in contrast to the cash-flow projection connotation used by many lenders. It's a check-and-deposit accounting system in which the bank statement serves as the cash journal and users reconcile the record book with the statement.

The value of reconciliation

Most of the farm software programs contain an intuitive program to reconcile with the bank statement. Unfortunately, not all users use it because they fail to post some of the personal expenditures. We see several reasons to encourage agribusinesses to adopt this procedure:

1. The only way to be sure you avoid omissions or duplications is through a mathematical procedure.
2. Reconciliation provides a mechanism to monitor the business monthly throughout the year and measure progress.
3. Monthly historical data provides an excellent source of information on which to base cash-flow projections.
4. Reconciliation organizes your records and makes it much easier to provide information needed in an income tax audit.
5. Corporations, partnerships and other multi-operator business structures, for the protection of all parties, should accept nothing less than such a complete accounting for all funds.
6. The greatest benefit may be



review requirements

gaining "financial control" or a better awareness of what's happening in the business financially.

Discipline takes time

The procedure to complete the cash flow is not complex, but it requires discipline to post regularly. Farmers who generate checks with the computer have the added benefit of being current on all check transactions at all times. Others who input into the computer or post in a manual record need to discipline themselves to post soon after they receive each month's bank statement (if not more often). It's also helpful to prevent other people or agencies from bypassing your system for controlling flow of cash.

Recently we seem to be observing fewer lenders asking for cash-flow projections. With our volatile agricultural economy, that's probably the wrong way to go. Tremendous increases in operating inputs as well as cash rents have the potential to generate a whiplash effect that could spell disaster for the lackadaisical manager.

Think of both the "historic cash flow" and the "cash-flow projection" in terms of what's best to help you manage your business. Don't look at either as just a hurdle someone else is asking you to jump over. A thorough cash flow projection likely will include information from several sources.

Base projections on history

The historic cash flow we refer to above may be the best basis for budgeting labor, fuel, repairs, drying, storage, utilities, insurance, interest and principal payments, and other miscellaneous expenses. You may find it most accurate to budget fertilizer, pesticides and seed from per-acre and per-unit charges. Cash rents and real estate taxes are probably known amounts you can budget accurately.

You'll understand the importance of recording all transactions when you try to project family living expenses, medical expenses, life and health insurance, contributions, etc. Previous years' actual totals should be a pretty good guideline. Estimates of income tax liability should be easy as you finalize income tax planning late in the fall.

See where you're going

Many farmers don't realize it, but if you summarize cash-flow projections — calculating account totals, bringing in revenues and adjusting for inventory changes — you've prepared a proforma income statement. Some people are surprised to see they've just planned a sizable loss for the year.

Financial management doesn't really begin until you start to compare the actual against the projected. Financial control will come about as you gain a better awareness of your costs.

On grain farms, you may prefer to budget quarterly rather than monthly. But the comparison of actual versus planned or projected helps you become a better planner and ultimately a better manager. Greater financial awareness about your business and the better management that results may be the advantage that ensures your success.

Comparing historic cash flow helps you make projections and improve management.