farm CREDIT MID-AMERICA | INSIGHTS REPORT

**VOLUME 06 WHAT'S INSIDE**

Understand the hidden costs that come with equipment, labor and family living expenses

Economic downturns create risk, but they also generate opportunity

When it comes to calculating working capital and cash burn rate, there are common misconceptions and mistakes

Every farm, business and community is unique. How can you adapt to changing local risks and opportunities while also keeping an eye on global trends and the nation's economy? With nearly 100 local offices and more than 1,200 employees, Farm Credit Mid-America is constantly working to help farmers in Indiana, Ohio, Kentucky and Tennessee leverage the economics of change in their favor. This report shares some of our insights to help you manage your operation and stand strong in today's competitive, ever-changing marketplace.

Vince Bailey
*Vice President Credit–Agribusiness*

LOOK BEYOND YOUR OPERATION'S TAX RETURN TO FIND COSTS THAT COULD BE TRICKLING DOWN YOUR BALANCE SHEET

## ARE HIDDEN COSTS AFFECTING YOUR BOTTOM LINE?

Are you using your tax return to track your operation's expenses? If so, you're probably not getting the full picture. Most farmers are good at tracking the money that comes in and goes out, with the goal of filling out tax returns and farm income statements. However, there are non-deductible costs that won't appear on any end-of-the-year tax forms, but will still affect your bottom line. With the ag economy facing challenges and many operations seeing their working capital position tightening, there is no better time to examine all expenditures.

Above all, pay special attention if you think you're making money, but your working capital position continues to decline. This can be a key indicator something isn't adding up in your operation's finances. There are three major areas that often house hidden costs for farmers: family living expenses, principal payments, and asset efficiency and labor costs.

### Pay your family a salary

Families keep an eye on large expenses, like home mortgages and car payments, but all costs of living should be tracked. Smaller withdrawals for everyday expenses can easily balloon if not properly controlled. Before you know it, your operating loan could actually be financing your family purchases. Over time, seemingly inconsequential costs can make a dent in your balance sheet, but they can be invisible because they aren't stated on the farm's tax forms.

A better method for controlling the cost of family living is to think of your family budget as a salary or stipend paid out from the operation. The best way to do this is to cut a single monthly check to the family and put it in an account separate from all operational expenses. This way, the cash your family has on hand is finite and it's also much easier to track how much your family spends annually.

Principal payments and asset efficiency

All term debt principal payments are paid from cash left over after living and income taxes are paid. What does that mean? Let's look at a simple calculation using just the schedule F from the tax return. We will keep it simple and assume cash accounting:

**CASH INCOME ANALYSIS**

| | | |
|---|---|---|
| Net farm profit line 34 Schedule F | | $75,000 |
| + | Non farm income front page | 35,000 |
| = | Taxable income | $110,000 |
| - | Income taxes (20%) | (22,000) |
| - | Family living | (55,000) |
| = | Net earnings | 33,000 |
| + | Depreciation line 14 Schedule F | 125,000 |
| = | Cash available for principal payments | $158,000 |
| - | Total principal payments | (175,000) |
| **Cash flow** | | **($17,000)** |

In this example, the operation is showing taxable income and net earnings after income taxes and living is paid, but cash flow is negative. This calculation is the beginning piece of what lenders refer to as a debt coverage ratio, or DCR. This negative cash flow transfers directly back to the working capital on the balance sheet. Additionally, if you choose to pay cash for any capital assets in the year using this example, 100 percent of the cash used for the purchase reduces working capital.

Be wary of the Section 179 trap. If you purchased a new tractor and chose to fully depreciate it in the purchase year using the 179 Deduction, but borrowed money to buy the tractor, you may have reduced your ability to manage your tax expense the following year. Using the example above and assuming $75,000 of section 179 depreciation was used when the tractor was purchased, you gave away your depreciation tax shelter and now must generate enough net earnings (after tax income) to cover the principal payment on the loan going forward. The table at right shows the impact on cash flow for the following year, assuming the only difference is the lower depreciation and the resulting tax expense.

Labor and equipment are tied together

The employees you need are directly tied to the equipment you have. An extra combine means your operation needs an additional driver, and maybe an additional tractor and cart, and semi or two, with each needing an operator. Too much or underutilized equipment will have a trickle-down effect and result in your operation spending more than necessary. While labor costs will be present on the farm income statement, the cost of unnecessary labor will not be stated. Think of capital as finite. Every dollar you invest in equipment and labor is a dollar that can't be invested in land or other assets, or used to build working capital.

**CASH INCOME ANALYSIS**

| | | |
|---|---|---|
| Net farm profit line 34 Schedule F | | $150,000 |
| + | Non farm income front page | 35,000 |
| = | Taxable income | $185,000 |
| - | Income taxes (20%) | (37,000) |
| - | Family living | (55,000) |
| = | Net earnings | 93,000 |
| + | Depreciation line 14 Schedule F | 50,000 |
| = | Cash available for principal payments | $143,000 |
| - | Total principal payments | (175,000) |
| **Cash flow** | | **($32,000)** |

Fortunately, there are many ratios that can be used as a general guide to help you plan for labor. Depending on the kind of operation you own, these ratios can be based on how many head of cattle you have, the bushels your operation produces, etc. In addition to standard labor models, there are a few other questions you may want to consider: Does my operation need all the equipment it has? Is the operation making enough net income to support all the family members currently working on it? Are there ways production could be more efficient that could ultimately reduce labor needs? If you haven't done so, it may be worth investing in workflow software that can help with more efficient tilling, planting and harvesting. Labor-related questions can be a tough call for any farmer, but as margins continue to tighten, it is worth reassessing.

If you're noticing your working capital position or margins declining, take care to assess the above situations. There are many costs that can have a negative impact on your balance sheet that may not be apparent when completing a tax return. Cutting your family one monthly check, revisiting the true costs of your assets and reassessing labor can each go a long way to ensure your operation's financial health. ✤

Gordon Hanson
*Chief Risk Officer*

COMPLETE FINANCIAL INFORMATION CAN OPEN DOORS, EVEN IN A DOWN MARKET

## RISKS AND OPPORTUNITIES IN TODAY'S AG ECONOMY

Whether we like it or not, an ag economic downturn is settling in. What started slowly in the grain sector a couple years ago is now spreading more broadly across the agricultural industry. And, despite an occasional rally in the grain market, most experts forecast up to several more years of low grain prices and elusive profits for most farmers. However, it is critical to remember that while economic downturns create risks, they also create opportunities. Do you know how you stack up in the face of current economic conditions and how you should respond?

### Risk or opportunity for you?

During an economic downturn, many folks definitely need to hunker down, cut costs and weather the storm, while others may actually be in an excellent position to take advantage of the uncertainty and expand their businesses. Ag economic downturns typically see equipment values decline along with land values and cash rents. This can create a rare opportunity to expand your operation at discounted prices. But how can some farmers bear the brunt of the increased risks while others are poised to seize rare opportunities — all during the same downturn? Because financial strength, cost structures and overall financial performance vary significantly.

Complete and accurate financial information is essential for understanding if you face more risk or more opportunity in the current and unfolding ag environment. Proper financial statements measure your financial health and performance, providing critical insight into both your ability to withstand risk and your ability to seize upon available opportunities. Consider the following in preparing your financial statements:

- List all assets on your balance sheet, including financial accounts (checking, savings, investment and retirement) and interests in partnerships and other legal entities.
- Use current and realistic values for all assets, including many that fluctuate in value over time. This includes land, equipment, livestock and grain inventories.
- Record all liabilities on your balance sheet, including bank loans, private party contracts, open accounts with suppliers, credit cards and any other unpaid bills.
- Recognize that your earnings information (income statement and/or tax return) and family living expenses should reconcile with changes in your balance sheet information.

Critical decisions have to be made during stressed times, and these actions, or inactions, have significant positive or negative implications for a long time. High-quality, complete financial statements provide you with the essential information you need to make the right decisions for your operation.

### Using your lender as a valuable resource

Any lender can give you money; your lender should also be able to deliver valuable expertise. And a strong value-added relationship needs substantive, two-way communication. You can do your part by asking your lender meaningful, probing questions. For example:

- Have I provided complete and sufficient quality financial information?
- How does my financial position and performance compare to my peers?
- How can I determine if I need to focus on reducing costs and weathering this downturn, or if I am well positioned to expand my operation through marketplace opportunities?

These types of questions demonstrate openness, interest, and a healthy drive for improvement and business success. And, perhaps more important, you can obtain valuable information, perspective and business insights, all while building trust and confidence between you and your lender.

## "High-quality, complete financial statements provide you with the essential information you need to make the right decisions for your operation."

What should you expect of your lender?

Your lender will have various expectations of you, but you should also have things that you expect of your lender, things that deliver meaningful value to you. For example, your lender should:

- Be able to assist you, if and as needed, in developing your financial statements.
- Have deep expertise and substantial history in your industry.
- Be able to answer a wide variety of questions, including the questions noted below.
- Be able to consistently provide you with credible and insightful information and perspective.
- Be able to deliver a long-term fixed rate on real estate mortgages, truly locked in for 10 to 30 years, to provide you and your operation with long-term financial stability and security.

A competitive interest rate is important, but you should also expect substantial value-added expertise and products that help secure your long-term financial future.

Find a value-added lender

In our four-state lending territory, we are having deep and meaningful conversations with our customers every day, and it's clear they are actively seeking to understand both the risks and the opportunities in today's ag economy. While many are experiencing financial challenges, others are finding strategic opportunities. The stakes are high. Expanding at the wrong time or in the wrong way can unnecessarily jeopardize your farm operation. On the other hand, not seizing opportunities at the right time can cause you to miss out on rare and profitable possibilities. Make sure you have a lender that can deliver what you need to make the right decisions for your farm, family and future. ✤

**ASK YOUR LENDER THESE QUESTIONS:**

- Have I provided complete and sufficient quality financial information?
- How does my financial position and performance compare to my peers?
- Do I need to focus on reducing costs and weathering this downturn, or am I well positioned to expand my operation through marketplace opportunities?

Evan Hahn
*Vice President Credit*

REVISIT THE BASICS OF THESE KEY FINANCIAL INDICATORS

## CLARIFYING WORKING CAPITAL AND CASH BURN RATE

Farmers know calculating working capital and cash burn rate are crucial components to understanding the financial situation of their operations. Having a good grasp of these two measures can help you prepare for lean years and assist in developing a cohesive risk management plan. But, when it comes to calculating these two measures, there can be quite a few misconceptions and mistakes. If you haven't done so recently, now is the time to revisit working capital and cash burn rate.

### What is working capital?

Working capital has a very simple definition: current assets minus current liabilities. However, it's often oversimplified as the cash on hand for an operation. Working capital accounts for much more than just money in the bank: When working through your current assets, take stock of not only your cash on hand, but also any savings, outstanding checks from inventory that has been sold, feed, livestock, grain inventories, supplies and prepaid expenses. Liabilities to account for include all accounts payable, accrued taxes, credit card debt, payments to input supply vendors (seed, fertilizer and chemical companies), any accrued interest and the principal portions of debt payment due in the next year. Working capital should function as a cushion for your farm, so understanding your working capital position gives you the knowledge and flexibility to make crucial decisions, while minimizing the risk to your operation.

| CURRENT ASSETS | |
|---|---|
| Cash | $10,000 |
| Accounts receivable | 5,000 |
| Inventory | 8,000 |
| Market securities | 2,000 |
| **Total assets** | **$25,000** |

| CURRENT LIABILITIES | |
|---|---|
| Accounts payable | $7,000 |
| Notes payable – short term | 2,000 |
| Wages payable | 3,500 |
| Income tax payable | 1,500 |
| **Total current liabilities** | **$14,000** |

**NET WORKING CAPITAL = CURRENT ASSETS - CURRENT LIABILITIES**

### Common mistakes and misconceptions when calculating working capital

The ins and outs of calculating working capital are far more complicated than a simple arithmetic problem. Farming is a complex business, and it's easy to miss a liability or an asset when trying to get a handle on your current financial situation. These kinds of mistakes can provide an inaccurate picture of an operation's financial standing and may unearth unpleasant surprises later. Here are some common mistakes or pitfalls to avoid when calculating working capital.

- **Not accounting for accrued interest and other annual expenses**

  Depending on the loan size and payment frequency, accruing interest can represent a large liability on an operation's balance sheet. Often these payments are scheduled on an annual or semiannual basis. Like any expense that's only charged once a year, these payments can easily become out of sight and out of mind after they are paid. Take time to go through your operation's entire book to make sure you are planning for all expenditures throughout the year or you may overstate your working capital position.

- **Not accounting for current portion of term debt**

  Working capital is a financial indicator that is meant to measure an operation's annual assets and liabilities for an operating cycle. While the long-term liability for any debt should not be counted against working capital, the current portion of term debt — what's due in the current year — should be calculated and included as a line item.

- **Calculating working capital at the wrong time of year**

  Going through the exercise of calculating working capital on an annual basis is key, but certain times of the year are more beneficial than others. A common mistake some farmers make is calculating working capital based on their projections for going to market after harvest. Depending on what actually materializes at harvest and happens with marketing, this can overstate the operation's assets. Working capital should always be based on real numbers on a balance sheet, not predictions or forecasts. A better time to calculate your working capital position is at the beginning of the calendar year for grain farms.

- **Believing working capital is "nonworking" capital**
  Some farmers may see working capital as money that's simply sitting on the balance sheet and not being put to use. However, having a strong working capital position allows you to do what's needed on your operation. Beyond the ability to secure financing, working capital is there as a cushion for hard times and as a reservoir, allowing you to take advantage of in-the-moment opportunities you may have had to pass on otherwise.

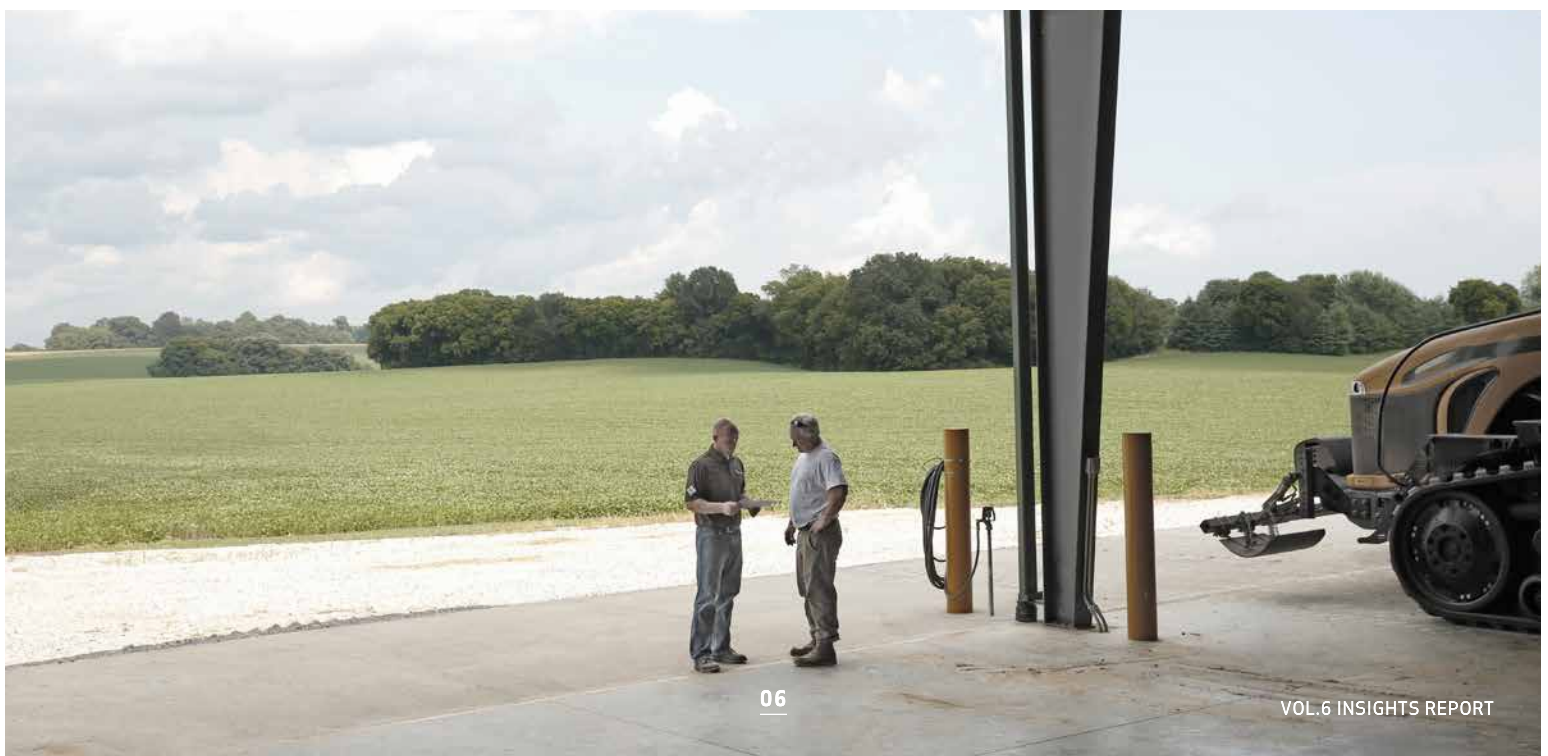
### Working capital and cash burn rate

Cash burn rate is calculated after the working capital position has been determined. Take the dollar amount of the working capital your operation has on hand and divide it by projected loss for the year. For example, if your operation has $300,000 of working capital, but has an annual projected loss of $100,000, your burn rate is three years. Cash burn rate is a key financial measure, because it indicates whether your operation is in a position of strength or a position of challenge. During a struggling ag economy, knowing your cash burn rate aids in making key financial decisions, including whether or not to refinance loans or if any fixed costs need to be better controlled.

There are a lot of different ways both working capital and cash burn rate are measured and weighed. Some universities may recommend measuring working capital as a ratio of assets over liabilities. Farm Credit Mid-America generally weighs working capital as a percentage of gross annual income. We consider a minimum working capital position to be approximately 20 percent of an operation's gross annual income. Ideally, your operation should have enough capital on hand to withstand multiple years of losses. At a bare minimum, your operation should have enough working capital to cover one year of loss. A solid risk management plan that includes crop insurance can help make sure you maintain your working capital position even if the season doesn't go as expected.

### Going forward

Knowing your working capital position helps you make important operating decisions, such as purchasing inputs or feeder livestock. If an opportunity presents itself for a down payment on capital assets or a cash discount on inputs, your working capital position influences the final decision you make. Understanding working capital and cash burn rate means having a strong grasp on the financial situation of your operation and helps to ensure its longevity. ✤



The information in the report is derived from Farm Credit Mid-America's experience in rural and agricultural lending, and does not take into account the financial needs of particular individuals. This content is intended to be informational and is not a substitute for detailed advice on your specific situation.

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