Fact Sheet # 16 Making Money

How will you know if your operation is making money?

Cash Flow, **Net Worth** and **Profit** are the three pillars that sustain a business. All need to be positive for a business to thrive in the long run.

Cash Flow tracks the cash dollars into and out of the farm business. You should be able to balance all of the money that came in and went out:

> start-up money + cash from operations + borrowed money =
>
> cash paid on expenses + debt payments + end of year money

In many operations, cash flow expenses will be high in the spring as crops are planted and income will be high in the fall when crops are sold. Therefore, cash flow requires planning and savings to be sure income covers future costs. Cash flow records are a way to keep track of your money, ensure that you can cover monthly expenses. They are crucial to long term profitability.

Net Worth tracks your investments in the farm. It is also called the Balance Sheet.

> **Net Worth** = everything the business OWNS - everything it OWES
> **Your Ownership** = assets you manage – what you owe
> **Equity** = assets – liability

Some assets, such as land, gain value over time. This is called *appreciation*. Some assets, such as equipment, lose value over time. This is called *depreciation*. Depreciation is a measure of the wear, tear, and obsolescence of an investment.

The primary function of net worth calculations is to measure the risk-bearing ability or financial solvency of your business. In simple terms, this is how much you really own versus how much the bank or other entities own.

Profitability is measured with the Income Statement. It is the result of your operation's work, decisions, and return on investment.
Profitability is harder to track as it blends cash flow and investment decisions. It also makes

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Profit = value of production – cost of production

adjustments for family-related withdrawals, "free or family" labor, and return on investment.

Some examples of High Cash Flow, but Low Profitability:

- Living off of inventories or depreciation and not reinvesting in the operation
- Outside income or off-farm jobs that help reduce need for family living withdrawals
- Borrowing money
- Not paying bills
- Farmer doesn't pay him or herself for labor

Some examples of Low Cash Flow, but Good Profitability:

- An expanding business with increasing assets but few cash sales
- High withdrawals for family living, for example, college expenses
- Paying down debt rapidly
- Buying next year's assets from this year's cash (prepay for fertilizer, etc.)
- Increase in accounts receivable (amount of money you are owed for assets that were sold)
- Farmer pays labor (including their own) fairly and equitably

Methods of Accounting

For your tax return you may want to use *cash accounting*, but for profitability you want to use *accrual accounting*. In cash accounting you report the income and expenses as they are actually received or paid and in accrual accounting you report the income and expenses at the time they occur. Accrual accounting looks at changes in inventory and price, changes in accounts payable and receivable, appreciation and depreciation, unpaid labor, opportunity costs to work elsewhere, interest on equity, and your labor and management inputs.

Interest on Equity

No bank lender would allow you to borrow money without interest, yet many farmers "lend" their farm business money without collecting interest. If you had invested your money in the stock market, for example, you would earn dividends on your money. Should you not also earn interest on the money you invest in your farm? You should plan to pay yourself 3% minimum return on your equity invested on your farm.

Calculating the Value of Labor and Management

- What is the value of your efforts on the farm?
- What is the “opportunity” for you to work elsewhere?
- What could you earn if you worked elsewhere in a similar job?

Farm manager’s role in financial management

Managers make the decisions about investments and tasks. They define the mission and philosophy for the operation. They develop the plan, hire and motivate the people to implement the plan, invest in the assets to implement the plan, set priorities, and evaluate the results so they can adjust the plan if needed.

Enterprise Budgeting

Partial budgeting helps farmers make decisions for specific investments that may not affect the whole farm operation. It focuses only on the changes in income and expenses that would result from implementing a specific alternative. Thus, all aspects of farm profits that are unchanged by the decision can be safely ignored. For example, by shifting some land out of beef production to pork production, your business may make more money on pork products, but lose money on other meats. What matters is the overall profit when revenues and losses are considered. This will help you decide how much you can invest in a specific enterprise and the impacts on other parts of the business. A great guide to resources for developing a business plan and creating enterprise budgets (including links to examples) can be found on beginningfarmers.org.