Farm Financial Analysis Series

Managing Farm Finances in Turbulent Times

Farmers and agricultural producers can be subjected to many sources of stress—disease; family issues; psychosocial stresses, including social isolation and long work hours; physical stresses, including environmental extremes and chemical exposure; and financial issues. Ways to deal with stress include regular doctor visits, eating right, finding time to relax, and actively managing areas that cause stress when possible.

This publication addresses methods to manage a farm's financial health. It is part of the Farm Financial Analysis Series, which also includes these: P3713 *Balance Sheet*, P3710 *Cash Flow Statement*, P3707 *Income Statement*, and P3712 *Ratios to Measure Farm Financial Health*. To ensure you get a full picture of your farm's financial situation, be sure to use all five publications in the series.

Agriculture in general can be a very "turbulent" industry. Low commodity prices, weather events such as flooding or droughts, global trade wars, pandemics, and rising input costs are some examples of things that can stress farm finances. It is important to know the various options available to manage your farm's finances so you can be better prepared for these events.

You can determine your farm's financial health by monitoring financial statements, such as a balance sheet, cash flow statement, and income statement, on a regular basis, and calculating financial ratios. Financial ratios that measure financial health are liquidity, solvency, profitability, and efficiency measures. These ratios can be compared to a benchmark value to determine if the farm's financial health is strong, stable, or weak. You can then take actions to improve weak areas or prevent susceptible areas from becoming weak. When compared to a benchmark, these ratios can indicate the level of financial stress that the farm business is experiencing and identify areas of the business that would respond to corrective actions. A more detailed discussion of financial ratio analysis with examples can be found in Extension Publication 3712 *Ratios to Measure Farm Financial Health*.

Agricultural producers are constantly planning for next year's crop, for the next group of cattle going on feed or pasture, or for production on a new farm they just acquired. But planning for unforeseen stressful situations such as depressed commodity prices, volatile input prices, or international trade wars requires contingency planning that takes production planning to another level. Contingency planning considers how you would adjust your current plans if conditions changed. Having a detailed plan to overcome negative conditions can help mitigate stress if they do occur.

Contingency planning begins with understanding the current situation and the outlook for key business areas such as the commodity prices for your crops; availability of inputs such as seed, fertilizer, feed, and fuel; and availability of labor and custom services. Understanding current and future conditions helps you form expectations for the production planning process and develop annual budgets. Once the production plan and budgets are complete, consider what-if scenarios that could disrupt the plan, then develop alternative action plans that address each disruptive circumstance.

An example of a disruptive circumstance would be that a hired farmhand is ill and cannot work for more than a week. If that happens, the manager plans to hire Bob Smith, a retired farmer down the road, on a temporary basis until the farmhand can return to work. This scenario examines an unexpected situation that must be addressed (farmhand cannot work), a trigger point at which action must be taken (farmhand is unable to work for more than a week), and an action (hire Bob on a temporary basis). Contingency plans should be written and communicated to the rest of the management team, including family members involved in the business.

This common example scenario illustrates three key parts of contingency plans:

1. Identify a potentially disruptive circumstance
2. Define an easily identified trigger point at which action must be taken.
3. Develop an action plan that can be executed when the trigger is reached.

Other disruptive scenarios may not be as common and may require more involved planning. An example could be an unexpected drop in revenue from plunging commodity prices or severe weather conditions. In this scenario, you may need to extend the operating loan into the next production year, thereby increasing the business's total liabilities. The increase in total liabilities increases the farm's debt-to-asset ratio (total farm liabilities divided by total farm assets) to a point that it is considered in a weak condition (greater than 0.6). In this case, the trigger would be that the debt-to-asset ratio is in a weak position. The action plan could include refinancing the carryover debt for a longer term and lower interest rate and selling some seldom-used capital assets to reduce debt.

If the farm business is in financial stress or moving toward it, taking certain actions can lessen the impact for the short run. These actions fall into three strategies to improve the financial situation of the farm business:

1. Managing cash flow
2. Managing liabilities
3. Managing assets

Managing Cash Flow

Control costs. Reducing costs is an ongoing challenge for agricultural producers. In financially stressful times, it is even more important. Evaluate all procedures and purchases. Is there a way to make this process cheaper or use fewer inputs, including time and machine hours? Is there a way to lower the cost of the input, by buying in bulk quantities or from a different supplier? Make sure each input produces enough revenue to cover the cost.

Reduce or postpone capital purchases. Capital purchases are not generally made unnecessarily, but if you can postpone the purchase of a new tractor until the financial crisis is past, it should help the cash flow situation. Consider repairing for another year rather than replacing. Consider postponing the purchase of new technology that will pay off in the long run but will be a drain on cash flow for the first few years.

Reduce family withdrawals. Family expenditures may be the most difficult to reduce. Consider replacing a weeklong vacation at the beach with a long weekend at a local state park. Postpone new family car purchases.

Increase nonfarm income. Consider an off-farm job, especially if it's part-time or offers flexible hours, for a period to get through financially stressful times.

Renegotiate leases. Approach the landlord with a proposal to reduce the lease payment or shift from a cash lease to a shared lease agreement.

Managing Liabilities

Extend loan terms. Extending loan terms will ease cash flow pressures by lowering loan payments, but it will not reduce interest expenses. This is typically just a short-term measure to provide time to make fundamental adjustments to the business.

Refinance carryover debt. In times of financial stress, operating loans often cannot be repaid in full in the production year, resulting in carryover debt. Lenders often will allow refinancing of the carryover debt to a loan with a longer term that can be paid over a period of years.

Pay interest only. If the financial stress is temporary, the lender may allow you to pay interest only instead of the scheduled interest-plus-principal payment.

Reduce debt. Reducing debt by using outside funds will certainly relieve some financial stress. Sources of funds may be off-farm income, gifts or investments from others, or sale of farm assets.

Refinance. If interest rates have declined, as they often do if financial stress affects the general economy, this may be a good time to consider refinancing loans to get a lower interest rate or to switch from a variable interest rate to fixed.

Managing Assets

Liquidate cash and investments to reduce debt. If the farm business has maintained a financial reserve of cash or investments to be used for a "rainy day," this may be the time to use it to reduce debt.

Sell inventory to reduce debt. If the farm business is holding inventory waiting for higher prices, consider selling that inventory to reduce debt. Carefully consider projected commodity prices, storage charges, tax implications, and the severity of financial stress caused by debt levels.

Sell capital assets to reduce debt. Selling assets such as land or machinery and equipment may be a good strategy to generate funds to reduce debt, especially if the equipment is seldom used. Selling capital assets may impact your ability to generate revenue in the future.

Summary

Farm businesses weather financial downturns by relying on their financial resilience. You can ensure your farm's financial resilience by establishing strong liquidity and solvency positions and developing contingency plans for financially stressful times. Monitor the farm's financial ratios for signs of financial stress, and take quick action when problems arise.

Depending on the area of financial stress, you can improve the farm's short-term financial situation by managing cash flow, liabilities, and assets. Improving financial resilience should be the long-term goal of your farm business.

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