RANCH BUSINESS MANAGEMENT

by

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Why are you people in the cattle business? Some of you may say you like the way of life, you like working with livestock, you want to be your own boss, you want to work outdoors, you want to raise your kids on a ranch, you like working a family business, or basically it is all you have ever wanted to do.

What about profit? Regardless of your reasons for ranching you can't continue to do it without making money - i.e. profit. What is profit? Well, in spite of what our liberal press implies, it is not a dirty word and it is not something you should be ashamed of striving for. It is a necessity for our free enterprise system.

I am sure all of you like to make money and enjoy the few profitable ranching years. However, how many of you really put effort into running your operation as a business? Do you evaluate your important decisions from a business viewpoint?

You will be hit with a lot of information today, most of it aimed at helping you to make the most profitable decisions. That is what management is all about - making the most profitable decisions. You won't be able to absorb everything that I and the others will be talking about today. I hope that you can remember a few of the high points. However, if you can only remember one, let it be this: try to run your operation as a business. You are businessmen.

I am talking today about something that many of you think of as drudgery: paperwork. I wish that I had a more interesting topic like how to save a calf. Ranch paperwork, however, is very important to you as businessmen. Farm and ranch business records fall into two categories: financial and physical. I will talk only about financial records.

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First let's take a brief look at farm or ranch accounting systems. Many of you that keep records, either by yourself or through an accountant, have a records system that was designed for a 'typical' retail business. These businesses buy goods in quantity in a wholesale market and sell a little each day in a retail market. A simple income and expense summary is good enough for them. A farm or ranch however is more like a manufacturing business. It buys production inputs in a retail market, puts them into a production process and from 6 months to years later has something to sell in a wholesale market. A manufacturing business has separate profit centers (e.g. wheat, calves) and should have an accounting system that allocates costs to these centers.

An adequate set of farm financial records should include a balance sheet, an income statement, a cash flow statement, and enterprise reports. Let's look more closely at each of these.

First the balance sheet is simply a tabulation of what you own and what you owe. The difference is what you are worth. The balance sheet is divided right down the middle with the assets (what you own) on the left and the liabilities on the right. A good balance sheet also has three time classifications for both assets and liabilities. These classifications are necessary for you and/or your lender to do a good financial analysis of your operation.

Current assets include cash and things (such as livestock and crops to be sold) that can easily be converted to cash. Intermediate assets include the things that you will keep for a while and will not soon be converted to cash. Machinery and breeding stock fit in here. Fixed assets are your land and buildings. The assets again is everthing on the left side of the balance sheet and in this example equals $500,000.

On the right side of the balance sheet current liabilities include everything that calls for payment within 12 months. This includes loan principal and interest payments and taxes. Intermediate liabilities include payments mainly on the inter-

mediate assets: machinery and breeding stock. These typically are loans between 1 and 10 years long. Long term liabilities are mortgages or land contracts on your real estate. Notice that this balance sheet also has an entry for contingent income tax. That is it accounts for Uncle Sam's share if you actually did sell the land.

Next, the liabilities are added up, which in this example is $255,200. Finally, the difference between assets and liabilities is calculated. In this example it is $334,800.

A balance sheet is usually done at the end of each year. It is like a picture or snapshot of the business on that day, only it is in numbers rather than shapes and colors.

The balance sheet, in addition to telling you how much you are worth, also is used to make calculations on the solvency and liquidity of your business. These are things your lender wants to know. Perhaps the most important ratio is the current ratio, which is current assets divided by current liabilities. It is a measure of how well you can meet next year's obligations. Lenders like to see a current ratio of 2 or better.

While the balance sheet measures where we currently are in financial terms, the income statement tells us how we did for a certain time period, usually one year. Well-managed operations often make income statements more often, on a monthly or quarterly basis.

Many farmers and ranchers are on a cash basis accounting method for IRS income tax purposes. They simply subtract cash expenses and depreciation from cash revenue to get net income. For example, cash revenue of $80,000 and expenses and depreciation of $60,000 would appear to give a net income of $20,000.

This, however, may not accurately show the real income for the year because changes in inventory were not accounted for. In our example $55,000 income was derived from this year's production. The remaining $25,000 was sold out of storage

from the previous year's production. Accounting for inventory change, as a good income statement should, the true net income in this example is a loss of $5,000. This can work the other way, too, of course. Your ending inventory may be greater than your beginning inventory, so your total revenue is greater than cash revenue.

This is what an income statement looks like. The revenue section shows the source and amount of income. The expense section is similar. Net farm income is simply the difference between the two. Don't forget, however, that you have partners that won't let you keep all of that income. Your partners are Uncle Sam and Uncle John who confiscate some of your income in the form of income taxes. Therefore, a useful income statement accounts for after-tax income.

The income statement and the balance sheet are related. The income statement can show the changes from the beginning-of-year balance sheet to the end-of-year balance sheet. In this example the beginning net worth was $252,200 and the ending net worth $284,000. The difference was the net income after taxes and family living withdrawals.

The cash flow statement, in my opinion, is the most important of the financial statements. It simply accounts for cash inflows and outflows for a certain time period, usually a month. The ranch business checking account can be used to construct the cash flow statement. Money can come into the account from sales, new loans, etc., and can flow out for expenses, debt payments, etc.

An actual cash flow statement shows what last year's cash transactions were. The cash flow summarized for the whole year might look like this example. It shows the category totals for the year but doesn't show the timing, which is the purpose of the cash flow statement. You might be interested in when to borrow and pay back money to minimize interest costs.

A projected cash flow budget is represented in this example. It breaks the year into quarters (months is better) and shows exactly when you need to borrow money and when you can pay it back. Lenders like to see this and many require it.

You as a manager can make use of cash flow statements first by starting with last year's actual transactions and projecting a budget for next year. Then you can compare budgeted to actual as the year progresses to see if things are going according to plan. If they aren't you may need to make some management decisions. For example, if your fuel costs are much higher than budgeted, you will probably want to find out why. Maybe your fuel storage has a hole in it or you have a theft problem.

How should someone who has never constructed a cash flow budget start? Well, all of you are required by the IRS to file a Schedule F each year. On this form you list all of your business expenses.

Some cash flow forms have a space for you to enter last year's expenses. If yours doesn't, you can do it on a separate paper, like in this example. You simply consider each expense category and estimate next year's based on last year's actual expenditure. This example has some higher and some lower expenses with the total being lower. With serious cost cutting and lower fuel and interest costs this might be real for next year.

Next, you enter the years estimate in the appropriate column. These totals, then, need to be allocated to the appropriate month. Last year's cash flow statement, if there is one, can be a big help here. The bottom line is what you are interested in and shows your projected cash surplus or deficit. This is a useful planning tool that you and your lender can use.

One word of caution: a cash flow statement says nothing about profitability. A very profitable business can have a poor cash flow and a business can also have a very healthy cash flow and go bankrupt.

Although cash flow statements can indeed be useful in making management decisions such as: should I stop raising livestock, there is another financial statement that should also be used. It is the enterprise report.

An enterprise report is like a mini income statement for a particular enter-

prise (profit center) such as potatoes, wheat, or a cow-calf operation. It can be extremely useful for making management and marketing decisions.

Like cash flow statements, there are two types of enterprise statements. The enterprise report is history; it is a summary of last years actual costs. The enterprise budget is an estimate of the future. Both are useful.

Let's take a look at something I call the profit equation (Price x Production - Costs = Profit). Notice that there are three parts to the equation. Some researchers and producers think that production is the only variable and that if yields increase there is no farm income problem. This is not true. Costs and prices are equally important, if not more important.

The enterprise report usually lists all three variables but concentrates mainly on costs. There are three types of costs: fixed, variable, and non-cash. Let's look more closely at each type.

Variable costs are also known as operating expenses. They are called variable because they vary depending on how much you produce. If you decide not to produce anything, you have no variable costs. Examples are fuel, fertilizer, labor, etc.

Fixed costs, also known as overhead costs, don't change with production. Depreciation, interest, taxes, and insurance are examples of fixed costs. If you cut back the size of your herd by 10% your fixed costs don't change. That is, they remain fixed.

Non-cash costs are costs that don't show up in your checking account or your cash flow statement. Depreciation is one example. When you buy a new piece of equipment you use it for more than one year. Depreciation allocates the purchase price among the years that equipment is used. It also accounts for the loss in value of the asset.

Some businessmen also like to look at opportunity costs. You contribute capital, labor, and management to your ranch operation. If you put that money and work into something else you could earn a return. That is you have opportunities

to make money elsewhere. An opportunity cost simply puts a value on your contributions to the business.

Let's consider a $10,000 truck to illustrate an example of opportunity costs. Assume that you don't owe any money on it and if you had excess cash you could invest in a bank CD at 10%. The opportunity cost of the $10,000 you have tied up in the truck is $1000.

Budgets prepared by the University of Idaho include opportunity costs. There is a value placed on all factors of production. Therefore, since a return to your capital, labor, and management is included in the budgets, they have a built-in profit. This may have confused some of you that have looked at UI budgets and saw what appeared to be very high costs.

This is an example of a UI budget that I have on my computer. This is an actual slide picture of the computer screen. This is a wheat budget rather than a cattle budget because it is simpler and I want to use it to illustrate a point. First, is the revenue estimate. Next, is an estimate of variable or operating costs and finally fixed costs and returns.

This computer program also does break-even analysis. In this example, assuming a yield of 100 bu., the break-even price is $3.44. If a price of $3.50 is assumed the break-even yield is 98 bu.

Livestock budgeting is not as simple as crop budgeting. Multiple outputs is one problem. A cow-calf operation, for example, sells heifer and steer calves, and culls from the breeding herd. This makes it tough to do break-even analysis. The cost of replacements is another complication. If replacements are purchased they should be depreciated. If they are raised the raising costs should be included. When there are some of each, it gets complicated. Another problem is the value of home-grown feed. Should it be the cost of production (if known) or the market value?

The University of Idaho has tackled these problems and came up with a livestock budget book that is in each county agent's office. The Table of Contents shows the areas and size of operation for the cattle budgets.

Perhaps the Cassia County budget most closely fits this area. First, the budget shows the estimated revenue, then operating costs, then ownerships costs. Notice that this budget shows a loss of $175 per cow. Is this right?

I don't think that you cattlemen are losing that much per cow. Remember that the University budgets include opportunity costs. The best enterprise budget that you can use is one for your own operation.

How can you do it? Well, again the best place to start is last year's Schedule F. Then, next to last year's expenses write in your estimate for next year.

There will be a problem here if you are in more than the cattle business. If you also grow crops or raise sheep you need to allocate the total costs among the enterprises. This is where the value of a good accounting system is realized. Most of you don't have a very sophisticated accounting system so you will need to allocate each expense.

I don't have time to get into cost accounting and cost allocation but your estimates can work fine. You might also want to use UI budgets as a guideline. For example, these budgets can show that it takes 4 times as much fuel to produce an acre of potatoes as it does an acre of grain.

Next in your enterprise budget you will need to look at what you expect to sell. This example ranch sells steer calves, heifer calves, cows, bulls, and cull replacement heifers. Let's consolidate these into culls and calves to make our analysis simplier.

We estimated our costs at $125,000. Since we want to determine a break-even calf price we need to assume a value for the culls. I picked $45 which may or may not be close. Subtracting cull income from costs we are left with $78,875. Dividing this by cwt of calves we get a break even price of $65.75.

In a break-even analysis it is useful to look at a range of production. In this example, if we had a tough year and produced 100 cwt less calves the break-even

price increases to $71.70. With 100 cwt more the break-even price drops to $60.67. Remember that this price is an average for steer and heifer calves. Steer prices will be higher than the average and heifer prices lower. The actual spread, of course, can vary.

My last topic is the use of computers in budgeting. The University of Idaho has purchased Apple microcomputers for each County Agent's office. This is a picture of the Apple system.

The University has also provided the county agents with programs on crop and livestock budgets. The budgets that are in the livestock budget book are in these computer programs. They can easily be modified to fit your ranch. The computer simply takes the place of pencil, paper, and calculator. You might want to try it out in your County Agent's office.

This is what the computer screen looks like when working with this program. First, you select the program from the menu. Next, you get the revenue page, then the variable or operating cost page, then the fixed cost, total cost, and profit page. This example is for Lemhi County. Any of the costs in this budget can easily be changed by the computer user to get a budget for his own operation.

In summary, run your operation like a business. Use enterprise budgeting and the three financial statements.