The Oklahoma Cooperative Extension Service

Education Everywhere for Everyone

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; family and consumer sciences; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and research-based information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

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EXTENSION

Farmers in Transition
Evaluating Options for Change

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Often it is only when circumstances force us to reexamine our daily routines and plans that we do so. High input prices fueled by inflation and geopolitical disruptions of imports, for instance, are causing many producers to rethink farm plans, either to reduce inputs as a crop producer or to seek lower cost feed inputs as a livestock producer. Within an industry, periods of high profitability often do not provide an incentive to change. But "good" times may be the best time for a business audit and fine-tuning; when businesses are in financial trouble, the options available for change are often very limited.

With changing economic circumstances, the risk environment changes, as does the operator's ability to tolerate risk, both personally and financially. New constraints may arise. Goals that may have seemed reasonable may no longer seem appropriate or may conflict with each other. Once goals and priorities are reassessed, the operator is prepared to develop a revised plan for the future. The ability to change with changing circumstances depends on the business financial position, its historical performance and its stage in the business life cycle (start-up, growing or mature) as well as the financial demands placed on the farm by the family.

The discussion that follows is intended to be a guide in beginning an internal audit of the farm business.

General Considerations

Farm profitability can be improved by implementing changes that increase either the amount produced or the price per unit received or that lower cost per unit of production. Farm net worth or equity can be increased over time by increasing profits, carefully managing risk as well as debt loads, limiting withdrawals and managing income taxes. As a component of cost control, capital asset utilization and management are critical to success. Capital assets include land, machinery, equipment, vehicle and breeding livestock.

Any proposed change in a farm business should first be evaluated as to its potential impact on farm and family goals. For example, adding a dairy enterprise makes little sense for the family who values being able to take a two-week family vacation each year (unless substitute labor is readily available). In addition to the impacts on labor and management, financial repercussions should be anticipated, including impacts on liquidity, solvency and profitability. How will the change affect the business' ability to pay bills in a timely fashion? Will additional borrowing be needed to finance the change? Will the change generate positive net returns in the long run? The human and capital resources available, the economic climate or regulations and governmental policies may limit the alternatives. Intangibles such as family involvement and reliability of existing and proposed new business partners should be considered.

Evaluating changes should include long-range budgeting with total receipts, total costs and net earnings for each alternative estimated. In developing the long range budget, estimate all ownership and operating costs. Ownership costs include depreciation, interest on investment, insurance, property taxes and housing or storage costs on capital assets. Operating costs include fuel and lubrication, repairs, labor, feed, seed and annual operating capital.

If a major change is planned, cash flow planning is essential to assess whether the business can survive a transition from one plan to another. If credit is needed to finance the change, the farm's current debt levels and debt repayment capacity must be evaluated.

Risk assessment is also critical. Switching to an enterprise in which family members have no previous production, marketing or management experience is risky. Will an existing lender go along with the change? Can financing be obtained if needed to make the change? If new skills are required, is there sufficient time to learn them? If change is needed quickly, is there time to make any needed investments associated with the change and implement a new plan? If a new enterprise is added, will it require labor at peak or off-peak seasons?

Finally, when any substantial change is being considered, consult with a tax professional to ensure any potential tax ramifications are clear.

If Farm Financial Problems Exist

Farm financial problems may result from liquidity, solvency or profitability issues and may be temporary or chronic in nature. An honest assessment of whether financial stress is

temporary or long-standing is needed. Liquidity problems are evidenced by cash flow difficulties. Solvency problems develop when businesses over-extend themselves with respect to debt and fail to maintain profitability. Strategies for change should be directed at the source of the problem.

Cash flow problems include trouble paying bills when they come due or repaying loans timely. If liquidity appears to be the main problem, increasing or speeding up cash inflows plus decreasing and slowing down outflows (including reducing family spending) will help. If loan payments are part of the liquidity problem, restructuring the level and timing of debt repayment should be explored. When profitability is the weakness, consider alternatives that improve production, marketing and financial efficiencies.

If solvency is a problem, but profitability and liquidity are not typically an issue, a difficult situation may correct itself over time. If the solvency position is not tolerable in the short run, giving up ownership of some assets and renting them back or soliciting outside equity capital may be required.

Farms with no debt are best positioned to weather financial adversity as they can draw on savings or unused credit to pay for unexpected expenses and support the family through low-income years. The risk of continued operations during poor income years is that owner equity may be eroded unless the investment horizon is sufficiently long to recoup losses. Prolonged periods of low prices and yields may prompt some older producers with no debt to choose retirement, perhaps liquidating some assets to generate retirement income.

Farms that have historically been profitable may be able to continue operations through several low profit years or lenders may be willing to provide credit to help with cash flow problems. The business may have sufficient savings or off-farm income to survive. Debt levels may rise with loan repayment placing greater demands on future income or savings may fall and consequently generate less investment income in the future. Until the operation returns to a profitable status, owner equity will likely decline.

The operations most vulnerable to low prices and yields are the most highly leveraged farms, often with younger operators. For these producers, one or more years of financial stress can jeopardize the operation as the need to generate cash for loan repayment and family living expenses is greater than for comparable size operations with less debt.

Farm Costs

While it doesn't offer attention-grabbing headlines, research consistently shows that controlling costs over time is a key element in long-term business success. Taking an objective view of your farm's finances can be revealing. Lay out three years of tax returns side by side. What are the high-cost categories? Where are costs high relative to other producers who are profitable? Are resources (land, labor, machinery, equipment, money, and management) being used efficiently, effectively and profitably? Study farm records to ensure that inputs are being purchased as cheaply as possible and are being fully utilized. Look closely at high-cost items such as interest, machinery costs, rent, feed, fertilizer and labor.

Some costs may be relatively fixed, some may be variable and some may be negotiable. Once you've bought land or machinery, equipment, vehicles, breeding livestock or similar capital assets, ownership costs are relatively fixed. If these fixed costs are not being spread over adequate levels of production, fixed costs may be reduced by expanding the business or using the assets elsewhere (for instance, doing custom work for others). Before investing in a capital asset, be sure to weigh carefully its impact on cash flow and profitability as well as intangibles. Before hiring labor, be sure they can be fully employed with minimal time spent on make-work jobs.

To lower variable costs, consider substituting comparable but less expensive inputs, for instance, adjusting feed rations to utilize relatively low price grains. Shop around for the best prices on all big ticket items. Assess whether inputs could be used more efficiently, such as feeding hay in rings to minimize waste. High repair costs on machinery or equipment may signal the need for additional investment in new equipment or preventative maintenance.

If rental rates are out of line with the market, talk to the landlord and see if a new rate can be negotiated. Renegotiating a cash lease to lower the payment will reduce current expenses. Changing a cash lease to a share lease will reduce cash outlays and improve liquidity, particularly in poor yield and low price years. Flexible leases can be used to share production and price risk between the tenant and landowner, for instance, by combining features of cash and share leases. In lease agreements, the payment amount, number of payments, timing of payment and end date are variables to evaluate.

Schedule loan repayments at times when crop and/or livestock sales are expected. Negotiate for lower interest rates if you have a good record keeping system and can provide financial statements for the lender. Check your depreciation schedule on your tax returns to make sure it is up-to-date.

In the longer run, rethinking asset ownership plans may lead to lower costs. For instance, renting land may be less costly than owning it. Custom hiring or leasing may be a good alternative when high-cost, specialized machinery and equipment is used infrequently or for relatively few hours.

Income Levels

Income generated is a function of both farm yields and prices received for production. Thus, improving either production or marketing practices can increase farm returns. Increasing the yield (or reducing production losses) may increase returns per acre or per head. Are you using the most productive seed variety? Are you managing livestock so death losses are minimized? Having the highest crop yield in the county or the highest average weaning weight may give you bragging rights at the coffee shop, but it doesn't guarantee a profit. Producing more is not always better--the increases in the value of higher production levels must exceed the additional costs incurred to generate those higher yields. Producing at the level at which returns to higher yields increases more than costs with yield increases and utilizing all assets that have income potential are keys to maximizing profits.

Identify both resources and assets that may not be fully utilized at present but have income potential. If range, brush, or timberland is not currently being used, could hunting leases be sold? If opportunities exist and labor is available, increase asset use through custom farming or renting machinery to other farmers. This helps increase machine utilization, thus lowering the ownership costs that must be paid by your farm and increases cash income. This must, however, be weighed against the new costs, such as the stress of working for other people and increased wear and tear on the machinery.

Learning new production or marketing skills may require an investment in terms of time and money. Join a marketing club to "practice" using new tools, then go slowly in implementing them on the farm. Absolutely do not expect to get rich quick and do not bet the farm through risky trading schemes. Rather, have a deliberate marketing plan and use marketing tools to manage risk.

Insurance Protection

To protect against losses that might cripple or ruin the business, consider insurance. Financially stressed farms often cannot afford a loss which might lead to delinquent loans or more borrowing. Federally subsidized crop and livestock insurance (and forage insurance in some areas) is an alternative for many producers. Don't forget to include health care and long term care insurance in your review as they are increasingly important risk management tools on farms.

Insurance helps minimize the losses associated with adverse events outside the producer's control. Known costs (annual premiums) are substituted for unpredictable and irregular losses. Insurance can stabilize the farm's cash flow and improve financial liquidity. Liability, property and life insurance also help protect farm assets. All insurance policies should be reviewed both from protection and cost standpoints. If your vehicles are aged, you may not need the same level of insurance that you did when they were new.

Enterprise Mix

A whole farm financial plan, complete with enterprise budgets, is a useful means of identifying farm cost and profit centers. Knowing the relative contributions of different crop and livestock enterprises allows producers to redirect resources, such as labor or land, to more profitable enterprises and away from less profitable enterprises. A particularly profitable enterprise might be expanded to use a greater proportion of the farm's resources or additional land could be rented to allow production on a larger scale. An enterprise which has been unprofitable could be dropped. Producers may want to consider a new, promising enterprise if it fits with the rest of the farming operation and farm and family goals. The impact on cash flow of a new activity depends on changes in the levels of production of existing enterprises, whether capital assets are sold or purchased and the added cash flow demands.

One way of determining the appropriate enterprise combination is to analyze the relationship between land and labor in the business. If land is scarce relative to labor, then labor-intensive enterprises (for instance, dairy or horticultural production) may increase returns. If labor is scarce relative to land, more land-extensive enterprises (for example, beef production) or machinery intensive operations may be more suitable.

Often people investigate alternative enterprises thinking they will provide higher profits with less effort. Wouldn't everyone like to stumble on a get-rich-quick opportunity? What they often find is that new enterprises are more demanding when it comes to management and also require new and different skills. Before adding a new enterprise, think about how it fits in with the rest of the farming operation. Does it complement, supplement or compete with present activities? A complementary enterprise will not negatively affect existing enterprises. A supplementary enterprise will generate new income, and at the same time, enhance profits in an existing enterprise. A new enterprise which competes with existing enterprises for resources may lower the profitability of the existing enterprise. Are the expected returns to the new enterprise enough to compensate for potential losses?

Asset Ownership

While producers often feel that they must own land to be farmers or ranchers, some enterprises will not generate the cash necessary to make principal and interest payments on a land purchase, even though potential price appreciation makes ownership seem rational. Real estate (land and buildings) can be controlled by owning, leasing with a multiyear arrangement or renting on an annual or short-term basis. Machinery and equipment can present a similar problem with respect to earning its keep, particularly on small operations. Machinery and equipment can be owned, leased or custom-hired. Breeding stock can also be leased or owned. Renting or leasing an asset reduces the ownership costs (depreciation, taxes, insurance, interest on investment), while increasing the cash flow (and possibly the operating capital) needed. A financial lease or custom hiring can be a reasonable alternative when equipment is expensive and used infrequently.

Rental markets may be better developed in some areas than others. Machinery availability may be a risk for the farmer with short-term or seasonal operating leases. A financial lease using a long-term contract may alleviate the problem. The long-term agreement is similar to ownership in providing exclusive rights to use the asset over its useful life. Under a financial lease, the farmer pays all repair, maintenance and operating costs.

With custom hire, ownership costs are avoided and the farm may benefit from the experience of skilled operators. Jobs can be completed faster using several machines, and machine hire can be easily adjusted to changes in crop mix and market conditions. The farm owner's capital and labor can be channeled to other uses. On the downside, service may not be available at the best time, reliability of custom operators may be a concern and rates are variable.

Older equipment that is fully paid for and depreciated will not contribute to cash flow or profitability problems unless repair costs and associated down time are very large. Delaying farm capital purchases or postponing improvements may help with short-run financial problems, but place a greater demand on farm income in future years. However, new machinery and equipment purchases can contribute to cash flow and profitability problems if the assets are held for a relatively short period of time and used on a few acres. Selling underutilized assets generates cash, but liquidation of capital assets and recapture of depreciation may increase income tax.

Sale or Sale/Leaseback

Selling assets can be a way to improve cash flow. Choosing which assets to sell depends in part on family goals. The potential tax liability associated with the sale or transfer of an asset is also an important factor to consider in choosing which assets to sell. The sale or transfer of assets may result in taxable income or the recovery of investment tax credit. A tax specialist should be consulted for assistance in evaluating potential tax liabilities associated with asset sales.

Unused assets are obvious candidates for sale if tax repercussions are not severe. Perhaps less obvious is what assets are the next best candidates for sale or perhaps sale

with a lease back. Land ownership purchases are often difficult to finance with farm cash flows, so if land note repayment is a contributing factor to stress, a real estate parcel may be a logical choice for sale. In some cases, developers are anxiously awaiting an opportunity to buy farmland and selling a small parcel can generate enough cash to substantially reduce debt, improving the financial situation. If continuing to farm the property is important, an option may be to covey the asset to the lender and lease the property back. Or the property might be sold to a third party with a leaseback agreement, using the sale proceeds to reduce debt. In the sale/leaseback case, the farm's cash flow may improve, while farm equity is little changed (assets and debts are reduced equally). This is of greatest benefit if cash rental rates are lower than the scheduled debt servicing requirements. Leasebacks with crop share rental arrangements further lower farm cash flow requirements.

In a similar vein, if custom rates compare favorably to loan payments, machinery or equipment can be sold and the farm work done by custom operators. For livestock operations, a shift from feeding livestock on farm to custom feeding is an alternative. Again, both financial and non-financial trade-offs must be carefully weighed.

Debt Rescheduling

Large interest and principal payments in a difficult year can be devastating. If the farm has been historically profitable, lenders may be willing to reschedule the loan payments by changing the length of the loan. Rescheduling spreads the principal payments over a longer period, thus reducing the principal payments in the short run, but obligating the producer to repay over more years. Reducing interest expenses reduces deductible expenses, increases taxable income and increases after-tax profit in the short run. However, lengthening the repayment period means more total interest expenses over the long run and a reduction in profit in later years. If financial conditions improve, the operator may be able to repay during the original time frame if no pre-payment penalty is included in the renegotiated loan contract. If problems making scheduled principal and interest payments are caused by lack of profitability compounded by a temporary stressor, then shortfalls will likely recur despite rescheduling.

Debt Restructuring

Debt restructuring was used during the farm financial crisis but is available only in extreme circumstances. A lender may write down either principal or interest if the borrower is unable to make scheduled payments or if the value of the loan collateral is lower than the principal balance. The lender's willingness and ability to negotiate depends on both the borrower and lender's financial condition as well as the regulations governing the lending institution. A permanent lowering of principal and interest obligations helps both cash flow and producer profitability, but tarnishes the future business relationship. Forgiven debt is taxable income, unless the farmer is insolvent or in bankruptcy.

Investment from Outsiders

If a producer is willing to give up some share of ownership in the operation, an infusion of cash from outside can help alleviate financial problems. An off-farm heir or another producer may be willing to either provide cash to reduce debt levels or pay bills in return for a share of the business. A lender might be willing to trade a debt obligation for an equity position in the operation. An equity infusion increases cash available and reduces financial risk by increasing the equity capital base. Taking on business partners means sharing future business returns or repaying in another way (for instance, by transferring ownership of specific assets).

Business Liquidation

A partial liquidation of assets may generate sufficient proceeds to reduce debt to manageable levels, but if the financial situation of the farm or ranch is beyond repair, the best choice may be to end the business. The business may be liquidated involuntarily if loan repayment delinquencies are severe. Bankruptcy is generally a last resort and refers to business termination or reorganization. Chapter 11 is for reorganization of a debtor's business affairs and Chapter 12 is specifically for family farm or ranch bankruptcies. Bankruptcy provides the legal vehicle for debt and asset adjustments that cannot be accomplished on a voluntary basis.

Family Issues that Impact the Farm Business

Family Withdrawals

Farm families should be sure that their expectations with respect to the farm's ability to generate income are realistic. Family living expenses typically rise as the family expands until the children are self-sufficient. If financial stress is an issue, curbing family living expenses frees up cash for other uses. Developing a budget, living within it and minimizing nonessential spending may allow producers to pay down high interest loans and credit card debts, reducing future cash obligations for loan repayment. At the same time, postponing major expenditures or purchases, such as a new vehicle or other similar items, may increase future demands on farm income. If long term plans include bringing children back into the operation as adults, additional careful planning must be done.

Supplemental Income

The number of families who earn income solely from the farm has dramatically decreased over time. Farm income can be supplemented through income from an off-farm job, a home-based business or from custom work done for other farmers. Supplemental income helps provide an income safety net and diversifies the financial risks that families face. Off farm jobs may also be important for healthcare or retirement benefits. Deciding if anyone, and who, should take an off-farm job may depend on the skills of family members, their age and the need for their expertise on-farm. Diverting hours from the farm may result in a labor shortage at critical times, reducing productivity and off farm job opportunities may be limited in rural areas.

Summary

Almost annually, opportunities arise to take advantage of changing economic circumstances. Sometimes the forces are positive such as an increase in demand, either domestic or export, for the farm product, leading to higher prices. In other cases, natural disasters or fluctuating commodity prices lead to financial stress. Adjustments may be needed in the farm plan or family spending to deal with either positive or negative stressors. While changes in the environment often provide the incentives to reevaluate farm plans, the benefits of doing so regularly may be higher returns, lower costs or greater satisfaction with business operations.

Areas for periodic introspection include family and farm withdrawals, capital purchases, cost control, enterprise returns, asset ownership and/or control agreements and use of supplemental income. Changes in the enterprise mix as well as production and financial management may be prompted. Financially stressed operations may need to investigate debt rescheduling, debt restructuring and investments by outsiders or even liquidation. The appropriate strategy or combination of strategies for a farm depends on both family and business factors. While the business financial position and historical performance are very important, the willingness and ability to change, the tolerance for risk both personally and financially, market conditions, potential tax liabilities and farm and family goals must also be considered.

While planning and budgeting may seem like a great deal of work, analyzing the potential impact of a change should enhance the likelihood of success. Any evaluation should include a review of impacts on farm profitability, cash flow and solvency as well as tax obligations. A planned change must be reasonable, given resource constraints. How much risk is involved? Is management ability there? Can you convince a lender that the plan is viable? Be objective in your evaluation, improve your record-keeping system if you find it needs improvement and seek the best outside information available. Your plan is only as good as the information used in developing it.

OSU Extension can help producers with cash flow planning when considering a change to their operation through the farm financial planning and benchmarking program. Find more information at extension.okstate.edu/programs/farm-financial-planning-assistance-and-benchmarking/index.html

Other OSU Fact Sheets in this Series:

AGEC-194	Taking Charge
AGEC-196	Finding a New Career
AGEC-197	Coping with the Partial Reduction or Loss of the Family Farm
AGEC-198	Negotiation Strategies
AGEC-213	Farm Family Decision-Making

Options for Change

Improved Management
- Cost control
- Improved marketing
- More efficient production
- Insurance protection

Change in Enterprise Mix
- Expand profitable enterprise
- Drop unprofitable enterprise
- Add new enterprise

Change in Asset Ownership
- Sale or sale/leaseback
- Lease or rent
- Custom hire
- Merger/acquisition

Supplemental Income
- Off-farm job
- Custom hire
- Home-based business

Debt Rescheduling or Restructuring

Recapitalization or Equity Infusions

Adjustments in Farm and Family Withdrawals

Business Liquidation
- Bankruptcy
- Sale

Revised from a fact sheet prepared by Damona Doye.