Changes in Farm Financial Management

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CHANGES IN FARM FINANCIAL MANAGEMENT

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In the 5 years ending with 1972, total net farm income in Indiana was more than $600 million in 3 years and around $450 million in 2 years. Some farmers enjoyed a year or so of good profits from livestock production; dairying began to look brighter; farmers who had corn blight in 1970 suffered -- those who didn't, fared well; money was generally tight and interest rates high. Financial management advice stressed sound investment analysis and use of credit. The outlook for farming was not very optimistic. Many felt that only the most efficient could hope to make good incomes in farming. This tended to be true until 1973 when even those who weren't very efficient made money. Now, perhaps to a greater extent than ever before, many farmers face the pleasant problem of what to do with substantial sums of cash.

Traditionally, farmers have been capital hungry. The very nature of farming causes this. A high percentage of farming assets are in long-lived assets such as land, buildings and machinery; thus the rate of capital turn-over is slow and financing difficult. Added to this is the stream of technological change since World War II. Technology thrives on capital. Farmers have had to run merely to keep up. Capital needs often have been so pressing that consumption levels have been low. Some farmers have lived "hard up" for a lifetime but died rather well off, the result of plowing capital back into the business.

Many of our farm families deserve to spend a portion of their current favorable returns on such things as remodeling the kitchen, buying new furniture and appliances and maybe even taking a vacation. This might also be the year to give away some money. Gifts to children or other family members may be a part of wise estate planning. Extra gifts to church, college, hospital, etc. may fit well into income tax management, but more importantly will provide the satisfaction of having assisted those organizations and causes which a family values.

After consumption expenditures, any remaining cash could be used for debt re-payment. But in our present economic situation, this might not be the best use of funds. Interest rates currently are higher than the rate on outstanding loans of many farmers. For example, Federal Land Bank bonds or certificates of deposit might yield more than the rates some farmers are paying on long term loans. In these cases, farmers could preserve their liquidity and make a profit by making these low risk investments rather than paying off long term loans.

Debts which are good candidates for prepayment are open accounts with carrying charges, installment loans and short term operating loans. Many lenders like to see operating loans "cleaned up" periodically, even though a new loan may be made soon thereafter.

What about financial reserves? Many farmers traditionally have not kept cash or highly liquid assets as reserves. Rather, they have not borrowed to the limit and have thus maintained a "credit reserve." In these times of high interest rates and tight money, credit may not be readily available and a high priority use of a limited amount of funds might be time deposits or short term government or other high quality securities (Federal Home Loan Bank, Federal Land Bank, etc.). This would provide for quickly
obtainable funds for emergencies or for investment opportunities which required funds in a hurry.

Next, farmers logically might look at investment opportunities in their farming operation followed by consideration of non-farming investment possibilities. A number of both farm and off-farm investments are rated subjectively in Table 1. The ratings are, at best, only rough guides to what might generally be expected. The individual farmer needs to estimate the following factors as they apply to his own situation:

Minimum size -- may be an important limitation even with the use of credit, in land purchase, buildings and major items of machinery and equipment.

Management required -- in the case of farm business and real estate investments; continuing management is important, even after the decision is made to invest. But in the case of financial assets, such as stocks, bonds and commodities, management is needed only in making decisions about acquiring and disposing of the assets.

Returns -- should be estimated after allowing a return for the management and labor necessary for the investment.

Risk -- generally is higher where returns are expected to be higher but in individual cases, high yielding investments may be found which have low risk.

Liquidity -- refers to the time and expense of converting an investment into cash.

Length of investment -- the productive life of the investment or the pay-off period.

These are factors which always have been important considerations. How does our changing world situation alter their significance?

In the first place, increased incomes resulting from our changing world situation open up investment doors which have been closed to many farmers. To make good use of funds, these farmers will be forced to analyze alternatives they never realistically faced before. Two of the factors listed above bear special mention in this period of high but fluctuating prices -- potential returns and risk. There is considerable optimism about the average level of farm product prices over the next few years, and this could lead to overestimation of returns. This is the same as saying that returns based on near-current levels of prices and costs are risky. Costs already have increased, and farm product prices could work lower over the next year or so. In addition, so much of our attention lately has been devoted to prices that we may have forgotten that yields of crops and livestock are subject to variation.

The risk factor becomes increasingly important when we seek leverage through the use of credit. In the first place, leverage works both ways; as long as the rate earned on the total investment remains above the interest rate, the rate of return on net worth is increased by using credit. But if the rate of return falls below the interest rate, losses are increased and equity may be impaired. In the second place, cash flows become increasingly important with the use of credit. If returns fall below expectations, cash flow problems may arise and could force liquidation of assets, possibly at considerable loss.

The usual advice for coping with risk problems is: a) to carefully budget costs, returns and cash flows, and b) to use conservative figures, i.e. apply a high discount to future earnings. To this could be added two suggestions: 1) On investments with a pay-off period of 2 years or more, break budgeted costs and returns into two or more periods. One period might reflect expectations for only the next 2 years; the other could be for years 3 through 7. When prices received are high and expected to decline at the same time costs of production are increasing, average prices for the period do not tell the whole story. The timing of receipts and expenses is important. 2) Budget two sets
Table 1. Investment possibilities for farmers, subjective rankings of various factors. Rankings may differ in individual cases, especially returns and risk.

<table>
<thead>
<tr>
<th>Type of investment</th>
<th>Minimum size(^1)</th>
<th>Management required</th>
<th>Potential returns(^2)</th>
<th>Risk</th>
<th>Liquidity</th>
<th>Length(^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land improvement (drainage, clearing, etc.)</td>
<td>low to med.</td>
<td>low to med.</td>
<td>hi</td>
<td>low</td>
<td>low</td>
<td>long</td>
</tr>
<tr>
<td>Grain handling</td>
<td>med. to hi</td>
<td>low to med.</td>
<td>med. to hi</td>
<td>low</td>
<td>low to med.</td>
<td>int. to long</td>
</tr>
<tr>
<td>Livestock bldg. and equipment</td>
<td>low to hi</td>
<td>med. to hi</td>
<td>low to hi</td>
<td>medium</td>
<td>low</td>
<td>int. to long</td>
</tr>
<tr>
<td>Field mach. and equipment</td>
<td>low to hi</td>
<td>low</td>
<td>med. to hi</td>
<td>low to med.</td>
<td>med. to hi</td>
<td>intermediate</td>
</tr>
<tr>
<td>Improved production practices</td>
<td>low to med.</td>
<td>med. to hi</td>
<td>hi</td>
<td>low to med.</td>
<td>med. to hi</td>
<td>short</td>
</tr>
<tr>
<td>Common stock</td>
<td>low</td>
<td>?</td>
<td>variable</td>
<td>hi</td>
<td>hi</td>
<td>short to long</td>
</tr>
<tr>
<td>Mutual fund</td>
<td>low</td>
<td>low to med.?</td>
<td>med. to hi</td>
<td>med. to hi</td>
<td>med. to hi</td>
<td>short to long</td>
</tr>
<tr>
<td>Corp. bonds</td>
<td>low</td>
<td>low to med.</td>
<td>low to med.</td>
<td>low to med.</td>
<td>hi</td>
<td>short to long</td>
</tr>
<tr>
<td>Other bonds</td>
<td>low to med.</td>
<td>low</td>
<td>low</td>
<td>low to med.</td>
<td>hi</td>
<td>short to long</td>
</tr>
<tr>
<td>Time deposits</td>
<td>low</td>
<td>low</td>
<td>low</td>
<td>low</td>
<td>hi</td>
<td>short to int.</td>
</tr>
<tr>
<td>Commodity futures</td>
<td>low</td>
<td>?</td>
<td>variable</td>
<td>hi</td>
<td>hi</td>
<td>short</td>
</tr>
<tr>
<td>Life insurance and annuities</td>
<td>low</td>
<td>low</td>
<td>low</td>
<td>low</td>
<td>low to med.</td>
<td>med. to long</td>
</tr>
<tr>
<td>Urban real estate</td>
<td>med. to hi</td>
<td>med. to hi</td>
<td>med. to hi</td>
<td>med. to hi</td>
<td>low to med.</td>
<td>long</td>
</tr>
<tr>
<td>Farm real estate</td>
<td>hi</td>
<td>med. to hi</td>
<td>med. to hi</td>
<td>low</td>
<td>low</td>
<td>long</td>
</tr>
</tbody>
</table>

\(^1\) Low, under $5,000; medium, $5,000 to $10,000; high, $10,000 and over.
\(^2\) Low, under 8%; medium, 8 to 15%; high, 15% and over (before income taxes).
\(^3\) Short-term, under 3 years; intermediate, 3 to 7 years; long, 7 years and over.
of costs and returns: those you consider most likely and those you consider less likely but still possible; then evaluate the consequences of the less favorable situation.

Let's look now at a few specific questions which farmers may be asking about farm financial management:

1. Should I carry a higher percent debt as a hedge against inflation? Inflation does not influence all prices equally, so careful thought should be given to its effects in farming. There have been times when farm incomes did not keep pace with inflation. Depreciable capital items and land values tend to increase with increases in general prices, but this might provide only a partial hedge against inflation. But in general, debtors tend to gain from inflation, especially when credit has been used for purchase of productive assets such as land, land improvements, buildings and machinery.

2. In the face of price uncertainty, how much leverage can safely be used? Safety and leverage tend not to go together. Use extreme care in increasing leverage beyond the point where unfavorable results which have some reasonable chance of occurring would force liquidation of assets to the extent of reducing future income below acceptable levels. Project unfavorable results and their consequences. If you worry, work toward reducing leverage by paying off debts.

3. What can I do about high income taxes? Be thankful you have an income level that puts you in a higher bracket! Use extra care in filing and documenting returns so that an audit will not cause you problems. Be sure to use income averaging if you qualify. Consider shifting income into next year by postponing sales and accelerating capital purchases which you already plan to make; trade tractors or expand the hog house this year rather than next, do the ditching you have planned to do "some day." Clear fence rows and wood lots, repair buildings and fences, take maximum allow-able write-offs on these items and investment credit on those that qualify. But be sure these are economically sound expenditures. Tax savings alone are no assurance of making money.

4. Should a share tenant shift to cash rental? Yes, if:

a) he can handle the extra financing and risk.
b) he can find land to rent at a price that will yield greater returns than he could expect as a share tenant.
c) he is capable of handling the management-marketing decisions which might have been made by the landlord.

He might want to consider a sliding scale cash rental agreement, especially with an agreement for more than 1 year. Example: Landlord and tenant decide that $75 per acre is a fair rental for 120 bu. corn land if the price of corn next fall at a definite time and place is $1.80 per bushel. They then agree to adjust the rent payment by, say, 60¢ per acre for each 1¢ per bushel departure from $1.80. If corn at the predetermined place and date is $2.10, the rent goes up to $93. If it is $1.50, the rent would be $57. Minimums and/or maximums could be established. Rental adjustments could also be based on departures from a given gross return (yield times price). But remember that the nature of cash rental is to shift risk from the landlord to the tenant. Don't try to make a cash lease do what a share lease can do better.

5. Should a crop share landlord shift to custom farming? Not if he has an excellent tenant with whom he has gotten along well, and if the landlord has not had management experience and ability. Maybe, if the tenant is average or below and if the landlord is willing to assume more risk and management responsibility. Sometimes a good farmer who is short on capital will agree to do custom work, perhaps to enable him to make payments on machinery or to provide a
definite income to a son who does the work.

A custom-incentive plan might be considered. Example: Pay agreed upon custom rates for plowing, discing, planting, cultivating, harvesting, etc. Then give the operator a share of production in excess of a stated yield. This yield should be easily obtainable to provide the incentive for earning more by doing a good job.

6. **Should I buy land?** Probably so, if:

   a) You know the land market well enough to feel confident that you could sell the land within a year for about what you paid for it, (an exception might be purchase of an adjoining tract for farm enlargement).

   b) You have the capabilities to get efficient, high production from the land, either as an operator or landlord.

   c) You can meet cash flow requirements, even in a year of lower prices and/or yields.

   d) The price does not include a substantial amount for buildings which would be difficult to sell or for which you have little use.

   Investment opportunities in land certainly should not be overlooked by farm people. They often have more of the land-related managerial and other resources than non-farm investors and should analyze carefully land investment opportunities.

   7. **Should I invest in common stocks?** Before investing more than a small amount in stocks, ask yourself the question: "Which do I know more about, stocks or farming?"

   You might want to consider setting up a retirement plan under the provisions of the Keogh Act. This allows the tax-free investment of limited funds in an approved retirement program.

   Changing economic conditions in late 1972 and 1973 have made farmers better off. Many would argue that this improvement is deserved and overdue. Wise financial management is needed to make good use of these financial gains to aid in the orderly transition to price and income levels in the mid 1970's which likely will be well below present levels.