Virginia Cooperative Extension

Farm Business Management Update
October – November 2006

To: Extension Unit Directors, Extension District Directors, Extension Program Directors, and Farm Management Agents, and ANR Specialists

Dear Co-Workers:

Farm Business Management Update is a joint effort of the Agricultural and Applied Economics faculty and the area farm management agents. Subject matter areas include timely information on farm management, marketing, tax management, finance, credit, labor, agricultural law, agri-business, estate planning, 4-H and economic education, natural resources, and CRD. Please use this information in your on-going Extension programs and circulate to all Extension staff. **Farm Business Management Update** is electronically accessible via the Virginia Cooperative Extension World Wide Web site (http://www.ext.vt.edu/). To see the articles listed in the reverse chronological order, select "News," then select "Farm Business Management Update" listed under the heading "Periodicals."

Gordon E. Groover
Extension Economist, Farm Management
and Farm Management Coordinator

Karen Mundy
Rural Economic Analysis Program
Communications Specialist

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VIRGINIA STATE UNIVERSITY

Alex & Dave's Economic Fore-Guess: October 2006

By Alex White (axwhite@vt.edu), Instructor, Agricultural Finance and Small Business, and David M. Kohl (sullylab@vt.edu), Professor Emeritus, Department of Agricultural and Applied Economics, Virginia Tech

What the heck is going on in the U.S. economy? Gas prices rise dramatically, then they fall. The housing market heats up, then slows down. Consumer confidence falls, then it rises. Alex forecasts gloom and doom, Dave says "Hey, there's a light up ahead." It seems like as if we've been on a mini-yoyo for the past six months or so. After in-depth analysis and many hours of throwing darts at an economic dartboard, here's our latest installment of the economic fore-guess.

For the past couple of months, the U.S. economy has been facing the prospect of increased inflation. Increased energy costs were pushing up other consumer costs, while increased production capacity in the manufacturing sector pulled the cost of living higher. But recent indicators are pointing towards an economic slowdown. The leading composite indicator has been dropping for the past three months; oil prices are falling; interest rates are slowly increasing, acting as a brake for the economy. So Alex's thoughts are still pointing towards "gloom and doom" in the form of a relatively stagnant economy for the next three to six months.

Dr. Ed Seifried and Dave shared the podium in Fargo, North Dakota at a recent bankers meeting. The following are some highlights from their discussion.

Currently the short-term rate (90-day T-Bills) is 4.76 percent, and the long term rate (10-year bond) is 4.71 percent. This situation represents a slightly inverted yield curve. Based upon historical research, this inversion would indicate approximately a 30 percent chance of a recession in the next four quarters.

Economic growth has slowed to a 2.5 percent annual rate. This factor, along with reduced core inflation and a slowing housing market, would indicate that the Federal Reserve is near the end of its interest rate increases. Dr. Seifried's economic models indicate that the federal funds rate next year at this time may be as low as 4.0 percent. This rate would equate to a prime rate of about 7.0 percent. At present, the federal funds rate is 5.25 percent and prime is 8.25 percent.

The Composite Leading Index is down 1.5 percent in the last seven months, along with the inverted yield curve – another sign of a slowing economy.

Housing starts are weakening drastically, well below the ideal level of $1.75 million annually. The current level is $1.665 million. Building permits are at a 4-year low along with the highest inventory of homes for sale in 15 years at 7.4 months. Housing has been the driver of the economy, creating the muscle for the heavyweight economy, so the next six months will be interesting. Time will tell which one is right.

The Management Calendar

By Gordon Groover (xgrover@vt.edu), Extension Economist, Farm Management, Department of Agricultural & Applied Economics, Virginia Tech

Farm business managers should consider putting the following activities on their management calendar for October-November.

- Time to order your farm record book: As we enter the last quarter of 2006, it is time to order a new copy of the Virginia Cooperative Extension "Farm Record Book: Expenses and Receipts" (Publication 446-017). This 120-page record book provides an organized way of keeping tract of annual financial, labor and personnel, and production related records. It provides forms for many categories of expenses, receipts, labor, and financial summaries to meet the needs of most agriculturally related businesses using cash accounting methods. Column headings are included for major items with some columns remaining blank for your own headings. Forms are arranged to facilitate transferring totals to income tax forms (Schedule F, tax deprecation, and Form 4797) and to help complete end-of-the-year analysis. Virginia Cooperative Extension "Farm Record Book: Expenses and Receipts" is available from Virginia Cooperative Extension for $12.00. Call your local extension office and request the order form VCE Publication 446-016 or contact me at 540-231-5850.
- 2007 DCP Sign-Up Began October 1, 2006. Signup for 2007 Direct and Counter-cyclical Payment Program (DCP) begin October 1, 2006 and continues until June 1, 2007. Farmers can sign up for the program through the online DCP sign-up service at http://www.fsa.usda.gov/FSA/webapp?area=online&subject=landing&topic=dcp or by visiting any USDA Service Center or their administratively assigned center to complete their 2007 DCP contract. Additionally, sign-up can be done online, allowing producers to choose payment options, assign crop shares, and sign and submit their contracts from any computer with Internet access. DCP participants can view and print out submitted contract options at any time.

  USDA computes DCP payments using base acres and payment yields established for each farm. Producers receive direct payments at rates established by statute regardless of market prices. For 2007, eligible producers may request to receive direct advance payments based on 22 percent of the direct payment rate for each commodity associated with the farm. USDA will issue DCP direct advance payments beginning Dec. 1, 2006. Counter-cyclical payment rates vary depending on market prices. Counter-cyclical payments are issued only when the effective price (which takes into account the direct payment rate, market price, and loan rate) for a commodity is below its target price. In more than four years since the 2002 Farm Bill authorized DCP, USDA has issued approximately $30 billion in DCP payments to America's agricultural producers. Additional information on DCP can be found by viewing the USDA fact sheet at http://www.fsa.usda.gov/FSA/printapp?fileName=pf_20060301_insup_en_dcp06.html&newsType=prfactsheet.
- Farmers faced with low prices, for example, milk prices, can look to their top five cash expenses as a way to reduce costs in the short run. Total all expenses and estimate spending for the remainder of the year. Then identify the largest expense items and

review each, looking for ways to reduce spending. Ask questions: Are there lower priced alternatives? Is this item needed? If I reduce usage, will output be reduced? Also, make use of local experts for advice on ways to improve costs management.

- Once the crops are harvested, get the farm financial records summarized, updating the third-quarter cash flow and comparing it to your projections. Watch for problems. Actual inflows or outflows that differ from your projections may not signal a problem, but understanding why you have differences helps you understand changes in the farm business.
- Using the last three-quarters of cash flow and financial records, estimate total farm expenses, income, and capital purchases and sales. Then make an appointment with your tax advisor to plan year-end tax management strategies. Be sure to estimate crop insurance payments and any government payments that will appear on this year's taxes. To take full advantage of year-end tax management strategies, farmers must make decisions before December 31, 2005. Be sure to review changes to state and federal tax laws with your tax advisor to make sure you have not missed deductions and/or credits.
- Farm business managers should never loose sight of the two objectives of tax management: 1) all decisions, including tax management, should be made to improve the long-term survivable and profitability of the businesses, and 2) tax management tools are used to level out the year-to-year swings in reported income and subsequent taxes paid. You can use the multitude of tools and techniques written into the tax code for farmers, and all businesses, to manage income and expenses and to even out the wide swings in annual profits and losses that many farmers experience. Leveling out the income tax liabilities year-to-year will lead to lower total taxes being paid.
- Be sure to keep crop records up-to-date during harvest: include yields, machine times and equipment used, weed problems, and differences in hybrids. If you're moving up in the information age, consider the fully integrated record keeping systems using yield monitors, GPS, handheld computers, and management software on your office computer. One example of this whole farm system (includes accounting, personnel, and livestock records add-ons) is FarmWorks at http://www.farmworks.com.
- Be sure to keep livestock records up-to-date during fall sales. At a minimum, include weight, grade, sale prices, and identification numbers of all calves sold and/or purchased.
- Be sure to check on crop insurance policies. A list on agents in your area can be found at http://www3.rma.usda.gov/apps/agents/. Check the following web site for closing dates for all insurance policies: http://www.rma.usda.gov/data/sales-closing-dates/

Financial Analysis of an Agricultural Business - the Income Statement

By Alex White (axwhite@vt.edu), Instructor, Agricultural Finance and Small Business, Department of Agricultural and Applied Economics, Virginia Tech

My previous article briefly discussed the agricultural balance sheet – what it is and what you can learn from it. Now I'll focus on another major financial statement: the income statement. To most producers, this statement is important because it shows the bottom line – how much net income, or profits, the business made during the year. The income statement is also called the Profit and Loss Statement, or the P&L for short. I use the income statement to analyze the profitability of the operation. When used in tandem with a balance sheet and a cash flow statement, I can get a good picture of the repayment ability of the operation as well.

An income statement is a listing of all the business-related incomes (revenues) and expenses for one year. It only includes incomes and expenses that stem from the business – household and family items are not included on an income statement. To simplify the process, I typically use an IRS Schedule C (Business Profit/Loss) or Schedule F (Farm Profit/Loss) as a proxy for an income statement. These tax schedules clearly lay out what items should be included on an income statement.

Unlike a balance sheet that is constructed for a given day, the accounting period for an income statement is one year. You can construct them for shorter time periods (a week, a month, a quarter, etc.), depending on the particular business. Similar to balance sheets, two methods are used to construct an income statement – the cash method and the accrual method. In a nutshell, the cash method records incomes and expenses when cash changes hands; the accrual method, which is more accurate, records incomes and expenses when a transaction takes place. For example, suppose I buy $10,000 of supplies on December 5, 2006, but don't actually pay for the supplies until January 5, 2007. Under the cash accounting method, the supplies expense will be recorded in January 2007; under the accrual method, the supplies expense is recorded in December 2006. Due to the simplicity of the cash method, and the fact you can play more "tax games" using the cash method, it is the most common accounting method I usually see. From an analysis point of view, I would rather have accrual method income statements, as they provide a much more complete picture of the business' financial situation.

The first section of an income statement is the income section. This section will include all the revenues that are generated by the normal operations of the business. Examples include gross income from the sale of crops, feeder livestock, livestock products such as milk, and any income from custom work performed. Any income from government programs or cooperative distributions may also be listed in this section. If managers use the accrual accounting method, they need to adjust the income for changes in the value of their inventories. A common mistake in listing incomes under the cash method is to include proceeds from the sale of a capital asset – these do not go on an income statement. They are listed on IRS Form 4562 because they are not incomes from normal operations of the business. Once all the incomes are listed, they are totaled to get Gross Income.

For most farms, the next section of the income statement is the expense section. This section clearly lists all of the main expense categories for a farming operation, such as chemicals, feed, fertilizer and lime, freight, labor expense, interest expense, and seed and plants. These items are all cash expenses for the operation. In addition, this section also includes depreciation expense – a non-cash expense. Depreciation estimates the loss of value for productive assets (calculated using IRS guidelines). Please note, income taxes are NOT listed as an expense on an income statement. After everything is listed, I calculate the total expenses by summing all the expenses.

For an agribusiness that manufactures a product or buys products for resale, the next section of the income statement is the "cost of goods sold" section. This section clearly shows the cost of producing or buying the products. For example, if I purchase sweet corn for $1.50/dozen and resell it for $2.00/dozen, my cost of goods sold is $1.50/dozen. Or if my florist business buys various inputs (flowers, baskets, vases, hired labor, etc.) for $5 per arrangement and sells the arrangements for $15 apiece, my cost of goods sold is $5 per arrangement.

After all of the incomes and expenses (and accrual adjustments) are completed, I can calculate the main financial profitability measure – Net Income. Net Income is calculated by subtracting total expenses from total income. In the business world, we call it Earnings Before Taxes (EBT). Obviously, we like to see Net Income or EBT greater than zero!

A Net Income greater than zero indicates that we generated enough revenues to cover our total expenses (including depreciation). Net Income greater than zero leads to a big issue that people have with profit calculations. Producers will tell me that at the end of the year their cash income is greater than their cash expenses, so they had a profitable year. They have more cash on hand than they started with, so everything is just great! My answer is, "Don't forget about depreciation!!" Producers often focus on cash only, and they forget about depreciation. Since a check isn't written to anyone to pay depreciation expense, forgetting is understandable. But depreciation expense must be covered over time!

Consider this situation – a business has total income of $100,000, cash expenses of $80,000 and annual depreciation expense of $30,000. Producers tend to see profits of $20,000 ($100,000 - $80,000), when in reality they have a "loss" of $10,000 ($100,000 – $80,000 – $30,000). Yes, they may have more cash on hand, but the value of their machinery and facilities has decreased by $30,000 (depreciation). The overall condition of the business is decreasing over time – if depreciation can't be covered, the asset base cannot be maintained at its current level; equipment cannot be replaced or facilities repaired over time. The business is slowly losing productive power. Total expenses must be covered, including depreciation, to stay in business for the long run!

Another common measure of profitability that we can get from an income statement is the Rate of Return on Sales (ROS). There are several methods of calculating ROS – I take the easy method and divide Net Income by Gross Sales (or Gross Income). This ratio tells how much profit is generated by each dollar of sales. Again, the higher, the better. The benchmark for this ratio varies for each industry. I use the Annual Statement Studies (Robert Morris Associates) to find the appropriate benchmark for a specific industry.

I can use the incomes statement in combination with the balance sheet to calculate other profitability measures, such as Rate of Return on Assets (aka ROA) and the Rate of Return on Equity (ROE). I'll discuss these ratios in a future article.

When producers talk about the bottom line, they are usually talking about net cash income (cash income minus cash expenses). I would highly recommend that producers go one step further and consider their net income (total income minus total expenses, including depreciation) to get a more accurate picture of the profitability of their businesses.

If You Build It, They Might Come

By Matthew Miller (mamille6@vt.edu), Extension Agent, Agriculture and Natural Resources, Farm Business Management, Southwest District

Most people have seen the Kevin Costner classic "Field of Dreams" with a mixture of farm struggles, sports, and family relationships. It's a definite top ten on my list of Hollywood's productions. Lately, I feel like I'm hearing the voice in the corn field "If you build it, they will come." The baseball diamond in the middle of an Iowa corn field worked wonders for the Hollywood farm family. However, Hollywood and everyday farm production are further apart then just miles on a map.

Please don't misunderstand my point. I am not implying that value added or product differentiation is not a good idea. In fact, value added and creating a differentiated product is a real profit opportunity and one of the success stories of the meat industry in recent years. My discussion goes beyond that level of product change. A Certified Angus Steak is a differentiated steak, raised and produced in a conventional marketing system. Strict Quality Standards and astute marketing create the value and recognized difference in the retail marketplace. My concern revolves around the desire to create a new product. Recently, I have been apart of multiple discussions regarding the creation of a variety of products ranging from meat to wine and everything in between. These new products are not what I would classify as value added or improved products. These new products fall outside of the typical production and marketing methods. Little to no market research, production science, cost projections, and sales estimations are done. There is, however, an overwhelming feeling that the new product will be better. That feeling much like the voice in the corn field has the ability to drive decisions not based on science or markets but on emotion. Again, don't think that I am against thinking outside the box, but agriculture is already an emotionally charged business. Business decisions cannot be solely based on emotion. No doubt markets and consumers will try new products. However, these products must be created with a foundation of sound science, market research, consumer preference, etc.

Another main concern that revolves around the production of new products is ability of the producer themselves. The individuals and groups that have been successful in such ventures have a common denominator: an unbelievable work ethic and managerial skill. If you are at the top of your game then a new venture may be for you. However, if in the course of your production you have been an average or sub par producer, history would indicate that moving in to a new product arena will probably not be a profitable move. New product ideas often have roots in the feeling that it will enhance farmers' ability to make more money. While increased profits may or may not happen, certainly expenses and challenges will increase in the new marketplace.

While traditional marketing methods for many commodities may be frustrating, they do work and are recognized by buyers and sellers alike. Traditional markets have created not only product expectations but are tried and true in matching supply and demand. I fully understand the need to differentiate commodity products. Product differentiation must continue to meet consumer demand and expectations and increase demand in the marketplace. Consumers will continue to demand product enhancement. But before a new product can be placed on the market, the producer needs to do more homework. Ideas are powerful tools that have the ability to change a farm for the better. If products or ideas are to succeed, they must be based on more than just a feeling or voice in the corn field.

46th Virginia Tech Income Tax School, WWW.TAX.VT.EDU

By L. Leon Geyer (geyer@vt.edu), Professor, Agricultural Law, Department of Agricultural and Applied Economics, Virginia Tech

This fall we have three seminars to offer you.

1. **Income Tax Seminar** -- two days of general sessions of intensive study with farm and forestry sessions at selected locations.
Register at: https://www.conted.vt.edu/ssl/tax/index.lasso
More info at: http://www.tax.vt.edu/tax_about.html

General Session Topics

- New Legislation
- Domestic Production Activities Deduction
- Rulings and Cases
- Individual Tax Payer Issues
- Business Issues
- Investment Issues
- Business Entities
- IRS Issues
- Retirement
- Estate and Gift Taxes
- Tax Aspects of Divorce
- Tax Practice
- Tax Credits
- Tax Consequences of being a "Trade or Business"
- Ethics

Farm and Forestry Session Topics

- Conservation Security Program payments
- What is farm income for different income tax purposes
- Gifts of farm products
- Tobacco tax problems

2. **Technology Seminar** is for tax professionals who want to better understand the role of technology in their practice. We cover the laws, rules, and risks technology poses in our workplace and then the solutions, procedures, and help that is available to comply to reduce risks.
Register at: http://www.conted.vt.edu/reg/introtax/
More info at: http://www.tax.vt.edu/technology_about.html

3. **Introductory Tax Preparation Seminar** is designed for those who are new or returning to tax preparation and want a course in basic preparation.
Register at: http://www.conted.vt.edu/reg/introtax/
More info at: http://www.tax.vt.edu/1040_about.html

Seminar Schedules

Income Tax Seminar

Site	Date	Farm & Forestry Session	$ Fee	$ Fee after Oct. 6
Richmond	November 6-7	Nov. 6	242	272
Staunton	November 8-9	Nov. 8	217	247
Bristol	November 13-14	Nov. 13	217	247
Roanoke	November 15-16	Nov. 15	217	247
Lynchburg	November 20-21*	Nov. 20	197*	227*
Dulles	November 27-28		242	272
Fredericksburg	November 29-30	Nov. 29	242	272
Williamsburg	December 4-5	Dec. 4	232	262
Chesapeake	December 6-7	Dec. 6	217	247
Richmond II	December 14-15		217	247

*In Lynchburg lunches not included

Introductory Tax Preparation Seminar

Site	Date	$ Fee	$ Fee after Sept. 12
Northern Virginia	Oct. 3	107	122
Richmond	Oct. 4	107	122
Roanoke	Oct. 5	107	122
Chesapeake	Jan. TBA	107	122 after Dec. 12

Sincerely,
From all of us at the Virginia Tech Income Tax School

Contact the registrar:
Income Tax School Registrar
Mail Code 0272
Blacksburg, VA 24061
Fax: (540) 231-3306
Phone: (540) 231-5182
vttax@vt.edu

WWW.TAX.VT.EDU

Calendar of Events

November

6-7 Income Tax Seminar. Richmond I. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

8-9 Income Tax Seminar. Staunton. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

13-14 Income Tax Seminar. Bristol. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

15-16 Income Tax Seminar. Roanoke. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

20-21 Income Tax Seminar. Lynchburg. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

27-28 Income Tax Seminar. Dulles. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

29-30 Income Tax Seminar. Fredericksburg. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

December

4-5 Income Tax Seminar. Williamsburg. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

6-7 Income Tax Seminar. Chesapeake. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.

14-15 Income Tax Seminar. Richmond II. Contact seminar registrar at (540) 231-4084 or by email at vttax@vt.edu or Leon Geyer, Program Director, at (540) 231-4528 or by email at geyer@vt.edu.