Farmer-to-Consumer Marketing #6

Financial Management

Scope of Financial Management

Managing the financial affairs of a direct marketing operation includes:

- Raising capital
- Identifying financial objectives and creating plans to achieve them
- Budgeting for the future flow of cash receipts and disbursements (cash management)
- Controlling the use and distribution of funds
- Protecting the operation's assets

Capital comes from two basic sources:

- *Equity capital* (also known as *ownership capital)* is from savings, gifts, and inheritances
- *Debt capital* is borrowed from lenders or from lessors through long-term lease arrangements.

Equity-plus-debt capital constitutes the primary source of external capital in the business. Internally, capital funds are generated through the sale of products and, ultimately, from profits.

Financial planning works to determine how much capital or money you need, when you will need it, and how you will acquire it. Planning also includes developing a business strategy to achieve long-term operating objectives such as survival, growth, and profits.

Cash management is budgeting for the future flow of cash receipts and disbursements in order to meet obligations when due. It also forecasts sales, *margins*, and expenses in order to budget for profits.

Financial control checks, evaluates, and measures your business's financial progress and enables you to take corrective action when actual results differ from plan.

Protecting the business's assets and capital encompasses:

- Estate planning
- Maintaining adequate business and liability insurance coverage
- Legally organizing the business as a corporation, partnership, sole proprietorship, or other form of company
- Adequately training employees
- Giving attention to diversification opportunities

The policies and operations of a direct marketing business should aim at achieving a targeted return on your equity investment in the business. Every action you take or decision you make usually affects the operation's bottom-line profits. Production plans, market stand layout and design,

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Farmer-to-Consumer Marketing: The Series

A successful direct farm marketing business requires knowing and understanding effective marketing and management practices.

This series of Extension publications, PNW 201–206, provides information about establishing and developing a direct farm marketing business. Production and marketing costs, management practices, personnel management, and financial management are among the topics discussed.

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operating practices, merchandising and pricing strategies, labor scheduling, and inventory control procedures all have an impact on profitability.

Profit is your return for the time, effort, and money you invest in the business and is your reward for risking possible loss. Profit, in essence, is the life blood of your business. It is not a "dirty word." By generating adequate profits, you can obtain the capital needed to enlarge or remodel present facilities, acquire new facilities, replace equipment, and diversify into new areas of operation.

Some direct marketers define profit as "something left over at the end of the year—if I am lucky." This attitude spells the beginning of the end for many operations, and indeed they will be lucky if *any* profits remain. While profits are never guaranteed, they are most likely to materialize when you plan for them.

A Good Financial Manager

Being a good financial manager means controlling financial operations without being controlled *by* them.

The essence of control is to establish financial objectives and create action plans to achieve them. Your objectives should be:

- In writing
- Specific regarding key results
- Quantitative and measurable
- Within an individual's specific area of responsibility
- Understandable by all concerned
- Realistic and attainable

For example, an objective might be to earn annually a 25-percent return on equity capital invested in the business.

An action plan describes, step by step, how you will achieve specific results within a stated time. In planning for sales, profits, and return on investments, give attention to pricing, merchandising, expense control, and inventory control. To create the plan:

1. Compare your operation with those of competitors. What features do you have to offer that others don't?
2. Forecast sales for the coming year and how they might change over time as you develop your business.
3. Consider economic trends, such as inflation and competitors' actions, in your market area.
4. Establish objectives beyond sales forecasts by "stretching" to improve the operation.
5. Build a realistic operating plan to achieve sales and profit objectives including budgeting for sales, margins, and expenses.
6. Evaluate results compared to your objectives.
7. Adjust the plan as needed.

Financial controls require identifying *key performance areas* (KPAs), which are vital to your operation's success. KPAs include sales, production, finance, public relations, personnel, and marketing.

Also identify *key indicators* (KIs)—a few vital indicators in each KPA that measure the actual performance of the operation. KIs may include, but are not limited to, market share, return on investment, number of customer complaints, employee turnover, and employee absenteeism.

Once you identify the KPAs and KIs, you can operate on the principle of "management by exception." Begin by establishing upper and lower boundaries for each key indicator in each key performance area. Results within the boundaries require no management action; but when results are outside the boundaries, that should signal you to consider corrective action.

Financial Records

Any business should prepare at least a balance sheet, a profit and loss (operating) statement, and a cash-flow statement. A direct farm marketer is no exception, regardless of size. As much as possible, keep your operation's financial records separate from your other business and personal financial activities, including any outside farm production. This allows you to analyze your direct market operation clearly.

These three financial statements can help you answer questions such as:

- What is my present financial status?
- What factors (strong and weak) have caused my business to be in this condition?
- How strong is my financial condition compared to similar operations?

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Essentially, the *balance sheet* indicates what the business owns, what it owes, and the investment of those owners (see Figure 1, below). It shows where the business is at a given point in time.

Figure 1. Sample Year-end Balance Sheet
December 31, 20___

Assets		
Current Assets		
Cash on hand	$ 130	
Cash in bank	900	
Accounts receivable	30	
Total		$ 1,060
Fixed Assets		
Equipment (less accumulated depreciation)	1,500	
Facilities (less accumulated depreciation)	11,000	
Land (for stand facilities)	3,000	
Total		$ 15,500
Total Assets		$ 16,560
Liabilities		
Current Liabilities		
Wage payable	60	
Accounts payable	130	
Notes payable (equipment payments in next 12 months)	400	
Total		$ 590
Long-term Liabilities		
Facilities mortgage	7,500	
Total		$ 7,500
Total Liabilities		$ 8,090
Equity		
Net Income (after income tax, assumed at 32%, from the past year's operations)	2,584	
Balance (equity) at beginning of January 1, 20__	5,886	
Total		$ 8,470
Total Assets		$ 16,560

A *profit and loss statement*, also called an *income statement*, is a record of how effectively the business's resources have been used and how well business finances have been handled (see Figure 2, below). It shows the overall profitability of the business and summarizes business operations over a certain period. In essence, it shows how the business got where it is.

Figure 2. Sample Income Statement
January 1 to December 31, 20___

Gross Sales		
Revenue	$ 44,700	
Less refunds and allowances	50	
Total		$ 44,650
Cost of Merchandise (grown or purchased)		27,300
Gross Margin		17,350
Selling Expense		
Nonfamily labor	2,500	
Family labor	6,600	
Supplies	1,200	
Utilities	300	
Advertising	250	
Facilities depreciation	1,300	
Equipment depreciation	300	
Interest (mortgage notes & operating capital)	400	
Insurance	50	
Taxes, licenses, and fees	650	
Total		$ 13,550
Net Return: income to operator's labor, management, and capital, before tax		$ 3,800

Figure 3. Sample Cash-flow Worksheet

	April–June	July–Sept.	Oct.–Dec.	Full Year
Cash Inflows				
(1) Net cash sales				
(2) Collection of accounts receivable				
(3) Capital sales, e.g., a truck no longer needed for the business				
(4) Other				
(5) Total cash inflows				
Cash Outflows				
(6) Cost of product grown (or purchased) and sold				
(7) Nonfamily labor				
(8) Family labor				
(9) Supplies				
(10) Utilities				
(11) Advertising				
(12) Insurance				
(13) Taxes, licenses, and fees				
(14) Capital expenditures				
(15) Loan principal and interest due				
(16) Other expenses				
(17) Total cash outflows				
Cash Balance				
(18) Net cash from operations (#5 minus #17)				
(19) Beginning cash balance				
(20) Net cash available (#18 + #19)				
(21) Minimum acceptable cash balance				
(22) Cash over (or short) (#20 minus #21)				
(23) New short-term borrowing for operating expenses necessary to maintain minimum cash balance				
(24) New long-term borrowing for capital expenditures necessary to maintain minimum cash balance				
(25) Owner capital additions (withdrawals)				
(26) Ending cash balance (#20 + #23 + #24 + #25)				
Accumulated New Borrowings for Year				
Short-term				
Long-term				
Total				

A *cash-flow statement* summarizes all cash inflows and outflows over a specific period (see Figure 3 at left, on page 6). It identifies the sources, amounts, and timing of cash income and expenses. It can show you when excess cash might be available and when to expect cash deficits. Given change in your capital (equity), you can anticipate how much you will have to borrow, plan repayment timing, and determine amounts available for new debt amortization. (**Note:** This example assumes that the business doesn't operate during the winter quarter of the year.)

Overall, it is critical to maintain adequate records so you know where you are going and can properly exercise controls. It also is important to develop skills to interpret these records as you move toward your goals.

Planning for Capital Needs

A good financial manager plans for future capital expenses. This involves determining how much capital your business needs, when you will need it, what is the appropriate type to get (such as short- or long-term debt, trade financing, or equity capital), where you can get capital at the best terms (such as from commercial banks, savings and loans, or equity investors), and how you will repay it (which you can estimate by preparing a cash-flow forecast). Note that when securing debt capital, it is important not to borrow more than you need to effectively operate the business. If traditional debt financing is in short supply, you may need to plan for a larger percentage of trade and equity financing to meet your needs. In part this involves maintaining a good working relationship with your financial institutions, vendors, and those who might be willing to invest equity capital in your business.

Maintaining a strong, stable capital structure

Keep your capital structure healthy by giving attention to such factors as liquidity, leverage, and profitability. Common measures of these factors appear in page sidebars, beginning on this page.

Liquidity means being able to pay bills when they come due. This requires maintaining adequate working capital. *Working capital* is the owner's equity in the business's current assets (cash, accounts receivable, and inventory). Essentially, it's a cushion for current creditors, and you can use it to take advantage of trade discounts and expansion opportunities. Only by generating profits can you internally increase working capital. Other sources of working capital are taking on debt and selling fixed assets such as land, buildings, and equipment. Most firms, however, are not in business to sell

Measures of Liquidity—End of Period

Working capital
= current assets – current liabilities
e.g., $1,060 – 590 = $470

Current ratio
= current assets ÷ current liabilities
e.g., $1,060 ÷ 590 = 1.8

Measures of Leverage (Solvency)—End of Period

Debt-to-asset ratio
= total liabilities ÷ total assets
e.g., $8,090 ÷ 16,560 = 48.89%

Equity-to-asset ratio
= equity ÷ total assets
e.g., $8,470 ÷ 16,560 = 51.2%

Debt-to-equity ratio
= total liabilities ÷ total equity
e.g., $8,090 ÷ 8,470 = 95.5%

Measures of Profitability

(assuming no withdrawal for operator's labor and management)

Return on assets (ROA)—before tax

= (net income before tax + interest)

÷ total assets end of period

e.g., ($3,800 + 400) ÷ 16,560 = 25.4%

(after tax)

= (net income after tax + interest)

÷ total assets end of period

e.g., ($2,584 + 400) ÷ 16,560 = 18.0%

Return on equity (ROE) —before tax

= net income before tax

÷ equity end of period

e.g., $3,800 ÷ 8,470 = 44.9%

(after tax)

= net income after tax

÷ equity end of period

e.g., $2,584 ÷ 8,470 = 30.5%

Return on sales (ROS) —before tax

= net income before tax ÷ net sales

e.g., $3,800 ÷ 44,650 = 8.5%

(after tax)

= net income after tax ÷ net sales

e.g., $2,584 ÷ 44,650 = 5.8%

Gross margin percentage

= (net sales – cost of merchandise sold)

÷ net sales

e.g., ($44,650 – 27,300) ÷ 44,650 = 38.9%

Mark-up percentage

= (net sales – cost of merchandise sold)

÷ cost of merchandise sold

= $17,350 ÷ 27,300 = 63.6%

fixed assets in order to increase working capital. Consequently, to maintain liquidity you need to focus mainly on generating adequate profits.

Leverage describes a reasonable and "safe" mix between the amount of debt and equity capital in the business.

A business capital structure highly dependent on debt runs the risk of being unable to meet repayment requirements if sales fall off and profits don't materialize as planned. Thus, it is critical to maintain a safe mix of debt and equity capital to help ensure the business's long-term survival.

Your ideal debt level may be as simple as your assessment about the repayment capabilities for your business. More often, however, the safe mix may be dictated to you by your lender's rules for the type of business you are operating. While businesses all have different safe levels of debt, generally the financial risk of loss for your business will increase as the amount of debt in your business increases relative to your equity capital.

Profitability means earning an adequate return on total capital invested in the business (assets), equity capital invested in the business (net worth), and sales. Measures of profitability including gross margin and mark-up formulas. These measures can be calculated on either a before- or after-tax basis. Before-tax values are easier to compare among other, similar business, since they avoid differences in proprietors' marginal tax rates. After-tax values more nearly show the actual return for the item in question and can be used to track the business's performance over time.

You also will want to assess how efficiently you are using the business's assets. Several common measures of efficiency are *asset turnover, inventory turnover,* and *working capital turnover.* These measures can be used to compare like businesses or to help you analyze your business over time.

You will need to establish targeted standards for each of these financial measures. That includes establishing a range of acceptable results. Track these results over time to measure the financial progress of your business. You will likely become more comfortable and skilled in this type of analysis as your business matures.

Some business operators find that similar business operations may be willing to share information as a group which can help you assess your competitive status. Having an independent person compile and summarize proprietary information from each business can help avoid confidentiality problems. There also may be trade associations and community college- or university-sponsored business development programs that can help you judge the performance of your business.

In summary, managing your direct farm marketing business needs to include a concern for the efficient use of your assets. Paying attention to financial measures, such as those discussed here, will help you maintain a strong, stable capital structure into the future. Maintaining adequate liquidity will allow you to meet debt obligations when due and to pay your bills on time. A prudent debt level allows you to perpetuate your business even during hard economic times. High levels of efficiency in the use of your assets will help you maintain adequate profit levels.

Measures of Efficiency

Asset turnover

= net sales ÷ total assets end of period

= $44,650 ÷ 16,560 = 2.7%

Inventory turnover

(not applicable here, assuming beginning and ending inventories both equal zero)

= (cost of merchandise sold

÷ average inventory value)

= (cost of merchandise sold

÷ beginning + ending inventory)

÷ 2

Working capital turnover

= net sales

÷ working capital at end of period

e.g., $44,650 ÷ 470 = 9,500%

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