



## Economic Toolbox

### **Working Capital**

About this time of year most farmers are pressing towards the limits of their endurance. In the physical sense, the pent-up energy and optimism from long winter months of waiting and planning have been vented during the spring planting season. The days grow longer, the work becomes more urgent and personal energy is drawn upon. Farmers who have not learned to pace themselves according to the limits of their physical and mental strength suffer the consequences with poor health and reduced quality of life.

The same laws apply to your farm business. Financial reserves replenished during the fall and winter months start to be drawn upon as the planting season progresses. More resources are needed during the growing and harvest seasons. Cash or operating credit lines are used to purchase seed, fertilizer and other necessary inputs to produce the crops that will be sold or fed in this year's business cycle. Labor needs to be paid and the family must have a draw to support itself until the fruits of the season are available. Proper planning is necessary to make sure enough resources are available to complete the long process. These resources are your farm's working capital.

Working capital includes the resources built up by the business that are available to meet the obligations of the business during the operating cycle. Strictly defined, *net working capital* is an absolute dollar figure calculated as the difference between current assets and current liabilities. These are found in your farm's most important financial statement, the balance sheet.

Current assets are owned items or cash equivalents that can be easily converted to cash within a year. These items include crop inventories for sale or to be fed, operating supplies in inventory, monies in savings or checking accounts, accounts receivable and

prepaid expenses.

Current liabilities include obligations owed by the business as of the date of the balance sheet. Money owed to suppliers, the portion of term debt principal due during the current year, operating lines of credit, and unpaid payroll or property taxes are all examples of current liabilities.

The question is often asked, "How much working capital do I need?" The answer depends on the quality of your current assets, the length of your operating cycle and amount of risk your farm is subject to.

### **Quality**

Current liabilities are almost always in the form of cash. If you owe your lender \$50,000, that's \$50,000 and not something less than that. Cash on hand is the best match to meet this obligation. Current assets that are not cash are of lesser quality simply because of they may not end up being as much cash in the end. For example, let's assume two farms have current liabilities of \$50,000. One farm has \$50,000 of hay in inventory to cover this obligation and the other has \$50,000 of cash sitting in a savings account. In order for the hay to be turned into cash, it must be sold at some future date at a (normally) undetermined price. Market fluctuations, insects, mold and moisture may reduce the value of the crop at any point before it's actually sold and delivered. Then, unless you delivered C.O.D. you may need to worry about getting paid. These variables present additional risk. An extra \$10,000 of inventory on hand may be necessary to cover a worst case scenario. The further away from cash your current assets are, the more you will need to maintain an adequate level of working capital.

### **Operating Cycle**

The longer a farm's operating cycle, the more net working capital the business will need. The operating cycle is defined here as the length of time it takes to produce and

receive payment for the things you produce. For a vegetable or field crop grower, the operating cycle could be several months to a year or more. For a broiler producer, hog fattening operation, or green house business, the operating cycle might only be two to three months. During the operating cycle, draws need to be taken, employees need to be paid, and debt may need to be serviced. Longer cycles require more working capital be available to make payments on these obligations.

### **Risk**

Finally, farms that have exposure to more risk due to highly variable yields or prices on a regular basis need to have a bigger cushion of working capital available to meet obligations during these downturns. A farm should have sufficient resources to make it through a period of below average prices, or the ability to replant due to an occasional late killing frost.

### **Manage Capital**

Working capital normally increases from the profits generated by the farm business. Reductions in net working capital can happen for many reasons. Several years of marginal profits or a disastrous year or two can wipe out a farm's working capital. However, not all causes of depleting working capital are related to profitability. Expanding a farm rapidly without consideration of operating capital needs can leave a business cash-starved. Paying too much cash for new equipment, expansion cows or facility improvements is another common way farmers find to deplete their working capital. Finally, drawing more cash from the farm than the farm business can afford for family living can reduce working capital to dangerously low levels.

Fixing a poor working capital situation can be done with your lender by restructuring debt. Your banker may be able to create an intermediate or long term loan for operating debts caused by disaster. This technique moves liabilities from the current to the non-current section of your balance sheet. Don't expect any lender to be enthusiastic about this type of debt restructuring if the causes are related to long run

profitability of your farm operation. Monitoring your working capital with quality annual financial statements gives you and your lender insight into how to better manage this important financial indicator. Thoroughly analyzing capital purchases and major expansions with pro-forma financial statements will help maintain a healthy working capital level in a changing business environment.

Bruce Dehm is president of Dehm Associates, a farm business services company in Geneseo, N.Y.