



# Heart of the Farm

## Financial Management Factsheet Series

### Understanding the Farm Financial Model

The farm financial model is linear and circular. Records feed into reports and reports into decisions. Reports seek additional information from records and call for additional decisions. Reports make sense of the records, allowing managers to integrate financial sense into production decisions.

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**The Financial Model illustrates the management-to-decision-making process and the tools used to make decisions; it conceptualizes the financial management thought process.** Beginning with collecting and organizing financial information (records) through an accounting system, the information is next transformed into financial statements for analysis and interpretation of the farm’s historical and current financial position and performance. Budgeting, feasibility, profitability and risk-ability analyses allow for making the best decisions for the farm business’s future.

#### Record keeping

Income and expense receipts must be

collected and organized before financial statements may be generated. The receipts must be recorded to account for them. Receipt accounting is referred to as record keeping.

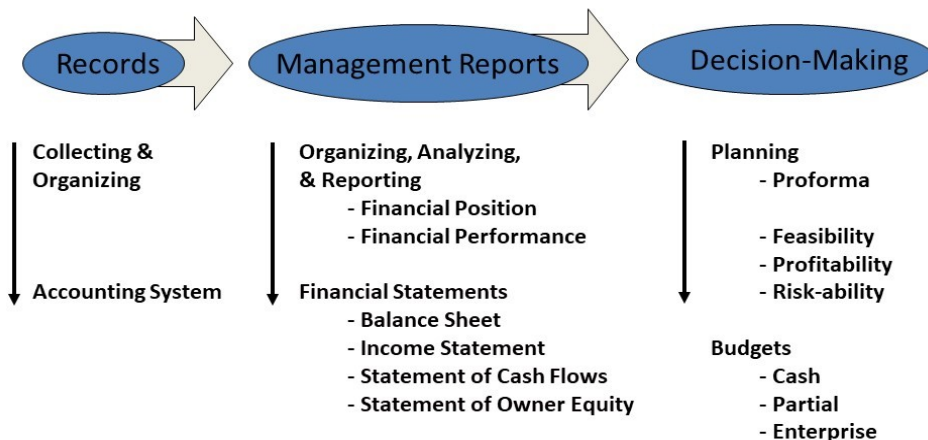
A checking account register is the simplest and most inexpensive record keeping system. The register is prone to math errors, assets and liabilities are not tracked and totals must be transferred to report templates.

Another method of record keeping involves collecting receipts and then taking them to an accountant. For some, paying the accountant to organize receipts and generate reports is the most economical approach.

Receipts may also be tracked using paper forms or Excel spreadsheets. The advantage of using Excel is that the program does the calculations, saving the operators’ need for a calculator. The operator must however design the spreadsheet and enter the figures correctly. Final totals must be transferred to report templates. It can be difficult to maintain complex accounts using Excel.

Computer accounting software tracks entries and automatically generates reports. Investing in the program and spending the time learning how to use it represent the costs and challenges involved.

## Farm Business Financial Management Model



## Management Reports

Records provide the financial information necessary to complete management reports, which are also known as financial statements. **The Farm Financial Standards Council (FFSC) recommends farms create four financial statements from which the farm's financial position and performance may be analyzed.**

The strength of the farm business at a point in time (position) and how well the farm business has performed over time (performance) are two historical insights captured by the financial statements. *The four recommended statements include the balance sheet, income statement, statement of cash flows and statement of owner equity.*

Financial position describes the assets. Assets are the tangibles needed by the business to function and include cash, equipment, livestock and inventories.

Performance describes how money flows through the business.

Performance describes how well a business can make payments, meet

payroll and it describes how much money is retained by the business.

Financial analysis allows for the understanding of the farm's current profitability and financial efficiency. Analysis allows the farm to benchmark to others in the industry, determine its strengths/weaknesses, measure financial progress and set goals. Analysis allows for future management and decision making.

## Decision-making

The historical understanding of the farm business's financial position and performance provides a basis from which to plan for the future.

**"Pro forma" refers to the future view of the financial position and performance.** It implies that the financial statements will be constructed to reflect the future view of position and performance. For example, what would the balance sheet look like after an expansion has occurred?

The financial position of this future view is analyzed for feasibility, profitability and riskability. Pro forma

financial statements are a complement to the budgets. *Cash, partial and enterprise are the commonly used budgets to assist in decision-making.*

Pro forma financial statements would include a balance sheet, an income statement, and a statement of cash flows. The pro forma balance sheet would show the projected assets and liabilities of the business. The pro forma income statement would show the projected income (or losses) for that future year. The pro forma statement of cash flows would show the projected liquidity and operating cash for that future year.

Budgets and pro forma financial statements are tools used to think through your decisions on paper before the investment is committed.

## Summary

This factsheet discusses the financial model as a concept for understanding the financial flow of a farm business. Keeping the model in mind aids in the development of best farm decisions.

*Next up....*

## ***Part I: Understanding the Concept and Structure of the Farm Business Balance Sheet***

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The Heart of the Farm – Women in Agriculture program addresses the needs of farm women and men by providing education on pertinent topics, connecting them with agricultural resources, and creating support networks. <http://fyi.uwex.edu/heartofthefarm>

For other farm financial information and resources contact: Center for Dairy Profitability: <http://cdp.wisc.edu>

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