

***CASH FLOW BUDGETING***

***By***

***Kevin Bernhardt***

[***bernhark@uwplatt.edu***](mailto:bernhark@uwplatt.edu)

***Farm Management Specialist with the Center for Dairy Profitability and UW-Extension and a Professor for the UW-Platteville School of Agriculture***

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***Note***

* ***Slides referred to in the text are from the PowerPoint presentation titled “Cash Flow Budgeting - Explained”.***

***Cash Flow Budgeting – What, Why, and How (Slides 2-8)***

Following his leadership of the allied effort in World War II, Dwight Eisenhower was quoted as saying “*Plans are useless, but planning is indispensable*.”[[1]](#footnote-1) General Eisenhower planned for victory and then worked his plan. Of course, things happened that disrupted plans, but the process of planning itself enabled better management of the war effort and ultimately success.

The same is true for the farm business. The planning function of management is one of the most important for the farm manager and completing a cash flow “forces” planning. A little simplistic, but “Plan for profits and then work your plan.”

The cash flow budget is a plan of how cash will be coming into the operation (cash inflows) and leaving the operation (cash outflows). The keyword is “cash.” If cash is not entering or leaving one’s pocket, then it does not go on the cash flow budget (slide 2).

The cash flow budget provides two primary values to the farm manager (slides 3-5).

1. Forces the planning function of management.
2. Provides a means of communication with the lender.
3. During low profitability times, cash flow is the focus.

Completing the cash flow budget requires that the manager plan ahead, know and/or estimate what they will raise, production, input needs, input costs, output prices, capital asset replacement, sales or purchases and other factors that could either provide or take cash from the business. As Dwight Eisenhower stated this depth of planning, of thinking through the year ahead, is indispensable even if later events ultimately void the accuracy of the original plan.

One unique difference about the cash flow budget is not only do you need to plan production and financing activities that you expect to occur, but you also must plan when they might occur. This is an asset to the manager especially in planning borrowing needs or investment opportunities with their lender.

The cash flow budget begins with cash inflows from operations, sales of capital assets and non-farm sources (slide 6). These inflows are used to pay for operations, capital asset purchases, non-farm needs and scheduled debt service. A final inflow of cash is new borrowed funds if needed to arrive at final net cash flow.

Unless the plan is to print your own money (not advisable!) then the final net cash flow each period[[2]](#footnote-2) cannot be negative. Something must give. Either sales must increase, purchases delayed, increase accounts payable or increase borrowing (new debt capital) to name a few possibilities. The process of arriving at a positive net cash flow each period necessarily involves adjusting the plan to a better understanding of reality!

The cash flow budget is not the same as an income statement (slide 7) and in-fact they can be quite different. The cash flow budget does not include non-cash items like depreciation, inventory changes or changes in accounts receivable/payable. However, the cash flow budget does include items the income statement does not such as principal payments, capital asset sales and purchases and loan proceeds. A business can cash flow very nicely for a while by just selling a few cows, pieces of machinery, acres of land or just allowing accounts payable to continue to build. The accrual income statement will quickly identify this situation as unprofitable, but the cash flow budget will see a positive cash flow unless one looks a little deeper to where the cash flow is coming from.

The cash flow budget is also not a substitute for the enterprise budget (slide 8). The enterprise budget includes depreciation and opportunity costs, both of which are non-cash items not found on the cash flow budget.

***Quiz Time (slides 9-20)***

Let’s check our knowledge of cash flow budgeting. Note, answers are below and in the notes section of each PowerPoint slide.

1. (slide 10) My cash flow budget is a positive $75,000, which means if all goes according to plan, I will have a profitable year.
   1. True
   2. False XXX (cash flow is not an income statement)
2. (slide 11) Depreciation is a “real” cost that reflects the loss in value of a capital assets due to wear, tear, and obsolescence. However, it is a non-cash cost so it should NOT be on the cash flow budget.
   1. True XXX
   2. False
3. (slides 12-20) For the following activities/transactions in the left column note the cash flow budget category (right column) where they should be recorded.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Activities/Transaction** | |  | **Cash Flow Budget Category** | |
| *A* | Milk sales |  | A | Cash inflow from farm operations |
| *I* | Son’s car insurance payment |  | B | Cash inflow from capital asset sales |
| *I* | Depreciation cost |  | C | Cash inflow from non-farm sources |
| *B* | Sale of tractor |  | D | Cash outflow from farm operations |
| *I* | Aunt Hazel’s million-dollar inheritance |  | E | Cash outflow from capital asset purchases |
| *G* | Mortgage payment |  | F | Cash outflow from non-farm sources |
| *E* | Cost of new milking parlor |  | G | Cash outflow from scheduled debt payment |
| *H* | Short-term operating loan |  | H | Cash Inflow from new borrowing |
| *I* | Seed purchase on credit with input supplier |  | I | Not on the cash flow budget |

Notes:

* The son’s car insurance payment could be a cash outflow for non-farm purposes if the farm business is planning on paying the son’s insurance.
* The same goes with Aunt Hazel’s million-dollar inheritance. If the farm business is going to use that money, then it belongs on the cash flow as an inflow from non-farm sources.
* If a loan was used to cover part of the cost of the new parlor then the loan proceeds would be a cash inflow from new borrowing.

***So What? Why Waste Time on Cash Flow Budgeting? What’s the Value? (slides 22-26***

I do not know too many farm managers who said they wished they had something more to do! Management time is valuable so what’s the value in spending time on cash flows. Slides 22-26 provide four examples.

J&J Dairy Farms (slide 22) is an example of spill-over effects from being “forced” to plan operations for the next year. To complete their cash flow, J&J Dairy had to estimate what price they would receive for their milk. It forced them to consult with market advisors, assess where in the cycle the industry was at, look at futures and consider the current supply and demand situation. J&J saw several indicators that the risk of price movement looked to be towards lower prices. It caused them to consider and pull the trigger on some marketing actions to secure the prices available today for a portion of their expected production. It also gave them a benchmark to watch. Just the process of completing the cash flow budget led them to market planning as well.

S&S Grain LLC (slide 23) knows they must replace their combine this next year. The cash flow budget enables them to plan for the best time to trade and communicate far in advance with their lender what their borrowing needs will be. They also will have knowledge of the impact on cash and knowing that helps in shopping and negotiations. In planning the results of this purchase, they incorporate some custom work as part of their plan. This change makes the purchase much more feasible and self-liquidating.

B&B Grain and Livestock Company (slides 24 and 25) has a meeting with their lender next week regarding borrowing needs for the year ahead. B&B has completed their cash flow budget and thus they know that barring any significant changes they will have short-term borrowing needs in the 1st and 4th quarters. But, they will have a significant surplus of cash in the 2nd and 3rd quarters when they sell their cattle. So, they have two discussions they want to have with their lender. One is setting up an operating line of credit and repayment terms for the times of cash shortfalls. Second is what to do with cash surpluses when they have them. Should they pay off debt ahead of time and save interest or should they invest it and earn some interest. It will be nice to head into the year knowing and already have ready the borrowing and investment needs.   
  
Bella Acres (slide 26) has studied the markets and it does not look like a good year for prices or profits. They have the infrastructure and management for a successful business, but this is one of those years when they just must survive. While they would love to have profits, their focus this year is how to squeeze the Cash Flow to make it to the other side of this crisis. They decide to hold off on some capital purchases, sell some underutilized machinery, negotiate their lease contracts and restructure debt.

***How to Increase Cash Flow (slides 27-35)***

As illustrated by Bella Acres, a primary value of the cash flow budget is that the manager can manage! That is, the manager can determine when cash will be short or in surplus and adjust decisions accordingly. For example, after the first iteration of the budget, adjustments could be made to:

* Sell inventory that will minimize new borrowing and paying of interest,
* Delay, reduce or eliminate planned capital asset purchases
* Prepay next year’s inputs if cash is available and/or to reduce tax liabilities

The final net cash flow each period cannot be negative. If it is, something must give. Slide 27 is a repeat of an earlier slide showing the structure of the cash flow. If the final net cash flow is negative, then one or more of the lines in slide 27 must change to increase cash flow. Slides 28-35 show potential changes that could be made.

Increasing Cash Inflows from Operations (slide 28)

One way to increase cash flow is increasing normal operational sales. Areas to consider include production efficiency, price, new or more enterprise activities, custom work and selling market inventory to name a few.

More impactful is generating greater revenues from the primary source of income (milk, grain, feeders, etc.). Revenue is from production multiplied by price. Therefore, an increase in production and/or price increase cash inflows. For net cash flow to be greater, increasing production or price must be relatively greater than any associated costs.

Benchmarking your operation may be a way to determine if there is potential for greater production efficiency – more milk, more bushels, more calves, etc. per unit of costs. Feed losses, death loss, conception rates, timeliness of planting, variable rate applications and many other factors might be a means for improving production efficiency.

Marketing may be a means of securing a better price, but marketing tends to be more successful at securing a known price ahead of time versus a “higher” price. Marketing a value-added trait may also be a way to increase sales.

Increase Capital Asset Sales (land, tractors and cows) (slide 29)

Selling capital assets such as machinery, cows and even land is a way to increase cash inflows. However, it is a double-edged sword – as you sell capital assets you also lose the future income generating capacity of that asset. For example, you can sell ten cows today and generate cash flow, but then you no longer have those ten cows to generate milk and calves to sell in the future. Factors to consider include:

* + Are there underperforming or underutilized assets?
  + Are there activities that can be outsourced for less cost than owning the assets such as hiring a custom harvester and selling the associated harvest equipment
  + Are there underperforming enterprises. For example, if you never make any money on the 200 acres of grain you farm then an alternative is to rent the ground out (or sell it) and sell the associated machinery.
  + With any of these options, there may be tax consequences to consider.

Increase Cash Inflows from Non-Operational Sources (slide 30)

Many farm families bring income and cash flow in from non-farm sources. Off-farm employment is a major source of potential cash flow for the farm business and one that is often not subject to the ebbs and flows of commodity prices and may come with other benefits such as health care and retirement. Other potential sources of non-farm cash include:

* + Contributed capital from family or non-family investors
  + Agritourism
  + Hunting fees
  + Horse boarding
  + Storage of boats and campers
  + Non-farming enterprises such as
    - Repair/maintenance shop
    - Record-keeping
    - Seed sales
    - Welding shop

Decrease Cash Outflows from Operations (slide 31)

A second overall way to increase cash flow is to decrease cash outflows. Examples include:

* + Negotiating lower lease payments
  + Using cheaper feed ingredients
  + Better feed management, less wastage
  + Variable rate application
  + Early detection health protocols
  + Lower labor costs or greater labor productivity
  + Collaboration
    - Bulk buying of inputs
    - Shared field work
    - Manure-Fertilizer agreements
    - Shared machinery/equipment
    - Shared labor

The key is assuring that production is not negatively impacted or at least is less negatively impacted than the gain from lower costs.

Delay/Eliminate Capital Asset Purchases (slide 32)

Can a piece of equipment be held for another year versus trading it this year? What will the potential repair costs be compared to the new piece? Can the purchase of an asset be held off in lieu of custom hiring the work done? Is leasing a viable option? If purchase is needed can I negotiate a lower purchase price?

Decrease Non-Operation Cash Outflows (slide 33)

Family living withdrawals are of two types. One is the “normal” compensation for labor and management that is to be expected from the work provided. Over and above that is additional withdrawal that drains cash from the operation. The latter is fine and expected in times of good cash flow. However, when cash flow is tight, hopefully for the short-term, then a tightening of the belt is a means of increasing net cash flow. Perhaps the big vacation needs to be put off in lieu of something more local this year. Remodeling the house, boat purchase etc. should not be forgotten, just perhaps delayed until times of better cash flow.[[3]](#footnote-3)

Are there “family bonuses” not related to farm operations or compensation that could be eliminated or at least reduced or delayed. Potential examples include:

* + Entertainment
  + Gas for and repairs of non-farm vehicles
  + Insurance premiums
  + Room and board
  + Costs associated with tractor pulling
  + Hobbies

Decreasing Current Debt Service (slide 34)

For many farm businesses, debt service is a major source of cash outflow. There may be ways to work with creditors to reduce debt service in the short-term. Examples include:

* + Restructuring loan amortizations, that is, lengthen repayment terms, thus reducing current payments
  + Interest only payments for a short time
  + Debt consolidation with a resulting lower current payment
  + Lower interest rates
  + Principal write-off (unusual and usually associated with much bigger problems than short-term cash flow)

The danger with any of these is that it adds debt service in the future. For example, an interest only payment leaves principal that must be paid back in the future and with interest. There is also the danger of accumulating debt service for reasons that are no longer relevant. For example, consolidating a three-year tractor loan with other debts and lengthening the amortization (pay-back time) using a mortgage or second mortgage may result in paying that “tractor” loan back when the tractor no longer exists. However, in the short-run, these may be ways to increase net cash flow.

Increasing Cash Inflow Through New Borrowing (slide 35)

Finally, when other avenues have been exhausted the last tool in the box is new borrowing to cover negative cash flow. In many situations, this is a normal part of the business. For example, an operating line of credit in a grain operation covers the purchase of seed, fertilizer and other inputs until the grain is harvested, sold and the operating note is paid back. Care should be taken to not use operating loans to pay for capital assets.

**How to do Cash Flow Budgeting – 8-Step Process (slide 36)**

Slide 36 shows the outline of an 8-step process for constructing a cash flow budget (first 5 steps) and using the cash flow budget to make management decisions (last 3 steps).

Construction

1. Determine boundaries of the farm business
2. Estimate/Plan operations
3. Estimate/Plan capital asset sales and purchases
4. Estimate/Plan non-farm income and expenses
5. Determine scheduled debt service

Analysis and Informing Management Decisions

1. Analyze “initial cash position” before new borrowing
2. Develop a borrowing, repayment and investment plan
3. Monitor variances from actual and adjust remainder of the year accordingly

**Optional: Explanation of Each Step in 8-Step Process**

Slides 40-46 show more explanation of each step in the 8-step process.

1. Eisenhower used some version of this quote on multiple occasions. One of the earlier documented uses appears to be in 1950 as part of a letter written to a U.S. diplomat in which he ascribed a military-oriented version of the saying to an anonymous soldier (<https://quoteinvestigator.com/2017/11/18/planning/>) [↑](#footnote-ref-1)
2. Time periods are the user’s choice, but are typically monthly. The teaching materials are based on quarterly time periods to lessen some of the complexity and data entry associated with 12 time periods versus 4. [↑](#footnote-ref-2)
3. Caution! A similar discussion at a workshop elicited a response from one of the farm wives in attendance that if she did not get a family vacation then next year, they (the bank) may be paying for a divorce! The point is well taken. [↑](#footnote-ref-3)