8-22-74
JW
SM

FACT SHEET

L-1250

# AGRICULTURAL CREDIT ANALYSIS AND PLANNING

Tom E. Prater*

Agricultural credit analysis and planning is important to the producer, agricultural financier, planner, manager and others who work with agricultural finance and make decisions for combining factors of production, land, labor and capital for optimum returns.

As credit needs increase, those responsible for farm and ranch credit will have greater responsibilities for making analyses and defining needs. The extent to which a definite process of analysis is followed will depend on the size of the loan, nature of loan, purpose, source, repayment plan and the individual's financial position.

Agricultural credit analysis calls for five basic steps essential in developing sound financial plans. They are (1) obtaining sound information on records, financial statements and operating statements; (2) analyzing the proficiency of the business; (3) planning credit for annual and long-term operations; (4) developing enterprise and capital budgets as needed to determine alternatives; (5) obtaining other basic information to assist with final loan decisions, such as claims on income, tenure arrangements, risks, stability and sound procedures.

An investigation of each of these areas will indicate some of the basic information and kinds of records, budgets and planning that will permit sound financial analysis and planning.

## BASIC TOOLS FOR ANALYSIS AND PLANNING

There are basic tools essential to the task of obtaining information.

### Records

Basic farm or ranch records are important for an accurate and complete business system. These records help to determine the effectiveness of the operator in organizing and using resources. An effective analysis of the records provides a key for improving the management of the business. Records also provide information which aids in planning, budgeting, determining financial and tax management and in establishing repayment capacity guides. Enterprise accounting may be essential to determine a more complete analysis of an enterprise and how it fits into the business.

In general the record system that will give an accurate income tax reporting method will allow a good business analysis.

### Balance Sheet or Financial Statement

Another tool that assists in credit planning is the financial statement, also called balance sheet and/or net worth statement. Analysis of this statement can give understanding of how the producer controls and uses assets and liabilities. When land values are determined wisely this statement gives a good indication of the farmer's or rancher's net worth and solvency. Generally speaking, the financial statement will give supporting information on assets owned and liabilities owed. This support material may be information on land, machinery, livestock or crops. It will also have descriptions of types of notes, accounts payable, intermediate-term and long-term liabilities. Cost, depreciation and annual payments are generally a part of the supportive information.

*Extension economist-management, The Texas A&M University System.



Texas Agricultural Extension Service • The Texas A&M University System • John E. Hutchison, Director • College Station

In fact, a good farm or ranch record system will have much information which can be transferred with ease to the support forms of a financial statement. A series of statements for a comparable time over a period of years provides a basis for forming an opinion of the operator's past history, and may be evidence of his future performance. It gives information which indicates solvency of the operation.

#### Profit and Loss, Income or Operating Statement

The other major tool used in the financial record is the profit and loss statement, sometimes called income or operating statement. This statement is a summation of income and expenses and the net profit or loss for the year (although it could be for a different time period). A comparison of several years can indicate progress and reason for degrees of progress or decline.

#### Analyzing the Business

One purpose of business analysis is to analyze the ability of the operator to utilize his resources and select enterprise alternatives which give the highest net returns.

Understanding how to utilize equipment and machinery to lower unit cost becomes very important for efficient production. Materials can sometimes be purchased at a lower price when volume of business or size of operation is sufficient to purchase in quantity. Economic analysis for optimum utilization of land, labor, capital and management also is important.

*Economic efficiency* is very important and should be considered in analyzing the farm or ranch operation or when consdering credit.

*Enterprise organization* should maximize profits according to management preference, but limited resources are usually allocated to enterprises which maximize returns to those resources. If labor is scarce, enterprises which will give higher returns to labor should be chosen; if capital is scarce, enterprises which normally yield high returns to capital should be selected.

In addition to analyzing the business from the above basis, financial tests by ratios are used. Some basic ratios are as follows:

A. Related to Capital

$$\frac{\text{Total current assets}}{\text{Total current liabilities}} =$$

Current assets available to meet current indebtedness

(This ratio reflects only the amount of assets, and not their quality. Current assets minus current liabilities gives the operator his working capital.)

$$\frac{\text{Total debt}}{\text{Net worth}} = \text{Debt to net worth}$$

(Gives some indication of risk.)

B. Related to Performance

$$\frac{\text{Gross receipts}}{\text{Total assets}} = \text{Turnover of assets}$$

$$\frac{\text{Profits}}{\text{Total assets}} = \text{Profit ability of all resources utilized}$$

C. Related to Debt Servicing

Debt Servicing to Gross Receipts:

$$\frac{\text{Annual principal and interest}}{\text{Gross receipts}} =$$

Proportion of receipts needed for debt servicing

Ratios provide a method of analysis, but should be used with good judgment.

#### Comparative Analysis

Comparative analysis of the financial statements, profit and loss statements and business analyses over a period of three to five years allows the farmer, rancher and credit institution personnel insight into profit potentials within an operation, and can strengthen credit and finance management, as well as general management.

## ANNUAL FARM AND RANCH CREDIT PLANNING

With increased emphasis on the importance of capital and management, it is necessary for the borrower and creditor to plan ahead for the amount of funds needed throughout the year, and to determine repayment plans and capacity.

Annual planning should include projections of the crop and livestock program, projections of the cash flow of expenses and income on a quarterly or monthly basis, and financial results.

The purpose of preparing crop and livestock projections is to estimate as closely as possible the costs and returns of enterprises. Fertilizer cost, seed cost, insect and disease control cost, feed cost, fuel, repair, interest and other costs pertaining to production can be closely estimated. This assists both the borrower and creditor in estimating expenses. Returns can be projected based on expected prices and level of production. This gives a good indication of repayment capacity and time of repayment.

Budgeting plays an informative role in agricultural credit analysis and planning. Budgeting is a way of developing consideration of expenses and returns in alternative uses of resources, and consideration of time and risk. This may be done through partial budgets, enterprise budgets or complete budgets.

In reality, farmers, ranchers, agricultural lenders, planners, managers and other decision-makers run a budget to determine if a decision is practical and profitable for the operation.

Budgeting is a method for determining savings, returns over costs, least cost or optimum returns.

## SUMMARY

Annual analysis and financial planning are the main determinants for establishing credit needs. But tnose who make credit and loan decisions also consider claims on income, family living necessities, expenses in the operation, and the individual's character, production ability and managerial level.

Farm and ranch operators who are to compete and meet present and future opportunities will utilize the latest techniques in record keeping, analysis, planning credit needs and determining profitable operations.

Cooperative Extension Work in Agriculture and Home Economics, The Texas A&M University System and the United States Department of Agriculture cooperating. Distributed in furtherance of the Acts of Congress of May 8, 1914, as amended, and June 30, 1914.

5M–6-74 AECO 5 & 6