AGRICULTURAL ECONOMICS
Farm and Ranch Management

Cash Flow Versus Profitability

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A lot of attention and focus can be placed on the cash flow of a farm or ranch operation but relying only on cash flow as a measure of success can be dangerous for the health of an operation. While both cash flow and profitability are important to an operation, they are different. A cash flow just measures the timing of sources and uses of funds while profitability is a function of income and expenses. You may be thinking you just read the same thing twice, but there are lots of differences between sources of funds and income, as well as uses of funds and expenses. Here are some examples:

	Cash Flow	Income
Sale of Inventory (Grain/Feeding Livestock)	Yes	Yes
Government Payments	Yes	Yes
Custom Work	Yes	Yes
Loan Proceeds	Yes	No
Non-Farm Wages	Yes	No
Sale of Assets	Yes	No
Inputs (Fert, Seed, Feed, Etc)	Yes	Yes
Interest Expense	Yes	Yes
Principle Payments	Yes	No
Personal Costs	Yes	No
Capital Purchases	Yes	No
Depreciation	No	Yes
Purchase of Feeder Livestock	Yes	Yes
Hedging Gains/Losses	No	Yes
Margin Calls	Yes	No

This list is certainly not all inclusive, but you can see some of the differences. For example, the difference between capital purchases and depreciation. For the cash flow, we care about how much money you are spending on the asset (and any proceeds from a corresponding loan). For income, we want to look at how that asset is reducing in value for the age as well as wear and tear.

I've come up with four things that I most often see producers confuse cash flow with profitability.

Timing of Sales and/or Inputs

We do a lot of planning with the timing of sales and purchases of inputs to manage tax liability. This impacts the cash flow but shouldn't impact your accrual net income calculation. For example, you can sell two years of crop in one year, generate a large taxable income and a great cash flow, but it doesn't mean you actually made any money that year. It only means you recognized a lot of income that year. It probably does mean that your cash flow for the following year will not look good, so that is one major danger of only watching cash flow.

Capital Sales/Purchases

As mentioned, capital purchases and sales are very different. Liquidating unused (or underused) equipment is a great way to increase cash flow without impacting net income much. A slightly more extreme issue is selling an income-producing asset. A sale of land will likely create a significant improvement on cash flow and will likely improve ratio numbers on the balance sheet. The problem with this is you have cut off your income source. If the asset was profitable, then your future cash flow has been hurt by the solution for an improved current cash flow.

Loan Proceeds/Payments

Refinancing debt is another solution to help solve cash flow problems. It's helpful to describe this as if you have a cut on your arm. If you cover that up with a band-aid and wait a week, the cut will likely have healed better and faster because it was covered and kept clean. On the other hand, if you cover up a cut that needs stitches and ignore it for a week, you will likely have a wound on your hands that needs much more care than it would have if you had taken care of it correctly right away.
Refinancing debt is not a bad solution, as long as we know what the problem is. If you only refinance to solve a liquidity problem, you will likely be back in the same place within a year or two. You need to evaluate the profitability problem in addition to the cash flow problem to really solve this.

Family Living/Taxes

It always comes back to family living and taxes. These two issues are what everyone wants to forget but they often are the difference between profitability and cash flow. These two are not figured into an accrual net farm income number but they are most definitely a significant part of a cash flow. If the sum of these is more than the net income from the farm, we will see cash flow deficiency and net worth losses (unless there is non-farm income to supplement the difference).

Each tool in your financial toolbox is important. Just like a hammer is not designed to do the job of a screwdriver, a cash flow, balance sheet and income statement are all separate tools that have specific — and important — jobs. Learning when and how to use each of these tools will likely save you time and headaches in the management of your business.

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