Crop budgets for 2014 may be jarring. Better cost analysis lets you make marketing decisions with confidence

RUDE AWAKENING

By Mike Wilson

If you haven't prepared 2014 crop budgets yet, you're in for a jolt.

"A lot of growers we work with are shocked when they realize the situation we could be heading into," says Alan Grafton, farm financial consultant with Kennedy and Coe, an agriculture-focused accounting firm based in Kansas and Colorado. "When you make just one change to a 2014 budget — expected crop prices — it's not pretty. We're running cash flows right now that break even or lose money for the same guys who were making six figures last year."

A $2-per-bushel drop in expected corn income can be sobering. At 180 bushels, that's $360 per acre less to work with. Unless you're planning to drop corn from your crop rotation altogether, it's time to take a fresh look at the cost side of your business. Without accurate cost information, you won't know breakevens needed to build a methodical marketing plan with price sales triggers. And you won't have the data you need to make intelligent decisions on cash rent bids or other key decisions for your farm business.

What is unit cost of production, anyway? It's a number describing total costs that must be covered. More important, it defines minimum price or revenue needed from the marketplace to achieve profit targets.

Cost of production has three key measurements: total dollars per profit or cost center, dollars per base unit of production (acre, head), and dollars per unit of marketable production (bushels, hundredweight, tons).

"You start out knowing how much you spend on inputs, machinery and land, then make an assumption on income based on projected price and production, and that gets you a ballpark number," says Dick Wittman, financial consultant, rancher and *Farm Futures* contributing editor. "We need all three of these measurements on our radar screen."

DRAWING BOARD

In the last five years farmers in many regions just had to wake up and get out of bed to make money, says Wittman. "With record grain and livestock prices, favorable crop insurance revenue protection levels, and good yields, ag producers have seen tremendous profits, but now we've got to go back to the drawing board," he adds.

When prices were high, it was easy to achieve high margins without actually knowing breakevens.

"Farmers have gotten lax on spending habits," Grafton says. "Farming is never easy, but when you can sell corn for $6.50 and beans for $14, it allows people to not think about costs as much — they're willing to take the price quoted."

That's a luxury you may not be able to afford — literally — in 2014.

"We really are entering a time when we're going to need to have a budget and know breakevens," says Grafton. "We need to evaluate every expense and ask three questions: Is this a necessary item we're spending money on? Is it saving me money? Is it making me money, and if so, is it making me more than it's costing me?"

Taken individually, those purchase decisions may seem insignificant. When you add them up, it could make a real difference to your bottom line.

"You really need to know your costs in order to make a good decision going forward, and it all plays in to marketing your crop," says Grafton, who will be leading a session on production costs at the 2014 *Farm Futures* Business Summit (*www.FarmFutures.com/summit2014*).

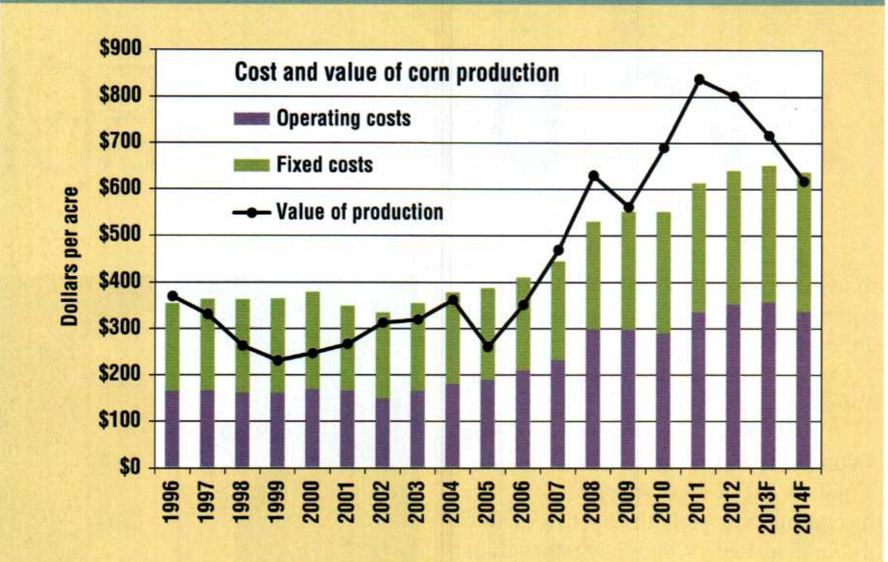
"If you don't know what it's costing you, it's hard to decide where to make that sale decision. This could be the year when breakeven is as good as it gets."

COST TRENDS

The variable-cost outlook for 2014 is a mixed bag. Seed cost is expected to rise 5% in 2014, while herbicide costs remain flat to moderately higher. Fuel costs could be volatile due to Mideast tension.

One of your biggest input costs — fertilizer — should actually be cheaper in 2014. Nitrogen prices stabilized this fall after dropping 20% to 25% at the

From big margins to treading water ... or worse



SOURCE: USDA, *FARM FUTURES*

retail level since spring planting, says *Farm Futures* Senior Editor Bryce Knorr, who writes the popular Weekly Fertilizer Review at *www.FarmFutures.com.*

"Phosphate and potash fell as much or more over the past two years, and could be headed even lower if inventories stay large because farmers around the world cut back on acreage due to low crop prices," he says. "This should cut $25 to $35 an acre off the cost of growing corn, especially for growers who push suppliers to obtain the best deals."

Fixed costs for land and equipment are more worrisome. Equipment prices have increased over 7% per year in the past decade, driven by higher grain prices and margins, says Purdue economist Alan Miller.

Grafton says he's seen equipment costs rise about $20 per acre the past three years for farmer-clients at his business. Meanwhile, Corn Belt farmland costs have jumped 78.5% per acre from 2009 to 2013, based on USDA National Agricultural Statistics Service figures.

Understanding fixed costs per acre gives you information to make more informed purchase or expansion decisions. Look at adding land or equipment this way: Is it going to increase revenue? Is it going to increase or decrease costs per acre?

If you're farming 2,000 acres, and add or replace a tractor that increases investment in equipment by $150,000, you've added $35,000 a year, or $17.50 per acre to your fixed costs. "That alone may seem minor, but if you're just doing that to avoid taxes, how much did it save you in taxes compared to the added payment?" says Grafton. "Does the end justify the means?"

Wittman cautions, "Few are assessing the increase in production costs created by inflation in the cost of replacing high-ticket farm equipment (combines, tractors, swathers, semitrucks). At a 7% annual price increase — a number equipment companies rationalize is 'defensible' — the cost of these big-ticket items doubles every 10 years. This inflationary impact on cost of production sneaks up on many producers if it is not clearly factored into the annual cost-of-production analysis."

If you pick up an extra 100 acres, the added equipment expense may be offset by additional revenue, but you're still adding cost to overall overhead. "The added tractor may make you more efficient in the field or help you get the crop out faster, and you need to decide if that is needed," says Grafton. "Every overhead or capital decision should be based on how it may drive down the overall costs per unit produced."

LAND OPPORTUNITIES

Softer grain prices may lead farmers to retire, causing some lands to open up for rent. In a tight-margin environment, you can't make a smart bid decision without intimate knowledge of costs and breakevens.

"You need to know what any change might mean to your overall cost, then translate that to your breakeven per acre," says Grafton. "You would also need to know what kind of extra overhead you would need in terms of equipment and labor. Having excess capacity is a big factor in a land decision."

If you're worried about tighter margins and don't yet have a good handle on costs, follow this four-step process:

1 **Take a look at your spending history.** Total them up and see where you're spending money. The more information you have, the more powerful it becomes. Allocate each transaction to the correct year. That can be tricky.

"You can't look at a Schedule F tax return and know what your expenses are," notes Grafton. "You may be prepaying for next year's production or preparing ground for next year's crop — so you're spending money on next year's crop. In one calendar year you may have three different farm-year transactions: prior year income, spending money on next year's crop, and the current year. Good records allow you to tag transactions in the appropriate way."

2 **Evaluate your recordkeeping system.** If you haven't kept good records in the past — or had a poor system for doing so — now is the time to make changes. Adopt an accounting system you're comfortable with that will do the job you need it to do: give you relevant financial indicators on an ongoing basis. That may be specialized financial software, a home-based bookkeeper or CFO, or working with a trusted accountant who can communicate.

Make sure it's a system that allows for easy transaction input on specific products and vendors. Good recordkeeping needs to do three things, says Grafton:

- track seed, chemical, fuel and fertilizer purchases, and apply those costs to specific categories and crops
- provide a cost breakdown by farm
- determine costs on a field-by-field basis

3 **Start tracking expenses.** First, create a budget to compare actual costs. That's where historic data comes into play. Your history gives you a benchmark and helps determine costs of production going forward. You can project costs for next year and use those figures to project breakeven values.

"Cost per acre is the easiest and most meaningful way to evaluate a budget," Grafton says. "As we make a plan going

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