

White, Gerald B.

Working Paper

Becoming an Effective Money Manager-Steven Steps to Successful Financial Management

Staff Paper, No. SP 87-26

Provided in Cooperation with:

Charles H. Dyson School of Applied Economics and Management, Cornell University

Suggested Citation: White, Gerald B. (1987) : Becoming an Effective Money Manager-Steven Steps to Successful Financial Management, Staff Paper, No. SP 87-26, Cornell University, Charles H. Dyson School of Applied Economics and Management, Ithaca, NY, <https://doi.org/10.22004/ag.econ.186385>

This Version is available at:

<https://hdl.handle.net/10419/276747>

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CORNELL
AGRICULTURAL ECONOMICS
STAFF PAPER

BECOMING AN EFFECTIVE MONEY MANAGER -
SEVEN STEPS TO SUCCESSFUL
FINANCIAL MANAGEMENT

By

Gerald B. White

November 1987

No. 87-26

Presented at "Horticulture - A Look to the Future",
a conference for the horticultural industry at
Raleigh, North Carolina, October 30-31, 1987.

Department of Agricultural Economics
Cornell University Agricultural Experiment Station
New York State College of Agriculture and Life Sciences
A Statutory College of the State University
Cornell University, Ithaca, New York, 14853

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BECOMING AN EFFECTIVE MONEY MANAGER - SEVEN STEPS
TO SUCCESSFUL FINANCIAL MANAGEMENT

by
Gerald B. White
Associate Professor
Department of Agricultural Economics
Cornell University

Managers of horticultural firms in the 21st century face major challenges and opportunities. Management, broadly defined, consists of making the most out of the scarce resources available to your firm. One of these scarce resources is capital. Those managers who get the most out of the capital available to their firms will be the ones who are successful and prosperous going into the 21st century.

What is it that effective financial managers must do to get the most out of their capital? Before I answer that question, I want to spend a couple of minutes discussing the economic and social environment facing the horticultural industry in the next 12 years. This environment is important to the successful manager because it affects the opportunities to earn an acceptable return on capital, it helps to determine which management strategies have a chance for payoff, and it determines the nature of the day-to-day problems -- headaches, if you will -- that go with the job of being a manager. No firm operates out of the influence of the economic and social environment, and it should be a part of your every day management responsibility to monitor and understand that environment. The astute financial manager can learn more about the factors affecting management strategies by reading the Wall Street Journal than he can by reading the latest horticultural trade magazine.

I am sure that you realize that the agricultural industry in general has been in a depression in the last five years. Your friends outside of agriculture can be excused if they think you should have your head examined to have committed most of your capital and management skills to an industry

that appears to be on the ropes, at least from the nature of media attention devoted to the industry. There is no question that traditional agriculture has gone through a real difficult phase, complete with bankruptcies, declining asset values, and the associated financial difficulties. To a certain extent, some of our horticultural industry has suffered in this downturn, but in a large part it has not, and the future appears brighter for the typical horticultural firm than for the typical dairy, livestock, or feed grain farm.

Why should the typical fruit, vegetable, or ornamental firm look at a brighter future than his neighbor who is in a more traditional sector of agriculture? The major reasons lie in the nature of demand for agricultural commodities and products. The total demand for food is largely constrained by the stomach capacity of consumers. Growth in demand is, therefore, largely determined by the growth and the demographic profile (age, sex, etc.) of the population. Continuing concern about the effects of diets high in saturated fats have caused important changes in consumer behavior. Furthermore, there is growing evidence that diets high in fiber help to decrease the incidence of some kinds of cancer. Most of these changes have been favorable for horticultural industries. Almost any nutrition article you read ends with a suggestion to eat more fresh fruit and vegetables. One only needs to look at the proliferation of new items carried in the produce section of the grocery store to realize the interest and excitement that is prevalent.

For ornamentals, the opportunities arise because the products are responsive to changes in income in a way that is somewhat unique among agricultural products. Beef used to be a good example of a product that was responsive to higher consumer income. As incomes rose, consumers ate more, and better (translate higher-priced) cuts of beef. Now, with the concern about cholesterol, the demand for beef is declining. Even as the incomes of

consumers increase, they do not purchase more of the higher-priced cuts of beef. On the other hand, there is a growing appreciation for aesthetics and the positive environmental effects of flowers, shrubs, trees, and growing plants. These are products which are not limited by the growth of population and consumption will increase as consumers' incomes increase.

On the negative side, some of our processed horticultural products (canned fruit and vegetables) and to a certain extent frozen fruit and vegetables, are experiencing difficulty or, at least, are not sharing in the growth of markets. New products (smaller serving sizes, such as single servings) or products which are more ready to eat (heat and serve dishes, microwave ready servings) do, however, offer an opportunity for increased utilization of processed fruit and vegetables.

This does not mean that everything is rosy for the horticultural sector. In a relatively free-trade economy, imports of fresh and processed fruit and vegetables and flowers have accounted for much of the gain in total market size and have, in some instances, supplanted domestic production. The availability of pesticides remains a critical issue for the horticultural industry. As most are "minor crops" in terms of pesticide registration, pesticide manufacturers are less and less inclined to devote the time and money necessary to register new products for horticultural use. The total pesticide market is much smaller for this industry than for the feed grain sector. It is frustrating for horticultural producers to see crops imported which are grown using pesticides which have been banned or are unavailable to domestic producers.

All of this discussion is not a digression, because it points to managers of horticultural firms viewing a future that is much brighter than for traditional agriculture in general. One concern is that as enterprises such as dairying and tobacco farming, for example, become less and less viable, farmers who are displaced in those enterprises will become producers

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of horticultural products, saturating these markets as well. I do not view this as being much of a threat. Management skills needed in horticulture are so different -- so intensive compared with many types of farming activity, and marketing plays such a crucial role, that displaced farmers from traditional agriculture will often find their managerial skills unsuitable for successfully managing horticultural businesses.

So the managers in this audience can, for the most part, look forward to the 21st century with confidence. That confidence can mean that you can look toward expansion of business volume and a transfer of an on-going business to the next generation, if that is the goal of your family. It will be a tough, competitive environment, and one in which not everyone will succeed. But, I am confident that substantial opportunities are there for those of you who have, or are willing to develop those skills. The management skills necessary include the implementation of efficient production technology, labor management and personnel relations, and financial management. This morning, I want to emphasize financial management activities and processes that are essential for managing horticultural firms to survive and prosper until the arrival of the 21st century. What is it that the financial manager must do to succeed?

First, the successful financial manager knows the current economic climate in which his business is operating. He or she not only knows what is happening currently to interest rates, the rate of inflation, input prices, and product prices, but is able to make informed estimates about what to expect of these important variables for the next five years or so. This does not mean that these expectations will always be correct, but at least there are some reasonable numbers which can be used to form the basis for business planning.

The manager has this knowledge about the economic environment in at least two levels. First is at the national level, at which macroeconomic

policies affect rates of interest, inflation, and unemployment. But, our successful manager also knows the economic climate in the market in which the firm's commodity or product is sold. If the manager is a seller of produce, he or she keeps up with the supply and price situation in competing producing regions. If the product is sold at retail - and many of you in the audience are engaged partially or wholly in retail sales - the successful financial manager has a finger on the key economic variables affecting the local market for his product. For example, if the manager is in landscape contracting, he or she is informed about the growth potential of the market area -- variables such as population age and distribution, employment, income, housing starts and other factors that affect the firm's market area.

The implication of this is that the successful financial manager will spend at least as much time, if not more, in studying economic and marketing trends as he spends studying production technology.

Secondly, the successful financial manager understands -- and uses -- basic financial management tools. This section of my talk could be called "back to the basics", because this recommendation has not changed in at least the last 20 years, which is the amount of time that I have worked with managers of agricultural firms.

The tools of the successful financial manager are the balance sheet, the income statement, and the cash flow statement. Time does not permit me to go into the details of each, but I will assume, because these are so basic, that you know what each is and how it is used. These are items that, when credit is sought, are routinely required by lending agencies. The successful financial manager will have a balance sheet which is updated annually, and perhaps quarterly depending on the size and nature of the business; an annual or quarterly income statement, and a monthly cash flow statement. Not only will a monthly actual cash flow statement be available,

but also a projected cash flow for the current year in which actual figures are compared monthly against projected flows.

This indispensable financial data will be so much a part of the manager's tools of the trade that they could be updated and ready for a conference with the lender in 24 hours. These are not statements that should require several days to accumulate the necessary information to prepare.

In farming enterprises in which land comprises a major part of the firm's assets, I would recommend that the balance sheet be kept with two columns of values -- one for current market value and the other column for book value, or the cost of assets less depreciation. I also think that growers should seriously consider double entry bookkeeping and accrual basis accounting. The new tax law requires growers of horticultural enterprises to capitalize preproductive expenses (orchards, for example). The tax law also brought years for depreciation write-off close to what is normal "useful life". All of this means that tax reporting requirements have now moved much closer to the requirements for good financial management decisions, making it more essential and practical than ever to improve financial management information.

Now if you think all this seems a bit complicated, involving a lot of computations, and time-consuming then you are right. Fortunately, the means to accomplish this kind of accounting is right at hand in the form of the personal computer and various accounting packages which are now available. This brings us to the third point - the successful financial manager utilizes the computer to enable instant access to financial data and other data essential for good management decisions. In addition to accounting systems, cost accounting by enterprise and accounts payable will be available to the manager, either through a software package or through a self-designed Lotus spreadsheet. For the firms with significant retail businesses, an accounts receivable package will also be in place. The amount and structure of

receivables will be readily apparent such that information on receivables due in less than 30 days, 30-60 days, and 60-90 days will be instantly available. Interest will be automatically computed for the balance due over 30 days.

The motivation for this is no longer simply effective collection of receivables, which is important enough, but also it is a matter of the cost of money to the firm. Nowadays, interest bearing checking accounts are common at rates of five percent or greater. The opportunity cost of a dollar for 30 days for a large firm is considerable. For example, for each \$10,000 of receivables due to a firm in a month, the opportunity cost is at least \$42.00. If the firm has to borrow its operating capital, then the cost is greater -- at 12 percent, it is \$100 per month. For a firm with a million dollars in annual sales, doing most of its sales on credit, the annual cost of this "float" is in the neighborhood of \$2,500 to \$6,000 per year, assuming an average of 15 days from time of purchase to time payment is due.

The flip side of this is on accounts payable. For expenses which are billed to the firm (and most are of this nature except labor), there is an economic incentive to delay payment until it is due. Labor typically makes up about 40 percent of cash expenses for many kinds of horticultural firms. For example, a firm with one million dollars a year in cash expenses has perhaps \$400,000 expense for labor and the other \$600,000 represents cash expenses which are often due in 30 days. This opportunity cost of paying cash immediately for these purchases is about \$1,250 to \$3,000 annually. While these are not amounts that will make or break a firm, the advent of computers has made it possible to run payables and receivables that tightly, and larger firms will find it advantageous to do so.

Having this information at hand is useful only if the manager has it in a form that is readily accessible and usable. Furthermore, the manager makes considerable use of the information. Quite a lot of records and information never gets used for managerial decisions, even if it is in a useable form.

In fact, this brings up an important point -- there is a potential for information overload -- that management has too much information and that a significant part of that information is inconsequential for management decisions. This brings me to my fourth point -- that the successful financial manager annually establishes meaningful annual objectives, usually numerical, for evaluating the performance of the firm. These can be established for important aspects of the business that can improve the firm's financial performance for the year. Some examples might be sales volume or production targets, cost containment objectives, or some other measure of performance. The critical point is that these objectives are designed to permit the attainment of longer-term goals. They may be directed toward identified weak points in the business.

The sixth point is suggested from above. That is, the successful financial manager has a business plan -- a strategic plan, if you will -- for where he wants the firm to be in 5-10 years. This means that the manager has goals in terms of what he wants for himself and the family and measurable objectives. Incidentally, a typical goal is to transfer the firm to the next generation, but many horticultural owner-managers have done very little estate planning to ensure that this happens in the way desired by the owner-manager and his or her heirs.

In today's economic environment, as I said in the beginning, I believe that this strategic plan should include a strategy for expansion unless the owner-manager is within a few years of retirement. It seems that new technology in farming and inflation in the general economy, when viewed over a longer time period than the last five years, means that orderly, planned expansion is essential. I am well aware that much of the agriculture sector is now in difficulty because of expansion done on highly leveraged appreciating assets, mainly land, and that the whole structure collapsed for many farmers with declining land values. Nevertheless, the appropriate

reaction, in my mind, is for growers to learn from the mistakes that were made in the past and to plan expansion carefully, but still making wise use of credit -- that is, that in addition to satisfying the lender's requirement for collateral, investments are made which add substantially to income, and are well within carefully projected cash flow plans. In fact, my outlook for the next three to five years would be for inflation rates higher than for the last five years, and for real interest rates to be lower (the real interest rate is the difference between what you pay the lender and the rate of inflation), implying that increasing debt is a good strategy for the next few years providing that investments meet the criteria for increasing income and meeting cash flow requirements. All of this implies the need for a plan which sets forth investment priorities which will lead to orderly expansion.

Now I know by now that you are saying to yourself, "hey, this is a lot of work!" Sitting in front of the computer or looking at computer printouts that someone else has prepared, making five to ten year plans, monitoring selected objective measures of performance, and preparing projected cash flow statements are time consuming tasks. I agree that it takes time -- and that brings me to my seventh point.

Successful managers spend time managing! This means that tasks of managing are accomplished daily, in the same way that certain production practices are performed. This means that the manager finds the time to monitor what is happening to actual cash flow versus projected cash flow for the month, just the same as he has time to observe his crops to see when a particular pesticide application is necessary. These management tasks must be seen for what they are -- time spent doing things that will improve earnings and satisfaction of owning and/or managing a business. Management time must be quality time, and not something to be done after all other tasks that involve labor or production technology are completed.

I hope that I have given you something to think about as you go back to your own businesses. I hope, first of all, that you will contemplate about what you want to accomplish in the next 12 years as we approach the 21st century. The theme of this conference, and various talks on the future direction of the horticultural industry, have given you plenty of "food for thought" as you drive home.

What I hope to have conveyed to you is that the next 12 years hold exciting promises and challenges for most segments of the horticultural industry. But, you have to make it happen. It will not happen for everyone. It will not happen for those who insist that the management practices which worked in the last 12 years will work in the next 12 years. And it will not happen for those managers who cannot find the time to devote to managing.

FINANCIAL MANAGEMENT REPORT CARD

Yes No

1. I know the current prime rate of interest.
 ___ ___
2. I know how my interest costs relate to the prime rate.
 ___ ___
3. On 24-hour notice, I could provide my creditor with an up-to-date, accurate balance sheet, annual or quarterly income statement, and monthly cash flow statement (actual and projected).
 ___ ___
4. I subscribe to at least one publication that provides me with up-to-date information about supply and demand characteristics of the products I sell.
 ___ ___
5. An up-to-date list of accounts payable (and receivables if retail sales are involved) is accessible to me in a few minutes time.
 ___ ___
6. I have annual quantitative objectives for my firm (e.g. production, sales, and/or cost containment).
 ___ ___
7. I have a written statement with goals for my firm to attain in the next 5-10 years.
 ___ ___
8. I have tracked the performance of my firm over the last five years in terms of net worth and net income.
 ___ ___
9. I discuss my financial situation at least once a year with my creditors and/or financial advisor(s).
 ___ ___
10. I know the average variable cost and average fixed cost of the major products or crops that I produce.
 ___ ___
11. Some manager(s) in my firm spends at least an average of one hour per day of quality time for each \$100,000 of gross income on management. (Do not count time spent entering receipts and expenses into a record book or computer or writing checks.)
 ___ ___
12. I always do a detailed potential profitability and cash flow analysis of major capital purchases before buying.
 ___ ___
13. I use accrual basis accounting for business and financial analyses.
 ___ ___

Score one point for each yes answer, except for question 3 which is worth 2 points.

My total score

- ___ 13 points - You have lied on at least one question.
 ___ 12 points - Give yourself an A.
 ___ 11 points - Give yourself a B.
 ___ 10 points - Give yourself a C.
 ___ 9 points - Give yourself a D and go to work on improving your financial management when you get home.
 ___ 8 points - Let's hope that you have at least 80 percent equity and maybe you can ride it out to the 21st century.