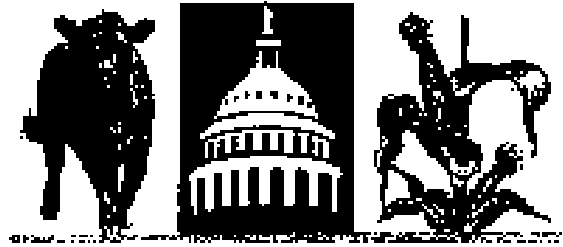


# ECONOMIC AND POLICY UPDATE

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## USDA Report Confirms Cattle Cycle is Stalled

USDA's January cattle inventory report confirmed what most people knew all too well, the cattle cycle has stalled. Dry conditions in the Southeast forced many cow-calf operations to sell more cows than usual last year, which is what drove the changes in U.S. numbers. According to USDA, total inventory of cattle and calves was down 0.3% and beef cow numbers were down 0.6%. At the same time, beef heifers held for replacement purposes was down 3.5%, suggesting that expansion was not on the minds of most cow-calf operators this winter.

The story was not the same in the U.S. dairy herd as milk cow numbers grew during 2007. Of course, the southeast represents a much smaller percentage of the milk cow herd and farm level prices of milk were very high last year. The higher milk prices appear to have offset rising feed and input costs, encouraging expansion.

As expected, Kentucky beef cow numbers declined during 2007. According to the report, Kentucky will start 2008 with 4% fewer beef cows than it had a year ago. Replacement heifer numbers were down 2.6%. One interesting item of note was an increase in the numbers of steers in the state weighing over 500 lbs. This is likely a function of increased interest in backgrounding.

Despite higher prices, dairy cow liquidation continued in Kentucky as milk cow numbers declined by about 2%. This downward trend has been steady over the last several years, but this was a much smaller decline than was seen during 2005 and 2006. It was closer to what was seen in 2004, which was another year that saw very high milk prices. It's not clear if better weather would have made much difference, but dry conditions clearly didn't make it any easier for dairy producers who may have wanted to grow. (Kenny Burdine)

## USDA January 1, 2008 Cattle Inventory Report

	2007 (1,000 hd)	2008 (1,000 hd)	2008 as % of 2007
<b>Total Cattle and Calves</b>	97,003	96,669	100
<b>Cows and Heifers That Have Calved</b>	42,023	41,777	99
<b>Beef Cows</b>	32,891	32,553	99
<b>Milk Cows</b>	9,132	9,224	101
<b>Heifers 500 Pounds and Over</b>	20,086	20,003	100
<b>For Beef Cow Replacement</b>	5,877	5,670	96
<b>For Milk Cow Replacement</b>	4,310	4,457	103
<b>Other Heifers</b>	9,899	9,876	100
<b>Steers 500 Pounds and Over</b>	17,222	17,305	100
<b>Bulls 500 Pounds and Over</b>	2,215	2,207	100
<b>Calves Under 500 Pounds</b>	15,456	15,378	99
<b>Cattle on Feed</b>	14,269	14,317	100
	<b>2006</b>	<b>2007</b>	
<b>Calf Crop</b>	37,519	37,361	100

Source: NASS, USDA

## Tax Return a Poor Indicator of Farm Profitability

Farmers are now scrambling to pay their income taxes. All farmers filing income tax returns with the Internal Revenue Service (IRS) file a Schedule F as part of their income tax return. Often the IRS Schedule F is the only indicator many producers have of the profitability of their farm business simply because the last line of the Schedule F carries the title of PROFIT. Schedule F is a poor indicator of the farm business's ability to generate a profit.

Most farmers file income taxes on a cash basis. The Schedule F is a cash basis income statement for the farm business. As such, it is a good summary of all Cash Inflows, Cash Outflows, and an allowance for depreciation. But, it is a poor indicator of farm profitability.

For this reason agricultural lenders always request three to five years of income tax returns when farmers apply for a farm loan. Farm lenders know a favorite farm management strategy is to reduce income taxes. To do to this, farmers have to reduce farm income. They use various methods of "moving" cash income and cash expenses around over time. This is a well known management practice; however, it results in an understatement of actual farm income for any single year. Farmers can only disguise the true profitability of their farm business, good or bad, for a limited number of years. Eventually, in three to five years, the actual income earning capacity of the farm business will be revealed.

The income shifting conundrum finds the farm manager trying to convince the lender that the farm business is very profitable and well deserving of the loan for which he is applying using the exact same evidence he has used to convince the IRS the farm business earns very little income. The solution to this problem is the **Accrual Adjusted Income Statement**.

The IRS requires most typical businesses to do their accounting and file income taxes on an accrual basis. This simply means that financial transactions are accounted for when they occur. Farmers are not required to file income taxes on an accrual basis. They are allowed to file income taxes on a cash basis, which simply means they are allowed to account for financial transactions only when "cash actually changes hands." This results in an important income tax management tool. And if the IRS Schedule F is used as a cash basis income statement for a farm business, this can be a poor indicator of farm profitability. An Accrual Adjusted Income Statement will solve this problem and eliminate

farm business managers' income taxes v. credit worthiness conundrum.

The Accrual Adjusted Income Statement combines information from the IRS Schedule F (cash basis income statement) and the farm's Balance Sheet to provide a more accurate estimate of farm profitability. Examples of the types of problems an Accrual Adjusted Income Statement will solve are:

- Selling only part of a years production or selling two years production in one year
- Failure to pay all production expenses during the year they were incurred or paying bills from last year during the current year
- Failure to collect all income when it was earned

All of these situations are quite common for the typical farm business. They all result in a distorted estimate of profit using the IRS Schedule F. Use of an Accrual Adjusted Income Statement will correct this distortion.

Putting together an Accrual Adjusted Income Statement is not difficult. It just takes a bit of time and some adding and subtracting of appropriate values. You are essentially combining the cash basis income statement information put together for the IRS Schedule F with adjustments taken from both the Beginning and Ending Balance Sheets for the farm business. The forms for both the Balance Sheet and an Accrual Adjusted Income Statement are available as part of the **Kentucky Farm Record Book** (pages 68 – 71 for the Balance Sheet and Supporting Schedules and pages 72 -73 for the Accrual Adjusted Income Statement and Supporting Schedules).

Basic instructions to help fill out and complete the forms are included. They provide a good "cook book" approach to putting together both the Balance Sheet and the Accrual Adjusted Income Statement.

Preparation of both the Balance Sheet and the Income Statement will provide a more accurate financial picture of any farm business and the ability of the business to earn a profit. It will also eliminate the need to rely on the IRS Schedule F as a measure of farm business profitability. (Dick Trimble)

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## Why Should I Get GAP Certified?

UK Cooperative Extension and KDA have been pushing hard on training and certification for growers for standardized good agricultural practices. These standards include record keeping for farm sanitation,

rodent control, worker sanitation, isolating non-compatible farm practices, and other practices that follow common sense. The issue for many, though, is why the record keeping? Why certify that these things are in place and practiced on the farm?

There are at least three good reasons:

**1. Marketing quality assurance** – Ready or not, the food sector is putting quality assurance controls throughout the supply chain. Although a relatively small number of food safety problems originate from the farm, supply chain leaders recognize that programs like GAP have to be implemented with careful record keeping through the entire supply chain – farms included. Buyers looking up the supply chain to those who they would select as preferred suppliers will look first to those individuals that have some credible measure of quality assurance. Most large scale farm operations already have third party certifications for HACCP and verified implementation of other quality assurance programs. Having this kind of certification, even in a direct marketing setting, is becoming an increasingly important selling point.

**2. Fragile industry reputation** – It only takes one bad experience to negatively impact a whole supply chain. The recent scares with *e-coli* in fresh spinach and *listeria* in bottled milk substantially shape consumer concern about product safety and, subsequently, entire demand for the product. Whole regions and producer groups are tied, typically, to quality assurance breakdowns. Again, many of the producers that focus on direct marketing may think they are exempt from being impacted. All it would take would be for one bad incident traced to a farmers market and it will impact them all. GAP doesn't provide 100% quality assurance. Nothing does. But good management practices and proper record keeping help reduce the overall frequency and risk of bad things happening.

**3. Management awareness** – Many farmers have a management plan in their own mind and may, indeed, be very conscientious. The advantage of having a formalized GAP management and recordkeeping system in place, is that farmers are able to better connect their employees to the quality assurance plan. More practically, there is great value in formalizing something like this into a practical management plan. Great worksheets are available to track these practices. Busy farmers can benefit from taking a moment to check off when certain practices have been implemented and strengthen their own management system. Right now it's voluntary and easily implemented.

GAP training is being offered in many locations. County agents are gearing up to offer the training in collaboration with the Kentucky Department of Agriculture. Farmers who are involved in production and marketing – where quality assurance is of the essence – should not consider this “optional” training, for the reasons stated above. GAP just makes good marketing and management sense. (Tim Woods)

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## Ag Exports Continue to Surge

On Friday, USDA released new agricultural trade estimates that show farm exports are surging. This is, of course, good news to an export dependent sector like agriculture – especially in a state like Kentucky where horse, grain, and tobacco exports are so important.

USDA is reporting that total ag exports for 2007 were \$82 billion. That's enormous growth in one year, since the 2006 total was an all-time record-high \$68.6 billion. And the rumor is that USDA will announce estimates of ag exports for 2008 in the range of \$90-91 billion, another unprecedented increase and a continuation of the surge in ag exports. In the graph below, you can see the impressive five consecutive years of record-high ag exports.

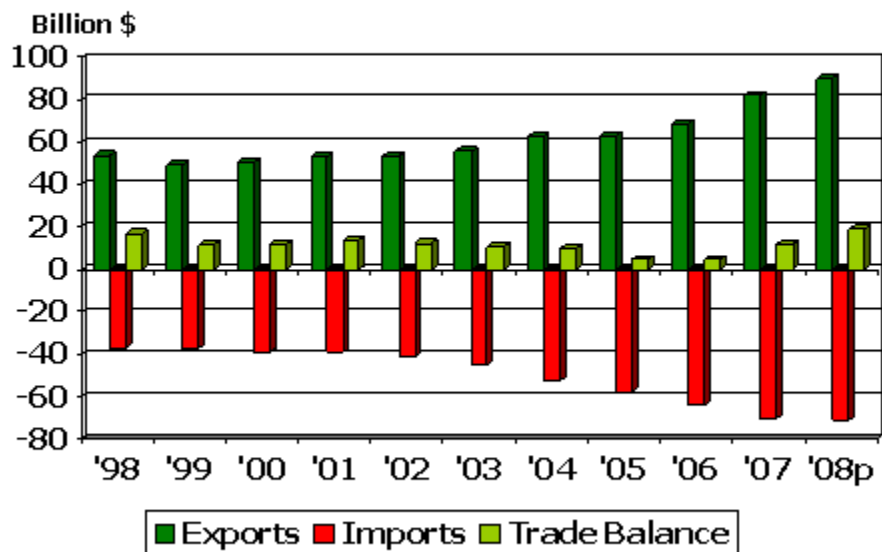
What's behind the surge in ag exports? Unquestionably, world-wide economic growth is stimulating new demand for food exports. With incomes rising in countries like China, India, Brazil and Russia, the demand for better food is boosting ag trade. This growth in demand is coming at the same time global grain stocks are low, especially for wheat. And the sinking value of the dollar – down 30% against the major currencies in the last five years – is making U.S. farm exports farm more price-competitive to foreign customers.

When you look at the monthly USDA trade data, the surge in exports is particularly apparent. On a monthly basis, ag exports in 2006 were in the \$5 - \$6 billion range, reflecting strong and steady foreign demand. But in 2007 monthly trade neared \$7 billion for every month and then surged to \$9 billion per month in the last quarter. USDA is projecting this trend to continue through 2008.

One immediate consequence of surging exports is a favorable trade balance. When exports exceed imports, we have a positive trade balance and earn foreign exchange to pay for our other foreign imports, like oil and all those goods from China. From 2004 through

2006 we experienced negative monthly trade balances, resulting in a very small positive annual trade balance of less than \$5 billion in 2006. However, surging exports is boosting the trade balance to a projected +\$19 billion for 2008, a very positive sign for our overall trade status. My former projections that the U.S. might be a net food importer “soon,” have faded against the new reality of agricultural trade. (Craig Infanger)

## U.S. Agricultural Trade 1998-2008



Source: USDA, ERS; p = preliminary

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