

Review points for exam 2

Chapters 8 (starting at p.238) and 9-13

Chapter 8 Financial Management (starting with Cash Flow management on p. 238)

Suggested review questions: 6, 9, 10

Key points

- Cash flow management is critical for both financially strapped farms and profitable farms.
- The four major sections of a cash flow statement are sources of cash, uses of cash, flow of funds summary, and loan balances.
- A projected cash flow statement is used for planning for the future and adjusting plans according to actual results.
- Actual cash flows can be compared to a projected cash flow budget to develop a cash flow deviation report. This report can be used to identify those categories deviating from the plan by more preset levels and thus, needing management attention.

Key terms: cash flow, flow of funds summary, deviation report, management by exception

Chapter 9 Investment Analysis

Suggested review questions: 3, 5, 7, 8, 9, 10

Key points

- Investments need to be analyzed for both economic profitability and financial feasibility.
- Economic profitability of an investment is measured by the payback period, net present value (NPV), and internal rate of return (IRR).
- Payback period is the number of years required to recover the initial cost of the investment. It can be estimated with either discounted or undiscounted future after-tax net returns.
- Net present value (NPV) is the sum of the present values of future after-tax net cash flows minus the initial investment.
- Internal rate of return (IRR) is the discount rate that sets the net present value of the investment to zero.

Key terms: investment analysis, capital budgeting, discount rate, economic profitability, financial feasibility, payback period, net present value, internal rate of return, NPV, IRR

Chapter 10 Land Purchase and Rental

Suggested review questions: 1d (given an answer to 1c), 2 (given a Table 10.5)

Key points

- Land value can be estimated by either the market value or income capitalization methods.
- With the market value approach, the value of land is determined by comparing it with similar pieces of land that have sold recently.
- With the income capitalization method, the estimated income per year is assumed to last into perpetuity and the present value of the land is estimated by dividing the estimated income by the capitalization rate.
- The two most common forms of rental agreements are the cash lease and share rent.
- With a share lease, the landowner agrees to share in some of the direct growing costs and receives a share of the production.
- If costs are not shared in the same proportion as production, optimal levels of fertilizer and other inputs may not be applied.
- With a cash lease, the landowner receives a fixed cash payment, does not pay for any direct production costs, and does not receive any production.
- Various forms of flexible cash rents are available but not widely used.
- Estimating and comparing the costs and returns of both the landowner and the tenant, and knowing current market rental conditions, provides both parties a good base from which to negotiate land rental rates.

Key terms: market value, income capitalization, cap rate, cash lease, share rent

Chapter 11 Risk Management

Suggested review questions: 4, 6 (given a Table 11.3), 7, 9

Key points

- Every decision involves some risk, so risk needs to be incorporated into the decision process.
- The goal of risk management is to balance a farm's risk exposure and tolerance with the farm's strategic and financial objectives.
- Risk can be described as coming from five main sources: production, marketing, financial, legal, and human resources.
- In order to decide which risks need attention first, sources of risk can be prioritized by considering their probability of happening along with the potential impact. Those risks which have a large potential impact and a high probability of happening need immediate attention.
- Risk can be managed or handled in one of five ways: retain risk, shift risk, reduce risk, self-insure, or avoid risk.

- A manager has many specific options for managing risks including, insurance, hedging, contracting, diversification, financial reserves, and so on.
- Payoff matrices, regret matrices, and decision trees can be used to organize information and, thus, help a manager make a risky decision.
- Decision criteria for risky decisions include maximin, minimax, maximum simple average, maximum expected returns, minimum expected regrets, safety-first rule, and probability of success.
- Managers can develop scenarios to better understand the impact of alternative views of the future and, thus, to make more informed decisions.

Key terms: risk, payoff matrix, regret matrix, decision criteria, maximin, minimax, expected returns, expected regrets, safety-first rule, probability of success, scenarios

Chapter 12 Production Contract Evaluation

Suggested review questions: 1, 2, 5, 7

Key points

- Contracting generally reduces all participants' exposure to risk by combining both market and production functions.
- Farmers enter into contracts for various reasons, including income stability, improved efficiency, market security, and access to capital.
- Processors enter into contracts to control input supplies, improve responses to consumer demand, and expand and diversify operations.
- Production contracts specify the quality and quantity of the commodity to be produced, the quality and quantity of production inputs to be supplied by the contracting firm, the quality and quantity of services to be provided by the grower, and the type, magnitude, and schedule of compensation that the grower will receive.
- The manner in which contracts are constructed affect the legal relationship between the producer and the contractor and, thus, the legal obligations of each party. There are four main types of production contracts.
- With sales contracts or market-specific production contracts, the farmer produces the crop or livestock and agrees to sell the product at harvest to the contractor. The farmer retains ownership until harvest and consequent sale.
- A production-management contract increases the control of the buyer over the production process.
- A production-management contract may be considered a bailment when someone else is entrusted with the possession of property, but has no ownership interest in it.
- Personal service contracts or resource-providing contracts specify that the producer is to provide services, not commodities, to the contractor.
- Evaluating a contract involves answering three basic questions. First, does the contract improve profitability? Second, how does the contract change the risks

that the farmer faces? Third, how does the contract change legal relationships and obligations?

- The best way to evaluate profitability is to develop two sets of budgets: one for operating under the contract and one without.
- Avoiding risk is a major reason for contracting, but contracts can introduce new risks.
- Signing a contract can change legal relationships, expectations, and obligations from established, yet informal, relationships.
- If economic and legal implications of a potential contract are not fully understood, a farmer should seek expert advice to help evaluate the contract.

Key terms: production contract, sales contract, production management contract, personal service or resource-providing contract

Chapter 13 Staffing and Organization

Suggested review questions: 1, 2, 6, 7, 8, 14, 15, 20, 22, 24

Key points

- Maslow's seven basic human needs are physiological, safety, belonging and love, esteem and self-esteem, self-actualization, cognitive understanding, and aesthetic needs.
- Since employees are human, these basic human needs are important to employees and, thus, managers also.
- An employee also needs responsibility, authority, accountability, and compensation.
- Human resource management involves several steps: assessing the situation; developing tentative job descriptions; matching present employees with tentative job descriptions; developing job descriptions for remaining tasks; recruiting, interviewing, and hiring employees; training employees; motivating, leading and directing employees; evaluating performance; and compensating employees.
- A job description needs to include the employee's responsibilities, authorities, evaluation standards, required and desired qualifications, supervision, time expectations, compensation information, and benefits.
- Proper recruiting, interviewing, and selection of employees helps insure better fit with jobs and, thus, productivity of the employees and profitability of the farm.
- Training is needed regardless of previous experience.
- Evaluation is the major source of control of employees and should be done whenever needed.
- The basic question in evaluation is whether the employee met the standards described in the job description or not. Both commendations and reprimands are needed.
- Negative evaluations should result in one of four actions: retrain, reassign, re-evaluate, or release.
- Release or firing is the most expensive option and should be the last choice.
- Compensation involves the base salary, incentives, and benefits. It is set according to the local job market and the performance of the employee.

- Formal incentive programs allow an employee to anticipate and work towards specific goals that are desirable for both the employee and the farm.
- Low labor costs are not directly related to low cash wages.
- The complexity of the farm business and the number of people involved increase the need for a formal description of how the farm and the people involved are organized and work together.
- A board of advisors can be a valuable management tool for a manager facing an increasingly complex business environment.
- Three common legal forms of business organization are the sole proprietorship, partnership, and corporation with the sole proprietorship being the most common among farms in the U.S.
- Other legal forms also used by some farmers include limited partnerships, Sub Chapter-S corporations, and limited liability companies.

Key terms: Maslow's basic human needs, employee needs, human resource management, job description, evaluation, incentive program, organization chart, business organization, sole proprietorship, partnership, corporation

Appendix C Estimating Subjective Probabilities

Suggested review questions: 2, 3

Key points

- Subjective probabilities can be estimated in five ways: direct estimation, cumulative probabilities, conviction weights, sparse data method, and triangular distribution.
- The choice of method depends upon how much information is available and upon personal preference.
- Conviction weights can be used when we have some knowledge and understanding of the events but have very little data.
- The sparse data method is used when we have some empirical data but not enough to perform statistical analysis.

Key terms: subjective probabilities, conviction weights, sparse data method