Ag Decision Maker

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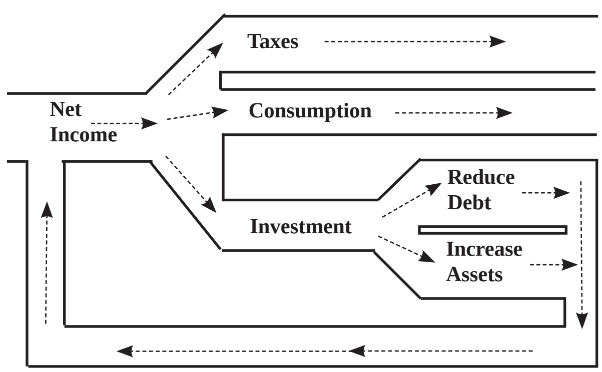
Building Equity in Your Farm

Building equity in the farm business is a goal of many farm families. Funds for building equity can come from net income that is not needed for family living or income taxes. Equity can be used to generate future income, as a source of retirement income, or a legacy to pass on to heirs.

As shown in Figure 1, net income is used for family living expenditures (consumption) and income taxes. Residual net income not used for living or taxes can be invested in the business to increase equity. This can be done by either purchasing assets or reducing debt. Either of these will increase business equity, which in turn, will generate additional income in future years.

Figure 1. Uses of farm family income, consumption or equity investment



Typical family income and living expenditures for a farm family is shown in Table 1. The average amount of income available for increasing equity is $31,000. To compute the income available for increasing equity you must first calculate the total family income by adding non-farm income to net farm income, which equals $72,000 in the example. Next, family living expenditures and income taxes are deducted. The remaining $31,000 is available for investment in the business (or elsewhere).

Table 1. Typical Farm Income Statement

Net farm income	$50,000
Non-farm income	22,000
Total family income	$72,000
Total family income	$72,000
Family living expenditures	34,000
Income taxes paid	7,000
Income available for investment (increasing equity by buying assets or reducing debt)	$31,000*

Based on Iowa Farm Business Association data for 2005

Investing the money increases farm equity by increasing assets or reducing liabilities. Regardless of whether assets are increased or liabilities are reduced, equity is increased.

A typical farm net worth statement is shown in Table 2. The beginning equity of $625,000 generated $50,000 (Table 1) of net income during the year. This is a return of eight percent on beginning equity ($50,000/$625,000). After making the adjustments shown in Table 1, $31,000 is available for investment in the business. As shown in Table 3, these funds can be used to purchase more assets which will expand the size of the business. As an alternative, the funds can be used to reduce debt at shown in Table 4. Regardless of which approach is used, equity increases by $31,000 to $656,000.

Iowa State University
University Extension

Don Hofstrand
extension value-added ag specialist
co-director Ag Marketing Resource Center
641-423-0844, dhof@iastate.edu

Table 2. Beginning farm net worth statement.

Assets	$815,000
Liabilities	190,000
Net Worth (equity)	$625,000

Table 3. Ending net worth statement (buying assets).

Assets	$846,000
Liabilities	190,000
Net Worth (equity)	$656,000

Table 4. Ending net worth statement (debt repayment).

Assets	$815,000
Liabilities	159,000
Net Worth (equity)	$656,000

Assuming the rate of return on equity remains at 8 percent, the $656,000 of equity will generate a net income of $52,481 or $2,481 more than the previous year as shown in Table 5. If family living expenditures and non-farm income remain the same and income taxes increase in proportion to net income, the effect of building equity over a ten year period is shown in Table 5. Note that the increase in net worth increases at an increasing rate over the ten year period. After ten years, net worth reaches $1 million and net farm income reaches $80,000.

Table 5. Increase in equity (net worth over a ten year period.

Year	Beginning Net Worth	Net Farm Income	Ending Net Worth	Increase in Net Worth
1	$625,000	$50,000	656,000	$31,000
2	656,000	52,481	689,273	33,257
3	689,273	55,142	724,932	35,659
4	724,932	57,995	763,167	38,235
5	763,167	61,053	804,164	40,997
6	804,164	64,333	848,123	43,959
7	848,123	67,850	895,257	47,134
8	895,257	71,621	945,796	50,539
9	945,796	75,664	999,987	54,190
10	999,987	80,000	1,058,092	58,105

Farm families can increase equity by increasing net income, controlling living expenditures and minimizing taxes.

Increasing Net Farm Income

Increasing income is the major way for farm families to increase equity. By either increasing gross income or controlling expenses, net farm income increases. A larger net income means that you have a larger income pie to divide between family living and equity investment.

Controlling Living Expenditures

Controlling living expenditures is often neglected as a way of increasing equity. It is easy to get into the habit of spending what you make. If you follow this approach you will never have money available for equity investment. Even if you increase income, you will simply spend more.

A frequent reason for financial trouble during the financial crisis of the 1980s was uncontrolled living expenditures. Farm families would monitor their incomes but not living expenditures. At the end of the year, not only would the income be gone but additional debt would have accrued. They were not prepared for a down-turn in income due to poor economic conditions.

The first step in controlling family living expenditures is to monitor what you are spending. The next step is to make a family living budget for the coming year. Make projections of what you plan to spend for food, clothing, recreation, etc. Then you need to monitor your budget to make sure you are meeting your projections. *Information File* **Managing Family Farm Finances** will help you develop and monitor a budget.

Other Methods of Increasing Equity

Non-farm income – Income generated from sources outside of the farm can be invested to increase farm equity. It can also be used to cover family living expenditures which will free-up farm income to be invested to increase farm equity. Sources of non-farm income include non-farm employment, gifts, inheritances, and other sources.

Non-farm investments – Instead of investing money in the farm business, farm returns can be invested outside of the farm in a retirement account, an ethanol plant, the stock market, a new house or other investment. The returns from these investments can be invested in the farm business. In making this decision, the rates of return and level of risk of these investments need to be compared to those from investing in the farm business.

Asset appreciation – An increase in the value of assets due to appreciation or general inflationary pressures will increase equity. This type of increase in equity may or may not increase the returns from the equity.

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