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PROFITABILITY IN DAIRY FARMING IN THE 1980's

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PROFITABILITY IN DAIRY FARMING IN THE 1980s*

During the 1980s dairymen have been facing substantial turmoil in their industry. In most years, output has exceeded domestic demand. Bovine somatotropin (BST) has been tested extensively in research trials throughout the country, but its impact on aggregate production, the number and size of dairy farms, and on costs of production remains uncertain. Throughout this decade structural change has continued; average farm size has increased at the fastest pace in this century. Milk production has become more concentrated in the leading states and the specialized dairy states have grown at the expense of other producing areas.

Two short-run federal programs were instituted to reduce milk production in the 1980s: (1) the milk diversion program, which paid participating farmers to reduce output for 15 months; and (2) the dairy buyout, which has paid dairymen to cease production for a span of five years. The dairy price support program remains in effect with the change in the support price now tied directly to the amount of government stocks accumulated during the most recent production period.

The setting for economic decisions by individual dairymen is clearly one of relative uncertainty. Productivity has increased rapidly on many farms. The promise of further gains in productivity from the adoption of new technology is great. Yet, as costs of

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production are reduced, aggregate supply pushes inexorably upward against relatively static domestic demand; producer prices leave little margin on the average to pay for new labor-saving or output-increasing technology. Competition among producing regions for markets and within a given producing region by individual farmers is a widely recognized phenomenon. Survival over time with a consistently profitable operation must be the concern and interest of every dairyman as he adjusts to forces of change around him.

Ten Year Comparisons of Distributions of Profitability

To get perspective on what has been happening in a recent span of ten years to business performance on dairy farms, the annual results from the "New York Dairy Farm Management Business Summaries for 1975-77 and 1985-86" were examined, especially with respect to changing distributions of labor and management income per operator. A three-year period from 1975-77 was examined to reduce the effect of a single unusual year. Some average measures of productivity and distributions of labor and management income per operator are presented in Table 1.

During this period, milk prices ranged between \$8.65 and 9.90 per cwt. Herd size averaged 71-72 cows; milk sold per worker held between 380,000 and 390,000 pounds. Labor and management income per operator was positive on the average in each of the three years. The 1976 operating year provided the highest rates of return on equity capital with and without real estate appreciation among the three years.

Table 1. DISTRIBUTION of LABOR AND MANAGEMENT INCOME PER OPERATOR
New York Dairy Farm Business Summary, 1975-77

Description	1975	1976	1977
Number of farms	605	615	570
Average price per cwt. of milk sold	\$8.65	\$9.90	\$9.76
Average number of cows	72	71	71
Cows per worker	30	28	28
Milk sold per worker, lbs.	387,900	380,200	385,920
Milk sold per cow, lbs.	13,000	13,400	13,600
Labor and management income per operator	\$3,703	\$7,960	\$3,049
Rate of return on equity capital	5.1%	7.9%	3.6%
Rate of return excluding real estate appreciation	2.2%	5.0%	1.3%
<u>Distribution of labor and management income per operator:</u>			
	<u>percent of all farms</u>		
\$-10,000 and below	9	5	13
- 9,999 to - 5,000	10	6	11
- 4,999 to 0	18	12	13
	(37)	(23)	(37)
\$ 0 to 4,999	23	21	21
5,000 to 9,999	17	18	20
10,000 to 14,999	11	15	10
15,000 to 19,999	6	10	6
20,000 to 24,999	3	5	3
\$25,000 and above	3	8	3
	(63)	(77)	(63)

The distributions of labor and management income indicated that 37, 23, and 37 percent of the farms had negative results in the three years, respectively. If the two extreme classes are excluded, \$-10,000 and below and \$+25,000 and above, 88, 87, and 84 percent of the farms were distributed over the range, \$-9,999 to \$+ 24,999.

When examining the same kind of table developed from the business summaries for the most recent two years available, 1985 and 1986, there are some important contrasts. Milk prices averaged between \$3.00 and \$4.00 more per cwt. Herd size has increased by

18-23 cows. Cows per worker remained constant, but milk sold per worker increased by 70,000 to 100,000 pounds. Milk sold per cow was up by 2,000 to 3,000 pounds.

Table 2. DISTRIBUTION of LABOR AND MANAGEMENT INCOME PER OPERATOR
New York Dairy Farm Business Summary, 1985-86

Description	1985	1986
Number of farms	404	414
Average price per cwt. of milk sold	\$12.90	\$12.65
Average number of cows	89	95
Cows per worker	28	31
Milk sold per worker, lbs.	442,125	497,555
Milk sold per cow, lbs.	15,679	16,237
Labor and management income per operator	\$2,850	\$3,837
Rate of return on equity capital	-1.3%	4.3%
Rate of return excluding real estate appreciation	-0.7%	-0.6%
<u>Distribution of labor and management income per operator:</u>		
	<u>percent of farms</u>	
\$-20,000 and below	13	15
-19,999 to \$-10,000	11	10
- 9,999 to 0	22	20
	(46)	(45)
\$ 0 to 9,999	19	21
10,000 to 19,999	15	16
20,000 to 29,999	7	6
30,000 to 39,999	4	4
40,000 to 49,999	4	3
\$50,000 and over	5	5
	(54)	(55)

Profitability per unit of output has narrowed on the average, but the range of losses and positive net returns has increased. The two distributions of labor and management income per operator in Tables 1 and 2 have the same number of classes but the intervals for 1985-86 are double those for 1975-77. While there has been some

increase in milk prices and dairy input prices, they have far from doubled. The distributions of labor and management income per operator have widened to somewhat more than twice their range in 1975-77.

One of the reasons for these differences may well be related to possible changes in the makeup of the farms included in the annual summaries. In both sets of time periods, they included farmers with above average rates of production and output, however. The widening of the range of losses and positive net returns in 1985-86 compared to ten years earlier seems to fit well with other evidence that variability in profitability has increased. It is somewhat surprising to find that in both 1985 and 1986, 13 and 15 percent of all the farms had labor and management incomes per operator below \$-20,000. In fact, six percent in 1985 and four percent in 1986 had labor and management incomes below \$-40,000. Such levels of negative returns to labor and management cannot be sustained for many years in a row.

The proportion of the farms with negative labor and management incomes increased to 46 and 45 percent in 1985-86. At the same time, the proportions with labor and management incomes per operator above \$+20,000 also increased to 20 percent in 1985 and 18 percent in 1986. If a base of \$+15,000 in 1975-77 were considered roughly comparable to \$+20,000 in 1985-86, then only in 1976 from the earlier period was there a comparable proportion (23 percent) that exceeded that base. The average rates of return on equity capital with and without appreciation in 1985-86 indicate that overall margins had declined for these account-keeping farms compared with the results in 1975-77.

Comparisons of Components of Labor, Management, and Ownership Income

One way of gaining further perspective on the profitability and net incomes of dairymen is to examine in more detail the components of net returns after cash operating expenses and depreciation are deducted from cash receipts, adjusted for inventory changes (Table 3). The labor and management income discussed in Tables 1 and 2 is only one component of this total. In 1975-77, average labor, management and ownership income ranged between \$21,200 and 27,500. More than half of this total in both 1975 and 1977 could be attributed as a calculated return to equity capital figured at seven percent, a conservative interest rate for that period. Real estate appreciation was relatively modest in each of these years, but this kind of capital gain does not provide current cash income for family living.

Table 3. LABOR, MANAGEMENT, AND OWNERSHIP INCOME PER FARM
New York Dairy Farm Business Summaries, 1975-77

Description	1975	1976	1977
Number of operators	1.21	1.23	1.23
Capital investment, end of year	\$248,000	\$263,000	\$284,000
Equity capital, end of year	170,700	178,800	189,100
Labor and management income per farm	\$ 4,492	\$ 9,823	\$ 3,738
Real estate appreciation	4,975	5,120	4,228
Interest on equity capital @ 7%	<u>11,949</u>	<u>12,519</u>	<u>13,237</u>
Total labor, management and ownership income per farm	<u>\$ 21,416</u>	<u>\$ 27,462</u>	<u>\$ 21,203</u>
Value of operator's labor and management	\$ 12,739	\$ 13,370	\$ 14,438
Return on equity capital including appreciation	8,677	14,092	6,765
Rate of return on equity capital including appreciation	5.1%	7.9%	3.6%

Farmers were asked to estimate the value of their labor and management each year. The averages of these estimates are listed in Table 3. These relatively modest figures can be compared directly with the calculated labor and management income when interest on equity capital at seven percent was deducted from the total. Only in 1976 was the rate of return on equity capital including appreciation equal to more than seven percent when calculated as a residual.

The same basic information for 1985 and 1986 as that in Table 3 indicate some important changes over the span of ten years (Table 4). With more cows and larger farms the average capital investment had essentially doubled. Equity capital was larger by 80 to 90 percent. Labor, management, and ownership income per farm averaged \$18,300 in 1985 and \$38,800 in 1986. Most of this substantial difference, however, can be attributed to the difference in real estate appreciation between the two years, \$-2,000 in 1985 and \$+16,900 in 1986. Interest on equity capital, calculated at a long-run rate of return of five percent, amounted to between \$16,000 and \$17,000 in each of these years.

Note the change in the evaluation of operator's labor and management as estimated by the farmers in each of the years. Between 1975 at \$12,739 and 1986 at \$24,116 this estimate essentially doubled, even though the calculated return, labor and management income per operator remained almost constant. One concludes from this examination of labor, management and ownership income that the average dairyman was paid less than market rates for the use of his equity capital in all of the years except 1976 and only then because real estate appreciation was included in making

the calculation. Further, average self-evaluations of labor and management increased substantially in ten years reflecting increased wage rates within and outside agriculture. Dairymen continued to increase net worth and equity, even though market rates were not being earned on the labor, management, and capital used in their businesses on the average.

Table 4. LABOR, MANAGEMENT, AND OWNERSHIP INCOME PER FARM
New York Dairy Farm Business Summaries, 1985-87

Description	1985	1986
Number of operators	1.4	1.3
Capital investment, end of year	\$518,000	\$559,000
Equity capital, end of year	325,700	338,800
Labor and management income per farm	\$ 4,037	\$ 4,988
Real estate appreciation (depreciation)	-2,022	16,903
Interest on equity capital @ 5%	16,283	16,939
Labor, management, and ownership income including appreciation	18,298	38,830
Value of operator's labor and management	\$ 22,613	\$ 24,116
Return on equity capital including appreciation	-4,315	14,714
Rate of return on equity capital including appreciation	-1.3%	4.3%

Comparisons of the Top Ten Percent in the Two Periods

As part of the annual business summaries, it has been customary to look at the results obtained by the top ten percent of the farms based on labor and management income. This examination of the most profitable farms in any given year provides some indication of what these successful operators have been doing and suggest what is possible for those who are seeking some standards of comparison against which they may look at their own operations. In the three

years 1975-77, there were many characteristics for this group which held relatively steady (Table 5). Size of business in terms of number of cows, worker equivalent and acres in crops, as well as milk sold per cow were quite similar each year.

Debt per cow increased modestly each of the three years. Percent equity in the business declined accordingly but debt was not a major problem. Milk sold per worker exceeded the average for all farms for equivalent years by 29 to 33 percent. Milk sold per cow exceeded the respective averages by a more modest 6 to 10 percent. Herd size was larger by 55 to 66 percent, however. Thus, a combination of greater size aided by greater productivity led to higher labor and management income.

Table 5. TOP TEN PERCENT OF FARMS: SELECTED MEASURES OF BUSINESS PERFORMANCE
New York Dairy Farm Business Summaries, 1975-77

Description	1975	1976	1977
Percent equity in business	74%	72%	71%
Debt per cow	\$937	\$1,036	\$1,179
Debt payment as percent of milk check	14%	14%	15%
Number of cows	112	118	112
Worker equivalent	3.2	3.4	3.3
Acres in crops	331	316	306
Milk sold per cow, lbs.	14,200	14,700	14,400
Milk sold per worker, lbs.	501,300	507,700	496,200
Percent feed is of milk sales	24%	24%	26%
Labor and management income per operator	\$25,257	\$33,045	\$25,076
Labor, management and ownership income per farm	65,324	77,337	75,313

The top ten percent of farms in 1985 and 1986 were substantially larger, by two times or more, than the average farm included

in the summary in terms of number of cows, worker equivalents, acres in crops and total milk sold for equivalent years (Table 6). Milk sold per cow exceeded the summary average by about 12 percent each year; milk sold per worker was up by 40 to 50 percent. Debt per cow was about \$300 per cow less than the summary average for each of the years; percent equity in the business was quite similar.

Table 6. TOP TEN PERCENT OF FARMS:
SELECTED MEASURES OF BUSINESS PERFORMANCE
New York Dairy Farm Business Summaries, 1985-87

Description	1985	1986
Percent equity in business	66%	65%
Debt per cow	\$1,767	\$1,880
Debt and interest payment made as percent of milk receipts	18%	30%
Number of cows	225	232
Worker equivalent	5.9	6.0
Acres in crops	581	609
Milk sold per cow, lbs.	17,598	18,209
Milk sold per worker, lbs.	669,899	705,028
Percent purchased feed is of milk receipts	22%	23%
Labor and management income per operator	\$30,022	\$ 39,805
Labor, management and ownership income per farm	86,477	130,322

In making comparisons across the ten-year span for the top ten percent of farms in the summary program, the most striking difference is the degree to which increased size marked the most profitable operations in the 1980s compared with the 1970s. This suggests again that operating margins per unit had shrunk; a combination of above average productivity in terms of milk per cow and per worker

when combined with substantially more units, contributed to good labor and management income per operator as well as growth in equity and substantial returns to labor, management and equity capital. In 1985 and 1986, some dairymen were doing very well at the same time that others were sustaining very substantial losses, or at the very least were essentially getting large negative returns for their labor and management.

Size of Herd and Profitability in 1986

Given the suggested tie between profitability and size of herd in 1985 and 1986 (Table 6), a summary of the averages for a number of standard measures of profitability for each of the herd size groupings in 1986 is examined in Table 7. There are relatively large numbers of dairymen participating in the farm business summaries with herds between 40 and 100 cows. About 15 percent had herds with 100-149 cows; a little more than 12 percent had herds of 150 or more.

Perhaps the most important point to make in studying Table 7, is that for net farm income, excluding real estate appreciation, there was positive average value for every size group from the smallest to the largest. There was an important step forward in the averages moving from 40-54 cows up to 55-69 cows. Net farm income more than doubled on the average and the rate of return on equity capital including appreciation turned positive. A second major shift upward in relative profitability occurred when comparing the group with 100-149 cows and the three groups immediately below. Essentially all of the farms with 100 or more cows used free stall

systems; this change in technology from conventional to free stall housing, is one important component in the observed increase in productivity and potential profitability.

Table 7.

SIZE OF HERD AND PROFITABILITY
414 New York Dairy Farm Businesses, 1986

Average number of milk cows	Number of farms	Net farm income (excluding appreciation)	Rate of return on equity capital (including appreciation)	Labor and management income per operator
Less than 40	32	\$ 6,845	-3.2%	\$-2,533
40 - 54	87	7,644	-2.1%	-2,168
55 - 69	76	16,164	0.1%	1,361
70 - 84	60	15,600	2.5%	-1,372
85 - 99	46	19,361	4.2%	378
100 - 149	62	39,080	7.3%	8,981
150 - 199	22	33,630	5.3%	3,696
200 - 249	10	42,881	5.1%	4,803
250 or more	19	123,246	10.6%	42,319
Average for all farms	414	\$ 23,853	4.3%	\$ 3,837

Source: A.E. Res. 87-20.

It is important to remember that increased size of business allows the opportunity for both increased net returns and increased losses. Some of this phenomenon is implicit in the similarity of average net farm incomes for the farms with 100-149 cows, those with 150-199, and those with 200-249 cows. The last open-ended class includes a few relatively large farms with more than 500 cows that were also quite profitable. The effect of these much larger units is readily evident in the averages for this last size group.

Effect of Size on Production Costs

Many of the important reductions in production costs per unit of output that come with increased size, have occurred by the time units of 100 to 150 cows have been organized successfully under typical resource conditions in the Northeast. The evidence in Table 7 simply reflects what has been shown in more detail in other studies of farm record data and budgeting studies done at a number of locations in the Lake States and Northeast. Farm profitability results from the interaction of two key components in an accounting sense: (1) net return or margin of profit per unit of output, and (2) number of units of output. Both are important. Up to a certain point, increased size of business helps to spread fixed costs and thus reduces production costs per unit. In the process, net return per unit of output is increased. After that point, however, the challenge of management when size is increased is to maintain the gains already achieved in production efficiency over a larger number of units.

Profitability on Conventional Stall Dairy Farms with Less Than 60 Cows in 1986

Profitable businesses are operated consistently on all sizes of dairy farms. While costs per unit can be reduced by spreading fixed costs over more units, it is also possible to make smaller businesses run efficiently with very good net returns by exercising strong management and control. Tailoring one's management skills to meet the needs of available resources is a basic key to profitability.

Some evidence of the abilities of cooperating farmers included in the 1986 farm business summary to make profitable business decisions on farms with less than 60 cows is provided in Table 8. Five different business factors calculated for each farm are arrayed from high to low and then averages calculated for each of ten deciles (ten percent of the farms averaged for each group). Each of the factors was arrayed independently. The same ten percent of the farms were not in the highest group in each category.

Table 8. DECILE AVERAGES FOR SELECTED BUSINESS ANALYSIS FACTORS
146 New York Conventional Stall Dairy Farms With Less Than 60 Cows, 1986

Net farm income excluding appreciation	Labor and management income per operator	Feed and crop expenses per cwt. milk	Pounds of milk sold per cow	Percent feed is of milk receipts
\$35,087	\$17,562	\$2.51	18,900	11
24,247	10,953	3.15	17,400	17
18,994	6,887	3.44	16,600	22
14,971	4,089	3.70	16,000	24
11,729	1,658	3.86	15,400	25
8,614	-1,401	4.05	15,000	27
5,490	-4,394	4.28	14,400	29
814	-8,524	4.59	13,900	30
-3,988	-14,528	4.97	13,000	32
-18,796	-26,431	6.06	10,700	38

Source: A.E. Res. 87-20.

The most important point this table makes, in terms of profitability analysis, is that the top ten percent of these farms, with less than 60 cows, had labor and management incomes per operator that were well above the average for all farms at \$3,837. They were equal to or above the results of many of the farms with more than

100 cows when comparing averages in Tables 7 and 8. A combination of wise control over costs together with emphasis on productivity from crops and the dairy herd can lead to quite satisfactory net returns on smaller farms. The top three deciles, 44 of the 146 farm businesses, were well above average compared to all of the farms in both net farm income and labor and management income per operator. The real key then is management and cost control within any size group or classification.

Examination of Three Years of Experience for One 70-80 Cow Farm

The median size group in the 1985 and 1986 farm business summaries was 70-84 cows. This is a fairly typical size of farm in New York for single proprietors or family partnerships. To get some insight into what can occur over a three year span on a successful but typical business in terms of size, some selected summary statistics for an actual farm are presented in Table 9. This is a partnership with two managers operating the dairy herd in a conventional stall barn with an around the barn pipeline milking system.

If one gives these three years of data a quick overview, one is first struck by the consistency of the numbers. This is unusual. Few businesses have such similar results in terms of net income and rates of production. This farm has above average profitability in regard to both net farm income and labor and management income. There are two operators. This means that net income must be shared between two families, but there is something to share, and both families draw a standard amount each month from the business for family living.

Table 9. **WISE FARM BUSINESS SUMMARY STATISTICS**
A Successful New York Dairy Farm, 1984, 1985, 1986

Selected Business Factors	1984	1985	1986
Average number of cows	75	80	74
Average number of heifers	60	50	44
Worker equivalent	3.0	3.0	2.5
Crop acres	170	170	170
Milk sold per cow	14,500	14,450	14,880
Milk sold per worker	362,600	385,450	440,400
Cows per worker	25	27	30
Grain and concentrate as percent of milk sales	44	34	28
Labor and machinery costs per cow	488	525	553
Farm debt per cow	1,921	2,070	2,276
Debt to asset ratio	0.41	0.43	0.46
Debt payments as percent of milk sales	18	20	21
Net farm income excluding appreciation	\$36,916	\$31,080	\$31,104
Net farm income including appreciation	35,897	37,615	37,352
Labor and management income	25,700	20,242	20,668
Rate of return on equity capital including appreciation	5.3%	6.3%	9.3%

As one studies this farm's performance, one can see that labor and machinery costs per cow have increased modestly while grain and concentrate purchases have been reduced substantially as a percentage of milk sales. Debt per cow has increased modestly each year; concurrently, the rate of return on equity has increased. Milk sold per worker has increased in each of the years while milk sold per cow has held steady. Both of these measures of productivity are below average for all farms in the summary in 1986. This result should serve as a reminder that each set of managers may succeed in different ways depending on their own skills and the resources available to them. Control of expenditure relative to current levels of production is one of the strengths of this

business. Debt per cow on this farm is about average; rates of net return per operator are above average, but not outstanding.

Summary Observations

1. Profitability can be measured in many different ways. For most farm businesses it is the return to the farm operators' own resources (labor, equity capital and management) that is most important. How the net return is distributed as payments to family labor, capital and management is not the critical question. It is much more nearly how much there is available as net returns that is of interest.
2. It is important in any analysis of profitability to separate out the impact of appreciation in real estate values in measures of net return. Appreciation or depreciation of total capital and of net worth is an important component of analysis, but it is important to recognize it as a separate component particularly when annual cash flow is at issue and debt and interest payments are large.
3. Variability in profitability on dairy farms is substantial within any size grouping. Moreover, that variability has grown in the ten-year period from 1975-77 to 1985-86 (Tables 1-2.)
4. Net returns to a business are the result of two components: the net return per unit of output and the number of units on which that net return is obtained. Size of business can help on both of these components. Economies

of size are commonly realized until herds of 100-150 cows are assembled. Then reductions in costs per unit are usually much smaller and gains come primarily from additional units.

5. Variability in profitability within any individual size group is large. There are always opportunities for successful managers on small farms to equal the profits of average managers on much larger farms (Table 8). Evaluating the resources available and making wise management choices within the constraints a business faces is crucial to sustained profitability.
6. Cost control is an important determinant of profitability. Control is not pinching pennies but putting money to work where it will pay the greatest net returns. In some cases, buying more concentrate feed and protein supplements would be a wise, controlled expenditure; in others, it may already be a weak point in the business. On many farms, not enough high quality, early cut forage is harvested. Cost control involves careful analysis of the home-produced feed supply and the economical balance required to meet production needs. Similar analyses must be made for all components of business expenditure.
7. The larger the business and the greater the number of workers, the more points where decision making must be delegated and the more opportunities for control to slip out of the hands of one or more managers. The size of losses and negative labor and management incomes on

significant percentages of farms in the business summaries for 1985 and 1986 (Table 2) indicates such loss of control. Profitability is tied to effective labor management and delegation of responsibility for individual activities where appropriate.

8. Profitability is strongly associated with the wise use of borrowed capital. There is no standard debt to asset ratio or debt level per cow which has been established as a general norm. Problems with "too much debt" on a number of dairy farms has been widely publicized and recognized. But each situation must be evaluated on an individual basis. An important warning sign of potential problems occurs when scheduled debt repayment programs cannot be met. The potential for cash flow problems in an otherwise profitable business must be part of any consideration of undertaking new debt regardless of the potential gains in productivity or profitability.
9. Profitability is associated with above average rates of milk sold per cow, milk sold per worker, and increased herd size (Tables 5-6). At the same time, above average net returns can be achieved without accomplishing each of these desirable characteristics (Tables 8-9). The interests, skills, and capacities of individual farm operators are different. So are the physical resources. Trying to increase milk sold per cow by 1000 pounds per year may not increase profits on one farm, but be a wise strategy on another. Each situation is somewhat unique.

10. At a time when the price received for milk has decreased and the price of concentrate feed and other purchased inputs has risen, a reexamination of some management practices may be in order to sustain profitability or maintain positive returns. Renewed emphasis on the quality of the forage production and harvesting program may be even more important, given the changing price ratios for grain and milk.

The primary way a dairyman can influence the profitability of his business is through his own management decisions. Margins have narrowed. Time spent in record analysis, cash flow planning, and cost control are increasingly important. In most cases, improvements can be made in business operations. Setting aside time for this component of management deserves priority.