A BALANCED MANAGEMENT APPROACH TO GROWING FARMS

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Abstract

Actual observations show that two neighbouring farms will typically report different financial outcomes. One farm will be better off than the other. Same enterprises. Same size. Same weather. The only variable is the difference in management decisions made for each of the farms. Longer term, the implications pertain to the potential impact on the ability of the farm to support growth objectives and sustainability. An increasing number of farms are facing the issue of not having the capacity to support growth. Why is this happening?

An obvious observation would be that farmers should not try to manage a 6,000 hectare farm the same way they managed a 600 hectare operation. At what point should the management systems change. 2,499 hectares? 2,500 hectares? There is no one specific increase in size that mandates a certain change in management practices. The management changes required to keep pace with growth are subtle. However, the need to align growth and management is very important. Businesses typically outgrow management and this axiom absolutely pertains to farming. This paper will examine challenges in managing growing farms; growth in terms of size and/or complexity and diversity. Given that management challenges exist, there are advanced management skills that are needed to ensure that farm businesses thrive. Increasingly, farmers are recognizing and adapting to change, with an increasing emphasis on advanced business management. No longer can farmers rely solely on good production management skills to see them through challenging times. More attention to planning is required. Planning not only for the next production cycle, but more importantly longer term planning that is strategic in nature. They must integrate the associated production, marketing, human resource and financial management activities. Because of historic, narrow margins and large capital investment, they must also work to align strategic objectives with financial performance and investment. The result is better managed farms, better financial outcomes for farm owners and managers and an enhanced likelihood of longer term sustainability.

Keywords: farm management, balanced management, strategy, finance

Subtheme: profitability and sustainability, managed growth

Introduction

This paper will examine management implications of farm owners and managers of growing farms; growth in terms of size and/or complexity and diversity. Given that management challenges exist, there are advanced management skills that are needed to ensure that farm businesses thrive. Increasingly, farmers are recognizing and adapting to change. There is an increasing emphasis on business management. No longer can farmers rely solely on good production management skills to see them through challenging times. This requires more attention to planning. Planning not only for the next production cycle, but more importantly longer term planning that is strategic in nature.

They must integrate production, marketing, human resource and financial management activities. Farmers need to ask themselves basic questions about what they want their businesses to look like in 5 years. In other words, what their vision for their business is. Once the vision is articulated, strategies can be set that are designed to work towards accomplishing the vision. Further, because of historic, narrow margins and large capital investment, they must work to align strategic objectives with financial performance and investment. The result is better outcomes for farm owners and managers.

Background

Canadian farmers are experiencing profound change, largely due to global economic conditions and technological advances that are forcing them to push aside traditional ways of doing things. This trend will result in significantly fewer farms in Canada over the next 20 years, with a greater percentage increasing in size because "under current economic parameters, it's the only way to stay in business." This is reinforced by the fact that 2% of farms produce 35% of the food in Canada today.

As this industry consolidation continues there will be approximately 10% fewer farmers every five years, resulting in approximately 35% fewer farmers 20 years from now, “a trend that will not likely subside given the current income situation for Canadian farmers and the aging farm population”. This will contribute to the growth of larger farms (those with greater than $500,000 in gross sales) as they will not only force smaller producers out of the market but will also pick up the pieces after farmers operating smaller units decide to leave the industry.

These fundamental shifts in the Canadian agricultural and agri-food sector present many challenges and opportunities for the future. The only certainty is that the players in the ag industry will require different and more sophisticated management skills and resources.

The agriculture business in Canada is a multi-billion dollar industry. It is a volatile industry filled with constant change, uncertainty and risk. External factors like BSE, Avian Flu, international trade disputes, weather conditions and currency fluctuations have had dramatic effects on the farmer’s ability to achieve and sustain profitability. These factors are compounded with growth in the size of increasingly complex farms. The landscape of agriculture has changed dramatically. Farms will continue to grow and better managed farms will prosper. Increasingly they will need to adopt advanced management practices in order to continue to successfully grow their businesses.

- 20% - Doing Well (highly profitable)
- 40% - Doing O.K. (experience 4 or 5 per cent ROI)
- 20% - Struggling to make profit
- 20% - On their way out.

An increasing number of farms are facing the issue of not having the financial viability and management capacity to support growth. Why is this happening?

It was not long ago when farmers were expected to be able to ‘do everything’ on their farm. A farmer’s broad skill set and abilities were directly connected to their strong sense of independence. Today, things are changing and while the foundation of multiple management skills sets still exists, it

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is far less common. There is a truism in business that applies to farming; a business typically outgrows its management.

The prevailing wisdom is that commercial-scaled farmers cannot be all things to all aspects of managing their business. For a lot of business owners and managers, it is difficult to change the way they manage their businesses. It is even more challenging for farmers because of seasonal production pressures. Stress (weather, finance, family) influences farmers to revert to long-held management patterns. It takes a lot of discipline to adopt new management practices.

Yet another obstacle to changing management behaviours lies in the subtleness of growth. A farmer should not try to manage a 6,000 hectare farm the same way they managed a 600 hectare farm. There is no light switch that says when they move from 2,499 to 2,500 hectares, they must do this or that. The requirement to introduce new management practices is more specific to the individual than it is to increasing acreage. Ideally, management upgrades should be aligned with the demands associated with growth.

There are typically gaps in management between what a given farmer is presently doing, what needs to be done and what could be done better. Examining the gaps helps to focus on what management practices are needed and what the related personal skill set development is required.

There is no one correct approach to ensuring the appropriate management practices are in place. External management advisors can help with identifying and implementing appropriate resources. But, ultimately, the primary responsibility rests with ownership and management.

The salient question facing growing farms is: will the management decision(s) they make get them to where they need to be in the future?

One of the challenges farmers face is aligning management and investment decisions within a defined strategy so that acceptable financial outcomes have a reasonable chance of being achieved.

Aligning Farm Business Growth and Management

As stated, there is no one specific increase in size that mandates a certain change in management practices. The management changes required to keep pace with growth are subtle. However, the need to align growth and management is very important.

A real-life farm discussion as an example. A farmer and spouse have 2 sons. One is actively engaged in farming and the other is working full-time off the farm and helping seasonally, as he is not yet ready to commit to a farming career. They have increased the size of their operation from about 1,800 hectares to nearly 4,000 hectares in the past 3 years and they have opportunity to add more. But, the father says that they are now “out of control”. He elaborated in detail on how they have been able to increase the size of the operation and the great amount of time, focus and energy required just to manage the operational components. What is being sacrificed are the other, more general management requirements – the ‘office stuff’. The farmer is worried as he does not like the feeling of being out of control and believes that they are dangerously close to something that will adversely and significantly affect them financially. He identified a solution, which was to scale back

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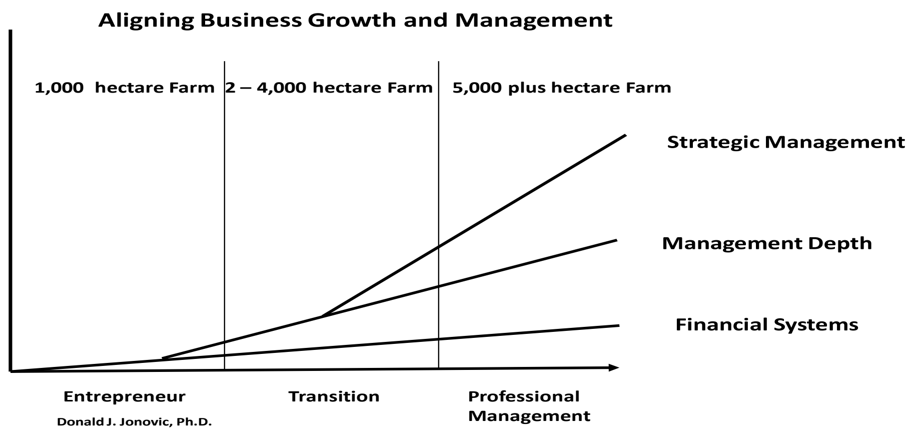
to 2,000 hectares but the farming son had a different perspective on things. The son wanted to take advantage of the opportunities and even further increase the size of the farm. Neither opinion is right or wrong, but they must first determine what can be done and needs to be done to bring the management functions into alignment with the size of the farm business.

The following illustration is adapted from work done by Don Jonovic, *Family Business Management Services*. It looks at how management must change as a business (farm) grows. The accompanying acreage correlations are not an exact science. At the Entrepreneurial stage (a typical 1,000 hectare operation), there is a base financial system in place. This would include formalized record keeping which results in an annual set of accrued financial statements. Attention to management (management depth) is important but the farmer still will focus a great deal of his time operationally providing a significant contribution to labour.



As farm size increases through the *Transition* phase and into the *Professional Management* phase, there is a continual requirement to advance the financial systems so that the appropriate information is available to management. For example, larger 5,000 plus hectare units might want to consider a managerial accounting application which is significantly much more involved from an administrative perspective, but provides more information in terms of cost centres and related margins.

Management depth starts to become more of an issue as farms grow through the *Transition* stage. The farmer (owner) needs to spend more and more time in the office. This is one of the more difficult changes to effect because it is contrary to what farmers like to do best, which is to work operationally (on the tractor). As the farm grows through to the Professional Management stage, there will be a need to add a formal middle management structure, people with responsibility for a certain area of management and who report to the farm owner/manager.

During the *Transition* stage, the need to introduce elements of *Strategic Management* begins. This includes formalizing the external resources that the farmer needs to help him with significant management decisions. The resources typically include accountants, lawyers, agronomists, lenders

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and management consultants. The *Strategic Management* function at the 5,000 acre plus size typically includes a formal advisory board.

Aligning growth and management is possible, but is not an easy task. It requires continual focus and a willingness to accommodate change.

A common reality across the industry is the lack of future-focused, or strategic, planning. A reason for the absence of this type of planning in farming is the reality that general industry impacts cannot be predicted or controlled. Therefore planning, especially longer term strategic planning, is generally thought to have little value. In the absence of trying to set any long term plans, what basis then is used to support management and investment decisions that have the potential to significantly impact future outcomes? Generally, it is hoping that things will work out.

Clearly, hope is not a strategy. Hope can be, and often is, the basis that underpins decisions, but it is not a strategy. The fact that farms must think more strategically about their future is a function of years of narrow profit margins, industry change and increasingly larger and more complex farms.

Balanced Management

The management functions on a farm can be categorized into 4 key areas: Marketing, Operations, Human Resources and Finance. Marketing includes a farmer's suppliers and consumers. Operations are the work that is being done (i.e. seeding and harvesting). Finance deals with financial performance and human resources represents the ownership, management and labour components. Businesses, including farms, especially those with growth strategies, must work to achieve and sustain a relative balance, or harmony, between and among the management functions.

Success is a function of many elements and while there is no one 'right' way to manage a farm, farmers have traditionally treated the management functions independently. Events that impact the farm management functions will result in those functions coming out of balance, creating uncertainty and risk as the farm moves forward. Long-term sustainability can be measured by a farmer's ability to keep the management functions in balance or as close to balance as possible.

Both internal and external events can take the functions out of balance. External events, such as a change in a country's trade policy or global grain supply changes can be very challenging but nonetheless must be managed. Internal events can at times be just as traumatic, but are typically within a farmer's control. Management decisions made by a farmer can result in a scenario where management functions come out of balance; usually with related and undesirable outcomes. This happens when the farmer treats each management functions in isolation and does not understand how the impact of a related decision will affect the function of another.

There is high correlation between growing farms and imbalance within management functions. Farmers can successfully manage growth in relatively smaller increments by focusing on the operation and marketing management functions. However, as farms continue to grow to larger and larger units, they need to re-focus and prioritize management attention on the finance and human resource functions. Additionally, they need to integrate all management functions and not treat them independently. Intuitively, farmers understand this is necessary but prefer to focus their efforts

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on operations. Many successful farmers recognize and accept this preference, utilizing external resources to help keep the management focus where it should be, which in turn keeps the management functions in balance.

Balanced management (Balanced Scorecarding) is a relatively widely applied theory on general business management, but not applied to any great extent in primary agriculture.

Growth oriented farmers have only one absolute constraining resource – their time. As noted above, the management functions of a farm need to advance and change as the business grows. Growth comes with the requirement that the farm owner and/or manager commit more time to balanced management. Coupled with the demand for more time comes the requirement for advanced management skill sets that extend well beyond those that are traditionally accepted. In addition to understanding the importance of managing a growing farm's human resources, farmers must, most importantly, effectively manage their own human resource.

While all areas of management require attention, financial performance remains key and underpins the other management components.

Using Financial Performance in Setting Business Strategy

Farms face real challenges in creating and sustaining profit. Notwithstanding the achievement of personal and family goals and the personal enjoyment of working in farming, management focus should be on increasing owner value. Owner value can be measured in several ways, the most common of which is in financial performance such as increased cash flow, increased equity, better utilization of capital and optimized profit as examples.

What is often missed is the connection between financial performance as presented in the year-end financial statements and setting business strategy. Financial performance can be, and should be, used in developing, implementing and modifying business strategy.

Firstly, strategy is about where the business is going while financial statements report on where the business has been - what happened last year or in the last couple of years. Secondly, most farms need to focus attention on the urgency of managing cashflow. Thirdly, profit margins are often small and there is a requirement to better manage operations to achieve improved profit. Depending on the operational cycle, this can be a relatively short term activity. What should be looked at is what can be done strategically and longer term that would provide the results wanted.

The connection between financial performance and strategy development is two-fold. Farms should use financial performance indicators in developing strategy and once developed, they should use financial information to test what progress is being made toward achieving the strategy.

The following statement is an example of how a business can use financial performance in setting and monitoring strategy.

Investment Statement

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The owners of Example Farms will accept a minimum annual Return on Equity of minus 4% on combined operations and believe that the business should be able to provide a target return of 16%. It is expected that owner equity increases by at least 6% per year maintaining an average leverage of 1/1.

What the statement is saying is that owners accept that events can happen in the farm business or in the agriculture industry in general that results in a loss for a year. It goes on to state that they believe the business should be able to achieve a good return, if everything goes as planned. However, problems occur in business. Targets are often not achieved and they accept that as well. They do, however, expect that the business at least reports a certain return.

Farm owners and managers make decisions that will increase the likelihood of achieving certain financial goals. Usually there is risk associated with these decisions. Theoretically, the greater the risk, the greater the return. Often the decision involves borrowing money. Farms can report better financial performance by using more borrowed money (leverage). The last sentence in the statement puts a parameter around risk associated with leverage. In this way, the farm business owner cannot simply borrow more money in an attempt to improve financial performance as expressed by return to equity because that would result in greater leverage and more risk.

The question then, is how does this investment statement translate into strategy? There should be discussion and agreement between owners and managers on the indicators as described in the statement above. This activity is one of the things that owners must do in setting strategy.

It is generally easier to set the desired return, 16% in the example. Equity in a business is the difference between the market value of all assets (all things owned in the business, including cash, inventory, land and buildings and equipment) and all liabilities (money owed). Return on equity is the relationship between the equity in the business and the profit. If equity (difference between assets and liabilities) is $500,000 and profit is $50,000, then there is a 10% return on equity. Large returns on equity are desirable but this indicator should be set realistically. Can the farm business actually achieve the target? If not, then as the farm grows, owners and managers can find themselves disheartened by never achieving the target and this can be counter-productive.

It is far more difficult to set the minimum target. As noted, most farm owners and managers accept that they will lose money sometime due to circumstances. The question is how much. And in a business with multiple owners, there is very likely some disagreement on what is acceptable. Just how much money are they prepared to lose? If the answer is none, then what must be done / what strategy must be used to ensure that this does not happen?

There is a follow-on point to make. If they are prepared to lose 4% in a year, how many times will they accept this until they decide to do something differently in the business so that the chance of a loss is reduced? Again, what must be done / what strategy must be used? This is a particularly difficult exercise to work through as most farm business owners are naturally optimists and would rather think of all the positive things that will happen in the business than the negative possibilities.

The most difficult aspect is the expected return because this is the financial performance that year in / year out will be achieved given the normal operational variability that exists in the business; in this

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case 6%. Further, this decision should be made in the context of the opportunity cost associated with getting a return on the equity invested in the business. For example, assume that equity in the business is $500,000. If someone were to receive $500,000 cash and subsequently invest it, what return (typically expressed as risk free interest rates) would be required before investing? Having $500,000 in cash or $500,000 in equity is really no different; at least from the perspective of what return is wanted. If the farm business cannot achieve a 6% return, what must be done / what strategy must be used? Often when faced with this decision, farm owners and managers try to improve operations and/or expand. This often simply perpetuates and/or magnifies the problems associated with poor financial outcomes. Sometimes significant strategies are required, such as diversification or value-added to increase margins or even exiting the business.

The following method can be used to measure how financial performance is aligned with strategy.

1. Average the past 5 years of income, using prepared financial statements that are normalized to exclude non-farm operating activities.
2. Next, use the current balance sheet to analyze financial performance.
3. Starting with the current balance sheet, forecast what the balance sheet (the amount of equity based on fair market value of the assets) will look like in 5 years (the time period being aligned with the strategic horizon) using the past 5 year's average income.
4. Analyze the forecasted balance sheet and determine how the results are aligned with strategic plans and the investment strategy. If the forecasted scenario is satisfactory, great! If not, determine what needs to be done strategically, to increase the likelihood that results will be achieved.
5. Lastly, compare actual results to the forecasted balance sheet on a yearly basis to determine if progress is satisfactory or if mid-term adjustment to strategy is required.

Conclusion

Profitability and long term sustainability requires that farm businesses develop and implement strategies that are designed to advance management practices. Combining a balanced approach to management with financial performance provides very useful information when determining which business strategies to use and how outcomes are measured. Making management decisions that have substantial growth and related financial performance implications demand much more than looking at the business 'from the rear view mirror'!

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