

Assessing and Repositioning

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The final step in positioning the farm business is crucial but often overlooked, at least in a formal way. It is taking stock, assessing how well the farm business manager did, looking at its records to evaluate performance. Did the farm business manager meet its goals? If so, how and why? If not, why not? Assessment involves the development of control systems and the use of benchmarks.

Types of Control

When developing management procedures, it is important to keep in mind three types of controls: 1) preliminary controls, 2) concurrent controls, and 3) feedback controls. Preliminary controls are concerned with preventing deviations from the plan. This is the type of control used to identify potential problem areas and develop plans for preventing these problems. Evaluating alternatives under different economic or policy scenarios would be one method of employing preliminary controls. Correctly anticipating potential problems can reduce the need for other types of control.

Concurrent controls allow adjustments to be made during an event. They are based on monitoring actual performance and adjusting the timing, method of use, or level of inputs to ensure an acceptable level of performance. These types of controls allow for mid-course corrections. Concurrent controls are widely used to monitor crop and livestock production processes.

Feedback controls are concerned with improving the next attempt. The year-end business analysis that seeks to identify the strengths and weaknesses of the farm business would be one example of this type of control. Another example would be the use of yield monitors and the development of yield maps for fields to help identify where yields were high and low and explain why these differences occurred. Feedback controls also provide the opportunity to modify the other types of control that are used by indicating that additional performance measures should be monitored or that some the current performance measures are not necessary.

Benchmarking¹

In order to have any type of control system, it is necessary to specify a set of written standards that can be used in measuring performance – a benchmark.

¹ This material was adapted from materials developed by DuPont Agricultural Products, *Modern Farm Management*, E.I. duPont deNemors and Company, 1997, pages 10-11.

Benchmarking generally means looking for those businesses that are the best at doing something and learning how they do it in order to emulate them. But this process also occurs in less formal ways. For example, if the cover story in the next *Successful Farming* reports on an innovative use of personnel management procedures for a particular farm, the best farm business managers will ask if that might work in their operation as well. There are three important principles of effective benchmarking:

1. Different ways of doing business or levels of performance are appropriate for different environments. It is important, therefore, for farm business managers to benchmark firms in similar environments.
2. Because it is unusual to find identical environments, it is important for farm business managers to understand the differences in the environments of the benchmarked firms and to take them into account when analyzing the applicability of the information to their own companies.
3. It is important for farm business managers to view the benchmarked firms as systems of complements. Studying a single feature or aspect of another firm, without considering how it fits with the other elements of the firm, can result in erroneous conclusions.

These principles apply to benchmarking production efficiencies or financial measures.

In specifying a standard or defining a benchmark, it is important to consider the appropriate unit of measure. Financial values such as the rate of return or profits are often used as a measure. However, it may also be desirable to use measures of quantity and/or quality. It will also be necessary to develop methods for collecting, storing, and processing the data associated with actual performance and making comparisons between actual and desired levels of performance.

The standards farm business managers establish should be realistic, yet challenging targets. Farm business managers obtain these standards from several sources. One source of standards would be the goals and objectives that are set by the management team. Another source might be budgets or cash flow projections that have been prepared when applying for operating loans. While these cash flow projections may be readily available, they may not be an appropriate source of management standards. Cash flow projections are often conservatively prepared. Costs may be biased upward and revenues biased downward in order to avoid an unpleasant surprise. Alternative sources of standards might include performance of the farm or management team during an earlier period, summary data from farms that are similar in type and size, and data from researchers and Extension specialists.

There are several different performance measures that can be monitored in any business, far more than any farm business manager would have time to monitor. Thus, for any business, a very important question to address is the question of which performance measures are the most important. Those few measures of performance that are of the utmost importance are referred to as the “critical success factors”. These factors are the small set of performance

measures where the farm business manager must achieve positive results in order for the business to succeed. These critical measures might be of a physical or financial nature. Regardless of the type of attribute, these are the areas where limited data collection and analysis resources must be focused.

Financial ratios or benchmarks are intended to help focus attention and raise the right questions. By themselves, financial ratios do not provide answers. Ratios should be examined by themselves and in relation to other measures. Interrelationships often tell a more complete story, so it is important to be selective in the choice of financial measures. Different measures and performance standards may be more appropriate for evaluating different types of businesses. In addition, it is useful to compare current financial measures with a business's own measures for previous periods, as well as against those of other businesses in the same industry group.

Assuring Accurate Benchmarks

Essentially, analysis is no better than the information it is based on. Financial measures derived from incomplete, inaccurate or inconsistent information can be misleading and often lead to bad decisions. Farm business managers need to be sure they are comparing financial “apples to apples.” Because of the sometimes inconsistent and incomplete methods of accounting employed in agriculture, this may be particularly true for farm and ranch businesses.

Following are just some of the factors that farm business managers need to consider in choosing accurate benchmarks.

- Is the income calculated on a before- or after-tax basis?
- Was the income statement prepared on a cash or accrual basis?
- Does the income statement represent only the farm business, or is it a combination of farm and non-farm businesses?
- Is the business a corporation, partnership, or proprietorship?
- Is net income before or after family living withdrawals?
- Was the balance sheet prepared on a cost basis, a market-value basis, or something in between?
- Were accrued assets and liabilities included or excluded?
- Were deferred taxes included or omitted?
- If the balance sheet was prepared on a cost basis, how was raised breeding stock valued?
- Does the statement describe only the business, or are personal assets and liabilities also included?
- Are the balance sheet numbers included in the financial measures from the beginning of the year or the end of the year, or are they an average for the year?

The operating cycle for many farm businesses is seasonal, so it is important to know whether the income statement information represents the same time period or whether the balance sheet information reflects the same point in time as the business being analyzed. For accurate comparative analysis and for determining true accrual adjusted net income, it is critical that farm business managers prepare a balance sheet as of the last day of the business's accounting period. Far too often, farm business analysis relies on a calendar-year, cash-basis tax return and balance sheets prepared as of some date other than year end, usually at the time of a loan request. It is impossible to do an accurate analysis without balance sheets from both the beginning and end of the period for which income is to be measured.

It is also important to know whether the information represents the same type of business as the one being analyzed. Obviously, a dryland row crop farm differs from a confinement dairy. But there are also differences between a single-crop dryland farm and an irrigated double-crop farm in another part of the country. Even when comparisons are made with groups of the same farm type, farm business managers should ask questions about the specific group being used for comparison. In some published studies, industry classifications may be segmented by business size and by quartiles. Averages for some farm record keeping services may represent only farmers in the top 25% of the region's producers; thus, the group average may represent a business in the top 15% of the total population.

Displaying the Results

A final comment on financial benchmarking: For many people, graphics are easier to understand than numbers. Therefore, it may be helpful for farm business managers to graph financial measures over time to show historical variability and trends. Graphing can also help make inter-firm comparisons much clearer.

For each critical success factor, farm business managers must decide what data will be needed to monitor performance. How will this data be collected to ensure consistent reliable data? What procedures will be used to convert the data into a form that is useful for decision making? When is the information needed?

Another graphic tool that farm business managers can use to help implement a strategy is the Action Plan. In an action plan, farm business managers can monitor the critical success factors. An Action Plan table lists the important action steps that will be necessary to implement the strategy. Each step is a row in the table. For each of the action steps, farm business managers should list the people, financial, equipment, and information resource requirements that will be needed. Also, they should identify the individual responsible for the item and the measure to be used to monitor the action. In some cases, the item that is monitored may just be the completion of the task. In other cases, the item to be monitored might require a specific calculation (purchase seed, fertilizer, and pesticides) or specific information (monitoring crop pests). The final columns in the table should include a time table for monitoring the step and possible corrective adjustments to make when performance is less than expected. However, it is also important to consider an appropriate response if levels of expected performance are needed.

Finally, farm business managers need to establish procedures for reviewing and assessing progress. How often will such reviews take place? Which items should be reviewed on a frequent basis, and which will only need an occasional review? Who will be involved in the review? When conducting reviews, it is important for farm business managers to determine why the deviation from the standard has occurred. Perhaps the standards set were too optimistic, or perhaps an unrecognized uncontrollable event had a negative impact on results.

A Final Comment

Benchmarking is a critical part of managing a successful farm business. Comparing production/operating and financial performance to industry standards or goals is an essential component of assessing sources of strength and opportunities for improvement. Accurate measurement and appropriate standards for comparison are essential to use benchmarking effectively in analyzing and improving your performance.