

Using Management Accounting as a Foundation for Linking Financial Performance Analysis and Strategic Thinking

R. L. “Dick” Wittman

Few farmers understand cost structures and the strategic decisions that differentiate successful farms from those struggling financially. Traditional Enterprise Analysis hasn't provided answers growers need to determine what decisions are contributing to success or failure. Ratio analysis is not well understood and seldom connected to goal setting and decision-making. This presentation is a primer course that showcases new initiatives in the farm management arena to implement professional managerial accounting systems. It also illustrates the often overlooked linkage between financial analysis and strategic decision making.

Specific technical topics and learning outcomes that can result from attending this session include:

- Evolution from enterprise analysis to managerial accounting – why and how?
- Building a foundation for performance measurement – use of ratio analysis to evaluate whole farm business performance
- Using the Dupont Model to assess the impact of performance in operational efficiency, capital asset management, and use of debt leverage; illustrate how the Dupont Model can be used to simulate the impact on bottom line performance from specific strategic shifts
- Sorting out Accounting and Economic Analyses
- Identifying manageable segments and developing standardized profit/cost center report formats
- Handling unusual transactions – how do you assure the initial transaction entry provides the ability to have integrity in both external financial reports and internal managerial accounting reports



- Agreeing on standard definitions: Direct vs indirect; variable vs. fixed
- Internal transfer pricing
- Alternatives for allocating indirect costs (i.e. overhead)
- Integrating financial and physical quantities (\$, bu, acres, employees)
- Numerous technical issues: inventory valuations; equipment gains/losses; should “land” be cost center

Participants attending this session will come away with: (1.) an appreciation for the benefits of building a professional managerial accounting approach in the business, and (2) a vision of the training and implementation strategy necessary to fully adopt this managerial practice.

Editorial Note: The presenter serves on the Farm Financial Standards Council’s Task Force that is developing guidelines for managerial accounting for U. S. farmers.)

Strategies for Implementing Effective Business Management Systems and Transitions

This session focuses on implementation techniques and strategies for putting in place professional management systems and transition plans for multi-family farm operations. Wittman draws on real world experiences gained from client consulting and personal management of a diversified, multi-family farm operation. Use of prepared illustrations plus informal question and answer format will provide a comfortable forum to discuss your most sensitive family farm business questions, challenges or transition concerns.

Topics in this session will take on a “how to” format. Experiences will be shared in methodology and strategy for implementing some of the following management issues:

- Writing mission, vision and core value statements
- Dividing roles, responsibilities and deciding on reporting structures (organization chart)
- Strategies for shifting these roles and structures as transitions are implemented
- Building more formalized separation of board, mgmt and staff identities & functions
- Identifying and managing career paths for family business members
- The Role of a CFO (Chief Financial Officer) – is it time for you to elevate this role to a defined position in the farm operation? How do you define duties, skills and role?
- Defining strategic issues and developing a dynamic strategic planning process
- Learning how to identify, negotiate and put in writing professional policy in a number of sensitive personnel and general business areas
- Identifying “Total Compensation” in family businesses and strategizing innovative approaches to structuring compensation packages for key employees and business owner/managers
- Tackling the “unimaginable”: Getting set up to do performance evaluations of managers and employees in a family business (those that are blood as well as the non-family help)
- Mini-case study on dividing earnings properly between owners and manager/laborers
- Problems and strategies for managing investment and withdrawal of capital from the family business
- Proper ways for handling inter-entity and insider transactions involving individual principals and the common business
- Strategies for appointing a member of the family business to “facilitate” the implementation of a professional management system.

Participants will be encouraged to raise questions about topics where they are having personal experience challenges dealing with family business issues and transitions.



Are You Getting a Passing Grade in Farm Business Management?

R. L. "Dick" Wittman

Introduction

Ignorance is bliss...unless it bankrupts your business or prevents you from successfully passing on the family business to the next generation. The gap is widening between farm operations with skilled managers and the masses of "production-focused" farm owners/operators who are unable or unwilling to apply basic elements of management to their family farm businesses. Building formalized and documented administrative structures (including mission and vision statements, policies, standard operating procedures, job descriptions, operating and strategic plans and control processes) may seem like a lot of bureaucratic bull to many farmers. But as businesses get larger, involve more family and non-family, and the technical complexities of production, marketing, financial and personnel management increase, the importance of a sound management structure is becoming critical.

Failure to bridge this gap and fill the hole in farm management basic proficiencies will lead to more concentration of our industry, increasing financial risk, and increasing stress on rural communities...especially those communities who are sparsely populated and too far from metropolitan areas to access off-farm jobs or revenue enhancing opportunities.

The format for this presentation will:

- Identify key proficiencies (or CORE COMPETENCIES) needed to successfully manage a family farm business. For each of these proficiencies I will illustrate examples of successful implementation as well as consequences of getting a failing grade in skill or implementation. The primary focus will be: Personnel, finance and marketing management – I'm NOT here to teach you about CROP PRODUCTION management... you could probably teach me more than I can teach you!
- Provide a self-test evaluation format for you to score your strengths and weaknesses (See Proficiency Test in Conference Proceedings incorporated at the conclusion of these comments).
- Offer a vision for how you can strengthen your proficiencies in areas where improvement is needed (resources available, strategies for self-development – including Guidebooks, farm management training & development programs, etc.)

Tabulation of Proficiency Test Results and Tie-In to Related Seminars During Conference

After this presentation, we will collect results from those willing to complete the test. The results will be tabulated and shared during the conference closing. Over the next two days I will cover two related topics in separate workshops:

"Strategies for Building Effective Management Systems and Transition Plans," and *"Using MA as a Foundation Linking Financial Performance Analysis and Strategic Thinking"*

Definition of Successful Farmer is Changing – Setting the Stage for Why You Should be Evaluating Your Management Process

Successful farmers are no longer simply those who have mastered farm production skills. Visionaries like farm management educator Mike Boehlje would tell you, "A successful farmer is one who effectively manages people, resources, information and technology." Australian farm management expert, Rob Napier, would say a successful farmer is a "Resource manager who knows how to turn knowledge into profits."

Many of you here today attended FarmTech2000 in Calgary. I asked 900 farmers in the audience 2 questions about evaluations: "How many think it would be a good idea to do performance evaluations in a family farm



business?” ... About 500 hands went up. I then asked: “How many would be scared to death to implement this?” ...about 1000 hands up! Well, today, you are going to get a chance to evaluate yourselves. No spousal coaching or cheating allowed!

Basic Business Beliefs – The following are my key beliefs about family farm businesses:

- The family farm business is still the most viable structure for stewarding our ag resources, but only if we connect these 3 terms: Family + Farm + Business
- Successful farmers strike a good balance between “managerial process” & “results”
- Farm management education is only valuable if theory is put into practice.
- Family farm businesses need to build more formalized management structures to accommodate the farm business of the future - larger operations with diverse makeup of personnel, high technology, more fluidity of capital and management transition
- *My Goal:* Change management behavior—not just tease you with wild ideas!

Common Reasons for Family Business Failures – Most family business failures result from business owners’ inability or unwillingness to incorporate basic business management practices in their operations.

What are “basic business management proficiencies” and how do they fit into a Management System? I will review a schematic of the **Basic Business Cycle** – this is an interactive and interconnected set of dynamic processes that assure business success. I will comment on each critical block in this process and ask you how these issues are addressed in your business.

Mission, Vision, and Core Guidance Statements

- Are these statements defined and committed to print?
- What are they, Sample of WF documents; consequences of not having these defined

Organization and Division of Responsibility

- Q. Is there a clear division of responsibilities?
- Q. Does each employee/principal have a written job description?
- Review sample organization chart, job descriptions/duty statements

Policies & SOPs

- Q. Are key policies covering personnel and administrative issues clearly defined & documented?
- List of common policy areas needing definition
- Consequences of undefined or inconsistent implementation of policies
- Q. Is compensation commensurate with skill, tenure, responsibility level and matches market rates for similar work
- Q. Are SOPs documented for repetitive tasks?

Planning Systems – Operating vs Strategic Planning

- Q. Is an operating plan done developed annually and compiled into Budget/Cashflow Projection?
- Q. Do you have a strategic planning process that periodically addresses key strategic issues?
- Q. Do you have goals and action plans defined for operating and strategic issues?
- Review “hot list” of strategic areas that warrant review.
- Why farmers don’t have time to plan...
- Discuss inter-relationship between operating and strategic planning
- Value of goals and consequences of not having them



Control & Communication Systems

- People do what is inspected... not what is expected!
- Q. Are performance records prepared and circulated to principals on a regular basis (monthly?)
- Q. Are performance appraisals/individual development plans done for each employee?
- Q. Are regular meetings held for managers, owners (investors), and spouses?
- Q. Are critical agreements documented & reviewed periodically (see list...)?

Financial Reporting and Performance Analysis

- Q. What are your managerial practices in preparing, interpreting and using the following?
 - Balance sheets
 - Are these prepared at least annually?
 - Do they reflect cost as well as market values (including deferred taxes)?
 - Income Statements
 - Are these statements adequate to meet tax needs and also facilitate accrual analysis to measure true farm profitability?
- Q. Do you calculate key ratios or performance measurements?
 - What “gauges” (financial performance indicators) are you watching?
 - Do you know what is a good number?
 - Do you have a performance goal for your farm for each of these indicators?
- Q. Can you define the cost of production for your basic products grown?
 - Do you know how to analyze what segments of your business are boosting performance vs. pulling you below your peer group?
 - Do record keeping systems facilitate analysis of cost and profit center performance?
 - Do you know the difference between Enterprise Analysis and Managerial Acctg?

Introduction to Management Accounting (MA) - Highlight key differences; summarize why MA is becoming increasingly important; discuss bias about why many don't get excited about performance analysis: Namely the FAILURE to link business performance analysis to Strategic Thinking and Positioning; give overview of information to be covered in workshop;

One of the most challenging assignments I have encountered on the Farm Financial Standards Council board is serving on the Management Accounting Task Force. After wrestling for two years with concepts and running a test group of producers through these concepts, I am more convinced than ever of the need for our producers to get a better handle on this subject. One epiphany has come out of this experience...we can't get interest in ratio analysis and cost accounting until producers make a direct connection on how these skills can provide a foundation for optimizing financial decisions. In both the Management Accounting (MA) project as well as teaching at TEPAP in Texas, I have experimented with connecting Ratio Analysis, Goal Setting, Strategic Planning, Dupont Model Simulation Exercises, and Management Accounting. The response was very positive. The Dupont Model is a powerful tool for examining how strategic decisions will impact business performance. In interaction with ag bankers, I have been surprised to see many can't calculate the basic ratios without a software program doing it automatically. And many more have never heard of the Dupont Model or don't make use of it in any regular fashion. This can be an extremely effective financial analysis and credit counseling tool.



There are many financial policies that should have common understandings in a family business. Two of my favorites issues deal with: (1) how family farms handle investment and disinvestment in the business, and (2) how earnings are shared between owners and labor/managers.

Q. Are financial policies clearly understood and administered in a sound business manner for:

- investment and withdrawal of equity
- dividing earnings between owners & managers (show quick case study)

Role of a Chief Financial Officer

Q. Is the role of a Chief Financial Officer clearly defined and staffed with skilled expertise?

- Outline typical duties of a CFO.
- Who is your CFO? ... dad, mom? Who should be? Many farms suffer from a common deficiency: the books are treated as “sacred cows” and kept under lock and key instead of being shared with decision makers and responsibility center managers.

Large commercial businesses couldn't imagine functioning without a top notch Chief Financial Officer. Few farm operations have given this position a clear identity or staffed the position with expertise needed to do the job well. Without a skilled CFO the criteria for many decisions become: “we can get by” ... “we can afford it”..., or “we can pay the loan back.” With a skilled CFO advising the management team, there is more opportunity and assurance that the criteria for the decision will be: “It was the decision that optimized our performance based on the options we considered!”

In our “I can do it myself” farmer mentality, many farm managers/CEO's are holding on to the financial functions, when they don't really like it, they are not good at it, and they complain constantly about the time it takes them away from what they really like to do. Farmers need help from outside professional to advance the implementation of this role. This is an opportunity area that needs to be pursued by farm lenders and other farm management professionals.

Optimizing Capital Asset Purchases or Acquisitions

Q. Do you know how to access and use financial analysis tools or decision aids to OPTIMIZE Capital Asset Acquisitions?

- Describe opportunity losses and tools available to avoid this using a buy, lease, or custom hire analysis question.
- Solutions: Stop by the Farm Management booth and play with the Decision Aids you can access on the internet and other sources.

Marketing and Risk Management

Not going to spend much time on this...I will ask a couple of quick questions:

Q. Do you project in advance of planting/harvest the products to be marketed in coming year?

- Why? Should we be marketing 1-2 years before we produce?

Q. Do you set market price targets based on known breakeven points (cost of production), profit margin targets, and cashflow requirements?

Q. Do we know how and when to use forward contracts, hedging and options to market products and manage risk?



How Do Other Farm Managers Score on This Test?

Assume you all took the test... What will the answer sheet look like for everyone in this room? To encourage you to be completely frank and honest, I am going to share with you the results from report cards compiled from other audiences.

The following summarizes results from administering this Proficiency Test to some of our best US & Canadian ag executives attending a 2-year management training program (TEPAP in Austin, TX). The level of adoption of key managerial applications bears out clearly that a big portion of our producer base gets a *flunking grade* in management skills. The results of this *report card* were alarming! Of those responding, only

- 38% had defined their *mission, vision and core values*
- 30% had written *short and long range goals or objectives*
- 33% had articulated key *strategic issues* and developed *strategic plans* for reaching their long term goals
- 39% had clearly divided *responsibility roles and job descriptions* for key employees and owner/managers
- 38% had written *personnel policies* that were communicated to employees and owners (*And these operations can't figure out why the spouses and partners aren't speaking!*)
- 26% had documented *standard operating procedures* for repetitive or routine tasks
- 51% followed a *formalized compensation program* that matched compensation and benefits to market rates and differentiated pay based on skill, tenure, and responsibility levels (for owner/managers and employees) [*The other 49% are prime prospects for conflict resolution or already in someone's consulting client base!*]
- 26% performed *performance appraisals* regularly, limited almost exclusively to non-family hired help. (Normal Response to this question: "*You think I should evaluate family associates? You've got to be kidding!*")
- 53% *circulate operating and financial records* regularly (monthly minimum) to key managers and owners, and have *regular meetings* for investors, owners, and spouses. (The *other half* must have a special talent for retaining talent and teamwork when key players are kept in an information vacuum.)

A majority of survey participants prepared (at least annually) balance sheets using cost and market values and income statements that measured accrual as well as cash income. However their adoption levels and proficiency in the following financial management areas was also alarming:

- 42% could *track enterprise profitability and cost center performance* from their record systems. (*That doesn't say how many actually do this regularly.*)
- 54% prepared *cashflow budgets* and *monitor budget performance* regularly
- 30% kept track of or monitored *key performance measures or ratios*
- 24% had a defined policy for *investment and withdrawal of capital* that included minimum capital levels and clearly understood *revenue sharing arrangements*
- 24% defined and followed a consistent policy for *dividing earnings* fairly between owners and managers of their farm business
- 49% used *financial analysis tools* to optimize capital acquisition decisions (purchasing, leasing, custom hiring major capital outlays or services)

The participants in this survey were managing millions of dollars in resources, involved in complex business enterprises, and often overseeing challenging personnel mixes of family and non-family owners and labor providers. But a majority of these entrepreneurs admit to a failing grade in basic farm management proficiencies! If you were an investor with a million dollars to invest, would you entrust in to today's farm manager to **grow** your investment?



What can you do to improve your skills?

- There is no “silver bullet” or best way to expand knowledge or skills; people learn in many ways. Take advantage of diverse strategies for self-improvement: home study, seminars/workshops; internet resources (templates and decision-aids); local information/exchange groups; advisory boards; consultants; CFBMC
- What are the costs of poor management?
 - Cost of losing key employee; running off a preferred successor; making a poor capital purchase decision
- What are you willing to pay (time & money) to “overhaul” your managerial engines?
 - Comparable costs for production overhauls (engine, transmission, veterinary bill)
 - Farm Business Mgmt tool costs – books, CD’s, attorney/consultant fees, workshops

Conclusions

- We are in this profession because we value our heritage as providers of food and fiber
- We find our greatest reward in harvesting the “fruits of our production labors”
- For many farm managers, finances and personnel management:
 - are “necessary evils” ...not our “first love”
 - get what is left over of our productive energies, after the “fun farming stuff” is done
- Farmers are “do it yourselves;” consequently they tolerate mediocrity in managerial processes and hesitate to get help or delegate these functions to outside expertise.
- We need to ask ourselves: “Who will be the survivors: those who excel in production? ... or those who excel as managers?” Is this “management stuff” just a bunch of bureaucracy?...or is this really critical?
- Discuss horror stories from those who wish they had a second chance to preserve family and business relationships LOST from violating these principles.

Farm Management Proficiency Test

This test is designed to highlight the key proficiencies considered essential to successfully manage a family farm business. Farmers, teachers, advisers, and bankers can use this test to assess strengths and weaknesses, develop curriculum and implement training and self-improvement programs. (**Note:** This test does not address basic production management proficiencies.)



Key Proficiency Areas: (Place an "X" in the column that applies.)	In Place Now	Working On It	Need It	Don't Need It
<u>Management System/Personnel Administration</u>				
1. Mission, Vision and Core Values are defined for the business.				
2. Farm History is documented (incl. narrative & financial trends).				
3. Goals and Objectives (Long and Short Range) are defined.				
4. Operating Plan addresses Production, Marketing, Financing, and Capital Purchases/Sales Plan and is compiled into an annual Cashflow Budget Projection .				
5. Strategic Plan identifies "Strategic Issues"* for the business, and, at least annually, updates strategies and action plans for achieving strategic goals. (* Estate planning/succession, business structuring, expansion, diversification, in-sourcing vs. outsourcing activities, value added, equipment and facility replacement, enterprise mix, financial capitalization, stewardship, strategic alliances, tillage strategies)				
6. Responsibility is clearly divided and each partner and employee has a job description outlining duties, responsibilities & authorities.				
7. Personnel policies* are written and communicated to employees and spouses (* Including: housing, meals on premises & utilities; medical/life/disability insurance; buyouts; inter-entity transactions; vehicle fuel, insurance and maintenance, retirement plans, vacation and sick leave, setting compensation, business expense reimbursement, etc.)				
8. Standard Operating Procedures are documented for repetitive or routine tasks.				
9. Compensation Program matches compensation to market rates and differentiates pay based on skill, tenure and responsibility levels (for owner/managers & employees.)				
10. Performance Appraisals and Employee Development Plans are done regularly for operating partners and employees.				
11. Performance records (operating and financial) are circulated to key managers and owners on a regular (monthly minimum) basis.				
12. Regular meetings (board, management, staff) held daily, weekly or seasonally to address communication needs of workers, investor/owners and spouses.				
13. Technical expertise and tools* allow efficient access to management information. (*Computers, internet, business publications)				
14. Critical agreements* and understandings are documented and reviewed periodically. (*Strategic plans, farm operating policies, partnership agreements, buyout agreements, estate plans & wills, lease/rental arrangements)				



Key Proficiency Areas: (Place an "X" in the column that applies.)	In Place Now	Working On It	Not Done - Need It	Don't Need It
Financial Management Proficiencies				
1. Records are updated and circulated on a monthly or quarterly basis to appropriate employees and owners.				
2. Balance sheets and income statements are prepared at least annually on a calendar/tax year basis.				
3. Balance sheets reflect cost and market valuations, including deferred tax liabilities.				
4. Income statements meet requirements to prepare taxes and measure true farm profitability on an accrual basis .				
5. Audit systems assure balance sheets and income statements reconcile to inventories and bank/loan balances; depreciation schedules reconcile to balance sheet values.				
6. Enterprise Profitability and Cost Center Tracking can efficiently be derived from farm records.				
7. Cashflow budgets are prepared at the beginning of the year and comparisons of actual cashflow to projections are made at least monthly or quarterly.				
8. Field and livestock herd records for production inputs, applications, and resource use (i.e. chemical, fertilizer, seed, pasture grazing utilization) are complete and accessible.				
9. Key performance measures and ratios (i.e. FFSC "Sweet 16" or Ferguson Ratios) are calculated for all critical production, marketing, financial and capital performance areas and compared annually to historical trends.				
10. Policies for investment and withdrawal of capital, including minimum capital levels and revenue sharing arrangements are defined, clearly understood and followed.				
11. Policy for dividing earnings due to <i>owners</i> vs. <i>management</i> is defined and consistently followed.				
12. Financial tools and expertise for optimizing <i>capital acquisition decisions</i> are accessible and used regularly (purchase, leasing, or custom hiring on major capital outlays.)				
13. Partial Budget Techniques are understood and utilized when evaluating partial shifts* in the business (enterprise selection, tillage systems, lease vs. purchase or hire, etc.				
Marketing and Risk Management Proficiencies				
1. Products to be marketed (quantity and types) are projected well in advance of production.				
2. Market targets are based on identifiable cost of production, profit targets, and cashflow requirements.				
3. Forward contracts, hedging, and options are understood and utilized <i>as marketing</i> and risk management tools.				
4. Crop insurance programs are implemented that provide balanced protection from hail, fire and multi-peril causes.				
5. Liability insurance programs adequately protect operation's owners and employees from financial liability, health, disability other business risk threats.				