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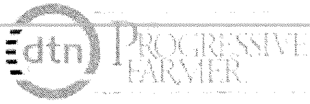

Klinefelter: By the Numbers

Boost Your Odds of Business Failure - 1

Danny Klinefelter DTN Farm Business Advisor

Mon Dec 14, 2015 07:06 AM CST

As he often does, Virginia Tech economist Dave Kohl recently wrote encouraging me with another column idea. This time he prodded me to write not about the attributes of successful farmers but about worst management practices. Particularly now with volatile returns and narrow margins, farmers don't have the luxury of being behind the curve and still getting satisfactory results.

There are an endless number of options, but I've picked 21 things that too many farmers have been doing that need to change. Because the list is long, we'll tackle the top 10 here, and finish the remainder in part 2 of my monthly DTN column later this week. Here are tend of the 21 practices I hope you'll avoid.

1. Using cash-basis net income and changes in market value net worth to assess business performance. It has been known for decades that cash-basis net income can lag accrual adjusted net income by 2-3 years in identifying changes in true profitability. Cash is great for tax management, but terrible for measuring actual profitability. There are too many strategies that can be used to manage cash-basis net income; inventory management is a prime example. Because timing is the key differentiator between the top 5% and the rest of the top 25%, the lag in identifying problems or capitalizing on opportunities is just too great. The same is true for using changes in market-value net worth, a lagging indicator, rather than changes in earned net worth to evaluate the quality of business management.

2. Practicing poor communication. This includes within the business and between those in the business and those not in the business but with a vested interest. Peter Drucker said 60% of all management problems are communication problems. Too many farmers keep things other people need to know to themselves. Family business consultant Don Jonovic always said most farms aren't just closely held, they are hermetically sealed. Employees and family members need to know: what they are expected to do and how; why they are doing it; how they are doing; how they can improve; where the business is headed (vision); how does it plan to get there; what is their role; and what's in it for them. Also, family members need to know the CEO's estate plan and plans for succession.

3. Being too independent. Success in the future is going to depend more on recognizing and capitalizing on interdependent relationships. Those can include collaborative farming; trading or jointly owning assets; employing specialized expertise; becoming a qualified supplier in a coordinated supply chain; or pooling purchases, etc. I tell my Extension cliental in Texas all the time that their extreme independence is both their greatest strength and their greatest weakness.

4. Not knowing your strengths and weaknesses. Most people have only a vague clue how well they stack up against the abilities of their competitors. Being successful doesn't mean being good at everything. It's about knowing and compensating for weaknesses and capitalizing on your strengths. Often this requires delegation, outsourcing or forming an alliance with someone who complements you.

5. Not setting priorities and then prioritizing the priorities. Many of the most important things never get done because people tend to do what they like to do, what's easiest and quickest to get done or what is urgent. That crowds out doing what is most important to continuously improve business performance. This is usually because most producers haven't set priorities or because they aren't willing to delegate.

6. Spending to avoid taxes. This isn't always a bad thing, but the first thing needs to be analyzing the marginal contribution of the investment versus the marginal cost of the investment over time and the impact on liquidity.

7. Not benchmarking against the leading edge of your competition. This isn't just financial, but also best management practices. It has to be based on comparable data and information. Again this is learning what

your weaknesses are and what you need to emphasize or do differently to keep improving your performance.

8. Not writing down your assumptions and the basis for them. Memory is limited and selective. If things change and you need to alter your plans, you need to know what you were thinking when you originally developed the plan. Do you need better or additional information the next time around? What have you learned from the experience so you can do better the next time you develop a plan.

9. Paying family members at levels not supported by the value of their job. If you want them to have a better standard of living, they need more responsibility or you need to be gifting to make it clear it's not for the value of what they're doing. It obviously makes sense from a tax deductibility standpoint but it sends them the wrong message as well as to the rest of the team. Pay should reflect the market for the job, responsibilities and performance. Otherwise it's a disguised form of charity or a welfare subsidy.

10. Investing in non-productive assets or excessive family living costs. These have been the downfall of too many operations. Living below your means is one of the primary findings discovered in a 20-year study published in the book, "The Millionaire Next Door." There is a tendency to raise the standard of living to unsustainable levels during boom periods and to buy too many non-productive "toys" as Dave Kohl likes to call them. Then operators assume the acquisitions are necessities when economic downturns occur. Personal spending is also among the biggest cost differences between high performing and low performing businesses discovered in numerous studies of farm records data.

For the remaining farm business practices that assure failure, watch for Part 2 of this column later this week on DTN.

EDITOR'S NOTE: Danny Klinefelter is an agricultural finance professor and economist with Texas AgriLIFE Extension and Texas A&M University. He also is the founder of the mid-career Texas A&M management course for executive farmers called TEPAP. Paid subscribers can access all of his DTN columns online using the News Search feature under News.

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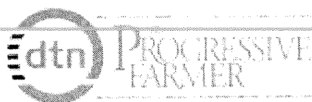

Klinefelter: By the Numbers

Boost Your Odds of Business Failure - Part 2

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Volatile returns and narrow margins don't leave farm operators the luxury to mismanage their businesses now. With prodding from Virginia Tech economist Dave Kohl, I'm sharing the 21 habits and financial practices that -- left unchecked -- become the downfall of many farm businesses. In this final installment I'm tackling the remaining ways lax practices can lead to business failure.

11. Not having detailed job descriptions or standard operating procedures. It is very hard to hold people accountable for things that aren't written down or explained to them. Lacking job descriptions and SOPs also leads to inconsistency in performance and makes it more difficult to train new employees.

12. Not recognizing that everyone "no matter how smart" (including yourself) exists in four states of knowledge. These are: (1) Knowing what you know; (2) Knowing what you don't know; (3) Not knowing what you don't know, i.e. ignorance, not stupidity; and (4) Thinking you know something and it just isn't so. Everyone needs honest and objective feedback, and to hear alternatives and different points of view. It is one of the main benefits of participating in peer advisory groups made up of successful peers. You want to soar with eagles, not scratch with turkeys. Douglas Adam quoted in the book "The Breakthrough Company" said that human beings, who are almost unique in the ability to learn from the experience of others, are also remarkable for their disinclination to do so.

13. Not continuously learning and improving. As I have said many times before, it is an economic reality that for your business to succeed and continue successfully beyond you, management must learn, adapt and continuously improve at the rate set by the leading edge of the competition and not by your comfort zone. Otherwise you'll be falling behind even if you are moving ahead. The most dangerous phrase in business is "because we've always done it that way." There is an old saying "if it's not broke don't fix it." Tom Peters, the author of "In Search of Excellence" and "Thriving on Chaos" said, "If it's not broken, you haven't looked hard enough." All he's saying is everything can be improved upon.

14. Not focusing on what you need to stop doing. In his book "Good to Great," Jim Collins said the most successful companies spent as much time analyzing what they needed to stop doing as they did evaluating new opportunities. That is one of the main reasons that I think companies with standard operating procedures need to incentivize employees to come up with ways to continuously improve them. Otherwise, your business can become like a union, a government bureaucracy or a university.

15. Being too myopic. This is a big one. Technology and the world are changing at an exponential rate. Too many farmers continue to focus on their own commodity, only agriculture, their own region of the country (often a 50-mile radius), the U.S., and looking out only as far as the next year. Consumer trends, demographic shifts, global competition, emerging technology, qualified supply chains and the likelihood of new regulations, to name just a few, mean horizons need to broaden or you'll get swept away by changes in the tide. We're drowning in information; but a strategic manager needs to look for leading indicators to help sort through the overload to help develop insights into where things are headed. It is also important to recognize most major changes occur because of a convergence of forces, not just one. More information is becoming real time. That's why the best managers are intentional networkers and members of peer groups made up of the best decision makers they can associate with.

16. Not getting better before getting bigger. A lot of the highly publicized failures have been large farms. But it's not being big that gets them in trouble. Some of the best managed, most profitable farms are very large. The problem occurs when farmers grow just to be bigger without management or the management system being improved at the same rate. A lot of the failures in the current economic downturn will be farms that grew using multiple-year fixed cash rents at rental rates above the market. That can be a recipe for growing

yourself broke. The successful operations have tended to have management teams made of management specialists and growing at rates that didn't increase at rates faster than their rate of growth in earned net worth.

17. Underutilization of assets, particularly machinery. Financial consultants John McNutt, Moe Russell and many farm recordkeeping studies have found that machinery and equipment cost per acre are one of the three biggest cost differentiators (in addition to land cost and family living) that separate the most profitable from the least profitable operations. Large dairies milk three times a day around the clock, several farmers I've gotten to know through the Texas A&M TEPAP management courses either share equipment with someone in another part of the country, have entered into collaborative farming arrangements, or farm in different states to take advantage of seasonal differences and spread overhead costs. Some benefit by using equipment three times as long during the year. Others have added doing custom work to more fully utilize machinery capacity. Kristjan Hebert, who produces canola in Saskatchewan, Canada, found it was cheaper per acre to hire another man to run a second shift than to buy another tractor and drill. Pushing this concept to the max involves farming in multiple states and running multiple shifts, but that isn't an option for many producers.

18. Having a victim mentality. Complaining, blaming or becoming depressed and wallowing in self-pity rather than learning, changing and adapting is a disease that affects too many farmers. Your best bet to beat the syndrome is to associate with winners who push, encourage and teach. Affiliating with losers who agree with you only reinforces your thinking and will get you nowhere.

19. Not monitoring actual versus budgeted performance throughout the year. Spotting changes early allows you to be more proactive than reactive. Developing contingency plans as you budget helps you take action if things don't go as planned and before a crisis exist.

20. Not using managerial/cost accounting. Not knowing your true costs on individual enterprises and individual farms doesn't allow you to separate the winners from the losers and know where you need to expand, cut back or get out and redeploy dollars and assets. Know the details of your operation. The most successful operators are consistently only about 5% better than average in all the key performance areas; but, the results are additive, multiplicative and compounding because they do it over and over again. It's like the example of the .300 hitter in baseball who will someday be in the hall of fame and make 10 times as much as the average player who hits .250. He only gets one more hit every 20 times at bat, 6 versus 5, but he works to improve all the time in order to continuously get better in all areas of his game.

21. Not knowing how to evaluate or using current technology. Some people try everything new that comes along, but that can be almost as big a problem. Others are way behind the curve because they believe most new technology is too expensive or too complicated. The reality is we're living in a technology driven world and technology is expanding at an exponential rate. Waiting until its use is commonplace can put you at a significant competitive disadvantage. Much of the new technology is designed to be yield enhancing or cost reducing. However, one of the often overlooked or undervalued aspects is that some new technology is going to be required to verify regulatory compliance, provide traceability, or to verify end user requirements on contract specifications. In some cases, the new technology is going to require training that requires outside education. It can be expensive but it's often necessary. In any case, new technology needs to be evaluated in terms of marginal revenue versus marginal cost. The issue is that these will need to include the cost of non-compliance or verification audits, often on a real-time basis which may be even more expensive or impossible without the documentation capabilities technology can provide.

Continuous management improvements will be the major differentiator between those who are the winners and losers in the current economic environment. Hopefully, you'll find that most of the management practices discussed in this two-part column don't apply to you.

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To read Part 1 of these column, go to http://goo.gl/...

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