

Kentucky Farm Business Management Program State Newsletter

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FARM BUSINESS PLANNING AND ENTITY AGREEMENTS

by Darwin Foley



When two Wisconsin dairy farms decided they wanted to combine their operations and build a modern, efficient dairy facility they had no problem finding a consultant for facility design, but finding someone to help them create a new business entity was not so easy. They contacted Lakeshore Farm Management Association, and were referred to John Roach of F&L Business Consulting and George W. Twohig, J.K. of Twohig Law Offices, S.C. In Wisconsin these two individuals work as a team to organize, plan and put together business entities that can meet the goals and objectives of multiple farm families and potential business partners.

The expansion of animal agriculture is progressing rapidly. Farmers are looking for creative ways to compete, but the risks are so great

and the decisions are so complex that advisors are needed that have a substantial knowledge of agriculture, business planning, tax law and financial management. What follows is a brief summary from a presentation that Roach and Twohig made at the annual meeting of the National Association of Farm Business Analysis Specialists on June 21 in Wisconsin Dells, Wisconsin.

Farmers who are entrepreneurs view profitability as the purpose of management and investment. They are interested in lowering per unit cost of production in order to be competitive. To achieve this they must clearly define their business purpose, budget carefully, and track their performance with managerial accounting. They seek to integrate new technology and proven management strategies. By careful planning, they determine the most efficient size to take advantage of "economies of scale," thereby decreasing "per unit" costs.

They develop a business plan from three perspectives. From an **ownership perspective** they focus on profitability, risk management and return on investment. From a **management perspective** they focus on the best allocation of physical and human resources. From a

personal perspective they focus on meeting personal goals and objectives. They see the creating of a new business entity as a way to achieve one or more of the following common goals and objectives:

1. Sufficient income to provide for family needs.
2. Have a better quality of life by balancing work time with time to do other things.
3. Transfer the business to a future generation.
4. Treat their children fairly, whether or not they remain in the business.
5. Avoid or reduce income and estate taxes.

They view the business plan as an essential living document of their business entity. The overall plan contains the following components:

1. A **development and implementation plan** which establishes how a major business change will be made.
2. An **annual operating plan**.
3. An **entity plan** which establishes the structure (partnership, LLC, corporation) and terms for management and the ongoing relationship between owners.
4. A **succession plan** which deals with the future of the business and anticipates changes in ownership.
5. A **retirement plan** for owners and employees that deals with how retirement will be financed.

6. An **estate plan** that deals with how the owner's estate will be preserved, protected and distributed to the heirs.

A new business entity needs an operating agreement that includes a **mission statement** and a set of agreed upon rules established by the owners and managers. The rules of the agreement should meet the personal goals that led to the formation of the business. Ownership, management and labor roles need to be defined. A chain of command and lines of communication must be formally established. It is also important to establish written job descriptions and performance criteria. Roach suggests that the owners get together and write a job description for every position in the business, then fit the person to the job description, rather than build a job description around a person. Evaluations should be completed at least yearly and reviewed with the individuals who are evaluated.

Twohig says that a major reason for entering into a business arrangement with others centers on quality of life and that farm owners often compare themselves to employees of businesses when they should be comparing themselves to people who own businesses. If this is not done, they can expect to be disappointed because ownership requires more commitment than employment. The business plan should define a full time equivalent so that time can be fairly equalized and compensated for. The definition of a regular workday should be established. To recognize those who manage, it is suggested that they be paid a salary, while those who labor be paid an hourly wage. He suggests that time off be

broken down into vacation, regular time off, special time off and holidays.

Space does not allow for a discussion of all the items that need to be considered when a new business agreement is being considered, but Roach and Twohig have demonstrated that farm business planning is vitally important in today's rapidly changing agriculture industry. After their presentation, three of their business clients explained how Roach and Twohig had helped them create new business entities and develop business plans. One of the clients shared how plans should also be structured to allow for arbitration and dissolution. I left the meeting encouraged that there were ways that farm families could combine their efforts and resources to achieve goals and objectives that they could not achieve alone.

FAMILY COMMUNICATIONS ABOUT MONEY

by Rick Costin

Disagreements over money are a common problem in many families.



Sometimes a lack of income to meet basic needs and financial obligations is the cause of the problem. But, many times lack of communication about money is the cause for disagreement. Many financial problems occur because family members do not understand their money situation.

As individuals, we all have different values and attitudes toward money.

Your belief can be the opposite of what other family members have as values. Knowing what is important to others in the family can help us understand the differences that might exist.

Family involvement in money decisions usually is the plan of choice. Discussing the financial situation so that everyone knows what is expected or where the money is coming from and going helps family acceptance.

If families do not have a handle on spending or are not happy with their overall finances a budget or plan could possibly help.

Again family members should work on the plan together. A plan can help relieve stress and conflict. A budget doesn't have to be set in concrete. It is simply a guideline that should be reviewed and changed when needed.

UK Extension has several publications that deal with money management issues. Contact your county extension office or farm management specialist if you are interested in obtaining a copy.

STATE BOARD MEETING SET FOR JULY 19

by *Craig Infanger*

I am happy to announce that the annual meeting of KFBM



Delegates and the State Board will be held July 19, 10:30 a.m. (EDT) in Elizabethtown. The Lincoln Trail Farm Analysis Association and Rick Costin will be our hosts. We'll be meeting at the Golden Corral Restaurant. KFBM cooperator-members are invited to attend.

Since the agricultural finance situation is so serious this year, we've asked Mr. Brian Stull of the West Kentucky Bank to speak to the group. He'll review his bank's role in ag lending and talk about the implications of the current wave of consolidation in financial institutions. One question we've asked him to directly address is: "Where will farmers get access to credit in the next decade?"

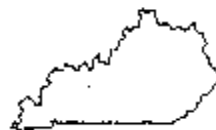
The business session of the summer meeting will include committee reports, software issues, personnel matters, and related topics. The Board will also select a new slate of officers for the new year.

If you have issues or concerns about KFBM, please contact your state delegate and have him bring these concerns up at the meeting or pass them directly to me.

SNAPSHOT VIEW OF KENTUCKY FARMS IN 1998

by *Greg Ibendahl*

The following table lists some of



the key financial characteristics for different types of farms in Kentucky. Liquidity is a measure of a farm's ability to meet current cash flow needs. Working capital is current assets minus current liabilities while the current ratio is current assets divided by current liabilities. While all the farm types have the ability to meet current needs, higher amounts of working capital are normally desired. An unexpected problem could cause a cash shortage.

The two solvency measures express debt as a function of either equity or assets. Solvency is used as a measure of the farm's overall financial strength and risk-taking ability. The debt to asset ratios listed here are higher than the U.S. debt to asset ratios (normally in the mid to high teens). However, the Kentucky debt to asset ratios are certainly in a reasonable range. Keep in mind though that the table lists median values. Therefore, half the farms have values higher than those shown in the table.

The profitability and financial efficiency ratios really illustrate which group of farms had good and bad years in 1998. The profitability ratios are useful when determining whether a farm can meet family living demands and retire debt. The efficiency ratios express expenses as a percentage of the value of farm production. Dairy farms, due to high milk prices and low feed costs for much of the year, earned respectable rates of return. The other farm types earned much lower rates of return. The hog farmers really suffered in 1998 as indicated by the negative ROA and ROE numbers.

Financial Characteristics of Kentucky Farms for 1998 by Type of Farm - Median Values

	All	Grain	Beef	Dairy	Hog
Liquidity					
Working capital	\$ 23,787	\$ 18,082	\$ 41,061	\$ 16,712	\$ (2,283)
Current ratio	1.26	1.22	1.47	1.84	1.23
Solvency					
Debt-farm equity (%)	47.10	61.84	43.93	32.16	32.37
Debt-farm assets (%)	33.06	38.19	30.43	24.24	26.79
Profitability					
Return on farm assets (%)	0.58	0.58	0.40	8.86	-11.34
Return on farm equity (%)	-2.33	-2.33	-6.40	8.65	-3.31
Financial Efficiency					
Interest expense ratio	9.84	8.42	9.84	6.32	15.53
Operating expense ratio	73.10	74.36	70.17	55.93	89.05
Depreciation expense ratio	11.48	11.28	11.48	7.93	15.28
Farm operating income ratio	4.51	2.10	7.10	33.45	-16.98
Asset turnover ratio	0.24	0.31	0.18	0.26	0.17

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