Step 5-Testing the Current Farm

Q: *Will the current farm be feasible in the future?*

An important part of planning is understanding what will happen if you don't change anything. Evaluating the future performance of your current farm, based on your assumptions and expectations for the future, will help you to know if and when changes are needed. This evaluation will provide the base, or benchmark, on which to measure the effectiveness of potential changes.

The object of this step is to determine whether the current farm operation will meet your goals in the future, or whether changes should be made to your current farm business. In the previous four steps you had the opportunity to describe your current farm operation (Step 1), identify your skills and interests (Step 2), specify your expectations about the future (Step 3), and set and prioritize your personal and business goals (Step 4).

If the analysis indicates that the current farm does not need to be changed (and you are not interested in pursuing changes), Steps 6 and 7 of the planning process can be skipped. But if the analysis suggests that changes should be considered (or you are interested in exploring options), Steps 6 and 7 outline some thoughts on describing and evaluating alternatives.

The first sections of this step provide an overview of the analytical process. Subsequent sections address several issues that arise in completing the analysis and suggest actions that can be taken, based on the result of the analysis.

Analytical Procedure

The question to be answered by completing this step is whether the current farm business, with no more than minor changes, will fulfill your personal and business goals in the future. To conduct the test, you should:

a. Use the description of the current farm as developed in Step 1 and the expected future prices and costs that were specified in Step 3;
b. Apply the analytical process described in Step 1; that is, project the farm business' cash flow, profitability, equity accumulation, and resource feasibility several years in the future;
c. Compare the projections to the long term business goals set forth in Step 4; and,
d. Compare the tasks needed to operate the farm to the interests and skills the owners want to pursue (as set forth in Step 2).

The next several sections of this section expand on certain aspects of the analytical process.

Projections

Remember, the focus of this step is on the **future performance of the current farm**; that is, projecting the financial performance of the current business based on the assumptions you made about the future. The procedure is similar to what was utilized in Step 1:

- An enterprise budget is developed for each activity;
- The enterprise budgets are combined to gain an understanding of the whole-farm; and,

- A determination is made as to how well the availability of resources matches with resource needs.

The period of time being analyzed is the future (rather than the past), and such projections often are referred to as budgets.

Time Frame

Another issue in testing your current farm operation is selecting the time periods to be analyzed. Many farmers start by testing their business for next year and usually are quite confident that their assumptions are realistic.

However, farm business planning emphasizes a longer time period. To look further into the future, most farmers select a second time period; perhaps five or ten years from now. Preparing projections beyond one year encourages you to think more broadly but it also complicates the analysis due to increased uncertainty about your assumptions as the time period is extended.

Most farmers are already implicitly making these long term assumptions even though they may not share or document them. For example, when a farmer purchases a machine, he has some expectations as to the value of the future productivity of the machine. However, many individuals may feel uncomfortable explicitly specifying their assumptions by writing them down because time may prove them wrong. But no one can foresee the future and if someone's projection turns out to be fairly accurate over time, it probably was good fortune as much as unique insight. Individuals should be encouraged to talk about their vision for the future. It is only through the sharing of ideas that owners of the farm can build on one another's foresight, and collectively be better prepared for the future.

One suggestion for selecting the time periods for analysis is to have them align with the periods followed in describing the future (Step 3) and setting deadlines for goals (Step 4). By using the same time periods, the pieces of information fit more closely.

For example, a farmer may want to specify assumptions for five years from now (Step 3), goals for five years from now (Step 4), and then project the performance of the current farm for five years from now. Such a consistent time frame allows the assumptions to be used directly in making the projections, which in turn, can be directly compared to the goals.

Most farmers will have two or more time periods in mind as they complete this step of the planning process-next year and several years into the future.

Which Changes Should be Considered in this Analysis?

Because this step involves projecting the future performance of the current farm operation, the analysis assumes the farm will not change over the time period being evaluated. There will be no change in the commodities being produced, the acreage being operated, nor the production and marketing strategies being followed. Only prices and costs are allowed to vary in this analysis, and those variations were specified as part of Step 3. New production techniques or marketing strategies and changes in the commodities being produced should be analyzed as alternatives (Step 6) of the planning process.

This strict limitation should help you recognize even minor changes that you make in your farm operations. A concern is that a series of minor changes can have an impact similar to a major change. If only major changes are analyzed, a series of unanalyzed minor changes may collectively result in a major change that has not been analyzed. Therefore, one goal of business planning is to help you recognize and evaluate even relatively minor changes. Imposing such a limit on the types of changes in this analysis should reveal minor, as well as major, changes that you need to address.

An exception to this strict limitation against change is those changes that occur due to the passage of time. For example, the passage of time alters the availability and productivity of labor—young people grow more productive while older individuals, transitioning toward retirement, may be less available. Likewise, as equipment ages some items will likely need to be replaced in order to maintain the farm's current productive capacity. For example, if one machine is replaced with a machine of identical capacity, it is probably a minor change. However, the implications of that purchase on the farm's cash flow should be analyzed. Another example of an inevitable change may be paying down long term debt.

But which changes should be analyzed as part of the current farm and which changes should be considered alternatives to be analyzed in the next step of the business planning process? Rather than list the types of changes that may fit in each category, it may be more helpful to specify a criterion that can applied. One criterion for deciding which changes to incorporate into this analysis would be to distinguish between:

- Changes resulting from the passage of time, unintentional changes; or,
- Changes that result from a reactive management style; or,
- Changes that occur intentionally, or that result from a proactive management style.

The first type of changes could be incorporated into this step as part of the current farm, whereas other types of changes could be tested as alternatives (Step 6).

This criterion would distinguish between: 1) the changes that occur as a farmer grows older while continuing the same enterprises and making only minor required changes; and, 2) changes made to enhance, expand, replace, or redirect the farm operation. The criterion could be restated as changes resulting from "rolling with the punches" compared to changes arising from "taking the bull by the horns."

Many farmers expect that they will need to make more than minor changes in their farm operations, particularly in the long run. They may envision involving a new co-owner, adding or changing enterprises, adjusting the scale of operation, or adopting new production technologies and marketing strategies. Despite such expectations and recognizing the need to evaluate alternatives, it is imperative that the current farm should be analyzed so the results can serve as a benchmark against which alternatives can be compared.

Preparing Enterprise Budgets

A beginning step in projecting the future performance of the farm business is to prepare an enterprise budget for the future time period. You can use enterprise analysis (developed in Step 1) but substitute expected prices (from Step 3) to project revenue and costs. This procedure allows you to understand the profitability and feasibility of continuing each enterprise without change.

Testing the Whole Farm: Resource Match

The next component of the evaluation is to develop a projection for the whole farm in terms of resource feasibility, profit, cash flow, and the other standardized financial measures.

Resource availability and needs can be analyzed with the same techniques described in Step 1. However, you should not need to emphasize testing the resource match during this step because of the limitation (as described above) that there will be no major changes to the business. This assumption implies that there will be no additional or no fewer resources, and that resource needs will not change either. Existing resource shortages or surpluses (as identified in Step 1) will presumably continue into the future. The primary exception to this assumption is that family labor will change as individuals grow older.

Testing the Whole Farm: Financial Feasibility

Another critical aspect of projecting the performance of the whole farm for a future time period is to analyze the business' financial feasibility. This analysis involves preparing the three basic financial statements—income statement, cash flow, and balance sheet—for the future period. Like the enterprise budgets described in a preceding paragraph, these are projections, rather than reports of past activities, and are referred to as pro forma financial statements. Outcomes for this evaluation should include:

- A budget for each enterprise to project its future profitability and cash flow for that year;
- A pro forma income statement for the whole farm;
- A pro forma cash flow for the whole farm for the year (a monthly or quarterly cash flow projection might be difficult to develop, highly speculative, and possibly not that helpful because the timing of the cash flows are perhaps most critical only for one year at a time since most operating loans are arranged for only one year at a time);
- A projected change in equity (by either preparing a pro forma balance sheet or estimating projected profit minus family living); and,
- An assessment of how well your goals are

being met, including whether your activities align with your skills and interests, and whether an acceptable rate of return is being earned for your labor and investments.

Criteria for Deciding Whether Current Business is Adequate

After preparing the projections you must decide whether the current operation, with no more than minor changes, will be adequate in the future. It is at this point that the first five steps of the planning process unite into a single thought process.

How do the projections (as just completed in Step 5) of operating the current farm (as described in Step 1) in the future (as you envisioned it in Step 3) align with your likes and dislikes (as specified in Step 2) and fulfill your goals (as set forth in Step 4)?

You can consider questions such as whether the projected profit is adequate; whether the business will generate sufficient cash flow; whether the activities sufficiently align with your interests; and, whether the projected performance adequately fulfills your goals. No one else can make that decision but you. The specific criteria will differ with each person, and the goals, as set forth in Step 4, should express the primary criteria for this decision. The following list suggests several questions that can be used as criteria for deciding the future adequacy of the current business.

- Would the current business, with no changes, be satisfactory five years from now?
- Would the business be profitable?
- Would the business generate the necessary or desired cash flow?
- Would the owner equity be changing as desired?
- Would the business fulfill your personal and business goals (Step 4)?
- Would the business permit you to pursue activities that you are skilled and interested in (Step 2)?
- Would the risk exposure align with the business' capacity to assume risk (Step 1) and your willingness to assume risk (Step 2)?

In some situations, owners may decide to revisit one or more of the previous steps and expand their thoughts or analysis, recognizing that the additional effort will enable them to more confidently answer the preceding questions.

If You Decide Your Current Farm is Adequate

There are some steps you may want to take even though you decide that the current farm will be adequate to fulfill your goals into the future. The questions may include:

- Can the business be operated more efficiently?
- Should the plans for how the business is operated be enhanced?
- At what point will the current farm likely become inadequate to meet my needs?

Testing Efficiencies

One question you may pose for yourself at this point might be, "Could I do a better job of accomplishing my goals even if I do not intend to change the operation?" One criterion for answering that question is whether additional revenue generated by making the change exceeds the cost of making the change. If the answer is yes, additional profit would result from the change; if the answer is no, the farm operation would earn greater profit by not making the change. This question and various ways of expressing the criteria are explained more fully in Step 6.

The criteria described above emphasize comparing the projection of the current farm to the owners' goals. Other comparisons include:

- Comparing the projection of the current farm to current and historical performance; and,
- Comparing the projection of the current farm to performance of peer businesses.

There are numerous efficiency measures, but for most of these measures there is no specified absolute standard. For this reason, you have to settle for making comparisons or other relative measures. The issue of efficiency is addressed again in Step 6 (Identifying Alternatives) and Step 9 (Monitoring and Control).

Revising Functional Plans

Another action that you can take if you decide that your current operation is adequate, is to refine your functional plans; that is, your strategies for production, marketing, labor management, risk management, and capital needs. For example, you may ask whether the strategies can be improved even though no major modifications are envisioned.

A similar question that you could ask yourself would be whether you understand your functional plans well enough to explain them to someone else so they could implement those plans. Along the same line, do you recognize your assumptions so you are prepared to alter your plans if the assumptions turn out to be invalid. These and similar questions should enhance efforts to improve current functional plans.

Managing risk and preparing for unexpected occurrences are two tasks farmers engage in even if their long-term plans do not include major changes. Step 8 provides ideas you may want to consider in developing contingency plans for managing in an environment of uncertainty. Step 6 and Step 7 can be bypassed if there is no need to consider major changes in the farm business.

If You Decide Your Current Farm is Inadequate

If you decide that your current farm business is not adequate to meet your future needs, you will want to develop and test some alternatives. Step 6 (Identifying and Evaluating Alternatives) and Step 7 (Transitional Plans) offer suggestions you may want to explore in developing a farm business that better meets your interests and goals.

The first activity in developing alternatives is to describe (as explained in Step 6) how the current farm is inadequate. The shortcomings might be an inadequate cash flow, an unsatisfactory return to the owners' labor, or having to forego goals that you consider important. By describing these shortcomings, you are setting forth ideas to help assess whether the alternatives are better than their current practices.

Conclusion

The purpose of this step is to determine whether the current farm operation will meet your future needs based on your assumptions and expectations about the future, and your statements about your interests and goals. The test involves developing projections of future performance for several time periods into the future.

If the current farm appears to be satisfactory for the future, you may still want to assess whether the efficiency of the operation can be improved or the functional plans enhanced. If the current farm appears inadequate for the future, you will want to consider describing the shortcomings, and identify and evaluate alternatives.