Managing for the Right Risks In Your Operation: An Action Plan

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The key to incorporating risk management into the daily operations of your business is to incorporate the process into each phase of your operation. This includes planning, production, marketing, financial management, legal issues, and human resources.

Global markets, changing agricultural policy, and increased environmental regulation have all created more risks for your operation. These risks translate into more variability in prices, yields, legal liabilities and potential human relation issues that could affect your bottom line. RightRisk$_{TM}$ has been designed to provide you with hands on learning tools aimed at helping you better manage the risks you face in today's agriculture. This publication is aimed at helping you incorporate risk management into each phase of your operation.

Risk management involves choosing among alternatives that can reduce the damage an adverse outcome can have on your operation and its ability to stay in business. Choosing from the available alternatives requires assessment, planning, decisions and implementation of strategies to address risk. Because every producer's attitude toward risk, each business's goals, and every resource base is different, no one risk management plan can work for everyone at all times. Thus, risk management is a continuous process that you as manager must work at just like you would production. The key to incorporating risk management into the daily operations of your business is to incorporate the process in each phase of your operation. A number of areas in your operation where risk management can be implemented are discussed below. These areas include business planning, production, marketing, financial management, potential legal issues and liabilities, and human resources.

Business Planning

Planning is the first step in assessing and incorporating risk management into the daily operation of your business. The starting point for any planning in your business is to establish goals that you and your family want the business to achieve. These goals need to be translated into written statements that are measurable, attainable, and tractable. Along with these goals, a business resource inventory must be done so you can assess what can and cannot be done with your current operation. For example, if we look at the resources in the "King Family Ranch" scenario for RightRisk$_{TM}$, we can see that the resource base likely could not allow a number of cropping alternatives such as fruit, etc.

Taking these steps will allow you to evaluate how to best use the resources you have available to reach your goals and what risk management alternatives will be conducive to meeting those goals. The business plan that comes from this process will then lay out a map of what, when and how the business will get to where you want it to go. Production plans, marketing alternatives, financial adjustments, legal risks to address and human elements can all be incorporated into this plan. Once this process is done, you will have a business plan that includes the goals of the business, the alternatives available to achieve those goals, risks inherent in those alternatives, ways to address those risks if necessary, and possible contingency plans. This plan enables you to evaluate, implement and assess all decisions regarding daily operations, making changes in the business and addressing risks while remaining focused on the long-term business goals.

As a way to start a management plan that incorporates your risk management alternatives, take the time to assess whether you have areas of risk that may need attention in your operation. An assessment at the end of this document will ask you questions, and from your responses you can decide if you need to take actions. Questions related to your business plan include the following:

- Do you have written goal statements for:
    - Individual family members?
    - The family as a whole?
    - The agricultural business?
- Do you have a written mission statement for the operation?
- Do you have regular family meetings to communicate ideas and make decisions?
- Have you evaluated individual family member’s and employee’s strengths and weaknesses in regard to meeting the goals and objectives of the operation?
- Have you conducted an inventory of the resources available to the operation?

If you answered “no” to a number of these questions, you may want to consider addressing the business plan area in your business. You may write down what you plan to do in the space provided in the business plan assessment form (found at the end of this article, p. 8).

Production Risks

Two basic strategies available to manage production risks, such as reduced crop yields or livestock performance, are enterprise diversification and crop insurance. Enterprise diversification involves producing a mix of products that has the characteristic of leveling out the lows and highs in your income. This involves producing another product that is unlikely to have a low yield and or price at the same time as your other primary enterprise. An example of this in “The Wheatfields” scenario for RightRisk$_{TM}$ is the complimentary relationship of the livestock enterprise to the wheat enterprise. Cattle prices are typically high when wheat prices are low, and those things often affecting wheat yields do not often impact weaning weights. The first step in evaluating a possible new or different enterprise is to develop a budget for the change you are contemplating. Once the costs and income associated with a new enterprise or change in your business has been estimated, you can assess how risky this new enterprise or adjustment will be. One measure of risk would be to estimate how many years the enterprise may fall below a target level of income. Other measures such as range in income, standard deviation and coefficient of variation can be useful in assessing riskiness (refer to other resources on the RightRisk$_{TM}$ website for examples of using these measures). If you decide to implement a change, a quick inventory of what resources are needed will help you plan for success. This evaluation requires you to assess the current status of your business and what could happen to your business after the change is implemented.

There are a growing number of insurance products being developed to help producers protect against losses and insure some level of cash flow in disastrous years. Crop insurance and livestock revenue insurance products are examples. The first decision you must make regarding the purchase of some type of insurance product is whether you have enough financial reserves to cover a disastrous year in terms of yields or performance. If the answer is no, then some type of insurance product may be an option you should consider in your risk management plan. You should choose the least expensive insurance coverage that will allow your business to survive. The level your cash flow needs to be for your business to survive should come from your goals and your business plan. Incorporating both enterprise diversification and insurance alternatives and strategies can help you reduce your income variability and hence reduce the effects of production risk to your business.

Questions related to assessing your production risk include the following:

- Have you evaluated possible enterprise combinations given the resources currently available in your operation?
- Do you have written goal statements for each enterprise of the operation?
- Have you evaluated the risk inherent in each enterprise, addressed those risks and developed a contingency plan?
- Do you know the breakeven cost of production for each enterprise with confidence?
- Have you evaluated the risk involved with major changes in an enterprise?
- Have you evaluated the use of crop or revenue insurance as a tool to cover a minimum level of cash flow required for the business to continue in operation?

A number of no responses to these questions indicate you may be exposed to significant risk in the production area. You may want to write down what you plan to do in the space provided in the production assessment form (p. 9).

Marketing Risks

Price variability or market risk is another area that a manager can address in the daily operation of the business. Unfortunately, most agricultural producers are price takers in the market, and thus, price variability in the market can be a large cause of income variability and risk to a farm or ranch. The first step in managing market risk is understanding the four types of price variation. Seasonal, cyclical, trend and random fluctuations affect agricultural commodity prices. While little can be done about random fluctuations, studying the other types of variations and historical patterns associated with prices for the commodities you sell can help you better time your sales or diversify when and how you market. For example, in the “King Family Ranch” scenario we have some idea about what the seasonal pattern for calves looks like. We may decide looking at that situation to forego selling some of our calves in the fall and retaining ownership of some or all of the calves until later in the marketing year. This not only adds saleable weight, but it changes the timing of sale for the “King Family Ranch’s” main product “calves.” You must decide whether the higher seasonal price in the spring coupled with the added weight of the backgrounding program more than pays for the added costs.

Other tools such as forward contracts, futures and options all provide a way to forward price your product (please refer to other publications available through the RightRisk$_{TM}$ website for information regarding basis, marketing alternatives, calculating breakevens, understanding various components of price patterns). This also diversifies when you price your product. By knowing such things as breakeven cost of production and basis for your commodity, you can shop around for a better price long before having to see what you get by taking your commodity to the auction barn or the elevator. By understanding the types of price variation you face, other marketing alternatives available to you, knowing your breakevens and knowing the basis for your product, you are armed with valuable tools that can be used in your marketing plan. Developing a marketing plan uses your business goals and plan to develop your marketing goals. Once you determine which marketing alternatives or tools you are willing to use, a written marketing plan can be developed. A written marketing plan will help you shop for the best marketing alternative which meets your goals, minimizes the emotion of marketing and allows you to reduce the market risk faced by your business.

Questions related to marketing risk for your business include the following:

- Do you have a basic understanding of the four types of price variation:
    - Seasonal?
    - Cyclical?
    - Trend?
    - Random fluctuations?

- Do you understand and have you evaluated for each enterprise:
    - Forward contracts?
    - Futures?
    - Options?
    - Basis?
- Do you have a written marketing plan for each enterprise of your operation?

A number of no responses may indicate your operation is exposed to unnecessary marketing risk. You may want to write down what you plan to do in the space provided in the marketing assessment form (p. 10).

Financial Risks

During your business planning process, developing key financial statements and analyzing where your business has come from and where it is now can be key criteria in deciding how important risk management is. The balance sheet, income statement, and cash flow statement are documents that should be used to develop key financial indicators for your business (for more information on these financial statements and developing key indicators refer to other publications available through the RightRisk$_{TM}$ website). For example, someone with 20% debt (this figure comes from your balance sheet) can have added borrowing capacity in downturns as compared to someone with a 60% debt load. This type of analysis can point toward alternatives to consider when changing your business, how much risk you can afford and perhaps provide the basis for deciding on investment and re-financing strategies. Financial analysis is key in determining whether you are moving in the right direction toward your goals and how well your business and risk management plan is working. Coupling this type of financial information together with trends in rural credit markets can help you better work with your lender to develop a line of credit that will work with your business in realizing your goals and creating a profitable firm that can survive agriculture's ups and downs.

Questions related to financial risks for your business include the following:

- Do you have the following financial statements developed and up-to-date for your operation:
    - Balance Sheet?
    - Income Statement?
    - Cash Flow Statement?

- Based on these financial statements, have you evaluated:
    - Liquidity measures?
    - Solvency measures?
    - Profitability measures?
    - Financial efficiency measures?

- Does your financial analysis indicate you are moving towards achieving your goals and objectives?

A number of no responses to these questions indicate financial risk may be an area of concern for your operation. You may want to write down what you plan to do in the space provided in the financial assessment form (p. 11).

Legal Risks

Production agriculture faces increasing liabilities and business costs associated with the changing legal environment. Three major areas of legal risk for agriculture are contracts, environmental regulation and estate planning and transfer. During your planning process another area of your business to consider and plan for is legal risk. Many agricultural firms use contracts for inputs, production agreements, marketing agreements and/or contracts for providing or receiving services. The first step in reducing potential exposure to losses from contract failure is knowing your rights and duties under basic contract law. It is also a good idea to have an attorney examine the contracts you are about to enter into. Knowing how environmental laws may affect your operation is another important piece of information that can be used in your risk management plan. The next step is to assess whether your operation is at risk of violating any of these laws, and finally, what action should be taken to negate or reduce your legal liabilities under environmental laws. This can remove the risk of large fines or imprisonment and potential loss of your business.

Current statistics indicate that only one out of three operations is successfully transferred to the next generation. If passing on the family business is an important goal, estate planning must also become part of your risk management process. First, you should discuss this subject with your family. Then you should develop a written set of goals for transferring the operation. It is wise to work with a team of specialists, which may include an attorney, an accountant and a financial planner when developing a will and an estate transfer plan. An estate plan can make the difference between whether your operation is transferred to the next generation or eaten up in probate court or taxes. All of these things are important in your daily operations and your business plan should incorporate strategies and goals for addressing these areas of legal risk.

Questions related to legal risks for your operation include the following:

- Are you familiar with all of the terms and conditions of legal contracts you have entered into?
- Has your attorney reviewed the same contracts?
- Are you familiar with current environmental laws that potentially could affect your operation?
- Have you discussed which family members are interested in taking over the operation and which ones are not?
- Based on the answers from above, have you developed an estate plan that will successfully transfer the operation to the next generation?
- Have estate planning professionals helped develop and review this plan?

If you answered no to a number of these questions, your business may face significant legal risks. You may want to write down what you plan to do in the space provided in the legal assessment form (p. 12).

Human Risks

Perhaps the most important and least addressed aspect of running the farm or ranch business is managing people. People have hopes, dreams and goals which shape where the business goes. People provide the labor and the management, and people make up the family that derives their livelihood and lifestyle from the farm or ranch business. It is interesting that inter-personal communication, personnel management and managing anger and stress tend to be low priorities for most agricultural producers. For example, producers often do not consult other family members when making decisions about the family business. If other family members are impacted by the outcomes of these decisions, stress and conflict can arise if these decisions are not discussed with them. Opening lines of communication by holding regular meetings and deciding major business issues in a group setting which allows all family members and laborers to express opinions, concerns, desires and goals is an important strategy for reducing stress and conflict amongst people involved in the farm or ranch business. Remember that if the people leave or turn away from the business, the business will likely die. Addressing and managing the human element of the business is just as important as the other risk management strategies previously discussed.

Questions related to the human risk area for your business include the following:

- Do you have regular family meetings to communicate about the business?
- Do family members communicate about stressful events and their feelings?
- Do you and members of the family business take short breaks during high levels of stress?
- Have you and family members written down personal, family, and work goals for three months, six months, and a lifetime as a way to help prioritize tasks and help manage time?

A number of no responses to these questions may indicate human risk is an area for concern in your operation. You may want to write down what you plan to do in the space provided in the human assessment form (p. 13).

Assessment and Developing a Plan

A business operating in the current environment that does not manage risk and is using risky practices in its daily operations is in danger of going out of business during an economic downturn. A farm or ranch business can incorporate management practices that position the business to survive an income downturn and take advantage of an economic upswing. The RightRisk$_{TM}$ materials have been designed to provide you with hands on learning that will help you apply risk management tools in your operation. Perhaps the most difficult part of the risk management process is breaking all the information available into usable pieces, assessing where your operation is at regarding risk as it relates to production, marketing, financial management, legal liability and the human element. Once you complete an assessment of the risks faced by your business, you can then decide and write down what actions you intend to take and by when they are to be taken, to move your operation toward being resilient. This risk assessment and action plan is intended to help you incorporate risk management into your plan for your business. You can decide which risks need to be managed, which risks don't need to be managed and what are the right risks for you to accept so you can meet your business goals.

References

Bastian, Chris and Dennis A. Kaan. "From Risk to Resilience in Agriculture: An Action Plan," Risk and Resilience in Agriculture. December, 1999. Article 7.3: 1-16. Published jointly by Colorado State University, University of Wyoming and Montana State University Cooperative Extension Services.

Assessing Which Risks Are Right For You and What Actions To Take

Date of Self-Assessment: ___________________________

Business Plan *Place a check in the column that is the most appropriate response to the question.*	***Risky***	***Not Risky***
Do you have written goal statements for:	No	Yes
Individual family members?		
The family as a whole?		
The agricultural business?		
Do you have a written mission statement for the operation?		
Do you hold regular family meetings to communicate ideas and make decisions?		
Have you evaluated individual family member's and employee's strengths and weaknesses in regard to meeting the goals and objectives of the operation?		
Have you conducted an inventory of the resources available to the operation?		
Total responses in each column:		

If the number of responses in the "risky" column is unacceptable to you, what do you plan to do to move your operation towards being more resilient?

When do you plan to have these action items completed? Date: ______________

Date of Self-Assessment: ____________________________

Production *Place a check in the column that is the most appropriate response to the question.*	***Risky***	***Not Risky***
Have you evaluated possible enterprise combinations given the resources available in your operation?	No	Yes
Do you have written goal statements for each enterprise of the operation?		
Have you evaluated the risk inherent in each enterprise, addressed those risks and developed a contingency plan?		
Do you know the breakeven cost of production for each enterprise with confidence?		
Have you evaluated the risk involved with major changes in an enterprise?		
Have you evaluated the use of crop or revenue insurance as a tool to cover a minimum level of cash flow required for the business to continue in operation?		
Total responses in each column:		

If the number of responses in the "risky" column is unacceptable to you, what do you plan to do to move your operation towards being more resilient?

When do you plan to have these action items completed? Date: ______________

Date: ______________Date of Self-Assessment: ____________________________

Marketing *Place a check in the column that is the most appropriate response to the question.*	***Risky***	***Not Risky***
	No	Yes
Do you have a basic understanding of the four types of price variation?		
Seasonal?		
Cyclical?		
Trend?		
Random fluctuations?		
Do you understand and have you evaluated for each enterprise:		
Forward contracts?		
Futures?		
Options?		
Basis?		
Do you have a written marketing plan for each enterprise of your operation?		
Total responses in each column:		

If the number of responses in the “risky” column is unacceptable to you, what do you plan to do to move your operation towards being more resilient?

When do you plan to have these action items completed? Date: ______________

Date of Self-Assessment: ____________________________

Financial *Place a check in the column that is the most appropriate response to the question.*	***Risky***	***Not Risky***
Do you have the following financial statements developed and up-to-date for your operation:	No	Yes
Balance Sheet?		
Income Statement?		
Cash Flow Statement?		
Based on these financial statements, have you evaluated:		
Liquidity measures?		
Solvency measures?		
Profitability measures?		
Financial efficiency measures?		
Does your financial analysis indicate you are moving towards achieving your goals and objectives?		
Total responses in each column:		

If the number of responses in the “risky” column is unacceptable to you, what do you plan to do to move your operation towards being more resilient?

When do you plan to have these action items completed?

Date of Self-Assessment: ____________________________

Legal *Place a check in the column that is the most appropriate response to the question.*	***Risky***	***Not Risky***
Are you familiar with all of the terms and conditions of legal contracts you have entered into?	No	Yes
Has your attorney reviewed the same contracts?		
Are you familiar with current environmental laws that potentially could affect your operation?		
Have you discussed which family members are interested in taking over the operation and which ones are not?		
Based on the answers from above, have you developed an estate plan that will successfully transfer the operation to the next generation?		
Have estate planning professionals helped develop and review this plan?		
Total responses in each column:		

If the number of responses in the "risky" column is unacceptable to you, what do you plan to do to move your operation towards being more resilient?

When do you plan to have these action items completed? Date: ______________

Date of Self-Assessment: ___________________________

Human *Place a check in the column that is the most appropriate response to the question.*	***Risky***	***Not Risky***
	No	Yes
Do you have regular family meetings to communicate about the business?		
Do family members communicate about stressful events and their feelings?		
Do you and members of the family business take short breaks during high levels of stress?		
Have you and family members written down personal, family, and work goals for three months, six months, and a lifetime as a way to help prioritize tasks and help manage time?		
Total responses in each column:		

If the number of responses in the "risky" column is unacceptable to you, what do you plan to do to move your operation towards being more resilient?

When do you plan to have these action items completed? Date: _____________

Additional Workspace