



Farm Management

RISK MANAGEMENT ON THE PLANNING PLANET

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Come with me, won't you, on a trip to the far-away galaxy of "Farm Business Management."

In that galaxy is a planet called "Business Planning." Business planning is made of a number of continents which are specific plans any business should consider. These plans include succession, future growth, and nutrient management, but there are others.

Of concern to this article is the risk management plan. You will see some aspects of this plan may be adjacent or even include other plans.

Before we set foot on this planet, let's consider why planning is important. (It's good to start with the easy questions.) Who would not rather deal with a situation calmly, with time to consult with the banker, nutritionist, extension agent, or whomever; evaluate the merits of different alternatives; and communicate your decision to key people (like selling the idea to your spouse)? It is not hard to understand where this environment is more likely to produce a good decision than making decisions within the hour in a high-pressure situation. As many alternative strategies as you can have laid out and set plans to handle, the better your decision making will be in those events. And your farm should be that much more profitable.

Risk management is the area on this planning planet where I

want to go with this article. Why risk management? For a number of reasons, risk management has become an increasingly important aspect of farm management. Statistically, farms have been on a general trend toward larger size. Coupled with growth in size has been growth in scale. Not only are farms producing more because they are larger, but they have to produce more *per unit* as well. They do this because profit margins are shrinking.

Economic theory shows this will happen when technology makes more efficient production possible. The risk of losing a penny per unit of production is of little consequence when the margin is \$2, but it gets pretty dear when the margin is only 5 cents! Farms are specializing on fewer enterprises, focusing more time on the specific management and regulatory aspects.

Market globalization not only means competing with producers all over the world, but also satisfying the whims of consumers everywhere. Do you remember the days when the protests of a French crowd could have no consequence on the marketability of your crop? What would happen now should the French decide they literally can't swallow meat from animals fed GMO grains? These are significant risks that farmers face today, without even mentioning everything that can go wrong when your livelihood depends on a biological process heavily influenced by weather. Top it off with the price interactions that usually move in the opposite direction as produc-

tion, and you wonder why aspirin sales aren't higher in rural areas!

Risk is the possibility of harm or loss. So anyone discussing the "risk" of winning \$100 or winning the lottery is not using the word correctly. It is not a risk to get less than the optimal (which is important in risk related to marketing), but it is a risk if getting less than a certain price means you have to default on a loan.

The risks that farmers deal with come from six different sources. The largest source is in production. Anything that can go wrong in growing a plant or animal at some time has. If that happened to you this year, would you be able to absorb the loss? How do you know these things aren't going to happen again? The majority of information available to farmers deals with mitigating the various diseases, pests, and other setbacks related to an organism growing in a certain place to be marketable at a certain time.

The rest of the risks are in alphabetical order, starting with environmental. This is a new one to farmers. It used to be the barn was cleaned out when time allowed and chemical sprays did not exist. Now nutrient management plans must be filed and followed to ensure that manure does not contaminate. And that pesticides are handled with care to promote the safety of applicator and the surrounding ecology.

Financial risk is a unique source to any business. On one hand, any impact on the farm is going to show up in the finances,

so financial risk is inherent in everything. On the other hand, if the business has enough net worth (enough to absorb all of the potential loss), then there is minimal financial risk and the manager is free almost to ignore the possibility of loss. For instance, it is only in rare cases where we get really worked up over losing a postage stamp. Most of us can absorb the loss of 33 cents if a stamp is misplaced. But we whistle a different tune when it comes to the possibility of our dairy barn burning down.

Legal risks entail those topics which require a lawyer. Any laws dealing with employees, proper title to assets, or farm organization (to name a few) must be dealt with properly or the possibility for loss will exist.

Marketing risk has really been in the news these past couple years. These risks include having a market outlet for your product when it is ready and getting the necessary price out of it. As I said earlier, the possibility that you will get \$5 for soybeans instead of \$8 is not a risk if unless \$5 is less than you need to stay in business. Knowing what number you need to stay in business is why you calculate your own cost of production (instead of having someone tell you what the state average is) and why you keep financial records.

The final risk is personnel. As farms grow in size, often employees are hired to allow the operator some time for management. These people may not understand fully their duties nor your equipment, or they may be accident prone. How will you

keep your farm from harm should an employee make a mistake?

Knowing the sources of risk helps you think critically about the dangers faced within your operation. This self-assessment identifies the risks that need to be removed, modified, or in some other way controlled. This assessment has to be done on a per-farm basis because the risks and their potential, or perceived potential, are going to vary by farm and by manager. Some managers take on more risk than others. In the U.S. economy, we usually see payoffs greater when greater risks are taken. But some managers are not comfortable with higher risks, and some financial situations would not withstand the loss if the greater risk did not payoff.

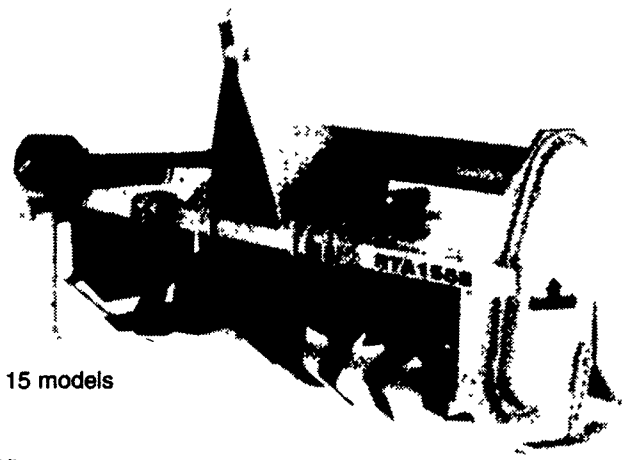
Given the conditions of the farm and the level of risk aversion of the manager, the risks can be thought of in terms of their level of risk and frequency of occurrence. If you see that something is a high risk and happens often, then this risk most definitely needs to be addressed.

Conversely, potential problems that are rare in occurrence and of little consequence when they do could be overlooked in most any situation. However, there are two areas where risk or frequency are high enough that you must review your own prejudices toward risk and decide if this is one worth accepting or also finding a way to manage. Also keep in mind the financial

(Turn to Page C3)

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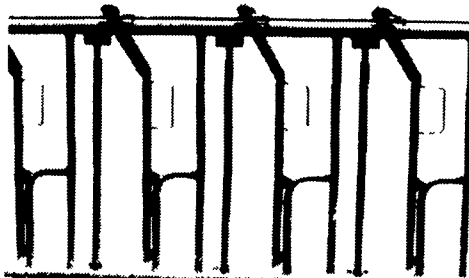
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