Step 7-Developing and Testing Transitional Plans

Q: What steps are needed to implement the feasible alternative?

Preparing a transitional plan is an opportunity for you to consider how you will transform your current business into your desired business. This transitional plan should explicitly specify what needs to change and why and when each action will take place. The resources required to accomplish the changes need to be identified and the potential risks considered. The various components of the plan need to be tested to ensure that the desired and expected results occur.

The objective of this step is to prepare a transitional action plan, implementing the changes you envision for your farm. Identifying which resources will be needed and when they will be needed are critical components of this plan. Establishing a time frame for accomplishing the changes, and an understanding of the financial impact is required. Thus, the decision criteria (profitability, cash flow, goal fulfillment, etc.) that you used in previous steps to determine the feasibility of initiating this change should be tracked to help stay on course. Also, a review of the farm's individual functional plans should be part of this step.

In practice transitional planning involves developing a series of successive short-run plans for several years. Alternatively, some may prepare short-run plans only for the years when major changes are expected in their operation. Regardless of approach, an important component in transitional planning is to outline, in sufficient detail, how, when, where, and why changes in the current farm business (or baseline farm) will occur. The description builds on the information assembled in previous steps and could include answers to some of the following questions:

- What needs to be changed?
- Why does that need to be changed?
- When does the change need to occur?
- What resources are needed to accomplish the change?
- What risks are associated with making the change (analysis of risk is described in Step 8)?
- Will the change generate the necessary profit/return?
- How will the change impact the farm's cash flow?
- How will the change impact the match between resource availability and needs?
- Will the change fulfill the owners' goals for making the change [compare the results of the change to the description of the problem/shortcoming of the current business (beginning of Step 6)]?

Most of these questions should be familiar because they are similar to the criteria suggested in the preceding two steps.

Importance of Transitional Plans

Transitional planning is important because farmers operate with a large proportion of fixed assets that are difficult to acquire and dispose of. Moreover, many assets are linked together. For example, row crop farmers usually have planters, cultivators and harvesting equipment of similar width, or least a multiple thereof. In such a situation, a question the farmer may ask is whether to replace each asset individually over several years or replace the entire set at once. A partial budget and time value of money analyses can assist with this decision.

Similar to the long-run planning step, the process of short-run planning begins with selecting a set of enterprises on the basis of net economic income. Once the set of short-run enterprises is defined, the business owners can develop functional plans for production, marketing, financing, labor, capital investments, and tax and estate management.

A complete set of projected financial statements including cash flow, net income and balance sheet statements should be developed. These plans can then be shared with interested parties (such as lenders, landowners, or investors) to inform them of the plan. That way, they can be prepared for fluctuations in cash flow that may accompany the transition. Moreover, major investment requests will not be a surprise.

Questions to Consider

To succeed in your planning efforts it is imperative that you think about and consider a wide range of issues. To aid you in this process the following list of questions is provided as a guide to help evaluate your proposed actions. You need only consider the questions/issues that are relevant to your transitional plan.

Generally describe the transition or steps necessary to implement the alternative:

- What is the goal of this transitional plan, and how will the success of this transition be measured?
- What resources are needed to implement the alternative?
- What resources does the business currently have?
- What resources is the business missing (consider both tangible and intangible resources)?
  - When will the missing resources be needed?
  - How will these resources be acquired?
  - How will the acquisition be financed?
  - What resources will the business no longer need?
  - When will the resources no longer be needed?
  - How will those resources be disposed of (including putting them to another use if that is more profitable than disposing of them)?
  - How will the revenue from the disposed assets be used?
- Does the business have the cash to implement the transition (as revealed by a whole-farm cash flow budget)?
- Is the transitional plan profitable (a partial budget analysis that considers the time value of money, for example)?
- How do these transitional steps align with the owners' skills/interests/ goals?
- What might go wrong with this transitional plan (refer to Step 8)?
- What are the advantages of this transitional plan compared to other transitional plans?
- What was assumed in deciding that this transitional plan would implement the alternative?

If this alternative changes the ownership of farm assets:

- When will ownership of the farm assets change?
- How will ownership of the farm assets change?
- How will this change in asset ownership be financed?
- What are the risks associated with changing ownership of the assets?
- Are there tax considerations in changing the ownership of the assets?

If the answers to these questions indicate that the transitional plan could be implemented, you should be ready to move your planning process to Step 8 (constraints, contingency plans, and risk management). If the transitional plan is not yet ready to be implemented, you may want to review and update some or all of Steps 6 and 7.

FUNCTIONAL PLANS

A comprehensive transition plan should address issues for specific activities or functions. Some of the plans for functional activities may be enterprise specific, such as production and marketing plans. Other functional plans may apply to the whole farm, such as income tax management. You will need to decide whether the functional plan encompasses the whole farm or only parts of the operation. Collectively, the functional plans could be considered an overall implementation strategy or transitional plan describing how, when, and where the objectives and goals will be accomplished for each function as well as for the entire business.

The information compiled in these functional plans has several uses. One, the information can be used in developing budgets. For example, the production plan should provide details about the type, quantity, and timing for inputs. This information can then be used in the development of enterprise budgets and the whole-farm cash flow budget. Two, the information can be used in assessing whether there are adequate resources to operate the business. For example, the labor management plan should provide an indication as to whether there will be sufficient workers available throughout the year. Three, the plans should indicate how resources will be managed. Examples would include the labor management plan and the capital budget. They should reveal how employees will be directed or when capital assets will be acquired.

The challenging part is coordinating the various activities of the different functions. The size, complexity, and inter-related activities of the farm impact the coordination task. The following sections suggest ideas you may want to consider as you prepare functional plans.

Production Plan

A production plan is an opportunity to specify the production practices for crops (such as no-till, minimum-till, organic, or conventional) and/or for livestock (such as cow-calf, feeder, dairy, or layers). Attention to labor requirements and crop or grazing rotation requirements could be critical for the enterprise. Even if it does not appear to be critical at this point, it could become critical as the whole farm plan is put together. For example, raising sugar beets requires a three year rotation whereas winter wheat requires the crop be planted in the fall. Therefore, winter wheat may not be able to follow sugar beets every year, especially during late harvest seasons for sugar beets.

The expected yields for the enterprise can be taken from Step 3, but you may want to specify a range of yields. Step 9 addresses specifying benchmarks (or milestones) for the farm business. If the expected yields for the first year are used in the analysis, the long-run profitability could be understated. If the expected yields for the later years are used, the short-run profitability could be overstated and there are no guarantees that the long-run expected yields can be achieved. In addition, the range of expected yields can be considered during Step 8 in testing the sensitivity of profitability to changes in yields.

Marketing Plan

In the marketing category, you should identify the consumer of the output of the enterprise. This allows you to adjust your production practices to better match the market. The availability of markets is an important factor for some commodities because you could have a product that cannot be sold. Assessing the availability of markets could be important, depending on the commodity, and can be tested as price variation as part of Step 8.

Financing Plan

A financing plan addresses who to borrow from (lending institutions, suppliers, relatives), when to borrow, when to pay back (fall, winter, spring, monthly), how long the repayment period should extend (e.g., six months, one year, five years, thirty years), and which aspects of the farm will be financed with borrowed capital (operating, equipment purchases, land purchases).

Capital Budgeting Plan

Managing the capital assets on the farm is often referred to as capital budgeting. To prepare this plan you need to consider questions such as: what assets will be acquired; when will they be acquired; whether they will be purchased or leased; and if purchased, what will be the likely source of cash for completing the purchase. Likewise, a capital budgeting plan may address when assets will be disposed of, and whether they will be sold to a co-owner of the business.

Labor Management Plan

A labor management plan may address family workers, employees or both. Issues might include defining tasks and jobs; assigning responsibilities and tasks; devising a communication system; designing a procedure for performance evaluations; determining form and amount of compensation; assessing need for additional laborers; and, recruiting, training, and supervising employees.

Risk Management Plan

This functional area primarily addresses how risk exposure will be managed. Most farmers do not want to eliminate risk exposure because that also eliminates most opportunities for earning a profit. But you will want to manage your risk exposure through diversification, insurance, or enrolling in government farm programs. Part of this functional plan has been addressed in earlier steps when you identified risks your operation is exposed to. The issue of risk management also is addressed in more detail in Step 8.

Income and Self-Employment Tax Management Plan

Tax management should identify tactics to follow to assure that a reasonable level of income and self-employment tax is paid by the owners. The goal should not be to eliminate these taxes, but to maximize after-tax income.

Plan to Transfer Ownership of Assets and Business

Acquiring a business also means that someday ownership will be relinquished. For most family businesses, one person's sale or disposal is another person's opportunity to acquire. Therefore, this functional plan will likely address when does someone else become a co-owner of the business, when will ownership of assets transfer to someone else, does an artificial entity hold ownership of assets so only ownership of the business needs to change over time. This is a complex area that often has ramifications throughout the business and family. Professional counsel is highly recommended in the development of this plan.

FINANCIAL EVALUATION

For all changes to the farm, the most critical evaluation is the financial impact, because if the farm is not financially viable all other considerations are eventually not possible. The following paragraphs provide some suggested financial tools that you should consider when preparing transitional plans to help make informed decisions and provide assistance in staying on track to accomplish the intended result.

Cash Flow Analysis

As discussed in Step 1, a cash flow statement reports the sources and uses of the farm's cash resources. Such statements not only show the change in the farm's cash resources throughout the year, but also when the cash was received or spent. An understanding of the timing of cash receipts and expenditures is critical in transition planning.

Because cash flow analysis is only concerned with covering cash expenses, it is important to remember long-term survivability depends on covering important non-cash needs. For example, machinery depreciation and unpaid farm management and labor are two critical non-cash expenses. The farm operation that does not generate sufficient cash to cover depreciation, and the farmer, who provides his management and labor for free, is on a dangerous downhill slide.

Partial Budgeting

Partial budgets are used to estimate the change that will occur in profit or loss from some change in the farm by considering only those items of income and expense that change. Partial budgets do not calculate the total income and expense of the two alternatives, but only involves those items of income and expense that change to estimate the difference in profit or loss expected from the change.

Partial budgeting is especially useful in analyzing relative minor changes in the farm business such as hiring a custom operator as opposed to purchasing a piece of equipment, or using a marketing hedge as opposed to selling at harvest. This tool is relatively easy to use because it ignores all income and expenses that remain constant.

The general format for a partial budget is presented in an accompanying table. To interpret the headings correctly, the farmer must select one practice as the base plan, and the other as the alternative. If the positive impact of the alternative is greater than the negative impact of the alternative, the change should be implemented.

Positive impact. This section of the budget

recognizes that both increased income and decreased expenses are positive impacts. First, list all items of income from the alternate plan that will not be received from the base plan in the section titled *additional income*. In the reduced *expenses section*, list the items of expense for the base plan that would be avoided with the alternate plan. The total of these two categories is the positive impact of engaging in the alternate, rather than the base scenario.

Negative impact. This section is the opposite of the positive side of the budget. In the *reduced income* section, list the items of income from the base plan that will not be received from the alternate plan compared to the base plan. In the *additional expenses* section list the items of expense from the alternate plan that would not have been incurred with the base plan. The total of these two categories is the total negative impact of engaging in the alternate activity, rather than the base plan.

Because the total farm business is a combination of several activities or enterprises that are inter-related and generally complement one another, accounting for those interrelationships is important. Budget analysis is one important tool that can be used in this assessment process.

Using the Information from Financial Statements

A word of caution: the need for accurate record-keeping is critical because decisions are no better than the information they are based on. Financial measures derived from incomplete or inaccurate information are typically misleading and can lead to bad business decisions. The value of accurate outlook information was discussed in detail in Step 3. As you implement your transitional plan it is imperative that you continue to evaluate the information and assumptions upon which your financial analysis is based.

Several types of financial analysis are appropriate. At a minimum, you should evaluate your performance over time. Comparing financial documents from past years is useful because they reveal trends or patterns. Comparing current statements to past statements reveal what has been happening to the farm business' financial situation. The balance sheets show changes in owner's equity and risk exposure (whether they have been increasing, decreasing, or remaining the same); the income statements reveal trends in profit; the cash flow statements can help you understand the timing of cash availability and needs. The information from these three financial statements also can be used to prepare additional financial measures that reveal the strengths and weaknesses of the farm. These additional financial measures (discussed in greater detail in Step 9) can be used to make several comparisons and help you understand how and why the actual outcome of the farm differs from what you had expected.

Conclusion

The emphasis on this step is determining the intermediate steps to change your current farm (as described in Step 1) into the targeted alternative farm (as described in Step 6). This step relies on methodologies described in previous steps (primarily Steps 5 and 6). The emphasis is on using functional plans to prepare a transitional plan, outlining the sequence of changes necessary to implement the alternative farm.

Partial Budget for: (Describe the alternative plan compared to the base plan)

Positive Impact		Negative Impact	
1A. Additional Income (List the items of income from the alternative plan that would not be received with the base plan.) • • • • • • •	$	**1B. Reduced Income** (List the items of income for the base plan that will not be received from the alternative plan.) • • • • • • •	$
2A. Reduced expenses (List the items of expense for the base plan that will be avoided with the alternative plan.) • • • • • •	$	**2B. Additional Expenses** (List the items of expense for the alternative plan that are not required with the base plan.) • • • • • •	$
3A. Subtotal (1A + 2A)	$	**3B. Subtotal (1B + 2B)**	$
Difference (3A – 3B) (A positive difference indicates that the net income from the alternative plan exceeds the net income of the base plan by this amount.)		$	