



Economic Toolbox

Business Health Management Organization Plan - BHMO

Health Management Organizations (HMO's) promote the health of their membership by urging annual physical checkups and preventative maintenance philosophies. Your farm business should also have an organized plan so you can check it's health annually and implement preventative maintenance procedures. This is your Business Health Management Organization or BHMO plan.

The similarities between the annual exam promoted by your HMO and the BHMO you should have in place for your farm business are striking. First, both are easy to put off until the demands of spring push everything else to the back burner. Second, both check-ups require you to do something outside your ordinary routines, making the process seem more difficult and time consuming than we want it to be. Finally, a degree of pain is usually involved in both. Face it, opening yourself to criticism by your doctor, lender, or others is no picnic.

The process of maintaining the health of your body and the health of your business is similar. In the doctor's office, information is gathered regarding blood pressure, body temperature, and general soundness. Special note is made of any abnormal symptoms. You doctor will analyze the information and make a diagnosis. He or she may recommend a plan of action - medication, change in diet or other solution, and schedule another checkup at an appropriate interval to evaluate the results of her recommendation. Assuming this is a simple annual physical, neither the costs or the recommendations are usually traumatic.

However, let your health deteriorate over a period of months or years before you visit your doctor and the whole process changes dramatically. Instead of a simple office visit, you may find yourself admitted through the emergency room, undergoing

expensive, radical and life saving treatments. Once the crisis has passed, a long and costly recovery process is usually in store.

Your farm business needs regular checkups so you can measure it's health as well. Your BHMO plan outlines the process you should go through at least once a year to review the health of your farm business. BHMO plans include the steps for developing a set of year-end financial statements and other information that is used for analytical purposes. Once the information is collected it needs to be evaluated and interpreted to assess what progress the farm has made during the past year. You need to know about the weaknesses and strengths of the business, and how the farm compares to other similar farms. Finding problems and evaluating solutions often requires the assistance of a trained professionals. If you don't have that expertise, hire it.

Many farm businesses by-pass the annual checkup process and then turn a blind eye towards the symptoms of an ill business. Ignore the symptoms of a deteriorating business and you may also find yourself in the business equivalent of an emergency room, implementing expensive, radical and life-saving treatments. Given the competitive environment we live in, few businesses can survive protracted recovery periods in which they must still compete with healthy farms.

A BHMO Plan

Your BHMO plan can be a simple outline of the tasks required to complete your year-end financial statements, analyze them, and make plans for the year ahead. It's a recipe for diagnosing the health of your farm business and making the necessary adjustments on a regular basis. A simplified BHMO plan for a December 31 fiscal year could look similar to this:

Balance Sheet:

December 31 - Account for all your business assets, including crop, feed, livestock, and supply inventories. Update the machinery and equipment list, list

out accounts payable, accounts receivable and get accurate balances on all your loans.

Cash Income Statement:

January 15 - Reconcile December checking account, summarize the year's income and operating expense. Break-out interest and principal payments. Develop a cash basis income statement.

Accrual Income Statement:

Finalize December 31 balance sheet, adjust cash income and expenses for changes in accounts payable, accounts receivable and inventory.

Cash Flow Statement:

Complete Statement of Cash Flows, including cash spent on capital purchases, family living, monies borrowed and repaid.

Financial Analysis:

Using completed financial statements, develop financial ratios to analyze the previous year's business performance. Compare performance to previous years and look for improvements. Join a benchmark, compare farm to others and look for weaknesses.

Planning:

Develop goals for the coming year based on financial analysis. Put a cash-flow budget together to see how the projected result of changes to be made. Adjust as necessary to meet the needs of the business and family.

Follow-up:

Compare actual business performance to the budget on a monthly basis. Re-adjust the plan as necessary to meet changing business conditions.

Developing a BHMO plan and implementing it is a formidable task. The process is time consuming and laborious, and it often takes as much time to complete for a small farm as it does for a large one. Additionally, like many aspects of running a farm these days, it requires a degree of expertise that most farmers simply do not have. Increasingly however, it is becoming one of the costs necessary to operate a successful farm

business, just like hiring someone to complete your income taxes, balance your feed rations, make spray recommendations and helping with marketing decisions. The question you need to ask yourself is just how bad do you want to keep farming and are you willing to take the steps and pay the price for the privilege.

Bruce Dehm is president of Dehm Associates, a farm business services company in Geneseo, New York.

Regardless of your approach to measuring and maintaining the health of your farm business, there are several tell-tale symptoms that should not be ignored.

Cash Flow Coverage

The amount of cash in your business is an good indicator of health. Not having enough cash to meet the obligations of the business is one of the first signs of a problem. By itself, insufficient cash does not indicate exactly what type of problem the business is having. It is entirely possible to have no cash and show an incredibly high profit. It is also possible to have plenty of cash and show operating losses. Too little cash can be caused by low profitability, too much debt, improperly structured debt, too many capital purchases from cash flow, increases in accounts receivable, increases in inventories, or too much family draw. Some causes are easy to fix while others may be impossible to overcome. Knowing the difference is critical to developing a workable solution to the problem.

Low commodity prices can lead to insufficient cash flow, but low prices take more blame than they should. Making prices responsible for the downfall of your business is easy, convenient and popular. It also prevents farm managers from addressing issues they can control. Blame low prices only after you determine that your cost of production is lower than most other farms.

Measure adequate cash on the farm by using the Term Debt and Capital Lease Coverage Ratio. Ratios greater than 1.1 indicate relative health.

Cost of Production

Over time, the most important factor leading to the health of the farm business is your cost of production. Businesses outside of agriculture that have the ability to set prices, however, there is no guarantee that there will be any buyers. In agriculture, a producer

has little control over prices, but does have the ability to sell everything the farm can produce. Farmers who have the ability to produce at low cost have a higher profit margin which can be used to reinvest in the business or provide the farm family a sufficient standard of living. Knowing your cost of production is the first step in determining the financial soundness of your farm business.

Your cost of production should include all variable expenses such as feed, crop inputs, fuel and labor, and all fixed costs such as property taxes, insurance and interest. Depreciation, a non-cash cost which should approximate your principal payments must also be included. These total costs divided by your total units of production (lbs of milk, bushel of corn or tons of vegetables) give you your cost per unit. These costs need to be lower than the price you receive with some margin left over for family living. If they are not, then you need to lower them by reducing operating costs, gain operating efficiencies by changing the number of units you produce, or producing more units for the same cost.

The Operating Expense Ratio is a quick and easy method of determining your production efficiencies. Expense ratios should generally fall between 70 and 80 percent.

<u>Term Debt and Capital Lease Coverage Ratio</u>	
Net Farm Income (Accrual Basis)	_____
+ Non-Farm Income	_____
+ Depreciation	_____
+ Interest Expense	_____
- Income Taxes	_____
- Owner Withdrawals	_____
= Available for Debt Service	_____
 Annual Interest and Principal on Term Debt	 _____
+ Capital Lease Payments	_____
= Annual Debt Service	_____
 Term Debt and Capital Lease Coverage Ratio	 = <u>Available for Debt Service</u> Annual Debt Service
 This ratio should be 1.1 or greater.	

<u>Operating Expense Ratio</u>	
Total Operating Expense	_____
- Depreciation Expense	_____
= Cash Operating Expense	_____
Divided by Gross Revenues	_____
= Operating Expense Ratio	_____
 Should be less than .8	

A Business HMO Plan For Your Farm

1. Year-End Balance Sheet
2. Cash Income and Expenses
3. Accrual Income and Expenses
4. A Statement of Cash Flows
5. Business Analysis- Financial Ratios
6. Develop a Budget
7. Compare Actual To Budget