Causes of Farm & Ranch Failure

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There were more farm failures during the 1980s than at any time since the 1930s. Financial stress was widespread, geographically, and affected all types of farms. Unlike previous agricultural recessions, however, the nation's general economy was relatively strong during the same period.

There were a number of studies examining the characteristics of farmers who have failed or experienced financial trouble. The following overview deals with those characteristics observed most frequently. The list is not presented in any order of importance or order of association with failures. Failures usually display elements of several, and in some cases, many of the characteristics discussed.

Death or Disability of the Owner

Many farm businesses are managed as one-man shows. Little financial information and almost none of the business decision-making functions are shared with others in the business or the family. There is seldom a plan for management succession or for developing backup management. Thus, when something happens to the only decision maker, many firms either fail or experience a traumatic adjustment process.

Natural Disasters

We generally think of weather when we talk about natural disasters. However, they also include such things as disease outbreaks (i.e., the 1971 corn leaf blight), severe insect infestations and environmental problems such as water pollution.

Because they can't change the weather, many farmers have largely ignored it in their planning and management. Top operators, on the other hand, recognize that successful business management is, to a large extent, successful risk management. Not being able to control a source of business risk does not mean that the business can't be managed to compensate for it and, in some cases, to capitalize on the risks involved.

For example, multi-peril crop insurance has been underutilized by many farmers experiencing financial stress, particularly given the level of federal subsidy involved. Frequently, farmers have been underinsured because they view insurance as an investment rather than a risk management tool.

Another characteristic associated with weather problems is increased market variability. Because markets tend to overreact on both the up and the down side, there has been a tremendous payoff to farmers who have taken advantage of the pricing opportunities presented. Yet only a few top farmers understand or have learned to effectively use the many pricing tools currently available, such as the futures and options markets.

Better managers employ production practices that reduce yield risks, maintain and use rainfall and temperature records, study commodity stock levels and carryover/use ratios for both the commodities they produce and their substitutes, consider preplanting subsoil moisture levels in selecting varieties and seeding rates, and analyze both projected cash flow margins and their historical variability. A high percentage of those who have failed due to weather related problems have done none of the above.

Marital Problems

The most obvious of these problems is divorce, which takes its toll on the business in many ways. The stress on the parties involved invariably leads to a reduction in the time and energy going into managing the business. The legal costs involved and the potential division of assets also can create financial stress. Even when a divorce does not result in the sale of assets or additional borrowing to meet the demands of the settlement, management quality often suffers. This can occur for a number of reasons, such as the loss of a key member of the management team, the involvement of more parties in the management process (sometimes without adequate knowledge or ability), outside interference by persons offering advice to the estranged spouse, and in some cases, the problems created by dealing through attorneys.

Even when divorce does not result, marital problems usually reduce the quality of management, if for no other reason than the emotional stress they cause.

Speculation

There is an old saying among commodity traders that “the markets have room for bulls and bears, but not for hogs.” The same is true for most markets. Too many people have gone into business or expanded without adequate planning, without adequately analyzing the added costs associated with the added returns, or without analyzing potential risks. Moreover, much of the planning that has been done has been based on inadequate research and information and on unrealistic expectations. Land buyers, in particular, have often relied on expected inflation, low real interest creates and expected capital gains to justify investments not supported by the investment's repayment ability. This philosophy may have worked reasonably well for commercial real estate speculators who were willing to sell and take a profit when the market offered one, or who were willing to get out and cut their losses when things began to sour. Unfortunately, too many farmers become "married" to their land. Land ownership need to be more of a business proposition and less of a romance.

Another problem has involved looking for a pot of gold in alternative enterprises. For example, a major problem in fish farming has been the lack of adequate market research and the assumption that the market is virtually unlimited. Many agricultural commodities have a very inelastic demand and the response of market prices to rapid increases in production often have been dramatic. Demand is said to be inelastic when commodity prices decrease proportionately more than aggregate production increases, which results in a decrease in total revenue. "New" industries are particularly vulnerable. The problems are compounded by the fact that many of these enterprises require new skills and often more intensive management than traditional crop and livestock enterprises. The potential returns may be high, but so are the risks.

Inadequate Information

Most decisions are no better than the information they are based on. Unfortunately, too many farm businesses have poor recordkeeping and inadequate management information systems. The result has been that much of the planning and analysis that has been done can be described by the computer slogan "garbage in – garbage out." The ability to use financial information to control costs, to spot and correct problems and to recognize profit opportunities has been a major factor in separating successful from unsuccessful farm operators.

One study of 300 Production Credit Association borrowers over a 4-year period found that, on average, they overestimated cash receipts by 15 percent and underestimated cash expenditures by 17 percent. The uncertainty in agriculture obviously caused some of this error. However, if the errors were purely a function of market and production variability, both revenues and expenditures should have been underestimated as often as they were overestimated. Too often plans are not based on accurate, well documented information, and instead involve too much wishful thinking.

This doesn't mean that every farm needs to be on a computerized, double-entry accounting system. But for commercial farm business, management should have regular summaries of financial position and performance down to the individual enterprise level.

Insufficient Monitoring

Farmers need to realize that financial management is not just an exercise to be carried out at the beginning and end of the year. Rather, it involves keeping on top of what is going on in the business by comparing plans to actual performance and taking action when it is needed. From the financial standpoint, this includes comparing actual versus projected cash flows on a regular basis. Too many businesses have failed or developed serious problems simply because it was too late before the farmers or their lenders recognized that something was wrong.

Good financial management is more of a prevention than a cure. Regular monitoring and control can help prevent many mistakes; keep the mistakes that are made from becoming as big, help identify strengths, weaknesses and opportunities; and focus attention on the causes and not just the symptoms of problems. It doesn't guarantee success, but it does improve the odds.

Overdependence Upon Collateral

Both borrowers and lenders have been guilty of this. To quote agricultural consultant Roy Ferguson, "it's not borrowing money that gets people in trouble, its borrowing for things that can't pay for themselves."

The problem is that most borrowers and lenders have only gone half way in their analysis of repayment ability. They have limited themselves to analyzing annual cash flow projections and historical cash basis income. While cash flow is an important element of repayment ability, plans which are limited only to annual cash flow projections can be very misleading. An operation can be going broke and still generating a positive cash flow for several years by reamortizing debts, selling off assets (including inventories), increasing accounts payable and not replacing capital assets as they wear out (i.e., living off of depreciation). Moreover, because cash flow projections are based on expected values, the actual outcome can vary significantly. Too little effort has gone into evaluating the impact of alternative possible outcomes. Even when some attempt has been made to do so, it has usually involved evaluating a standard decrease in expected revenues, i.e., a 10 percent reduction. This is a first step, but it isn't specific to the performance history or risk inherent in an individual industry or business. In their planning and analysis process, farmers or lenders need to attempt to determine exactly how much of a decrease in revenues and/or increase in expenses the farm can actually withstand relative to both its net worth and its total cash flow commitments.

The neglected half of repayment capacity has been the evaluation of historical and projected profitability on an accrual basis. Numerous studies have demonstrated that cash basis income accounting can lead to lags of as much as 2 years in recognizing developing profitability problems. The reverse is also true, in that cash basis accounting delays recognition of profits during growth periods when the problem may be liquidity rather than profitability.

In any case, without sufficient inheritances, nonfarm income and/or asset appreciation to offset losses, in the long run a farm has to be profitable to survive.

We need to remember that equity isn't the only thing that can be too highly leveraged. During the 1970s, the debt/asset ratio for agriculture remained relatively constant because debt and asset values were increasing at approximately the same rate. Yet the debt/income ratio was clearly indicating that a major connection was going to occur. From 1970 to 1980 the debt/income ratio for agriculture increased from 3:1 to 8:1.

Improper Loan Structuring

Debt servicing problems often occur if the loan repayment period is not matched to repayment ability. This occurs most frequently when operating funds are used for capital purchases. But it has also been a problem when too much debt has been taken on for expansion or capital investment in response to favorable price levels. Both producers and lenders have too often ignored the fact that agriculture is a cyclical industry. Many failures have resulted building up term debt in the good times, without thought to the repayment capacity margin that will be needed to get through the less favorable times that will likely occur sometime during the repayment period. These unfavorable periods may be caused by natural disasters, lower commodity prices, reduced government program payments and higher input costs, including interest rates. Debt structure should be based on conservative repayment estimates. Prepayment, if results are better than projected, is much easier than attempting to refinance under unfavorable circumstances.

Lack of an Effective Marketing Program

Too many farmers have taken excessive price risks without trying to reduce uncertainty by using options, hedging, forward contracting, etc. Many failures have been based on "homerun fever" and the emotional reactions to what is going on in the market. A related problem has been that many producers don't even know their total cost of production or what their breakeven price is.

Rick Brock, who heads a marketing consulting firm for grain producers frequently makes the point that he knows farmers who spend $150,000 and 6 months producing a crop, then spend $1.50 on a farm magazine and an hour in the coffee shop talking to their neighbors to decide when to market it.

The problem is even more apparent for specialty enterprises. For example, one of the main reasons for failure among fish farmers has been the lack of attention to marketing. Unlike the markets for more traditional agricultural commodities such as cattle, corn or wheat, many of the markets for fish are not well developed, are very seasonal and/or are highly differentiated based on consumer preferences. Many producers have not adequately considered the availability, market power, financial stability or the specific requirements of potential buyers or processors. Unfortunately for them, specialty products usually require more emphasis on selling skills and greater use of contractual arrangements than do the more homogeneous agricultural commodities.

Producers also need to remember that the product pricing decision is not the only marketing decision. Purchasing inputs represents the other half of the equation. Buying right is the first half of any effective marketing program. If someone pays to much up front, they frequently can't get the margin they need when it comes time to sell.

Some producers have failed because they didn't consider the impact of substitutes for their products, or the effect that increased supplies would have on price. Economists refer to these as price elasticities. Many producers have made major capital investments requiring long-term financing based on the assumption that current price levels would continue, only to find that prices fell sharply as other producers came in or expanded in response to the same price incentive.

Tunnel Vision Toward Production Technology

Many of the producers who have failed or are in trouble have been considered by the farming community to be top farmers. This is largely because the general definition of a top farmer is tied almost entirely to his production ability, but attaining the highest yields does not necessarily result in the highest profits. Many top producers have neglected or not understood the financial and marketing aspects of management. More emphasis needs to be placed on marginal cost and return relationships in determining input levels. It is not that production is unimportant, but that economic analysis and management balance are too often lacking.

Poor Production Management

Although most sound production practices are well known, some producers fail to apply them. Some are not using the latest knowledge or technology, are sloppy in their production practices or are not timely in the things they do. While trying every new idea or tool that comes along can be disastrous, being too slow to adopt available technology also has been the undoing of many operations. “A day late and a dollar short” is not a bad management axiom.

Poor Money and Time Management

Analysis of a large number of failures has shown that many farmers were spending too much time and/or money on non-productive and non-profitable assets and activities. In large measure, these problems resulted from a lack of planning and failure to establish goals and priorities. The old 80/20 rule is applicable to a wide range of situations. It refers to the fact that without well defined objectives and self-discipline, most farmers and ranchers will spend 80 percent of their management time on activities that produce and 20 percent of their profit and only 20 percent on those things that account for 80 percent of their profit. This rule also applies to the lack of balance often seen among the key areas of business management such as production, financial management, marketing and human resources.

Good managers recognize that things never go exactly as planned. Therefore, for every plan they have a backup plan in much the same manner that a successful coach develops a game plan using several different strategies. This contingency planning allows time to evaluate alternatives before events occur, and shortens the time it takes to respond to changing conditions. One of the most obvious differences between successful and unsuccessful managers is that those who are successful tend to be proactive and always thinking ahead, while the unsuccessful always seem to be reacting to the latest crisis.

Failure to Control Living Expenses

This problem often arises when business and family goals and priorities are not established, or when there are conflicts between them. Rather than striving to maintain an absolute standard of living, the family needs to be willing and able to adjust its standard of living to business income. During periods of higher income, the family may be tempted to make major purchases such as a new home, more expensive cars and recreational vehicles. Then, if income decreases, these assets may have to be sold, often at a loss. Lowering one's standard of living can involve a loss of social status and personal dignity. Many business failures have involved farmers who were either unable or unwilling to live within their means when income fell, and many profitable businesses have failed because the owner(s) took more out than the business earned.

Emphasis on Tax Minimization

Financial problems can result when unnecessary capital investments or capital replacements are made to minimize income taxes without an adequate analysis of the impact on the farm's repayment capacity or profitability. The objective should be to maximize after tax profits over time, not simply to minimize income taxes in the short run. Most tax accountants have not considered, nor have they been paid to consider, the overall business management implications of tax minimization strategies. It isn't that tax management is unimportant, but that it should not be an overriding factor in the firm's overall financial management.

Attempting to Support Too Many People from the Operation

Many failures have resulted from a parent's desire to bring children into the business or to help them get started. In the cases studied, problems occurred because of the amount of debt taken on to expand the business, the increased risk resulting from higher financial leverage, and/or because family living withdrawals exceeded the net income of business. As problems began to develop, many parents had too much pride or sense of obligation to make the needed changes until it was too late. In many cases, children should have begun participating in the operation on a part-time basis while continuing full-time, off-farm employment until the business could realistically support them.

Managing the Family in Business

When several members of the family are directly involved in the business, management problems often occur. The most serious problems usually result from the lack of a clear division of responsibilities, the inability to separate personal feelings from business decisions, and unclear or conflicting goals and priorities among the individuals involved. The problems frequently involve not only the family members employed in the business, but also their spouses and other employees who are not part of the family.

When several family members are involved in management of the business, it may be difficult to objectively and fairly reward performance, especially if there is favoritism or if responsibilities are assigned on the basis of age or sex rather than ability. Also, there may be differences in philosophy and operating style. Parents often create problems when they are unwilling to delegate any decision making responsibility or at the other extreme, when they totally abdicate their authority in order to avoid hurting feelings. The goal of the family business should be to develop a team approach which recognizes and capitalizes on the different interests, skills and abilities of the family members involved.

Lack of Management Ability

This may be the most difficult factor for an individual to recognize or to objectively assess, but it is critical. Many farmers have failed not from a lack of intelligence or hard work, but as in any other business, simply because they did not have the training, aptitude or ability to be effective managers in an increasingly complex and high risk environment. Problems also have developed when the business, or a new enterprise, was started on too large a scale allowed to grow too rapidly without allowing adequate time for management ability to grow with the business. Many farmers who have failed were excellent operational managers; but most have not been good businessmen, particularly in terms of executive management skills. Many of them have been unable to see the total picture of the farm business and have focused more on the symptoms than or causes of problems. Still others have been able to see only the big picture without paying enough attention to the necessary details. These individuals often made snap decisions, relying heavily on their intuition. When they failed they tended to blame everyone and everything but themselves. More than 60 percent of all new nonfarm businesses fail within the first 5 years, largely because of poor management. Is there any reason why commercial agriculture should be expected to be any different?

Inadequate Attention to Personnel Management

One of the weaknesses of many farmers has been in the area of personnel management. Hiring practices often have been penny wise and pound foolish. Using the lowest cost inputs, including labor, is often a mistake. Cost needs to be measured against quality and productivity. As non-farm businesses have learned, the strength of a business is in its people. Hiring quality employees and rewarding them appropriately not only reduces employee turnover but also allows the business to acquire people with better skills and greater capacity for learning and assuming additional responsibilities. With dependable, quality employees, management has more time to concentrate on those activities with the highest payoff. Good employees not only get more done but also are more likely to get the job done right.

Concluding Comments

There are farmers and ranchers who are very successful because they are doing exceptionally well in one area of business (i.e., marketing or production), or because of a favorable investment such as buying land just before a land market boom. But this kind of success often has more to do with favorable circumstances than with management skill.

If inheritances, non-farm income and windfall gains are excluded, the farmers and ranchers who have succeeded over time have done so largely because they are good managers. The characteristic that most differentiates the successful from the unsuccessful is management balance, both among the key areas of business performance and between short run and long run considerations. From a profitability standpoint, the most successful often have not been the best in any one area, but they have been consistently better than average in each year.

The importance of management balance was emphasized in a 1980-87 study of factors contributing to farm profitability. In this study, the differences between the top 25 percent and the bottom 25 percent of a group of producers were analyzed. It was found that the top group averaged only about 5 percent better than the overall group in terms of yields on comparable quality land, costs per unit of production returns per dollar invested in machinery and equipment, and average "net" price received for the commodities produced. The bottom group, on the other hand, was about 5 percent worse than the overall group on these same performance measures. Strangely enough, the debt/asset ratio for the two groups was about the same. While the differences were marginal in each performance area, net income averaged a positive $50,000 per year for the top group and a negative $25,000 for the bottom group.

In addition to a more balanced approach to management, the successful group was found to be much more heavily involved in planning and monitoring business performance. This included generating better information at both the whole farm and the enterprise level. Former Secretary of State James Baker has a plaque on his wall which succinctly summarizes this aspect of successful management: “Proper Preparation Prevents Poor Performance.”

Finally, the desire for independence has been one of the primary motivations of many people who go into farming .Yet it has also been the Achilles heel of many farmers because they have attempted to do everything on their own resources. The owners of many small operations can capture the economies of size and specialization available to larger producers by pooling resources (through consolidation, joint ownership or cooperative arrangements) and/or by employing outside expertise.