

QUARTERLY NEWSLETTER

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Family Business Transfer - Developing a Financial Management Checklist

Ed Farris, Purdue Extension Huntington County

The old saying “take a load off” comes to mind when thinking about transferring a business. The owner/operator may feel that they are ready for a new generation to carry “the load.” In preparation of moving “the load” between generations, it is important to take time to consider financial management. Turning financial statements and analysis into a roadmap is a critical step.

Important questions to consider include the following:

- Are we on the right path to achieving our goals?
- Is our farm profitable?
- Do we have a competitive advantage?
- Do we have the resources to expand?
- Would it be feasible to bring another family member into the business?



A review of year-end balance sheets and earnings statements in recent years will reveal if there is sufficient income to service capital debt. Is the return on equity (net farm income – unpaid operator labor / average farm equity) greater than the interest rate? If it is not, then the operation may not be in the position to borrow additional money.

Next, financial resources should be given consideration. Liquidity can be measured using the current ratio (current assets/current liabilities). A good benchmark is to be above “2” for the current ratio. Solvency can be measured using the debt to asset ratio (average total debt/average total assets). A good benchmark is to be below 0.40 for solvency.

Family Business Transfer... (continues from page 1)

Two additional ratios can be calculated to assist with understanding business profitability:

1. Operating profit margin ratio = $[\text{net farm income} + \text{interest paid} - \text{unpaid operator labor} / \text{gross income}]$. A benchmark for this ratio is to be above 0.20 or 20%.
2. Asset turnover ratio = $(\text{gross income} / \text{average total assets})$. A benchmark for the asset turnover ratio is 0.35 or 35%. However, benchmarks for this ratio will vary depending on the type of business.

If earnings are insufficient and/or debt is not properly structured, this can lead to communication issues. Consideration must be given to the fixed costs of owning assets. Fixed costs include the “DIRTI Five”, which is depreciation, interest, repairs, taxes, and insurance. There should be time set aside at least annually to review how income is divided when both generations own business assets.

Ultimately, cash flow must be satisfactory to replace depreciable assets. The computation of economic profit reflects the idea that the farm must earn enough to cover debt obligations and opportunity costs on owned assets. What does this mean? All costs, cash and opportunity costs, have to be covered if we are creating economic value. Here are examples of resources with opportunity costs:

- Operator labor and management
- Machinery
- Buildings
- Land

In many cases, earnings are not large enough to cover owner withdrawals (i.e., family living expenditures) and generate a return to owned assets such as machinery, buildings, and land. It is possible that a loss of owner’s equity will be noted, if this situation occurs over time. In extreme cases, business owners may decide to retire by selling off assets.

It is also likely sweat equity will exist when there simply is not enough earnings to support owner withdrawals for both generations. This means individuals are paid less than their true opportunity cost. Oftentimes, the older generation says, “One day we will need to make things right with son/daughter for all the work they’ve done without being paid in full.”

Taking time to go through a checklist of financial management will benefit both generations. There may be important changes that are possible to adequately address sweat equity and make other needed corrections. Steps taken in advance will help “the load” to shift more smoothly to new owners.

“In preparation of moving “the load” between generations, it is important to take time to consider financial management. Turning financial statements and analysis into a roadmap is a critical step.”

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Purdue Agriculture 2022 TEAM Award Honors Extension Succession Planning Team

Jillian Ellison, Purdue College of Agriculture

Created in 1995, the Purdue Agriculture TEAM Award honors the interdisciplinary team achievements of faculty and staff each year. The 2022 TEAM Award has been presented to the Purdue Extension Succession Planning Team.

Helping farming and small business families in some of their greatest moments of need, the Purdue Extension educators and specialists on the Succession Planning Team have worked since 2011 to navigate the process of transferring ownership of the company to continue the family's legacy. The TEAM award honors the team's efforts to cultivate strong Indiana farm families through the succession planning process.

The Succession Planning Team offers regional workshops and visits family farms to assist in the often-complex process of passing down a family business. Some of the topics covered are financial skills, communication strategies, business structures and

risk management tools. Fees for the team's services are significantly reduced due to grant funding by the North Central Extension Risk Management Education Center.

The Succession Planning Team Extension members include: Heather Caldwell, Linda Curly, Miranda Edge, Ed Farris, Kelly Heckaman, Nicholas Held, Michael Langemeier, Maria Marshall, Jenna Nees, Jeff Pell, Krista Pullen, Denise Schroeder, Kyle Weaver, and Renee Wiatt.

The team was presented with the 2022 TEAM Award on Friday, January 27, 2023 during a celebration in the Deans' Auditorium in Pfindler Hall on the Purdue University campus.

AUTHOR

Jillian Ellison
Purdue College of Agriculture



Pictured (left to right): Ken Foster, Michael Langemeier, Maria Marshall, Kyle Weaver, Krista Pullen, Heather Caldwell, Jenna Nees, Denise Schroeder, Jeff Pell, Nick Held, Ed Farris, Linda Curley, and Renee Wiatt.

LLCs as Multi-Tools

John Rowe, The Rowe Law Firm LLC

Ease transfers to the next generation, eliminate estate taxes, avoid probate, continue the business, maintain relationships, reduce income taxes - all are challenges and goals we think about in the succession process. A limited liability company (LLC) is a flexible tool that can help accomplish these goals. LLCs can be taxed as partnerships, S corporations, or C corporations as members may choose and may be managed by members, a manager (who does not need to be a member), or officers, similar to a corporate structure.

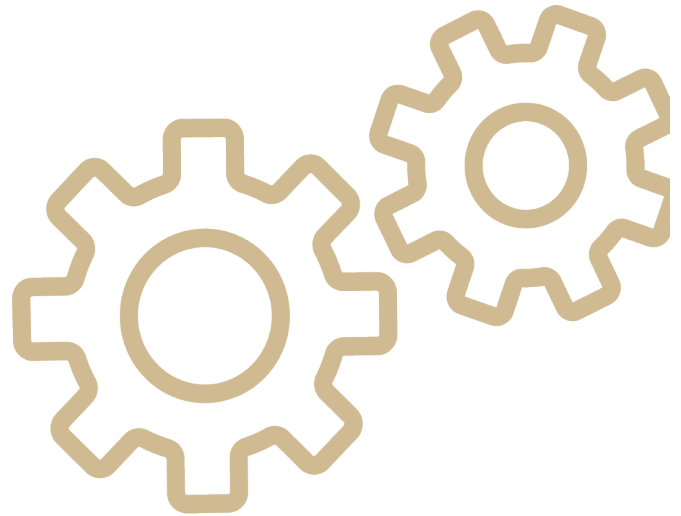
An Operating Agreement, adopted when the LLC is formed, establishes rules by which an LLC is run. The Operating Agreement may designate the ownership of units, the persons authorized to act on behalf of the LLC, the number of votes required to adopt a resolution, the actions that require a majority or supermajority to approve, whether units have different voting rights, and the restriction on transferring units, such as the a right of first refusal or right of first offer.

Case Study

Simply for purposes of discussion, assume that Dad and Mom have three grown children (Drew, Morgan, and Riley) and land and equipment. Drew operates the farm with Dad and Mom, Morgan has an affinity to the land, and Riley has non-farm interests. Drew has a child who may be interested in continuing the farm operation, but it's too early to rely on that in the farm's decision-making process. Also, Dad's and Mom's total assets are worth \$10 million with \$8 million to land, \$1.5 million to operating assets, and \$500,000 to investments and miscellaneous assets.

Keep in mind that Drew and Morgan both have an emotional attachment to the land and that Riley may be happy to have cash rather than land. Of course, sufficient cash won't be available to give Drew operating assets, Drew and Morgan land, and Riley cash.

Given these facts and goals (which understandably may change with time), let's consider how an LLC's flexibility might help the family achieve its goals, while also maintaining a harmonious relationship among Drew, Morgan, and Riley (and their children).



- Voting and non-voting units. Dad and Mom convey land to LLC and issue voting and non-voting units to each of Dad and Mom. For example, voting units could control operations and majority or supermajority of both voting and non-voting unit would be required to incur debt, mortgage land, or buy or sell land.
- Dad, Mom and Drew could be managers with Drew remaining as Manager after Dad and Mom both die.
- Dad and Mom could own voting units transfer on death (TOD) to Drew and non-voting units TOD to Morgan and Riley.
- Dad and Mom would own all voting and non-voting LLC units during their lives and Dad and Mom, and perhaps Drew, would own operating assets.
- Both voting and non-voting units would receive the landowner's share of income—essentially cash rent that, after Dad's and Mom's deaths, would be divided equally among Drew, Morgan, and Riley.
- Dad and Mom could change the arrangements and ownership during their lives.
- Operating assets would not be part of the LLC. Ownership of operating assets could be owned by Dad and Mom and TOD to Drew, so upon Dad and Mom's deaths, Drew would own the operating assets and Drew would be Manager on the LLC.

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LLCs as Multi-Tools... (continues from page 4)

- Drew would have a conflict of interest as both the farm operator and LLC Manager. The conflict of interest could be avoided by Dad and Mom providing in the Operating Agreement a cash rent formula the operator would have to pay the LLC. For example, the Operating Agreement could provide that a conflict of interest would not exist if the operator were to pay the LLC an amount equal to the most recent Purdue cash rent survey results for the area in Indiana and the particular land class.
- Restrictions on transfer of units could require each unit owner to offer units to the LLC or the other unit owners if a sale were desired. This restriction also could apply to a marriage dissolution, transfer due to death, or some other circumstance. Appraisals, arbitration, and financing terms of the purchase also could be included. For example, if Riley wanted cash, Riley could be paid in the form of an unsecured promissory note payable over 15 years with interest at prime + 1 reset every 3 years.
- TOD ownership of units avoids probate. TOD beneficiary designations also can be used to transfer real estate. Contingent beneficiaries can be named in case the primary beneficiary predeceases Dad and Mom or if the primary beneficiary were to disclaim.
- For now, federal estate taxes are not a concern for Dad and Mom or their kids. Assuming no prior gifts exceeding the annual exclusion, Dad and Mom each has a 2023 federal estate tax exemption of \$12.92 million, or a combined exemption of \$25.84 million if a federal estate tax return is filed at the death of the first spouse to port to the surviving spouse the unused part of the exemption of the first spouse to die.



“On January 1, 2026, the federal estate tax exemption reverts to \$5 million per person, which, adjusted for inflation, will be about \$6.24 million per person or a combined \$12.4 million.”

- On January 1, 2026, the exemption reverts to \$5 million per person, which, adjusted for inflation, will be about \$6.24 million per person or a combined \$12.4 million.
- Gift tax strategies can be used now to preserve the higher exemption.
- Stepped-up basis continues to be available to increase the income tax basis of inherited assets to the fair market value on the date of the decedent’s death.

These comments and observations are offered as a springboard for thought about opportunities available to preserve healthy family relationships, maintain a sound business structure, and achieve succession goals. Multiple alternatives exist within each topic. Building a team that includes knowledgeable advisors is essential and well worth the time and cost.

The contents in article are informational, general in nature, and does not constitute legal advice. The material should not be relied on or used without consulting a lawyer to consider specific circumstances. The material was written on the date specified and does not include changes after that date (February 22, 2023).

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Exploring Small Business Income Variations: What Age of Owner & Business Reveal

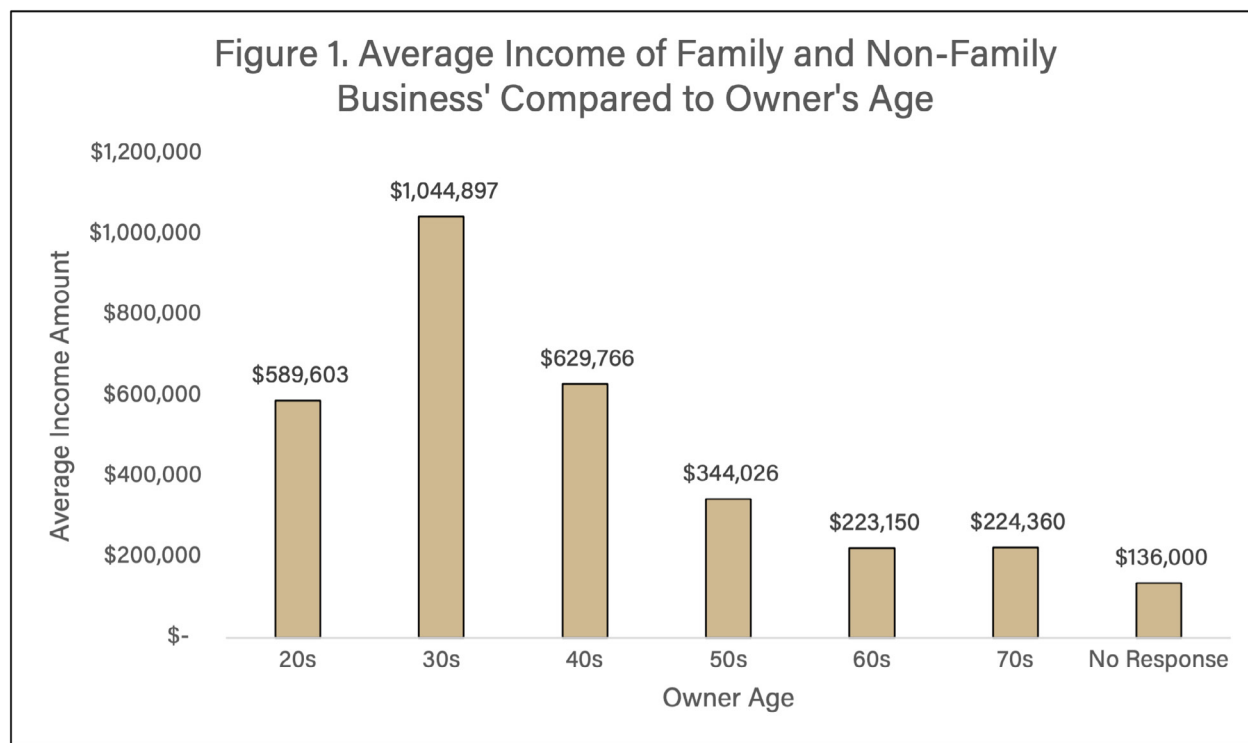
William Walls, Renee Wiatt, and Maria I. Marshall, Purdue University

Small businesses continue to play an important role in Indiana's economy, especially the farms that provide agricultural production not only to the state but to the rest of the country. The idea of succession, cross-generational promotional practices, and business longevity, becomes key to the long-term success of small businesses. Interestingly, a large majority of respondents to the 2012 Intergenerational Farm and Non-Farm Business Survey had yet to start the processes of management transfer, ownership transfer, or estate planning, and only 28% of respondents had found a successor for their business (Marshall et al., 2012). A study by Mishra et al. (2003) found similar results, with only 27% of farm operators in the United States having a named successor for their operation.

Utilizing the Small Business Values Survey (Marshall and Wiatt, 2019), we sought to better understand the correlation between low succession numbers in the businesses and the importance of the continuation of small businesses. Our data visualizations compare average income levels across a variety of business

characteristics. Average business income for each category was used as a constant variable due to profit being the second most important business goal, behind a positive reputation with customers, per the 2012 Intergenerational Farm and Non-Farm Business Survey. Below are two figures along with descriptions of our findings that compare the financial measure of business success against owner age and business age to observe what trends exist.

Figure 1 depicts the owner's age compared to the average income of family and non-family small businesses. The largest average annual income occurred when respondents were in their 30s at just over \$1,000,000. The next two highest data points occurred when owners responded that they were in their 40s, followed closely by owners that responded that they were in their 20s. The trend follows a bell curve, with the income decreasing as respondents aged. When observing this trend, the three highest average income data points are within the three youngest age groups. This demonstrates that the age of the owner of the business can have



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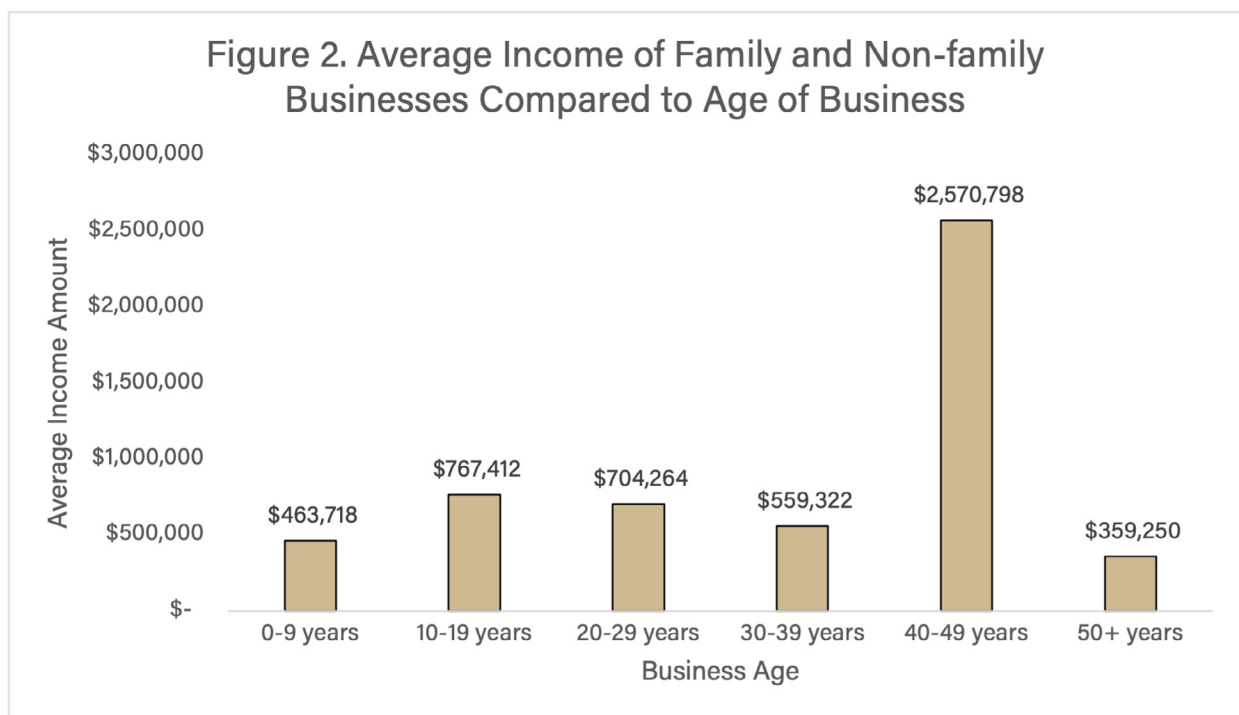
Exploring Small Business... (continues from page 6)

strong effects on the average income of a small business. It is important to note that these averages are a combination of family and non-family small businesses.

Figure 2 illustrates business age compared to the average income of family and non-family small businesses. The largest average income, by a wide margin, occurs when businesses are 40-49 years old. The next most profitable business age group was 10-19 years old, but the distinction between that data point and the remaining four age groups is minimal. There is not much of a trend for this data set, but a striking observation of business' age at the 40-49 year-old data point. This demonstrates that small businesses that have been in business for this time period are significantly more profitable than businesses that are younger. It is important to notice that the 50+ business age data point is the least profitable (but the sample for this group may not be representative, with only 8 observations with business age between 50 years and 83 years).

Founder-owned businesses that are in their 40s likely have owners who are nearing and considering retirement and who are also considering bringing in that next generation to the business.

Every small business is different and therefore succession will look unique for each business. Each succession process takes a different amount of time and has different key players, and successful succession strategies will differ. Family businesses may do things differently than non-family businesses, and younger businesses may operate differently than more experienced businesses. However, based on our analysis, cross-generational promotion practices may be useful regardless of the status of a small business. The longer a small business is in business, the higher the chances are that they will continue to be profitable. At the same time, somewhere along the small businesses' lifespan, a change in ownership to a younger generation may be important in order to continue seeing high amounts of income.



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What Will Be the Capabilities and Skills Needed to Manage the Farm of the Future?

Michael Langemeier and Michael Boehlje, Purdue University

A recent article discussed a number of automation and precision agriculture technologies that will be increasingly used in production agriculture. The adoption and use of these technologies will require additional expertise and skills of managers and the workforce on the farm in the future. This article explores the capabilities and skills that may be needed to manage automation and precision agriculture technologies, and provides a list of options for farms to build the workforce of the future.

Staffing and Managing the Workforce

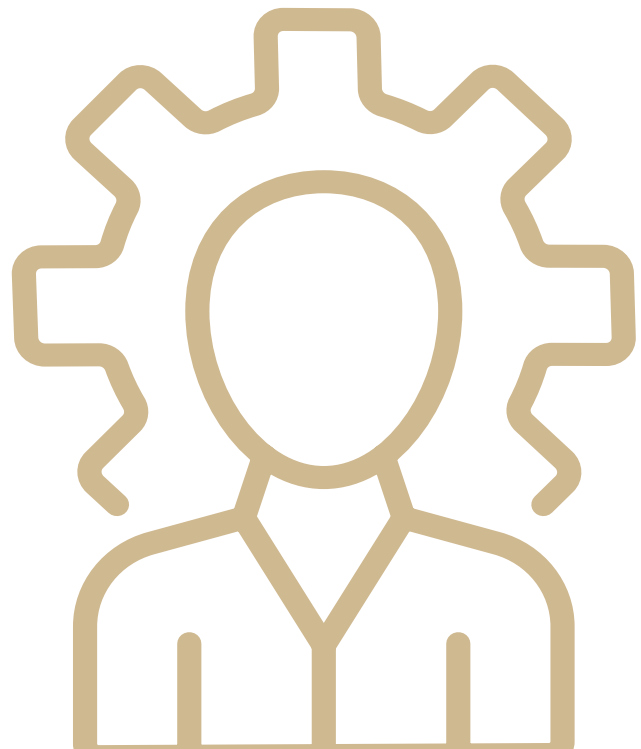
Even though the quantity of labor used in production agriculture has been declining for decades, improving labor efficiency and finding the “right people” for the “right jobs” remains imperative to the success of farms and ranches. In general, labor efficiency can be improved by investing in more capital per worker and/or the adoption of less labor-intensive technologies. As a farm increases capital per worker, particularly in today’s environment where many of the new technologies utilize automation, it is important to assess whether the farm’s employees have the prerequisite capabilities and skills to fully take advantage of new technologies. As noted by Langemeier and Boehlje (2017), technology is a key driver influencing both financial performance and consolidation in production agriculture.

Precision farming will require a different (or at least enhanced) “mental model” of the farm manager and farm workforce. Choosing and using precision farming tools and technologies requires an enhanced appreciation and understanding of science and fact-based decision making. This includes a more advanced understanding of the biological and physical sciences to frame these decisions, and the ability to use data analytics and quantitative analysis tools such as statistical analysis and optimization models to make these decisions. It is thus essential to bring new capabilities and skills into the farm of the future.

Skill Assessment

One of the ways to get a handle on the farm’s ability

and proficiency with regard to a skill set such as working with new technologies is to perform a skill assessment, which simply stated is an evaluation of each individual’s ability to perform a specific skill or set of skills. A skill assessment measures what employees can do, and does not distinguish whether those skills were obtained through education or experience. Skill assessments are often used when recruiting, for career development, and when rapidly adopting new technologies which require new skills, reskilling, or upskilling.



A couple of previous articles discussed production skills and management practice skills. Langemeier (2018) noted the importance of using a suite of technologies that provides the most efficient use of inputs; employing consultants to assist with difficult or complex production problems; and identifying, monitoring, and benchmarking key production efficiency measures. Langemeier (2019) discussed the importance of developing a strategic plan that

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What Will Be the Capabilities... (continues from page 8)

identifies “strategic issues”. One of the components of a strategic plan is a regular assessment of technology needs for the business and a financial plan that examines how the business is going to pay for new technologies.

Skill Gaps

The emergence of precision farming and in particular automation technologies is rapidly changing the nature of work for all businesses, including farms and ranches. To maintain a competitive advantage, farm operators will need to take a more active role in identifying the capabilities and skills needed by the business, and to develop mechanisms to recruit, train, and retain employees. As part of a skill assessment, it is important to identify “gaps in capabilities and skills” and to determine how the business is going to address these gaps. The discussion below will first discuss potential gaps in capabilities and skills and then pose some potential responses to these gaps.

As noted by Manyika et al. (2017) and Willcocks (2020), automation could perform certain tasks at medium to high performance. For example, general equipment and navigation, inspecting and monitoring, basic data input and processing, and basic communication could be performed relatively well with automation technologies. However, capabilities pertaining to creativity, leadership, complex information processing and interpretation, and advanced IT skills and programming would be difficult to emulate with automation technologies. In particular, tacit knowing or the fact that humans know more than they can describe is problematic to automation (Polanyi, 2009). Obviously, tacit knowledge makes it difficult to write code for machine learning.

Table 1 illustrates current capabilities and skills with potential future skills needed in production agriculture. This table was adapted from Willcocks (2020). To summarize the table, skills related to those that are difficult for machines to emulate (e.g., creativity, leadership, strategic positioning, and interpretation of data and information from precision agriculture technologies) will be critical to the farms in the future. Individual farms need to assess whether they have someone on board that has these capabilities and skills. If they don't, would it be possible to contract for these skills? More options related to developing the workforce of the future are discussed below. From a time management

Table 1. Changes in Capabilities and Skills Needed in Agriculture (Adapted from Willocks, 2020)

Current	Future
Physical	Digital
Non-Technical	Technical
Non-Cognitive	Cognitive
Basic Human	Distinctive Human
Repetitive	Non-Repetitive
Low Skills	Medium to High Skills

standpoint, one of the upsides of current trends in automation is that it may free up employees to spend more time on their distinctive human capabilities and skills (e.g., interpretation of data and information from precision agriculture technologies) rather than on predictable physical work, potentially augmenting labor productivity.

In addition to discussing changes in skills needed in the workforce as businesses adopt automation technologies, Bughin et al. (2018) describe potential changes in the business workforce environment and options for companies to build the workforce of the future. Though the authors focus their discussion on businesses with numerous employees, many of the concepts discussed also apply to small businesses. In terms of the workforce environment, developing a mindset of life-long learning, stressing collaboration, and making sure that we have personnel that are responsible for leadership tasks, for supervising and training employees, and for developing a strategy to purchase and fully utilize precision agriculture technologies is important. Options for building the workforce of the future include retraining current employees, redeploying employees so that they can focus on future skills needed, hiring individuals with specific automation skills, contracting with outside parties for a portion of the automation skills needed, and removing skills that are not as pertinent as they have been historically. Even with a small workforce, farms will likely use a combination of these options rather than just one of the options.

We would be remiss if we did not indicate that there is going to be substantial competition for individuals

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What Will Be the Capabilities... (continues from page 9)

with distinctive human capabilities and skills. Having these individuals in place or making sure that one of the operators or employees has the necessary skills set is likely to be critical to a farm's competitive advantage. Thus, developing a plan to develop or obtain these skills from an outside party is very important.

Concluding Comments

This article discussed the capabilities and skills that will be needed to manage the farm of the future. As we have noted, production agriculture is changing very rapidly. Adopting precision farming and automation technologies (e.g., robotics, drones, autonomous machines) will be critical to a farm's competitive advantage. Each farm needs to evaluate whether it has the workforce in place to take full advantage of precision agriculture and automation technologies, or develop a plan to access these capabilities and skills from an outside party.

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PURDUE INSTITUTE FOR FAMILY BUSINESS (PIFB)



PIFB is aptly named to reflect its permanent and ever-important presence in the state of Indiana and at Purdue University. PIFB's aim is to enhance the knowledge of family business owners, successors, employees, advisors, and educators to improve family functioning and business success. According to PIFB's director, Dr. Maria Marshall, "PIFB's purpose is to enhance the resilience of family businesses".

Dr. Maria Marshall and Renee Wiatt (research and Extension specialist) conduct high-quality research focused on family businesses, along with Extension programming around the state of Indiana.

<https://ag.purdue.edu/department/agecon/fambiz/>

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