RIGHTRISK ...

**STRATEGY** 

"the smallest

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# **RIGHTRISK NEWS**

# Irreversible Decisions

n farming and ranching, like many businesses, some decisions have an element of irreversibility. For instance, decisions that select between alternatives and are accompanied by the requirement for a large quantity of resources and/or a large number of implementation steps can cost a lot to reverse, once the implementation phase has begun. Other decisions are simply difficult to completely undo. For example, it is hard to "un-fire" an employee. Even if the employee is persuaded to come back to work, there is likely damage to the relationship that will persist into the future.

Irreversible decisions should be made with great care. The most important aspect of doing so is making sure the irreversible choice aligns with the overall management strategy.

A strategy is defined by the Oxford Dictionary as "A plan of action designed to achieve a long-term or overall aim." Van den Steen (2017) more recently defined a strategy as "the smallest set of choices to optimally guide (or force) other choices." This suggests that decisions which inform and guide irreversible decisions may be more strategic than the irreversible decision itself. However, that does not diminish or take away from the importance of the irreversible decision.

For example, a farmer or rancher may have a marketing strategy that involves locking-in prices by mid-summer to cover at least 50 percent of expected production costs. This is a strategic decision that informs and guides future marketing decisions, many of which are irreversible.

Another example might be a farmer who makes the choice to enter into a forward cash delivery contract to deliver grain to a local elevator at harvest time. The more irreversible the marketing decision, the more the decision maker must ensure that it aligns with the overall marketing strategy. If the farmer's marketing strategy also involves leaving a percentage of ex-

pected grain production open to storage and winter marketing options, the farmer would want to make sure the quantity of grain obligated to the cash delivery contract does not exceed the quantity needed to meet the strategic objective of having storage and winter marketing options.

Van den Steen (2017)

Irreversible decisions also represent risk to the organization in making the choice. This implies care in developing a list of alternatives,



evaluating the choice. This implies care in developing a list of alternatives, evaluating their cost, as well as time spent in analysis of the potential benefits they may offer under differing assumptions about the future. The greater the degree of irreversibility, the greater care and diligence should be taken to ensure that the decision is the best possible at the time it is made.

Likewise, the more reversible a decision is, the less risk it poses to the business and the quicker a choice can be made. Obviously, determining the degree of irreversibility is a key, but often overlooked, step in the decision-making process.

Consider the situation where a producer has mapped out a strategic plan for expansion that includes the hiring of a crops manager and a livestock manager within the next six years. The producer realizes how important it is to have good people working for the operation, so the strategic plan includes a strategy for attracting and retaining good employees.

# Jou? Right for Risk Much

REMEMBER

Forage Insurance - September 30th

**RI-PRF Coverage** November 15th, 2019 for 2020 crop year coverage

**DATES TO** 

Acreage Reporting: - November 15th

> For more information see: http://www.rma.usda.gov http://www.fsa.usda.gov

## **HIGHLIGHTED TOOL**

ost of today's farms and ranches involve more than one enterprise. Production risk spread over  $\mathsf{L}$ several enterprises often contributes to their financial successes. Enterprise risk analysis – estimating net returns for an enterprise and the variability in those returns (risk) - is an often-neglected, but necessary part of developing an overall risk management strategy. The Enterprise Risk Analyzer (ERA) tool helps evaluate farm/ranch financial performance once the necessary data has been entered. Analysis includes whole farm/ranch net return, enterprise net return, break-even prices, and break-

even yields. Comparing enterprise performance and determining how much each enterprise contrib-



utes to whole-farm/ranch profitability is then possible. The ERA tool also provides risk estimates based on user projections for commodity prices and yields. The ERA tool estimates probabilities for earning a given level of net income, a break-even price, or a given break-even yield.

For More Information on the Enterprise Risk Analyzer tool, see RightRisk.org > Resources > Risk Management Tools.

### **IRREVERSIBLE DECISIONS** CONTINUED FROM PG. 1

Implementing this strategy will involve many decisions that will be difficult to reverse once they are made. For example, the previously described decision to fire an employee is nearly impossible to reverse. It is also difficult to take back a pay raise or to re-train employees once they have been trained to do things a certain way. All of these are instances where careful thought and consideration are warranted to make sure the action taken is correct and that it aligns with the overall strategy.

Other decisions might be easily reversed like the decision to hold weekly employee meetings on Monday mornings at eight o'clock. These decisions can be made quickly, knowing they can be changed if it isn't working out.



By allowing future flexibility, reversible decisions are better from a risk management point of view. However, irreversible



decisions play a significant role in getting the organization to where it wants to go.

Irreversible decisions cannot be avoided if the business truly desires success. It is important for the manager and other individuals involved to recognize these types of decisions for what they are. Once identified, time must be set aside to make sure that careful consideration is given to the alternatives available and their potential contribution to the future of the organization. Particular attention must be given to how these various choices do or do not align with overall management strategy and goals for the business.

Van den Steen, Eric. 2017. A Formal Theory of Strategy. Management Science 63(8):2616-2636.

Colorado

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EXTENSION



# **RightRisk helps decision-makers** discover innovative and effective risk management solutions.

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