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FARM BUSINESS OVERVIEW FACT SHEET

GRDC Grains Research & Development Corporation

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SOUTHERN REGION

HOW DO YOU KEEP TRACK OF YOUR FARM BUSINESS PERFORMANCE?

Maintaining a sound business management discipline of **measuring** business performance, using this information for **planning** and then **learning** from each year's results, will ensure a healthy and sustainable business.

KEY POINTS

- Essential farm business management tools.
- Indicators of farm business sustainability.
- The management cycle - plan, monitor and review.

Key Management Concepts

When managing any business, it is good to have both of the following concepts in mind:

1. **Liquidity** – This refers to cash flow which should be managed to ensure more cash comes into the business than goes out.
2. **Efficiency** – This addresses the issue of whether the farm business is getting the best return on the capital being managed, and is measured through both a profit and loss and a balance sheet budget.

By managing both of these concepts (see Figure 1), the farm business will have a greater ability to be sustainable.

What farm business 'tools' do you need?

For a farming business to have a long-term future, it needs to be efficient and have an ability to grow. A business that does not grow over a period of 10 years will be going backwards, not standing still, and this can only be tracked properly by measuring the key indicators of the business health of a farm. But what are the tools that provide these indicators? Knowing the right financial tools to use to assess your business decisions will depend on your long-term business goals. Most farmers have one of two business goals – these, and the financial 'tools' to achieve them, are outlined in Table 1.

When do I use these financial 'tools'?

Each year, you should have a major planning phase which follows an accurate reporting of the previous season. Your tax return and cash flow reporting are not sufficient to give all the information your business needs.

Business planning cycle

Regularly monitoring business performance by evaluating indicators of profit, cash flow, net worth, equity and return on capital is the only way of knowing whether failure is only days away, or whether there is capacity to expand and continually improve aspects of the business.

Every well managed business should have a planning cycle comprising periods of goal setting followed by action and monitoring, with results feeding back into the re-setting of goals and targets. It can be an annual cycle (Figure 2), quarterly or monthly cycle, depending on the intensity of the business.

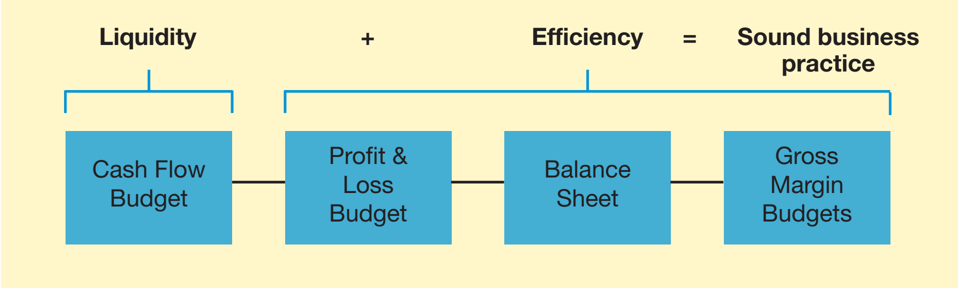
Farm business management requires focus on both part and whole business measurements in order to find business solutions and test business decisions. Your business feedback will come from a combination of the following farm business performance 'tools': Profit and Loss, Cash Flow, Balance Sheet and Gross Margins.

Key business tools and indicators

Profit and loss, cash flow, balance sheets and gross margin budgets provide the fundamental business planning and recording tools for the farming business. They should be used for planning and then be completed as 'actuals' at the end of the season, so that the business performance is monitored.

If a business has a clear set of goals then these budgeting tools can be used to assess how well the goals are being met. These tools provide key measures of business health, sustainability and wealth generation. Without knowledge of these tools, the owner or manager of the business is 'running blind' and it is more difficult to manage business risk and capitalise on opportunities. Without this set

Figure 1 Liquidity and efficiency



Source: *P2PAgri Pty Ltd*

Table 1 Financial 'tools' to guide your farm business management

Farm Business Goal	Financial 'tools' needed to track business health	What do these 'tools' indicate?
1. Continue to build the farming business for the next generation.	• **Profit & loss**	**Profit** - the measure of profit gives the financial performance of the business.
	• **Cash flow**	**Cash availability** - measures whether the business can meet its obligations of loan repayments and the required living standards of the owners.
	• **Balance sheet**	**Net worth** – growth indicates the business's financial stability. **Return on capital** - with profits, measures business efficiency. **Equity** – measures the percentage of assets owned.
	• **Gross margins**	**Enterprise profitability** - compares relative profitability between the farm enterprises.
2. Maintain farm value as superannuation for the current generation operating the farm.	• **Cash flow**	Measures whether the business can meet its obligations of loan repayments and the required living standards of the owners.
	• **Balance sheet**	Measures the owner's wealth if the business is sold.

Source: *P2PAgri Pty Ltd*

of budgets, business failure can come as a complete surprise.

1. Profit and Loss

Profit is a key business indicator and will vary significantly from season to season because productivity is affected by seasonal growing conditions and commodity prices by market volatility. The profit level achieved will depend on the size of the business and the cost structure. A **viable farm** by definition has a profit greater than $0 in an average season, but a **sustainable farm** will need a figure significantly above $0. What this figure should be depends on the size of the business and its goals. However, a figure of at least $50,000 per family unit would be a good start. A very good farming business is one that does not experience losses, even in a drought or major commodity price down-turn.

Expected profit improvement is the test to use when assessing any change proposed for the business. Figure 3 provides a pictorial insight into the measurement of 'net profit' and business growth.

2. Cash Flow

The banker's truism that 'a positive cash flow is king' has significant validity. Most business failures occur because of an extended period of poor cash flow. In general terms, the more that cash coming into the business exceeds the amount of cash going out, the healthier the business.

While this is a simple concept, the challenge is to continually monitor it, best done monthly with a 12 monthly cash flow budget.

A sound cash flow is needed to build reserves for more challenging seasons.

It also tells the owners and bankers of the business's ability to meet its lending obligations, which is another key performance indicator. Figure 4 shows the elements of a cash flow.

3. Balance Sheet

Figure 5 shows the components of a balance sheet.

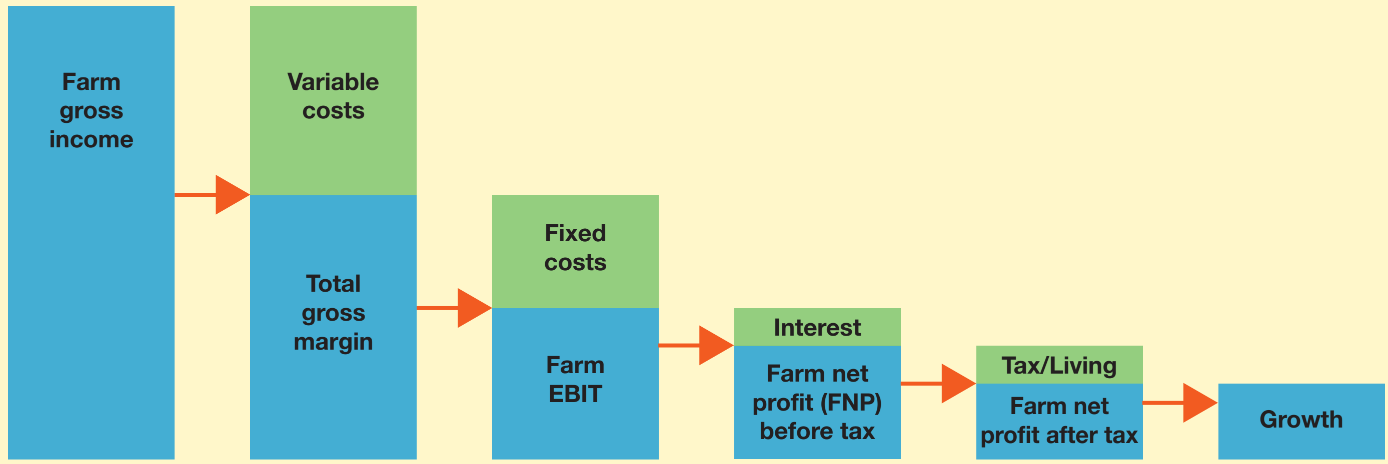
Some farmers question the use of a balance sheet as they do not plan to sell the farm. Despite this, a balance sheet does provide a great measure of business success if monitored over a period of time. Also, if you are borrowing money from a bank, a balance sheet is essential for banks to assess the security you offer them in exchange for the loan.

The key indicators from a balance sheet are:

Figure 2 Farm business yearly planning cycle

Source: *P2PAgri Pty Ltd*

Figure 3 Profit and loss



Source: *Assoc. Prof. Bill Malcolm, 'Pursuing Growth without Regret in Risky Crop-Farming'*

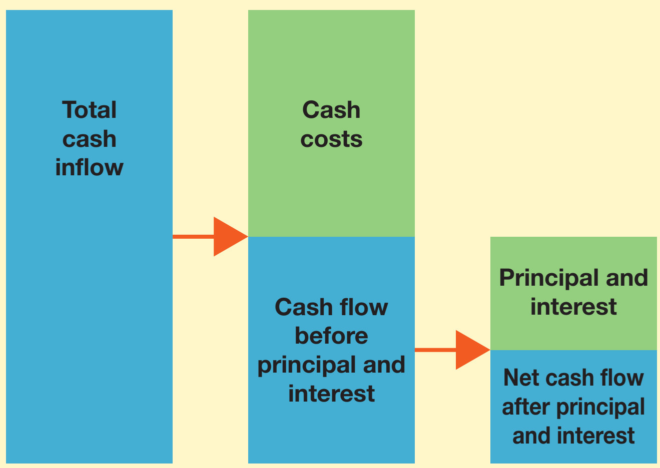
- **Net worth** is the best single indicator of how a business is performing over time. Net worth is the difference between total assets and total liabilities. In a sustainable business, this figure grows over the years. It is good to measure net worth annually, on the same date each year, and monitor its growth. If it is not growing, then the business will be in danger of becoming non-viable in the long-term.
- **Equity** is another measure of net worth but is measured as a percentage of the business' total assets. It indicates the financial security of the business. It is calculated as business net worth divided by total assets and indicates how much of the business is owned by the farmer. As an indicator of financial stability, dryland farmers should aim for more than 70% equity.
- **Return on capital** - If you are interested in measuring the efficiency of the business, then the best measure is return on capital. It is calculated by dividing profit by the total assets managed by the farm. Greater than 8% return on capital is considered to indicate a very efficient farm business. Unfortunately, most Australian dryland farms are performing between 2% - 3% efficiency.

4. Gross Margins

Gross margins are used to compare the relative profitability between a farm's enterprises. A gross margin is the difference between the gross income (yield x prices) less the cash costs (also known as variable costs) of the enterprise. As land is usually the most limiting resource on a farm, the gross margin is normally expressed as $/ha. So, if a wheat gross margin is $350/ha and barley is $275/ha, then wheat is more profitable than barley. The key to using gross margins is balancing the financial expectations with the agronomic requirements of the farming system. Some enterprises provide complementary benefits rather than just being competitive for land; for example, grain legumes provide nitrogen to the following season's crop.

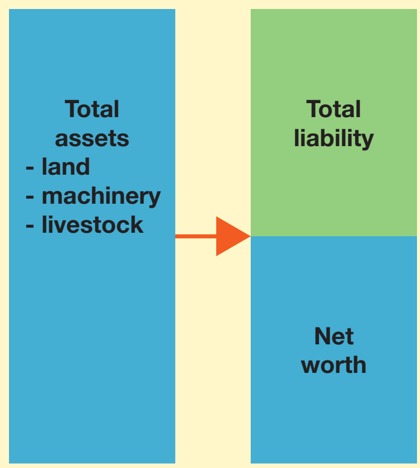
The measure of actual gross margins provides essential profit measures of the components of the whole business.

Figure 4 Cash flow



Source: *Assoc. Prof. Bill Malcolm, 'Pursuing Growth without Regret in Risky Crop-Farming'*

Figure 5 Balance Sheet



Source: *Assoc. Prof. Bill Malcolm, 'Pursuing Growth without Regret in Risky Crop-Farming'*

Other commonly used performance measures:

• Benchmarks

While they provide some specific farm information, benchmarks are only reference points, not indicators of business performance.

Most business benchmarks are ratios and should be used to identify the issues a business needs to focus on and not be used to provide solutions. Benchmarking assesses only parts of a business, whereas solutions require consideration of the whole business.

For example, issues that may be guided by benchmarking include lambing percentage, weaning rates, water use efficiency, machinery value / tonnes of grain produced and the various bank ratios. However, while these highlight specific components of the business, they do not provide the whole business picture.

• Tax Returns

Tax returns are legally required to be completed annually to assess what tax the business is required to pay the Australian Taxation Office (ATO). As they are a legal document, banks rely quite heavily on the information provided in the tax return. Please note they do not provide complete business performance measures as they are completed to ATO rules. While they do have a 'profit and loss' and a 'balance sheet', these do not provide a true measure of management profit or a true financial record of the business assets and liabilities. Unfortunately, many Australian farmers use their tax return as their major measure of farm business performance, and at best this document provides only a very approximate guide to this and is a very poor planning tool.

With a little more effort, you could get your accountant to produce a set of management budgets in addition to the tax budgets: a 'management profit and loss' will provide a better measure of business performance and a 'management balance sheet' will give an accurate measure of equity. These would then provide an excellent set of financial records that can be used to improve the management of the business.

FAQs

How essential is it to run a management accounting or farm business management system in my farming business?

It is excellent business practice to plan and have a good set of farm business management records and budgets to set the foundation for business planning and provide the best chance for success into the future. However, there is no legal requirement to have this information completed for the farm business and many farmers rely on their intuition in decision making. There is also little safety net for 'going broke' and a sound set of management information will help minimise business risks.

Can my business be run by just using industry benchmarks

No, for a healthy business there is no replacement for having a well recorded set of farm business management records. Benchmarks are interesting and useful to indicate where the business is positioned in the agriculture sector. However, as there is a large range of farming businesses, comparing between them has many limitations. The best use of benchmarks is to compare them within a business over a number of seasons. In this way, you are comparing 'apples with apples'!

Can my accountant provide me with a set of farm business management budgets?

Unless you ask an accountant for this information, they will not usually provide it as they assume their role is to calculate the business tax liability. It may cost you more to obtain this business management information, but it is worth it if it gives you a greater ability to manage your business. So, begin by asking your accountant for information on your business's efficiency, viability and the relative profitability of the various enterprises in your business. If they cannot answer these questions, find a professional advisor who can, or attend workshops and courses to learn how to do it yourself.

Is there farm business software available to put together a set of farm business management budgets?

Yes, there is a number of farm software packages available, depending on what you are after. Most professional agronomists have software available that can do gross margin budgets for cropping enterprises. There is less software that can do 'whole farm' budgets but these include Phoenix, Agrimaster and P2PAgri software packages. Check them out.

Why is farm business management budgeting a good idea?

Although it will take effort to get a good set of farm business management budgets together to record the farm business performance, measuring business performance will mean you can more accurately assess if the business is achieving its goals. The 'thinking' behind the farm business management budgets is the key ingredient to maintaining business performance. There is a saying, 'If you don't measure it how can you manage it!' Farm business management budgets provide an excellent approach for testing what strategies are needed for the business to achieve its goals. However, it does take discipline. Either learn how to complete your own farm business management budgets, or hire a professional to do this task for you.

USEFUL RESOURCES

Related GRDC Fact Sheets
Other fact sheets in this Farm Business Management series provide further detail on farm financial tools: Cash Flow Budget (Order Code: GRDC913), Profit and Loss Budget (Order Code: GRDC916), Balance Sheet (Order Code: GRDC917), Crop Gross Margin Budget (Order Code: GRDC914) and Livestock Gross Margin Budget (Order Code: GRDC915).

Copies of all the above fact sheets are FREE plus P&H and available from:

Ground Cover Direct Freephone: 1800 11 00 44 or email: ground-cover-direct@canprint.com.au

These can also be downloaded from www.GRDC.com.au/fbm

'Pursuing Growth without Regret in Risky Crop- Farming', Assoc. Prof. Bill Malcolm, 'Cropping in hard times' Conference, Horsham, July 2010.

Plan to Profit (P2P), a whole-farm financial management program that can help calculate a farm's financial budgets: www.P2PAgri.com.au

MORE INFORMATION

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