OCTOBER 2015

GRDC Grains Research & Development Corporation
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BUSINESS MANAGEMENT FACT SHEET

USING PROFIT TO MANAGE VOLATILE BUSINESS PERFORMANCE

Building financial reserves and equity in good years, to provide buffering against the impacts of low income years, are keys to financial success in today's high cost farming systems. What can you do during years of favourable returns to influence business performance during periods of low returns?

KEY POINTS

- Appropriate use of profits in the good years plays a key role in overall financial success of your business.
- Convert profits into increased equity by investing profits into financial buffers, debt reduction or capital for business growth.
- Using equity growth as a financial buffer against future losses allows your business to survive and ride out the down times.

The role of undeductable expenses

It is easy to get confused about yearly business profits when the accountant's financial statements show a taxable income profit and your bank balance shows a loss. The difference relates to undeductable expenses.

Undeductable expenses that contribute to equity growth such as debt repayment and capital purchases are a valid part of business management as they help grow the balance sheet. However, expenditure on non-capital items, such as lifestyle choices and family needs, reduce your bank balance without increasing equity resulting in a genuine loss which will require future profits to recover.

Where do the profits go?

Consider the different areas to which profits can be allocated, and the impact on the business's equity (Table 1).

Profit volatility

Whole-of-business costs have doubled over the last decade according to analysis by Ag Profit. However, costs are not as variable as income from year-to-year. The variation in income, due to rain, climate and commodity price, have resulted in larger losses in low income years and strong profits in good seasons.

This increase in profit volatility has made building financial resilience through careful use of profit even more critical.

Determining where to allocate your profits

During the life of your business, it will go through the different stages of the business life cycle and encounter a variety of challenges that have different financial implications. Where you allocate the profits shifts according to your stage of the business life cycle (Figure 1).

In the **emerging and growing stages** of a business, equity is low, indicating financial risk is high. Allocating profits becomes a balance between investing to improve productivity, growth in scale and investment in capital, while maintaining tight cash flow and curtailing lifestyle choices. Machinery purchases are likely to be second-hand and the focus is on buying small parcels of land, with the main growth occurring through lease or share farming.

Ways to increase equity through use of profit:

- debt repayment;
- farm management deposits;
- supperannuation contributions;
- capital investment in land, machinery or improvements;
- off-farm investments such as real estate or shares; and
- business expansion, including leasing or share farming.

TABLE 1 Summary of areas for profit allocation*

Financial buffers	Business growth	Lifestyle	Off-farm
Cash reserves	Machinery upgrade, which results in ongoing machinery finance costs	Team bonus, such as additional drawings	Superannuation
Farm management deposits	Land purchases, which increase debt, as well as scale, production and income	Holidays	Holiday house
Debt repayment	Business diversification, such as value adding	Upgrading the car or kitchen	Diversifying into external businesses
Growing the business, such as expanding business turnover through leasing or share farming			Hobbies

*Assumes personal and/or family needs have been addressed.
Note. Tax is paid on undeducted allocations, such as business capital growth or lifestyle choices. Consult your tax adviser for further advice.

FIGURE 1 Different stages of the business life cycle and the associated level of equity

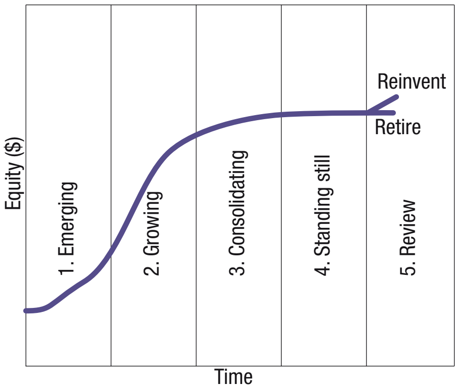

TABLE 2 Setting priorities for profit allocation using a profit allocation line

Profit $ ('000)	Priorities for allocation of profit
0–20	Debt repayment on term loan to bank
21–40	New machinery to replace old technology
41–50	Bonus paid to family to recognise achievements
51–80	Superannuation for older generation, as part of retirement plan
81–100	Farm management deposits (FMDs) for the younger generation
101–140	Machinery upgrade, capital purchase
141–160	Debt repayment on term loan to bank
161–170	Bonus to employees
171–200	Bonus to family, such as a special holiday
201–250	Superannuation and FMD contributions

Note. This illustrates the concept of profit allocation prior to tax implications. The profit allocation line would be adjusted according to individual circumstances. Consult your tax adviser for further advice.

Once a business reaches the **consolidation stage** there is equity in business assets, which act as a financial buffer. This equity can be used to cover a poor year, allowing the business to carry a higher level of financial risk. Profit allocation can be directed towards property investments and capital investments with some debt reduction. Redrawing equity to seek new business opportunities and upgrade machinery with new technology may be on the cards. There is a risk of burn-out at this stage so holidays become important to balance lifestyle.

Standing still businesses are safe and comfortable. There is little desire for growth through additional debt and the priorities become clearing debt and looking to investments off-farm, with a focus on tax management tools such as farm management deposits and superannuation. These businesses transition into **re-inventing, retiring, or transition** to the next generation.

The profit allocation line – creating a plan for your profit

As part of your strategic planning or annual business review, determine your intentions for future cash-flow profits. One way to do this is using a profit allocation line. A profit allocation line maps out the preferred allocation of profits in $20k to $50k intervals (Table 2). It assumes that $0 profit is the point where essential living and family needs are covered and all scheduled budgeted items are paid, including machinery finance repayments.

It is important that all members of the business have discussed and agreed on the profit allocation line prior to the start of the next year. This allows positive discussion around what can be achieved and removes the emotion from spending when money is in the account. It allows for rational communication of the needs and preferences of individuals in the business and sets up realistic expectations about the order of fund allocations.

FREQUENTLY ASKED QUESTIONS

How do I know how much cash flow profit I have available for allocation?
Cash flow profit refers to dollars left of last year's income once all next year's costs are subtracted. If there is a surplus remaining then this is your cash flow profit and its allocation is discretionary according to your predetermined profit allocation line.

Is debt reduction a financial buffer?
Yes. Debt reduction results in equity growth which may be redrawn if needed to cover future losses or for deposit on asset purchases.

How much should I spend on machinery capital purchases?
This depends on your business life cycle stage, other costs in your business that may need higher priority, such as debt reduction, or the likely benefit to production and efficiency through machinery upgrade. A quick check of your benchmarks and current machinery efficiency will help to determine priorities.

USEFUL RESOURCES

Farming the business, sowing for your future
www.grdc.com.au/Resources/Publications/2015/01/Farming-the-Business-Manual

A range of farm business management fact sheets can be downloaded at:
www.grdc.com.au/Resources/Farm-Business-Management

Machinery investment and costs
www.grdc.com.au/FBM-MachineryInvestmentAndCosts

Your farm business management checklist
www.grdc.com.au/FBM-Checklist

Farm financial tool: balance sheet
www.grdc.com.au/GRDC-FS-FFT-BalanceSheet

Farm financial tool: profit and loss budget
www.grdc.com.au/GRDC-FS-FFT-ProfitLossBudget

PROJECT CODE

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This Fact Sheet is produced as part of the GRDC's Farm Business Management initiative.

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