

VALUING FAMILY DRAWINGS AND YOUR MANAGEMENT FACT SHEET

SOUTHERN REGION

WHY SHOULD YOUR MANAGEMENT BE VALUED IN YOUR FARM BUSINESS?

Australian farmers own and manage complex businesses in risky environmental and marketing conditions. They provide these businesses with valuable labour and management but rarely pay themselves the commercial rates for these services. Are you under-valuing your management?

KEY POINTS

- Value your labour and management at commercial rates to accurately assess your business's true financial capacity and performance.
- Do your farm business management decisions reflect your business goals? Is it a lifestyle business, or is the goal to develop an efficient and sustainable business?
- Family drawings should be valued in your farm business accounting.
- Valuing your management could be the key to improving farm business performance.



Correctly valuing your management is sound business practice

Why many farmers pay themselves a drawing only

Most farmers have a passion for agriculture and their family farm, and it is this passion that gives them the perseverance and resilience to endure the cyclical financial performance their businesses experience.

This passion is often driven by family heritage – they inherited the family farm from their parents and in turn wish to give the next generation the same opportunity to farm as they have had. As a result, farmers often sacrifice personal income so money can stay in the farming business to fund working capital requirements.

Does your management reflect your farm business goals?

Farmers who look only to short-term viability will be focused mainly on the cash

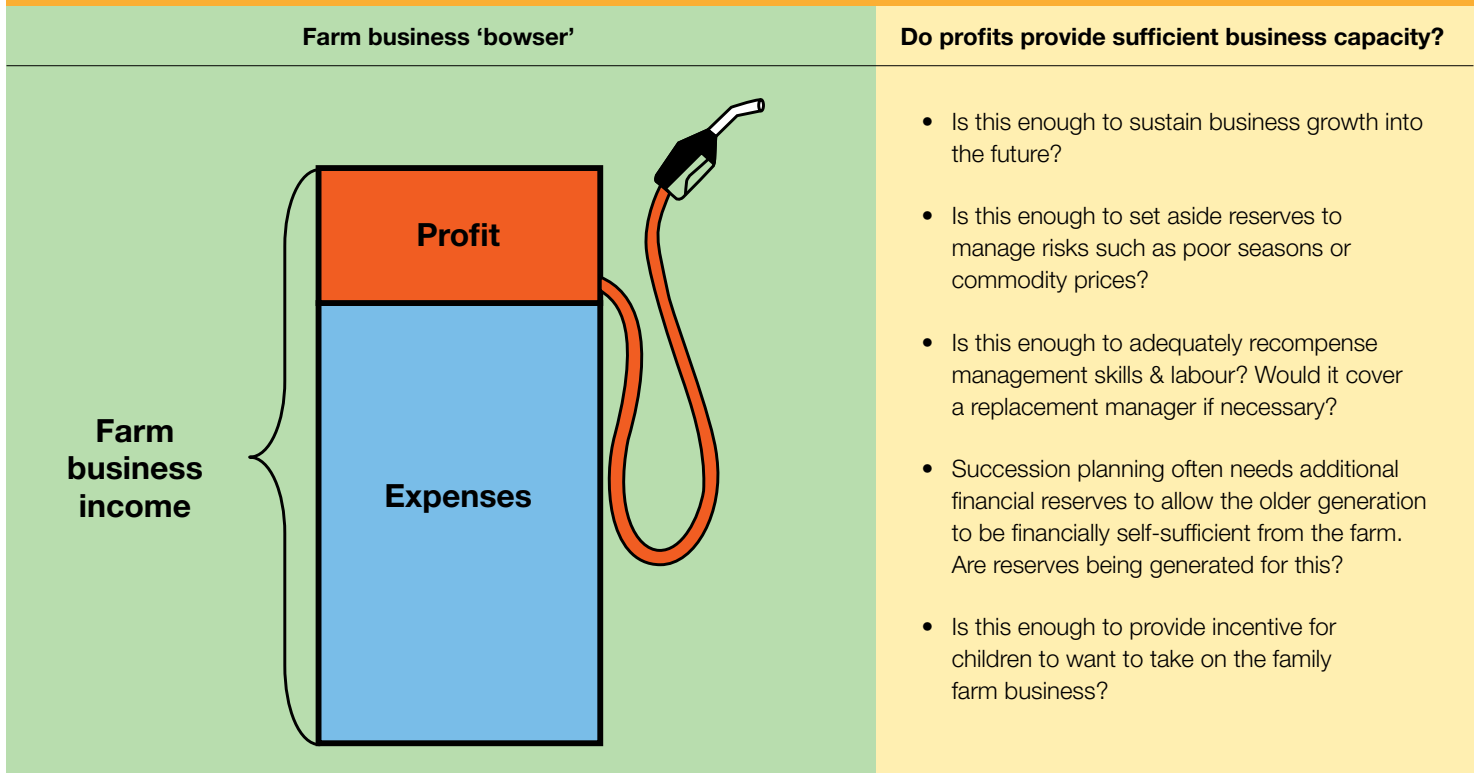
flow from year to year and may only use a cash flow budget to manage their farm business. Even though they may only be just making 'ends meet' with enough cash to cover business costs, including the family drawings, they feel they are doing OK.

Paddock names reflect the history of changes in Australian agriculture

When you ask farmers about the names of their paddocks, common names that regularly appear include 'Ram Paddock', 'School Block' and 'Shearing Shed Paddock'. However, previous land owners' names also regularly appear, such as 'Schmidt's Paddock', 'Smithy's Paddock' and 'Jack's Paddock'. These paddocks were once entire farms for previous owners, and

reflect the trend in Australian agriculture toward increasingly larger farm size as a sustainable business. Many factors, including technological developments, have facilitated this trend. But it is not just an historical trend – it is a slow but constant evolution, and is still happening today. What are you doing to prevent your farm becoming another farmer's paddock in 50 years' time?

Figure 1 Financial capacity in a farm business



These farmers are sometimes referred to as 'lifestyle farmers'. This is fine if the goal is to be 'viable today' and the business may well remain viable for the short-term.

However, if the business is unable to save significant surplus cash in most years, financial reserves will probably not be enough to sustain it through difficult periods such as drought, and the business may not remain viable in the long-term. Building business wealth (sometimes viewed as surplus cash) is needed to help a business manage seasonal and market price downturns, adopt new proven technologies and expand when the opportunity is available. These surpluses will greatly add to a business's long-term success.

The financial challenge to farm businesses

Farmers more concerned with long-term financial sustainability may require different business thinking to ensure their farm business has the financial capacity to meet their goals. (Figure 1).

The key to achieving long-term farm business sustainability is to measure profitability and efficiency, in a similar way to 'corporate agriculture', by looking at business performance (profits) and business efficiency (return on capital). If family farms are to assess their business in this way, they

need to value all of their costs at commercial levels. This would include valuing machinery depreciation and their own management and labour at market rates.

What do farmers typically pay themselves?

Farmer estimates of family drawings can vary from \$20,000 to \$120,000 per year per family, depending on the age and number of family members and whether the children are going to boarding school or university.

Most farmers pay themselves out of the farm business cheque account for the weekly shopping, medical, educational and personal needs. Since this expense item is not tax deductible and is therefore not required by the accountant in order to complete the farm's tax assessment, this major expense is not necessarily recorded. If a farm uses a computer-based accounting system, then family drawings are more easily recorded and some of these farm businesses have a greater understanding of their living costs. There are significant benefits to recording these costs:

- It is important to know what the family drawing is so that this cost can also be monitored and managed like any other cost in the business.

- Once you accurately know the family drawing requirement, you can budget to measure whether the farm business can sustainably meet this objective through the range of seasons it experiences.

- This information also greatly informs the various strategies for succession planning, when generational transfer is occurring.

What are the market rates for labour and management?

Currently, the market rates for labour on a farm vary between \$18.54/hr to \$25.76/hr, which equates to \$48,204 - \$66,976 per year (considered data from AgProfit). However, if a farm manager had to be hired for a year, depending on the quality of skills and experience, it may cost from \$80,000 - \$120,000 per year. This is the owner/operator's true value to the farming business. Another way of looking at this is what it would cost the farm business to replace its owner/operator for a year and hire a professional farm manager.

Why should you value your labour and management at market rates?

If the true 'market value' of an owner/operator's labour and management were used, two key calculations could be made:

1. Time efficiency - The owner's time may be allocated to more effective higher level management activities. For example, they may be in the office closely managing the 'grain selling' activity rather than doing a lower cost job such as mending the fences. The opportunity cost of doing the reverse, fencing instead of managing 'grain selling', could be significant. If management is perceived to be a resource of greater value, it can be used more efficiently in the business. In other words, management and labour should be allocated a value and the farmer put his energy into more profitable activity.

2. Business efficiency – The true measure of business efficiency is the financial ratio Return on Capital (ROC), measured by Annual Profit (EBIT) divided by Total Assets managed. According to AgProfit farm survey data, dryland farms in the Wimmera Mallee for 2010 – 2013 averaged 4.3% ROC, which is well below the efficiency benchmark set by economists of 8%. If farmers use family drawings as the cost of owners' labour and management, they would actually be undervaluing this cost and artificially inflating the profit calculation, which would in turn give a higher ROC calculation. If farmers used the market value for owners' labour and management, the ROC would be lower. If farmers challenged themselves to 'raise the bar' and look for strategies to obtain a more efficient ROC, businesses would be more likely to improve performance and sustainability. (Other useful financial ratios are discussed in the Key Financial Ratios Fact Sheet, referred to in Useful Resources).

The challenge is to value the owner's labour and management at market rates, then correctly measure management profits and business efficiency. Once the correct efficiency is determined, it needs to be assessed against the recommended level of 8%. If it is lower than this level, what part of the business can be improved so that it can be achieved in the future?

How can management improve business capacity?

Farm businesses have adopted a number of wide ranging strategies to achieve improved business performance.

These include:

1. Expanding the business by managing/ buying additional land. This additional land can be obtained by purchase, leasing agreement and/or share farming where the land owner and farmer share in the gross margins.

Case study: The long-term impact of business expansion through land purchase

Farmer A & Farmer B were both interested in buying the same block of land.

Farmer A's father had expanded his farming business through buying more land, which meant that although the business was passed on to the next generation with debt, the farm grew and maintained efficiencies.

Farmer B's father's goal was to pay off the farm debt and pass on the farm debt free. As a consequence, although debt free, this farm did not grow in the 30 years it was managed by his father.

The parcel of land was eventually bought by Farmer A for \$1,000/ha (\$400/ac).

Farmer A's business capacity was such that the parcel of land could have been purchased for \$2,000/ha (\$800/ac).

Farmer B's business capacity was such that the parcel of land could only have been purchased if it were \$500/ha (\$200/ac). Essentially, the business was too small to gain efficiencies. The only sustainable strategy left for land expansion was taking on land through leasing or share farming. In reality, Farmer B purchased other land at a later date, but unfortunately the lack of financial capacity meant this farm eventually went out of business.

The take home message of this case-study is that business expansion, managed well, assists with long term sustainability. Also, *sound financial analysis works*, as Farmer B was advised the business did not have capacity to purchase additional land at market prices. Farmer B ignored this analysis to his peril.

2. Increasing productivity through improved technology. This could include improved seed and fertiliser placement, improved fertiliser rates through the use of yield mapping, and clay spreading on sandy rises. An example of the impact of improved technology is the adoption and success of direct drill. Farmers are now achieving yields in low rainfall years where farmers of 20 years ago using 'work up, work back' would have experienced no yields. This means that direct drill technology has allowed profits to be achieved in low rainfall years where this would not otherwise have occurred.

3. Decreasing costs through the use of improved technologies. These include auto-steer for operations to decrease chemical and fertiliser overlapping and to improve labour efficiencies. Farmers have reported that their chemical and fertiliser use declined in the order of 10% due to managing overlapping, which occurs when full coverage of a paddock is attempted without auto-steer and associated mapping technologies.

4. Decreasing costs through changes to the business structure. One such example is machinery syndication. Numerous studies and books point to the economic benefits of machinery syndication as it helps spread overhead costs. Machines are efficiently used when they are at their capacity, and generally a single farm finds it difficult to achieve this. Spreading the machine among a number of farmers makes economic sense, as it achieves optimum machinery use and spreads cost of ownership.

5. Using farm boards with independent members is one of the biggest growth areas in Australian farm management, driven by the increasing complexity of managing a farming business. While there are different ways of developing farm boards, essentially they should all provide improved accountability, decision making, management of assets and business governance. Your business advisers may be a good starting point to investigate this strategy.

6. Using professional advisers with expertise in the enterprises being managed in the business to provide up-to-date information and knowledge to management. In the last 20 years, there has been a large increase in private farmer advisers, particularly agronomists.

Largely driven by improved cropping technologies and the use of chemical weed control, this advice has led to increased yields and crop production.

- 7. Using improved business models** to allow for larger operations. An example of this is 'collaborative farming' where a number of smaller farming operations have been combined to allow for improved labour, and overhead and machinery efficiencies.

Case study: Collaborative farming

The 'Bulla Burra' farm operation in SA Northern Mallee is an excellent example of farm collaboration. Two farms have come together to combine management, labour, machinery ownership and to lease additional land. The objective has been to improve business efficiencies while separating land ownership from the business of farming. All land is leased regardless of who owns the land, so the original farmers get an annual lease for their land. Larger machinery has been purchased and matched to the labour and land area to achieve optimum efficiencies. In 2010, the financial benefit of this collaboration was demonstrated when the cost of wheat production decreased from \$204/t as a single farm to \$171/t for the collaborative farm. The new business model improved profits, lowered costs of production, rewarded innovation and provided an improved quality of life for all involved in the operation.

- 8. Using decisions support tools** such as 'Plan to Profit' (P2P) to assist with financially modelling the possibilities and identify the subsequent risk profiles of the business. Farming is a complex business and risks have recently significantly increased with fluctuating commodity prices and seasonal variations. Computer modelling the farming business has greatly assisted farmers in decision making. The ability to model the 'what-if' questions before they occur helps farmers understand the risks of various scenarios and their likely

impact on the business. While better decisions are clearer with hindsight, improved understanding increases the probability of making the right decisions.

FAQs

I have been one of those 'life style farmers' but I want to smarten my business skills to build my business to be more sustainable. How do I go about doing this?

A good place to start is to invest in your own learning as there are some great tools and farm business management skills that will help you. GRDC have a series of fact sheets on some fundamental farm business management concepts and budgeting tools. Details of how to access these are listed under Useful Resources. There may also be courses and workshops available in your area. GRDC are also conducting 'Business Update' conferences for farmers, so start to attend them. Your accountant and banker may also be a good place to start for guidance. The important thing is to be on the lookout for opportunities to learn - take these opportunities and turn them into action.

How important is management to the success of a business?

Management is the oil that runs the farm business engine. The better the oil, the better the engine will run. The quality of management is one of the greatest risks to any farm business. Conversely, it can also provide the best strategy to control risks. Continually looking for ways to improve the farm's business management is a great way to manage risk and create a sustainable business.

I'm excited about agriculture and our farming business and I'm 'putting in' as much as I can. How can I do better?

Farmers by their nature are hardworking from sun-up to sun-down and beyond, but sometimes 'working on the business' rather than 'in the business' allows you thinking time to see what can be done better. By stepping back and looking at the business, and maybe by using wise mentors (advisers, some accountants and some bankers), you will develop strategies that will improve business performance. This should also allow you

to have regular holiday breaks to allow you to personally 're-fuel'.

USEFUL RESOURCES

Related GRDC Fact Sheets

Other fact sheets in this Farm Business Management series provide further detail on farm financial tools:

- Farm Business Overview (Order Code: GRDC909),
- 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),
- Livestock Gross Margin Budget (Order Code: GRDC915),
- Production Economics (Order Code: GRDC937) and
- Key Financial Ratios (Order Code: GRDC911).

Copies of 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

Plan to Profit (P2P), a whole-farm financial management program – this will assist with calculating a farm's financial budgets: Cash Flow, Profit and Loss, Balance Sheet and Gross Margins.

www.P2PAgri.com.au

MORE INFORMATION

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