

WHAT YOUR TAX RETURN TELLS YOU FACT SHEET

SOUTHERN REGION

HOW MUCH DOES YOUR TAX RETURN TELL YOU ABOUT YOUR BUSINESS?

One of the few legal obligations on a farm business is to have an annual tax return completed, so by default, tax returns remain the number one financial record of a farm business. However, as few farmers know how to read and use them, they are one of the most under-utilised resources in a farming business. Are you getting the most out of your tax return?

KEY POINTS

- ▶ If you do nothing else with your finances, at least understand what your tax return is telling you!
- ▶ Know what your tax return is not telling you!
- ▶ If you don't understand your tax return, at least know what questions to ask your accountant.
- ▶ If you want a better business, move your financial understanding beyond your tax return.

The annual tax return

An annual tax return is required by law to be undertaken on each Australian business entity. For some farm businesses this means numerous tax returns as they can have a partnership and a number of trusts, each requiring a tax return. Usually, a qualified accountant is used to complete the tax returns.

Prior to the advent of the Goods and Services Tax (GST) in 2000, many farmers used to take their 'shoe box' full of receipts to the accountant annually for the tax return to be completed. Now, with having to submit the Business Activity Statement (BAS) at least quarterly, farm business finances are being recorded better than ever, and usually with an accounting software package.

The big challenge for farmers is to spend about 20% more time and develop a sound



PHOTO: P2P2P2P2

set of farm business management budgets from the financial recording that is already being completed for the tax return(s). The benefit of a tax return is that it is a legal requirement and so these records have to be completed. It sets up a sound financial recording discipline in a business. The main problems with tax returns is that they are completed using the Australian Taxation Office (ATO) guidelines and rules, and so do not provide a very good set of accounts needed to more effectively manage the business. Tax returns are only undertaken

to assess tax liability, not vital business information like management profit, business equity and business efficiency.

With a little extra targeted effort, the information collected for tax returns can be turned into a complete set of farm management budgets, which provide the fundamental measure of farm performance and sustainability.

However, as we have tax returns completed, we might as well understand what they are telling us about the business.

Table 1 Information from a tax return

	Profit and Loss	Balance Sheet
What your tax return DOES tell you:	<ul style="list-style-type: none"> The profit and loss in the tax return gives some indication of the true management profits to the business. If the business is making taxable 'losses', then this is an indication the financial performance in that financial year may not be good! They can indicate financial trends in the business. For example, if taxable losses have occurred over the last few seasons, then these indicate the business is heading in the wrong direction to maintain financial viability. Note with dryland farming, the use of a financial year means income of one season is lined up against the costs of the next season. So, tax profits are not representative of the same season. 	<ul style="list-style-type: none"> The balance sheet in the tax return does show what the total debt is on the 30th June each year. Again, if total liability is increasing from year to year, it indicates an increased reliance on the bank to maintain the business. This may also not be a good sign for the business, depending on the reasons why the debt is increasing.
What your tax return DOES NOT tell you:	<ul style="list-style-type: none"> The profit and loss does not take into account the family drawings on the business, because these are not tax deductible items. In a financial year where the farming business showed taxable losses, the financial performance could be far worse as family drawings have not been taken into account. 	<ul style="list-style-type: none"> The balance sheet does not have the most valuable capital item, land, included at the current market value. So, the business's true net worth is not measured in a tax return's balance sheet. Net worth is the most valuable benchmark that needs to be accurately measured each year in a farming business, to see if real progress is being made. It is certainly important to your banker – just ask them!

What is your level of business understanding?

There is a chronic need for farmers to understand the financial performance of their business. There is a great saying, 'If you can't measure it, you can't manage it!' So, if you're not measuring business performance, how do you know how well you are doing?

The annual tax return, while it's not the best source, is at least a start in understanding your business better.

Unfortunately, few farmers know how to 'read' their tax returns. For example, recent farming businesses had taxable losses in each of the last 5 years and yet had not grasped the financial difficulties they were really facing. No, it doesn't mean they had used good accountants who had constructed the books to allow them to pay 'no tax'. This is a dated way of thinking how well their accountant is performing!

Five taxable losses mean that these businesses are not travelling at all well. Yet

the business owners had no idea this had occurred, and what is even more damning is that their accountants had apparently not brought this 'downward financial spiral' to their attention! The really challenging question is who is responsible for this lack of understanding? The answer isn't 'totally the accountant's fault'. After all, someone in the business had to sign off for the tax returns to be submitted! And perhaps the business owners did not ask the right questions.

What information is in a tax return?

Simply, a tax return essentially tells you what tax, if any, has to be paid to the ATO. Also, importantly, banks put reliance on tax returns because they are legal documents, and are expected to be accurate.

The other two most useful pieces of information are the profit and loss budget, and the balance sheet. However, as these two budgets are not fully reported in a tax return, they should not be relied upon as

the sole measure of business viability or performance. Table 1 highlights what your tax return does and does not tell you about profit and loss, and balance sheet.

What a good accountant or financial advisor can answer

The main question arising from Table 1 is whether you or your accountant track profit/loss and total debt from year to year in order to understand the trends in the business. As a prudent business manager, you should be actively seeking this information.

A good set of farm business management budgets should be able to answer the following questions of your business:

- Was my business profitable in the last year?
- What enterprises on the farm performed well and what did not?
- Was my business efficient, in terms of return on capital? If not, why not?

- ▶ What was the cost of production of each enterprise?
- ▶ How did my farming business perform compared to other forms of investment?
- ▶ What was the growth in net worth of the business?
- ▶ Given these performance results, what could I learn from last season to help improve my management in the coming season?

A sound set of farm business management budgets can be used to record the 'actual' business financial performance and also be set up to estimate the next season's expected performance. In this way, the business is being correctly monitored.

A good accountant or financial advisor should be able to assist with developing a sound set of farm business management budgets to provide answers to these vital questions.

If your accountant or financial advisor cannot answer these questions and/or do not consider this information vital to the running of your business, then find an accountant or financial advisor who can help you.

How do I get a better understanding of my business?

If you wish to have the knowledge to do this vital business analysis and answer these questions yourself, or the confidence to ask these questions of your business advisors, the GRDC may have some answers for you. The GRDC has been actively putting resources into a number of farm business management areas by:

- ▶ Working with farm systems groups (especially in dryland areas), establishing small groups to analyse the profitability and risk of farm businesses based on real figures and then using this information to assist consultants and other farmers. This includes short courses using local consultants and accountants.
- ▶ Conducting 4-day 'Advanced Farm Business Management' courses for agronomists and farm advisors.
- ▶ Conducting 1-day 'Farm Business Management Essentials' for farm businesses.

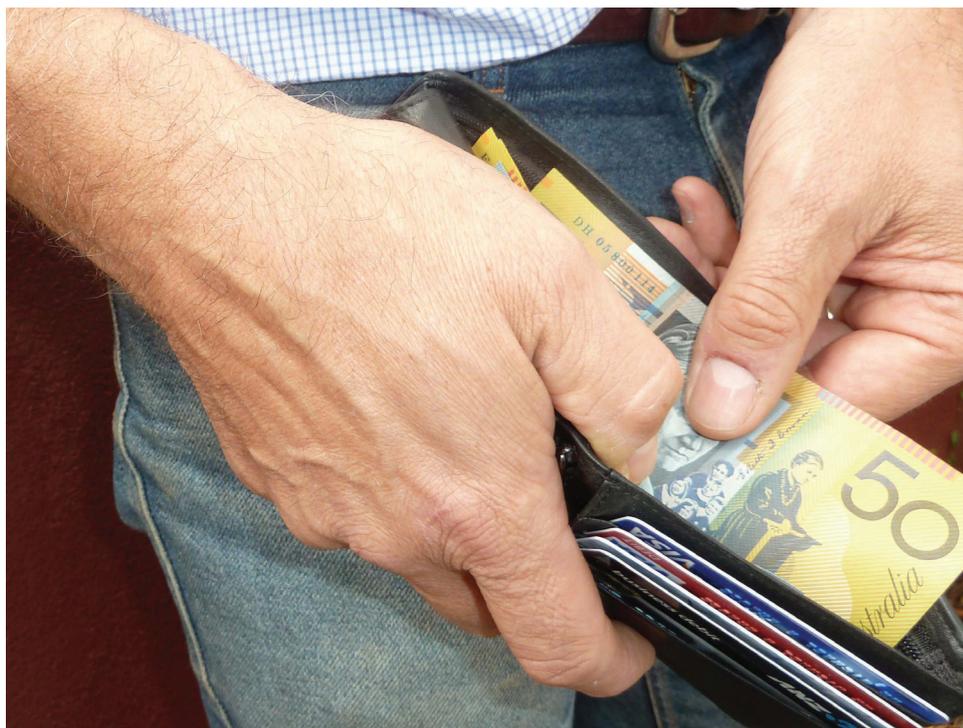


PHOTO: P2PAgr

- ▶ Running 'Farm Business Management Updates' for farm advisors and accountants.
- ▶ Developing a number of farm business fact sheets that will be released progressively from late 2013 to mid-2014 to help develop farmer and advisor thinking in this valuable area.
- ▶ Developing an e-book manual on 'Farm Business Management'. This will be available mid-2014.

FAQs

What is the benefit of using farm management budgets over tax return information?

To help manage a farming business, you should have information that tells you the relative profitability of each enterprise on the farm, the efficiency of the whole farming business, the state of the cash flow and balance sheet of the farm, and an understanding of profitability, so you can assess how well risks are being managed. A sound set of farm management budgets will give you this information. A tax return at best can only provide an approximation of business profitability, and that's all.

So to clearly steer your business to continual success and sustainability, it would be better to see all the instruments clearly on the 'business dashboard'. This is what a sound set of farm management

budgets will give you. Relying solely on tax return information is like steering your business with a 'fog affected' windscreen with little idea of what is on the dashboard!

Should my goal be to increase profits or go for a lower profit so I don't pay tax?

This is an old 'chestnut' as I have heard farmers say a 'good accountant is one where you don't pay tax'!! Essentially, if you haven't paid tax in the last few years it is highly unlikely you have made any money and the business has probably gone backwards.

So, your goal should be to make as much profit as you can. In this way, you can build the business financial wealth and improve its ability to weather poorer seasons when they come. Once you have made profits, look at ways with your accountant to minimize the tax you need to pay. This is a legitimate and sound business strategy.

How do I find a good accountant?

Before you answer this question, you will need to identify what you need your accountant to do. Understanding the main goals for running the business will guide what accountant and/or farm advisor you should use. An accountant's core skill is in completing tax returns. If that is all you want your accountant to do, then most accountants will fulfil this need. If you wish to have the improved farm business



PHOTO: P2P Agri

A tax return gives a 'rear view' or historic view of your business. To plan for the future of your business, you need to develop good management budgets.

management information outlined in this fact sheet to guide better management decisions, then ask your current accountant if they can provide these services. If they can't, then take this fact sheet to other recommended accountants and ask if they can provide you with this service. It will be a matter of inquiring of enough accountants until you find one who does.

Why do I have so many legal entities to run my farming business?

Some farming businesses have a number of legal entities such as partnerships, family trusts and maybe a company to run the business. If you are one of these businesses and do not understand why you have so many, then the answer may be that you have too many! A business structure needs to be understood for it to be well managed. Ask your accountant to help you understand the need for these entities. Accountants help farmers set up these multiple business structures to assist with tax minimization and family succession, and in some cases, to protect the farm assets

from the effects of divorce. Just remember, the more legal entities you have, the more you will pay in accountancy fees to complete the necessary tax returns.

What does the tax return tell me about the future?

By definition, a tax return is an historic record of what has happened in that particular financial year. So, it is directly influenced by the season and the commodity prices experienced in that financial year. As a financial tool to help predict the future it is restricted, and depends on how well it models the seasonal and commodity prices outcome for the coming seasons. For predicting possible outcomes, it is far better to use a good set of farm management budgets with conservative expected yields and commodity prices. You could also go one step further and model both a poor and good season, which will give the range of possible results and help judge the financial risks to the business. Information on these management budgets is available through other fact sheets in this series.

USEFUL RESOURCES

Related GRDC Fact Sheets

Other related fact sheets in this Farm Business Management series are: Marketing and Selling (Order Code: GRDC932), Leasing and Share-Farming Land (Order Code: GRDC933) and Valuing Family Drawings and Your Management (Order Code: GRDC936).

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

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

Mike Krause

P2P Agri Pty Ltd
08 8396 7122
www.P2PAgri.com.au



GRDC PROJECT CODE

AES00006

DISCLAIMER

Any recommendations, suggestions or opinions contained in this publication do not necessarily represent the policy or views of the Grains Research and Development Corporation. No person should act on the basis of the contents of this publication without first obtaining specific, independent, professional advice.

The Corporation and contributors to this Fact Sheet may identify products by proprietary or trade names to help readers identify particular types of products.

We do not endorse or recommend the products of any manufacturer referred to. Other products may perform as well as or better than those specifically referred to.

The GRDC will not be liable for any loss, damage, cost or expense incurred or arising by reason of any person using or relying on the information in this publication.

Copyright © All material published in this Fact Sheet is copyright protected and may not be reproduced in any form without written permission from the GRDC.