Acknowledgments

This document is part of the Plan, Prepare, Prosper program that was developed under the Pilot of Drought Reform Measures ('the pilot'), a joint initiative between the Australian Government and the Western Australian Government. The program aims to support farmers and rural communities to prepare for drought, climate variability and other challenges.

Plan, Prepare, Prosper is a strategic planning process that will help farmers to assess their enterprise and determine the best course of action in response to known and projected challenges to business performance.

The Department of Agriculture and Food, Western Australia would like to recognise and thank the Rural Business Development Corporation, Curtin University, the Centre for Entrepreneurship, Agknowledge®, Farmanco, Plan Farm, David Koutsoukis, Greg Barnes, Kylie Cutten and others for their contributions in the development of this program and permission to use their intellectual property. Acknowledgments for their invaluable contribution go to economist David Kessell (DAFWA), Tracey Ebert, South Coast Facilitation and AAAC WA members, Ashley Herbert, Steve Hossen, Rod Grieve, Andrew Ritchie, and Tim Johnston.

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GOVERNMENT OF WESTERN AUSTRALIA

Department of **Primary Industries and Regional Development**

Contents

OVERVIEW OF THE FINANCIAL MANAGEMENT WORKSHOP

Outcomes

Today we will be working through your financial management program, and possible strategies for increasing your profitability and creation of wealth.

We will explore the need to look beyond the physical production to a whole of business approach. We will look at the three main financial reports: the profit and loss, balance sheet and cashflow and how the use of financial ratios and benchmark analysis can help you improve your overall performance.

We will subsequently explore your Gross Farm Income, Gross Margin, Operating Surplus and operating efficiencies. We will also specifically look at ways to improve profitability and evaluate the strength of your business.

Finally, we will look at the importance of your relationship with your financial provider and the typical bank assessment criteria.

Throughout the day we will be bringing current financial theory, practice and experiences back to you, your business and your strategic plan, with considerable time made available for you to progress your plan.

Workshop Manual

To make it easier for you to review your ideas and thoughts that you collate during this workshop we have provided a number of locations to write down your thoughts, notes and calculations.

This manual contains the concepts and knowledge shared by your facilitator today. This section is very helpful as reference material after the workshop when you want to revisit an explanation of a concept.

Financials template

To collect all your financial information and analysis.

1. Introduction

A truly successful business should provide the income to support the lifestyle you want and the discretionary time to enjoy it.

The business of farming is distinctive in comparison to other business ventures because for most people it provides an income and a lifestyle choice. It tends to be a family business, which can create some major challenges when different generations work together and when it is time to pass the business on to the next generation. Although this is not unique to farming, some characteristics that accompany farming are often unique — for example, the tendency for the business to have a large asset base but to remain generally 'cash poor'.

We all aspire for different things in life and much depends on our time of life, capacity for risk-taking, personality, circumstances and goals. No two farming businesses are the same.

The objective of strategic planning is to identify your aspirations and goals, then decide how to achieve them.

This Financial Management workshop is all about understanding how to measure your business performance and to identify what you can do to improve it. Regardless of your reasons for farming, it remains a business and a truly successful business should provide the income to support the lifestyle you want. Are you achieving this? How do you know if you are running a successful business? How do you evaluate the performance of you your business?

The aim of this Financial Management workshop is to teach you how to measure your business performance and evaluate its strength. This is achieved by providing you with a framework and method of analysis using one year's data which you can apply to other years. Once you understand how well your business is performing you will be able to make more informed decisions about your future.

We hope you enjoy this workshop and get enormous benefit from either learning new skills - or just reinforcing old ones - and taking the time to spend 'on' your business and not 'in' your business', as so many people find they do.

At the end of today, you will have set some clear goals and developed the strategies to achieve those goals.

2. The business of farming

Farm managers wear two hats to run a successful farm business - the production management hat and the business management hat.

This workshop focuses on the activities you do while wearing your business management hat specifically – financial management.

Figure 1 The two sides of your business

Business Management Hat Vs Production Management Hat

What aspects of farming fall under the business management hat and production management hat?

Understanding what drives a successful business

The ability to generate profit is what drives a successful business - the more profit generated means more resources are available to make more choices, either to reinvest the money in the business or other lifestyle choices.

Profit in farming is generated from the equation:

Yield x Price – Costs = Profit

Equation 1 Profit

At first glance, this looks like a very simple equation. However, we know it is not quite that simple because each part comprises a number of complex interactions that contribute to the result. Table 1 shows some of the components that contribute to each part of the equation.

Table 1 Components of profit:

Yield	Price	Costs
Rainfall	Global markets	Global markets
Soil type	Marketing decisions	Amount of inputs used
Inputs such as fertiliser and chemicals	Quality	Lifestyle choices
Technology inputs	Timing	Investment decisions

As a farm manager, you may have 100 per cent control over some of these components. For example, how much fertiliser is applied to crops or how much supplement is fed to sheep? There are other components, such as rainfall, however, over which you have neither control nor influence. It is important to distinguish between the two.

The first habit in Steven Covey's popular book *Habits of highly effective people* is: 'Be Proactive'. This is particularly helpful advice when you feel powerless against life's forces.

Covey recommends looking at what ***you can do*** instead of focusing on worries over which you have no control. He suggests that you first note all your concerns and then determine where you can take action. Your circle of influence increases and your circle of concern will shrink as you understand better what you can influence and what you can't. **By focusing on what you can do to improve profit, you become part of the solution and not part of the problem**.

Which part of the profit equation do you have the most influence over?

Using the first principle of Steven Covey's habits for highly effective people it becomes apparent where you can have most impact and where more effort should be applied to improve profit.

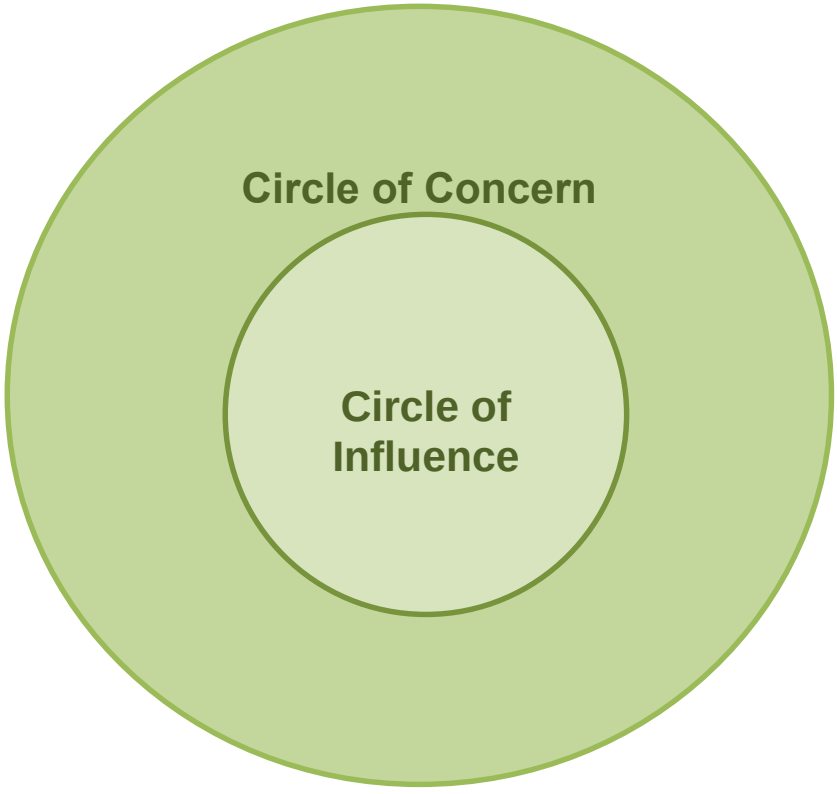
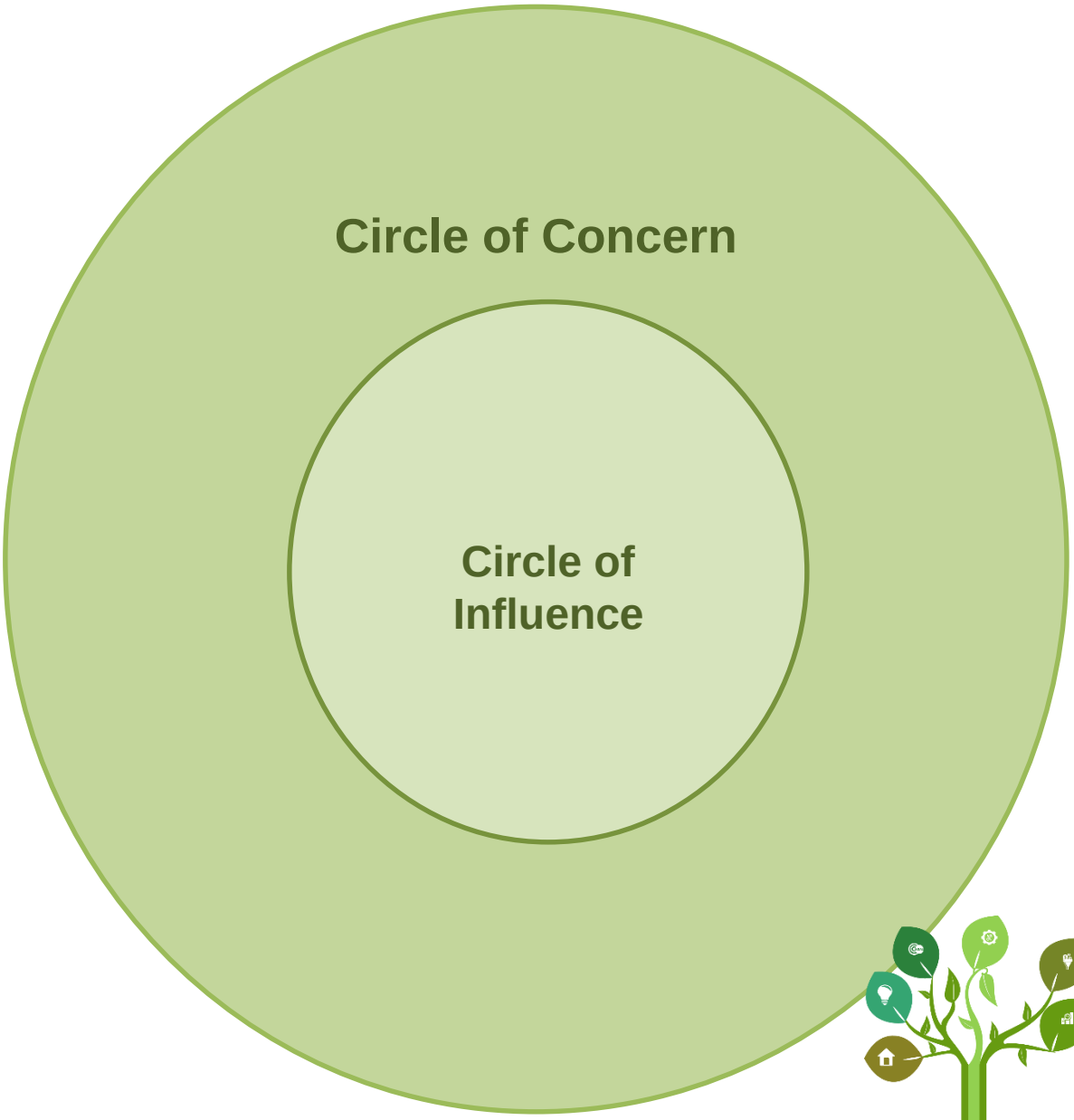


Figure 2 Covey's circles of influence and concern

As you become better at concentrating on what you can influence, your Circle of Influence gets bigger.

Activity 1 Covey's circles of concern and influence

Write down in these circles what your concerns are and what you can influence, e.g. where would you put 'weather'? Where do you spend your time and energy?



Planning point! Can you develop any actions for your strategic plan from those items in your circle of influence?

3. Business performance analysis

Whatever your situation, understanding your business goes a long way in helping you to succeed. You need to gather some information about the different aspects of your business before you sit down to analyse it.

The information needed to achieve this is:

- Production records (3–5 years)
- Cash flow statement showing the actual income and expenditure for the production year (3–5 year summary)
- Statement of Position (3–5 year summary)
- Key financial ratios (trends over 3–5 years)

This data will allow an objective analysis of the performance of your business over time.

A three to five year analysis provides an understanding of trends and recognition of the financial impact of prices and seasonal variation. However time constraints mean that this one day workshop does not allow for such in-depth analysis. What we will do, however, is provide a method using one year's data that you can apply to your own data over time.

First we are going to look at some of the monitoring and evaluation tools that you might use to manage your farm business.

Tools used to measure and monitor farm business performance

The following figure shows information flows and what data is used to monitor and measure farm business performance.

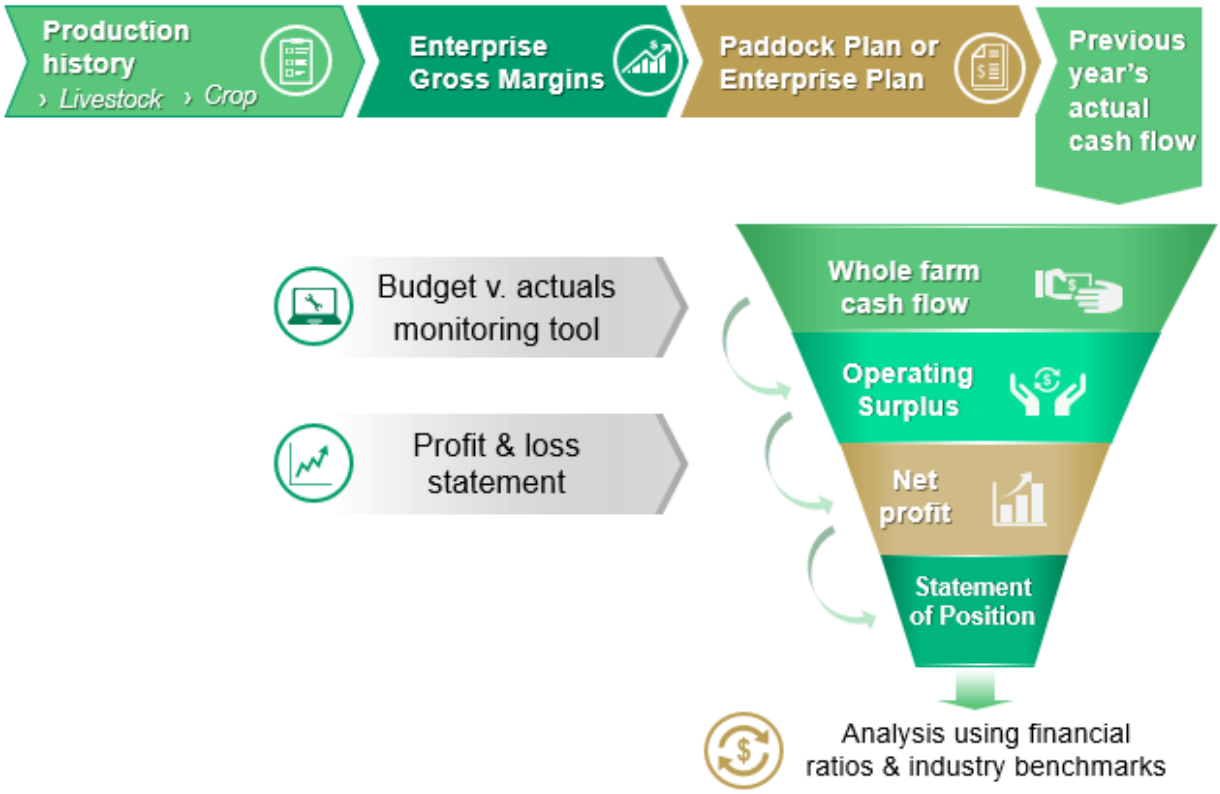


Figure 3 Information used for analysing farm performance

Most of the information that you will use to measure and monitor your farm business performance comes directly from your business.

Financial ratios and industry benchmarks can be very useful in helping you to identify risks and opportunities to improve your businesses financial position.

Benchmarks must be used with caution as they do not represent individual farm businesses and they only provide an indicative idea of the cost of production and performance.

Many of the exercises in this manual create an opportunity for you to compare your financial information with other businesses financial information, employing the Bankwest Planfarm Benchmarks for broadacre agricultural businesses.
Vegetable Gowers WA also provides a benchmarking service for its members as will a number of industry organisations and consultants.

Activity 2 Business Tools

What tools do you use in your business and how do you use them?

Tool	Yes/No	Who is involved?	What format? Whiteboard? On paper? In head?	How often is it referred to?	Could you improve? How?
Paddock plan					
Gross Margins					
Cash flow budget					
Actual vs. budget comparisons					
Profit and loss statement					
Statement of position					
Financial ratios					
Benchmarks					

Planning point! Should you add updating your annual Statement of position an action for your strategic plan?

Whole farm cash flow

The whole farm cash flow budget estimates your income and expenditure for each month and calculates your Operating Surplus. It tells you how much money you have on hand or available to draw on to stay in business while you are becoming profitable. You can analyse the cash flow to identify when your peak debt occurs and to determine the limits on your seasonal borrowing.

The important uses for the whole farm cash flow budget are:

- Monitoring Budget v. Actual data — how far does actual performance deviate from your plan?
- Calculating farm Operating Surplus

Identifying when peak debt occurs (not such an issue for dairy).

Profit and Loss Statement

This statement gives the actual profit (or loss) generated by your business yearly. It takes into consideration non-cash costs like depreciation and is mainly used by government to assess your taxable income.

Statement of Position

You may know this as a Balance Sheet or as an Assets and Liabilities Statement. The Statement of Position states the type and value of assets owned by the business and the amount of debt owed. Net worth or equity, usually expressed as a percentage of assets is calculated using the information in this statement.

We will discuss the Statement of Position in much more detail later on in the day.

Relationship between Profit & Loss / Balance Sheet & Cash Flow

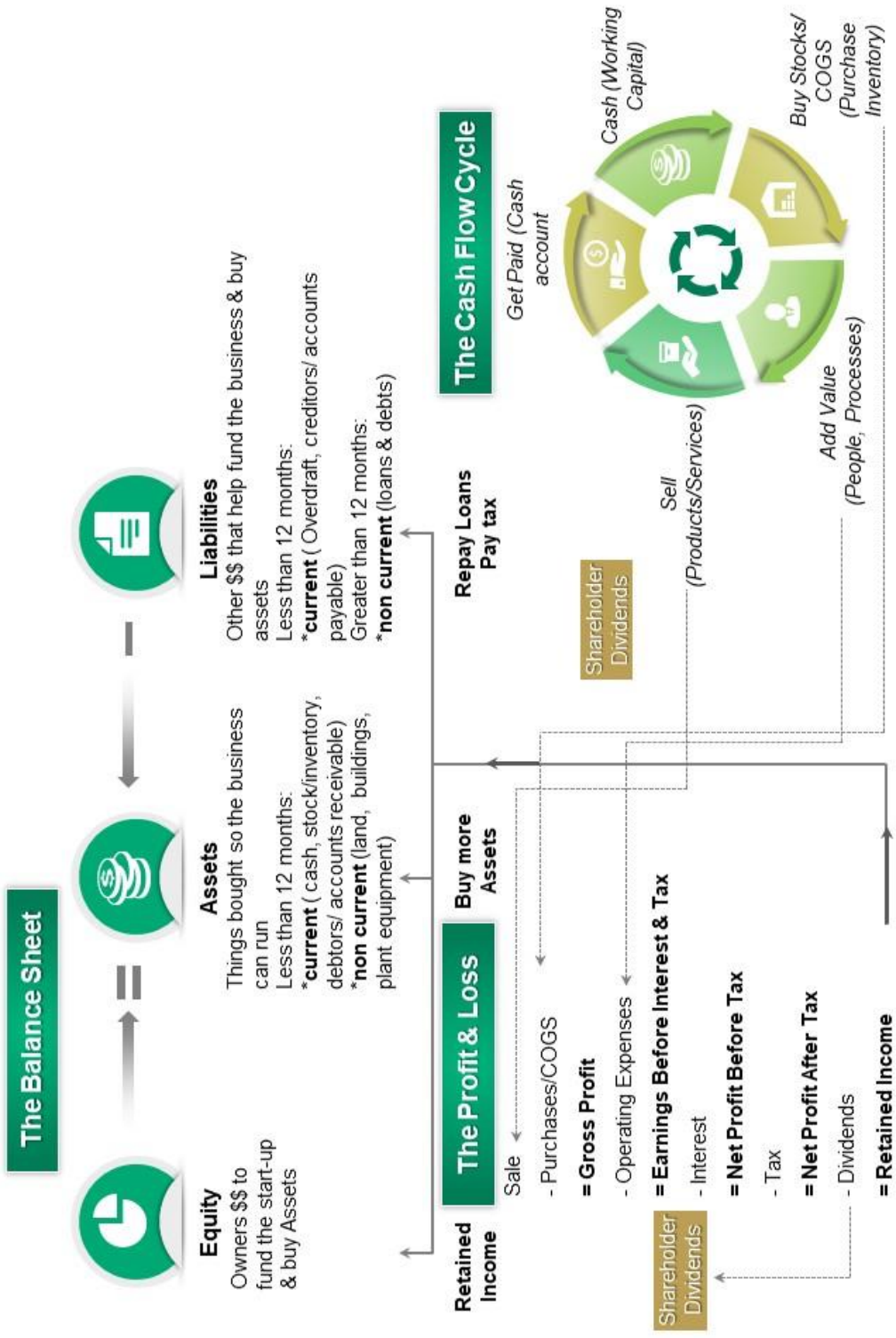


Figure 4 Profit & Loss / Balance Sheet / Cash Flow

February 2011	Statement of Position	Unit	Price	Sub total	Total
	Assets				
	Land	hectares	$/ha	**Total**	**Total**
3,032,000	Farm 1	2,000	1,516	3,032,000	
1,559,964	Farm 2	1,029	1,516	1,559,964	
4,591,964					**4,591,964**
	Buildings				
500,000	Farm 1				500,000
200,000	Farm 2				200,000
700,000					**700,000**
250,000	**Livestock**				**274,780**
	Plant & Machinery	292	($/ha)		884,468
900,000	**Total Plant & Machinery**				**884,468**
	Current assets	tonnes	$/t		
15,000	Malt Barley Pools or warehoused grain	450	72	32,400	32,400
5,000	Canola pools	64	100	6,446	6,446
	Wheat pools	495	60	29,681	
	Feed Barley	200	52	10,400	
11,000	Grain on hand				
15,000	Seed on hand				
50,000	Fertiliser on hand				
12,000	Chemical on hand				
	Crops in ground (ha)				
12,000	Wool in store				
	Farm management deposits				
	Cash at Bank/financial institution				
120,000	**Total Current Assets**				**38,846**
	Off-farm Assets				
	Real Estate – residential, business, commercial			685,000	
	Shares				
	Superannuation fund				
	Other (including interest in an estate)				
	Total Off-farm Assets				**685,000**
7,247,464	**Total Assets**				**7,175,058**
	Liabilities				
300,000	Overdraft			500,000	
520,000	Term Loan			500,000	
392,000	Commercial Bills			372,000	
	Credit card 2				
	GST & BAS liabilities				
100,000	Ma & Pa Kettle (purchase of land)	10,000/yr		90,000	90,000
	Off-farm liabilities				
	Off-farm real estate				
	Borrowing against shares etc.				
1,507,000	**Total Liabilities**				**1,532,000**
5,740,464	**Net worth**				**5,643,058**
79%	**Equity %**				

Figure 5 Sample Statement of position

4. BUILDING YOUR BUSINESS ANALYSIS.

Whole farm cashflow

The Whole farm cashflow or Statement of Cash flow is how we measure the flow of cash IN and the cash OUT of the business. It highlights:

- **Amounts** in dollar**s**
- Liquidity - the **availability and timing** of cash as it moves in and out of the business

When **peak debt** will occur.
A Whole Farm Cash Flow will provide the opportunity to highlight any cash shortfall that may occur, is necessary to carry out the operational and production plan for the business and may facilitate a discussion with the bank.

When planning and estimating the cash flow of your business, a Cash Flow Budget broken down into months can provide information that will be useful for monitoring your business.

Whole Farm Cash Flow comprises of your business' Gross Income and Variable Costs. Whole Farm Cash Flow will be influenced by your paddock plan or enterprise plan.

Gross Income

All the income generated by your business and any additional revenue sources is called gross income.

The meaning of **Gross Farm Income** is:
Yield x Price

Equation 2 Gross Farm Income

Gross Farm Income is sometimes called Total farm income but there is a small difference.

Gross Farm Income is your income ***BEFORE*** any costs are deducted.

Total farm income is your income ***AFTER*** some costs, such as grain freight and levies, are deducted.

Activity 3 Calculate Gross Farm Income

Income	Your Business $/ha	Your Business % of Gross Farm Income[1]	Planfarm BankWest Benchmarks	As % of Gross Farm Income
Grain income				
Wool sales				
Sheep sales				
Other livestock sales				
Fuel rebate				
Other farm income				
Gross Farm Income				

Notes:

1. To calculate each income item as a % of Gross Farm Income divide by Gross Farm Income

Gross Margin

Gross Income – Variable Costs = Gross Margin

Equation 3 Gross Margin

When using Gross Margins remember to compare apples with apples but be aware of their limitations:

- They are only an annual comparison of enterprises.
- It is difficult to consider capital investment required using Gross Margins and some enterprises will require more than others.
- The rotational benefits are difficult to account for.
- The interactions between enterprises are often lost.

Subtracting your Variable Costs from your gross income gives you Gross Margin.

What cost is that?

Variable Costs are those costs that vary depending on the business volume of production. They increase if the business produces more and decrease if the company does less.

Fixed Costs are costs that do not vary if production increases or decreases. That is, they are fixed in relation to production volume.

The difference between the two can be seen as the difference between the costs of doing something (i.e. your Variable Costs, that are only incurred when you do something) and the costs of doing nothing (i.e. your Fixed Costs, that are incurred even if you don't get out of bed in the morning!).

Activity 4 Is it a Variable Cost or Fixed Cost in your business?

Cost	Variable or Fixed?
Wages	
Contract	
Rates, Licences, Water	
Administration	
Elec/Gas/Sundry	
Cartage	
Insurance	
Fertiliser	
Seeds/Grading	
Fuel/Oil	
Weeds/Pest	
Plant Repairs	
Blds/Fen/Water	
Fodder & Agistment	
L'stock Expenses	
Shearing	
Rams	
Sheep Purchases	
Cbh & Levies, Other	

Variable Costs

Are incurred when something is produced or grown; they are readily allocated to an enterprise and disappear when nothing is produced.

The difference between variable and Fixed Costs

What are Variable Costs and what are Fixed Costs? What is the main difference?

Activity 5 Your business Variable and Fixed Cost Examples

Activity 6 Calculate and compare your Variable Costs

Variable Costs	Yours $/ha	Planfarm BankWest Benchmarks
Fertiliser		
Seeds/grading		
Chemicals		
Repairs and Maintenance		
Contract		
Fuel and Oil		
CBH and Levies		
Wages (casual)		
Blds/fen/water		
Cartage		
Livestock expenses		
Fodder and agistment		
Shearing		
Rams		
Sheep purchases		
Total Variable Costs		

Variable Cost control requires a sound knowledge of limiting parameters an informed and disciplined approach to inputs, a strong agronomic and financial focus and best practice operational timeliness. (Gordon Verral Western region growers count their costs 2018 GRDC Ground Cover Supplement- Profit Drivers)

Activity 7 Calculate Gross Margin

	Yours $/ha	Planfarm BankWest Benchmarks
Gross Farm Income		
MINUS Total Variable Costs		
***EQUALS* Gross Margin**		

Operating Surplus

Experts have generated a whole language around business management, created exclusive jargon and developed benchmarks and guidelines. Figure 2 introduces some of the industry terminology that most people will be familiar with and shows how it is used to calculate one of the most important numbers for your business — Operating Surplus.

Operating Surplus is the same as operating profit, Net Margin, Net Cash Flow and earnings before interest and tax (EBIT).

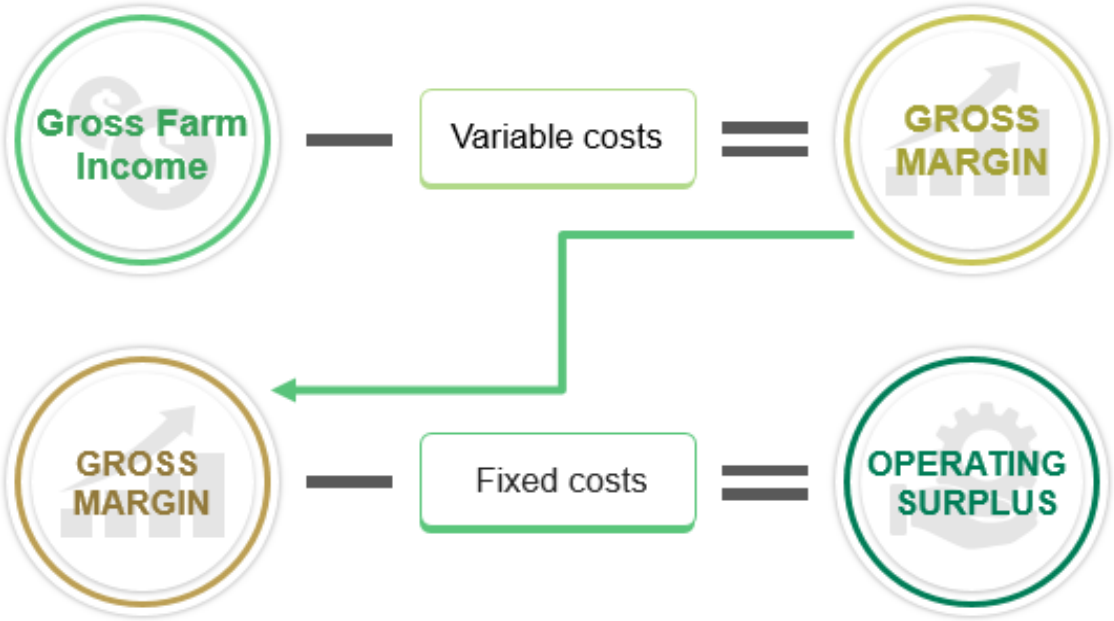


Figure 5 Calculating Operating Surplus

Operating Surplus is also known as Operating profit, Net Margin, Net Cash Flow or Earnings before interest and tax (EBIT).

Is required to pay for other discretionary expenses like personal expenses, loan repayments or finance costs.

The cost of finance might not seem like a discretionary expense, however it is a product of the decisions the business manager has made around the level of borrowing i.e. purchasing land.

FIXED COSTS

Also called overhead costs are still there if nothing is produced on the land, for example rates and utilities are Fixed Costs.

Activity 8 Calculate your Fixed Costs

Fixed Costs	Yours $/ha	Planfarm Bank West Benchmark
Wages (permanent)		
Rates, licences, water		
Administration		
Elec/Gas/sundry		
Insurance		
Professional fees		
Total Fixed Costs		

How to calculate farm Operating Surplus

- Gross Farm Income ***MINUS*** Total Operating Costs = Operating Surplus

To calculate your Operating Costs and surplus as a % of Gross Farm Income divide by Gross Farm Income.

Work through the next tables to calculate your Operating Surplus and Operating Efficiency.

The main cost categories are colour coded, for example “Total Variable Costs” = yellow. “Gross Farm Income” = orange etc.

Activity 9 Calculate Operating Surplus

	Yours $/ha	Yours as % of Gross Farm Income[1]	Planfarm BankWest Benchmarks	Planfarm BankWest Benchmarks As % of Gross Farm Income
Gross Farm Income				
Total Operating Costs				
Operating Surplus				

Operating Efficiency

Operating Efficiency is total Operating Costs expressed as a per cent of Gross Farm Income.

- Variable Costs *PLUS* Fixed Costs = Total Operating Costs
- Total Operating Costs *DIVIDED* by Gross Farm Income x 100 = Operating Efficiency.

This is a **KEY** ratio for growers. If it is too high (> 75%), it means there is not enough Operating Surplus to allocate to personal, finance and capital costs.

How to calculate total Operating Costs and Operating Efficiency

- Variable Costs ***PLUS*** Fixed Costs = Total Operating Costs
- Total Operating Costs ***DIVIDED*** by Gross Farm Income = Operating Efficiency

Activity 10 Calculate Total Operating Costs and Operating Efficiency

	Yours $/ha	Yours as % of Gross Farm Income[1]	Planfarm BankWest Benchmarks	Planfarm BankWest Benchmarks	Planfarm BankWest Benchmarks As % of Gross Farm Income
Total Variable Costs					
Total Fixed Costs					
Total Operating Costs					

To calculate your Variable Costs and Fixed Costs as a % of Gross Farm Income divide by Gross Farm Income $/ha.

Net Profit

- Operating Surplus ***MINUS*** Personal, finance and capital costs = Net Profit

Activity 11 Calculate Net Profit

	Yours $/ha	Yours % of Gross Farm Income	Planfarm BankWest Benchmarks $/ha	As % of Gross Farm Income
Operating Surplus				
Tax, Finance and Capital				
Net Profit				

Calculating Net Worth or Equity

If all assets were sold and all debts paid, the balance remaining is the Net worth. This is also known as Equity and is often expressed as a percentage of total asset value.

Net worth (Equity) = Total assets – Total liabilities

Equation 4 Net Worth

Normally expressed as a percentage of assets:

Statement of Position

The Statement of Position — also known as a Balance Sheet or the Assets and Liabilities Statement — summarises the value of your assets and liabilities at current market value.

Operating Surplus is also known as:

- Operating Surplus / deficit
- Net Cash Flow
- Net Margin

or

- Earnings before interest and tax (EBIT).

Complete the Statement of Position for your farm using the format on the following two pages.

Information for summary statement of position

Livestock	Number	$/Hd	Total	
Ewes & Lambs				
Weaners				
Wethers				
Rams				
Breeding Cows				
Heifers				
Steers				
Bulls				
			Total	
Stock on hand				
Grain	t	$/t		
Lupins				
Oats				
Seed				
Wheat				
Barley				
Oats				
Canola				
Fertiliser				
DAP				
Chemical				
Glyphosate				
Gramoxone				
			Total	
H.P/ Lease Contracts				
e.g Header	25,000/yr	Six years		150,000
			Total	

Summary Statement of Position

Statement of Position	Unit	Price	Sub total	Total
Assets				
Land	hectares	$/ha	**Total**	**Total**
Farm 1				
Farm 2				
Buildings				
Farm 1				
Farm 2				
Livestock				
Plant & Machinery				
Total Plant & Machinery				
Current assets				
Malt Barley Pools or warehoused grain				
Canola pools				
Wheat pools				
Feed Barley				
Grain on hand				
Seed on hand				
Fertiliser on hand				
Chemical on hand				
Crops in ground (ha)				
Wool in store				
Farm management deposits				
Cash at Bank/financial institution				
Total Current Assets				
Off-farm Assets				
Real Estate – residential, business, commercial				
Shares				
Superannuation fund				
Other (including interest in an estate)				
Total Off-farm Assets				
Total Assets				
Liabilities				
Overdraft				
Term Loan				
Commercial Bills				
Credit card 2				
GST & BAS liabilities				
Ma & Pa Kettle (purchase of land)				
Off-farm liabilities				
Off-farm real estate				
Borrowing against shares etc.				
Total Liabilities				
Net worth				
Equity %				

Congratulations – you should now have completed your Statement of Position.

The Statement of Position is an important document to understand the financial position of a business. It is used with Cash flow budgets and Profit and Loss Statements to assess the strength of a business.

Banks use the Statement of Position to assess the level of risk associated with the business and ensure they have adequate security to cover monies lent.

Generally, when a bank is looking at taking on a new client, they want a loan-to-security ratio of 50%, meaning that for every dollar of debt they want two dollars of security. This is calculated by using the value of assets at worst case scenario (low market value or fire sale value) and when the cash flow for the business is at peak debt. The template Statement of Position on the previous pages provides an example of what should be included.

The Cost of Borrowing: What is the real interest rate?

Debt can be a useful tool that helps you to expand your business. Debt also represents a risk to your business If not managed appropriately.

The **Effective Rate of Interest** is used to compare interest rates for different products.

There are a number of ways of expressing interest rates and table provides an explanation for the different terms used. The idea is to relate them back to EFI.

• **Effective rate of interest**
Is the benchmark to use to evaluate all loan offers? Is the amount of interest that would be charged if interest was paid, in one payment only, at the end of each year. After allowing for compounding it is the amount actually paid.
• **Periodic rate of interest**
The rate at which the interest is actually calculated (as distinct from charged) at the end of each quoted period, whether six monthly, monthly, daily or other agreed period.
• **Nominal rate of interest**
Usually the rate quoted when applying for a loan. The periodic rate x the number of calculation periods = the annual equivalent of the periodic rate.
• **Discount rate of interest**
This rate only relates to commercial bills, although the discount rate is not the quoted rate it is useful to understand how interest on bank bills is calculated.
• **Annual yield rate of interest on commercial bills**
This is the same as the nominal rate of interest and should be converted to ERI.

Converting Nominal Interest Rate to ERI

Calculation 1

$$ERI = (1+ (i/n))^{n} - 1$$

Where i = nominal or stated interest rate and n = number of compounding periods per year.

For example, what is ERI if nominal rate is 7.5% charged monthly?

$ERI = (1 + (0.07/12))^{12} - 1$

ERI = 7.5% + 0.7%

ERI = 8.4%

Plus the costs of borrowing or bank fees known as ERIC – Effective rate of interest including costs.

Calculating ERIC

A worked example:

Bank retail indicator rate is	7.5%
Plus a margin	1.5%
Nominal interest rate applicable to loan	9.0%
Interest is charged to your account monthly	
Size of loan	250 000
Loan term	10 years
Monthly line fee	$800
Loan approval fee payable now	$1000

Calculating ERIC on the above example

Step 1:

List the quoted interest rate — nominal or if using commercial bills the yield 9.0%

Step 2:

Calculate the administration fees as a percentage of the loan $\frac{800}{250\ 000} \times 100 = 32\%$

Step 3:

Add the administration fee to the quoted interest rate 9.0% + 0.32 = 9.32%

Step 4:

Convert this to EFI $(1+(9.32/10)^{n} -1) = 9.72\%$

Step 5:

Calculate the annual cost of the establishment fee:

1. Establishment fee as a percentage of loan	$\frac{1000}{250\ 000} \times 100 = 0.4\%$
2. Length of loan	Ten years
3. Interest rate calculated in step 4 (rounded)	9%
4. Look up amortisation fraction	0.1627
5. Multiply the establishment fee (0.4%) by the above fraction	0.006

Step 6:

Add the annual cost of the establishment fee to the ERI calculated in step 4
9.72% + 0.006 = 9.72%

So from a quoted nominal rate of 9% the actual interest rate is 9.72%.

Two last ratios -How to assess if you are using debt constructively

There is a relatively simple method to determine if you are using debt to build wealth or destroy it. It involves a comparison of two financial benchmarks, return on assets (ROA) and return on equity (ROE).

Return on assets (ROA) is a financial ratio that shows the percentage of profit a company earns in relation to its overall resources. It is commonly defined as net income divided by total assets expressed as a percentage.

Return on equity (ROE) is a measure of profitability that calculates how many dollars of profit the business generates with each dollar of owners' equity. The formula for ROE is: ROE = Net Profit less interest / Equity. ROE is sometimes called "return on net worth."

Ratio 3 ROA

$$\text{Return on Assets} = \frac{\text{Net Profit}}{\text{Total Assets}} \times 100$$

ROA is a measure of how hard the asset base is working to generate a return on the capital employed.

Ratio 4 ROE

$$\text{Return on Equity} = \frac{\text{Net Profit} - \text{Interest}}{\text{Net Assets}} \times 100$$

ROE measures how effectively borrowed funds are being employed. ROE should always be greater than ROA. If it is then borrowed funds are generating a return greater than their cost and wealth is being created, however if:

The business ROA is 8.6% and it's ROE is 6.4%

The business is in the process of destroying wealth. It is borrowing funds from a financier and employing them to generate a return less than their cost.

Strive to have ROA > 8%

Strive to have ROE > ROA

Source: Holmes Sackett & Associates Pty Ltd AgInsights 8.0.

An example

Using the figures from PlanFarm BankWest Benchmarks for the Medium Rainfall 4 area in 2010.

	2011	2013
Net Profit	-$289 000	$440 550
Interest	$189 038	$116 340
Total assets	$5 718 119	$4 251 360
Total liabilities	$1 632 758	$948 690
Net assets	$4 085 361	$3 303 670
ROA	-5%	10%
ROE	-12%	10%

What is yours? Using your own figures calculate

	2015	2017
Net Profit		

Interest		
Total assets		
Total liabilities		
Net assets		
ROA		
ROE		

5. IMPROVING YOUR BUSINESS POSITION

Increasing Operating Surplus

Businesses have many opportunities to increase Operating Surplus and finding these opportunities is a matter of continually reviewing farm operating income, Variable Costs and Fixed Costs. Increasing yields can increase income but may also increase costs. But income may be directly increased by better marketing strategies and contract negotiations with brokers.

Enterprises may be spending as much as 30% of Variable Costs on fertiliser applications. However there is research that has shown that most phosphate applications have no yield benefits. Soil testing will show whether this Variable Cost can be reduced. It may be possible to find savings in the renegotiation of phone contracts, insurance and consultancy services. These types of opportunity should be sought but managers may find them to be 'one off' or limited in some way.

Know and understand all items that make up the enterprises income and costs. Keep reviewing every item for opportunities to improve. **'Look for your one percenters!'**

The one-percenter principle

Increasing Net Profit becomes a critically important focus to a successful business. However, due to the 'one-percenter' principle of business finance, there are almost always significant opportunities for a business to achieve this.

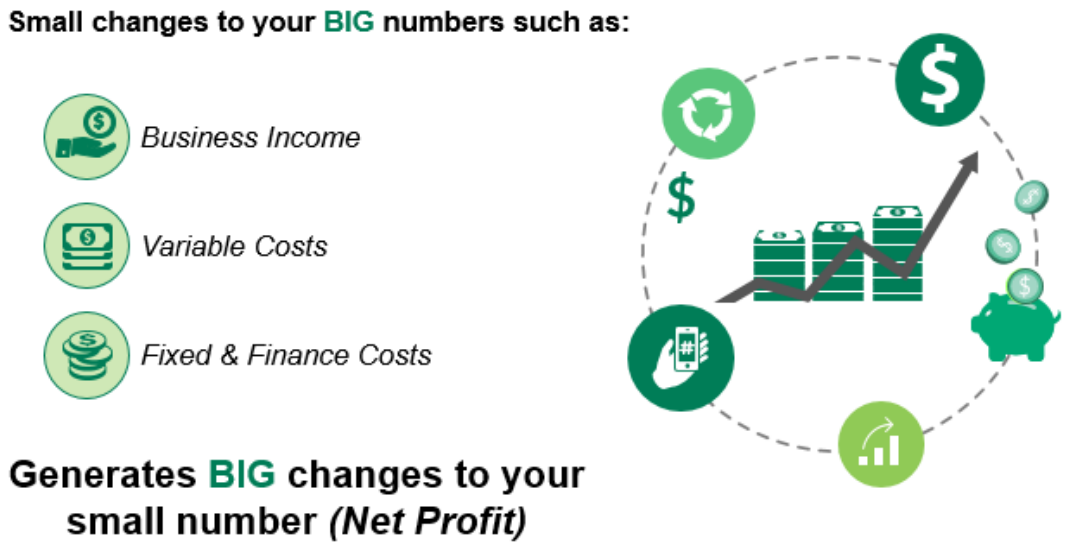


Figure 7 One percenter principle

Profit Drivers

By working through six Profit Drivers, and the key factors influencing each of these, you may identify affordable and readily achievable ways to go about increasing Net Profit in your business. These Profit Drivers are:

1. **Sell more:** Increase yield / production (units sold).
2. **Get more:** Increase the price you are paid.
3. **Keep more:** Decrease how much it costs you to make what you sell (i.e. decrease Variable Costs).
4. **Focus more:** Sell more above-average profit margin products; do more business with above-average profit margin customers.
5. **Spend less:** Cut overheads (i.e. decrease fixed and finance costs) without damaging your business.
6. **Lose less:** When things go wrong.

The top 20 percent of western region growers have almost identical effective rainfall to the average grower…

Ok so what are they doing differently?

Top 20 percent growers often manage similar effective farm area, but they crop a greater portion of it… 92% cropping versus only 81% of the average owner..

Grain price received is not fundamentally different between top 20 percent growers and average growers… When a price difference does occur it is generally due to improved grain quality rather than marketing. … Grain quality generally results from timeliness of operations, with harvest strategy especially important in some zones..

Wheat yield is 200 kilograms per hectare greater for top 20 percent growers. … an additional 8% of yield, although this varies between zones..

Source – GRDC GroundCover Supplement Profit Drivers Jan-Feb 2018

Profit Driver 1: Increase yield / production (sell more)

Increasing yield / production by 1%

Farm op. income	**100**	Increases by 1% →	**101.00**
Variable Costs	**60**	Increases by 1% →	**60.60**
Gross Margin	**40**	Increases by 1% →	**40.40**
Fixed Costs	**36**	Stays the same →	**36**
Operating Surplus	**4**	**Increases by 10%** →	**4.40**

Figure 8 Sell more

In figure 8, a 1% increase in yield and production generates a 10% increase in the Operating Surplus.

Increasing sales relates to the production activities of a business.

Examples: planting; seasonal soil rotations; ensuring proper water drainage; utilising fertilizers; soil testing; seed quality; fodder quality; herd structures, animal health, reproductive management etc.

Write down any ideas you have for increasing the yields of your business:

Profit Driver 2: Increase price (get more)

Increasing price obtained by 1%

Farm op. income	**100**	Increases by 1% →	**101.00**
Variable Costs	**60**	Stays the same →	**60**
Gross Margin	**40**	Increases by 2.5% →	**41**
Fixed Costs	**36**	Stays the same →	**36**
Operating Surplus	**4**	**Increases by 25%** →	**5**

Figure 9 Get more

In figure 9, a 1% increase in price generates a 25% increase in Operating Surplus (assuming no additional costs of getting the additional 1% price).

Increasing price can be as simple as putting prices up, or as complex as building a more attractive brand over time that customers are prepared to pay a greater premium for. Being able to negotiate better also often helps.

Write down any ideas you have for possibly getting a higher price for what you sell:

Profit Driver 3: Decreasing Variable Costs (keep more)

Decreasing your Variable Costs by 1%

Farm op. income	**100**	Stays the same →	**100.00**
Variable Costs	**60**	Decreases by 1% →	**59.40**
Gross Margin	**40**	Increases by 1.5% →	**39.5**
Fixed Costs	**36**	Stays the same →	**36.00**
Operating Surplus	**4**	**Increases by 15%** →	**4.60**

Figure 10 Keep more

In figure 10, a 1% decrease in Variable Costs generates a 15% increase in the Operating Surplus (assuming no additional costs).

There are a variety of different ways to decrease Variable Costs, including decreasing wastage, better buying, shopping around, better negotiations, increasing productivity, and changing raw material inputs.

Write down any ideas you have for possibly decreasing your Variable Costs:

Profit Driver 4: Focus on profitable customers and products (focus more)

Identify and focus on profitable sales

Product	Gross Profit %	Total Sales
Grain	35%	25%
Lamb	40%	15%
Wool	20%	40%
Beef	35%	20%

Figure 11 Focus more

This is fully covered in the previous Plan Prepare Prosper workshop – Introduction to Strategic Planning and further explored in the Plan Prepare Prosper workshop – Sales and Marketing.

Which is your best enterprise, within your business? Why? What can you do to make it more profitable?

Profit Driver 5: Reduce Fixed Costs (spend less)

Reducing Fixed Costs by 1%

Farm op. income	**100**	Stays the same →	**100.00**
Variable Costs	**60**	Stays the same →	**60**
Gross Margin	**40**	Stays the same →	**39.5**
Fixed Costs	**36**	Decreases by 1% →	**35.64**
Operating Surplus	**4**	**Increases by 9%** →	**4.36**

Figure 12 Spend less

In figure 12, a 1% decrease in Fixed Costs generates a 9% increase in the Operating Surplus (assuming no additional costs).

There are a variety of different ways to decrease fixed, finance and non-cash costs, including decreasing wastage, better buying, shopping around and better negotiations. Fixed Costs are diluted by increasing your farming output.

Write down any ideas you have for possibly decreasing your Fixed Costs:

Profit Driver 6: Reduce frequency or impact of bad things happening (lose less)

Lose 25% less of a 2% discount on all sales

Farm op. income	**100**	Decreased by .5% →	**99.5**
Variable Costs	**60**	Stays the same →	**60**
Gross Margin	**40**	Decreases by 1.25% →	**39.5**
Fixed Costs	**36**	Stays the same →	**36**
Operating Surplus	**4**	**Decreases by 12.5%** →	**3.5**

Figure 13 Lose less

In this example, the business sales rep was offering a 2% discount to all customers as a matter of course during taking orders, rather than using this as a way to secure bigger sales, stronger relationships or new customers only.

By stopping the discount on 25% of sales, the business owner was able to increase Operating Surplus by 12.5%.

Write down the main things that are happening that may cause you to lose money unnecessarily, and any ideas you have for making them happen less often, or decreasing the impact when they do happen:

Planning point! Any actions for your strategic plan?

6. ANALYSIS USING FINANCIAL RATIOS AND INDUSTRY BENCHMARKS

The Operating Surplus is required to pay for a number of other expenses to meet business and lifestyle requirements such as personal expenses, interest and loan repayments. These expenses are made at the discretion of the business manager based on choices about the level of debt they are willing to carry and personal expenses.

Table 2 demonstrates why Operating Efficiency is so important. The target benchmark is 65–75%. That is, Operating Costs should be between 65% and 75% of Gross Farm Income to meet other costs such as finance, personal and capital costs.

Table 2 Operating Efficiency

Gross Farm Income	100	100
Operating Costs	**65**	**75**
Operating Surplus	35	25

Table 3, evaluates the strength of the business based on the capacity of the Operating Surplus to meet personal, finance and capital costs. For example, a strong business makes an Operating Surplus and can allocate resources as required, including having the capacity to make investments or achieve structural changes such as funding a succession plan.

A non-viable business is where an Operating Surplus cannot be achieved. However, this definition has to be put into context because of seasonal variation. In some years, an Operating Surplus may not be achieved but this does not necessarily mean the business is non-viable. A non-viable business is where an Operating Surplus is not achieved over a number of years and the debt-to-income level is non-sustainable.

Evaluating the strength of your business by doing an end of year assessment

Table 3 Allocation of Operating Surplus and evaluation of business strength

	Strong business	Secure business	Insecure business	Insecure business with low equity	Non-viable business Or a bad year
Operating Surplus	✓	✓	✓	✓	×
Personal expenses	✓	✓	✓	✓	
Finance (interest)	✓	✓	✓	✓	
Tax	✓	✓	✓		
Loan repayments	✓	✓			
HP and / or machinery replacement	✓	✓			
Business expansion	✓				
Structural adjustment + / or off farm investments	✓				

Adapted from Blackburn, A & Ashby, R. (2006), Financing your farm, 4th edition.

Assessing net worth or equity

$$\text{Equity \%} = \frac{\text{Total assets} - \text{Total liabilities}}{\text{Total assets}} \times 100$$

Ratio 1 Equity %

The level of debt a business is carrying can have a profound impact on the security and performance of a farm business. Low Equity % levels (below 60%) with a low Operating Surplus due to poor seasonal conditions can put significant stress on the business. Banks and farm consultants use a number of risk assessment guides similar to this example from Farmanco Management Consultants.

Table 4 Interpreting equity levels

Equity (%)	Interpreting level of equity
> 90%	Low risk; problems with tax; capital base not expanding — a 'comfortable position' but not optimum (depends on life cycle).
75–90%	Seen as optimum. Equity 'manageable'; assets accumulating; ability to manage taxation.
67–75%	Equity 'high performance operations' — can be sustainable but often needs high levels of performance to finance debt levels.
50–67%	Medium-to-high risk situation — would not take much to push the equation the wrong way irreversibly.
< 50%	Extremely unlikely that this can be reversed as interest costs are too high relative to the business's ability to generate income.

Adapted from Sands, R 'Financial yardsticks', Farmanco Management Consultants 2014

However, looking at equity levels in isolation can be less meaningful than if you consider cash flow as well. Table 5 provides a further guide to a business's capacity for managing risk based on cash flow at different levels of equity. This is related to debt-to-income levels, which are discussed in the next section. .From your Statement of Position take your % equity or if you do not have your own set of financials then calculate the equity % using the example Statement of Position. Then using the matrix provided, determine what is the level of risk for this business?

Activity 12 Self-Assessment Business Risk Level

Equity	Risk Level	Cash Flow	Comment	Where are you on this matrix?
> 85%	Low			
75–85%	Low	Deficit Neutral Surplus	Eroding equity, act and assess Plan carefully, reduce costs Strong commercial business	
65–75%	Medium	Deficit Neutral Surplus	Susceptible to cyclical downturns Maximise use of capital Look at amortising debt	
< 60%	Medium-High	Deficit	High risk, short term sustainability	

Equity and cashflow

Assessing the interaction of equity and cash flow

Equity (%)	Risk level	Cash flow	Comment
> 85%	Low		
75–85%	Low	Deficit Neutral Surplus	Eroding equity: act and assess Plan carefully: reduce costs Strong commercial business
65–75%	Medium	Deficit Neutral Surplus	Susceptible to cyclical downturns Maximise use of capital Look at amortising debt
< 60%	Med–High	Deficit	High risk: short-term sustainability

Debt-to-income ratio

For every dollar of debt, income is required to service the interest and repay the principle.

Debt-to-income ratios are a key criteria used by banks to assess a business's capacity to service debt. It is calculated by dividing the total amount of debt by the Gross Farm Income, thereby informing them by how well the income can cover debt. For example, a 1:1 debt-to-income ratio means that for every dollar of debt there is $1.00 of income (i.e. $1 million debt and $1 million of income.)

Ratio 2 Debt to Income Ratio

$$\frac{\textbf{Total debt}}{\textbf{Gross Farm Income}}$$

Table 6 Understanding what debt-to-income ratio means

Debt-to-income ratio	Risk assessment
0.5:1 to 1:1	Low risk
1:1 to 1.5:1	Minimal risk
1.5:1 to 2:1	Medium to high
> 2.5:1	High risk

Table 6 provides a risk assessment guide to the debt-to-income ratio, which is used by most banks when reviewing clients and understanding their capacity to repay debt.

Activity 13 Calculate your Debt to Income Ratio

Total liabilities (debt) DIVIDED by Gross Farm Income

Total Liabilities	Gross Farm Income	Debt to Income

Understanding what debt-to-income ratio means

Debt-to-income ratio	Risk assessment	Your Debt-to-income ratio
0.5:1 to 1:1	Low risk	
1:1 to 1.5:1	Minimal risk	
1.5:1 to 2:1	Medium to high	
> 2.5:1	High risk	

7. Looking ahead and setting goals

Once you have established your financial position and understand how well your business is performing you are more empowered to know what, if anything you can do to improve the production performance of your business.

Calculating your Operating Surplus and Equity % should have given you an insight into where you are allocating your resources. You should have more knowledge about how effectively you are generating an Operating Surplus. For example, if your Operating Efficiency is poor (> 75%) then perhaps you need to re-examine your inputs.

Farm management is all about improving profitability through effective use and allocation of resources. It is a complex set of decisions usually using the production management hat.

How will you allocate your Operating Surplus?

Allocating your Operating Surplus

Personal, Finance and Capital Costs	Yours $/ha	Yours % of Gross Farm Income	Planfarm BankWest Benchmarks $/ha	Planfarm BankWest Benchmarks % of Gross Farm Income
Personal Expenses				
Finance				
Estimated Tax[1]				
HP payments				
Machinery Replacement				
Loan repayment				
Investment / business expansion				
Capital purchases				
Total				

Note:

Estimated tax = 20% of Operating Surplus *MINUS* machinery depreciation (10% of machinery value).

Developing strategies to improve profitability

We have discussed the components that contribute to profit:

Yield x Price – Costs = Profit

The key to improving profit on a farm is productivity, defined as a higher level of output achieved per hours worked. You may know this as output per hectare. Improving productivity means improving the margin between the input and the output.

The potential for individual farms to improve productivity (and hence profitability) is often underestimated. Analysis of the top 25 per cent of farmers often shows not that their land is better but that their productivity is higher (high yields and low input costs).

Such farmers tend to:

- identify best practice and key performance indicators (KPIs) associated with it
- study examples of best practice at field days, study tours and in discussion groups
- offer their farm for small trials and welcome the opportunity of working with research personnel
- trial new approaches before proceeding to large-scale adoption
- undertake an economic appraisal where necessary before adopting new practices
- engage a farm management consultant(s) and crop consultant(s).

Source: Blackburn A & Ashby R 2006, Financing your farm, 4th edn, p. 190)

Increased productivity often comes about as a result of the use of new technology.

8. SUMMARY OF THE DAY

Take 10 to 15 minutes to review your business from the viewpoint of the major topics covered today:

- Profit Drivers
- Business management activities v. production management activities
- Calculating and evaluating Operating Surplus
- Calculating personal, finance and capital costs
- Understanding strong businesses
- Identifying what we can do to improve profit

Enterprise Profit Drivers

Production management hat

Table 7 Profit Drivers

Cropping	Livestock
• Yield	• Stocking rate
• Price	• Lambing percentages
• Cost of production	• Prices
• Fertiliser	• Feeding
• Weed control	• Costs
• Soil constraints	• Time of lambing

What things can you most easily work on to improve profit?

Note the key points you got out of this session for you and your business.

Is there anything you need to include in your strategic plan?

Farm ratio	Formula	Actual 20xx	Actual 20xx	Actual 20xx	Actual 20xx	Budget 20xx	Target Benchmarks
Gross Margin %	GFI - Variable Costs / Gross Farm Income X100						≥ 45%
Operating Efficiency	Total Operating Costs (V+ F) / Gross Farm Income X100						60 o 65%
Total Operating Surplus/deficit $/ha	Gross Farm Income - Total Operating Costs (V+F) / Effective area (ha)						>$35/ha
Net Worth	Total assets - Total liabilities						
Equity %	Total assets – Total liabilities / Total assets X100						65 to 75%
Debt to income ratio	Total liabilities / Gross Farm Income						1:1 to 1.5:1
	ROA = Net Profit / Total Assets X 100						>8%
	ROE =Net profit – Interest / Net Assets X 100						ROE > ROA

9. Additional information and resources

These sections provide some additional information and resources which you might find useful:

1. Calculating your cost of production
2. Understanding bank information requirements and assessing how you are using debt
3. An example of banks lending criteria
4. The cost of borrowing and understanding interest rates

1. Tips for getting a better price - know Cost of Production

Knowing your cost of production allows you make better decisions when selling your product. In a deregulated grain market producer's choices have increased and understanding a good price for your business is essential. This requires you to understand your cost of production. The pie chart provides an example of the costs of production for a medium / high rainfall farm in Western Australia.

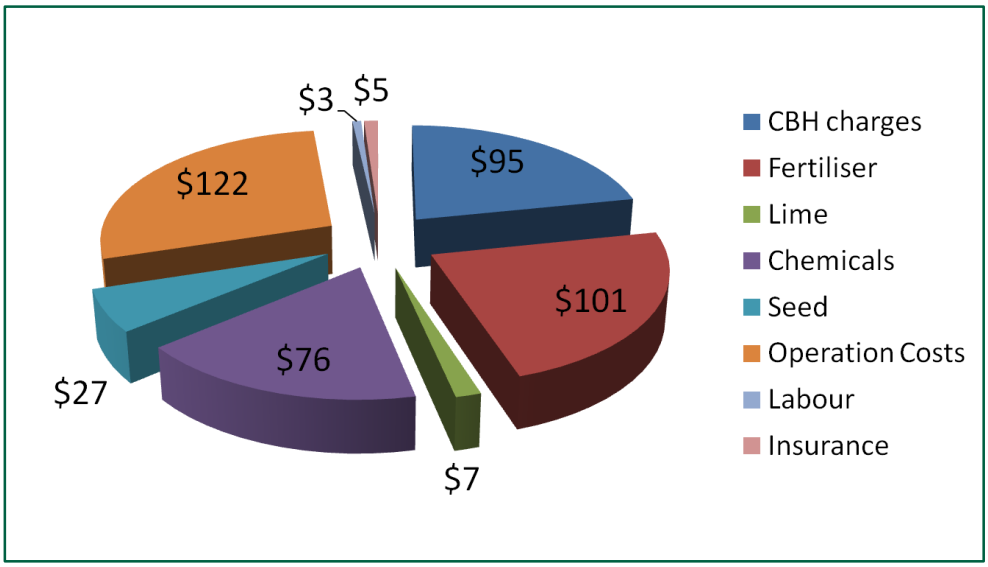


Figure 13 The elements of Cost of Production

This table provides an example of how to calculate your cost of production and it provides spare columns for you to calculate your cost of production dollars per tonne.

Variable Costs	$/ha	$/ha	Fixed Costs	$/ha	$/ha
Fertiliser	$101		Rates, licences and water	$9.54	
Seed	$27		Utilities	$3.40	
Chemicals	$76		Administration	$10.75	
Lime	$7		Finance	$62.40	
Fuel and Oil Repairs and Maintenance	$122		Personal	$38.40	
Insurance	$5			$7.50	
Labour	$3		Capital	?	
Total	**$340**		**Total**	**$132**	
Total cost of production (Variable + Fixed Costs)	$472	Divide total cost of production by expected yield			
Expected yield	2.4				
Cost of production $/tonne	$196				

2. Understanding bank information requirements and assessing how you are using debt

Banks and financiers can be viewed as an important 'partner' or 'investor' in your business. It is important to build a good relationship with your financier.

Having a good relationship with your financier will stand you in good stead in case you want to expand your business and require additional borrowing.

Or, you may require additional finance if you don't make as much profit as you had planned.

Understanding the requirements of the bank goes a long way to building a strong relationship. You can prepare information for any conversations regarding finance. This information should be something that you do as part of doing business.

The Five C's of Banking

Cash flow

Your banker needs to be certain your business generates enough cash to service the loan, that is, to meet interest and principal repayments.

Your historical performance will be considered. Completing a Cash flow Budget is important. You bank may request a periodical Cash flow Budget vs Actuals.

Collateral

The bank will want to be certain that in the event there is not enough cash flow at some point in the future to repay the loan, then the business has enough collateral to sell and repay the loan.

That is, the business has enough assets to provide as security for the loan. This is a secondary source of repayment in the event the business cannot service the loan from cash flow and is seen as a 'backup plan'.

Capital

The bank is looking for sufficient capital or equity in a business. Generally banks do not intend to lend to businesses who make a loss, but sometimes there is a 'blip' in the business and capital or equity is relied upon to weather the storm.

Banks looks at how much Equity the borrower has in the business. Equity is a measure of long term viability and while businesses at 65% equity may have the ability to trade their way out of debt, one or two poor seasons means that the farming operation may have problems funding the business program.

Most financiers get concerned if your business falls below 65% equity.

Character

This is assessed using a combination of 'fact' and 'gut' feel. Character is assessed by factual information such as credit rating and ability to pay back loans.

There is also an intangible measure of character that is influenced by the reputation you have from past dealings, the way you interact with your bank manager, particularly in times of stress.

You can influence your character assessment by provided accurate and timely information and being proactive in communicating issues with your bank.

Conditions

The bank considers the overall environment your business operates in. It will assess economic, political and industry factors and trends to determine key risks facing your business.

Whilst you cannot control all outside factors influencing your business, the bank is interested in how you assess and mitigate for risk.

Bank Assessment Criteria

Please find following a list of criteria as a checklist of what the bank might look for.

You can also use it as a checklist to ensure that your business is well placed for earning profits.

Banks have a number of legal requirements that they need to comply with under Australian legislation to provide finance to their clients. Banks are governed by Australian Prudential Regulatory Authority (APRA).

Banks and financiers ask for your annual financial statements that have been prepared by your accountant. These annual financial statements become legal documents, when prepared by a professional accountant in accordance with Australian Taxation Laws as you have signed and agreed to the information that they contain.

Banks will use your Statement of Income and Statement of Position to analyse your business and if you are seeking additional finance as it is a legal document.

Credit assessment

Criteria for credit assessment	
Gross Farm Income	**Debt to income ratio**
< $250 000	Ability to clear capital requirements yearly
$25 000 to < $1.1m	1.5:1 up to 2.1:1
GFI $1M and over	2.0:1
Equity	
> 55%	Irrigated agriculture enterprise
> 65%	All other activities

Gross Farm Income	Ratio of cash available for debt service (CAFDS)[1]
< $250 000	2.0:1
$250 000 to less than $1m	1.75:1
$1m and over	1.5:1

3. An example of a Banks assessment criteria

[1] Definition of Cash Available for Debt Service (**CAFDS**) for rural enterprises is: Gross Farm Income + Net off-farm income minus farm operating + overhead costs + personal expenses (includes education drawings and personal income tax) add back interest and depreciation less Capital expenditure and business taxation.

Table 8 Bank credit assessment

Criteria for credit assessment	
Gross Farm Income	Debt to income ratio
< $250 000	Ability to clear capital requirements yearly
$25 000 to < $1.1m	1.5:1 up to 2.1:1
GFI $1M and over	2.0:1
Equity	
> 55%	Irrigated agriculture enterprise
> 65%	All other activities
Gross Farm Income	Ratio of cash available for debt service (CAFDS)2
< $250 000	2.0:1
$250 000 to less than $1m	1.75:1
$1m and over	1.5:1

Resource sustainability (primary consideration)

- Long term sustainability of the enterprise and matching of enterprise with appropriate land use capability.
- Production levels at or above district levels.
- Does future availability of land or water restrict any expansion program.
- Machinery and plant well maintained and housed.
- Experience, track record and integrity of key people.
- Have operators performed at acceptable levels in the past?
- Have limits been respected?

[2] Definition of Cash Available for Debt Service (**CAFDS**) for rural enterprises is: Gross Farm Income + Net off-farm income minus farm operating + overhead costs + personal expenses (includes education drawings and personal income tax) add back interest and depreciation less Capital expenditure and business taxation.

- Are operators up to date with techniques and industry developments in terms of marketing, agriculture techniques and research developments?
- Do they take an active part in their industry organisations?
- Previous background and experience in agriculture and / or enterprise under consideration.
- Enterprise diversity where appropriate.
- Risk management.
- Demonstrated ability to record, monitor and analyse financial data for the business.
- Knowledge of breakeven points and target pricing.
- Knowledge and application of appropriate risk management tools and strategies, including environmental risks.
- Are budgets maintained for management and planning purposes?
- Use of consultant enterprise specialists and professional advisers.
- Can the borrower indicate a knowledge of breakeven rates and prices to cover all expected expenditure.
- Does a second income stream exist (off farm income) or do sufficient reserves / liquid assets exist to cope with a downturn?
- Income stream not subjects to control by agents or brokers (i.e. stock mortgage).

Staff numbers and skills suitable for purpose

- Knowledge and acceptance of modern techniques and technologies relevant to enterprise base.
- Ability to identify and complete critical tasks on time.
- Awareness of wider industry relevant issues and likely impact on own business.
- Adequacy of scale and efficiency of operations.
- YIYO evidence of serviceability.
- Is the influence of FX rates acknowledged and relevant precautions taken?
- Does a succession plan exist? Has Key Man insurance been considered?

Additional Support

Rural Financial Counselling Service Western Australia

The Australian Government's Rural Financial Counselling Service Program provides grants to state and regional organisations to provide free rural financial counselling to primary producers, fishers and small related rural businesses who are suffering financial hardship and who have no alternative sources of impartial support.

The Australian and the Western Australian Governments jointly fund the Rural Financial Counselling Service Western Australia (RFCSWA).

The RFCSWA offers a free, confidential, mobile service which can assist you and your family to calm, clarify, regain focus and create solutions, including actions to:

- help identify your financial and business situation and your preferred options
- help negotiate with your lenders
- help you develop an action plan
- identify information about relevant government and other assistance schemes
- help support you to access the Farm Household Allowance (FHA)
- identify with you useful sources of advice and knowledge to achieve your goals including accountants, agricultural advisers, professional support and educational services.

There are currently rural financial professionals across your region and community who are able to visit you at home or business to discuss your financial situation.

To access a rural financial counsellor phone RFCSWA direct on 1800 612 004. Or visit www.rfcswa.com.au

Enterprise Connect

Enterprise Connect is a division of the Department of Innovation, Industry, Science and Research.

Enterprise Connect offers comprehensive, confidential advice and support to eligible Australian small and medium businesses to help them transform and reach their full potential.

With a national network of centres and around 100 experienced business advisers and facilitators, Enterprise Connect provides business improvement services to businesses in industries as diverse as manufacturing, clean technology, resources, defence, tourism and the creative sector.

Enterprise Connect's services include business reviews delivered at no charge to businesses, grant assistance to implement recommendations flowing from the business review, and a range of tailored innovation services to meet individual business needs.

Business Structures

Before deciding on your business structure, it is important to seek professional advice from a business adviser, solicitor or accountant to ensure the structure you choose meets your personal circumstances and business objectives.

It is important to know that you're not locked into one business structure for the life of your business. As your business grows and changes, you may decide to move to a different type of business structure. Before changing structures, you need to be aware of the differences and obligations for each.

Sole trader

A sole trader business structure is a person trading as the individual legally responsible for all aspects of the business. This includes any debts and losses, which can't be shared with others. This is the simplest, and relatively inexpensive business structure that you can choose when starting a business in Australia. As a sole trader, you'll generally make all the decisions about starting and running your business, although you can employ people to help you.

Key aspects of a sole trader structure

- Is simple to set up and operate.
- Gives you full control of your assets and business decisions.
- Requires fewer reporting requirements and is generally a low-cost structure.
- Allows you to use your individual Tax File Number (TFN) to lodge tax returns.

- Has unlimited liability - all your personal assets are at risk if things go wrong. Your assets can be seized to recover a debt.
- Any losses incurred by your business activities may be offset against other income earned (such as your investment income or wages), subject to certain conditions.
- Doesn't require a separate business bank account, unlike a company structure. You can use your personal bank account but must keep financial records for at least 5 years.
- As the business owner, you're not considered an 'employee' of the business. You should pay yourself, which is usually a distribution of your profit, but this is not considered 'wages' for tax purposes.
- If you're a business owner without employees, there's no obligation to pay payroll tax, superannuation contributions or workers' compensation insurance on income you draw from the business. You can choose to make voluntary superannuation contributions to yourself though, to help you build up your superannuation.
- You can employ people to help you run your business. There are compulsory obligations that you must comply with, such as workers' compensation insurance and superannuation contributions.
- It's relatively easy to change your business structure if the business grows, or if you wish to wind things up and close your business.
- You can't split business profits or losses made with family members and you're personally liable to pay tax on all the income derived.

Company

A company is a type of business structure. You may consider a company structure when starting or growing your business.

A company is a separate legal entity, unlike a sole trader or a partnership structure. This means the company has the same rights as a natural person and can incur debt, sue and be sued. The company’s owners (the shareholders) can limit their personal liability and are generally not liable for company debts.

A company is a complex business structure, with higher set-up and administrative costs because of additional reporting requirements.

You need to register a company with the Australian Securities and Investments Commission (ASIC). Company officers and directors must comply with legal obligations under the *Corporations Act 2001*.

Key aspects of a company structure

- Is a separate legal entity.
- Has limited liability compared to other structures.
- Is a more complex business structure to start and run.
- Involves higher set up and running costs than other structures.
- Requires you to understand and comply with all obligations under the *Corporations Act 2001*.
- Means that business operations are controlled by directors and owned by the shareholders.
- Must be registered for goods and services tax (GST) if the annual GST turnover is $75,000 or more. The registration threshold for non-profit organisations is $150,000.
- Means the money the business earns belongs to the company.
- Requires an annual company tax return to be lodged with the ATO.

Partnership

A partnership is a business structure that involves a number of people who carry on a business together. You may choose a partnership over a sole trader structure for example, if you'll be jointly running the business with another person or a number of people (up to 20). There are two types of partnerships - general and limited. Partnerships are governed by the relevant law depending on your state or territory:

- ACT - *Partnership Act 1963*
- NSW - *Partnership Act 1892*
- NT - *Partnership Act 1997*
- QLD - *Partnership Act 1891*
- SA - *Partnership Act 1891*
- TAS - *Partnership Act 1891*
- VIC - *Partnership Act 1958*
- WA - *Partnership Act 1895*.

Key aspects of a partnership structure

- It's relatively easy and inexpensive to set up.
- It requires a separate Tax File Number (TFN).
- If you are carrying on an enterprise, you can apply for an Australian Business Number (ABN) but this is not compulsory.

- It's not a separate entity - like a sole trader, you and your business partners are personally liable for the debts of the business.
- You have shared control and management of the business with your partners.
- The partnership doesn't pay income tax on the income earned. You and each of your partners pay tax on the share of the net partnership income you each receive.
- Requires a partnership tax return to be lodged with the Australian Taxation Office (ATO) each year.
- Each partner is responsible for their own superannuation arrangements - you are not an employee of the partnership.
- You must be registered for GST if the annual income turnover is $75,000 or more.

Trust

A trust is an obligation imposed on a person - a trustee - to hold property or assets (such as business assets) for the benefit of others, known as beneficiaries.

Key aspects of a Trust

- can be expensive to set-up and operate.
- require a formal trust deed that outlines how the trust operates.
- require the trustee to undertake formal yearly administrative tasks.
- if you operate your business as a trust, the trustee is legally responsible for its operations. A trustee of a trust can be a company, providing some asset protection.

Knowing the main features of a trust business structure may help you decide if this structure is best for your business.

Sourced: Australian Government: https://www.business.gov.au/Info/Plan-and-Start/Start-your-business/Business-structure/Business-structures-and-types

The tables below summarise the advantages and disadvantages of each type of business structure.

Table 9 Sole Trader – Advantages and Disadvantages

Sole Trader	• You're the boss.	• You have unlimited liability for debts as there's no legal distinction between private and business assets.
	• You keep all the profits.	• Your capacity to raise capital is limited.
	• Start-up costs are low.	• All the responsibility for making day-to-day business decisions is yours.
	• You have maximum privacy.	• Retaining high-calibre employees can be difficult.
	• Establishing and operating your business is simple.	• It can be hard to take holidays.
	• It's easy to change your legal structure later if circumstances change.	• You're taxed as a single person.
	• You can easily wind up your business.	The life of the business is limited.

Table 10 Partnership – Advantages & Disadvantage

Partnership	• Two heads (or more) are better than one.	• The liability of the partners for the debts of the business is unlimited.
	• Your business is easy to establish and start-up costs are low.	• Each partner is 'jointly and severally' liable for the partnership's debts; that is, each partner is liable for their share of the partnership debts as well as being liable for all the debts.
	• More capital is available for the business.	• There is a risk of disagreements and friction among partners and management.
	• You'll have greater borrowing capacity.	• Each partner is an agent of the partnership and is liable for actions by other partners.
	• High-calibre employees can be made partners.	• If partners join or leave, you will probably have to value all the partnership assets and this can be costly.
	• There is opportunity for income splitting, an advantage of particular importance due to resultant tax savings.	
	• Partners' business affairs are private.	
	• There is limited external regulation.	
	• It's easy to change your legal structure later if circumstances change.	

Table 11 Company Advantages & Disadvantages

Company	• Liability for shareholders is limited.	• The company can be expensive to establish, maintain and wind up.
	• It's easy to transfer ownership by selling shares to another party.	• The reporting requirements can be complex.
	• Shareholders (often family members) can be employed by the company.	• Your financial affairs are public.
	• The company can trade anywhere in Australia.	• If directors fail to meet their legal obligations, they may be held personally liable for the company's debts.
	• Taxation rates can be more favourable.	• Profits distributed to shareholders are taxable.
	• You'll have access to a wider capital and skills base.	

Table 12 Trust – Advantages & Disadvantages

Trust	• Limited liability is possible if a corporate trustee is appointed.	• The structure is complex.
	• The structure provides more privacy than a company.	• The trust can be expensive to establish and maintain.
	• There can be flexibility in distributions among beneficiaries.	• Problems can be encountered when borrowing due to additional complexities of loan structures.
	• Trust income is generally taxed as income of an individual.	• The powers of trustees are restricted by the trust deed.

10. REFERENCES

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11. FINANCIAL GLOSSARY

Table 13 Glossary

Accounting Policies	The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
Accounting Profit	Profit or loss for a period before deducting tax expense.
Accountants Report	Formal document that communicates independent accountants' expression of assurance (or lack thereof) on financial statements as a result of performing inquiry and analytical tests.
Accounting	Recording and reporting of financial transactions, including the origination of the transactions, their recognition, processing and summarisation in the financial statements.
Accounts Payable (Trade Creditors)	Amounts owed to creditors for delivery of goods or completed services but not yet paid for in cash.
Accounts Receivable (Trade Debtors)	Claims against debtors for uncollected amounts, generally from completed transactions of sales or services rendered but not yet collected in cash.
Accrual Basis of Accounting	A method of recording accounting transactions in which revenue is recognised when earned and expenses are recognised when incurred without regard to the timing of cash receipts and expenditures.
Accrued Expenses	Or accrued liabilities, represents that amount of a company's operating expenses that it has incurred and been recorded but not yet paid in cash.
Accumulated Depreciation	Total depreciation pertaining to an asset or group of assets from the time the assets were placed into service until the date of the financial statement or tax return. This total is the contra account to the related asset account.
Activity Ratios	Frequently referred to as turnover ratios. They measure how rapidly an asset or liability "turns over" or is converted into something else. Since the conversion is frequently to cash, activity or turnover ratios have significant implications for the cash position of the company.
Amortisation	The systematic allocation of the depreciable amount of an intangible asset over its useful life.

Annual Report	Report to shareholders of a company which includes the company's annual, audited balance sheet and related statement of earnings, shareholders' or owners' equity and cash flows, as well as other financial and business information.
Asset	Property or economic resource owned by a business. Assets are presented on the balance sheet in the order of liquidity. The usual major groupings are: current assets, non-current assets and intangibles.
Bad Debt	All or portion of an account, loan or note receivable considered to be uncollectible.
Balance Sheet	Also known as Statement of Financial Position. Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in the preparation and presentation at a specified date. It includes the entity's assets, liabilities and the equity of its owners.
Bank Overdraft	Indicates that a company has written cheques in excess of the amount of cash it has on deposit. It is usually unclear whether such cheques have been presented for collection and honoured by the bank, even though there were insufficient funds in the company's account. A bank overdraft is a current liability.
Borrowing Costs	Interest and other costs that an entity incurs in connection with the borrowing of funds.
Budget	An organisations action plan, translating strategic objectives into measurable quantities that express the expected resources required and returns anticipated over a certain period of time.
Capital	Under a financial concept of capital, such as invested money or invested purchasing power, the net assets or equity of the entity. The financial concept of capital is adopted by most entities. Under a physical concept of capital, such as operating capability, the productive capacity of the entity based on, for example, units of output per day.
Capital Budget	A schedule detailing planned investment in capital assets, property and equipment.
Capital Gain	Portion of the total gain recognised on the sale or exchange of a non-inventory asset which is not taxed as ordinary income.
Cash	Cash on hand and demand deposits.

Cash Accounting	A method for recording accounting transactions only when cash actually changes hands, not when the transaction occurs. Consequently, a record of cash transaction may differ considerably from a series of transactions recorded on an accrual basis.
Cash Flows	Inflows and outflows of cash and cash equivalents over a specified accounting period
Compliance	Adherence to those statutory requirements, regulations, rules, ordinances, directives or other externally-imposed requirements in respect of which non-compliance may have, or may have had, a financial effect on the reporting entity.
Consolidated Financial Statements	The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.
Cost of Goods Sold (COGS)	Represents the cost of producing the product sold. Such costs will include the following general elements: goods and materials, labour, depreciation and amortisation expense associated with production and overhead associated with production.
Current Asset	Assets that one can reasonably expect to convert into cash, sell or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year.
Current Liability	A liability or obligation that will normally be liquidated by cash payment or the creation of other liabilities within one year or the next operating cycle.
Depreciation	The reduction in value of a fixed or capital asset from use or obsolescence. The decline is recognised by a periodic allocation of the original cost of the asset as a current expense.
Dividends	Distribution of earnings to owners of a company in cash, other assets of the company or the company's capital shares.
Expenses	The monetary figure reflecting goods or services consumed in operating the business, such as: cost of goods sold, operating expenses, miscellaneous expenses, tax expenses, income taxes and extraordinary expenses.
Equity	Residual interest in the assets of an entity that remains after deducting its liabilities; the amount of an entity's total assets less total liabilities.

Extraordinary Item	Events and transactions distinguished by their unusual nature and by the infrequency of their occurrence. Extraordinary items are reported separately, less applicable income taxes, in the entity's statement of income or operations.
Fair Value	The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
FIFO (first-in, first-out)	The assumption that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced
Finance Lease	A lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.
Financial Position	The relationship of the assets, liabilities and equity of an entity, as reported in the balance sheet (statement of financial position).
Financial Statements	Or Financial Accounts. Presentation of financial data including balance sheets, income statements (or profit and loss accounts) and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended.
Fixed Costs	Costs that remain the same through a wide range of production and sales volume.
Gearing	The relationship between a company's assets and the relative funding for those assets that is provided by the owners of the company.
Going Concern	The financial statements are prepared on a going concern basis (assumption the business can remain in operation beyond the current operating cycle) unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.
Goodwill	The premium paid in the acquisition of an entity over the fair value of its identifiable tangible and intangible assets less liabilities assumed.
Gross Margin	Gross profit divided by total revenue. Gross Profit is total revenue minus cost of goods sold.

Historical Cost	A measurement basis according to which assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
Insolvent	When an entity's liabilities exceed its assets.
Intangible Asset	An identifiable non-monetary asset without physical substance yet has value to the company.
Investing Activities	The acquisition and disposal of long-term assets and other investments not included in cash equivalents.
Inventory (or Stock)	Tangible property held for sale, or materials used in a production process to make a product. Customarily recorded on the financial statements at the lower of its cost or market value.
Invoice	A detailed list of goods shipped or services rendered, with an account of all costs; an itemised bill.
Joint Venture	A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.
Liability	The claims of creditors against the assets owned or obligations to give assets or provide services to another. Liabilities are presented on the balance sheet in order of maturity. The usual major groups are current and non-current liabilities.
Liquidity	The availability of cash in the near future after taking account of financial commitments over this period.
Liquidity Ratios	Indicate the likely ability of a company to meet all of its liabilities coming due (the current liabilities) by conversion of the company's current assets to cash.
Lockup	The time it takes to convert unbilled work in progress plus debtors into cash
Net Present Value	The current value of a future stream of cash flows, based on specific interest rate assumptions.
Non-Current Asset	Assets which will normally not be converted into cash within one year, includes fixed or capital assets

Non-Current Liability	Liabilities or obligations which mature beyond one year and normally will not be liquidated by cash payment within one year.
Notes	Notes contain information in addition to that presented in the statement of financial position, statement of income, separate income statement (if presented), statement of changes in equity and statement of cash flows. Notes provide narrative descriptions of items presented in those statements and information about items that do not qualify for recognition in those statements.
Operating Activities	The principal revenue-producing activities of an entity and other activities that are not investing or financing activities.
Operating Cycle	The time between the acquisition of assets for processing and their realisation in cash or cash equivalents.
Operating Income	Revenue less cost of goods sold and selling, general, and administrative costs.
Operating Lease	Essentially rental payments: a company gets the use of various capital assets without claiming ownership and without showing the asset or obligations on its financial statements. The assets are never owned by the company; it just wants access to their use for a period of time.
Provision	A liability of uncertain timing or amount.
Ratio Analysis	Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyse trends or relationships.
Realisable Value	The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
Residual Value (of an Asset)	The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
Revalued Amount of an Asset	The fair value of an asset at the date of a revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.
Revenue	The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows

	result in increases in equity, other than increases relating to contributions from equity participants.
Revenue per Employee	A measure of productivity, calculated by dividing total revenues by the number of full-time employees.
Sensitivity Analysis	Analysis of the impact on a pro forma or forecasted statement by a change in one or more of the input variables.
Solvency	The availability of cash over the longer term to meet financial commitments as they fall due.
Subsidiary	An entity that is controlled by another entity.
Taxable Profit (tax loss)	The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
Variable Costs	Costs that fluctuate with incremental changes in output.
Work-In-Progress	Inventory account consisting of partially completed goods awaiting completion and transfer to finished inventory. Also known as work in process.
Working Capital	Excess of current assets over current liabilities. Represents the amount of long-term funding (long-term liabilities and owner's equity) over and above that required to support long-term assets that is used to support working (current) assets.

Sourced from: Moody's Company; Finance Basics - Harvard Business Press; Bloomberg Financial Glossary