Managing the farm business - Getting value from accounts

THE FARM MANAGEMENT ACCOUNTING LITERACY OF ACCOUNTANTS

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Acknowledgments:
The paper is based on an article by Mike Stephens which was originally published in Australian Farm Journal.

Number of words: 1,890

Applied paper

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Abstract

A positive relationship between the farm business manager and their accountant is a key one in the management and success of the farm. While this relationship is very positive in many cases, Agricultural professionals believe that an increased understanding of farming financial literacy would benefit both parties. Feedback from accountants and farmers supports this. Historically, training programs and packages have focused on improving financial literacy skills of farmers. This paper considers a greater focus on agricultural financial literacy for accountants might be more successful, and proposes a model to deliver this. It also includes a checklist to assist farmers in reviewing their existing relationship with their accountant.

Introduction

The (Australian) National Farmers Federation (NFF) claims that farmer financial literacy is the number one priority in addressing drought and many professionals who assist farmers make the same claim. Further, the low level of farmer financial literacy is often a major hurdle in farm intergenerational transfer or succession and in arguments with lenders.

It is an everyday complaint that the figures prepared by accountants don’t help in the management of the business. Most financial accounts are prepared with taxation in mind. The accounts are tax focused, tax dominated, and tax driven.

The relationship between accounting for compliance purposes and accounting for management purposes are commonly at odds. In many cases farmers don’t understand accounting and accountants don’t understand farming. The value that farmers get from their accountant could be improved by greater understanding from both parties.

The historical approach (in Australia) has been for governments and Research and Development Corporations (RDC's) to develop and offer programs aimed at lifting the level of farmer financial literacy. This paper explores the possibility of changing the emphasis from the financial literacy of farmers to the farm management accounting literacy of accountants

Comment on this issue has been made with an Australian perspective and it is possible (hopefully likely) that other countries have addressed the issue with satisfactory results. Further, it is acknowledged that previous attempts to ensure that accountants have a better understanding of farm management economics and farm management accounting have largely failed.

Material studied

This paper has been written from the perspective of professionals who work with farmers on a day to day basis so no specific material has been used.

Discussion

In Australia every time there is a drought (and droughts occur frequently) or a financial downturn attention is focused on the level of financial literacy of farmers. In the last thirty years in most states there have been significant efforts aimed at ensuring that farmers have an understanding of business. Schemes such as the Meat Research Corporation's Business (MRC) Skills and Best Practice program, or programs of MRC's successor Meat and Livestock Australia's (MLA) Edge Network, Business Edge, Agriculture Victoria's Farm Smart, and Young Farmers Financial Business Boot Camp, and the Federal Government's Farm Bis, and MLA's Cost of Production workshops, all work to the same end. Add a large effort by Rural Financial Councilors which have all been aimed at lifting the level of business management skills of farmers.

Further, despite all the efforts to enhance farmers' financial literacy most accountants will confess that the majority of their farmer clients have a poor understanding of the annual accounts including profit and loss and balance sheet which underpin the annual taxation return declaration which they sign. That doesn't mean that the client is lacking an understanding of the income which is at their disposal and the understanding of the individual cash position has improved since the introduction of GST. But it does mean that many are unclear about where the real profit drivers are in the business.

The situation is compounded by the use of gross margin analyses which stop at an enterprise level and fail to do a whole of business gross margin or whole of business EBITAD[1] adjusted for machinery leasing. Many farmers are blissfully ignorant of the real cost of machinery, particularly when it is leased

Similarly, many specialist lamb producers when asked what they think the profit per lamb is will pick a figure which is at least double the real profit per head. It can be telling to ask this question of a farmer and then having made some adjustments for cull and cast for age ewes and wool to divide the profit by the number of lambs sold.

Many cropping farmers are inclined to look at the best performing crop (yield by price) rather than considering the full range of crops in a rotation over all the land taken out of other forms of production.

The third factor which confuses the picture is that many farmers look at a March profit. That is, working with the accountant or consultant they estimate the taxable income at June 30th and then look for tax deductible expenditure. They work from July 1st to March 31st trying to make money and from April 1st to June 30th trying to bury the profit to reduce tax.

Historically the emphasis has been on increasing the business management and financial literacy skills of farmers and the success rate has been patchy. To a large extent this may be because many of the farmers who need to engage prefer to stay at home ‘checking stock’ or engaging in ‘occupational tillage’ or its present day equivalent of ‘occupational spraying’.

In the Australian context rather that continuing to throw money directly into farmer training Government should consider providing vouchers for farmers to use to assist

[1] EBITAD Earnings before interest, tax, amortization and depreciation.

paying for accountancy services which assist the farmer to gain an understanding of farm management accounting

The score card at the end of this paper could be used to ensure that farmers get value from their accountant. However, before addressing the issues raised in the score card it should be remembered that accountants are like scorers in a cricket game. The team which has scored the greatest number of runs is the winner. It’s really very simple and much easier to understand than the new simplified Australian income tax system.

The scorer isn’t part of the game. The scorer has an important task but does not contribute to the field of play. The scorer is there so everyone knows state of the game in real time.

The idea of cricket without the scorer providing vital information for those playing the game is ridiculous.

Now contrast that with the scorer in many farm businesses. At some time after the end of the year the scorer will send the score. Too often it will be written in a language which the farm business operator doesn't understand and it will arrive well after the game is over. Increasing the farm management accounting literacy skills of accountants will go a long way a long way to increasing the financial literacy of their farmer clients. If the scoring system was meaningful it could also ensure that the farmer client started to use the state of the game (the score) in making management decisions.

Can you imagine Meg Lanning leading her Australian First Eleven from the ground and cricket fans walking away calmly at the end of the game without knowing who won and then, waiting for months to find out what the final score was? That's what happens in a lot of farm businesses.

How can you run a business if you don’t know what the score is? It's true that since the introduction of GST most will have a much better idea of the cash position. But GST returns won’t help you decide if wheat is better than canola or if sheep out-return cattle. To get the answers to those questions you need good management accounts.

That brings us to the central questions in this paper; “Does your (the farmers) accountant add value?” and “Do you use your accountant wisely?”

In businesses it is important to have a management conversation with the accountant or farm management consultant about the implications of the tax return/financial position. This is almost as critical as actually doing the figures.

Farmers (especially older ones) have embedded in their generational make up that accountants (and solicitors) are trusted and wise people and they are very reluctant to question what they say. Part of this is also based around a significant lack of understanding of what is said. Many participants in a series of ‘Young Farmer Financial Boot Camps’ which have been designed and delivered by Meridian Agriculture have commented that although they may not have learnt enough to truly analyse their business, they have learnt enough basics to be able to have a much more robust conversation with their accountant. Previously they blindly believed what they were being told by their accountant.

Too often the chart of accounts that the accountant uses is not useful as a management tool. The account descriptions are too vague and in some cases, not even agricultural. An early conversation about how the chart of accounts should be set up to suit the particular farming enterprise is important. Also, a short description of what goes where is helpful in ensuring consistency in the allocation of both income and expenditure.

Farmers shouldn’t let the accountants preferred (or mandated) accounting package drive things too much. This space seems to be moving quickly, but farmers need information that supports their business, not a package that makes life easy for the accountant, or that the accountant gets a financial advantage from recommending and using

If farmers find that the annual accounts really help in the management of the farm business they are very fortunate.

Farmers should answer the following questions and tick the box on the right if the answer is ‘yes’.

Do your annual accounts:
Assign all variable costs to individual enterprises? ☐
Proportion all fixed costs to individual enterprises? ☐
Show how individual enterprises contribute to disposable income? ☐

Explain clearly what is happening to:-
Cash reserves ☐
Equity debt ratio ☐
Change in inventory value of fodder, livestock and grain for sale ☐
Borrowings ☐
Capital value ☐
Crop (value of standing crops) ☐

Do your financial returns show:-
Total income – adjusted for change in stock and produce on hand ☐
Total operating costs ☐
Management allowance ☐
Change of equity ☐
Farm area ☐
Farm operating costs ☐
Total financing costs ☐
Surplus / deficit after financing costs ☐
Assets ☐
Liabilities ☐
Equity ☐
Change of liabilities ☐
Expenditure on capital ☐
Expenditure on drawings ☐
Expenditure on taxation ☐
Farm operating surplus per ha ☐
Farm operating costs as a % of total income ☐
Plant and machinery replacement allowance ☐
Return on capital ☐
Return on equity ☐
Do your accounts provide comparisons back over say five years, so you can identify trends? ☐
Do they provide any comparative analysis? ☐

Now add up the number of ticks.

A farmer might find this sort of business score sheet a bit complicated but think about cricket. The scoring system in cricket is no more complicated than it has to be to show the state of the game and the accumulated performance of individuals.

The scoring system needed in farm businesses is no more complicated than it needs to be to show the state of the game and the accumulated performance of individual enterprises

Farmers who have a scoring system in the business which does not keep them up to date with the state of the game in the business need to ask why. Is it the farmer of the accountant who fails to watch the score?

In the score sheet above if the score was:

28 to 35	Offer to take your accountant to the cricket
21 to 27	Send your accountant a card at Christmas
14 to 20	Send your accountant a copy of this article
7 to 14	Talk to your accountant about better performance
0 to 6	Find a new accountant

A voucher system, funded by government and only redeemable by accountants or farm management consultants who deliver financial reports with a score of 21 or better could go a long way to enhancing the financial literacy of farmers but the starting point remains enhancing the farm management accounting skills of accountants. As with many ideas this has been tried before both in Australia and other countries. The first attempt in Australia was in the 1960's and again in the 1990's.

Conclusion

Notwithstanding the failure of previous efforts the situation in Australia where farmer leaders are calling for initiatives to enhance the financial literacy of farmers it is worth revisiting educating accountants instead.