Ranching For Profit

Healthy Land, Happy Families & Profitable Businesses

By Dave Pratt

Allocate At Your Peril

At the Ranching For Profit School we make a clear distinction between overhead costs and direct costs. All land and labor costs are overheads. Overhead costs tend not to change very much as the units of production change. Direct costs do. There are exceptions to this rule of thumb. A lot of ranchers pay rent (a land cost) on a per head basis. That doesn't make it a direct cost. All land costs are overheads.

There are always a few participants in the school that feel it is important to allocate all of the overheads to the enterprises. Many other economic analyses do this, and in my opinion it is a huge mistake. It can lead to some very bad decisions. This is best illustrated with an example.

Let's say I have a livestock and a farming enterprise in my business. The cow/calf enterprise produces a gross margin of $50,000. The gross margin for the farming is $30,000. Let's see the misinformation that results if we allocate our overheads to these enterprises.

We will focus on just four overheads, rent, a pick-up truck, a tractor and our salary. Let's make the following assumptions:

- I pay $10,000 to rent the grass for my cattle and another $5,000 to rent the land for my farming.
- The average annual cost of operating a pick-up truck on a ranch these days is about $12,000 (including license fees, interest, insurance, repairs & maintenance, depreciation and fuel & oil). Let's split the cost of the pickup 50/50 between the two enterprises: $6,000 to the livestock and $6,000 to the farming.
- The cost of owning the tractor (interest, depreciation, insurance and repair & maintenance) $10,000. We figure 80% of the tractor usage is for the farming and 20% for livestock, so we allocate 80% ($8,000) of the cost to our farming enterprise and 20% ($2,000) to the livestock.
- We want to take a draw of $40,000 from the business. We feel it is fair for each enterprise to contribute 50% to our salary, so we allocate $20,000 to each enterprise.

	Totals	Allocation	Cow/Calf	Farming
Gross Margin	$80,000		$50,000	$30,000
Overheads				
Rent	$15,000	67%/33%	$10,000	$5,000
Pick-Up	$12,000	50%/50%	$6,000	$6,000
Tractor	$10,000	20%/80%	$2,000	$8,000

Salary	$40,000	50%/50%	$20,000	$20,000
Total Overheads	$77,000		$38,000	$39,000
Division Profit/Loss	(Gross Margin – Overheads)		**$12,000**	**-$9,000**
Business Profit/Loss	**$3,000**			

From our $30,000 farming gross margin we would deduct $39,000 in allocated overhead costs ($5,000 in rent, $6,000 for the pickup, $8,000 for the tractor and $20,000 for labor). That's a loss of $9,000.

We deduct $38,000 in overheads ($10,000 in rent, $6,000 for the pickup, $2,000 for the tractor and $20,000 for labor) from our $50,000 livestock gross margin making the livestock profit $12,000.

A profit of $12,000 plus a loss of $9,000 gives us a total profit of $3,000. One might conclude that we'd be better off to stop the farming enterprise since that part of the business produced a loss. But if we stop the farming, the overhead costs we allocate to that part of the business don't disappear. We wouldn't have to pay the $5,000 rent for the farm ground, but we still have to make our payments on the truck and tractor. We still have those interest payments and have to pay the insurance. They still depreciate. We don't want to cut our pay in half. If we stop the farming division, the overheads we allocated to that part of the business would have to be paid for by the livestock division. Now instead of making a business profit of $3,000, we make a $22,000 loss!

	Totals	**Allocation**	**Cow/Calf**	**Farming**
Gross Margin	$50,000		$50,000	0
Rent	$10,000		$10,000	0
Pick-Up	$12,000	100% / 0%	$12,000	0
Tractor	$10,000	100% / 0%	$10,000	0
Salary	$40,000	100% / 0%	$40,000	0
Total Overheads	$72,000		$72,000	0
Division Profit/Loss	(Gross Margin - Overheads)		**-$22,0000**	**0**
Business Profit/Loss	**-$22,000**			

To achieve a $3,000 profit without the farming enterprise we would have to increase the livestock gross margin by $25,000! That means we would have to increase the number of livestock by 50% without incurring any more overheads!

You can change the proportion of each overhead allocated to each division, but every time we guess about how a cost should be split you introduce error. And it misses the bigger point: If you stop the division, it doesn't mean that all of the costs stops with it.

Our desire to allocate overheads proportionately to one part of the business or another may stem from our desire to have one number tell us the whole story. That's just not realistic. The numbers always have to be considered in the context of the whole picture. Allocating overheads takes us in the opposite direction. As a result, in our effort to be more precise, we can create a distorted picture of what's really happening.

The bottom line is you should only allocate overheads if 100% of the cost can be attributed to one part of the business. The test is: would I lose the cost completely if I stopped operating that part of the business. If the answer is "Yes, allocate it." If the answer is "No, don't allocate it!"

We are in the business of putting profit into agriculture!

Phone: 707-429-2292 • Fax: 707-429-2100 • E-mail: rmc@ranchmanagement.com • web:www.ranchingforprofit.com