The Business Of Farming: Economics

By S.D. Parsons

In this first article I propose to use a broad brush to introduce the topic of business management - a subject that I believe has received too little attention in small business in general and in agriculture in particular.

In my opinion businesses succeed or fail on the basis of the strategic level decisions made in the setting up and the on-going running of the business. As farmers our training concentrates on the technical aspects of cropping and animal husbandry, supervision of labour and machine maintenance – all very important subjects but they do not constitute *management*.

They are technical subjects that determine how well a crop is produced and how well the business is run on a day to day basis, but in themselves they do not determine profit. Of course if the daily activities are sloppy, or if the yields are poor, the business may well be unprofitable. That's obvious, but the converse does not hold true. In other words if the yields are outstanding, and the efficiency excellent, the business will not necessarily be profitable. Another way of saying that is that *what we do we may do well, but are we doing the right thing?*

So where does one start? I suggest we start with the subject of profit. Profit means having a bigger business and a greater net worth at the end of the year than one had at the beginning. Profit is an economic subject while the amount of money you have in the bank is a financial issue. Economics and finance are different subjects. It is quite possible for a business to have made a profit (increased the net worth), but have less money in the bank than there was a year ago.

Economics concerns the way that a business is structured - akin to the way an engine is designed. Finance on the other hand is the fuel that makes the engine run. In the same way that a poorly designed engine will use up enormous quantities of fuel and produce very little, many businesses are structured to fail no matter how much is poured into them.

From an economic perspective there are only three things that determine profit. They are the gross margin produced per unit, the number of units produced and sold by the business and the overheads involved in producing those units. Thus, to improve profitability, we can either increase the gross margin per unit through more efficient production techniques (or look for more profitable enterprises), increase the size of the business to produce more units (relative to existing overheads) or decrease overheads.

Unfortunately many decisions in agriculture are taken on an ad hoc basis without due consideration to the impact they will have on the business structure as a whole. For instance, what may appear to be a good decision because it increases yield may have a catastrophic impact on overheads.

I suspect that is what has happened on many farms in this country over the last few years and it has resulted in major *financial* problems. Generalising, think for example of the person who decides to convert from dryland production to irrigation. Earlier planting, and assured moisture conditions make this a no brainer, but then comes the issue of more capital equipment, associated higher depreciation and repair costs and of course interest. It is the latter, which has caused so many problems in this country under the prevailing economic conditions.

What started out looking like a good economic proposition turns into a financial nightmare and the beginning of the slippery slope to oblivion. Yields, associated gross margin and turnover may have gone up, but if the increase in overheads is even greater, or if the debt load cannot be serviced in an ever escalating financial market, trouble lies ahead.

All that I have said above is nothing but common sense, and I have no doubt that many readers will say so what's new? Nothing, including the fact that there will be many farmers who will make precisely the type of mistake that I have outlined above. It may not be irrigation; it may be prickly pear or a better breed of animal or some other get rich quick scheme. There are no magic bullets. If the basic business structure is not sound the business will fail no matter how much money is poured into it – and if it is borrowed money that will only add fuel to the fire.

It's not the situation but what you do about it that determines the future.

In the next article I will explore some of the pitfalls in financial management, especially why we invest in things we mean to keep rather than things we mean to sell.

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