The Business Of Farming: Business Analysis

By S. D. Parsons

"Records are a waste of time!" Ever since I first made that statement at a farmer's meeting in Norton in 1968 it has created excited discussion – just as though I was questioning the audience's parentage. In today's article I take delight in stirring controversy on this and another closely held view on business analysis.

I make the above statement on records in all seriousness based on many years of looking for ways to identify the deadwood in a business. Because 'record keeping' is a paradigm that has been thrust down our throats for aeons the statement that records are a waste of time causes untold argument.

As my friend and colleague Dr. Alg. Kassier previously head of agricultural economics at Stellenbosch says, "Records are monuments to past follies". But to be fair, yes, there is a need for some records, like your birth certificate, title deeds, insurance policies etcetera, but generally the mass of production records we are urged to keep are of little value for decision making purposes. Like driving a car using only the rear-view mirror, trying to manage a business using records is fraught with danger.

I prefer to analyse a business not by what happened in the past but rather by what we intend to do in the future. To that end the far preferable procedure is budgeting. In this sense budgeting means making decisions about every aspect of the business. Remember there are two main areas of concern when we budget, namely economics and finance. Next week I will discuss finance but let us first consider economics and budgeting.

Economics concerns profitability and you will recall that the only three things that can be done to improve profit are to increase the gross margin per unit, produce more units (thereby increasing total gross margin), or decrease overheads. In your business one of those three requires more attention than the other two. The question is which one? You find out by budgeting.

The procedure is really very simple. The tricky part comes not in the mechanics but in using the right information. I have a very strong objection to using 'standard' numbers provided by the CFU, ZTA and others who have compiled average figures. It is most unlikely that your fertiliser application, machine use or other production systems will, or more importantly should, agree with what the 'average' person does.

Budgeting is a time for decision making – deciding exactly what you are going to do under your specific climatic, managerial and financial circumstances. The value in budgeting is the decision-making process, the rigour of thought involved. As such it cannot be undertaken by your consultant, accountant or clerk. Managing means making decisions and the end result is the tabulation of those decisions in the budget. However, there is a right way and a wrong way.

Allocating Overheads Is Wrong

The wrong way is the result of an unfortunate legacy of an accounting procedure called 'cost accounting'. In this procedure so called fixed costs are allocated to individual enterprises. That act decreases the value of budgets enormously. There are two fundamental errors in doing so. Firstly these costs are not 'fixed'. They can be changed. Calling them fixed conjures up the mental image of something we can do nothing about. I prefer the term *overheads*; a term that applies to a group of costs that tend to remain unchanged as production levels fluctuate. As such most land related, machinery and labour costs are overheads.

The second fallacy is that overheads change in proportion to turnover. Costs that do vary in direct proportion to level of production are *direct* costs. Again I deviate from the more common term of 'variable' costs. My definition of a direct cost is a cost that will change if the size of the enterprise changes by one unit i.e. one hectare or one animal. Any cost that does change in that manner is a direct cost.

So why is it wrong to allocate overheads? It is simpler to demonstrate by example. The ZTA claims that it costs $200 000 to produce one hectare of tobacco. Probably true if you count all labour, machinery and other overheads, but let us assume we want to grow just one additional hectare. It is patently obvious that the additional hectare will not cost $200 000. The cost increase will be proportional to the direct costs of growing that additional hectare, and the contribution toward net profit will be gross income minus direct costs, i.e. the contribution will be equal to the gross margin from that hectare.

Another example demonstrates how wrong decisions are made when overheads are allocated. In the early 1990's stupid management decisions on the part of the Australian wool board caused the price of wool to drop from $8 to $4 per kg. As a result some farmers slaughtered sheep saying it wasn't worth shearing because their cost of production was greater than the wool income would be. Another stupid mistake. With a shearing cost around $2 per sheep and 5kgs of wool per sheep the gross margin or contribution to overheads was $18 per sheep. On the other hand a slaughtered sheep made zero contribution. Which would you rather have?

As I write I have just had a phone call from a large operator in Glendale, a client, who is preparing his budgets for next year. He commented, "I am amazed by what comes out when I analyse my business along the lines you suggest". That is not surprising. This process reveals the business and exposes weaknesses and dead areas remarkably well. If you want to stay in business in these trying times start managing your business rather than merely working in it.

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