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Griffith Business & Technology Forum

Importance of Financial Skills in a Business

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Why are financial skills important?

Making a profit in farming is harder than ever before.

- Cost of land & water has increased significantly
- Cost of inputs has increased significantly – leading to diminishing cash returns
- Advances in technology have improved production but technology cost money.

There is a clear linkage between the level of understanding of the financial position of the business (i.e. capacity, costs and profit drivers) and the long term profitability of the business.

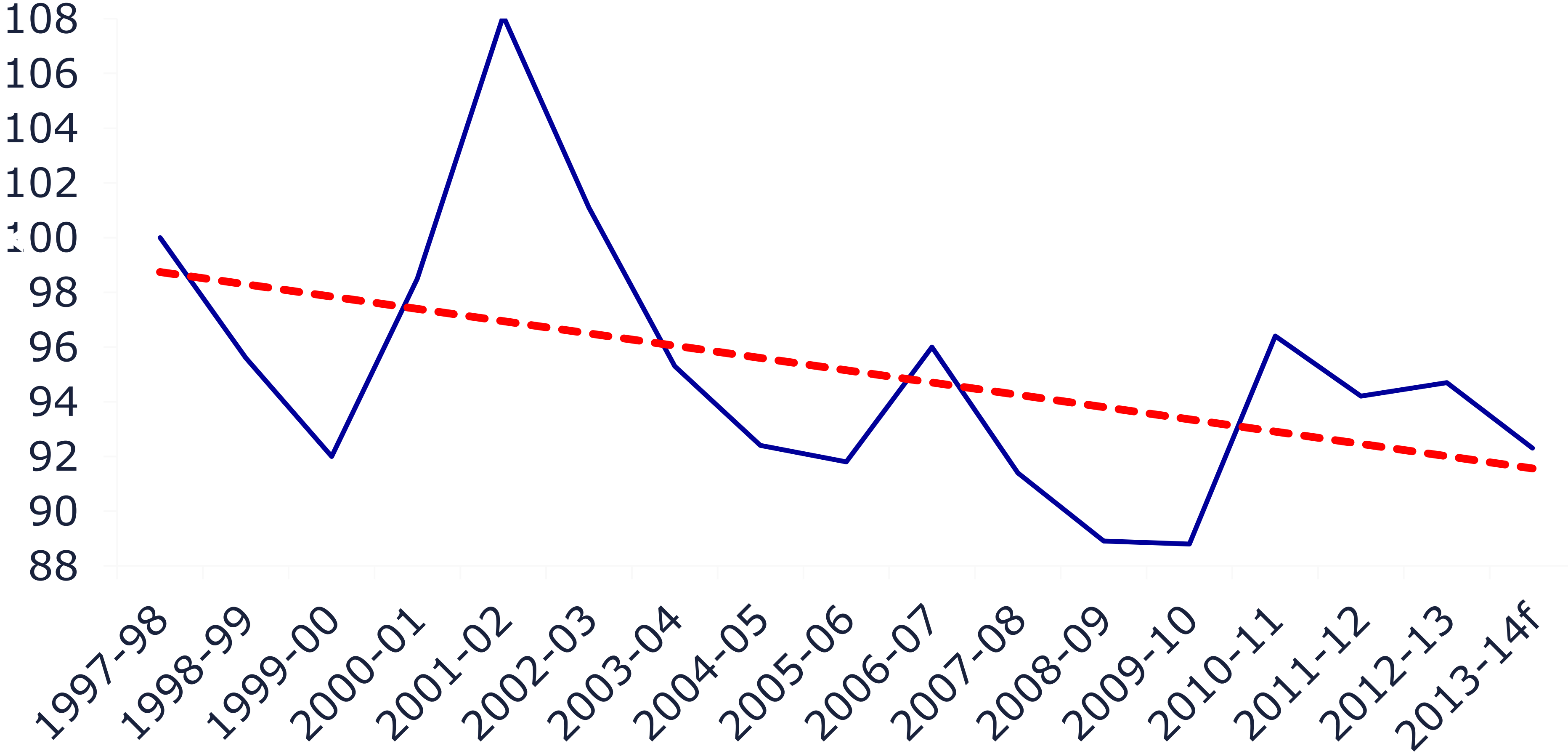
Challenges facing Primary Producers

- Terms of Trade are putting a squeeze on Agriculture over the long term.

- Cannot rely on increasing commodity prices to maintain your current level of profitability.

- If you don’t continue to move forward and improve, you will eventually go backwards.

Australian farmer's terms of trade



•Ratio of index of prices received by farmers and index of prices paid by farmers.

•Source: ABARES, Rabobank 2014

Have a plan & goals for your business

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In 1979 Harvard Business School conducted a study regarding goal setting and plans

Researches asked the 1979 graduates from the Harvard's MBA Program and found that :

- 84% had no specific goals at all
- 13% had goals but they were not committed to paper
- **3% had clear, written goals and plans to accomplish them**

In 1989, the researches again interviewed the graduates of that class. The results were as follows:

- The 13% of the class who had goals were earning, on average, **twice as much as the 84 percent who had no goals at all.**
- The 3% who had clear, written goals were earning, on average, **ten times as much as the other 97 percent.**

Source: McCormack, M. "What They Don't Teach You in the Harvard Business School"

Mt Kilimanjaro – Roof top of Africa 2017

Summary of borrowing money

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	Information Required	Why?
Past – Historical earning capacity	Financial Statements & Tax Returns	Need to demonstrate that you have a history of earning capacity/profitability. Losses ok but need to be explained. Building equity/repaying debt over longer period.
Present – Current position of the Individual/Business	Assets & Liabilities	Need to demonstrate that the individual/business has sufficient resilience to withstand a below average result. Need to understand other commitments.
Future – Cash flow of the business going forward	Cash Flow Budget	Need to demonstrate that the loan can be serviced and repaid AND there is sufficient cash left over for drawings.

Financial Accounts
Profit & Loss

Profit and Loss

- **Trading accounts:** The cost of goods sold and movements of stock eg. For livestock
- **Income:** All income for the full financial year
- **Expenses:** All expenses for the full financial year
- **Depreciation**: The cost of plant and machinery depreciation. This is not a cash flow expense and is accounted for in the balance sheet
- **EBIT or Operating Profit**: A calculation of the earnings before interest and taxation
- **Net Profit Before Tax:** A calculation of the total earnings less EBIT and interest

Capital Movements

- **Capital Introduced**: Money introduced into the trading entity such as inheritance or off farm income
- **Capital outgoings:** Money that flows out of the business that is considered a 'one off' expense eg. FMD's, purchase of shares or superannuation
- **Drawings:** Non tax deductable expenses that are drawn from the business such as school fees, taxation ,personal portions of electricity/fuel/phone bills and general living expenses

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Financial Accounts
Balance Sheet

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Balance Sheet

- **Current Assets:** Assets that can be liquidated within a 12 month period
- **Non-Current Assets:** Assets that cannot be liquidated within a 12 month period
- **Current Liabilities:** Liabilities that can be paid within a 12 months period
- **Non-current Liabilities:** Liabilities that cannot be paid within a 12 month period
- **Equity:** The net asset value less the net liability value is the equity in dollar terms.
- *Please note that the balance sheet records the value of all items at purchase price, therefore the values are lesser than in reality as time progresses.

Relationship between the P & L and the Balance Sheet

- There is a relationship linking the P & L and the balance sheet. For example if there is a loss after Net Profit and drawings the only way the business can make up the loss is by introduced capital.
- How could the loss be funded so that the business has enough working capital to keep running?

Types of financial ratios (profitability)

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3. Serviceability Ratios

a. Interest Cover

$$\text{Interest cover ratio} = \frac{\text{Earnings Before Interest, tax \& depn (EBITDA)}}{\text{Total interest}}$$

b. Finance costs as a percentage of Income

$$\text{Interest costs} = \frac{\text{Total finance costs}}{\text{Total Income}}$$

c. Debt/Income

Total liabilities/Gross income

Financial Performance Indicator Summary

1. Interest Cover: <1.25x (Weak); 1.5x (Satisfactory); >2.0x (Strong)
2. Finance Costs: >20% (Weak); 15% (Satisfactory); <10% (Strong)
3. Debt/Income: >2.5:1 (Weak); 2:1 (Satisfactory); <1:1 (Strong)

Statement of Assets & Liabilities

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Statement of Assets & Liabilities

- **Assets:** All current and non current assets at market value savings, deposits , debtors, shares and superannuation
- **Liabilities:** All current and non current liabilities including creditors, livestock , fertiliser accounts and home loans

  Total Assets – Total Liabilities = net worth taken at a certain point in time

Difference between the A & L and the Balance Sheet

- **Assets**: The A & L includes all assets at market value, whereas the Balance Sheet includes assets at a historical cost eg. Original farm purchase price. The A & L also includes all assets owned by the borrower and any related party, however the balance sheet includes assets held only by the Financial Statement entity.
- **Liabilities:** The A & L includes all liabilities of the borrowing entity and any related party, whereas the balance sheet only includes liabilities held by the Financial Statement entity. Sometimes 'soft loans' are excluded from the A & L such as a forgiven family loan
- **Timing:** A & L can be taken at any point in time whereas the balance sheet is generally at June 30th.

Types of financial ratios (Equity)

Equity:

- This is a measure of your net worth and your ability to create wealth for you and your family.

Equity/Gearing (%)

$$\text{Equity} = \frac{\text{Total Assets} - \text{Total Liabilities}}{\text{Total Assets}}$$

$$\text{Gearing} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Equity: <60% (Weak); 70% (Satisfactory); >85% (Strong)

Cash Flow Budget

- Allows for an accurate estimate of your working capital requirement for the year (Peak operating debt)
  - You won't run out ¾ way through the year
  - Saves time & loan increase fees
  - Allows you to plan better for unforseen situations

- Adopt Realistic scenario's
  - Average Yields
  - Long term average prices
  - Full Costings + 10%
  - Use previous years cashbook figures as a guide
  - Factor in outside business costs e.g., drawings, school fees, tax, debt repays, Cap Ex
  - Set an opening balance from your drawn balance or cash on hand

- Cash flows are difficult & they change,
  - This is not an excuse not to do them
  - demonstrates to your financier that you understand your business and its cash requirement

Cash Flow Budget

- Liquidity

  - Is there sufficient head room in the cashflow

- Surplus/Deficit

  - Where are surplus funds going to be applied
  - How is the deficit funded. Debt/ Capital injection / Asset sale

- Debt Sustainability Limit

Gross Margin Analysis

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- Can be used by farmers as a guide to the relative profitability of various enterprises and help in the decision making process.

- Definition - The gross income from an enterprise less the variable costs incurred in achieving it. It does not include fixed or overhead costs such as interest payments, rates, or permanent labour

- Final GM is usually expressed in the unit of the limiting factor, e.g. $/ha $/meg or $/DSE

- Can be used to compare your business to other business in the district or DPI figures

Some take home points.

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- If you don't continue to move forward and improve, you will eventually go backwards.
- There is a clear link between the level of understanding of the financial position of the business and the long term profitability of the business.
- Clear written goals and plans will lead to increased success.
- If you are weak in one area, then you should be strong in another.

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"The financial link in the global food chain"™

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