I MADE A PROFIT — BUT I HAVE NO CASH??!

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QUICK TAKE

- A profit is not always a profit but it is preferable to a loss.
- Tax (compliance) profits are determined by ATO rules designed to raise taxes.
- Management profits should be reflective of the true cost of owning and operating a business.
- Profits do not always reflect the availability of much needed cash flow.
- Profits without accrued losses make debt reduction difficult.
- Spending "dollars" on capital purchases to save "cents" on tax can be a poor business strategy.

Agriculture is a capital intensive and long-haul industry with a lumpy cash flow pattern. Cash management problems are exacerbated by seasonal and market fluctuations. More recently, the escalating imposts of bureaucratic and political risk have emerged as serious management challenges.

While profits are important, cash is king in the commercial environment of today's agriculture.

What is a profit?

Because we all must keep financial records and lodge our tax returns each year, defining a taxable profit is a good place to start. In its simplest form a taxable profit is ***gross farm income less costs***.

Costs include:

- overhead costs
- salaries, wages and related costs
- variable allocated costs
- variable unallocated costs
- finance costs
- depreciation.

In most farm businesses, the owners' drawings are not deductible, and for livestock producers the use of the average cost based trading account further confuses the issue.

To obtain a simple measure of a ***management effective profit,*** take the taxable profit (or loss) and:

- deduct, for example, a $60,000 management fee—anything less is subsidising your business with low salaries
- add back depreciation and replace this with a more appropriate provision for capital renewal—the rule-of-thumb provision is 15% of the fair clearing sale value of all your plant and equipment.

Note that capital renewal also needs to consider repairs and maintenance (R&M) levels. As a rule repairs and maintenance should be no more than your fuel costs. If your repairs and maintenance costs are greater than fuel costs it is time to consider upgrading your equipment.

A broad rule of thumb is that a taxable profit of $100,000 is equal to a zero management profit—to which most owner/managers respond by taking minimal drawings and limiting capital upgrades, which puts pressure on balance sheets.

Profits are historical

For most businesses, the calculation of profits is based on what has happened in the past year plus a last minute rush to legitimately limit the amount of tax payable within the rules set by the Australian Taxation Office (ATO) and the ruling legislation.

For the more attuned managers, the balance between profits, cash flow and business growth are more proactive than the usual reactive approach to management. More about this later.

Cash is king

For the broadacre irrigator there are two good current examples of the need for planning and executing the management of cashflow budgets.

In the 2011–12 financial year, cotton was the crop with the highest potential gross margin. However, it is also the crop with a very high cost of production and delayed cashflow. The large area grown in southern NSW last summer has in part led to delays to ginning and consequently payment. The delayed payments will place stress on cash flow, possibly into early 2013. Delayed payments will place undue pressure on financing the spring planting of the next summer crop.

Rice is the other summer crop for which growers are suffering cash flow difficulties. Rice has a much lower gross margin than cotton but has the benefit of Rice Orders to ease the cash flow burden via creditor comfort. What Rice Orders cannot do is overcome the drawn out payment system. As all rice growers realise, it takes two years to reach a steady state cash flow after a drought, and the third year to start to see real flows of cash.

From a risk management perspective there is merit in growing a mix of cotton, rice and/or other summer crops to keep open your access to cash when it is needed. The right crop mix will also retain currency with growing skills, and winter crops are also part of this mix.

Further compounding the issue is the potential need to invest in specialised and costly plant and equipment. Too much equipment can dramatically alter immediate cashflow and the capital renewal provisions for your business.

Cashflow & capital renewal

Compounding the cash flow problems coming out of a drought and/or an extended period of market downturns is the need for capital renewal. Prioritising capital expenditure is specific to every business and needs to be carefully planned in conjunction with:

- overall debt and equity structure of the business
- need for improving future productivity, efficiency and profitability
- need for opening up new production opportunities
- need for succession planning
- financier requirements.

Repairing the balance sheet after a long drought or commodity downturn comes with the knowledge that another inevitable market downturn or drought will follow. Spending too much in an inappropriate manner on renewal will undermine the ability of a manager to control his future business destiny simply because of the restricted availability of cash, and increased pressure on the balance sheet.

Cashflow projections

Good managers are well-attuned to the benefits of preparing their cash flow budgets. However most only project their needs out for one year and, in some instances, follow that with an assessment of their profitability at average seasons and markets.

The more astute managers appreciate that decisions made this year will have consequences next year and even for years beyond that. The real key benefits of extended budgeting include:

- the earlier identification and understanding of emerging liquidity problems
- more informed decisions when confronted with the inevitable variations in trading conditions.

Best practice managers also project both future tax and management effective profits as a part of the budgetary process and monitor any changes as they implement business programs.

Cashflow & balance sheets

Cashflows and balance sheets are intricately linked and must be considered on a management effective basis. It becomes too easy to lose sight of a likely asset and/or equity run-down behind a supposedly good cash flow.

Tax (compliance) balance sheets are rarely useful as they rely on historical cost less accumulated statutory depreciation. Alternatively, balance sheets based on current market values are not without inherent problems although in the hands of experienced managers are necessary for effective planning and business monitoring.

Best practice cash flow budgeting must start with an opening balance sheet and finish with a closing balance sheet.

June 2012 outlook

At the 30 June, 2012 the pragmatic outlook for broadacre irrigators may be as follows:

- the big wet (??) is over and there will be a slide into drought before the next wet period
- cotton prices seem to have had their run and are joining the low prices of other commodities
- the dams are near full with winter releases to keep airspace and a relatively wet catchment.

From a water supply perspective, allocations may be relatively good for say two years and possibly at least okay for the following year or two. Beyond that it is anyone's guess.

From a business perspective and subject to your specific circumstances, the broad aim needs to be:

- get through any inherent cashflow hump of 2012–13
- by June 2013, make and commence actioning key decisions on capital renewal and balance sheet repair
- plan to have any renewal and/or repair under control by say June 2015
- fine-tune and settle your financing needs in the process.

Given the current varying world trading outlook, caution with budgets will be paramount. Ensure you are well placed to optimise the outcomes of any beneficial seasonal, trading and/or marketing opportunities.

Trusted advisors

Independent advice from trusted advisors such as the following in collaboration is most important—these are your accountants, consultants, solicitors and financiers.

Independent and factual input will optimise the outcomes for your business and its owners. Use your advisors to help review your plans and help you consider and test a range of relevant risk scenarios to choose the best management policy and to test the resilience of your business.

Further information

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