PROFIT IS NOT ALWAYS PROFIT

Michael Ryan
Booth Associates, Griffith

QUICK TAKE

- The profit and loss statement (P&L) prepared for taxation purposes is rarely the same profit or loss figures upon which sound business decisions should be made.
- Real P&Ls should include drawings that equal the cost of paying a manager and provision for capital renewal (as distinct from depreciation of existing items) to allow the business owner to compare their performance against other similar businesses or investments.
- Current real profits backed up with accrued tax losses and sound cash flow projections provide the opportunity to pay back debts post drought and repair balance sheets.
- It is best business practice to minimise tax, but beyond capital growth (which is difficult to influence), making a profit and paying tax is the only assured way to increase your equity.

When accountants are calculating profit or loss, what profit or loss are they really calculating?

The profit or loss statement (P&L) that most people see and use is the one prepared by their accountants as at June 30 each year. The resultant tax liability will be based on factors such as the net outcome of the year's business trading, specific balance sheet changes, accrued losses and any adjustments for 'last minute' actions such as buying new equipment, upgrading assets, or works of a conservation or other specific nature.

Without question we accept that our accountant is preparing documents fully compliant with the intent and provisions of the Income Tax and Assessment Act and accepted accounting standards. The Income Tax and Assessment Act and surrounding rulings and policies are all designed to define the guidelines by which income and capital taxes are to be raised by government.

In isolation, however, the P&L prepared for tax rarely provides a sound measure of the actual business profit and loss upon which sound management decisions can be made.

Rule of thumb

At a simple level, a taxable profit of $100,000 is not a profit or a loss in a true business sense. Whilst there are many and varied provisos, the core reasons include the need for extra deductions from actual business profit or loss to comply with the Income Tax and Assessment Act. These include:

- arguably, $75,000 for management drawings
- say $25,000 for the increased cost of capital renewal as against recorded depreciation.

With livestock enterprises there are further adjustments with average-cost based trading accounts.

Whilst we have not touched upon inventory changes, the role of equipment finance, abnormal repairs and maintenance (R&M) and a raft of other possible issues, the rule of thumb is enough to demonstrate there are real differences in the way in which 'profits' are able to be determined.

Which profit?

Business profitability can be expressed in many ways but for practical purposes in this article there are four key measures of profit, namely:

- to meet Income Tax and Assessment Act compliance
- to keep your financier happy
- to measure yourself against other investments and similar businesses
- to reflect living and operational standards acceptable to you.

The first two measures are often diametrically opposed in that you seek a low (compliance) P&L to pay as little tax as is legally possible, while you need a high P&L to keep your banker happy. Luckily a good banker can see through the compliance P&L although there are some issues that are not always obvious and need clear factual explanation. Examples are certain inventory changes, abnormal R&M and changes in end-of-year commitments.

The third measure of P&L is based on switched-on managers asking us to benchmark them against alternative investments on the basis they are in the business of being 'in business' and that their chosen industry is agriculture. Accordingly they require a P&L based on drawings equal to that which they would have to pay an independent manager, among other cost/income assessment standards. Often quite confronting this is not a commonly used measure but is one which drives harder critique of business options and strategic planning exercises.

The final measure of P&L faces day-to-day reality where we subsidise our business with reduced drawings, keep machinery and vehicles going for longer than desirable and accept infrastructure run-downs until the next up-turn. The flipside is that when, say drawings need to be increased to cover increased education costs, the relevant drawings need to be increased up to at least what an independent manager would be paid.

In practical terms there is potential to combine all but the needs of the tax P&L into a single management focussed P&L, with accompanying notations for benchmarking, and banker's and personal needs.

Profits & cash

Making a profit does not ensure cash is available and remember we pay our bills with cash not profits. With taxable profits the relevance to cash flow is less so, especially because of the need to meet drawings, renew capital, meet on-going operational costs and provide for payment of income tax if accrued tax losses have been used up.

If debt reduction is required by your financier and/or you see it as necessary to repair your balance sheet in time for the next down-turn, then ill-considered commitments and payments can pressure cash flow, leading to compromised decisions and less than acceptable productivity outcomes.

If you have accrued losses and are beginning to generate profits, this is the time to review the potential to reduce debt in an orderly manner whilst ensuring consistency with your budgetary projections. Averaging of P&Ls could extend the available timeframe but not enough to overcome complacency in planning.

Future profits

Agriculture is a long-haul and capital-intensive industry open to the vagaries of seasons, markets and a growing volatility in policies relating to agriculture, management of natural resources and to our economy in general. This makes forward budgeting difficult but far from impossible. The same goes for forecasting future taxable and management P&Ls.

Decisions made this year will impact on next year and the year after. Running around in the lead-up to the end of the financial year may reduce tax commitments and provide comfort with the presence of a new tractor or header. However there is often an elevated risk of undue future cash flow constraints.

Successful businesses plan three to four years ahead, even for annual reviews, and even for estimating future tax liabilities. Management-effective rather than compliance-based (tax) balance sheets for both the start and end of the planning period are crucial in minimising the risk of hiding an asset run-down behind a seemingly good cash flow.

Managing profits

A dryland farmer will have a sound idea of what the current year's profit could be by the end of December and should be able to forecast it with some reasonable measure of accuracy by the end of January. An irrigator will have a good idea by the end of February subject to the autumn grain harvest, vintage or cotton picking outcomes.

Good managers start planning their financial options no later than the end of February for a 30 June financial year. This planning includes P&Ls, balance sheets, cash flow needs, capital renewal needs and debt obligations, as well as personal needs and growth needs of the business, ahead of the next inevitable industry down-turn and the imposts of the relentless decline in the terms of trade.

Since there is not pot of gold in farming, a sound understanding of 'true' profit and business performance is essential.

Starting early ensures on-going consideration of the implications of options, whilst getting ready for the winter crops and harvesting summer crops. By 30 June you will be well placed to make and implement an informed set of decisions, there are likely to be fewer mistakes in the current and future years, and opportunities can be optimised.

Introducing NPAT: net profit after tax

In business and in life generally: Total Assets = Liabilities + Equity

To grow equity (net worth) in real terms you will need to make profits and/or increase the value of your assets beyond the CPI (consumer price index). Increasing (capital) costs to increase future productivity and asset values to minimise tax has a mix of advantages and disadvantages. For example, spending $50,000 on say lasering will not add $50,000 to the value of your farm and in practice it may be as little as 0–20%. That part of the cost which does not go to tangible assets must be serviced by increased productivity and profitability. Spending hard-earned dollars to save cents is not logical unless there is an identifiable and worthy parallel benefit.

Aside from reinvesting profits into your farm to increase its value, there is little you can do to influence capital growth. So the only other way to increase your equity is to make a real profit, not a tax profit. Without the benefit of accrued losses (which are most likely capitalised as debt on your balance sheet) if you make a profit, you will have to pay some tax. It is sound business practice to minimise tax but ultimately, if you want to grow your equity, you will have to pay some tax.

The hard reality is that tax is another business cost and hence the need to consider net profit after tax (NPAT), which is another form of P&L.

NPAT principles can be applied to the P&Ls and business planning exercises we discussed earlier to achieve a balance between tax commitments, optimising access to cash flow, growth in equity and other business decisions.

Monitoring profits

Once you have fine tuned and settled on your P&L at the end of the financial year, it is an essential part of best management practice to monitor the outcomes of your decisions and actions. There are a number ways to do this in conjunction with monitoring your cash flow budget. The methods are not costly — but are beyond the scope of this article.

Your trusted business, tax and banking advisors working as a team—not in isolation—are essential for a successful profit outcome and the satisfaction you gain from managing a successful business.

Further information

Michael Ryan
T: 02 6964 991
E:m.ryan@boothassociates.com.au

It is great to be able to harvest efficiently and on time, but new equipment is very expensive and puts pressure on cash flow.