



# **Financial Budgeting in Sheep and Beef Businesses**

For Kellogg Rural Leaders Programme

**Sam Orsborn  
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## *Executive Summary*

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Over the past twelve months we have seen extreme fluctuations in factors affecting agricultural return such as exchange rates and dairy payout. This volatility is changing the risk status of agriculture in New Zealand. Farmers need to take greater control of the financial management of their businesses. There is a great opportunity to increase profitability on sheep and beef properties but it needs to be driven by a willingness of farmers to up skill themselves on what influences profitability. This has to be done by being informed, knowing where the business is now and then looking forward.

This project sought to identify levels of budgeting skill amongst sheep and beef farmers, to explore the impact of effective financial budgeting and to examine the barriers for farmers to financial budgeting. Data was collected by interviewing eight rural bank managers and five farmers individually plus eight farmers in a focus group situation. The data gathered, yielded some interesting results. While there were many points highlighted by the analysis of data, four key findings warranted further discussion; clearly defining budgeting levels, the introduction of risk based interest rate pricing, farmers knowledge and understanding of what creates farm profitability and importantly what are the barriers to financial budgeting.

The most significant finding was identification of three key budgeting categories amongst sheep and beef farmers; Expert Budgeters, Budgeters and Non Budgeters. From data collected, it was identified that only 5% of sheep and beef businesses are regarded as 'expert budgeters'.

Following the analysis, a number of recommendations for both farmers and professionals are offered. It was recommended that; the budgeting categories are utilised to establish skill levels, there is a clear understanding of the effects of risk based pricing and breaking down the barriers to effective financial budgeting.

## *Introduction*

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Over the past year financiers have tightened up their lending policies to all rural borrowers. This has been an implication of the financial crisis along with poor farming returns, especially in the sheep and beef industry over the past three years, in addition to the volatility of the dairy payout over the past 12 months. This situation is forcing financiers to look closely at the security and viability ratios of their clients farming businesses. In the past it has been easier to borrow money due to a continual increase in land prices, therefore ensuring safe security ratios. However, now with a decrease in land price in addition to poor viability, security and viability ratios are being stretched to breaking point in some cases. More than ever before farmers now need to manage their businesses more efficiently both physically and financially. While this is going to be extremely tough for some farmers, it may encourage farmers to refocus on their business viability and profitability, a skill that may have been lost during the good times of farming. In turn farmers will ideally focus on how to increase profit rather than relying on land price increases, to keep their banking ratios in line.

The initial intent of the project was to collect enough data to illustrate the financial benefit of budgeting through analysis of profit data from farms. However, it quickly became apparent that the number of sheep and beef farmers that were budgeting effectively was exceptionally low. This meant the data set required to gain accurate information on the profitability benefits of budgeting needed to be extremely large, to create a viable study. This was not feasible hence a directional change to focus on the benefits of budgeting from a financiers and farmers perspective.

This research project explored the effectiveness of financial budgeting and planning in sheep and beef businesses. The research data was gathered by interviewing both financiers and farmers. The aim was to ascertain how many farmers successfully manage the budgeting and planning in their business, in addition to identifying what the barriers are to successfully budget and plan.

The report will initially outline the aims and objectives of the project. An overview of the methodology will then be provided before presenting the findings. An analysis of the data will be highlighted and recommendations for the future will conclude the report.



## *Aims and Objectives*

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- To identify levels of budgeting skill amongst sheep and beef businesses
- To explore the impact of effective financial budgeting
- To examine the barriers for farmers to financial budgeting
- To develop recommendations for future practice

## *Methodology*

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The research involved interviewing eight rural bank managers/financiers. This provided a wide coverage of sheep and beef businesses with a variety of performance levels, ages, debt levels and abilities to plan.

An initial pilot interview was conducted with one financier which while useful, prompted an early change to the interview questions. Following analysis of the data generated from the interview, three levels of budgeting skill emerged. Prior to this interview I had envisaged two skill level categories (Budgeters and Non Budgeters) but it became apparent that there were in fact three clear categories (Expert Budgeters, Budgeters and Non Budgeters). This provoked a change in question two below. Following the pilot interview, seven other rural bank managers from the Wairarapa region were asked the following revised questions;

1. How many sheep and beef clients do you have?
2. How many of these clients fit into each category of budgeting?
3. Is financial budgeting beneficial and why?
4. What are the barriers to Sheep and Beef farmers budgeting?
5. What is the banks view on accurate and timely budgeting and reporting?

The second group to be interviewed was eight farmers in a focus group format and five others individually. The questions for this sample were;

1. Why Budget?
2. What would/does budgeting do for your business?
3. What is budgeting?
4. What are the barriers stopping you from doing more accurate and timely budgeting?



## *Findings*

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Initial research of my own identified that from 150 client budgets I have with my Agricultural Consultancy business, only three clients over the past five years had a full and accurate budget completed prior to my meeting with them to discuss their business performance. This is an extremely low number but this prompted me to further consider the rationale for such a phenomenon.

### **Budgeting Categories**

As previously discussed, following the pilot interview it became apparent that sheep and beef farmers could be categorised into three categories on their ability to budget. The financiers all conceded that this was a useful working model. The categories are as follows;

#### **Category 1 – Expert Budgeters**

- Expert budgeters own their budget.
- They know their expected financial results well in advance of it happening. They know their expected and actual Gross Farm Income (GFI), Farm Surplus etc.
- They very rarely exceed set banking limits and if they do it is usually picked up months before it occurs.
- They have stress tested their businesses
- They know the key sensitivities in their business.
- They look at risk management when they are planning.
- They use variance reporting.

#### **Category 2 - Budgeters**

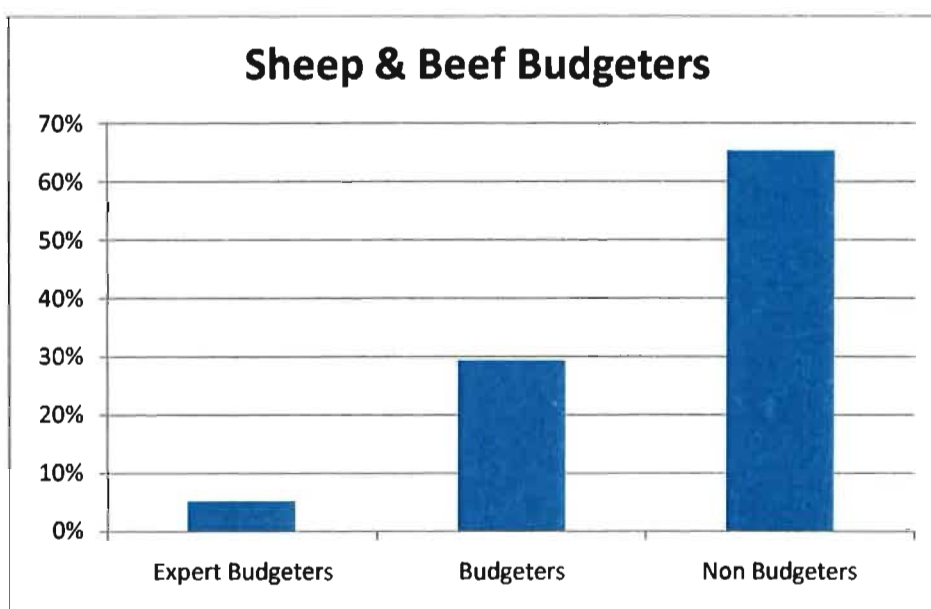
- They budget and generally understand it well but then goes into the bottom draw and never compared back to, see where and why there were changes.
- Some of these farmers budget regularly but they are not looking at the variances from previous budgets and asking “why did that change?”

- Budgeting is not generally a priority over other farming activities.
- Sometimes these budget are done with consultants or accountants to plan once or twice a year.
- Limited ownership of budget.

### Category 3 – Non Budgeters

- The business budget may be done once a year by their financier or no budget at all.
- These businesses are the most prone to surprises for the owners and bank managers such as exceeding banking limits.
- A lot of these businesses think they cannot influence profitability because they can't influence what price they get for stock or what price they have to pay for purchases e.g. fertiliser.

A key finding from the initial questions was the extremely low numbers of expert budgeters that exist in the eight Wairarapa bank manager portfolios. The graph below shows these results.



The data suggests that only 5% of sheep and beef farmers are considered expert budgeters by their bankers. The statistics indicate that 30% farmer's budget but are not constantly using the results to make better informed decisions. The remaining 65% do not budget themselves. This is an alarming statistic, but not totally unexpected. When critiquing data from a paper produced by



Pryde and Nuthall (1984), it appears that despite the increased ability to use technology assisted budgeting programmes; there has been negative improvement in the number of farmers producing farms budgets. While it is acknowledged that the current study is small in comparison, Pryde and Nuthall document that 45.3% of farmers budget which is loosely comparable to the 35% reported in this small current study. There are clear opportunities to improve these statistics.

Over the past few years bank managers have produced financial budgets for clients which have been passed onto their respective credit departments. The bank managers interviewed indicated that this was going to change, because the budgets are being done by the bank manager the farmers are not taking control and owning their budgets.

Bank managers have a large and diverse client base. All of them confirmed that the clients that were the easiest to manage were those that knew exactly how their business was performing. The bank managers agreed if farmers know what is happening in their business, they can then make the appropriate changes to correct any problems. Some of the clients in the category “Budgeters” and most of the “Non Budgeters” do not know how their business has performed until they receive their accounts back from their accountant which is typically six months after the end of the financial year. This is obviously too late to correct any issues, or capitalise on opportunities that may have arisen. Conversely the clients that were easier to manage were seen as the higher performers both in regard to on farm production and financial performance. These clients know their key indices such as production of meat and wool per ha and the factors driving it. This enables these clients to make changes in a timely fashion to increase production. These are also clients that financiers have confidence in lending money to, knowing that even in the harder times banking covenants will be respected or changes of plans will be implemented prior to any problems occurring.

## **Risk Based Pricing**

Financiers are now adopting risk based pricing of interest rate margins. This is due to the adoption of the Basel II Accord. This means that a banking client that has performed well over a wide range of factors will have a lower interest rate margin than a business that has not performed so well. This will put a greater emphasis on the importance of farmers producing

accurate financial plans/budgets. This risk based pricing assessment is based on some key business performances. A succinct explanation of Basel II Accord, provided by a local accountant, is outlined below.

### **Basel II Accord**

Basel Accords are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. Basel Accords have been adopted by a large number of global regulators including the Reserve Bank of New Zealand (RBNZ), and Australian Prudential Regulatory Authority (APRA). All of the major banks in New Zealand are owned by Australian parents. Hence, New Zealand banks are required to meet the capital requirements set by the RBNZ, and also report to their parents and meet the rules governed by APRA.

The Basel Accords aim to protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. Basel II (replaced Basel I for NZ banks on 1<sup>st</sup> Jan 2008) aims to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices.

Hence, in order to calculate Basel II credit risk capital a bank is required to risk grade its lending portfolio. The amount of regulatory capital, mainly in the form of equity or subordinated debt, the bank needs to hold is dependant on the risk grade of the customer or business. A poor risk grade (dependant on profitability and security) results in the bank needing to hold significantly more capital compared with a customer who has a good risk grade. In addition, capital requirements are linear with the size of the loan, i.e. the greater the loan, the more capital the bank needs to hold.

Regulators enforce the banks to hold regulatory capital in the strongest forms of capital, being equity (mainly retained earnings) and subordinated debt. Being the highest forms of capital there is a significant cost to the bank of holding that capital. Hence, the banks must ensure they are using it efficiently and obtaining sufficient returns for their shareholders to be able to continue to attract it and lend to their customers. Therefore,

pricing to risk is an essential part of a banks strategy to maintain and attract cost effective capital. (H. Edge, Personal Communication, October 17<sup>th</sup>, 2009)

Below is a table showing an example of how two different businesses may assessed.

<b>Bank Risk Model</b>		
	<b>Business 1</b>	<b>Business 2</b>
Sales	Decrease	Increase
Profit Record	<b>Strong</b>	<b>Poor</b>
Equity	High	Low
Cash Flow	<b>Strong</b>	<b>Poor</b>
Repayment Capacity	Marginal	Marginal
Management Skill	<b>Good</b>	<b>Adequate</b>
Integrity	Reputable	Reputable
Succession	<b>Broadly Defined</b>	<b>Broadly Defined</b>
Loan History	Trouble Free	Marginal
Location	<b>Low Risk</b>	<b>Low Risk</b>
Productivity	Stable	Increase
Industry Risk	<b>Low Risk</b>	<b>Low Risk</b>
Risk Management	Very Good	Adequate
<b>Rating (Viability and Personal Factors)</b>	<b>C</b>	<b>F</b>
Primary Security	\$3,652,000	\$1,638,000
Secondary Security	\$0	\$1,075,000
Total Facilities	\$2,000,000	\$3,079,000
<b>Rating (Security)</b>	<b>A</b>	<b>D</b>
<b>Overall Rating</b>	<b>B</b>	<b>F</b>
<b>Lending Margin</b>	1.20%	3.00%

As you can see from the table Business 1 was marked more favourably than Business 2. Business 1 received a rating of a “C” and Business 2 an “F” for viability and personal factors. For security

factors in these businesses they received an “A” and “D” respectively. This gave an overall rating of “B” for Business 1 and “F” for Business 2.

The margin on top of the base rates would be approximately 1.2% for Business 1, and 3.0% for Business 2. If both of these businesses had \$2 million of borrowing this would equate to a \$36,000 difference in interest cost between these two businesses. This is primarily due to Business 1 having better control of their business financial models and budgets.

## **Farm Profitability**

Farmers more often than not have a sound understanding of the value of budgeting but often fail to enact them. From the interviews conducted, farmers demonstrated a good understanding of the benefits to financial budgeting and planning. Most farmers interviewed believed that budgeting does create greater profitability in their farming businesses. Budgeting does this by quantifying in detail what is likely to occur going forward, such as lamb sale weights and lamb price along with all other factors to forecast where the business is likely to be in a period of time. These budgets are typically based on how the business has performed in the past.

The farmers described budgets as providing a basis on which decisions can be made to increase profitability. Additionally they can be used as a target for the business and people involved in the business, such as managers. They can provide a sense of achievement when met and a focus of discussion when they are not. Furthermore a budget provides a business with a basis to balance the books within a financial year when times are tough and a platform to grow profitability through the better times.

Farmers believe that budgeting provides a benchmark to compare against both their own performance and the top operators to point out how to make their own businesses perform better.

Unfortunately, this is what farmers say but ultimately, many are not doing it. There are big opportunities to increase farm profitability through decision making based on financial performance.

For example, the average Gross Farm Income (GFI) for New Zealand sheep and beef farmers in 2008-09 was provisionally \$343,000. If through better decision making there was an increase in

GFI of 5%, this would equate to an extra \$17,000 for the average sheep and beef farmer. Most of this increase would be reflected in profit. The average farm profit before tax for 2008-09 would be approximately \$56,500, therefore an increase of \$17,000 would represent a 30% increase in profit.

## **Barriers to Financial Budgeting**

From the interviews with financiers and farmers some key barriers were discovered which inhibits sheep and beef farmers from effective financial budgeting. These barriers can be broadly summarised into three categories; training, time and technology.

### **Training**

Most budgeting I have seen, and likewise for the financiers, has been focused mainly on cash flow and not looking at profitability of the business. This has caused these businesses to look at short term gains, which may not be in line with the long term gains and the overall business strategy. Cash flow budgets when completed accurately are useful for predicting cash flow only, however cash flow does not always correspond into profitability. Most of the banks clients, and farmers interviewed were using Cashmanager RURAL, which has the ability to do forecast cash flows along with full stock reconciliations.

The biggest limitation for clients was actually knowing how to use the stock reconciliation to forecast profitability. The stock reconciliations need to be accurate to forecast change in stock value between opening and closing stock for the financial year. If this process does not occur and stock numbers dramatically decrease (stock sold or not retained) this may mean a good cash result but potentially a poor profit result and vice versa. In most cases farmers should be aiming to maximise profit which will flow through to cash flow. Budgeting solely for cash flow may be detrimental to the long term aspirations and performance of the business.

One of the problems with the financier's clients and the farmers interviewed was the lack of understanding the process of forecasting profit. The financiers and farmers indicated that up skilling was required to produce accurately forecasted profit results. This step is not a big step

for farmers to make because they all know the number of stock they own. The limitation is how to use this information when forecasting profit.

### **“Better Budgets Better Business”**

An initiative that directly resulted from this project was the establishment of ‘Better Budgets Better Business’ workshops. Before the final analysis had occurred these workshops were started by a bank manager and myself. The course is run with a bank manager, farm consultant (myself) and the Cashmanager programme designers. Having a bank manager there provides insight into bank requirements and reporting.

‘Better Budgeting Better Business’ is a two day workshop on up skilling farmers on budgeting. The course has been running now for the past three months. The course is based around the use of Cashmanager RURAL which the majority of sheep and beef farmers use. The farmers work on their own farm data and at the end of the course they will have created their own budget and revised it. The course has mainly Category 2 budgeters who generally understand budgeting and want to take the next step and take more control of it.



The course is run over two days with approximately six weeks in between. Day one focuses on the basics of budgeting, including;

- Establishing the level of coding detail required for decision making.
- Completing the actual stock reconciliation for the previous year, establishing the stock adjustment and therefore reporting indices such as Gross Farm Income, Farm Expenses and Economic Farm Surplus.
- Creating a financial budget for the coming financial year.
- Producing reports for stakeholders and financiers.
- Saving budgets to create variance reports.

Day two focuses on;

- Revising the financial budget.
- Reporting to stakeholders.
- Variance reporting.
- Interpreting the reports.

The feedback from these courses has been excellent. Many farmers commented that the fear or unknowns of budgeting have disappeared and created confidence in what they are doing. Most farmers have confirmed at the end of the course that the process is easy when you know how.



## **Time**

The second barrier identified by farmers was time. Farmer's perception is that budgeting takes a lot of time, however this is not the case with most budgeting if the process is clear. Farmers generally set aside the evening for budgeting time, as it is most often not perceived as working and generating profits. Physical work such as fixing fences, dagging sheep and moving stock are seen as the drivers of profitability which is true, but it needs to be in conjunction with financial planning. All financiers and farmers stated that good planning and budgeting means more timely decisions which flows through to greater profit.

## **Technology**

Technology was perceived as another barrier to producing accurate and timely financial budgets. The systems and programmes available today are very effective as they are quick, easy to use and provide real time feedback on cashflow and profitability. Despite this, many farmers stated they were not confident using this technology, therefore are not maximising the benefits. Confidence of using a programme comes back to training and use of these programmes. Some programmes can be made to complex, for example, cashbook codes need to be set up with management decisions in mind not the IRD or their accountant. There are quite often codes set up for even the smallest items despite this information never been used. This then flows through to having too many codes to choose from when it comes to budgeting which in turn puts farmers off budgeting. Budgeting and coding needs to be kept simple and only record levels of detail which is going to be used to make decisions in the future.



# *Recommendations*

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## **Farmers**

- To participate in training opportunities such as Better Budgeting Better Business workshops
- To develop an understanding of profitability
- If unsure about the process, develop relationship with professional such as Farm Consultants, Accountants and Financiers
- To participate in discussion groups with budgeting focus
- To regularly read and watch agricultural media related to financial management.
- To develop an understanding of banking covenants

## **Professionals**

- Continue to develop appropriate training and support such as Better Budgeting Better Business workshops
- Disseminate financial planning benefits regarding profitability and risk based pricing, using a variety of accessible medium.
  - Field days
  - Discussion groups
  - One on one consultation
  - Use of media such as agricultural publications, television, internet and radio.
- Work with clients to develop client driven budgets – making client more accountable to their budget – ownership
- Utilise the budgeting categories model to develop understanding of client skills.
- Research new technologies available and match appropriately to clients needs.
- Work with programme developers to create/simplify programmes such as Cashmanager RURAL to increase usability.
- Formalise the budgeting skills category model into a working model that can be used with clients to establish skill levels and self development programmes.

## *References*

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Ryde, J. & Nuthal, P.L. (1984). *Farmers record keeping and planning practices: A postal survey*. Canterbury, New Zealand: Lincoln College.

## *Appendix 1: Interview Data*

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Interviews were conducted with Rural Bank Managers and farmers. The answers below are a summary of all the managers.

### **Financiers Questions**

#### **How many sheep and beef clients do you have?**

The range for this question was 25 to 250 depending on their position in the bank and how intensive their client portfolios were.

#### **How many of these clients fit into each category of budgeting;**

##### Category 1 – Expert Budgeters

The range of answers was between 2% and 20%

Some businesses fit into this category without formal budgeting. These people instinctively know their businesses but also generally have less debt. Most expert budgeters have medium to high debt levels and budget formally.

##### Category 2 - Budgeters

The range of answers was between 23% and 44%

##### Category 3 – Non Budgeters

The range of answers was between 36% and 75%

The budget may be done

## **Is financial budgeting beneficial and why?**

All financiers said yes to this question and comments are shown below.

Better budgeting means better businesses

More confidence around decision making

Planning and budgeting generally means greater profitability for the farmer, which is what everyone wants.

Bank interest rate margins are often more favourable when the bank is kept informed and the bank can trust the clients financial control. Budgeting improves the clients risk rating at the bank.

Bankers don't want to go back to their credit departments asking for more money when a limit is exceeded when the plan was already set for the year.

If the facilities are respected the cost of funding will be cheaper.

Farmers who know what is happening in their businesses are generally the more profitable businesses.

Financial budgeting gets the business owners thinking about their businesses and focusing on the decisions that drive profit.

Timely decision making.

If budgeting or planning does not occur, quite often stock are sold at the wrong time for the wrong reason i.e. holding onto stock heading into a dry period or into winter and looking at the short term gains from trading stock.

It is easier to run the business because there is better information to make decisions.

### **What are the barriers to Sheep and Beef farmers budgeting?**

Fear of technology. This is generally in the 55-65 year old age bracket.

Don't enjoy budgeting.

No cheques have been bounced for over the past few years so this has driven a lack of respect for bank limits. Cheques were bounced in the 1980's and this forced farmers to respect limits.

If a farmer has low debt levels they see the need for budgeting to be less.

Not knowing where to start.

Some farmers think that being outside doing physical farming activities is where all the money is made. The harder they physically work the greater the profits.

Don't understand the benefits to their business in regard to profitability and interest rates.

There is too much working in the business and not on the business.

### **What is the banks view on accurate and timely budgeting and reporting?**

This has changed a lot of the last year with the credit crunch, dairy industry payouts and general profitability on sheep and beef properties.

Banks in the past have done budgets for clients once a year and this been sufficient when product and land prices were rising. This is not the case anymore and banks are requiring farmers to take a greater ownership in the financial management of their businesses.

It is absolutely essential that people can produce and adhere to a budget.

Banks are rated on their client book, so if their book is performing well in regard to security ratios and viability they will be lent money cheaper therefore clients will get the benefit. Accurate and timely reporting is a big part of this.

If a business is going to go over an overdraft limit, banks want to know this in advance from the farmer rather than after it has happened.

There is going to be more interest rate pricing based on how the business performs, and personal factor has a strong influence on this. Part of the personal factor includes accurate and timely reporting to the bank.

It gives the bank faith in who they are lending the money to.

## **Farmer Questions**

### **Why Budget?**

Provide a target for the business owner or manager.

It gives an idea about pressure points around production and pricing.

It allows the business to know exactly where the business is now and where it is heading in the future.

A tool to know how much money can be spent on farm before it is spent.

It is a planning tool for long term goals such as debt reduction.

A decision making tool that gives the business peace of mind.

### **What would/does budgeting do for your business?**

It provides a reality check on dreams and aspirations.

The budget aids in setting the business goals.

Budgeting enables the business to make better and timelier decisions so the business can make more profit.

It enables the business to make more money.

Without a budget, businesses wouldn't be able to plan capital expenditure.

### **What is budgeting?**

Budgeting is having a financial plan of the likely profitability of the business from short to long term.

It is knowing how much you produce and what you get for it.

Being informed on where the peaks and troughs in the cashflow are.

Giving the business the ability to benchmark against the top farmers and making decisions to improve business profitability.

### **What are the barriers stopping you from doing more accurate and timely budgeting?**

Opportunity cost – could be outside fixing a fence instead of budgeting.

Recognising it is just as important if not more, than being outside doing the physical things on the farm.

Time.

Don't know how to do it properly.

Fear of the unknown.

People don't know how easy it is.

Change in mind set.

Getting sick of been fed bad news.

Organisation – need to find the desk.