Governance in Husband and Wife Type Farming Businesses

Governance

A lot has changed over the last 20 years or so. The world is more knowledgeable, more demanding, less forgiving and smaller. The stakes are higher, the opportunities and rewards are huge and the risks are significant. Businesses that have a sound understanding and a strong culture of governance will have a greater chance of not only succeeding, but succeeding at a much higher level.

Governance of farming businesses is becoming more relevant and is starting to become more widely used and understood. Yes, the level of governance has improved, but like most of my school reports said, the level of performance is ok but can do better.

I will firstly explain why governance is becoming increasingly important, and then explain what is required to have an appropriate level of governance.

In a second paper I will discuss the various options and requirements at more of a corporate and technical level.

The "Olden Days"

I thought I would share a story and some of my own observations, which may help to put some context around why governance is becoming more and more important in farming businesses.

I clearly remember as a 10 year old, standing out in the sheep yards, asking Dad, "What was it like in the olden days?" It would have been about 1969 and Dad would have been 50. I clearly remember the stunned look on his face as he asked, "How old do you think I am?"

Oh how the wheel turns. A couple of months ago my 11 year old daughter asked me the exact same question. I gave her the same stunned look and answer Dad gave me 43 years ago.

However it got me thinking about what has changed in farming businesses since the olden days. Over the page is a table with some of my thoughts. For the sake of this discussion, the olden days were 1990 and I had just started working for the Rural Bank in Timaru.

Note: The numbers quoted here are anecdotal and therefore may not be totally accurate. These are mostly drawn from my memory, but will be accurate enough to serve the purpose.

Issue	The "olden days" – 1990	Today - 2013
Scale	The average Gross Farm Income would have been less than $150,000. I remember telling clients if their income was less than $100,000 they lacked the scale they needed to survive.	When I resigned from the National Bank in 2010 I had several clients whose income was in excess of $3.0m. The average would have been close to $800k or maybe even higher.
Number of farms owned	The vast majority of farmers had one farm.	It is probably more common, particularly in the dairy industry, to own at least two farms. It is not uncommon for some dairy businesses to own three or more farms and own 15 or more houses over all farms.
Total debt	The average debt per client in my lending portfolio was $70,000. I had two clients who owed just over $1.0m each	In 2010 I had a couple of clients who had <u>less</u> than $1.0m of debt. I had a couple of clients who owed more than $20.0m and quite a few from $10 - $20.0m. Some farming businesses have more debt than some publicly listed Companies.
Debt/Equity ratio	Most farming businesses had 75% equity in their Businesses. Very few would have had less than 50%.	A few have 75% <u>debt</u> levels and many have less than 50% equity.
Total Equity	I suggest the average level of equity would have been less than $500,000.	On average it may be around $7.0 - $8.0m. It is not uncommon for farming businesses to have between $10.0 - $20.0m of equity.
Interest rates	In 1990 the National Bank made its first real foray into rural banking by offering a fixed rate of 14.75%, which undercut the market by around 2.0% Overdraft rates were still over 20%. Farmer's dreamed of rates below 10%.	Historical lows, with variable and fixed rates ranging from 5.0% to 6.5%.
Financial Products available	Other than the National Bank's promotional 14.75%, there were no fixed rates as such. Interest rates were reviewed from time to time and adjusted as required. Certainly there was no ability to hedge against interest rate risk.	There is a full range of financial products available, allowing farming businesses to hedge against interest rate risk. Fixed rates, forward starting fixed rates, bill rates, interest swaps, cap rates, caps and collars are being offered to varying degrees by all Banks. However they are complex products and should not be entered into without an in depth understanding of how they work.

Issue	The "olden days" – 1990	Today - 2013
Financial Management	With lack of technology, budgeting was a laborious task for farmers, not that it really mattered, because the vast majority never did one! GST had recently arrived and was improving their accounting skills. But most Accountants still referred to the "shoe box of invoices" at year end.	CashManager, which is the only specialist rural electronic cash book, is now widely used. However it is used to varying degrees of reliability. Most Accountants say accuracy is variable. Very few farming businesses update their cashflows on a monthly basis. Some large scale businesses have no real accurate picture of their likely seasonal funding requirement or their expected cash result.
Staffing	Most were husband and wife partnerships. Many wives had returned to the non farming work force to earn money to keep the businesses going. Minimal outside labour was employed.	Most businesses employ staff and the larger scale dairy businesses may employ up to 15 staff, albeit under the control of a Contract or Lower Order Sharemilker. Be that as it may the business owners are still ultimately responsible for compliance breaches by staff. The demand for quality staff is well out of balance with the supply. Some wives choose rather than need to work outside the farming business, and most of them are actively involved in the business. Both in a management and governing role.
Career path	The dairy industry had a great career path via the Sharemilking industry. Other than family succession, or marrying the boss's daughter, the sheep industry had no real career path.	Nothing has changed in the sheep industry, and the sharemilking industry is being decimated through lack of 50-50 jobs, as the debt burden on land owners, and the increase in equity partnerships reduces the number of 50-50 jobs available.
Family succession	Was largely centred on getting the oldest son into the Family farm. Wasn't necessarily fair or equal.	A much more holistic approach is being taken, particularly in the larger scale businesses. More likely to be centred on fairness, although not necessarily equal.
Meat industry	Fragmented industry which was in a bit of a shambles. Union power was still strong, but on the wane. Meat companies mostly had too much debt, after the soaking up of failed companies Waitaki and Challenge Meats. Fortex was still going strong.	Still in a shambles but for different reasons.
Dairy industry	About 7 – 8 dairy companies and all marketing done by the Dairy Board. A well structured industry with a single selling desk. Dairy Company shares existed but held little value.	Slightly more fragmented, but still one dominant player. Co-operative structure still in the majority. Fonterra shares now traded with significant value, requiring a need to be well informed.

Issue	The "olden days" – 1990	Today - 2013
World food supply and demand	It was often talked about how demand would outstrip supply. But there was no evidence of it ever having happened and the eventuality of it ever happening seemed so very far away.	Demand at times exceeding supply, but not in total control. Hence volatility, which is creating risk and opportunity.
Environmental compliance	Resource Management Act 1991 was not yet in existence. Environmental sustainability was not really understood and on farm practices reflected that.	The RMA is having ever increasing influence on compliance and on farm practices are changing as a result. Nutrient budgeting is required, and there are increasing requirements to farm by consent. Penalties are significant for breaches.
Health and Safety compliance	The Health and Safety Act 1992 was not yet in existence. Hazard identification and accident prevention was not as good as it could have been.	The responsibility is on owners and operators to do everything practicable to protect the health and safety of all. Penalties are significant for breaches.
The Green lobby	They existed, and were considered by many to be insignificant, whacky, sandal wearing tree huggers who were out of touch with reality.	Have become NZ's third largest political party, and wheel considerable power. The world is becoming a smaller place and NZ's reputation of clean and green is under threat.
Food safety, security and hygiene	Existed as an issue, but not so much as hygiene issue. Probably more of a trade barrier by trading partners.	An increasingly important issue. The customer is becoming more demanding of traceability and less forgiving of breaches.
Employment Laws	The Employment Relations Act 2000 had not yet been drafted. Other Acts filled the gap, but common sense largely prevailed.	Employment law is complex, ignorance is not a defence and penalties are significant for breaches.
Information technology and information transfer	A scarcity of readily available information. Information transfer was largely through Farm Consultants, MAF, Dairy Board Consulting Officers, Farm Discussion Groups and the local pub. Social media was probably thought to mean reading The Truth, Rugby News and glossy magazines of ill repute.	An almost over load of available information via Bank Publications, Internet and Social Media. A shortage of good Farm Consultants. The local pub has probably closed for good.
Time	Businesses were smaller and easier to run, with less compliance issues and fewer choices around decision making. Time was not a big constraint.	More and more I hear that lack of time is one of the biggest constraints in farming businesses. There is an old saying that the difference between an average and a good farmer is three weeks. I suggest that the difference between a good and great farmer may only be one week.

So, has the world changed? Unbelievably so, and it will continue to change. So I reiterate what I said above.

The world is more knowledgeable, more demanding, less forgiving and smaller. The stakes are higher, the opportunities and rewards are huge and the risks are significant. Businesses that have a sound understanding and a strong culture of governance will have a greater chance of not only succeeding, but succeeding at a much higher level.

What is Governance?

There are many technical definitions of governance, however I will try to keep this discussion simple. A follow up paper will discuss governance at a more corporate and technical level.

To give a very simplified definition, governance is about stopping what you are doing, and sitting down with your business partner/s to think and talk about:

- what you are doing,
- why you are doing it
- what you are hoping to achieve
- and how best to achieve it.

Admittedly this is a very simple overview and there is a lot more to it than that. In essence though, by stopping, thinking and talking about what you are doing, you are taking off your Management and putting on your Governance hat.

To put it another way, in a typical farming business, the value of the Management's role may be $80,000/yr. The value of the Governor's role may be $200,000/yr or more. Yet which gets done more often? In large scale businesses, the owners need to spend less time being workers and more time being owners.

Sadly we all get tied up in the urgency of what needs to be done here and now. We can so easily lose sight of what is important. Urgency of management forces us to act, where as the importance of governance can be put off until tomorrow.

A simple analogy is the woodsman. He is so busy chopping down trees he doesn't have time to stop to sharpen the saw. The saw becomes blunt and so he must work harder. This leaves less time to do what is really important – stop sit down and sharpen the saw.

Of course acting on the urgent must be done. Although always acting on the urgent and ignoring the important is a sign of poor governance.

(*Refer to our paper on the time management matrix* www.farm-plan.co.nz/resources/)

If I look at businesses I have dealt with over the last decade, it is fair to say the quality of governance covers the full range. In my view there is a strong relationship between the quality of governance and the quality of business performance. I use the term business performance, because this includes financial, productivity, sustainability and personal satisfaction.

There are those businesses that have extremely high quality levels of governance, and yet they are striving to continue to improve their governance skills. It is also fair to say that their level of business performance matches their quality of governance.

Then there are those that do an adequate job, and I see that these businesses could make significant improvements to both their governance and business performance. Finally there are those that have little focus on governance and their business performance reflects this.

What Level of Governance is Appropriate?

Irrespective of the legal ownership structure, the majority of farming businesses are still husband and wife partnerships. The business may be owned by a company or trust but it is still a husband and wife undertaking the business of farming together. Sometimes in conjunction with other family members.

Most will meet with their banker, accountant, farm consultant and lawyer throughout the course of the year. These meetings would all be considered to be part of governing their Business. However in a lot of cases the purpose of the meeting may well be to meet the needs of the advisor. The accountant needs to get the Annual Accounts completed, the Bank needs to complete a review or gather information for a lending proposal and the Lawyer needs to get documents prepared, explained and signed for whatever is happening at the time.

Yes, these are all for the benefit of the Business, but who is helping the Business design its vision, strategies for success, identification of the strengths, weakness, opportunities and threats and what to do about them. When was the last time the husband and wife actually had a formal discussion about their Business. Such as:

- What are the Business's values?
- What is the purpose of the Business?
- What is the vision of the Business?
- What is the current reality of the Business?
- How is the gap going to be bridged?

The owners of successful businesses are very good at this.

Equity partnership and some large scale family owned businesses have their own board. This is entirely appropriate for those businesses. Boards of Directors have significant legal responsibilities and risks. These are discussed in a follow up paper.

However, most businesses do not need governance to be that formal. Other businesses have what could be called an Advisory Council. I know of one very successful business that has quarterly combined meetings with their Accountant, Banker and Farm Consultant. The agenda is to discuss, monitor and review the values, purpose, and vision of the business and the plan to achieve the vision. Their role is to challenge the business owners and to keep them on task.

An Advisory Council has no power to vote or veto and is all care and no responsibility.

Stepping back a level from an Advisory Council, the next level would be employing a Business Consultant to be actively involved in the Business. This may take the form of an Accountant, Farm Consultant or a specialist Business Consultant. Whoever it may be, the purpose is the same as the Advisory Council. The focus needs to be on values, purpose, vision and the plan. It is not a management meeting it is a governance meeting.

The advantage of having a Board, Advisory Council or Business Consultant, means the important gets to take priority over the urgent for a couple of hours. Having outside people involved in the business provides the discipline to stop and sharpen the saw. It also provides a culture of synergy where outside eyes and minds can challenge and stimulate increased business performance.

The appropriate level of governance should be decided upon by the business owners. However, the risk of leaving governance solely to the ownership team of the husband and wife is that the three week window of opportunity between the average and the good gets missed. There will potentially be a lack of clarity of purpose and vision and this leads to distractions and frustrations.

They can end up working harder than ever only to get further behind. Not only in their business, but their personal and family life as well. After all, what is the real purpose of the business? To end up the richest person in the graveyard or to enjoy life and your family?

How Can Farm Plan Help?

Farm Plan specialises in Rural Business Consulting. Our Purpose Statement is to help people and their businesses succeed. Our four core activities are:

- Business Planning
- Financial management
- Family succession
- Equity partnership facilitation

Our website www.farm-plan.co.nz gives a full overview of how we operate and what we are trying to achieve for our clients.

If you wish to discuss this paper further, or how Farm Plan might be able to help you contact Peter Flannery on peter@farm-plan.co.nz or 027 615 4500.

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