



## WHY THE FOCUS ON EXPENSES PER CWT. MILK SOLD?

I have received some feedback asking why the project is focused on production expenses on a per cwt. milk sold basis rather than a per cow or other common denominator. The project had the initial purpose of documenting the costs of producing a hundredweight of milk and helping project participants to make informed decisions based on that information. Since all dairies are paid for milk on a per cwt. basis, it becomes easy to see how far above or below revenues expenses were.

Because business size varies dramatically among participants, using per cwt. milk sold as a common efficiency denominator allows for direct comparisons, regardless of size. In the analysis reports, the per cwt. milk sold comparisons are used as a starting point for understanding business performance. Of much more interest, however, are the factors which drove performance on a per cwt. milk sold basis. In most of the analysis points, physical performance factors are used to understand what drove the level of efficiency.

Also of interest to managers is how the business is performing on a per cow basis. Expenses and revenues stated on a per cow basis provide insight into the productive capacity of the business, rather than an efficiency focus. Per cow information varies dramatically among production systems, particularly given the diversity among project participants. However, this variation is important to understand given the different objectives and constraints of participants.

There have been requests for more project information on a per cow basis. In the upcoming 1998 summary report, some per cow information is used to understand differences among groups. Look for more information on a per cow basis and a continued focus on efficiency.

## THE PROJECT, FFSC, AND GAAP

The Dairy Business Analysis Project adheres to recommendations provided by the Farm Financial Standards Council (FFSC). This is a group of lenders, accountants, attorneys, academics, and other parties interested in farm financial performance. When first organized in 1989, the group met to develop a set of standardized methods for financial reporting and analysis among farm businesses. Several meetings and

recommendation drafts followed, with the 'Financial Guidelines for Agricultural Producers' published as a result of the Council's efforts. More information about the FFSC including the guide can be found at their website (URL <http://www.ffsc.org/>).

While most of the FFSC recommendations promote standardization of records and consistent treatment of financial transactions, there are still several limitations to the information generated by FFSC. The FFSC makes no claim to produce information in compliance with the standards of the Generally Accepted Accounting Practices (GAAP) that are determined by the Financial Accounting Standards Boards (FASB). As such, the project is not designed to comply with the accounting standards of those organizations and will not take the place of the accountant or GAAP.

However, the FFSC recommendations do reflect practices that are in common use among production agriculture businesses and the entities that depend on information generated by those recommendations. An objective of this project is to generate information that can be uniformly compared among businesses and consistently measure business performance. As long as the limitations of the recommendations are understood, the information can be used for effective business decisions.

## A GLANCE AHEAD...

- ✓ 1998 Summary Report. This will be mailed to all participants (and to those who request it) at the beginning of December. I realize the report is late this year but we have focused on increasing the number of dairies that went into the summary in order to make more valid and realistic comparisons. The summary is anticipated to be posted on the project website on 3 December.
- ✓ Special issue of DBAP.COM. In December, a special issue of the newsbrief will be mailed. We will publish the '99 fiscal year timeline, detail new service opportunities and strategies, and post some year-end reminders that will facilitate the '99 data collection.

We are still adding new clients, so it is not too late to join. If you want to add an advisor to the mailing list, feel free to forward their contact information.

## WHAT IS DEPRECIATION AND WHY IS IT IMPORTANT?

Some initial project results have shown the importance of controlling depreciation expense. Depreciation is the cost of investments in machinery/equipment, buildings/improvements, and livestock that is taken over the useful life of the investment. As such, it is the cost of ownership independent of operating expenses.

There are several reasons that depreciation is an important expense to understand and control. First, if depreciation expense is high on a per cwt. milk sold or per cow basis, it is a good indication that the level of investment in depreciable assets was mismatched with the productive capacity of the business. In other words, depreciation expense per cwt. milk sold will tell you if your resource level is matched with the volume of the business. If there is a mismatch, there are negative implications for operating efficiency, capital efficiency, profitability, and more than likely debt service ability.

Second, the level of depreciation is a good indicator of the value and usefulness of those depreciable assets. A high depreciation level provides tax advantages that allow cash to be used for other business activities. However, the asset must be paid for using profits, which is the basic reason tax code allows for depreciation in the first place. Conversely, if the depreciation level is low and repair expenses are high, it may mean that reinvestment may be a feasible option to consider.

Related to the previous discussion, is that the depreciation rate is important because highly depreciable assets such as cattle, machinery/equipment and buildings/improvements eventually wear out and require replacement. This is very evident when looking at the cull rate of your herd-the animals need to be replaced in order to maintain or expand the productive capacity of the business. If this replacement of assets does not occur on a regular basis and equity 'erodes' due to depreciation, the business falls behind the depreciation 'curve'. To experience this, just trade in equipment or a vehicle.

In other words, depreciation links investment activities with the operating efficiency of the business. While it may seem like a 'fictitious' number generated for tax returns, it provides important insight into the overall performance of the business.

## WHAT'S IN AN AVERAGE?

Some feedback has been received regarding the averages generated by the project. Two basic issues continue to surface, one dealing with the Top 25% profit group and the other dealing with the relevance of the overall project average. To address this, a discussion

regarding the project purpose, sample size and statistics, and the practice of benchmarking is useful to understand.

First, the purpose of the project is to uniformly collect and compute cost of production and financial performance information for project clients so that effective management decisions can be made. I believe, as part of that decision process, it is useful to understand the strengths and constraints that an individual business faces by comparing performance to that of their competitors. This process is common across both agricultural and non-agricultural industries and is an essential component of sound business planning.

Second, in the process of comparing your business to an 'average' of a group, it is usually not important whether or not a number is high or low. More important is understanding why a specific expense or investment parameter is high or low and if management control needs to be exerted to improve performance. While it is helpful to understand what the 'average' means (no pun intended) it is more useful to understand and explain why your business deviates.

Third, this project makes no claim that the averages generated from clients are in any way a 'statistical' average for the region. To do that, random sampling techniques would be used and more thorough statistical tests would need to be performed. Remember that the primary purpose of this project is to improve the performance of individual businesses with the 'average' published as a useful benchmarking and educational tool. Without the 'average' it would be difficult to assess performance for individual businesses.

In short, the averages contains a variety of businesses having a variety of goals and using different production systems, not all of which may be applicable or feasible for your business. However, in comparing businesses to the averages, a great deal of insight into your own business can be gained. The average should be seen as a tool for understanding your own business and not necessarily a 'standard' that needs to be achieved. In its most basic form, the 'average' represents the summary of what businesses are doing, making comparisons that much more realistic.

## PROJECT CONTACTS

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