Understanding the business

Becoming an independent director of a farming company

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Introduction

This guide has been produced by DairyNZ to be read alongside "Farming Directorships: A Due Diligence Guide" produced by the Institute of Directors and DairyNZ. It aims to provide further context for people considering a position on the board or advisory board of a farming company.

The material in the guide is based on information given by many independent directors on farming board when reflecting on the challenges and experiences that they have faced having taken up those positions.

These contributors had a wide range of commercial backgrounds and governance experience and in all cases found that there were unexpected challenges in taking up their role as an independent director a farming business.

Contributions were sought from those who had experience in either of;

1. Closely held family businesses or
2. Farming syndicates either with small or large number of shareholders.

The current form of the document should be seen as a compilation of the responses from many experienced commentators to the following question;

"What have you found that as a commercially experienced director you have not well understood about farming and that has resulted in either not being able to objectively appreciate the level of risk associated with being an independent director, or have delayed the usefulness of the governance in this business?"

This document is to provide more depth to some of the farming specific issues raised in the Institute of Directors Guide.

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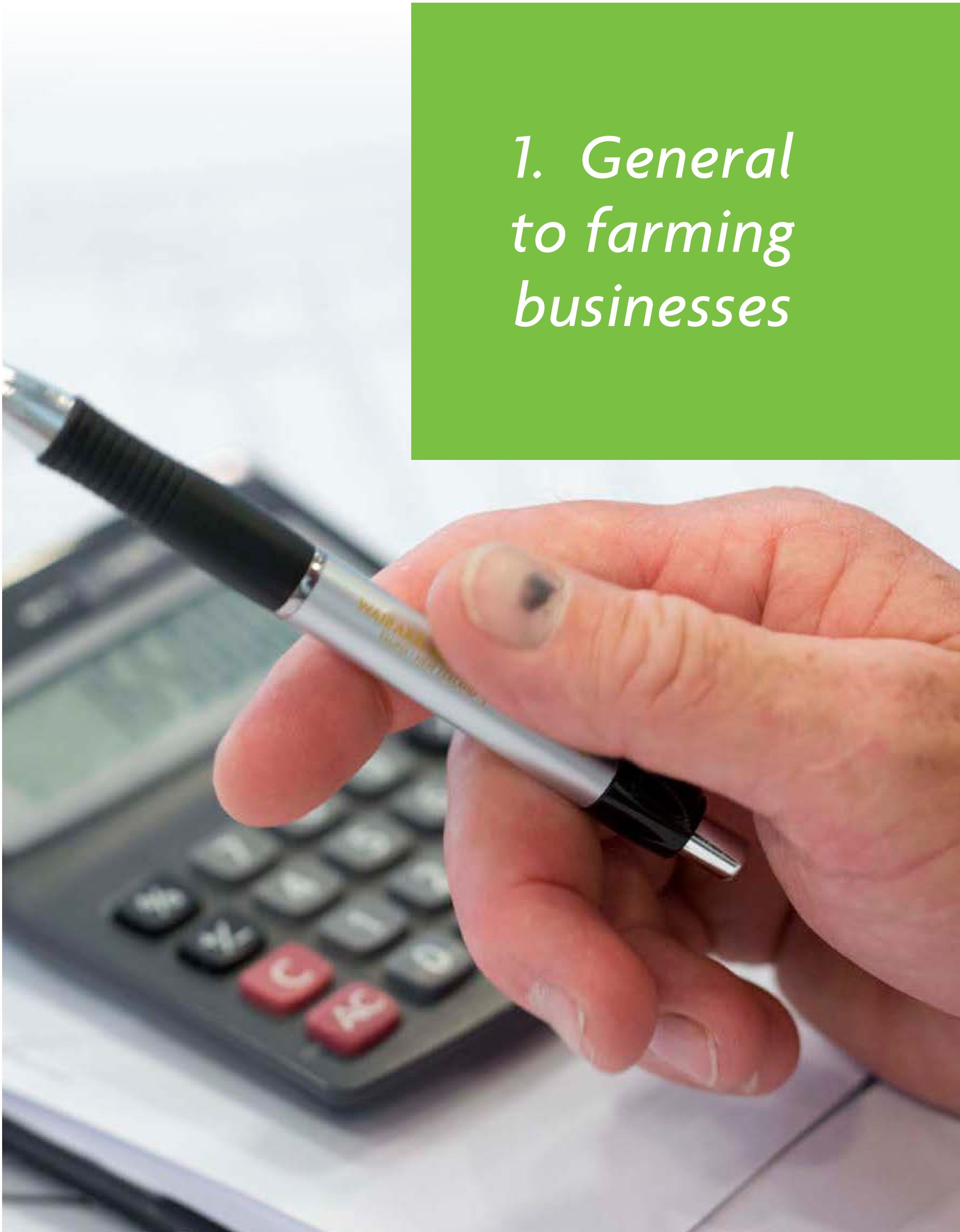
Issues relating to dairy farming businesses

Independent directors need to be aware of aspects of dairy farming businesses that can impact on either the ability of the board to control and lead the business or result in increased risk to a director.

Most of these are common to all farming businesses but some are specific to family farming companies and others to farming syndicates that are operating as Limited Partnerships.

1. General to farming businesses



1. General to farming businesses

a) Closely held ownership and governance

Farming companies often have a small number of shareholders and these are most often also directors of the company and often one may be the Managing Director or CEO of the business.

While the principles of governance are the same as those in the commercial world the application can be quite different in closely held farming business. Directors need to be much more aware of the aspirations of the owners and of the level of risk that they are prepared to take. For directors to be able to do their role properly owners need to provide very good clarity business purpose, their risk appetite, and their business values.

The challenge for a single independent director on such a board is that at key times (especially in challenging times) all the other directors will be conflicted in relation to the hard decisions that the business needs to make. This can make the role of the independent director very difficult.

b) A board of one

New Zealand company law unlike most western countries allows a board of one.

Several independent directors have found themselves in this difficult and high risk situation.

Occasionally this has occurred due to the unexpected death of the other director (sole shareholder) but most often this has occurred where an overseas investor (most often an individual) has set up a New Zealand registered company to meet legal investment requirements and so has opted for the minimum of a board of one. Initially this might be the accountant of lawyer for the business who has then invited another independent director to the board and then resigned stating concerns about conflict of interest.

The remaining sole director has few options. Resignation would put the company in default of its legal requirements and would be contrary to the fiduciary duties of the director. It is also not an option if the business wishes to continue to trade.

To be able to resign the business must engage at least on other director before they initial sole director can resign. This has proved difficult in the cases that we are aware of because there has not been the budget support for this from the owner or their agent in New Zealand (usually the business accountant or lawyer).

c) Limited knowledge on governance matters

Many people involved in the dairy farming have very little formal training and/or previous experience in matters relating to business governance.

A study of over 100 dairy farming businesses in recent years has shown that even when the farm owners have experience of governance on various industry or community entities that few are able to take that experience and effect formal governance in their own farming businesses.

Most often there is confusion about their rights and obligations as shareholder, director and manager. Most of the owners who are in both governance and management roles do not see them as different roles but rather see governance as an extension of their more important role as the CEO or manager.

d) Asset rich and cash poor

Farming enterprises that own the land on which they farm have very high levels of capital investment when compared with the cash income that they generate.

In the past over 90% of this investment has been in appreciating assets such as land and stock and businesses vary greatly in the amount of support land that they also own in addition to the milking platform. In recent years businesses can also hold significant capital in shares (e.g. dairy company, LIC, fertiliser co-op, irrigation company and rural supply co-ops).

Another trend has been for an increasing percentage of capital to be invested in depreciating assets, e.g. irrigation equipment, machinery, information technology, robotics, and off paddock housing structures for stock.

Land, stock and plant can easily absorb all cash profits unless there is discipline within the business regarding the generation of cash surpluses.

The very high relative capital value of these enterprises means that protection of ownership interests and of the capital value of the asset features high in both governance and management thinking and is often tied up in complex ownership structures.

e) Debt levels

Debt levels in growing businesses are typically higher than would be seen in urban commercial businesses.

The reasons for this include:

- Investment is primarily into appreciating assets eg land and stock would typically account for 80+% of the investment.
- Longer term ownership tenure – accumulation of land into family estates so are prepared to pay more.
- Acceptance of lower investment returns.
- Focus is on capital gain rather than cash return.
- Most dairy farms supply co-operatives and so are guaranteed to be paid for any milk supplied (provided it meets quality standards).
- Dairy co-operatives rarely become insolvent.
- Availability of interest only loans.
- Lower interest rates than typical for commercial loans

This is aligned to a focus on wealth creation due to expansion and appreciating asset values rather than to wealth creation due to accumulation of cash profits.

The Reserve Bank Financial Sustainability Report of May 2015 showed that between 2003 and 2009 even though production increased the debt / kg milksolids rose from $9.50 to $20.80 and that by the end of the 2013-14 season the 10% most indebted farms have average debt in excess of $25 / kgMS while the least indebted 20% of dairy farms had less than $10 / kgMS.

At the payout levels of 2014 -15 and those projected for 2015 – 16 were taken into account then at the previously stated debt levels about 60% of farms would be cash negative. Using data from 2000 sets of farm accounts it showed that on average the most profitable farms have $14.90 / kgMS debt (with associated interest costs of $0.70 / kgMS) while the least profitable farms had debt over $23.50 / kgMS (with associated interest costs of $1.50 / kgMS).

The report also indicated that about 11% of dairy farms have LVRs above 65%. These businesses are unlikely to be able to borrow more working capital and are highly at risk of foreclosure.

f) Loan securities

i. Business assets that can be held as security
Land, stock, shares, another person's / business guarantee

ii. Director Guarantees
These are still a common part of rural lending especially where debt levels are high and in more complex business structures.

iii. Linked Securities
This is the most common situation where the business owns multiple farms. These are an instrument used by the banks to limit their risk and are an advantage to the farming business when expanding because it makes debt funding more accessible and cheaper.

However it can complicate matters if the business either wants to sell individual properties or to split the business between shareholder or family members.

g) Timing of revenue vs farm expenses.

The cash income generated also varies greatly during the year and the months of highest cash income do not coincide with the months of highest expenditure – this has significant implications for cash flow and the businesses overdraft arrangements with the banks.

Most farms are spring calving so that feed demand is matched by pasture availability. Production peaks in late spring and declines through the rest of the season until it ceases when the cows are no longer milked in the winter.

Complicating this is a complex payment system back to farmers involving advance, interim and final payments as well as a dividend on shareholding (if shares are held). Each dairy company also has its own schedule of payments /kg of milk solids supplied. At the start of the season this payment will only be a fraction of the expected final payment and this increases during the season (with retrospective payments for production already received) as the dairy company as more confidence about the final returns that it is getting in the market. These retrospective payments continue once the cows cease supplying milk for the season and the final payment for the previous year's production is in October.

The impact of seasonal calving is also that most expenses are incurred during the winter and early spring and before serious revenue streams start coming back to the business. This means that seasonal finance in the way of an overdraft facility is also essential for most farming businesses.

During tough financial times many suppliers will also offer deferred payment options for operational supplies, breeding costs and machinery. While these can be helpful to manage overdraft levels they can also be used by management to mask unbudgeted expenditure.

The overdraft facility may also need to cover provisional and terminal tax payments.

As well as complicating financial budgeting exercises this also means that extra thought needs to be taken when considering;

- the accounting system e.g. cash vs accrual accounting
- the provision of management / enterprise accounts in addition to taxation accounts
- any dividends to shareholders. These are most commonly on an annual basis.

h) Dividends and cash distributions

Very few businesses have a clear policy on dividends and cash distributions to shareholders and the financial disciplines to realise them.

This is because

i. Most farmers find surpluses difficult to predict. Uncertainty of milk price, milk production, and operating costs due the impact of weather, and stock health all contribute to make most farmers uncomfortable about being held accountable to delivering these on a predetermined basis.

ii. Most farming business do not have the financial disciplines so that even in profitable years costs are not allowed to inflate. Catching up on deferred maintenance, replacement of machinery, minor development projects and additional stock heath treatments can easily adsorb any potential cash surpluses.

i) Financial Reporting

Legislative Requirements – current rules

- IFRS compliant Financial Statements may apply for larger farming businesses. This is triggered when the company either has over $60 million of assets or generates over $30 million of revenue. Most will then need to meet Tier 2 requirements and only the biggest will need to meet Tier 1 reporting requirements. This will be triggered even if the business has a parent and several subsidiary companies but many large farming business may exceed this asset trigger but do not need to comply because sufficient of the asset is in a Trust and not in the trading Company.
- Most business are not requirement to be audited. This will be because they are not publicly listed companies or because the shareholders have voted for the accounts not to be audited.

Issues related to financial reporting

- Revaluations via the P&L can distort reported profitability
- Most businesses only receive financial statements with report tax profit and not true business profit.
- Most management financial reporting is cashflow based and not accrual accounting.
- It is common to have significant variances between cash profit and financial reporting profit

Stakeholders and Users of the Financial management information

- Financiers
- Accountant
- Farm Consultant
- Farm Management Team
- Board
- Share holders

Specific Taxation Issues for Farming Businesses

- Livestock Valuation – Herd and Trading schemes
- Income Equalisation Scheme Deposits
- Deductible Farm Development Expenditure
- Fertiliser Deferrals

j) Office and Administration systems

Directors from the corporate world find the lack of a dedicated office and the lack of dedicated office staff along with poorly developed administration systems a big culture shock when becoming involved in farming businesses.

In most cases the farm manager, owners or CEO also do all the administration. As a result most are time poor and will prioritise management concerns ahead of any governance support and reporting role which is becoming increasingly problematic as compliance reporting broadens and more detail is required.

There is plenty of evidence as a result of inspections by Environmental Compliance Officers, MBIE Workplace and Health and Safety Inspectors that most non-compliance is as a result of non-existent records.

k) Contract Milker, Lower order, Herd and 50:50 Sharemilkers

A high proportion of farms are managed by another legal entity. There are different types of relationships each with their own specific contract.

Each contract includes;

- a specified duration
- the apportioning of revenue
- the apportioning of operating costs
- the provision of plant and machinery
- the responsibility for the provision of labour
- the responsibilities of the owners
- any delegated authorities
- dispute and early termination of contract procedures

Copies of standard contract milking and sharemilking contracts are available from Federated Farmers http://shop.fedfarm.org.nz .

There are a range of common amendments to these contracts, and these amendments are often regionally specific. The best way of finding out about these would be to contact a local farming employment advisor.

l) Farming System

The traditional lower cost, grazed grass based, seasonal calving farm system has evolved because it has proved to be the financially and practicably most robust system given the challenges of;

- Revenue generated from the sale of mostly commodity dairy products into distant protected export markets
- Large variations in milk returns – due to changes in international supply and demand
- Limited availability of skilled labour
- Limited supply of additional quantities of quality feed at economic prices.

Businesses have been most successful when they have

- Maximised their investment in appreciating assets
- Minimised their investment in depreciating assets
- Focused on lifting the ability of the land to grow more feed
- Become excellent at pasture management
- Have excellent stockmanship and herd management
- Taken on debt to expand their productive assets of land and cows
- Focused on simple, easily repeatable production systems.

Some business have also been successful when they have moved from this into more intensive feeding systems but this requires much higher levels of management, financial and operations skill as well as financial reserves and market knowledge. They are also very exposed to increases in feed input costs that are driven by local feed shortages due to adverse weather events rather than to increased demand due to higher returns.

m) Quality of farm infrastructure

Farm infrastructure and layout can have a very large impact on the performance of the business, on the staffing levels required, on the hours worked, the level of health and safety risk to operational staff as well as on the quality of staff that will be attracted to either manage or operate the business.

Many farm business set production and profit targets that are the same as the best performing farms in their general area. In most cases these are unrealistic because of deficiencies in

a) Soil type and fertility

b) Composition of the pasture

c) Shape or contour of the land

d) Quality of the stock

e) Layout of the farm

f) Poor stock water and or irrigation water supply

During periods of expansion, the increase in the size (cow numbers and land area) of an individual operational unit can result in key infrastructure such as milking parlours, effluent systems, water supply, lanes, and staff housing quickly become undersized and require significant investment to make operationally fit for purpose and compliant with consents.

Any changes that lead to increased stock numbers will most likely also require new consents to be obtained.

Farm offices also very rarely get the investment that they need to be effective workplaces. The home is the office. This creates a very different feel to the business then when the business office is elsewhere and home is separate.

n) Provision of housing on farm

It is almost universal that farms provide housing and accommodation for their farm staff. This generally works well and reduces employee travel costs and ensures that employees are always nearby to assist with animal emergencies on farm.

However there can be complications;

- Perceived unfairness related to differences in the standard of this housing.
- The enforcement of conditions within the tenancy agreements
- If an unsatisfactory staff member also badly damages the house before they leave it can compromise the business ability to attract a replacement staff member.
- Loss of the house due to drugs e.g. met lab.
- The potential for undesirable interactions and disputes between non-employed family members residing on the property.
- Complications regarding health and safety when the workplace and staff place of residence are the same.

o) Working with a biological system

The reality of working with a biological production system is that;

a) Changing one part of the production system will flow on to impact many other parts of the production system

b) Budgetary decisions by business owners as well as management mistakes or the impact of extreme weather can have long lasting impacts.

c) Accountability for current poor performance may not be fair to allocate to the current staff, manager or CEO.

Examples of this are;

- Poor management at mating will not affect this year's production but will impact in future years through;
  - › Less cows to calve (unless additional stock purchased), more spread out calving – leading to less production in the next year.
  - › More spread out calving is likely to also lead onto a lower number in calf in the following year and more cows culled.
  - › Less replacement heifer calves born to grow into herd replacements.

- Poorly grown herd replacements might cost less now but
  - › less get in calf as heifer replacements,
  - › they do less production in the first year,
  - › have more difficulty in getting in calf a second time and
  - › so the business can quickly lose the highest genetic value animals from the herd.

- Not putting on annual fertiliser applications may not affect pasture production in the current season but will increasing impact pasture production in future years.

- Pugging pastures in early spring wet conditions will not affect production at that time but will result in reduced pasture growth which will last for most of the season and in the worst cases will need the pastures to be resown.

- Poor pasture management in the spring can lead to either;
  - › running out of feed – incurring more feed costs or lower production or
  - › can lead to loss of pasture quality with will lead to lower production and can take a long time to fix.
  - › encouragement of pasture weeds to overrun pastures

p) Covenants and legally enshrined rights of access

a) QE II Trusts are a method of protecting tracts of land with ecological significance from future development and farming operations – once bequeathed by a land owner they must be honoured by subsequent landowners.

b) Paper roads are legal access points for the public even though they are no longer maintained by the local authority

c) Easements – examples are;

I. access to water from a bore on your property for an adjacent properties use or

II. a right of access through your land to an adjoining property by another business.

d) Queen's Chain along main waterways – rights of hunters, fishers and general public

e) Power companies – power transmission lines

f) Warranted officers have rights enshrined in law and have the right to enter a property without prior permission.

Entity	Pretext
MBIE /Worksafe NZ	• Casual observation of poor safety practice when travelling by • Random inspections of documentation • Report of Serious harm or fatality
MBIE	• Random inspection of time records • In response to a complaint from an employee
MPI	• Report of an animal welfare issue – and they have powers of search and seizu**re.**
SPCA (warranted officer)	• Same as MPI
Regional Council	• Annual Inspection • Report of or observation of an environmental spill • Random checking water take
HazNo	• Random inspection of registered chemical storage sites and applicators
Police	• Investigating a fatality • Investigating a crime
Immigration	• Suspicion of illegal workers or over stayers • Presence of overseas workers on work permits • Right to check work time recording and pay records
Assure or other (Contracted to the dairy company)	• Annual inspection – permission given as part of the supply agreement with the dairy company.

q) Staff

All farming organisations from time to time suffer from the shortage and availability of good staff. This can be crippling if it occurs at peak work times of the year (spring).

Acquiring staff will be more difficult if;

I. The farm is in a remote location

II. The business has a poor reputation for staff management

III. The quality of housing is poor.

IV. The hours of work and time off are not reasonable.

Many times the pressure to find an able body ready to start work now overrides any real focus on undertaking a proper recruitment process. This frequently extends to the recruitment of managers as well. As a result there is high staff turnover in the industry and many farms struggle to achieve the performance targets required by the owners.

r) Health and safety

While some businesses have been proactive in anticipation of the changes to the Health & Safety Act most businesses are slow to react and are still arguing the detail about helmets etc – the latter is most common in family owned businesses. There is still a high level of failure to recognise risks in the workplace and enact proper health and safety training, processes and procedures.

This is with respect to

- Themselves (the owners) and their families
- Staff and
- Contractors coming onto farms.

WorkSafe NZ provides a comprehensive range of excellent resources for farmers that are available from their web site www.farmsafe.org.nz and there are other businesses that are effective at helping farming businesses set up efficient processes.

The bigger problem is getting everyone involved with the farming operation to implement these processes and recording systems let alone change their culture from health and safety being something they feel they have to do to one where working safely is something the want to do.

s) Environmental Matters

Each farm exists with a defined water catchment and is zoned according to the environmental sensitivity of that catchment. This designation will increasingly define both development opportunities, potential change of land use, current operational management and eventually land value.

Farms will also be zoned according to land class which may also define both development opportunities and operational management.

Each farm must now meet the consent requirements from the local Regional Councils in which each farm is located. Specific consent issues are;

- Complying with discharge consent for effluent and other waste water.
- Discharge of contaminated milk to storage or land.
- Complying with consents relating to the taking of ground water.
- Nitrogen leaching targets – future requirements and operational impacts.
- Requirements to meet water use and efficiency targets
- Irrigation allocations and restrictions of extraction of water from waterways and groundwater.
- Fencing of waterways and wetlands
- Bridging of water crossings
- Preventing effluent runoff from stock lanes any standoff areas.
- Preventing soil loss to streams
- Storage of fuel and hazardous chemicals

All farming businesses are now required to submit Farm Environment Plans to the regional council. Where the farm business is part of an irrigation scheme these FEP's will be required by the Irrigation Scheme as part of their consent. The cost for this is born by the farm business as is the cost of any Audit.

Farm environment plans are audited and the results of this audit are acted on by the agents of the local regional council. The range and scale of penalties continue to increase and at their worst can result in the farming operation being shut down. Each time a farm manager or sharemilker changes the farm will be required to be audited.

Land values for farms located in environmentally sensitive zones are already being discounted. Lower land value means increased debt to asset ratio and a danger of not meeting banking covenants

t) Stock

i) Animal health and welfare

All farms must be registered with NAIT (National Animal Identification & Tracing) and all stock must be tagged with NAIT approved tags and the registered. This is part of the disease control and traceability initiative between farmers and the government.

- Compliance with animal welfare codes including those relating to the transport of pregnant cows as well as bobby calves.
- Compliance with TB testing regimes and other animal health regimes.
- Compliance with other statutory requirements relating to animal health and traceability.
- Biosecurity risk from diseases either introduced from overseas (eg foot and mouth) or from other diseased stock currently on other properties

The New Zealand dairy industry in agreement with MPI and the Vet Association score animal condition as an indicator of health. The scale goes from 1 to 8. Animals under score 2.5 are considered to be emaciated and the farmer is very likely to be prosecuted. Animals over score 7 are considered to be obese and also unhealthy and at risk of metabolic diseases.

Dairy cows are fattest prior to calving and the target is for heifers (1st calvers) and three year old cows (2nd calvers) to calve at score 5.5. The target for mature cows is 5.0. These target scores help set up the best production and reproductive performance for the animal as well as the best financial result for the farmer.

DairyNZ runs courses in how to condition score dairy cows and there are an increasing number of people who are accredited in condition scoring.

ii) Droving, crossing public roads and grazing the long acre

In general all councils will allow stock to be moved along local roads as well as grazing the grass on the side of the road. Each council will have its own set of local rules about these activities and there is a requirement to have council approval in advance for all these.

iii) Requirement to keep boundary fences stock proof.

Must local councils require that a boundary fence is a minimum of an 8 wire post and batten fence. Deer and goats have more specific requirements.

iv) Liability for wandering stock

The Ministry of Transport takes a serious view of any stock that have escaped from a farm and are wandering on public roads. Public liability insurance must be purchased.

u) Food Safety Risks

Most drugs, drenches and antibiotics used in farming have rules and regulations relating to the withholding of milk and animal products after their use.

Fines for first offences are increasingly large and for second and subsequent offences are very harsh and my result in closure of the business.

Antibiotic grades in milk are the most common offence. A farm business must expect that the dairy companies will test every milk pickup. Antibiotic in the milk can result for long or short acting antibiotic administered a "dry off" that have not been properly flushed from the udder after calving or from antibiotics used to treat either subclinical of acute mastitis. In both cases the required withholding periods have not been adhered to.

Failures of record keeping, clear marking of antibiotic treated cows and of keeping these animals in a separate mob are often how mistakes are made – especially when the usual team are not milking and relief milkers are used.

v) Operational and Financial Benchmarking

The dairy industry has a comprehensive benchmarking tool called DairyBase. It is the best tool for benchmarking farm and financial performance by farm system, and against either the regional averages, or top 25%.

Find out more a dairynz.co.nz/dairybase. This site also has explains all the financial terms used in the dairy industry.

w) Concept of Strict Liability

Although this is not unique to farming businesses there are a number of situations where a director of a farming company can be liable in a criminal sense without having any knowledge or intent in relation to the event that has occurred. The most obvious examples relates to breaches of resource management consents in respect of discharges to waterways, and animal welfare.

x) Dairy industry resources

DairyNZ is a levy-funded farmer-lead industry good organisation. It provides on farm research, development, extension and education. It has a wide range of information and resources that are free and specifically designed for the sustainable and profitable management of dairy farming businesses. Information about all these resources are available at dairynz.co.nz

2. Issues specific to family owned businesses

2. *Issues specific to family owned businesses*

The vast majority of dairy farming businesses in New Zealand are family owned with tightly held shareholdings and with the owners taking many roles from operational to governance in the business. This group are also where the greatest rate of increase in business size is occurring and this becomes even more so as they become multi-generational.

a) Closely held ownership and governance

i. The directors and CEO are family members and necessarily come from a limited pool with a strong preference for involvement of the bloodline family.

ii. Farming companies often have a small number of shareholders and these are most often also directors of the company and often one (the founder) may be the majority shareholder and the Managing Director of the business.

iii. The challenge for a single independent director on such a board is that at key times (especially in challenging times) all the other directors will be conflicted in relation to the hard decisions that the business needs to make. This can make the role of the independent director very difficult.

iv. Some farming family companies involve several children in an operational, management and/or governance role. Other companies are more like a Joint Venture between the parents and the "chosen" family successor. Sometimes this means that there is a wide divergence in risk appetite and a divergence in approach to farm system. The independent director role can be as much about moderating family member behaviour as it is about bringing discipline, governance process and business acumen to the situation.

b) Ownership of the business assets.

There can be different owners of the different assets in the business eg the Partnership could own the water rights – early consents were generous and for a long period and in many cases these advantages are worth a lot of money and would be lost if ownership was transferred to another entity. A Trust could own the land and one or more companies could own the rest of assets e.g. stock, plant and machinery, shares etc. and be the trading face of the business.

Very few businesses consolidate these into a single set of management accounts so that the true position of the businesses is understood.

c) Alignment of family trust and company purpose

Many farming family businesses have one or more Family Trusts as significant shareholders in the company. Each should have a Trust Deed and a Memorandum of Wishes (or known as Letters of Intent) from the settlors.

If properly constructed the Memorandum of Wishes should clearly state the outcomes that the settlors required of the Trustees to deliver. The Trust settlors should also have given clear directions about the role of the Company and these should align with the outcomes in the Memorandum of Wishes.

Most families would have very little knowledge of the details in these documents.

d) Deference to the founder of a farming business

Family owned farming businesses often have a business structure that is hierarchical with the founder of the farming business being the most influential. It is important that parties involved in the organisation do not by virtue of how the business has been established and grown up, defer to the founder of the business without considering their own position and without trying to be involved in decision making processes. Although not a farming business, the way the South Canterbury Finance Group was governed and managed is a good example of what not to do.

The "founder" has often been in a position of absolute power for some time and would identify that the businesses only exists because of their passion and efforts. The transition to formal governance "group decision making" can be problematic and there needs to be a very clear understanding between the Board and the Founder CEO about the delegated authority that person actually has in regards to capital expenditure and any legally binding contracts.

A useful indicator where these issues have been well settled is where the "founder" has agreed to a job description and an employment contract for the role in the business that they undertake and that there is a working process to hold them accountable to these.

e) Personal Guarantees

Personal Guarantees are common between family members as individuals and between individuals and legal entities in family businesses – most often between the older and younger members of the family. Personal Guarantees are often forgotten about past their intended use date and are not deactivated.

This can leave some members of a family business exposed to an unknown and increasing liability which in the worst case scenario could also compromise the financial viability of their business.

f) Lack of differentiation between business and personal expenditure

i) Living expenses

Many farming businesses operate "one cheque book" for both farm expenses and personal drawings.

Best practices is to have these separate and that drawings are a budgeted item in the business accounts with a regular set transfer of funds from the business to a personal account.

ii) Business funding personal capital purchases

It is not uncommon for family farming business to provide the capital or debt funding to purchase large capital items such as a beach house or large "toys".

g) Levels of personal drawings

It is not uncommon in all but the largest farming business for the level of drawings to be in excess of available funds especially in low income years and more commonly to be sufficiently excessive to compromise the growth of the business.

This may be related to the costs of education when children are away at boarding school but is most commonly found when the owners are not paid a management salary or there is no agreed annual personal drawing budget within the business.

h) Breakdown of ramily relationships

Farming entities are often owned by quite complex legal structures involving several members of the same family or a number of families. In the event of a breakdown these become very problematic and costly to unwind to facilitate a separation of business entities.

The implications of the Matrimonial Property Act may not be accounted for in the ownership structure of the farming business.

i) Lack of succession planning

Failure to act early plus a lack of detailed and comprehensive planning and governance is prevalent in farming. Little thought is given to exit strategies for owners at the different levels within the business or of the requirement to grow the business and governance skills of the next generation.

Successor generations frequently are expected to take on large businesses that have been built up over a long time by the parents. It is important for their confidence and for the confidence of business stakeholders that successor generations have the ability to manage and or govern the enterprise.

It is important that the directors of a farming company address these issues and review succession plans and the capability of the both generations on a regular basis.

In some farming companies, where there are several siblings involved as owners (and probably managers and governors) while the issue of current succession appears to be resolved there is now an even more difficult matter of succession to the third generation.

<u>Limited use of appropriate advisors (particularly in succession planning).</u>

Most farming business tend to rely on the advice of either their accountant or lawyer on this matter. This is usually a person who has a close relationship with the parents and can result in plans that actually do not meet the family needs because the views of the next generation are not properly represented and taken into account. Many succession plans are not successfully completed because of this.

The primary failure is that not enough time is put into understanding the individual family needs and to identify the common ground on which a successful succession plan can be built. Best practice is for the family to engage a specialist succession planning specialist facilitator in this first step of the process.

<u>Tax Losses</u>

Accumulated tax losses by the parents either in a partnership or Trust can delay the transfer of ownership and the implementation of a succession plan. If the parents business had been in a company then the accumulated tax losses remain with the company even as the shareholding changes as part of a succession plan.

j) Use of key advisors

I. Reliance on advisors

In addition to the business accountant and lawyer farmers often involve a range of "on farm" advisors. The farm advisor, vet, breeding company sales rep and fertiliser reps are the most common and some farmers will rely on their advice without question when that advice is production focused.

Much of this advice is without any robust financial analysis and is based on the perception that increased production = increased profit. Sadly this perception can be very wrong and farming businesses most frequently get into financial stress because of unprofitable increases in production or from significant capital investment that offers the promise of increases in production.

II. Conflicting advice from advisors

Farmers are poor at involving advisors in teams so that a thoroughly debated consensus is reached. Nor are the good and at providing advisors clarity about their business purpose and strategic plan.

This frequently results in conflicting advice and advice that leads to decisions that pander to the ego of the farm manager but are not aligned to achieving the key underlying outcomes that the family expects from the business.

III. Advisors in common

It is often common for the several family members to have the same team of financial and legal advisors. This can be advantageous for the younger generation when making a start in the business career but over time it is better for these key advisory teams to be different.

In the event of a dispute where these advisors are engaged it becomes impossible for these advisors to properly represent the different family members in often very challenging situations. The sad result is that not only to family business relationships cease but also do personal relationships within the family.

3. Issues specific to farming syndicates

3. Issues specific to farming syndicates

Farm syndication (a term including equity farming and farm equity partnerships) is used to identify multi-investor farming entities. The investors can vary from overseas investment funds, trusts, companies or individuals to other New Zealand farmers or residents.

Farming syndicates can be divided into two groups;

a) Closely Held syndicates (CH Syndicates) or

b) Professionally promoted and managed syndicates (PM Syndicates) - (ref Gould)

CH Syndicates

These usually have 2 to 6 investors and have been put together by a facilitator/s to enable the investment by "friendly" investors in suitable farming property.

In these closely held syndicates the following issues are important;

a) Are all parties involved solvent, untainted and compatible?

b) There must be an agreed Clarity of Purpose / outcomes to be delivered to shareholders.

c) There must be alignment of business values. This is particularly critical where one of the shareholders was the original land owning family. Business performance or activities that impact negatively of their personal reputations in the community will cause a failure of the syndicate.

d) It is essential that the advisors providing profession services to the syndicate are 'independent' from the advisors providing professional services to the investor entities because of severe conflicts of interest and a rapid loss of confidence that the professional advice being offered to the syndicate is the best for the syndicate and not just advice that best protects one of the investors.

PM Syndicates

PM Syndicates generally cater for a larger number of investors, generally carry less debt and are put together by a professional Promoter. The invariably have a wider range of investors and employ initially at least agree to a management contract with the promoter. The creation of these syndicates requires a greater level of due diligence and a greater amount of documentation. The required documentation is identified in a conference paper "Farm Syndication" Brett Gould, NZLS CLE Conference – Rural Law – the big issues.

Management of Syndicate farms.

About half of syndicate owned farms are managed by one of the shareholders. This person is often referred to as an Equity Manager.

While this is often seen as positive by the other shareholders because the manager has a vested interest in the farm performing well and being profitable problems can occur.

Three particular circumstances are;

- The manager is often unproven at this scale of operation
- The manager unexpectedly dies of is severely disabled.
- The manager and their partner separate.

There is a range of contractual arrangements that Managers and Equity Managers are employed under;

- A salaried full time continuing position
- As a Contract Milker
- As a Lower Order Sharemilker
- As a Herd Owning Sharemilker
- As a 50% Sharemilker

All but the salaried position have agreed lengths for the contract and so provide easy opportunities for the performance of the manager to be assessed and if deemed to be unsatisfactory it is very easy to not renew the contract. If the position is a salaried position it will require a well-documented performance management process with no predetermined outcome to have taken place for the manager to be dismissed.

Information about standard Contract Milking and Sharemilking contracts can be obtained from Federated Farmers.

Legal Structures

At the moment the preferred legal structure for farming syndicates is the Limited Liability Partnership (LLP). It is essential that the Directors of the General Partner and the investors in the Limited Partnership fully understand the provisions of Schedule 1 "Activities that do not constitute taking part in the management of limited partnership" of the Limited Partnerships Act 2008.

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