

# QUESTIONS ABOUT PROFITABILITY ANALYSIS OF THE HUNGARIAN FAMILY FARM BUSINESSES

## OTÁZKY ANALÝZY RENTABILITY HOSPODAŘENÍ RODINNÝCH FAREM V MAĎARSKU

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### **Abstract:**

Since the political transformation there were radical changes in the relations of the ownership and usage of the Hungarian agricultural land. Several agricultural laws formed and created the conditions of the Europe-wide spread and accepted ownership and estate structure, namely the family farm businesses. In order to meet the EU-requirements, and to become competitive against any other agricultural enterprises, these family farm businesses have to be informed about their own profitability status. According to the current legal circumstances, they don't have to keep strict record of their operation and supply detailed data about their income. This is why there's a great need for a simple and transparent system of financial ratios from the part of the family farm businesses.

### **Keywords:**

financial analysis, family farm business, management, profitability ratios

### **Anotace:**

Od politické transformace došlo k radikálním změnám ve vlastnických vztazích a využití zemědělské půdy v Maďarsko. Bylo zformulováno několik zemědělských zákonů s vytvořenými podmínkami pro v Evropě široce rozšířené a akceptované vlastnictví a majetkovou strukturu, zejména hospodaření rodinných farem. Aby byly splněny požadavky EU a aby byly maďarské farmy schopny odolat konkurenci jiných zemědělských podniků, musejí být tyto podniky rodinných farem informovány o jejich vlastním stavu rentability. Podle současných právních podmínek nemusejí poskytovat podrobné zprávy o svém hospodaření a údaje o jejich příjmech. Právě proto zde vzniká velká potřeba jednoduchého a přehledného systému finančních ukazatelů z této oblasti rodinného hospodaření.

### **Klíčová slova:**

finanční analýzy, hospodaření rodinných farem, management, stupně rentability

## **INTRODUCTION**

Since the political transformation there were radical changes in the relations of the ownership and usage of the Hungarian agricultural land. Agriculture's transformation went on continuously in the last decade, in which one of the crystallized objectives is to form the conditions of the Europe-wide spread and accepted family farm businesses. Several agricultural laws passed in 2001 fit in the process, for that lay stress on improving the competitiveness and the operation's conditions of the already established family farm businesses instead of urging the new establishing. Further objectives of these laws are the creation of an ownership and estate structure that is accepted by the European Union, to

enliven the trade and to reduce the speculation with agricultural lands. (Magyar, 2002)

In order to meet the EU-requirements, and to become competitive against any other agricultural enterprises, these family farm businesses have to be informed about their own profitability status. According to the current legal circumstances, they don't have to supply detailed data about their income. The state built up a simple framework for the fulfilment of tax-liabilities and they are not obligated to keep strict record of their operation. Certainly, they have to operate their businesses in our global economy, but it's not really expectable to maintain and operate a clear management decision/information system in the everyday work. This is why there's a great need for a simple and transparent system of financial ratios, which could be filled out by data easily, and which can be used and analysed by the banks in the process of credit standing.

## **DISCUSSION**

### **Concept of family farm business**

Introduction of the concept of family farm business into the Hungarian rule of law lays down new and more favourable condition to the farmers who were operated before as sole proprietor or agricultural entrepreneur for the realisation of the above mentioned objectives. Information has to be passed to the farmers through utmost channel in order to make the best of the preferences.

The family farm business is a form of farming based on the utilization of the land and the connected moveable and immoveable properties (farm implements and buildings, structures, agricultural equipment and machines, beasts and stock, etc.). At least one of the family members has to be full-employed in the business the others can collaborate. A family farm business can own or use up to 300 hectares of agricultural land. It is important that there is a unity of interests within the family, which serves as a base for the development of both business and its competitiveness. The family farm business can have the advantage of special loans and financial support over the basic agricultural aid. A family farm business can deal with agricultural activities (vegetable production, horticulture, animal husbandry, fishery, fish farming, forestry, silviculture, etc.) and with complementary activities (rural tourism, agro tourism, handicraft, sawn timber processing, primarily food processing, utilization of secondary product or spin-off, waste matter arose from agricultural activities, and direct manufacturer sales). Family farm business consists of a full-employed farmer (who deals with agricultural and complementary activities as a profession) and at least one more member (contributor family member). The maximum number of the family farm business's members isn't determined exactly, but the members have to be part of the close family of the farmer (spouse, companion, child, and parent). Brother or sister, father-, mother, daughter- or son-in-law cannot be member. The primarily objective of most family farm business is not the profit-maximisation, but to maintain the control and to transmit a secure and state business for the next generation. Thus the autonomy, independence, survival and succession, maximisation of profit or return for short or long term is mixed up with traditional aims. (Gasson – Errington, 1999)

The following items are required for the family farm business's registration:

- statement of the farmer that he will deal with agricultural and complementary activities as a profession, he won't do any other wage-earning activities from the beginning of 2005, and he will not have any labour relation,
- at least intermediate agricultural qualification, in absence of this, 3-year justified agricultural production activities is necessary,

- statement of the farmer that his habitation at least for 3 years is in that settlement which was signed as the seat of the family farm business
- sole proprietor's or agricultural entrepreneur's certificate, and tax-declaration
- statement that the reported data about crop land belonging to the family farm business is equal to the data represented in the land register,
- contracts about property and income circumstances, and the related inventory.

### **Problems about the family farm business's profitability analysis**

As the financing and profitability problems of the Hungarian agricultural enterprises are important questions in the view of the Hungarian economy and Hungary's EU-membership, it could be important to represent the methods of the profitability analysis of the agricultural enterprises.

First of all, we have to attract attention to the special situation of the agricultural enterprises. The reason for the demand of special agricultural accounting and special analysis methods is that there are more factors, which have effect on conditions of production, and on profitability of this activity, than in the case of any other activities (industry, services, and commerce). As a consequence of anomalies in agriculture (e.g. depending on nature, biological periods, seasonal problems, interdependence of processes), and the general problems (uncertain economical situation, unfavourable financing opportunities, obsolete motorization, limited sales opportunities), profitability of agricultural enterprises is formed under many factors' common influence.

The analysis of the profit(ability) and income is an important task because of many reasons. Partly because in Hungary and in the European Union's countries the tax authorities consider the income represented in the Profit and loss statement as the base of tax liability. Partly because the banks take changes and measure of the profit (income) into consideration during the credit rating for precluding the risk of non-repayment of credit. So, in the case of any other type of enterprises, the Profit and loss statement (annual report) is the key factor in the profitability analysis. In Hungary, every enterprise has to put in the annual reports to the Firms' Court every year for giving information about their business performance to the interested parties. Every company has to prepare annual report, but not the sole proprietors, agricultural entrepreneurs, or family farm businesses. According to the current legal circumstances, family farm businesses haven't got to supply detailed data about their income or profit. The state built up a simple framework for the fulfilment of the family farm businesses' tax-liabilities (in order to facilitate their administrative obligations) and they are not obligated for keep strict record of their operation. Certainly, they have to operate their businesses in the same global economy than the other types of business organisations, but it's not really expectable that they could maintain and manage a clear management decision/information system in the everyday work. This is why there's a great need for a simple and transparent system of financial ratios, which could be filled out by data easily.

### **Profitability analysis**

"Profitability is the ability of the firm to generate earnings" (Gibson, 1991) or "the measure of how efficient the business is in using its resources to produce profit or net farm income" (Kay, Edwards, 1994). Every management has to become aware of the profitability of its business: how efficient do they operate and allocate its resources, and how much revenues and costs can be produced. This is why it is essential to analyse the result of the business operations in relation to the resources being used by the business and controlled by the management of the business. This leads to a variety of relationships and ratios that need to be explored. These ratios can provide information on anticipated rates of return, present net

worth and other measures of profitability. They can also be used to evaluate the profitability of competitive management alternatives, and this information is useful for financial planning and for documenting the value of the activity to prospective buyers, too. For this reason the management has to know the application of these financial tools in order to assess profitability of the farm business and to understand what bankers are looking for in the income statements. The applied analysing techniques are various in different countries, because of the different agricultural, legal and economical circumstances. This is the reason why there are many analytical methods to employ. We have to mention that in these days real profitability analytical system for the family farm businesses doesn't exist in Hungary.

Profitability ratios are generally developed from the income statement and measure the ability of the organisation to turn sales into profits and to generate profit from assets. Family farm businesses don't have to prepare such a statement, so our first aim is to create a simple framework to represent the income of the business. It has to show the revenues and expenses for a given period.

Profitability is the earning of the farm business. Profitability can be measured as total money earned, money earned by farm assets or money earned by farm equity. There are 4 common measures of profitability in the practice of the developed countries, e.g. in the United Kingdom:

**1, Net Farm Income (NFI):** money returned to the labor, management and equity invested in the farm business. It is the money the family farm business has available for living expenses, personal income tax payments and to re-invest in the farm business.

**2, Rate of return on farm assets = (Return on farm assets / Average farm assets)\*100**  
Return on farm assets = net farm income + farm interest - a charge for operator's labor & management  
The interest rate is earned on all farm assets, those assets the family farm business own and those assets the bank owns.

**3, Rate of return on farm equity = (Return on farm equity/Average farm net worth)\*100**  
Return of farm equity is net farm income - a charge for operator's labor & management. The interest rate is being earned by the family farm business's investment in the farm.

**4, Operating profit margin = (Return on farm assets / Value of farm production)\*100** is the operating efficiency of the farm. A low profit margin can be caused by low commodity prices, high operating expenses or inefficient production.

Other:

Gross farm income = gross cash farm income + inventory changes in crops & feed, market livestock and breeding livestock + changes in accounts receivable.

Value of farm production = gross farm income - feeder livestock purchased - purchased feed.

As it appears from the previous lines, these measures are too difficult to calculate for a farmer, who doesn't keep record of the family farm business's operation. According to this system, our aim is to identify the Hungarian specific profitability measures and a rule of thumb (percentages, income categories, e.g.), which could be used among the Hungarian circumstances to represent the financial status of the family farm business. New and more simple income categories, measures and scorecard should be build up in connection with the family farm business's need. We would like to develop a Family farm businesses' finance scorecard (by the practice of the University of Vermont) that allows the farmers to score the financial strength of their farm business. Our aim is that they could use this scorecard to see how their business measures up. Family farm businesses should be aware of the tools to assess profitability of their farm business, and understand what bankers are looking for in their statements in order to give credits for them. The scorecard lets the farmers assess the financial position of their business. In order to complete the scorecard they must have a start

of year balance sheet, an end of year balance sheet, an income statement and a cash flow statement (the primary objective is to create simple statements for the family farm businesses). Measures could be liquidity, solvency, profitability and financial efficiency ratios/indices. After it, we have to determine the vulnerable, neutral, and strong values of these ratios in order to show the business's position.

## **CONCLUSION**

The newly established type of ownership, namely the family farm business forms an interesting, and new challenge from the view of the profit-calculation. In order to the survival and the competitiveness, these family farm businesses have to be informed about their own profitability status, too. According to the current legal circumstances, they don't have to keep strict record of their operation and supply detailed data about their income. This is why there's a great need for a simple and transparent system of financial ratios from the part of the family farm businesses. Our aim during the examination is to identify the Hungarian specific profitability measures and a rule of thumb (percentages, income categories, e.g.), which could be used among the Hungarian circumstances to represent the financial status of the family farm business. New and simpler income categories, measures and scorecard should be built up in connection with the family farm business's need. Family farm businesses' finance scorecard has to be developed that allows the farmers to score the financial strength of their farm business. Family farm businesses should be aware of the tools to assess profitability of their farm business, and understand what bankers are looking for in their statements in order to give credits for them.

Development of a competent and best fitting profitability measurement system, data and income categories, registrations filled up with data by the farmer, and Family farm businesses' finance scorecard will be the task for our future examination. We hope that in this way we could help the family farm businesses, this newly developed ownership in order to control their business performance and improve their efficiency.

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