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# farm management deposits

## use and interaction with exceptional circumstances assistance

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- » *Farm businesses holding farm management deposits (FMDs) in 2005-06 were characterised by better financial performance than farm businesses not holding such deposits.*
- » *The trigger for most farm management deposits is tax liability, with income smoothing being the second consideration. Accountants play a key advisory role in FMD decision making.*
- » *Withdrawals of farm management deposits have been mainly for farm working capital.*
- » *In addition to farm management deposits, debt financing has been a preferred means of farm businesses to manage fluctuations in farm income.*
- » *In some cases, the provision of Exceptional Circumstances may reduce the effectiveness of the FMD scheme as a risk management tool.*

### Farm Management Deposit scheme

The Farm Management Deposit scheme was established in April 1999 as a tax linked, financial risk management tool for primary producers. The primary objective of the scheme is to assist primary producers deal more effectively with fluctuations in their cash flow resulting from climate variations and changes in market prices.

The scheme is an element of the *Agriculture Advancing Australia (AAA)* package, an integrated policy package developed to encourage farmers to adopt a more self reliant approach to risk management. It allows eligible primary producers to set aside pretax primary production income in profitable years to establish cash reserves to help meet costs in low income years, facilitating increased financial self reliance.

FMDs are only available to individual primary producers. To be eligible to invest in an FMD, individual primary producers must not earn more than \$65 000 in off-farm income in the year of deposit. In addition, only primary production income can be invested in FMDs, up to a maximum holding of \$400 000 at any given time. Deposits are tax deductible in the year they are made, and withdrawals are included as taxable income in the year they are withdrawn. To qualify for the tax deduction, deposits must remain in the account for at least twelve months, unless the withdrawal is made in Exceptional Circumstances (EC), and the deposit was made prior to the area being EC declared.

## farm management deposits

### 1 financial and physical performance indicators for broadacre farms that held FMDs in 2005-06

		average per farm	
<b>physical</b>			
total area operated at 30 June	ha	5 788	(49)
- total area sown to crops	ha	543	(6)
sheep at 30 June	no.	1 940	(7)
- change in sheep numbers	%	-2	(143)
beef cattle at 30 June	no.	310	(17)
- change in beef numbers	%	5	(69)
age of owner operator	years	55	(1)
<b>industry</b>			
wheat and other crops	%	24	(8)
mixed livestock-crops	%	27	(7)
sheep	%	17	(12)
beef	%	22	(10)
sheep-beef	%	10	(17)
<b>financial</b>			
total cash receipts	\$	414 074	(4)
total cash costs	\$	299 671	(4)
farm cash income	\$	114 403	(8)
- farms with negative farm cash income	%	11	(19)
farm business profit	\$	33 158	(26)
rate of return			
- excl. capital appreciation	%	1.7	(14)
- incl. capital appreciation	%	6.0	(12)
total farm capital at 30 June	\$	3 739 027	(5)
- net capital additions	\$	60 752	(21)
farm debt at 30 June <b>a</b>	\$	318 971	(10)
- change in debt <b>a</b>	\$	27 114	(42)
- change in working capital debt <b>a</b>	\$	13 749	(44)
- change in investment debt <b>a</b>	\$	13 365	(83)
equity ratio at 30 June	%	91	(1)
liquid assets (including FMDs) at 30 June	\$	216 850	(8)
off-farm income			
- investment	\$	16 101	(8)
- wages and salary	\$	9 242	(14)
farm management deposits			
- held at 1 July	\$	92 548	(7)
- held at 30 June	\$	88 496	(9)
- ratio of FMDs at 30 June to receipts	%	21	(7)
exceptional circumstances relief payment	\$	1 499	(24)
government assistance to farm business	\$	3 308	(21)
- ratio of total government assistance to receipts	%	1	(16)
estimated population	no.	15 013	
sample	no.	413	

**a** Debt responding farms only.

Note: Figures in parentheses are standard errors expressed as percentages of the estimates.

As at 30 June 2007, 40 574 farmers held a total of \$2.78 billion in FMDs. There was a small reduction in the number of deposit holders during 2006-07, reflecting poor seasonal conditions across Australia. However, despite significant fluctuation in the total value of holdings throughout the course of the 2006-07 financial year, the total value of holdings at 30 June 2007 ended up being similar to total holdings at 30 June 2006.

### reviewing the scheme

In 2006 the effectiveness and efficiency of the scheme was reviewed by a committee overseen by the Australian Government Department of Agriculture, Fisheries and Forestry. The committee found that the scheme was meeting its objectives as a tax linked, financial risk management tool for primary producers. The 2006 review also examined the uptake and use of FMDs during drought. Drought conditions have been widespread throughout Australia since 2002-03 and during this period, FMD holdings have risen at a slower rate than previously.

Some of the key issues surrounding the scheme are the characteristics of the farms using FMDs (table 1), the role of FMDs in facilitating the self reliance of farm businesses through the drawing down of available FMD reserves and the effectiveness of the scheme as a risk management tool for drought preparedness and management. Another important issue is the interaction between FMDs and government funded drought assistance, particularly the Exceptional Circumstances Relief Payment (ECRP) and Exceptional Circumstances Interest Rate Subsidy (ECIRS) provided to farms in EC declared regions and industries.

### 2005-06 ABARE survey

To investigate these issues, ABARE collected information on the awareness and use of FMDs in late 2006 as part of its Australian agricultural and grazing industries survey. This survey collected data on the physical and financial performance of farms in 2005-06 from a total of 1450 broadacre farms. Around 480 of these farms were asked supplementary questions on their use of FMDs. This collection included information on persons most influential in FMD decisions, reasons for making FMD deposits, reasons for not making FMD

withdrawals, use of funds withdrawn from FMDs, likely uses of funds from future FMD withdrawals, alternatives if there is no early access to FMDs in EC declared areas, alternative uses for funds if the FMD scheme did not exist, the importance of the FMD scheme to risk management strategies, and risk management strategies in addition to the use of FMDs.

Data from this survey have been analysed in conjunction with the core survey data, including information about the receipt of EC assistance. Analysis included tabulation of data by EC declaration status, change in FMD holdings, farm industry type, sources of FMD advice, age of farm operators and farm business size.

### characteristics of FMD holders

Farm businesses holding farm management deposits in 2005-06 recorded superior financial performance, including higher farm cash incomes, higher rates of return, higher farm equity ratios and higher liquid assets than farms of similar size and enterprise mix that did not hold FMDs. In 2005-06, the proportion of farm businesses holding FMDs rose with increasing farm business size (defined by a measure of turnover). Two-thirds of aggregate FMD deposits of broadacre farms were held by the largest third of farm businesses (figure A). However, within all farm size groups, it was superior financial performance that was the key characteristic associated with FMD holding.

In recent years, the profile of deposit holders in the FMD scheme has broadened to include a much larger proportion of operators of medium size and small farm businesses, as well as younger farm operators than was the case in the early years of the scheme. On average, the operators of farm businesses with FMDs were younger than those without FMDs in 2005-06.

fig A **FMD holdings, by farm business size, 2005-06**

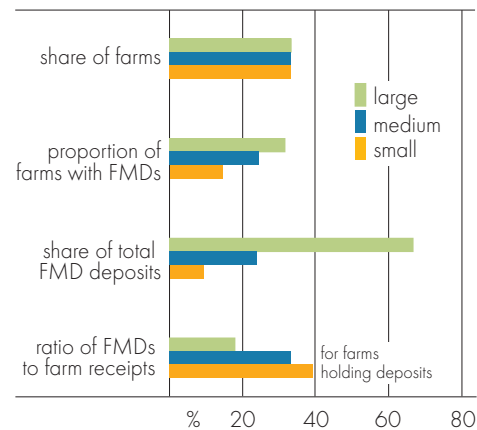
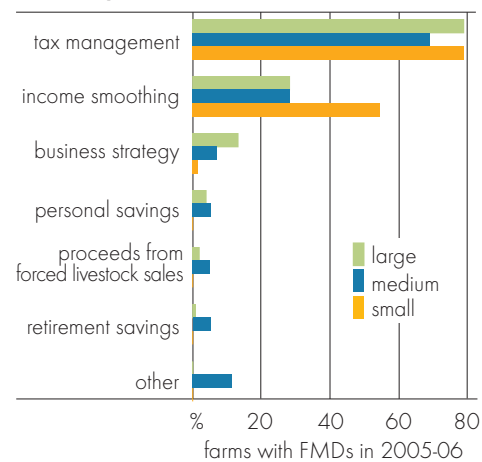


fig B **reasons for making latest FMD deposit**



### analysing farmers' decisions about FMDs

#### triggers for FMD deposits

The majority of farm business operators indicated that deposits were triggered in order to manage tax liability, with income smoothing a second consideration (table 2). Tax management triggered the latest FMD deposit for the majority of farms in all size categories (figure B) and all industry types, and in EC declared areas and non-EC declared areas. Income smoothing was a distant second for all groups, except small farms in EC declared areas.

While tax management remained the highest ranked trigger for FMD deposits, income smoothing was also ranked highly by small farms (figure B).

## farm management deposits

### 2 reasons for decisions made by broadacre farmers holding FMDs in 2005-06

	proportion of responding farms %	
<b>most influence on decisions relating to FMD</b>		
accountant	58	(10)
bank manager	1	(74)
financial adviser	1	(88)
partner	6	(51)
respondent	34	(17)
rural financial counsellors	0	(112)
other	0	(998)
<b>reasons for making most recent FMD deposit</b>		
tax management	75	(7)
income smoothing	33	(18)
business strategy	9	(32)
personal savings	4	(72)
retirement savings	2	(67)
receipt from forced livestock sales	3	(26)
other	4	(73)
<b>reasons for not making FMD withdrawal</b>		
income sufficient to meet needs	66	(17)
used debt facility	7	(66)
keeping funds for retirement	12	(62)
received government assistance	11	(65)
other	5	(101)
<b>made an FMD withdrawal</b>	61	(10)
<b>purposes of FMD withdrawal <sup>a</sup></b>		
working capital	69	(9)
capital purchase	8	(35)
debt reduction	19	(35)
household expenses	4	(86)
off-farm investment	3	(80)
retirement expenses	3	(73)
tax management	11	(41)
other	6	(43)
<b>importance of FMD scheme to risk management strategy</b>		
most important	13	(25)
highly important	40	(16)
important	29	(20)
minor importance	17	(27)
not important	1	(64)
<b>risk management strategies other than FMD scheme <sup>a</sup></b>		
off-farm income from wages, contracting etc	37	(15)
off-farm income from investments	38	(15)
debt financing	45	(11)
enterprise diversification	20	(25)
forward contracting/hedging	9	(36)
seasonal conditions forecasts	8	(35)
insurance against loss of production	18	(25)
other	5	(49)

<sup>a</sup> Percentages do not add up to 100 as farmers could give more than one response.

Deposits triggered as a business strategy, while low for all farm sizes, were significantly higher for large farms. Among non-EC declared farms, deposits for retirement savings were significantly higher for medium size farms.

In EC declared areas, around 7 per cent of medium size businesses and 4 per cent of large businesses indicated that proceeds from forced livestock sales had triggered the FMD deposits.

#### source of advice

Accountants were identified as having the major advisory role in FMD decisions, particularly among larger farm businesses and businesses operated by older farmers. Accountants were nominated as the main influence on FMD decisions by 58 per cent of farm businesses with FMDs (table 2). The farm operator was the main influence nominated by a third of farm businesses with FMD holdings in 2005-06. Smaller farm businesses and farm businesses in EC declared areas relied equally on the farm operator and the farm accountant in FMD decision making.

The average financial performance of farm businesses seeking professional advice on FMD use was better than that of farms not seeking professional advice.

For farm businesses using professional advice on FMD use, there was a stronger emphasis on FMD use for tax management and a relatively lower ranking given to the importance of FMD use as a risk management strategy (figure C). Instead, farms in this group put stronger emphasis on debt financing as a non-FMD risk management strategy compared with businesses that obtained no advice. Farms not using professional advice gave stronger emphasis to off-farm wages and contracting as a risk management strategy (figure D). Further, average liquid asset levels for the group using professional advice were more than double those of the group not seeking advice.

#### use of funds withdrawn from FMDs

The 2005-06 survey indicated that the majority of FMD withdrawals have been to provide working capital, although debt reduction and tax management are also significant. Around 70 per cent of farms made their most recent FMD withdrawal to cover working capital, 19 per cent for debt reduction, 11 per cent for tax management and 8 per cent for capital purchase

(table 2). Withdrawal for household expenses, off-farm investment and retirement expenses were each nominated by around 3 per cent of farms. Detailed financial and physical survey data suggest that cattle purchase was likely to have been a significant component of the expenditure funded by FMD withdrawals in 2005-06.

While at least 50 per cent of farm operators in all age groups indicated the main reason for FMD withdrawal was to provide working capital, around 35 per cent of farmers aged 51-60 used withdrawals for debt reduction. Around 25 per cent of farmers over 60 years of age indicated that withdrawals were made for tax management purposes and these farmers generally put withdrawn funds to a broader range of uses (figure E).

Similarly, farms with FMDs indicated that the most likely reason for making FMD withdrawals in the future would be to fund working capital, with other reasons being tax management, debt reduction and retirement, but these ranked much lower.

Withdrawals under the early access provisions of EC were reported by only 4 per cent of farms with FMDs in 2005-06 and 8 per cent of farms that had FMDs prior to 2005-06. These withdrawals were almost all made by medium and large farm businesses.

**risk management strategies**

Debt financing was listed by all farm size groups as an important risk management strategy other than the FMD scheme. However, small and medium size farms with FMDs gave a significantly higher rating to off-farm wages and contracting as well as a higher rating to off-farm income from investments (figure F). Nevertheless, a broader range of risk management practices were identified in the responses of larger farm businesses.

Debt financing was identified by an estimated 45 per cent of FMD holders to be an important risk management strategy other than FMDs. Off-farm income from wages and contracting and off-farm investments were each identified by around 38 per cent of respondents. Enterprise diversification was identified by 20 per cent and insurance against production losses by 18 per cent (table 2). Only 9 per cent of farms indicated that forward contracting or hedging was an alternative risk management

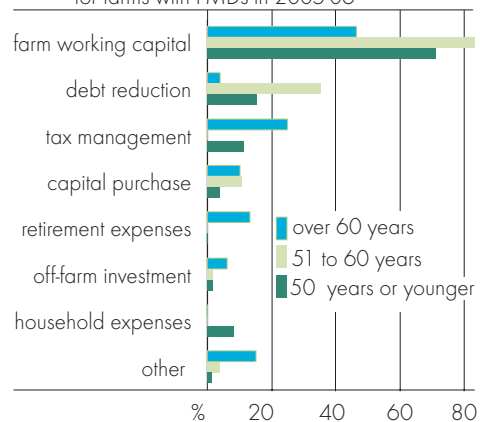
fig C reasons for using FMDs, by source of advice for farms with FMDs in 2005-06



fig D risk management strategies other than FMD scheme, by source of advice for farms with FMDs in 2005-06



fig E purposes of FMD withdrawal, by age of farm operator for farms with FMDs in 2005-06



## farm management deposits

strategy. Larger incorporated farms, including feedlots and cotton producers that generally undertake more forward contracting or hedging, are not eligible to hold FMDs.

A significantly higher proportion of large farms with FMDs cited enterprise diversification, forward contracting or hedging, seasonal conditions forecasts and insurance against production losses as important risk management strategies other than FMDs than did small and medium size farms with FMDs (figure F). These results are likely to reflect the greater concentration of large cropping businesses in this size category.

Reliance on debt financing to manage fluctuations in farm income is further supported by financial data that indicated a strong preference for debt financing of working capital requirements in recent years, even where holdings of FMDs have been substantial. While the impact of increases in working capital debt on farm equity has been more than offset by rising land and livestock values in recent years, increases in working capital debt are not productivity enhancing and reduce measures of farm financial performance.

fig F risk management strategies other than FMD scheme, by farm business size

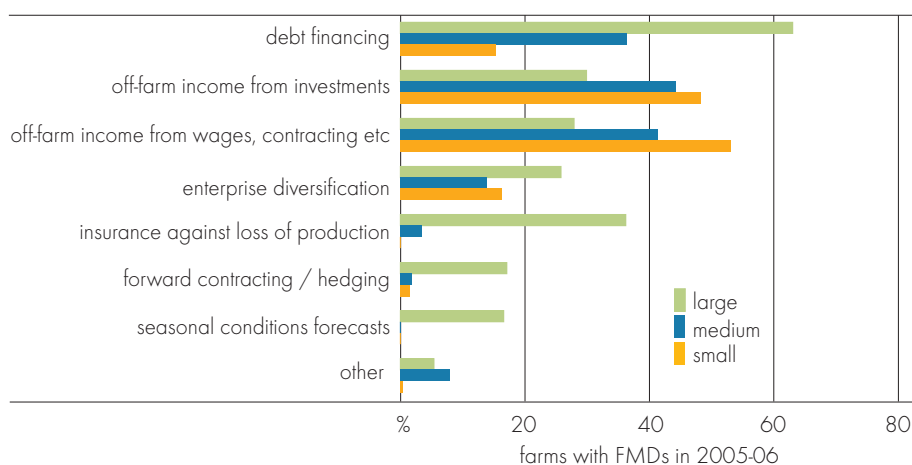
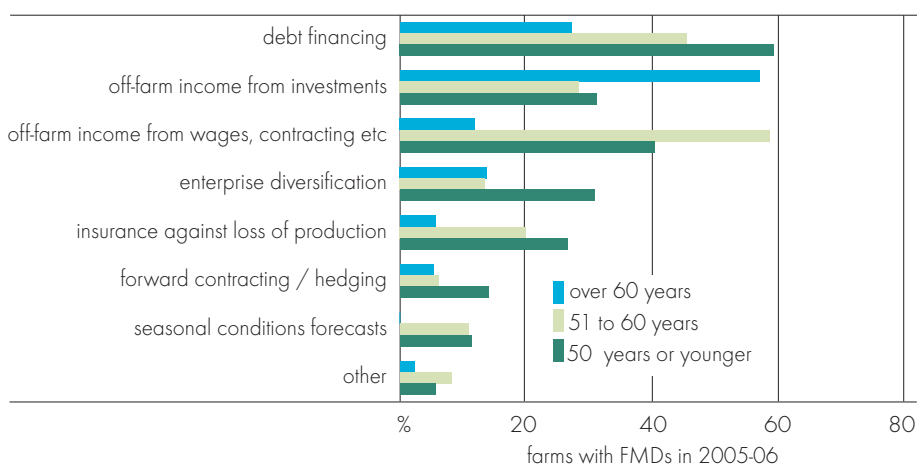


fig G risk management strategies other than FMD scheme, by age of farm operator



The survey results indicate that emphasis on debt financing to manage income fluctuations declines with increasing age of the farm owner manager (figure G). Owner managers under 50 years of age put significantly greater emphasis on access to a debt facility than do older farmers. This might be expected in view of the average age of these farmers (which at 44 puts them at an earlier stage in their careers) as well as the superior capacity of their businesses to service debt. Farmers over the age of 60 place greater emphasis on off-farm income from investments, while owner managers aged 51–60 put greatest emphasis on income from off-farm wages and contracting. Debt financing was also relatively highly rated by farmers in this age group as a tool for managing income fluctuations.

### reasons for not making an FMD withdrawal

Around two-thirds of farms did not make a withdrawal in 2005-06 because they had sufficient income to meet their needs. A further 12 per cent made no withdrawal because money was being kept for retirement; 11 per cent because government assistance was received; 7 per cent because they used their debt facility; and 5 per cent indicated other reasons (table 2).

Current government policy allows for FMD holdings to be considered as exempt assets, in certain circumstances, when farmers apply for EC assistance. Therefore, it is difficult to draw meaningful conclusions about the impact of the FMD scheme in the context of exceptional circumstances events, including drought.

However, there is some evidence of interaction between FMD holdings and assistance provided by government through the EC provisions. In 2005-06, farm businesses in EC declared areas with FMD holdings received significantly less government assistance through Exceptional Circumstances Interest Rate Subsidy payments and Exceptional Circumstances Relief Payments than farms with no FMDs in both absolute terms as well as relative to their business size. This generally reflects the better financial performance of farms with FMD holdings. This may suggest that, in some cases, EC provisions reduce the effectiveness of the FMD scheme as a risk management tool.