A Different Type of Record System for the Rancher and Veterinarian

Eddie Hamilton, *BS, DVM, MAgr*
South Dakota State University, Box 166, Kimball, SD 57355

Abstract

Historically, agriculture has assembled financial/ accounting information for taxes, credit and management (profitability). The need for tax based information has always been the driver, and management information is quite often missing altogether. This can lead to poor decisions by management.

Managerial accounting gives management the tools needed to manage a business in today's complex world. It allows management to manage cost where and when it occurs, and to manage the segments of the business that are manageable.

The Balanced Score Card is a set of measures that provides a fast, comprehensive picture of how an organization is creating and sustaining value—in the eyes of its customers, stakeholders and employees.

Managerial Accounting in Production Agriculture

Historically, agriculture has assembled financial/ accounting information first for taxes, then credit, and sometimes management (profitability). This focus has resulted in cash basis earnings statements and market basis balance sheets. Lack of managerial focus can lead to a lack of profits. Without profits, there are no taxes to pay or need to obtain credit (in the long run). It is suggested that a different order of priority is more appropriate. The focus should be on management (profitability) – continuous need and focus first; then credit – annual/semi-annual activity; and finally taxes – annual event.

No other industry—regardless of size, manufacturing complexity or capital intensity—attempts to manage its businesses with the lack of management-focused information as does production agriculture. For decades, managerial accounting—with its profit and cost centers—has been the accepted methodology for businesses in other industries. These techniques are widely employed in all areas of our commercial sector except production agriculture.

Agriculture has traditionally used enterprise accounting as an analysis tool. Managerial Accounting (MA) and enterprise accounting do not provide the same decision information for any analysis tool. NCBA Standardized Performance Analysis (SPA) in1991 is an example of enterprise analysis. Examples of managerial accounting activities are: NPPC/NPB – Pork Production and Financial Standards (1995), ISA – Corn and Soybean Production and Financial Standards (1998), Cotton Inc, and FFSC – Managerial Accounting Guidelines.

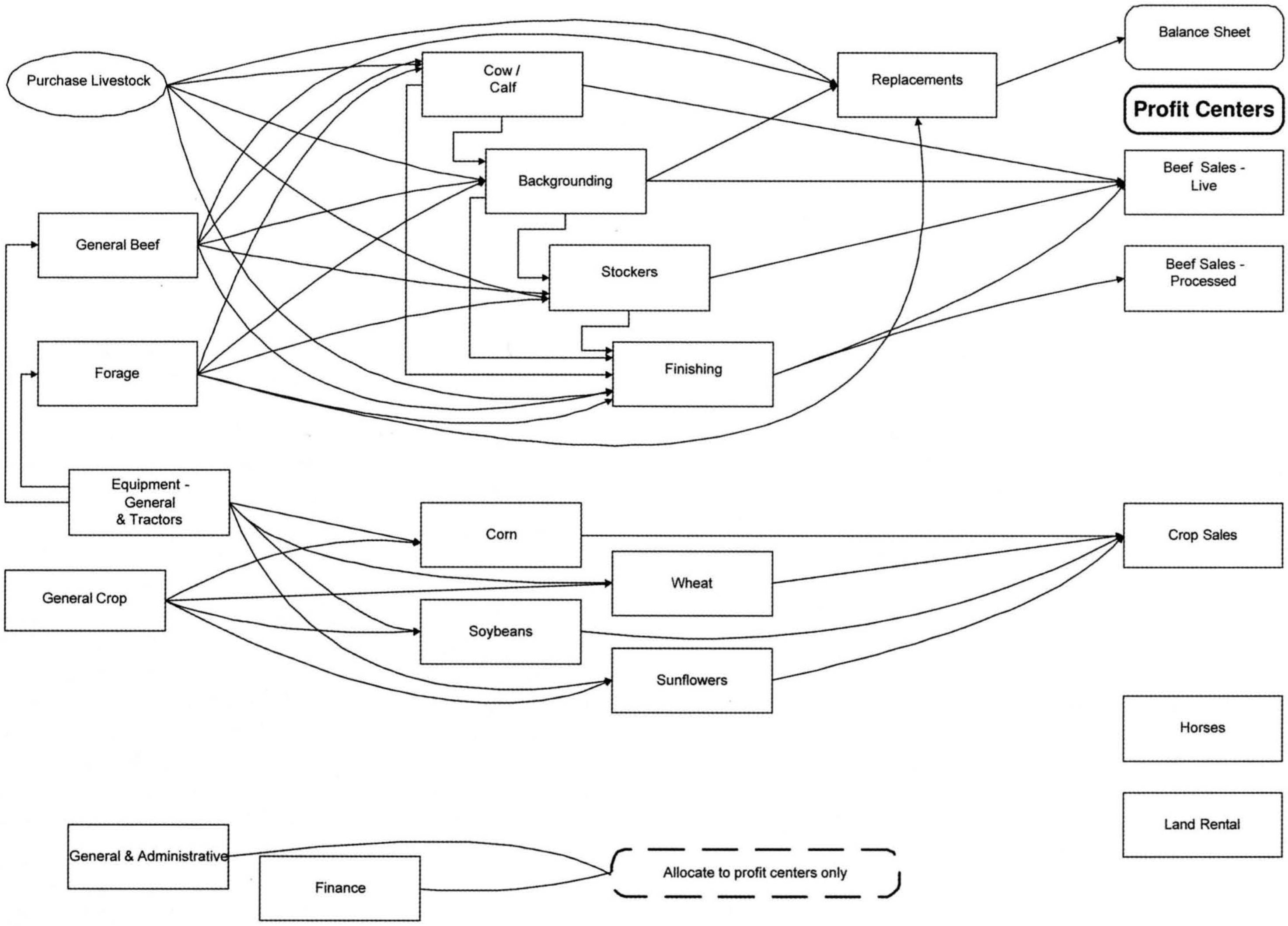
Enterprise accounting has focused primarily on the direct revenue and expenses of the enterprise (corn, beef, pork, beans, etc.). It does not provide for separate accumulation of costs by manageable segment, and allocation of cost centers to profit centers. It uses line-item allocation of indirect costs across multiple enterprises, and carries a significant loss of management information as a result.

Managerial accounting permits owners/ management to more effectively monitor and manage the results of profit and cost centers. This allows management to better manage human resources, profitability, capital asset management and cost.

Managerial accounting is focused internally – on information that managers need to run the business. It captures cost information at the level where costs can be influenced and managed. It aggregates numbers as they are "rolled up" in the entity. It takes a manufacturing approach to the development and internal reporting of numbers. MA facilitates optimal profitability in each profit center, effective cost management in each cost center, rational in-source versus out-source decisions, and rent-versus-own analysis.

Managerial accounting is focused on accumulating transaction-based information by manageable segment of the business. Manageable segments are the responsibility centers that management chooses to manage. They are divided into three major centers: Profit Centers, Cost Centers, and Cost Support Centers. See Table 1 for an example of a multi-commodity farming and ranching business. A Profit Center is a portion of the business whose primary emphasis is on creation of revenue (ultimately then, profits). Cost Centers are the portions of the business whose emphasis is to support other Cost Centers or Profit Centers. MA uses the accumulated segment information to improve the producer's ability to manage those parts of the business by focusing on: Personnel/Area Performance measurement, Revenue/Profitability measurement, Asset Management/Asset Utilization and Cost Control.

Table 1. Example of a multi-commodity farming and ranching business.



Profit Centers are typically commodity oriented (corn, soybeans, pork, beef, wheat), but they may be product line oriented (food grade, commercial grade, high oil, forage) or location-based. Management intent is the primary determining factor.

Cost Center types are Production Stages/Segments (activities), Support Operations, Sales, General and Administrative (G&A) and Financing.

The following definitions are useful in understanding the relationship of various cost numbers:

Production Costs – costs incurred in the production process to bring goods to the point at which they are ready for sale, or costs incurred to produce services.

Operating Costs – costs associated with generating revenues, other than cost of goods sold (COGS). This includes marketing, storage, transportation and G&A.

Direct Cost – a cost item that can be identified specifically with a single cost object in an economically feasible manner.

Indirect Cost – a cost item that is common to two or more cost objects, and cannot be identified specifically with any one of them.

Inventory is recorded at cost! All production costs are first allocated to Work in Process (WIP) on the balance sheet. They are then transferred to Finished Goods (FG) when the product is ready for sale. Revenue is recorded when the product is sold, and inventory is relieved and Production Costs (COGS) are charged when the product is sold.

Major changes in the Managerial Accounting context versus Enterprise Accounting can be listed as follows:

- Inventories and Work in Process are recorded at cost
- Only Production Costs are included – no transportation, storage, interest, or G&A
- Depreciation is primarily a Production Cost, and is therefore "buried" – either in COGS or in inventory
- Period Costs are expensed when incurred, regardless of whether revenue is recognized
- Enterprise Accounting-Revenue includes cash sales, A/R accrual adjustments, and inventory ad-

justments

- Enterprise Accounting-Expenses include ALL cash operating expenses plus accrual adjustments
- MA-Revenue includes only products sold (which is the same as cash sales and A/R accrual adjustment)
- MA-Expenses include Production Costs related to sales
- MA-Some are Period Costs

The differences between MA and Enterprise Accounting result in more accurate cost recording and analysis for MA. MA also offers better support for historical and strategic analysis. The ability to do real benchmarking is enhanced. MA significantly raises the bar for internal accounting systems and personnel requirements for its operation. MA allows the integration of production, managerial and financial systems. MA creates a foundation for cost-behavior pattern understanding and Activity-Based Costing (ABC).

MA can enhance credibility in managing relationships with customers/vendors in strategic partnerships and alliances. MA can lead to the adoption of more complete metrics such as the Balanced Score Card (BSC).

Balanced Score Card

The Balanced Score Card (BSC) is a concept that facilitates translation of strategy into action. BSC starts from the company vision and strategies; from here, critical success factors are defined. Measures are constructed that aid target-setting and performance measurement in areas critical to the strategies. Hence, BSC is a performance measurement system, derived from vision and strategy, that reflects the most important aspects of the business. The BSC concept supports strategic planning and implementation by federating the actions of all parts of an organization around a common understanding of its goals, and by facilitating the assessment and upgrade of strategy.

Traditional performance measurement, focusing on external accounting data, was quickly becoming obsolete, and something more was needed to provide the information age enterprises with efficient planning tools. For this purpose, Kaplan and Norton introduced four different perspectives from which a company's activity can be evaluated:

- Financial perspective (how do we perceive our shareholders?)
- Customer perspective (how do we perceive our customers?)
- Process perspective (in what processes should we excel to succeed?)
- Learning and innovation perspective (how will we sustain our ability to change and improve?)

Two additional perspectives to be considered by agricultural producers are:

- Public/Environment perspective (to achieve our vision how should we appear to the public? How shall we focus on the environment and community?)
- Family/Lifestyle perspective (To achieve our vision, how shall we fulfill family and lifestyle objectives?)

Kaplan, the "father" of the balanced score card approach, suggests that a balanced score card links and integrates four key strategic questions:

- How do our clients or customers see us?
- At what must we excel? (e.g., what are our core competencies and processes)
- How are we performing overall?
- How can we continue to improve the performance environment of our employees and recognize that they are our most important asset?

For each of the four questions, businesses need to identify, understand and commit to:

- Identifying the most critical variables
- Measures for each variable
- Objectives and targets that consider each question/variable in relation to the organization's vision
- How the objectives and variables link and align with organizational strategy.

An effective score card will identify a set of strategic questions and measures that address the issue of adding value—and doing so at a rate that is better than the competition. This is the essence of strategy. Too often, managers look only at the bottom line—shareholder return or revenue targets—or, in our case, preg rates, net cash flow, and net income. However, a balanced score card emphasizes that programmatic and business measures must be part of an information system for employees at all levels of the organization. If implemented successfully, the score card provides data for discussion that forms the basis for strategy, tactics and operational decisions. The front line employees understand how they contribute to the organization's goals, and management better understands what constitutes adding value—the key to long-term success.

A recent Fortune Magazine cover story on why executives fail suggested that an inability to execute strategy was the most common reason for failure. The ability to create mission-critical strategy and measures that are value-based may not immediately emerge from strategic planning efforts. However, managers who use a balanced set of indicators can systematically stimulate better understandings and deeper insights that can form the basis for strategy. Businesses which adopt a balanced score card can better facilitate the change and growth needed to achieve strategic goals.

Benefits of balanced score cards have great potential in helping us meet our challenges rapidly, effectively and efficiently. However, the reality of implementing and staying with the balanced score card approach requires real change within our businesses and among our consultants. Even in the best of times, the creative talents and the individual agendas of our team members make it difficult to maintain discipline and focus on results. And during periods of change, it is even more challenging to maintain this focus. As Mark Twain once said, "I am all for progress, it's the change I can't stand." I think you would agree that change is best embraced when we have a burning platform or a specific performance that is measurable. Therefore, the balanced score card provides a rationale for change and performance enhancement.

BSC was developed in the early 1990s by Drs. Robert Kaplan (Harvard Business School) and David Norton as a new approach to strategic management. It served as a response to the weaknesses associated with traditional performance measures which focused solely on financial data. The name reflects the balance between short and long-term objectives, financial and non-financial measures, between lagging and leading indicators, and between external and internal performance.

Businesses that use the BSC to monitor, evaluate and achieve success are listed below in business categories.

- Consumer / Retail
  - Best Buy
  - Coca Cola
  - The Gap
  - Wendy's
- Financial Services
  - Bank of America
  - National City Bank
  - New York Stock Exchange
- Manufacturing/Technology
  - Anheuser-Busch Companies
  - Hewlett-Packard
  - DaimlerChrysler
  - Motorola
- Education
  - Numerous universities
  - Numerous state education systems

The BSC approach is a management system that helps translate strategy—the overall "game plan"—into action. It provides feedback so that performance may be continuously improved. Moving from performance measurement to performance management requires a distinction between measurement and management that is subtle but crucial! The goal of a score card is not to develop a new set of measures, but to develop a framework for deploying a management system. The score card should provide a framework for organizing vital information and issues with a continuous process for evaluation of performance, updating targets and goals, identifying action plans and following up on progress.

Development of a BSC requires clarifying the vision and strategy of a business. After a BSC is developed, the next step is to communicate the score card to the entire team. This clarifies how each individual impacts performance. Individual performance objectives may be established and linked to the score card. A score card review process may be implemented with appropriate frequencies (i.e. weekly and monthly reviews, and quarterly and annual reviews that focus more heavily on strategic issues). This is a continuous, cyclical process. It has neither a beginning nor an end. This insures ongoing feedback and learning.

Balanced Score Card pitfalls include failure to agree upon and understand the vision and strategy of the business. Using the BSC as an "off-the-shelf" checklist that is universally applicable will not work. Not taking the time to identify which performance drivers make the greatest contribution to specific needs is another weakness. Failing to ensure that measures are linked to the strategy, and not developing causal models to ensure appropriate links to the strategy, are others.

Other pitfalls include setting performance targets too high or using invalid measures which do not capture what they're supposed to (i.e. customer surveys that do not ask the right questions).

In an industry such as agriculture—regulated by government, dependent on public perception, lifestyle businesses—it is a prerequisite that we develop a tool that includes both financial and non-financial metrics of success.

Additional Reading Material

Books

Kaplan RS, Norton DP: *The Balanced Scorecard: Translating Strategy into Action.*

Kaplan RS, Norton DP: *The Strategy Focused Organization: How Balanced Scorecard Companies Thrive in the New Business Environment.*

Niven P: *Balanced Scorecard Step by Step.*

Articles

Focusing Your Organization on Strategy – with the Balanced Scorecard, *Harvard Business Review* OnPoint Collection October 2000

Ittner CD, Lacker DF: Coming Up Short on Nonfinancial Performance Measurement, *Harvard Business Review*, November, 2003

Organizations and Websites

Balanced Scorecard Collaborative	www.bscol.com
The Balanced Scorecard Institute	www.balancedscorecard.org
QPR	www.qpr.com
Farm Financial Standards Council	www.ffsc.org