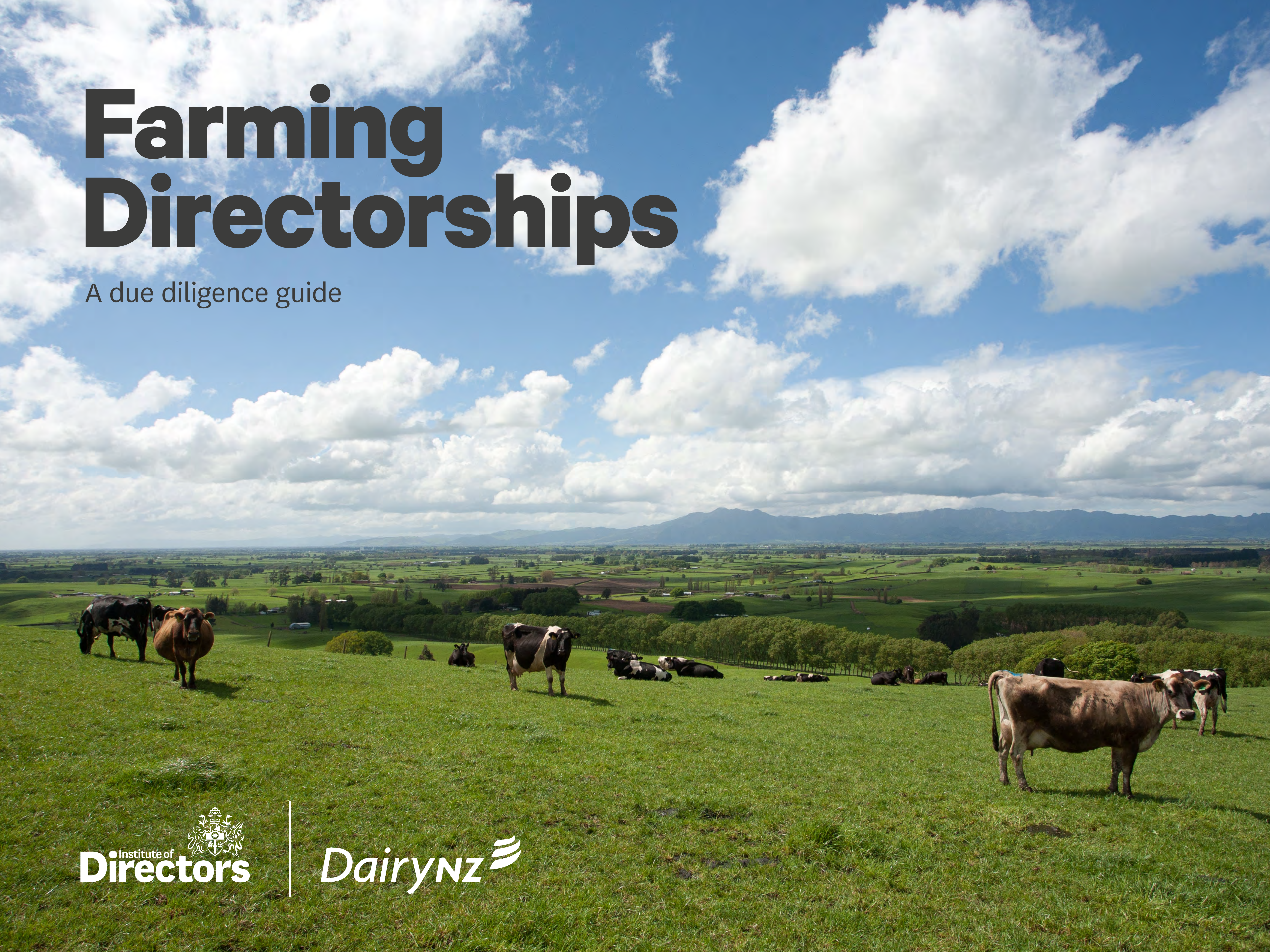
Farming Directorships

A due diligence guide



Institute of Directors | DairyNZ

Being an independent director on the board of a farming company can provide a rewarding opportunity to participate and add value in one of New Zealand's largest and most important commercial sectors. There is growing recognition of the important role that governance structures and disciplines play in creating and protecting shareholder value in a farming business. As a result there is an increasing demand for independent and non-executive directors to join farming company boards.

An invitation to join the board of any organisation can be appealing and complimentary, however, it also requires time, effort and professionalism. Taking on the role involves substantial legal duties and other responsibilities. Getting it wrong could mean expensive legal proceedings, loss of personal assets and reputational damage. This is why undertaking robust due diligence is so important.

This due diligence guide has been produced to assist prospective independent directors with questions to help them understand the nature of the business, as part of their preparation in deciding whether to join a farming company board. It can also be used as a framework for considering farming advisory board appointments.

This guide was developed between the Institute of Directors, its Waikato Branch and DairyNZ, with input from Tompkins Wake and BDO.

Disclaimer: This practice guide has been prepared as a resource for boards and should not be used or relied upon as a substitute for proper professional advice.

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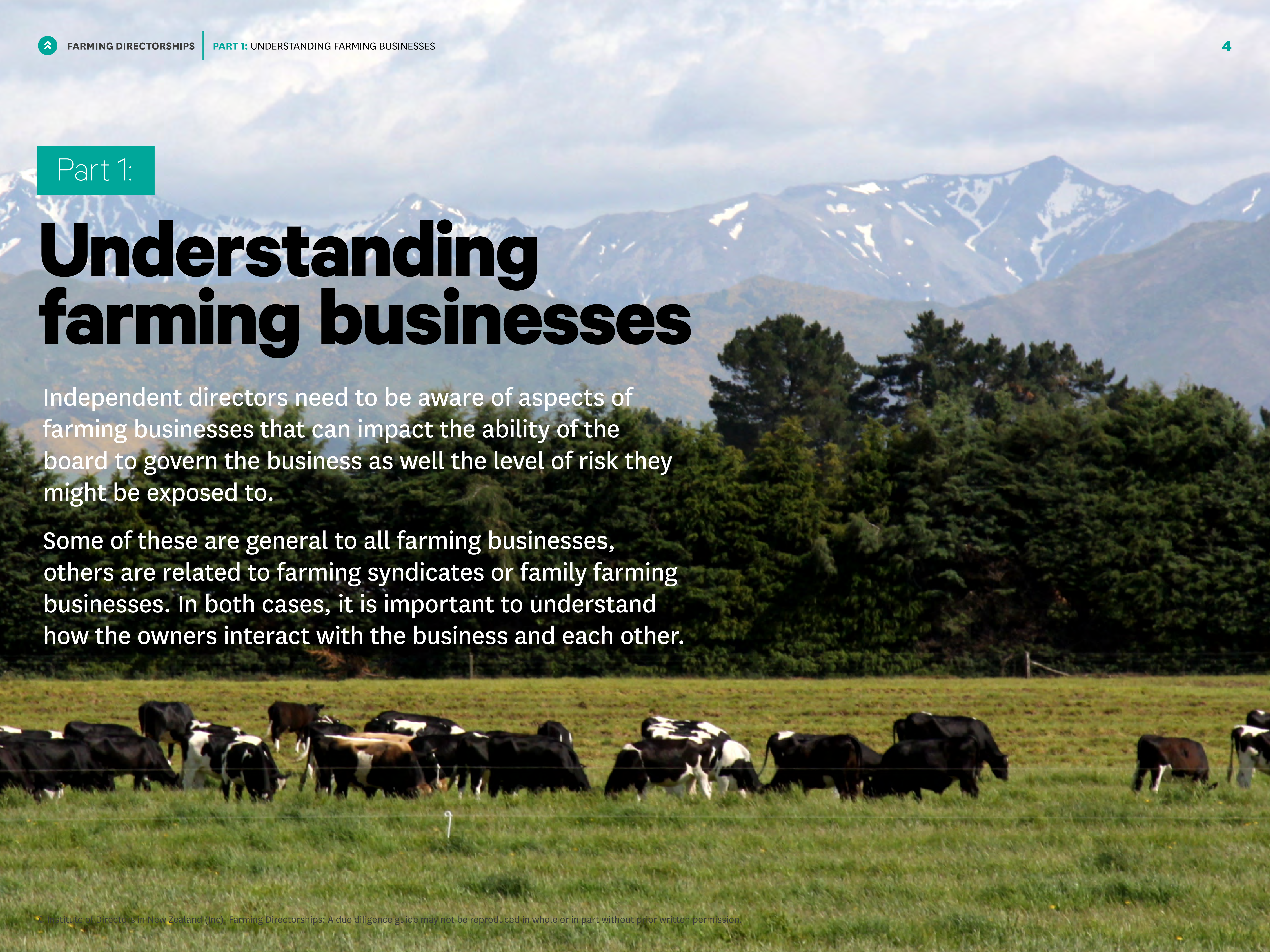
"The principles of company governance apply equally to farming business as they do in any other business, but the drivers of business value and risk can be very different in the farming sector.

This guide is a useful starting point for anyone considering a director or trustee appointment to the governing board of a farming company. It highlights the key issues, raises the right questions, and will support making a well informed decision."

EARL RATTRAY, CFInstD
(IoD Waikato Branch Committee)



Part 1:

Understanding farming businesses

Independent directors need to be aware of aspects of farming businesses that can impact the ability of the board to govern the business as well the level of risk they might be exposed to.

Some of these are general to all farming businesses, others are related to farming syndicates or family farming businesses. In both cases, it is important to understand how the owners interact with the business and each other.

1 General farming businesses

Understanding the company structure

The way in which farming companies run, depends on a range of variations in form, structure and ownership. Understanding the legal structure and business relationships from shareholders to farmers (who in many cases are the same people) is critical to understanding what the financial accounts report, and in family-owned farms, how the business will transition between generations of owners.

Ownership and governance

It is common to have a small number of shareholders. These are often also directors of the company and one may be the managing director.

At times, this can give rise to conflicts in relation to complex business decisions, which can make the role of the independent director particularly difficult and important.

Many people involved in farming businesses have little formal governance training and/or previous governance experience. When joining a farming board it is important to gauge the level of governance and other expertise around the table.

A high proportion of farms are managed by another legal entity (for example, contract milkers or 50:50 sharemilkers). The relationships that make up this category of farming entity have their own specific contract, so it is important for directors to familiarise themselves with these.

Before accepting any appointment a director should familiarise themselves with:

- the legal nature of the shareholding entities
- the legal and operational structures within the business (including business units, chains of delegated authority, and staffing levels/ experience)
- who (or what legal entities) own/s which assets (including land, plant, capital and other specific assets such as water consents).

Do you have a clear understanding of the structure of (and the structures within) the company?

Sole directorships

All New Zealand registered companies legally require one New Zealand resident director on their board. In some cases, such as foreign-owned farms, if caution is not taken, a director may find they have joined a board as a sole director. This creates significant risk for the director. It also creates risk for the company in that if that director chooses to resign, the company is unable to trade. Clarifying the current structure and make-up of the board before accepting appointment is critical.

Current board capability and operation

As with any team, unless the board of a farming entity is functioning efficiently with a common understanding of the entity's purpose and objectives, directors will find the role demanding, and their ability to perform constrained. It should be kept in mind, that as an independent director, your expertise may be sought precisely in order to instil this governance focus and discipline. There are some core matters which a prospective board member should assess before accepting the appointment.

- How long has this business operated with a board?
- Does the board have a strategy for the company which is realistic and regularly reviewed?
- What is the experience and skill level of the existing directors?
- Are the directors' skills appropriate and complementary?
- What is the chair's leadership style and are you comfortable with it?
- Are there any subcommittees of the board and are they clearly constituted and functional?
- Does the board have an annual work plan?
- Are agendas and board papers for meetings sent out in advance of meetings?

Current business operation

Before joining a farming organisation, a director should familiarise themselves with the company's performance and whether there are substantial areas of underperformance in the organisation which need addressing. Directors without a farming background would be well advised to consult a reputable independent farm advisor to assess the farms capability relative to the proposed performance in the business plan.

- Do the board and business owners have confidence in the CEO/manager?
- Does the annual business plan align with company strategy?
- Are existing information systems and access to management sufficient to enable the company's performance to be properly monitored?
- Is management executing and delivering on the current year's plans?
- Are there any significant issues outlined in the preceding two years' annual reports/ financial statements?
- Has the company been in breach of any of its consents or legal obligations in the last three years?
- Is the company involved in or likely to become involved in any significant litigation or investigation (eg by the IRD)?
- Does this business benchmark its performance using industry tools such as DairyBase?

Finances

Directors need to be aware of financial reporting standards required by the External Reporting Board (XRB). These vary depending on the size of the business. For example, businesses with assets over $60M or revenue over $30M are classified as large companies and have to follow XRB standards.

Directors also need to be aware of some specific issues related to financial reporting in farming entities:

- re-valuations via the profit and loss statement can distort reported profitability
- many businesses only receive financial statements which report tax profit and not true business profit
- most management financial reporting is cash-flow based and not accrual accounting
- it is common to have significant variances between cash-profit and financial reporting profit.

Directors should also be familiar with specific taxation issues for farming businesses, including:

- livestock valuation
- income equalisation scheme deposits
- deductible farm development expenditure
- fertiliser deferrals
- assessing and valuing feed on hand.

Farming enterprises that own the land on which they farm tend to have very high levels of capital, compared with cash income generated.

Most farms have a seasonal production profile and are exposed to highly volatile international commodity markets. This means monthly and annual income will also be variable through the year and from year to year.

> The months of highest cash income do not coincide with the months of highest expenditure. For this reason, seasonal finance, in the way of an overdraft facility is essential for most farming businesses.

Additionally land, stock and plant can easily absorb all cash profits, unless there is discipline within the business regarding the generation of cash surpluses. These issues can also impact upon the ability of farming businesses to determine a clear and consistent policy around payments back to the owners as dividends and cash distributions.

The high relative capital value of these enterprises also means that protection of ownership interests and capital value of the assets feature high in governance and management thinking. This value is often tied up in complex legal structures.

If the company cannot pay its debts, or is insolvent, then a prospective director may run the risk of liability under the reckless trading provisions of the Companies Act. At a minimum, the company's financial statements for the previous three years (preferably audited) and the current management accounts should be critically examined.

It is recommended that you ask questions of the chair, CEO, and accountant. A private meeting with the external auditors (if financial statements are subject to external audit) is highly recommended.

- Are the financial statements an accurate representation of the company's financial position?
- Does the company have the ability to meet its financial obligations for the foreseeable future?
- Are the reasons for any peculiarities in the statements disclosed?
- Does the company have any outstanding tax payments?

Debt

Debt levels tend to be higher than other commercial businesses. Reasons for this include:

- investment in appreciating assets
- longer term ownership tenure
- the inclusion of capital gain in addition to cash returns in considering business performance.

Farming businesses may have easier access to interest-only loans and lower interest rates than many commercial businesses.

- Does the company have a fixed assets register with the age and carrying value of the assets?
- Is there any business debt related to non-farming assets?
- Are there any existing commitments for major capital expenditure?
- Does the organisation have a secure credit overdraft facility with the bank and how often is it used?

Biological systems

The reality of working with a biological production system is that animal welfare must be actively managed every day and management mistakes, or the impact of extreme weather can have long-lasting impacts. For example, poor management at mating will not affect the current year's production but will impact in future years, with fewer cows to calve or more spread out calving.

- Do you understand the biological systems involved in the operation of the business and the most common causes of animal welfare issues?

Workforce

Farm infrastructure and layout can have a strong impact on:

- the performance of the business
- staffing levels required
- hours of work
- the quality of staff attracted to work there.

Farming businesses often operate in remote locations and have variable policies in respect of recruitment and retention.

- Is there a good understanding of workforce needs including how they may change over time?

Health and safety

It is particularly critical for farming businesses to ensure that risks in the workplace are recognised and managed in respect to the owners, families, staff and contractors. Directors must understand and give effect to health and safety legislation with appropriate policy, training, processes and procedures.

Health and safety is an integral part of everyday business. Directors of farming organisations in particular need to be proactive, to understand health and safety culture and risks, to be informed and ensure the company meets its obligations.

- Does the board have clearly documented health and safety policies?
- Does the board understand the nature of hazards and risks associated with the business?
- Are there appropriate resources and processes to eliminate or minimise those risks?
- Has the management team implemented effective health and safety processes/procedures and are each of the operational units fully health and safety compliant?
- How does the board monitor this?

For further guidance regarding good practice health and safety governance in New Zealand there are a range of resources on the IoD website, including the latest guidelines and information regarding the new Health and Safety at Work Act 2015.

Identification and management of risk

Risk management is critical to business success and a key responsibility of the board. Risk must be considered with strategy, as directors are responsible for ensuring the organisation has an effective risk management programme.

- Are you satisfied with the existence and quality of the company's risk management (and systems of internal controls)?
- Have you visited the farm(s) to assess the state of farm infrastructure (for example the effluent system and the operational process relating to this)?
  - Are the quality and management of the effluent system sufficient to meet 100% compliance?
- Does the board have a current 'protection of assets' policy and appropriate insurance cover?
- Can the business manager provide evidence that they are keeping records adequate to satisfy legal compliance requirements?

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 and current operational management.

Most regional councils are now enacting catchment level plans which will require farming businesses to limit nitrogen, phosphorus and sediment loss. Farm businesses will be required to provide Farm Environment Plans which they will be audited against. These plans detail the current level of losses and the actions that they will undertake to reduce those losses.

These restrictions can impact negatively on land values. Lower land value means increased debt to asset ratio, and an increased risk of the business not meeting banking covenants.

Farms are zoned according to land class which may also affect both development opportunities and operational management.

- Is there a good understanding of environmental matters, including water catchment issues?

Liability

Directors need to understand the extent of their liability in relation to their role on the board. The legal framework for New Zealand directors depends on the sector of business they operate in. Core components include the Companies Act 1993 and other legislation, the company Constitution, as well as regulations. It is not unique to farming businesses for certain situations to result in criminal liability of directors. In some cases, this can occur without having any knowledge or intent in relation to the event in question, for example breaches of resource management consents regarding discharges to waterways.

Personal liability, risk transfer and insurance are discussed in Part 2.

- Are you aware of potential legal liabilities incurred as a result of accepting the role?

2 Family-owned farming businesses

The majority of farming businesses in New Zealand are family-owned with closely held shareholdings. The owners often fulfil a range of roles in the business, both in operations and governance.

Ownership and governance

Commonly both the directors and CEO of the farm are family. This makes for a limited pool for succession, and needs to be carefully managed.

Typically there are a small number of shareholders, who are also directors. Often, one (usually the founder) will be the majority shareholder and managing director. It is important that all parties involved in the organisation engage in their own due diligence and consideration for business decision-making, rather than simply deferring to a founder, as can be the culture in some organisations.

Complicated entity and asset ownership structures spread between partnerships, trusts and companies add further risk. These structures often involve several members of the same family or a number of families, so relationships need to be carefully managed.

The role of an independent director in a family farming business can involve moderating between family members, as well as bringing discipline, governance process and business acumen.

- What is the motivation and level of support for having an independent director?
- Is there a separation between family and business finances?
- Is a family member acting as the CEO and are they effectively held to account by the board?
- In the event of a relationship breakdown, how would a separation of the business into different entities impact upon the operation of the company?
- Is there a process to ensure family stakeholder goals and objectives are understood and accounted for?
- Is there a process or approach to objectively review and provide performance feedback to management and governors?

Trusts

In some cases one or more family trusts may own significant portions of the company (including shares or assets such as land, infrastructure, capital or resource consents). Each trust should have a trust deed and a memorandum of wishes (also referred to as a letter of intent) from the settlors. If properly constructed, the memorandum of wishes should clearly state the outcomes that the settlors wish the trustees to deliver. The trust settlors should also give clear direction about the role of the company that should align with the memorandum of wishes.

If the company is part owned or controlled by a family trust:

- Is there clear alignment between the directions of the settlors and the company purpose (as detailed in the trust deed and/or memorandum of wishes)?
- Are there trustees who are also directors of the company? Does this pose any risks?
- Are there any liabilities (cash or non-cash) that might influence the way the company is run?
- Do the trust documents allow the company to borrow money from it?

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 and are not deactivated. This can leave some members of a family business exposed to an unknown and increasing liability. In a worst case scenario it could compromise the financial viability of the business.

- Are there any personal guarantees in place to other businesses or individuals?

Succession planning

Comprehensive succession planning is important for business continuity. If an organisation has a limited pool of successors, it is even more critical. Thought should be given to exit strategies for owners alongside the need to grow the business and governance capabilities for the next generation.

In some instances, where there are several siblings involved as owners (and probably managers and governors), succession to a third generation should also be considered.

Consideration should also be given to whether there are any Enduring Powers of Attorney (EPA) for property as an additional safeguard in family owned businesses.

- Is there a succession plan in place? At what stage of the plan is the business at?
- If it is a company with several children or blood relatives as shareholders, does the succession plan extend across multiple generations? Are there EPAs in place?
- Does the succession plan include planned actions regarding the building of management and governance expertise in successor generations?

Advisors

Some farming businesses rely on the advice of either an accountant or lawyer, alongside on-farm advisors such as a farm consultant, vet or fertiliser rep. This can be beneficial but it is important not to limit the scope of guidance offered for the sake of business growth. Advice should be considered alongside robust analysis of financial implications.

It is also common for members of a family to use the same team of financial and legal advisors. This can be advantageous (for example, for the younger generation when making a start in their business career), but it is important to continually monitor that the advice is robust and objective.

It is also important to manage any potential conflicts of interest, eg when advisors are advising different parties.

Business advisors help farmers develop their business by providing advisory services, often through one-on-one meetings, discussion groups and field days. There are some risks that accompany the benefits associated with having multiple advisors. Ensuring a collective understanding of purpose, robust analysis of advice offered, and independence of thought are all important considerations.

- Are the company's legal and accountancy advisors independent?
  - Are the company and individual family members using different advisors?
- Does the CEO meet regularly with key business advisors?

3 Farming syndicates

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

Syndicates can facilitate greater buying power, economies of scale, succession and enable investment risk to be spread across investors. Excellent rewards can be achieved if implementation and governance are appropriately managed.

Alignment of business values is important as business performance or activities that impact negatively on personal reputations in the community commonly cause the failure of a syndicate.

Farming syndicates can be divided into two groups:

- closely held syndicates
- professionally promoted and managed syndicates.

Closely held syndicates (CH syndicates) usually have two to six investors and have been put together by a facilitator/s to enable the investment by friendly investors in suitable farming property.

Sometimes CH syndicates are used to facilitate farm succession or to attract, retain or reward good staff within or outside farming families. Additionally they can be vehicles for purchasing farms or extending farming enterprises.

These syndicates can be successful but can face more risks. Some parties can be acting in three roles at once – ie director, shareholder and farm manager.

Professionally promoted and managed syndicates (PM syndicates) generally cater for a larger number of investors, carry less debt and are put together by a professional promoter. They invariably have a wider range of investors and also tend to have a greater rate of success due to a combination of clarity of investor roles (governance, management, and shareholding), better management and reporting.

The creation of these syndicates requires a greater level of due diligence and documentation.

This documentation and a range of further guidance around both CH and PM syndicates can be found in Brett Gould's paper, Farm Syndication.

Limited Liability Partnerships (LLPs)

Some farming syndicates operate as Limited Liability Partnerships (LLPs). In such a structure it is essential that the directors, general partner and investors understand the provisions of Schedule 1 of the Limited Partnerships Act 2008, and the activities that do not constitute taking part in the management of a limited partnership.

If the business is a limited partnership:

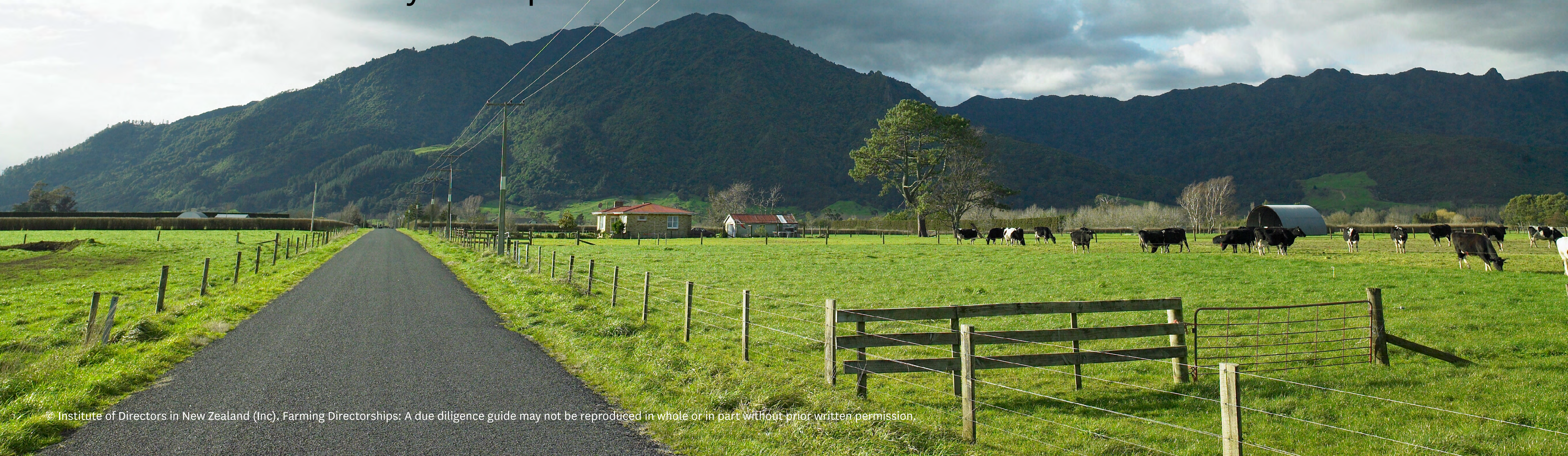
- Do the parties involved understand the conditions of Schedule 1 of the Limited Partnerships Act 2008?

- Are all parties involved in the partnership solvent, untainted and compatible?
- Does the syndicate have a shared understanding of its purpose and the outcomes to be delivered to its shareholders?
- Can the aligned goals actually be delivered/met by the syndicate?
- Are the business values of all partners aligned?
- If the syndicate is managed by an equity partner, is the individual who has been appointed manager/CEO of the syndicate capable of managing this scale of operation?
- Are advisors providing professional services to the syndicate independent from the advisors providing professional services to the investors/investor entities?

Part 2:

Understanding your personal and professional suitability

Once a prospective director has a sound awareness of the nature of the business they may be joining, it is important to assess their own suitability for the position.



Motivations for acceptance

Acceptance of the position should be motivated by a desire and ability to add value to the business. The experience can also offer a broadening of skills and experience as well as considerable networking and personal relationships.

The role of a director has serious duties and responsibilities backed by legal accountability and liabilities. With your personal reputation and assets at stake it is important your decision is well considered and thought through.

- Do you understand why you have been approached to consider this role?
- Are you comfortable with your reasons for accepting the role?

Skills and experience

Directors are usually appointed for qualities fitting into three categories:

- generic attributes
- skills and experience
- specialist expertise.

Generic attributes are broadly applicable and include having sound business judgement, integrity, wide general knowledge, breadth of vision, an inquiring mind, independence of thought and the ability to work harmoniously within a team.

Skills and experience can be specific to the industry or the business of the company.

Specialist expertise is sometimes sought by the company for specific circumstances, and can include things like a background in accounting, human resources, international growth, law or IT.

- Do you possess the required generic attributes to perform well as a member of this company's board?
- Do you have a comprehensive understanding of the role, duties and obligations of a company director?
- Do you understand the farming business and the underlying fundamentals that will make it profitable?
- Can you look at the company accounts and see what they mean in relation to the company's financial position, performance and trends over recent years?
  - Do you have an understanding of the company's performance in relation to other businesses in the industry?
- Do you have specialist skills which could add value to the company?

Available time to commit

It is important to ensure you have the time required to undertake the role properly and effectively, taking note of the director's duty to act with due care, diligence and skill. Discussing expectations with the chair is a good place to start.

- Do you have the time available to fulfil the requirements of the role?
- Do you understand that at times (business crisis, natural or environmental disasters) the time needed to fulfil your duties could increase significantly?

Personal liability and risk transfer

Directors need to know the level of indemnity and insurance afforded by the company in relation to their role on a board.

- Does the company's constitution authorise the company to indemnify or insure directors for actions against them?
  - Are you satisfied as to the availability of directors' liability insurance for the role?
  - Have you checked the company's policy on paying necessary insurance premiums? Does this policy exist?
- Is it desirable to have an additional cover beyond that paid for by the company?

Conflicts of interest

It is important to consider whether you have the independence required to make sound, unbiased decisions. Some personal and business relationships carry obligations which may hamper your ability to act in good faith in the best interests of the company.

For an overview of conflicts of interest, and processes to identify, declare and manage them, see the IoD's Conflicts of Interest Practice Guide.

- Would any of your current businesses or personal interests produce a conflict of interests?
  - If so, are these manageable?

In summary

Once you have carried out your due diligence it is important to reflect thoroughly on the information you have accessed.

- *Are you satisfied with the answers you have received to these questions and the information provided to you?*
- *Do you believe that you will be able to work constructively with this board and the organisation to add value to the business?*

For more information

governance Leadership centre

See the Governance resources section of the IoD website iod.org.nz or the DairyNZ website dairynz.co.nz

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