

# Wine Business

A newsletter for the Australian wine industry

## Introduction

Welcome to this edition of our new look Wine Business.

Our feature article is a case study which challenges some popular assumptions about determining the profitability of products.

As the name suggests this publication is all about helping you build a great wine related business. Not an easy task in today's environment which is why Wine Business is a must read.

If you have particular issues you'd like to see us address in future editions—just email us at [enquiries@bdosa.com.au](mailto:enquiries@bdosa.com.au)—we look forward to receiving your feedback.

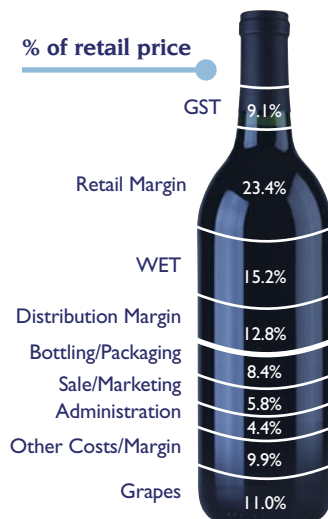
## Also in this issue

- National Wine Export Conference News
- Boar's Rock BFL offer cash flow relief to small to medium size wineries

## Understand your inventory: A “case” study on the Naked Vignerons

The Naked Vignerons Pty Ltd (“NV”) owns and operates a winery and a vineyard and has a small number of grape purchase contracts to supplement its own supply.

The company has established a presence in the domestic and UK markets and enjoys a reputation for producing consistently elegant wines at affordable prices. While sales have grown by \$1m since 2002, profit has fallen sharply. There are some real concerns emerging as to whether NV can sustain growth or survive a major change in its market.



	Sales	Net profit	Assets
F2002	\$3.6M	\$360K	\$12M
F2003	\$4.0M	\$280K	\$16M
F2004	\$4.6M	(\$50K)	\$17M

Recently NV's financial controller, Jim, was enjoying a generous glass of NV red and the morning paper when the curvy image to the left caught his attention.

*Adapted from ACIL Consulting - Pathways to Profitability for Small and Medium Wineries, pg 51; (2002)—for purposes of example, no WET rebate has been included*

Reading the article, Jim began to think about some of NV's products. He suspected that certain products were not performing financially whilst others were probably critical in keeping the company afloat. Jim phoned his former business colleague and forensic expert Will to discuss the article:

Jim: "I reckon our winery processing costs are on the high side when compared to the figures in this article."

Will: "You reckon? You mean you're not completely sure?"

Jim: "Mate, who can be sure - the production process is so long and complicated. And we've got separate systems managing our vineyards, winery and accounting."

Will: "So which product do you 'think' is delivering against budget?"

Jim: "Definitely the Warsaw Hill Shiraz, it sells like hot-cakes and retails for about \$21."

Will: "Ok. If you can hook me up with a healthy discount on some wine, I'll come down and analyse the costs of the Warsaw from vine to shelf."

Jim: "Agreed."

### NV Vineyard

Warsaw Hill Shiraz is a blend of 95% Shiraz grown at NV's cool climate vineyard and 5% Viognier purchased from a contract grower. The cool climate vineyard was planted according to a detailed soil and climate consultancy and was consequently mapped out into an irregular array of blocks growing multiple varieties.

Vineyard operating costs are accumulated per hectare and at vintage-end allocated based on tonnes harvested. Apart from some canopy management and bunch-thinning costs which are diluted across some white varieties, Will is satisfied that the basic methodology of allocation is accurate. After all Jim is in regular dialogue with the vineyard manager.

120 tonnes of Shiraz fruit (at \$1,300 per tonne) was used in the production of the 2002 Warsaw Hill Shiraz. The Viognier was purchased at \$1,600 per tonne including hauling costs.

### NV Winery

The physical movement of the 02 Warsaw Hill Shiraz is detailed below:

2002 Warsaw Hill Shiraz	
Tonnes Crushed	127
Litres of Juice Fermented	89,000
Litres Aged in Oak	81,000
Cases Bottled (12 x 750ml)	9,000

NV's method of cost allocation was simple, especially given the complexity of the production cycle spanning several years. Grape costs were straightforward and allocated accordingly. All other processing costs except for bottling were pooled and allocated to a specific product (WIP) according to the percentage of the total volume in process (i.e. all wines held in bulk inventory absorb their relative proportions regardless of the processing activities undertaken). Wines bottled in a year absorbed bottling costs, whilst wines held in bottled inventory absorbed bottle-aging costs.

The production cost breakdown of the 02 Warsaw Hill Shiraz is summarised as follows:

2002 Warsaw Hill Shiraz Production Cost	\$Total	\$/Case
Grapes	167,200	18.58
Winery	275,000	30.55
Bottling & packaging	216,000	24.00
Bottle aging	13,000	1.44
<b>Total</b>	<b>671,200</b>	<b>74.57</b>

Will recognised that NV's treatment of "aggregating" product costs under a periodic system was not technically correct, given that no two wines are the same. He decided to "peel off" a few extra layers of the production process to determine if the average cost applied by NV was causing a significant distortion of the actual cost of a case.

### 2002 Warsaw Hill Shiraz under the microscope

The 02 Warsaw Hill Shiraz was crushed, pressed and fermented in the fourth quarter of F2002. It was fined, filtered, matured in oak for 15 months and subsequently prepared for bottling in the second quarter of F2004 (i.e. Oct 03). Based on its share of total volume processed, it was allocated 18% of the F2002 winemaking costs, 12% of the F2003 winemaking costs and 9.0% of the F2004 winemaking costs.

Existing Allocation	F2002	F2003	F2004	Total
Total winery production costs	\$600,000	\$750,000	\$850,000	
2002 Warsaw Shiraz allocation (%)	18.0%	30.55	12.0%	
2002 Warsaw Shiraz allocation (\$)	\$108,000	\$90,000	\$77,000	\$275,000

Will was determined to remove the production costs out of the periods in which they occurred and into the activities that caused them (Activity Based Costing, often referred to as ABC). After careful analysis and discussions with NV staff, the actual usage percentages for the 02 Warsaw Hill Shiraz was identified and applied against the total cost for each activity:

Revised ABC Allocation	Year	Cost	Usage	ABC
Crush, Press & Ferment	F2002	\$180,000	28%	\$50,400
Fine, Filter & Mature	F2003	\$420,000	39%	\$163,800
Fine, Filter & Mature	F2004	\$480,000	15%	\$72,000
Prepare for Bottling	F2004	\$80,000	45%	\$36,000
<b>Total ABC Allocation</b>				<b>\$322,200</b>
Convert to \$/Case				\$35.80
Existing \$/Case				\$30.55
Difference				\$5.25

### NV Distribution

Nuisance Wines Pty Ltd operates in Sydney and plans for a 20% (after freight) gross profit margin on its portfolio of wines. Nuisance, one of NV's best customers, purchased and sold a significant quantity of the 2002 Warsaw Hill Shiraz, mostly to the off-premise, boutique retailer market.

### NV Retailer

The Sydney Wine Store has forged an enviable position by repositioning itself as a provider of ultra-premium, limited supply wines including the Warsaw Hill Shiraz. With high overheads, the store strives to achieve a 28% gross profit margin.



### Will's finding

Will collated the plethora of data including additional marketing and overhead costs and prepared a cost breakdown in a format which Jim could easily understand. The results surprised Jim.

Will: "Jim, I have completed my review and two issues have emerged. First, an analysis using your existing allocation shows that the 2002 Warsaw Hill Shiraz does contribute profit, but only at \$0.39 per bottle sold with a net profit on sales of less than 5%. I am sure that this is well below your expectations.

"The second issue relates to your method of cost allocation. Although your approach is commonly used in the industry it does not provide an accurate indication of real costs. I reworked your costs using ABC and the result is that you actually lose \$0.05 per bottle.

"I've also compared your production costs with the figures provided in the newspaper article. You can see that your costs in grapes, marketing and administration compare favourably, however, at 14.8% your processing costs are well above the average. The bottling costs are also comparably higher.

Jim: "A problem identified is a problem half-solved! I can undertake the same analysis on the remainder of our products to determine each one's profitability. The production process may be the domain of our winemaker, but it'll need some modification if we're losing money."

Will: "And don't forget to include in your analysis your current and potential sales channels. The Warsaw Hill Shiraz is a popular product but over 60% of its domestic sales value is collected by the government and intermediaries. Perhaps you should investigate alternative markets."

Jim: "Will do Will. Thanks for your help."

*If you identify with any of these issues and would like to explore them further, please contact one of the advisers listed on the back cover of this publication.*

## National Wine Export Conference News

The National Wine Export Conference, which was held in Queensland in May this year, presented an opportunity for industry members to experience first hand—via post-conference tours—the progress Queensland has made in adding another State to Australia's wine production and export focus. And whilst it still has further progress to make to reach the successes of its southern counterparts, the quality and reputation of Queensland wines is fast on the rise.

BDO continued its support of the Australian Wine Industry with conference sessions presenting on a range of topics including price position issues for export markets, developing and capitalising on a strong brand, as well as a global market outlook. If you would like to know more about these topics, please contact a BDO Wine Industry specialist in your state.



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## Boar's Rock BFL offers cash flow relief to small to medium size wineries

*Wine making is a long, drawn out affair; from harvesting the grapes through fermentation and maturation to bottling and distribution and then finally the blessed retail sale can take 2 years or more. So too, the flow on effect of funding can be long and slow, inevitably creating cash flow hot spots in the production chain.*

Boar's Rock BFL, a division of the Boar's Rock group of companies and a BDO client, can now offer at least some cash flow relief for many small to medium size wineries. In partnership with South African company Vincorp (Pty) Ltd, who have provided a similar service in that country since 1997, Boar's Rock BFL provides a barrel finance and logistics service to assist in financing one of the perennial long term cash demanding necessities of quality wine making—oak barrels.

The service is also designed to remove many of the hassles of barrel procurement for the winemaker and, in fact, can reduce the winemaker input to just barrel selection for the coming vintage. Once the barrels are selected the winemaker need only place one barrel order with Boar's Rock BFL. Boar's Rock BFL, armed with the order, will then provide any or all of the following:

- Order the barrels on behalf of the winemaker, no matter how many coopers, agents and barrel combinations are required;
- Manage the foreign exchange risk;
- Manage freight and delivery of the barrels to the winery;
- Provide a flexible rental payment program to suit winery cash flow; and
- Require only moderate financial security; normally just the barrel and a trusted relationship with the winery and the winemaker.

For contact details or more information about Boar's Rock and Boar's Rock BFL visit the web site at [www.boarsrock.com.au](http://www.boarsrock.com.au)