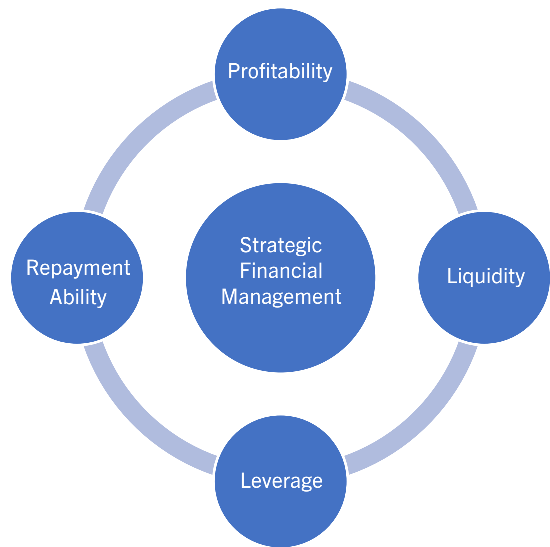
Assessing Financial Performance Overview

The balance sheet, cash flow budget and earnings statement are an integrated set of statements that provide the foundation for strategic financial management. Every business runs on financial data that is captured in these statements to sum up the financial health of the business. When used together they provide important insights that can be used to improve financial performance, strategic decisions and assess potential investment opportunities.

Measures of Financial Performance

Measuring financial performance requires a complete set of financial statements combined with a strong understanding of business performance measures and metrics. Producers can use a wide range of financial measures and metrics to track progress for strategic decision making. Identifying the most important measures may vary between producers depending on business models and the commodities produced. While specific metrics may vary, the following categories of financial performance are commonly measured and assessed by business owners and CFOs across industries and business types.

- Profitability
- Liquidity
- Leverage
- Repayment Ability



Profitability Analysis Overview

Profitability measures and ratios are a category of financial metrics used to assess a business's ability to generate earnings relative to its revenues, operating costs, balance sheet assets and owner's equity. Profitability ratios are often compared with efficiency ratios which consider how well a company uses its assets internally to generate income. Many measures of profitability can be pulled directly from the balance sheet and income statement as outlined in the following table.

Financial Measures	
Balance Sheet	**Income Statement**
Current Asset and Liabilities	Gross Income (Revenues)
Working Capital	Variable and Fixed Expenses
Non-Current Assets and Liabilities	Gross Income
Total Assets and Liabilities	Operating Profit
Net Worth	Net Profit

These are important measures of financial performance, but often are insufficient to assess questions such as: are the businesses profits large or small? How much profit is achieved with each dollar of sales? What operational changes can be made to improve profitability? Is performance comparable or better than peers? Is the business positioned well for the next opportunity?

This is where financial ratio analysis is important to assess profitability and requires looking beyond the income statement. A financial ratio is just two key numbers from a set of financial statements expressed in relation to each other. The following financial measures and ratios derived from the balance sheet and income statement are used by business owners and CFOs throughout business and across different industries. Analyzing ratios in terms of units (i.e. acres, bins, tons, etc.) can help to provide context to profitability and efficiency measurements.

Liquidity and Leverage	Profitability and Efficiency	Repayment
Current Ratio	Gross Profit Margin	Fixed Charge Coverage Margin
Working Capital	Operating Profit Margin	Fixed Charge Coverage Ratio
Working Capital to Expense Ratio	Net Profit Margin	Debt Coverage Ratio
Debt to Asset Ratio	Return on Assets	

This guide will focus on assessing business profitability and repayment capacity.

This guide focuses on profitability, efficiency and repayment capacity. Review the Assessing Capital Strategic Planning Guide for a comprehensive examination of liquidity and leverage. Use the steps below to analyze an income statement to calculate key profitability, efficiency and repayment metrics.

Step 1: Gross Profit and Gross Profit Margin

Definition: Gross profit is the amount of money left over from product sales after subtracting the direct or variable expenses (also known as cost of goods sold, or COGs). The gross profit margin metric is sometimes referred to as the return on sales. The higher the margin the better.

Instruction: An initial assessment of business profitability begins with evaluating the income statement.

Start the analysis by evaluating top-line business results which includes calculating all accrual adjusted gross farm income and the related direct or variable expenses associated with production (COGs). This includes calculating the gross profit of the operation and gross profit margin.

Calculation:

- Gross Profit ($): Gross Income (Revenues) – COGs.
- Gross Profit Margin (%): Gross Profit/Gross Income.

How it is used: Allows owners to assess the amount of profit made before deducting selling, general and other fixed administrative expenses. This is helpful when evaluating number of units produced, prices and management of direct and variable expenses in a given timeframe.

Step 2: Operating Profit (Earnings Before Interest & Taxes, also known as EBIT) and Operating Profit Margin

Definition: A financial indicator that measures how much profit a company makes on a dollar of sales after paying all expenses (excluding interest expense and taxes). The larger the percentage the better.

Instruction: Continue the analysis by calculating all selling, general and other fixed administrative expenses (fixed costs associated with production that do not vary in the short term) and deduct it from gross profit.

Calculation:

- Operating Profit ($): Gross Profit – Fixed Expenses (excluding interest expense and taxes).
- Operating Profit Margin (%): Operating Profit /Gross Income.

How it is used: Allows business owners to assess and compare how efficiently a company is able to generate profit through its core operation considering all expenses (excluding interest expense and taxes). It is also helpful to calculate Earnings Before Interest, Taxes, Depreciation and Amortization, (EBITDA), which is a closely related financial metric used to measure a company's overall financial performance.

Step 3: Net Profit and Net Profit Margin

Definition: The basic measure of profitability for a business. Net profit is a company's bottom line after all expenses including taxes, interest expense and depreciation have been taken out of gross income. The net profit margin represents the percentage of each dollar of gross income that is retained as net profit.

Instruction: Continue the analysis by determining the bottom-line results of the business which includes calculating net profit and net profit margin.

Calculation:

- Net Profit: Gross Income - Total Expenses.
- Net Profit Margin: Net Profit/Gross Income.

How it is used: Net profit is important to monitor over time to assess trends and adequacy for family living, distributions, debt repayment and to replace capital assets. Net profit margin expressed as a percentage is a helpful tool for business owners to track performance over time, compare to peers and other opportunities.

Step 4: Return on Assets (ROA)

Definition: A measure of profitability that indicates how profitable a company is in relation to its total assets. A higher ROA means a business is more efficient and productive at managing its balance sheet to generate profits while a lower ROA indicates there is room for improvement.

Instruction: Using the income statement and balance sheet calculate ROA to assess business returns in relation to total assets.

Calculation:

- Net Profit/Total Assets.

How it is used: Allows business owners to compare how efficiently a business is using its assets to generate net income across different sized businesses, varying industries, commodities and/or enterprises.

Step 5: Debt Coverage Ratio

Definition: A measure of a company's cash flow available to pay scheduled debt obligations.

Instruction: Calculate the debt coverage ratio using the following as a guide: a 2 to 1 ratio is considered strong coverage, 1.2 or greater is marginal to sustainable and 1:1 is at maximum coverage.

Calculation: Adjusted EBITDA / Debt Payments

Note: Adjusted EBITDA can be calculated using the Operating Profit as follows:

- Operating Profit + Depreciation and Amortization – Income Taxes – Family Living – Distributions.

How it is used: Allows business owners to assess earnings adequacy to service existing debt after considering income taxes, family living and distributions.

Step 6: Fixed Charge Coverage Margin and Ratio

Definition: A measure of overall cash flow available (surplus or deficit) from net profit after principal debt payments, interest expense, taxes, unfunded capital expenditures, family living and distributions have been accounted for.

Instruction: Calculate the Fixed Charge Coverage Margin and Ratio to assess repayment capacity. A fixed charge coverage ratio of 1 to 1 or greater is acceptable and 1.30 or greater represents strength. **Calculation:**

- Fixed Charge Coverage Margin: Adjusted EBITDA – Scheduled Principal Payments – Total Interest Expense – Unfunded Capital Expenditures (not funded through debt and not of trade).
- Fixed Charge Coverage Ratio: Adjusted EBITDA / (Debt Payments + Unfunded Capital Expenditures).

How it is used: Allows an operation to assess if profits were sufficient to service all obligations and create surplus cash flows to build working capital and/or for reinvestment back in the business.

Strategies to Improve Financial Performance

Strong or weak financial results can be driven by many factors. Some may be rooted in drivers outside of a business owner's control while others are the direct result of management decisions. Strategic financial management is the process of assessing results, considering these factors and proactively developing alternatives. The following outlines possible alternatives to enhance financial performance.

Strategic Alternatives to Enhance Financial Performance
Intensify/Modernize: Use fixed assets more efficiently to drive stronger production while lowering the overall cost of production. Accomplishment of this strategy can include adoption of more modern, more intense production technologies (higher yields, lower feed waste, less labor).
Expand: This strategic alternative has merit once efficiencies have been exploited within current facilities. Expansion can present an opportunity to utilize existing fixed assets more efficiently across a larger operation (buy or rent additional facilities, acreage, livestock).
Diversification: Consider alternative enterprises or crops with stronger returns. This strategy can also be helpful in reducing risk in highly concentrated businesses.
Integrate: This strategy involves moving into different stages of production and/or processing to capture efficiencies and/or reduce costs.
Network: Economies of size in production, processing and marketing can be achieved through networking with other operators (new marketing channels, shared resources, increased buying power).
Focus: Commit to improving efficiency, reducing variable and/or fixed costs. Concentrating on one activity can aid in cost reduction through a more intensely managed operations and/or reducing debt.
Downsize/Rightsize: The decision to downsize the business may include reducing labor, selling nonstrategic or underperforming assets or exiting enterprises to help improve the focus of the business or the efficiency of the business.

**See Strategic Alternatives to Growth and Non-Growth (add hyperlink).*

Group Conversation Guide

Including family members, partners, management team members and other trusted advisors such as AgWest Farm Credit in these conversations can be helpful to share lessons, insights and goals.

Prepare Participants

- Schedule a dedicated time (1-2 hours depending on the group size) for a focused discussion.
- Provide the Business Lifecycles Guide to all participants.

Define Roles

- Identify a facilitator to keep the group focused and moving through the discussion.
- Designate one person to take 'official' notes, documenting the discussion and any decisions.
- Ask the group the following question: **'Why is it important to review financial trends together?'** and engage participants to understand their perspectives.

Instructions

- Use the questions below and space provided to gather group perspectives.

Assessment Questions	Discussion Notes			
How is profitability trending in the business (tabulate results below)?	Calculation	Prior Year	Current Year	Difference
Gross Income ($)	Top line results from the income statement (revenues)			
# of Units	Unit production for the period			
Direct or Variable Costs (COGs)	Direct costs associated with production			
Gross Profit ($)	Gross Income – COGs			
Gross Profit Margin (%)	Gross Profit / Gross Income			
Fixed Expenses ($)	Fixed costs associated with production that do not vary in the short term			

Net Profit ($)	Gross Income - Total Expenses			
Net Profit Margin (%)	Net Profit/Gross Income			
ROA (%)	Net Income/Total Assets			
Family Living Expenses and/or Draws	Cash flow used for draws and distributions			
Taxes	Income tax			
Principal Debt Payments	Cash flow used to service current portion long term debt			
Unfunded Capital Expenditures (purchased from cash)	Cash flow used to purchase capital assets less bank financing			
Fixed Charge Coverage Margin ($)	Adjusted EBITDA – Scheduled Principal Payments – Total Interest Expense – Unfunded Capital Expenditures			
Fixed Charge Coverage Ratio (%)	Adjusted EBITDA / (Debt Payments + Unfunded Capital Expenditures)			
Debt Coverage Ratio (%)	Adjusted EBITDA / Debt Payments			

**Tip: Add additional years to the analysis to see longer term trends in performance. Consider how direct or variable costs, fixed expenses and prices may affect next year's performance.*

How was gross income (revenues) influenced by number of units, prices or both? **Tip: Consider drivers that were controllable through management decisions versus external.*	
Why did direct or variable expenses (COGs) and gross profit margin change year over year?	

Is operating margin growing or shrinking and what does this suggest about fixed expenses?	
How would you summarize the changes to net profit and net profit margin year over year? • How did it compare to expectations?	
What strategies could be explored to improve profitability considering insights learned from these measures of profitability?	
How does ROA compare to the risk and asset base and which of the following	
strategies could be explored to improve it?	
Is debt coverage and fixed charge coverage margin adequate to meet obligations (family living, taxes, debt service, and capital expenditures)? • If yes, what opportunities should be considered? • If no, what options should we pursue?	
How does our profitability compare to peers or the industry (if available)?	