

How Do I Improve Financial Performance?

Unacceptable financial performance or financial ratios can be caused by many problems. They may result from temporary setbacks beyond the farmer's control. The appropriate response then may be to use one of the previously described responses to financial stress to "hunker down and wait for the storm to pass." On the other hand, they may be symptomatic of more persistent problems. In that case, the farm business manager must make adjustments to improve financial performance, even if the underlying cause is external to the farm. For short-run survival, it is only necessary to cash flow. Longer run survival is only assured through the effective use of resources to generate revenues and produce profits at levels that are competitive in the farming industry and sufficient to meet the farmer's needs.

One approach to improving profitability involves assessing some of the key drivers of farm profitability. With that in mind, it is useful to think of the farm business in terms of scale, employment, efficiency, and leverage.

Scale

Scale refers to the size of the farm business. Farm businesses can be either too large or too small. In large, complex operations, managerial control or input can be spread too thinly, which can result in inefficiencies. Conversely, small farm businesses can be inefficient because fixed investment costs are spread over too few units of output. Scale problems can also occur when the labor supply is too large relative to the productive capacity of the farm business, so it cannot generate enough income to support the families involved. One of the more critical tasks farm business managers must accomplish is to determine the optimal scale for their businesses. This generally involves being large enough to take advantage of economies of size and to minimize per unit costs, while not overextending their management capabilities.

Employment

Employment refers to both employment in the farm business and off-farm employment. Full employment is, in most cases, necessary to ensure an acceptable standard of living. If labor is in excess, the dollars withdrawn for wages or family living expenses can adversely affect the profitability and liquidity of the farm business. If the scale of the farm business is inadequate, and the farm business is too small relative to its labor supply, farmers can consider a number of options. They can reduce labor supply through nonagricultural employment or by eliminating hired family employees. Or they can increase labor utilization through expansion by purchasing or leasing additional assets, shifting to more labor-intensive enterprises, or improving productivity through more intensive management.

Efficiency

Efficiency refers to the relationship between inputs and outputs. To a large extent, it is determined by the farm business manager's managerial and technical skills. In larger operations, efficiency will reflect the performance of the owner as well as of the hired managers and workers. Although there are no perfect measures of efficiency, there are a number of efficiency measures from which to choose. Because a farm business is a large, complex, interrelated system, an analyst must examine several aspects of the farm business to conduct a comprehensive assessment of farm business efficiency.

Efficiency can be measured in physical, economic, and financial terms. Physical terms include such measures as crop yields, pigs per litter, rate of gain, etc. Economic measures include variable costs per acre and returns per dollar feed fed. Financial efficiency measures the intensity with which a farm business uses its assets to generate gross revenues and the effectiveness of cost control strategies. Financial efficiency is influenced by production skills as well as by purchasing, pricing, financing, and marketing decisions. Successful farms must produce net income in substantial amounts in order to succeed longer term. Achieving optimal efficiency in physical, economic, and financial terms is every bit as important as scale in determining whether there will be any net income.

Leverage

Leverage, in a financial sense, is the relationship between the debt and equity capital used to finance a business. The more debt that is used in relation to total assets, the more highly leveraged a business is said to be. Leverage can either work for or against a business, depending on whether or not debt is used to generate profits in excess of its cost. When it is not working for you, the more debt you have the worse off you will be. A critical responsibility of every farm business manager is to structure the farm's financial capital in such a way that leverage will work for and not against the farm business.

A farm can have too little debt, limiting its size, efficiency, growth, and earning capacity. A farm can have too much debt, leading to financial inefficiency, accelerating financial losses, and ultimately business failure. Any debt at all can be too much when a farm business does not generate net income. Debt influences profitability through interest costs, liquidity through debt servicing requirements, and solvency through the value of the assets available to secure the farm's liabilities. Debt problems can arise in the short run even when debt is used profitably. Temporary setbacks can lead to financial stress, because the debt load is excessive based on current income, too costly because of rising interest rates, poorly structured because of repayment terms that call for repayment to be made over too short a period of time, or unsecured because of a drop in the value of collateral. The previous section outlined some of the ways managers can respond to financial stress in the short run.

Debt structure refers to the particular mix of debt repayment terms used by a business. Capital assets typically are financed with a combination of owned equity capital and borrowed capital. The structure of non-operating debt should reflect the useful, productive lives of the productive assets it finances, so as to achieve somewhat of a balance between the assets that are financed and the corresponding financing. For example, farmland is a long-term investment, and the financing should be long term as well.

Operating debt should be self-liquidating. Farm business managers should use operating loans to finance profitable production activities only. They should repay the annual operating loan in full each year. They should set up all other debt, including operating debt carry-overs, over a long enough term to ensure the debt can be repaid with projected net income.

Farm business managers should focus on preventing problems with debt by making good decisions about using debt. In the long run, borrowed capital must be used productively/profitably, or no amount of stretching out or putting off payments will help. Term debt ultimately can only be repaid with net income. Farm business managers must know their limits in terms of how much their farms can comfortably repay with the net income that they expect to generate.

The earlier discussion of “How far in debt can I safely go?” provides helpful information about how to determine a borrowing limit for a farm. If you make sure all of your capital investments have a high potential payoff, then you are less likely to run into financial difficulties with the debt that finances part of those investments. You should use benchmarking to establish minimum acceptable standards of profit performance for new investments that are consistent with or higher than the annual financial performance levels you have targeted. You should use those standards to cull capital purchases you are considering that don't look profitable enough.

Once you have evaluated your farm business in terms of its scale, employment, efficiency, and leverage, you can select and implement corrective actions targeted at improving performance and preventing future performance problems. Table 6 presents several potential courses of action that you might use to head-off or correct poor financial performance stemming from problems related to the scale of your farm business, employment of labor resources, efficiency of the business, and the extent to which you are utilizing financial leverage. Numerous additional actions are possible. These are presented only to illustrate the possible managerial responses to different types of problems.

Table 6. Possible Courses of Action to Improve Profit Performance¹

Scale

1. Expand by adding an enterprise or expanding existing enterprises. Use demonstrated results (records) to make expansion decisions.
2. Use fixed resources (machinery and labor) fully.
3. Identify low-cost ways to expand, such as renting additional land or facilities, custom feeding livestock, crop-share renting, or custom farming.
4. Examine whether your management ability and emotional stability are sufficient to handle the additional stress of expansion.
5. Increase off-farm employment, but assess its effect on efficiency.
6. Scale back your farm business to allow a significant increase in off-farm income.
7. Consider retiring, if appropriate.
8. Consider merging with another farming unit.

Employment

1. Eliminate hired family employees.
2. Obtain an off-farm job.
2. Move to part-time farming status.
3. Add labor-intensive enterprises with low-capital requirements.
4. Expand operations to increase labor use.
5. Increase intensity of operations (thruput) to increase labor productivity.
6. Reduce family withdrawals to a level that is consistent with efficiency or level of farm employment.

Efficiency

1. Reduce family living expenditures and operating costs.
2. Focus on productivity and thruput.
3. Improve enterprise record keeping and analysis.
4. Reorient priorities; spend more time on management.
5. Use advisory services. Don't do things that others can do cheaper and better.
6. Improve marketing skill and performance.
7. Evaluate whether the operation is too large to manage efficiently.

Leverage

1. Establish minimum standards for the financial performance of new investments.
2. Evaluate the costs and returns associated with every investment considered.
3. Don't use cash flow or operating loan proceeds to finance capital purchases.
4. Use retained earnings to finance the equity component of capital purchases.
5. Maintain adequate financial reserves.
6. Structure debt in order to maintain balance between assets' useful lives and repayment periods. Don't abdicate your role in negotiating repayment terms.
7. Never give more collateral than is absolutely necessary.
8. Avoid high-cost borrowing, such as overdrafts and credit card debt.
9. Estimate how much you can afford to owe based on expected future income.
10. Identify and sell unproductive/unprofitable assets; reduce and restructure debts.
11. Don't own what you can control through leases; sell and lease-back.
12. Evaluate the rate of return expected from capital investments, and compare to the interest rate of borrowed debt.

¹ Adapted from Jolly, Robert and Alan Vontalge. *Financial Troubleshooting, Iowa State University Extension Publication, Pm-1618, May, 1995*