FINANCIAL ANALYSIS

FARM CREDIT KNOWLEDGE CENTER

What is Financial Analysis?

- Using financial tools:
  - *Enterprise budgets*
  - *Balance sheets*
  - *Income statements*
- To identify a business' strengths and weaknesses
  - *Helps the manager improve the business*

Why is it Necessary?

- Financial Analysis:
  - *Helps a manager take actions to improve the business*
  - *Identifies potential problems before they occur*
  - *Helps lenders analyze loan applications for strengths, weaknesses, and risks*
  - *Helps the manager understand the business more fully*

Types of Financial Analysis

- Ratio Analysis
  - *Use ratios and figures (net income, RAVC, etc.)*
  - *Compare those ratios and figures to "benchmarks"*
    - Benchmarks are "goals" or "standards"
- Trend Analysis
  - *Look at changes in ratios and figures over time*
    - Are they improving or getting worse?

Main Areas of Analysis

- Liquidity
  - *Having enough current assets to cover your current liabilities*
- Solvency
  - *Having enough total assets to cover your total liabilities*
- Profitability
  - *"Are we making money above our expenses?"*
- Financial Efficiency
  - *How well are we controlling our costs?*

Liquidity Analysis

- Use the Balance Sheet
- Current Ratio is the main measure
  - *Current Ratio = Current Assets / Current Liabilities*
- Like to see:
  - *A minimum ratio of 1.0*
  - *Greater than 2.0 is strong*
- Interpretation:
  - *A Current Ratio of 2 means that you have $2 of current assets for every $1 of liabilities that are due within the next year (current liabilities)*

Solvency Analysis

- Use the Balance Sheet
- Debt/Asset Ratio is the main measure
  - *Debt/Asset Ratio = Total Liabilities / Total Assets*
- Like to see:
  - *Less than 40% for an existing business*
  - *Less than 705 for a new or start-up business*
  - *Decreasing over time*
    - The lower it is, the less risk you face

Solvency Analysis

- Interpretation:
  - *A Debt/Asset Ratio of 40% shows that you owe your lenders 40% of the value of your assets*
    - Or – that you have paid for 60% of your assets
  - *Another way to look at it:*
    - Your lenders "own" 40% of your assets
    - You own 60% of your assets

Profitability Analysis

- Use the Income Statement or Enterprise Budget
  - *Gross Margin or Return Above Variable Costs*
  - *Net income or Return Above Total Costs*
- Also need the Balance Sheet
- Main ratio is Rate of Return on Assets (ROA)
  - *ROA = (Net Income + Interest) / Total Assets*

Profitability Analysis

- Like to see:
  - *ROA > 0% at a minimum*
  - *ROA > interest rate (APR) on your loans*
  - *ROA > 8% is strong*
  - *Growing over time*
    - The higher, the more profitable your business
- Interpretation:
  - *An ROA of 10% means that you earned $0.10 of profit for every $1 of asset used in your business.*

Financial Efficiency Analysis

- We're just focusing on cost control here
- Use the Income Statement
- Operating Expense/Receipt Ratio
  - *Op. Exp/Rec = (Total Exp. – Int. – Dep.) / Total Revenue*
- Like to see:
  - *Less than 75%*
- Interpretation:
  - *A ratio of 75% means that the business spends $0.75 in expenses to generate $1 of revenue*

Summary

- Look at your ratings for each area
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Area	Rating	Strength or Weakness?
Liquidity	Strong/Okay	~ Strength
Solvency	Poor/Okay	~ Weakness
Profitability	Poor/Okay	~ Weakness
Financial Efficiency	Poor/Okay	~ Weakness

Summary

- Now the manager can see what areas need to be improved!
- Main ways to improve a business:
  - *Reduce the top 5 expenses*
    - Without hurting production
  - *Increase revenues*
    - More units produced & sold
    - Different price
  - *Get rid of unneeded or un-used assets*

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Summary

- A manager must look at the financial and the production aspects of the business
  - *They are directly related!!*
  - *Too often the financial aspects are ignored*
- Lenders use this same analysis to review loan applications
  - *Managers should know their own strengths and weaknesses BEFORE meeting with the lender!*

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