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FREE CASH FLOW IS AT LEAST AS IMPORTANT AS PROFIT IN ASSESSING A FARM FIRM

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ABSTRACT

This paper suggests that most small agribusinesses can use a short cut to see how their firms are doing financially. The short cut requires that they calculate and follow (1) profit and (2) free cash flow. Both are defined and clarified. The reason for this short cut is that most small firm owners do not do enough financial analysis and that this simple and quick study may encourage them. The paper does not encourage the substitution of these two numbers for a proper analysis. They are useful but more of a bait to land the full course.

Key words: Financial analysis, small agribusiness firms, profit, free cash flow, allocation, income statement

THE ARGUMENT

Most of us know that farmers prefer production to marketing and marketing to financial management. In their book, financial management is what accountants do and it has something to do with taxes. After nearly 30 years of trying to encourage small agribusiness owners to get directly involved with the finances of their firms by following liquidity, solvency, profitability, efficiency and coverage trends, I am now prepared to let others fight this battle. But before I give up, I shall make one last try. This paper is it. Here I attempt to focus on two numbers only, in the hope that agribusiness owners might spare some time for them, rather than blissfully ignore the plethora of data that I previously offered with such clarity.

These two numbers are profit and free cash flow. Everyone thinks they know profit, though my experience suggests that few can define it. It is widely recognized but little understood as the main reason that firms exist. They know that the bigger this number is the better the firm has done. By and large, this is true, albeit with a few wrinkles, for it does also depend on how well the profit is allocated. The second number is free cash flow (FCF), which few, including many accountants and finance professors can define and even fewer can understand. But likewise, folks believe that the bigger the number is the better the firm is doing. Here they are more accurate, for free cash flow has fewer wrinkles than profit does.

This paper will concentrate on both profit and free cash flow. It defines them and shows how they can both be used as a quick and simple way to follow firm progress. I also suggest that FCF may well be the better of the two measurements, though the jury is still out on this suggestion. Even then, I will try to show why I tend to prefer it. Simply it is because this number shows unequivocally what we have available after running the firm.

WHAT IS PROFIT?

Profit is the bottom line for all firms and it is shown on the firm's quarterly or annual income statements. This is the only financial statement that shows profit. Profit is also known as (1) net income, which is an accountant's phrase and is used in income statements, (2) the bottom line, a media phrase and slang term to pique the recipient, and (3) earnings, a word used widely in financial markets, for it does indeed show what the firm earned over the life of the income statement. All three terms should mean the identical thing, namely what is left after paying all

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the firm’s operating expenses, depreciation , overhead, taxes (cum FICA) and interest. Most firm owners probably know this, or at least come close.

What they generally don’t realise is that profit is totally consumed by one or more of three things. Consequently, profit is not an available lump sum lying there at the end of the income statement, which the owner can pick up and run with. These three uses are fulfilled, sometimes by default, by the firm’s owners and it is true to say that this allocation probably tells us more about the success of the firm’s management than the amount of profit does. In other words, we can separate the good from the not so good firm managers by how they allocate profit and well as how they got it.

Profit is spent entirely on these three things. (1) owners’ salaries or dividends, (2) reinvesting in new assets for firm growth and (3) paying principal on firm debt. In accounting terms, the latter two items (2 and 3) are called retained earnings and end up in the equity statement on the balance sheet.

The word “reinvesting” needs clarification. Here it means buying new stuff which will increase firm size. For example, increasing the cow herd by 200 cows; buying another 100 ha. of citrus grove, or purchasing an additional six pick up trucks. It does not mean replacing culled cows or worn out trucks. These purchases are for replacing used up assets and are charged under depreciation. Reinvesting can also mean adding to the firm’s cash. So if \$5,000 of the firm’s profit simply stays in the bank as cash, this sum is also classified as reinvesting.

Obviously, the more profit one of these three allocations receives the less that’s available for the other two. This is a difficult balancing act for a manager. The higher the proportion allocated for salary, the less that goes for new assets and reducing debt. If reinvesting is inadequate, the firm will eventually stop growing or even wither. If too much principal is demanded by lenders, then there will not be enough for firm growth and a reasonable living standard for owners. If the owners’ living standards are unacceptable, there could well be some family troubles and consequential firm personnel changes. So allocation is more than important, it’s a vital and perhaps the vital cog for a firm’s future success.

Table 1. An illustrative income statement for quarter 3

ITEM			
		\$	\$
Sales			100
	- cash cost	60	
	- depreciation	12	
	- overhead	8	
	= total costs		<u>80</u>
Earnings before interest and taxes (EBIT)			<u>20</u>
	- interest	6	
	- tax	4	
= Profit			<u>10</u>
	- Salaries	4	
	- Reinvesting	4	
	- Principal	2	<u>0</u>



But allocation is not as straightforward as it might seem. There is no one lump sum of profit that an owner can play with. The income statement shows what has happened in a firm over a period of time and these allocations occur during that time. Thus profit shows what has already been allocated as well as what might be left over. For example, salaries are drawn, principal payments made and assets purchased during the time frame, not all at the end. So the owners have to get the allocation right continuously rather than at the end of a quarter. Profit is what a firm has made over time, not what it ended up with. And that's the problem with profit. If we need to do something about its allocation, it may be too late.

Table 1. summarises what we've covered so far. It shows that we have nothing left at the end of the day, in that, as always, profit is entirely allocated between its three uses. Note that the \$6 retained earnings, or (4+2) from reinvesting and principal will add to the retained earnings in the equity statement of the firm's balance sheet. We have \$4 more new stuff and have reduced our principal owed, or increased our asset ownership, which is the same thing, by \$2. Also recall that the three uses of profit have occurred during, rather than at the end of the third quarter of the year that the income statement represented. It is, however, normal that some profit will be left over at the end of the quarter. The majority of this left over sum will usually be in cash or unpaid owner salaries. These salaries are the dividends for corporations.

WHAT IS FREE CASH FLOW?

Free cash flow (FCF) is essentially the cash that is left in the firm after it has paid all its bills and bought new stuff. This means that the firm has paid all the costs shown in table 1 as well as interest, taxes and capital spending on new (reinvestment) and replacement assets. So the cash remaining is an actual lump sum. It is also the amount that was not considered necessary to run the firm during the quarter.

Thus the owners have some money they can do what they like with. They can, for example, pay their salaries, reduce debt, reinvest more than they already have, replace assets more quickly than originally planned or buy back stock. The firm's FCF encourages decision making on an item that is there, unlike profit, where most of it has usually been allocated. This is a huge difference. It is, essentially, the cash that owners have to play with after they have managed the costs of their firm. Obviously, its allocation is important, but here it is ex ante (though they

		\$	\$
Sales			100
	- costs		<u>80</u>
= EBIT			20
	+ Depreciation & Amortization		<u>12</u>
= EBITDA			<u>32</u>
	- Interest	6	
	- tax	4	
	- reinvesting	4	
	- replacements	3	<u>17</u>
= Free cash flow			15

obviously must draw salary and pay principal) rather than mostly ex post.

Cash is the major asset for all firms today, agriculturally or otherwise. The saying “cash is king” is true. If we have cash, we can do things, if we don’t we’re in trouble (vide airlines in USA). Realise that “it is cash flows, not profits that are actually received by the firm and can be reinvested. Accounting profits... are shown when they are earned rather than when the money is actually in hand.” (Keown et.al). FCF shows how much we have after we’ve paid the bills. Profit doesn’t. Look at Table 2 and compare it to Table 1.

Thus the firm has \$15 in FCF that they can allocate as they wish, or nearly so. After adding back depreciation, which adds \$12 cash to the firm, because we don’t pay any depreciation bill to anyone, and subtracting \$17 for cash purchases of \$7 and interest and taxes of \$10, there is \$15 left. Some at least must go for owners’ salaries and principal, but it is a lot easier to decide after seeing what’s available rather than apportioning what one thinks will be available. It would, however, be fair to concede that this approach may not be particularly palatable to either the lender or the family of a small firm owner.

As a sideline, FCF is the main tool used (or should be) in capital budgeting, so it has been around for some time. Capital budgeting occurs when a firm considers investments that last longer than a year. Examples include land, breeding stock, buildings, machinery and trees. Regardless of the discounting methodology used, it is the future FCF of the potential capital investment that are discounted back to compare whether it is worthwhile or not. The decision is whether the discounted return is greater than the expected return. Capital investing is usually covered in any basic agricultural finance class. Consequently, it is a little surprising to me that FCF has not been used much for firm analysis until fairly recently.

I tend to prefer FCF to profit when analyzing a firm because I know what is left over. But it is probably a good idea for firm owners to use both. It is a pious hope that agribusiness owners will eagerly plough through a complete firm analysis involving at least three dozen numbers plus their trends, as is done regularly by financial analysts in financial markets. Profit and FCF are simple to calculate and pretty simple to use. They show where the firm has been and, with good allocation, where the firm is going. In agricultural management, it is perhaps unreasonable to expect more.

Perhaps the best thing to know about these guides to success is that we want them to grow, to continue to grow and to grow as fast as possible. If they don’t then we have to consider what we’re doing a little more closely. This will involve examining the traditional tools of liquidity, solvency, profitability, efficiency and coverage as mentioned earlier. If they do grow, then we should do more of the same. (If they don’t then the owner or someone has to examine the tools mentioned above). This approach is simple, direct and possibly even sensible for those who enjoy spending their time in the field.

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