May 2021

University of Wyoming Extension

BARNYARDS & BACKYARDS

USDA

UW Extension | Agriculture & Horticulture | USDA | NIFA

Understanding financial performance: Part 3 in the *Getting on Track* series

What to do with or how to interpret financial statements is often not easily understood. This is a problem for many farm and ranch businesses.

The third course in the *Getting on Track* series, Understanding Financial Performance, was designed to help farm and ranch business owners properly evaluate their financial status by calculating various ratios and indices.

There are many benefits to constructing financial statements and knowing financial performance. Financial analysis can highlight areas of risk or poor performance and show where improvements can be made. Knowing the financial information a lender looks for can help put you on the same page as well.

The course follows example producers highlighted in the previous two courses and explains the practical aspects of financial analysis and understanding financial performance. The course examines five areas of financial analysis.

LIQUIDITY AND SOLVENCY

Liquidity measures the ability of a business to meet current financial obligations without disrupting normal business operations. The course outlines three main ratios for measuring liquidity: the current ratio, working capital ratio, and working capital/gross revenue ratio. These ratios are calculated using information on the balance sheet. The current ratio is estimated by current assets divided by current liabilities.

Solvency refers to the ability of a business to meet all long-term obligations and the ability of the business to withstand financial adversity. Solvency is measured by the debt/asset ratio, equity/asset ratio, and debt/equity ratio. Information for these ratios is also on the balance sheet. As with liquidity ratios, measures of solvency can be compared over time or to industry benchmarks.

PROFITABILITY AND FINANCIAL EFFICIENCY

Profitability refers to the ability of a business to generate more revenue than expenses over a period of time. The course outlines five measures of profitability including rate of return on assets (ROA); rate of return on equity (ROE); operating profit margin; net farm income; and earnings before interest, taxes, depreciation, and amortization (EBITDA). Data for these ratios are on the income statement, statement of owner equity, and book value balance sheet.

Financial efficiency measures can help determine whether or not the physical assets of a business are being applied effectively. The five ratios discussed in the course are asset turnover, operating expense, interest expense, depreciation expense, and net farm income from operations. As with the profitability ratios, what makes a financial efficiency ratio good or bad depends on the type and size of the operation.

Liquidity Ratio Benchmarks

Liquidity Benchmarks	Low Risk	Moderate Risk	High Risk
Current Ratio	>1.5	1.0 – 1.5	<1.0
Working Capital	The appropriate level will vary primarily due to farm size, inventory levels and accounts receivable.		

Possible actions for improvement
- Increase sales
- Decrease short-term debt and other financial obligations
- Restructure debt to better reflect current assets
- Evaluate a marketing plan to better time cash inflows and outflows

REPAYMENT CAPACITY

The ability of a borrower or potential borrower to repay farm debt from farm and non-farm sources is an important financial measure. The course outlines the important ratios for measuring repayment capacity, including capital debt repayment capacity and term debt/capital lease coverage ratio.

Financial analysis allows farm and ranch managers and lenders to assess a business' financial health and chart its progress. Analysis can identify strengths and weaknesses and identify where action may be necessary. The information can assist decision making, goal setting, and comparing business performance across several years and to similar operations. Negative trends can provide an early warning system, indicating changes or adjustments are needed.

James Sedman is a consultant to the Department of Agricultural and Applied Economics in the University of Wyoming College of Agriculture and Natural Resources, and **John Hewlett** is a farm and ranch management specialist in the department. Hewlett may be reached at (307) 766-2166 or hewlett@uwyo.edu.

ADDITIONAL RESOURCES AVAILABLE FROM RIGHTRISK.ORG

- The Risk Scenario Planner Course
- Enterprise Risk Analysis
- Lasting Legacy
- Management Succession Planning
- Evaluating Risk Strategies
- Analytics Tool Box

FOR MORE INFORMATION

RightRisk.org is a premier risk management resource for producers, including the *Getting on Track* series highlighting the importance of financial record keeping and analysis.

Point your browser to RightRisk.org and select the Courses tab to access any of the three *Getting on Track* courses. Due to the removal of Flash player, audio is not currently available with the course slides, but all accompanying resources remain accessible.