Farm Management Fact Sheet

Using and Understanding Financial Ratios and Benchmarks

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Financial ratio analysis can identify trends, assess strengths and weaknesses within a business, and help identify areas that may require attention. Through benchmarking, you can use financial ratios to compare trends in an operation's historical records, or compare the operation to farms of similar size within the same sector. When comparing ratios with other farms, you should take care to ensure the comparison is based on financial data from the same year.

Common Financial Ratios

Liquidity refers to the operation's present ability to meet short-term (due within one year) obligations, such as current debt and accounts payable. Two common measures of liquidity are **current ratio** and **working capital**.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

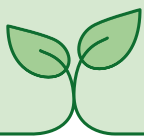
Current ratio indicates whether sufficient assets can be quickly and easily converted to cash to cover amounts owing in the near future. Generally, a ratio of 1.5 to 2 is ideal, and between 1 and 1.5 is acceptable. A ratio less than one is unfavourable.

Working Capital = Current Assets – Current Liabilities

A positive working capital will ensure the operation can cover short-term debts and operating expenses. As a benchmark, working capital is best used within an operation, and comparing historical data. Since liquidity is measured at a moment in time, the measures can vary in any given period and may not necessarily reflect the operation's future ability to meet short-term obligations.

Solvency is the amount by which assets exceed debt, indicating the operation's ability to cover its long-term bills and debts, and how much of the operation outsiders/creditors own. Two common measures of solvency are **debt/asset ratio** and **debt/equity ratio**.

$$\text{Debt/Assets} = \frac{\text{Long Term Debt}}{\text{Assets}}$$



$$\text{Debt/Equity} = \frac{\text{Total Debt}}{\text{Equity}}$$

These ratios are basically equivalent, so only one would need to be used in an analysis. Debt/asset ratio shows how much of the operation's assets are financed by debt. Debt/equity ratio relates the long-term debt to the amount of equity owners have.

Equity refers to the amount of personal funds the owners/shareholders have directly invested in the operation through direct capital investment and/or retained earnings. Growth through earnings (profit) shows the progress of the business.

These ratios will vary depending on the stage of the operation. A beginning producer may expect a high ratio, such as 70 per cent. An established farm would expect a more reasonable ratio, with 30 per cent or less generally considered good. Lending institutions tend to be wary if ratios rise above 50 per cent.

Profitability is related to how efficiently the business uses assets and inputs to produce output. Common measures of profitability are **return on assets**, **return on equity**, and **gross margin**.

Return on Assets (ROA) shows the effectiveness of assets to turn a profit.

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Equity}}$$

This ratio should be over 10 per cent. A high ratio could indicate the operation has little equity. Analysis of the trend of the ROE could demonstrate the progress of the operation. Comparison to possible returns from off-farm investment will show the value of the investment in the farming operation.

Gross Margin shows the direct costs of production.

$$\text{Gross Margin} = \frac{\text{Gross Profit*}}{\text{Sales}}$$

*Gross profit is the difference between revenue and the cost of making product or the "cost of goods sold." "Cost of goods sold" consists of raw materials and supplies used, labour, and overhead allocable to production. A gross revenue greater than 25 per cent is considered good, between 10 and 25 per cent is average, and less than 10 per cent is concerning.

Some ratios are generated from either the Income Statement or Balance Sheet, whereas others use values from both statements, linking the two. Good record keeping and accurate statements are imperative to derive accurate and meaningful ratios.

You may use ratio analysis and benchmarks to compare past performance and projected trends within an operation to determine whether financial status is improving, or expected to improve. They may also be used to compare the operation's financial status with other operations of similar size within the same industry, or with the value of investment in the next best alternative with similar risk (the opportunity cost). When performing ratio analysis, it is also important to consider seasonality, stage of business development, market price trends, and factors affecting yield.

The Agriculture and Lands Branch of the Department of Fisheries, Forestry and Agriculture offers resources to assist with farm management, including short courses, consultations, publications, and financial assistance for eligible applicants.

For more information, please contact the Agriculture Business Development Division Farm Management Specialist in your area.

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