Calculate a Farming Operations Overall Financial Risk

In this Module we discussed the important information reported in, and interconnectivity of, a complete set of financial statements. Once we understood the financial statements we analyzed them for financial measures. We broke the financial measures down into three main groups: solvency, liquidity, and profitability (debt servicing). Benchmarks were given to quantify the measure relative to these three financial parameters. Which financial parameter is most important?

This question can be debated at length. For the purposes of this document we will state that they are all equally important. The example that we followed throughout this document had good ratios for solvency, liquidity, and profitability (through the debt servicing analysis). The overall financial risk related to this farm is easy to calculate – it is low. Each financial measure showed low risk. This is not always the case.

Farms generally have low solvency and higher liquidity and profitability measures. A low measure in one of the parameters should offset higher measure in another area. Table A1-4 shows a simple overall financial risk rating method.

Table A1-4

Farms' Overall Financial Risk Rating:		Rating
Closing Current Ratio	1.60	1
Closing Leverage Ratio	0.16	1
Closing Debt Servicing Ratio	1.55	1
Ratings: Current Ratio: <1.0 = 3, 1.0-1.5 = 2, >1.5=1; Leverage Ratio: >1 = 3, 0.42-1.0 = 2, < 0.42 = 1; Debt Servicing Ratio: <1.1 = 3, 1.1-1.5 = 2, >1.5 = 1.		3
Overall Farm Risk Rating: <=4 Good; 5-6 Caution; >=7 Not Good		

Points are awarded based on the financial risk apparent in the ratio when compared to industry benchmarks. 1 point was awarded for low measure, 2 points for medium measure, and 3 points for a high measure. The current ratio, leverage ratio, and debt-servicing ratio were all low level measures in this example and the farm risk rating was good at 3.

Table A1-5

Farms' Overall Financial Risk Rating:		Rating
Closing Current Ratio	1.34	2
Closing Leverage Ratio	0.11	1
Closing Debt Servicing Ratio	1.05	3
Ratings: Current Ratio: <1.0 = 3, 1.0-1.5 = 2, >1.5=1; Leverage Ratio: >1 = 3, 0.42-1.0 = 2, < 0.42 = 1; Debt Servicing Ratio: <1.1 = 3, 1.1-1.5 = 2, >1.5 = 1.		6
Overall Farm Risk Rating: <=4 Good; 5-6 Caution; >=7 Not Good		

The farm example in Table A1-5 has more variation in their financial measure ratios and consequently a higher financial risk rating than the farm in Table A1-4. The farm in Table A1-5 should not be taking on any additional debt with the low 1.05 debt-servicing ratio, and a higher overall financial risk rating. They should be monitoring their financial ratios and performance very closely month to month. A slight slip in crop yields or calf prices could require this farm to ask for a restructuring of their loans to survive.

The objective of this document was to assist you in understanding and evaluating financial statements.

For a summary of Key Financial Ratio Calculations and Benchmarks
http://www1.agric.gov.ab.ca/$department/deptdocs.nsf/all/econ2200

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