The Extension Connection

By Megan Vig

As we look at crop futures we continue to see downward trends. It is the same doom and gloom as last winter however the benefit of 2016 was that it brought us bin-busting yields to help our breakeven price points. As we continue into 2017, it is good to know the financial health of your operation. This week I share information from Iowa State University on the financial health analysis of your farm. Each operation should identify key ratios pertinent to their operation and management type to track over time to generate a whole picture of the financial health of a business. Such ratios deal with liquidity and solvency.

Liquidity measures the ability of a farm to generate sufficient cash flow to meet short term obligations from cash or assets that will turn into cash within 12 months. Two key measures of liquidity are the current ratio and working capital.

Current ratio measures the extent to which current farm assets, if sold tomorrow, would pay off current farm liabilities. It is calculated as current assets divided by current liabilities. A ratio of 1.7 means for every $1 of liabilities the operation has $1.70 of current assets. A ratio above 2.0 is strong.

Working capital is calculated as the difference between current assets and current liabilities. Working capital tells us the operating capital available in the short term from within the business. A ratio measure of over 25% is of good standing for an operation with a steady stream of revenue. An operation with seasonal income, such as grain production, should strive for a measure closer to 50%.

Solvency measures the ability of a business to pay off all debts if an operation were to be liquidated. Solvency is important in evaluating the financial risk and borrowing capacity of the business. Three ratio measures are used to evaluate asset, debt, and equity position of the farm operation.

Debt-to-asset ratio is total liabilities divided by total assets. A ratio of 30% means the farm operation has $0.30 debt for $1 of assets. A farm operation is in a good financial position if their ratio is less than 30%. High risk is considered when a measure of 60% is reached. A higher ratio is an indicator of greater financial risk and lower borrowing capacity.

Operating expense ratio measures the amount of income that is going to pay operating expenses which are typically variable expenses in an operation. An operation should strive to have a measure of less than 60%. That means for every $1 of income, $0.60 is going to pay operating expenses. The remaining $0.40 pays depreciation, interest and contributes to net income, return to labor, management, and investment.

Asset turnover ratio measures the efficiency in using capital. Value of farm production is gross revenue less items purchased for resale, ex: feeder cattle. Generating a high level of production with a low level of capital investment will give a high asset turnover ratio. This measure should be above 45% for a farm to be in a strong financial position.

Knowing the financial health of your farm or business and then evaluating ways to improve the key ratio measures is the key to success and viability. Work with your banker or financial professional when evaluating and making plans to improve these ratios. Source: Iowa State University Extension and Outreach.