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RightRisk™

RightRisk News

How Much Risk is Right for You?

Dates to Remember

Spring-planted crops sales deadline:
- March 15, 2019

Noninsured Crop Disaster Assistance Program (NAP)
Deadline for springseeded forage and all other crops
- April 1, 2019

For more information see:
http://www.rma.usda.gov
http://www.fsa.usda.gov

Evaluating Farm Financial Health

You faithfully keep good financial records for your farm, ranch, or other business. Yes, your accountant requires complete records to file your tax returns. But, there is another important use for your financial records – determining the financial health of your business. Information from the financial records and annually-completed financial statements allow a business manager to assess the financial health of the business. Review the RightRisk course, *Getting on Track: Better Management through Financial Statements* at rightrisk.org for more detail on pulling these statements together.

Much like doctors and nurses measure a person's physical health (temperature, blood pressure, etc.), financial analysis measures financial health. Financial analysis allows producers to assess the business's financial health and chart its progress. The analysis identifies any strengths and weaknesses and where action may be necessary to correct a problem.

Financial Health Indicators

Measures of financial health include liquidity, profitability, solvency, financial efficiency, and repayment capacity. Each of the key indicators provide insights into the relationship between different values found on your financial statements. There are hundreds of different financial performance measures that might be calculated. Each indicates a different aspect of financial health. Rather than be overwhelmed by the sheer number and variety of financial ratios, most business managers focus on just a few key measures appropriate to their businesses. Further, there are financial benchmarks for each area of financial health. The benchmarks are meant to be only a guideline for comparison purposes. Variations will occur due to size of operation, whether assets are owned or leased, type of operation, geographic location, age of the operator, and other factors. Thus, farm or ranch operators should establish benchmarks for their specific situation.

Selected Measures to Financial Health and General Benchmarks for Three Levels of Risk.

	Low Risk	Moderate Risk	High Risk
Liquidity Benchmarks			
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.		
Solvency Benchmarks			
Debt to Asset Ratio	<30%	30% - 70%	>70%
Equity to Asset Ratio	>70%	30% - 70%	<30%
Profitability Benchmarks			
Rate of Return on Assets	>5%	1% - 5%	<1%
Rate of Return on Equity	>10%	5% - 10%	<5%
Financial Efficiency Benchmarks			
Asset Turnover Ratio	Depend on the type of operation and whether the assets are owned or leased.		
Operating Expense Ratio	<70%	70% - 85%	>85%
Interest Expense Ratio	<10%	10% - 20%	>20%
Repayment Capacity Benchmarks			
Capital Debt Repayment Capacity	The measure is a dollar amount. As such, it is difficult to compare farm businesses or to develop a standard for a particular type of farm business.		
Term Debt and Capital Lease Coverage Ratio	>1.35	1.10 – 1.35	<1.10

Public and private organizations have analyzed financial data to establish benchmarks for the agricultural industry. These benchmarks are guidelines or general rules of thumb. Variations do occur between operations. Each operation should establish their own benchmarks over time.

Liquidity

Liquidity refers to the ability of the farm business to meet its financial obligations as they come due without disrupting normal operations. Two ratios commonly used by managers and lenders are the current ratio and working capital ratio. The current ratio is calculated by dividing current farm assets by current farm liabilities. The working capital ratio is similar to the current ratio and uses the same values. However, it is calculated by subtracting current farm liabilities from current farm assets. Both measures are used to evaluate if there is sufficient cash flow to meet all short term obligations; in other words, to pay the bills on time.

Solvency

Solvency measures the long-run ability of the business to meet all financial obligations and to withstand adversity over time. Two, commonly-calculated solvency measures are the debt to asset ratio and equity to asset ratio. The debt-to-asset ratio is calculated by dividing total farm liabilities by total farm assets. It measures the business's ability to pay long term obligations and to withstand financial adversity. The equity-to-asset ratio is calculated by dividing total farm equity by total farm assets. It measures the owner's level of investment in the business.

Profitability

Profitability measures the ability of the business to generate more revenues than expenses over a period of time. Two, commonly-calculated profitability measures are the rate of return on assets and rate of return on equity. Rate of return on assets is calculated with the formula: (net farm Income + farm interest – value of operator labor & management) divided by average farm assets. The result of this calculation allows a comparison of earnings to the value of the assets used in the production process. Rate of return on equity is calculated by the formula: (net farm income – value of operator labor & management) divided by average farm net worth. It compares the earnings of the business to the business owner's investment in the production process.

Financial Efficiency

Financial efficiency indicates whether or not the physical resources (assets, operating inputs, borrowed funds) of the business are being utilized and combined in an effective manner. Three commonly used measures of financial efficiency are asset turnover ratio, operating expense ratio, and interest expense ratio. The asset turnover ratio provides an assessment of how efficiently the business is using its assets to generate revenue. It is calculated by dividing gross farm income by average farm assets. The operating expense ratio measures how efficiently the business is using operating inputs to generate income. It is calculated by dividing operating expenses (excluding interest and depreciation) by gross farm income. The interest expense ratio evaluates the level of gross income used to pay for interest on borrowed capital and is calculated by dividing interest expense by gross farm income.

Repayment Capacity

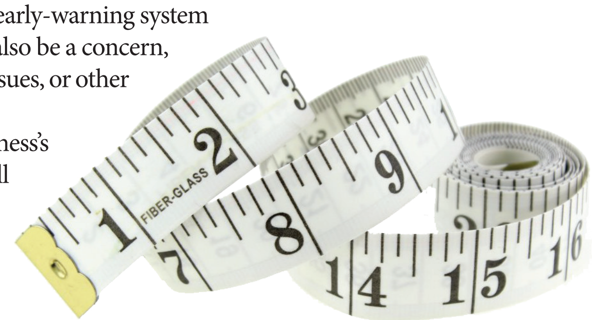
Repayment capacity measures the ability of the business to repay term debt from farm and non-farm income. Two commonly calculated measures are capital debt repayment capacity and term debt and capital lease coverage ratio. These measures provide an indication of the funds available to cover debt and lease payments or to make alternative investments. Capital debt repayment capacity is calculated with the formula: net farm income plus depreciation + net non-farm income - family living withdrawals - income taxes + interest on term loans. The term debt and capital lease coverage ratio is calculated by the formula: (net farm income + depreciation + net non-farm income - family living withdrawals - income taxes + interest expense on term loans) divided by scheduled payments for principal and interest on term loans and capital leases.

Stop-light Analysis

One, easy way to understand the benchmarks of financial health is to view them like a traffic light. A green light represents financial strength with low risk. A yellow light corresponds to moderate risk, and a red light indicates weakness and high risk. A green light does not guarantee success, nor does a red light imply failure. For example, a weakness in one area may be overcome by strengths in other areas.

Individual measures provide insight into financial performance, but trends in the indicators are even more useful. A trend is the general direction or tendency that a measure exhibits after two or more years. Monitoring trends can provide an early-warning system where performance is headed in the wrong direction. Erratic financial performance should also be a concern, as it may indicate a sign of instability due to swings in the underlying markets, management issues, or other factors.

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



RightRisk™

RightRisk helps decision-makers discover innovative and effective risk management solutions.

- Education
- Coaching
- Research

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How much risk is right for you and your operation?