Farm Financial Ratios and Guidelines

**Liquidity**
Is the ability of your farm business to meet the financial obligations as they come due - to generate enough cash to pay your family living expenses and taxes, and make debt payments on time.

- **Current Ratio**
  Measures the extent to which current farm assets, if sold tomorrow, would pay off current farm liabilities.
  \[
  \text{Total Current Farm Assets} / \text{Total Current Farm Liabilities}
  \]

- **Working Capital**
  Tells us the operating capital available in the short term from within the business.
  \[
  \text{Total Current Farm Assets} - \text{Total Current Farm Liabilities}
  \]

- **Working Capital to Gross Revenues**
  Measures operating capital available against the size of the business.
  \[
  \frac{\text{Working Capital}}{\text{Gross Farm Income}}
  \]

**Solvency**
Is the ability of your business to pay all its debts if it were sold tomorrow. Solvency is important in evaluating the financial risk and borrowing capacity of the business.

- **Farm Debt-to-Asset Ratio**
  Is the bank's share of the business. It compares total farm debt to total farm assets. A higher ratio is an indicator of greater financial risk and lower borrowing capacity.
  \[
  \frac{\text{Total Farm Liabilities}}{\text{Total Farm Assets}}
  \]

- **Farm Equity-to-Asset Ratio**
  Is your share of the business. It compares farm equity to total farm assets. If you add the debt-to-asset ratio and the equity-to-asset ratio, you must get 100%.
  \[
  \frac{\text{Total Farm Net Worth}}{\text{Total Farm Assets}}
  \]

- **Farm Debt-to-Equity Ratio**
  Compares the bank's ownership to your ownership. It also indicates how much the owners have leveraged (i.e., multiplied) their equity in the business.
  \[
  \frac{\text{Total Farm Liabilities}}{\text{Total Farm Equity}}
  \]

**Profitability**
Is the difference between the value of goods produced and the cost of the resources used in their production.

- **Net Farm Income**
  Represents return to your labor, your management and your equity that you have invested in the business. It is the reward for investing your unpaid family labor, management and money in the business instead of elsewhere. Anything left in the business, i.e., not taken out for family living and taxes, will increase your farm net worth.
  \[
  \text{Gross Cash Farm Income} - \text{Total Cash Farm Expenses} + / - \text{Inventory changes} - \text{Depreciation}
  \]

- **Rate of Return on Farm Assets**
  Can be thought of as the average interest rates being earned on all (yours and creditors') investments in the farm. Unpaid labor and management are assigned a return before return on farm assets is calculated.
  \[
  \frac{\text{Net Farm Income}}{\text{Total Farm Assets}} = \text{Value of Operator Labor & Mgt} = \text{Return on Farm Assets} / \text{Average Farm Assets}
  \]

- **Rate of Return on Farm Equity**
  Represents the interest rate being earned by your investment in the farm. This return can be compared to returns available if your equity were invested somewhere else, such as a certificate of deposit.
  \[
  \frac{\text{Net Farm Income}}{\text{Total Farm Equity}} = \text{Value of Operator Labor & Mgt} = \text{Return on Farm Equity} / \text{Average Farm Net Worth}
  \]

- **Operating Profit Margin**
  Shows the operating efficiency of the business. If expenses are low relative to the value of farm production, the business will have a healthy operating profit margin. A low profit margin can be caused by low product prices, high operating expenses, or inefficient production.
  \[
  \frac{\text{Return on Farm Assets}}{\text{Value of Farm Production}}
  \]

- **EBITDA**
  Earnings Before Interest, Taxes, Depreciation, and Amortization.
  Measures earnings available for debt repayment.
  \[
  \text{Net Farm Income} + \text{Interest Expense} + \text{Depreciation & Amortization}
  \]
Repayment Capacity
Shows the borrower's (i.e., your) ability to repay term debts on time. It includes non-farm income and so it is not a measure of business performance alone.

Capital Debt Repayment Capacity
Measures the amount generated from farm and non-farm sources, to cover debt repayment and capital replacement.

Capital Debt Repayment Margin
Is the amount of money remaining after all operating expenses, taxes, family living costs, and scheduled debt payments have been made. It's really the money left, after paying all bills, that is available for purchasing or financing new machinery, equipment, land or livestock.

Replacement Margin
The amount of income remaining after paying principle and interest on term loans and unfunded (cash) capital purchases.

Term-Debt Coverage Ratio
Tells whether your business produced enough income to cover all intermediate and long-term debt payments. A ratio of less than 1.0 indicates that the business had to liquidate inventories, run up open accounts, borrow money, or sell assets to make scheduled payments.

Replacement Margin Coverage Ratio
A Ratio Under 1.0 indicates that you did not generate enough income to cover term debt payments and unfunded capital purchases.

Financial Efficiency
Shows how effectively your business uses assets to generate income. Past performance of the business could well indicate potential future accomplishments. It also answers the questions:

Are you using every available asset to its fullest potential?
What are the effects of production, purchasing, pricing, financing and marketing decisions on gross income?

Asset-Turnover Rate
Measures efficiency in using capital. You could think of it as capital productivity. Generating a high level of production with a low level of capital investment will give a high asset-turnover rate. If, on the other hand, the turnover is low you will want to explore methods to use the capital invested much more efficiently or sell some low-return investments. (It could mean getting rid of that swamp and ledge on the Back 40 an getting something that produces income.)

The last four ratios show how Gross Farm Income is used. The sum of the four equal 100% (of Gross Farm Income).

Operating Expense Ratio
Shows the proportion of farm income that is used to pay operating expenses, not including principle or interest.

Depreciation Expense Ratio
Indicates how fast the business wears out capital. It tells what proportion of farm income is needed to maintain the capital used by the business.

Interest Expense Ratio
Shows how much of gross income is used to pay for interest on borrowed capital.

Net Farm Income Ratio
Compares profit to gross farm income. It shows how much is left after all farm expenses, except for unpaid labor and management, are paid

\* Includes payments on capital leases