

# Economic & Policy Update

## E-newsletter Volume 25, Issue 6

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JUN  
2025

## Know Your Ratios

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Published: June 30, 2025

Farming is more than planting, growing, and harvesting—it's running a business. And like any business, understanding your financial health is crucial for long-term success. That's where financial ratios come in. Think of them as vital signs for your farm's finances. Just like a doctor checks your blood pressure or heart rate, these ratios help you assess if your farm is thriving, surviving, or heading for trouble.

Whether you're talking to a lender, planning an expansion, or just trying to get a grip on your cash flow, knowing your ratios can give you the clarity you need to make better decisions. And the best part? You don't need a finance degree to understand them—you just need a little guidance. So, let's break them down in a way that makes sense for everyday farm life.

**1. Liquidity:** Liquidity is all about short-term survival. It answers the question: If the bills came due tomorrow, could you cover them with what's in the bank and what's easily sold or collected?

- **Current Ratio** = Current Assets ÷ Current Liabilities  
This tells you how many dollars of liquid stuff (like cash, feed, or accounts receivable) you have for every dollar you owe soon.

Benchmarks:

> 2.0: Strong  
1.3–2.0: Caution  
< 1.3: Vulnerable

- **Working Capital** = Current Assets – Current Liabilities  
This is the actual dollar buffer between what you have and what you owe in the short run. Bigger is better, it means you have room to maneuver.
- **Working Capital to Gross Revenues** = Working Capital ÷ Gross Farm Income  
This puts your working capital in perspective. A high ratio here means your cushion is strong relative to the size of your business.

Benchmarks:

> 30%: Strong  
10–30%: Caution  
< 10%: Vulnerable

**2. Solvency:** Measures your long-term strength. It's like checking the foundation of your house—how much of your farm is financed by debt versus owned outright.

- **Debt-to-Asset Ratio** = Total Liabilities ÷ Total Assets  
This shows what portion of your assets is financed by debt. A low percentage means you're less reliant on borrowed money.

Benchmarks:  
< 30%: Strong  
30–60%: Caution  
> 60%: Vulnerable

- **Equity-to-Asset Ratio** = Equity ÷ Total Assets  
This is your ownership stake. A high ratio means you own more of the farm—great news for stability and borrowing power.

Benchmarks:  
> 70%: Strong  
40–70%: Caution  
< 40%: Vulnerable

- **Debt-to-Equity Ratio** = Total Liabilities ÷ Equity  
This compares what you owe to what you own. Lower values mean you're in a healthier position if things go sideways.

Benchmarks:  
0.43: Strong  
0.43–1.5: Caution  
1.5: Vulnerable

**3. Profitability:** This goes beyond cash flow, it shows whether your operation is generating a solid return on what you've invested.

- **Rate of Return on Assets (ROA) and Rate of Return on Equity (ROE)**  
ROA: Profit generated per dollar of asset. Are you getting bang for your buck from your land, equipment, and inventory? Higher ROA means you're using resources efficiently.  
ROE: Profit generated per dollar of owner equity. This focuses on what you, as the owner, are earning from your investment in the business.

Benchmarks:

ROA: 8% or higher

ROE: 10% or higher

- **Operating Profit Margin** = Operating Profit ÷ Gross Revenues  
This is the share of revenue left after covering operating costs. After covering operating costs, how much is left over? A higher margin gives you more room to weather tough years.

Benchmarks:  
< 25%: Strong  
15–25%: Caution  
> 15%: Vulnerable

**4. Repayment Capacity:** Assesses the ability to meet debt servicing (principal + interest). Even profitable farms can get squeezed if debt payments are too high. This ratio looks at whether you have enough income to meet loan obligations.

- **Debt Coverage Ratio** =  $\frac{\text{Net Farm Income} + \text{Non-Farm Income} + \text{Depreciation} + \text{Interest on Term Debt} - \text{Family Living Withdraws} - \text{Income Taxes}}{\text{Scheduled Principal Payments on Term Debt} + \text{Interest on Term Debt}}$   
This shows if net income or cash flow can cover necessary debt payments. It tells you how comfortably your income (farm and non-farm) can cover debt payments. Lenders love this one.

Benchmarks:  
> 1.75: Strong  
1.25–1.75: Caution  
< 1.25: Vulnerable

**5. Financial Efficiency:** Efficiency ratios show how well your farm converts inputs into income. They point out areas where you might be overspending—or operating at peak performance.

- **Asset Turnover** =  $\frac{\text{Gross Revenues}}{\text{Total Assets}}$   
Measures how effectively your assets generate revenue. More turnover = better use of resources.

Benchmarks:  
< 45%: Strong  
30–45%: Caution  
> 30%: Vulnerable

- **Operating Expense Ratio** =  $\frac{\text{Operating Expenses}}{\text{Gross Income}}$   
This is the percentage of income spent just to operate. It shows how much of your income goes straight to operating costs. Lower is better—it means you're keeping more of what you earn.

Benchmarks:  
< 60%: Strong  
60–80%: Caution  
> 80%: Vulnerable

- **Interest Expense Ratio** =  $\frac{\text{Interest Paid}}{\text{Gross Income}}$

These reveal how much you're spending on financing and replacing assets. High percentages here can eat into profits.

Benchmarks:  
< 5%: Strong  
5–10%: Caution  
> 10%: Vulnerable

- **Depreciation & Amortization Expense Ratio** =  $\text{Depreciation} \div \text{Gross Income}$   
This reflects capital replacement costs.

Benchmarks:

< 5%: Strong

5–10%: Caution

> 10%: Vulnerable

- **Income from Operations Ratio** =  $\text{Income After Ops, Interest \& Depreciation} \div \text{Gross Income}$   
This is your “net” after covering everything. It’s what’s left to support your family and reinvest in your farm.

Benchmark:

> 20%: Strong

10–20%: Caution

< 10%: Vulnerable

## Summary

- Healthy liquidity means you can cover expenses and debt on time.
- Solid solvency shows you’re less reliant on debt and own more of your farm.
- Strong profitability ensures you’re making a return on assets and equity.
- Good repayment capacity means you can manage debt responsibly.
- Efficient operations leave room for owner income and reinvestment.

Understanding these ratios is like reading your farm’s health records. When you track them year after year, patterns emerge, and those patterns help you make smarter decisions. Whether it’s reducing debt, improving efficiency, or planning for the future, knowing your ratios gives you the tools to farm not just with hard work, but with confidence.

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## Recommended Citation Format:

Schlinke, K. "Know Your Ratios." *Economic and Policy Update* (25):6, Department of Agricultural Economics, University of Kentucky, June 30, 2025.

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