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Relating Farm Financial Terms to Real Life

Author(s): Kayla Brashears

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A producer that works with any type of lending institution may hear their lender use words like liquidity, solvency, and profitability. Their banker may tell them their Term Debt Coverage Ratio is less than 1:1, so the new farm purchase is off the table. A producer may know that their Debt-to-Worth is good or their Current Ratio is bad. However, oftentimes there is a disconnect between paper ratios and the daily farm operation. Outlined below are five pillars of financial health and their effect on daily operations.

Liquidity

Liquidity is the ability to get your hands on cash quickly. It is your ability to meet financial obligations as they come due by generating enough cash for family living expenses, taxes, and making debt payments on time. Ratios that are used to measure liquidity include working capital and current ratio, which both measure the ability to meet short-term obligations without disruption to the business.

A farm that does not have strong enough liquidity feels the effects of timing more than a farm that is better situated. A farm with limited liquidity may need a short-term operating line increase at year-end to bridge the gap until January grain sales. Outstanding accounts at suppliers can mark more moderate liquidity problems because there isn't cash on hand to satisfy the balance. Late or non-existent equipment payments, bouncing payroll checks, and cash infusions from unlikely sources like family or retirement accounts are other markers of severe liquidity problems.

A farm with strong liquidity will have cash available for expansion, such as new land or equipment. The farm may not need to utilize an operating loan and may opt to use cash for large purchases. Another indicator of a strong liquidity position is freedom within grain marketing decisions – the farm is not beholden to cash flow stressors.

Solvency

Solvency is the overall health of the business. If everything was sold tomorrow – could all debts be paid? Two measures used to calculate solvency are Net Worth (assets minus liabilities) and Debt/Equity which compares the bank's ownership to your ownership. A ratio of over 100% means

the bank has more invested in the business than the operation does. This is common in beginning farmers that have not had the opportunity to grow their Net Worth. A farm with solvency problems may have issues borrowing money or refinancing. A farm with a strong solvent position will have more flexibility to handle profitability or liquidity problems.

Profitability

Profitability is the difference between the value of produced goods and the expenses used to produce them. Net Farm Income is the hallmark measure of profitability; it is what the owner's time, energy, and money generates. An operation with probability problems may have wasteful spending either on the farm or on family living. They may have old, unreliable equipment, or poor family labor efficiency. The farm may be cropping ground that is poor performance or in general have subpar production practices.

Repayment Capacity

Repayment capacity is your ability to pay your debts on time. A very common measure used to calculate this is Term Debt Coverage Ratio, which divides term payments against business income. If the term debt coverage ratio is less than 1, it means the farm did not generate enough income to service its debt. A farm experiencing repayment capacity problems may sell grain at a less optimal time to make the annual farm real estate payment. They may borrow money, sell equipment, or leave a supplier bill outstanding in order to make scheduled payments.

Financial Efficiency

Financial efficiency is the measure of how effectively your business uses assets to generate income. It is less likely to show an exact manifestation, but farms with poor financial efficiency will experience liquidity, repayment capacity, and solvency problems. One of the more common measures of financial efficiency is Interest Expense/Gross Farm Returns. If this number is 7-10% or higher, many operations will experience difficulty meeting cash flow needs. A ratio this high indicates the farm has a lot of outstanding debt, and in some instances, may be experiencing very high operating interest rates.

Every farming operation, every year, is unique. A farm with strong liquidity this year may not be as well off the following year, as 2022 has taught us with skyrocketing input prices. Conversely, farms experiencing repayment capacity problems or solvency concerns one year may course-correct and improve their financial position the next year. If you are a producer, working with a trusted source like your lender or KFBM specialist, can help you understand financial measures and their unique relation to the farm.

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Author(s) Contact Information:

Kayla Brashears | **KFBM** Area Extension Specialist | **kayla.brashears@uky.edu**