Financial Ratios: Why They Matter

Bayarbat Badarch – North Dakota Farm Management Education Program Instructor at Lake Region State College in Devils Lake

Using your financial ratios to make management decisions for your farm or ranch business makes a big difference. In perfect competition, farm business management decisions are crucial for sustainability, yet the decision-making process is challenging in today's Ag environment. The North Dakota Farm Management Education program provides one-on-one lifelong learning opportunities in economic and financial education. Instructional assistance focuses on helping producers understand their financial numbers and why they are essential to the farm business management decisions.

According to the current updates on the Financial Ratios from Farm Financial Standards Council, experts surveyed recommended that farmers and ranchers consider 13 financial ratios to gauge the health of their operations as they make management decisions. These ratios are the outcomes of the financial information from your business operation, each of which provides unique information to support good decision-making. These ratios are the vital signs of your business and offer a tremendous amount of information about the business's performance. This paper explores the most basic—yet crucially important—five ratios commonly used for farm business management.

1. ***Current Ratio*** is the standard measurement of a business's financial health. The formula is *Current Ratio = (Current Assets) / (Current Liabilities)*. The current ratio for a healthy farm is two or above, meaning twice as many assets as liabilities. In other words, for every dollar you owe in the short-term coming period, you have two dollars with which to settle that obligation. The Current Ratio should be part of your business's primary financial planning and used monthly or quarterly. Closely keeping track of this figure allows you to take early action to prevent your business hardships. The grain in the bin is equivalent to the operating loan in many farms, creating challenges where margins are often squeezed. Therefore, pay close attention to this to manage your production risk, rather than liquidating your fixed assets to appease your bank's perception of valuation risk.

2. ***Total Asset Turnover Ratio*** is the most helpful number for small business management decisions. Because most of us want to know how efficiently farm business generates sales on each dollar of assets from your operation. The formula is *Total Asset Turnover Ratio = (Value of Farm Production) / (Average Farm Assets).* Farm and Ranch business owners should target a total asset turnover ratio of 40 to 50 percent above. Every month, you should review this ratio to compare it with the Regional Average because this is your basic scorecard. Today's farming and ranching operations require many assets to generate sales; thus, if you want to know how efficiently you use your assets, this financial ratio provides the information you need.

3. ***Operating Profit Margin Ratio*** is another critical ratio to watch for when the business is experiencing a cash flow crunch due to inadequate markups. In other words, this ratio indicates how profitable the farm operation has been during a specific period. The formula is *Operating Profit Margin Ratio = 100% × (Net Farm Income + Interest Paid –*

Charge for Operator and Unpaid Labor – Charge for Management) / (Gross Farm Income). A 15% or above ratio is a sign of a healthy business and checking this ratio almost every month (or at least each quarter) is advisable because it signals cash flow problems before they become urgent. Unfortunately, it is common for small businesses to ignore the operating profit margin ratio and end up losing their margin and becoming insolvent. Please do not wait until the end of the year to determine your operating profit margin ratio. The key is to track the trends in this ratio as frequently as possible to decide whether or not you need to adjust your marketing strategy to improve your profit margin.

4. ***Farm Debt to Equity Ratio*** is yet another critical ratio observed by lenders when deciding whether to issue an additional loan or initial round of financing. The formula is *Debt to Equity Ratio = (Total Debt) / (Total Equity)*. The Debt to Equity Ratio for a healthy farm should not be above a level of 1.0. Thus, this is a critical ratio to watch and observe every quarter (or at least annually) if you want to borrow more money from your lender. In addition, equity and debt are two key figures in the financial statement because lenders and investors usually use these figures and their relationship to analyze the farm financial risk. The higher the ratio, the greater the risk to the creditor. At the bottom line, too much debt can put your business at risk, but too little debt may prevent your business from reaching its full potential by hurting overall profitability.

5. ***Term Debt Coverage Ratio*** is another ratio your lenders look to consider. The formula is *Term Debt Coverage Ratio = (Net Operating Income) / (Debt Service)*. Most lenders like to see this ratio greater than 1.5. If the ratio is 1.0, this means the business can pay the payment at least once every month or quarter, depending on the loan terms and conditions. From the lenders' standpoint, this ratio helps to determine the business's repayment ability. For the business owners, this ratio is also helpful to assess if there is adequate cash to make payment on the current loan.

This paper explores only five of the ratios the ND Farm Management Education program uses for its clients' financial analyses. If you bring us at least one current year's Income and Expense Report with Beginning and Ending Balance Sheets, we can put your information in our Finpack software and calculate your financial ratios. Afterward, we can compare your ratios to the Regional Averages or State Averages to see how you are doing financially compared with your peers. Also, we help you understand your ratios to benchmark your operation and track improvements in its financial health. If you bring us more than one year's worth of historical financial data about your business, then we can provide a historical trend for each ratio to see your financial performance in the past versus now. My advice is that work with your ND Farm Management Education instructor to prioritize your financial ratios based on your business's strengths and weaknesses and start tracking two or three regularly. A couple of ones you look at quarterly and a couple of ones you look at annually, so you know how things are going by using your ratios. If your ratios are trending in the right direction, keep it up; if not, make adjustments to your financial management practices to improve them. By monitoring your ratios, you are effectively and efficiently controlling and managing your farm or ranch business.

The North Dakota Farm Management Education Program provides lifelong learning opportunities in economic and financial management for persons involved in the farming and ranching business. Visit ndfarmmanagement.com, Facebook @NDFarmManagementEducation, or contact Craig Kleven, State Supervisor for Agricultural Education, at crkleven@nd.govor 701-328-3162 for more information. The ND Farm Management Education Program is sponsored by the North Dakota Department of Career and Technical Education.

- ### -