MARYLAND COOPERATIVE EXTENSION
UNIVERSITY OF MARYLAND
COLLEGE PARK • EASTERN SHORE

Fact Sheet

Fact Sheet 538

Diagnosing Your Farm's Financial Health

Should I spray my corn today? What ration should I feed my herd? Should I buy that new grain combine? What crops should I grow this year? As a farm manager, your business skills are put to the test constantly. You make decisions, and you weather the outcomes of these decisions. You have an awareness of how the business is doing, but at the same time, you need more tangible measurements of the performance of your business. You want to know the specific strengths and weaknesses of your farm business. This fact sheet gives you a brief overview of financial analysis. It begins with a checkup on the financial health of your farm and then discusses the implications of the checkup questions.

Check Your Farm's Financial Health

Test your farm's financial health by answering the following questions. Choose the answer that best represents your operation and enter that number in the blank provided.

1. Over the past five years, I have generated ________________.
   a. a profit most of the years
   b. a profit some of the years and a loss others
   c. a loss most of the years
   d. don't know

2. The returns on my labor and management are ________________.
   a. greater than I could get if I took a job off the farm
   b. about the same as I could get if I took a job off the farm
   c. less than I could get if I took a job off the farm
   d. don't know

3. My investment in the farm business is earning ________________.
   a. a greater return than what I would get if I invested elsewhere
   b. a similar return to what I could get if I invested elsewhere
   c. less than I could get if I took a job off the farm
   d. don't know

4. I have prepared _______ cash flow statement for my business.
   a. a detailed
   b. a quick or rough
   c. no

5. My liquidity reserve __________.
   a. is sufficient to cover periods of cash shortfalls
   b. is sometimes close to being depleted
   c. is dried up
   d. don't know

6. My level of operating debt has __________ the size of my operation in the past 3 years.

a. decreased in relation to

b. kept up with

c. increased more rapidly than

d. don't know

7. My net worth is ______________ it was 5 years ago.

a. more than

b. about the same as

c. less than

d. don't know

8. My total debt is ________ my total assets.

a. less than half

b. about half

c. more than half

d. don't know

9. I keep __________ accounting records, enterprise budgets, and financial statements for my family farming operation.

a. complete

b.partial

c. no

10. I have ____________.

a. assessed my financial condition as being good, and I am continually trying to improve my financial well-being

b. assessed my financial condition as being stable but have made few plans for improving my situation

c. assessed my financial condition as being poor but have considered ways of pulling myself out of the slump

d. not assessed my financial condition but have determined to continue to farm the way I do now, regardless of the outcome

Add your numerical choices and compare your total score with the following:

10–14 points

Your farm financial situation is strong and as a farm manager you have things well in control.

15–19 points

Your responses indicate there are some problem areas that need improvement.

20–24 points

You need to tackle the weak areas and to work on them immediately. Developing your managerial skills through farm business management education resources may help.

25–29 points

You have identified many problem areas. Work to strengthen your managerial skills. Get help from a farm management consultant or specialist to speed up your improvement timetable.

30–38 points

Count the number of times you responded "don't know." Familiarize yourself with these areas of your farm operation, then work on improving them with the help of a farm management consultant or specialist.

Analyzing Your Farm Business

Implications of the Checkup

The answers to the checkup questions carry implications for the financial well-being of the farm operation. When measuring the financial strength of your farm operation, you must consider three categories: *profitability, liquidity,* and *solvency.*

Profitability. Questions 1 to 3 deal with profitability, the measure of the amount of farm income over and above the expenses required to generate that income. The first question concerning profit is the most important of all 10 questions. A farm must generate a profit to survive in the long run. If your farm has been losing money for the past 5 years, it's time to seriously reevaluate your production, marketing, and financial plans.

Questions 2 and 3 concern the returns that you are earning on your labor, management, and investment in the farm business. In calculating profit, farm managers often leave out the value of their labor, management, and investment. Not only must farm income cover the direct expenses of the business, but it also must cover these resources that are sometimes taken for granted.

Fact Sheet 539, "Assessing and Improving your Farm Profitability," describes profit and profitability in more detail and suggests ways to improve your farm's performance in this area.

Liquidity. Questions 4, 5, and 6 address liquidity, which means the farm's ability to meet cash obligations without disrupting the normal operation of the farm. Cash obligations include family living draws, cash expenses, capital purchases, debt payments, and taxes. The best way to monitor liquidity is through cash flow planning using your cash flow statement.

Most farmers have periods when they are short of cash for paying bills. Cash receipts from commodities sold rarely coincide with cash expenditures. A credit reserve for borrowing money through these periods is needed to maintain the cash flow.

Monitoring debt over time provides an insight into cash flow problems. Through the production period, the operating loan will increase during certain times, but then it should also decrease as commodities are sold and the debt is reduced. Usually the level of the operating loan should not increase more than the growth of the farm business over several production periods. Loan carryovers that are larger with each successive production period may indicate cash flow problems. It may also indicate a more serious problem of low profitability.

Fact Sheet 541, "Assessing and Improving Your Farm Cash Flow," discusses liquidity and cash flow planning in more detail and suggests ways to improve your farm's performance in this area.

Solvency. Questions 7 and 8 deal with solvency and net worth. Solvency measures the farm's financial security. Net worth, which is the value left after subtracting liabilities from assets, is the absolute measure of solvency. By increasing net worth over time, farm managers accumulate wealth and increase financial security.

A relative measure of solvency can be made by comparing the level of liabilities with the level of assets. Many farm managers try to keep their level of total debt at less than half of their level of total assets. This provides a margin of safety in the event of bad years on the farm or in case of an economic downturn in agriculture.

Fact Sheet 540, "Assessing and Improving Your Farm Solvency," discusses net worth and solvency in more detail.

Recordkeeping and Financial Analysis. Question 9 deals with recordkeeping. Accounting records, including enterprise budgets and financial statements, are needed to summarize information about the farm operation. Incomplete records will only result in a poor financial analysis of your farm.

Fact sheet 542, "Developing and Improving Your Farm Records," gives a more detailed description of the types of farm records that you need to keep.

Question 10 evaluates your attitude towards financial analysis. As a farm manager, you have a great deal to gain by spending time in your office to review the financial condition of the farm. Time you spend in the office will help you make production, marketing, and financial decisions.

Interrelating Profitability, Liquidity, and Solvency

Profitability, liquidity, and solvency are all areas of concern for the farm manager. The operation that is strong in one of these areas is often strong in the other areas as well. Profitability drives liquidity and solvency. A profitable farm will usually overcome liquidity and solvency problems in the long run, while an unprofitable farm will nearly always develop liquidity and solvency problems.

People often confuse probability with cash flow and vice versa. Some farm managers who experience cash flow problems think that their farm is not generating any profit. Likewise, some farm managers who have a positive cash flow have the impression that their operation is profitable. Neither of these assumptions is necessarily true. You cannot equate profits with cash flow.

For example, a farm that generates an annual profit of $35,000 could have problems covering taxes and family living costs of $20,000 and coming up with another $20,000 to pay the principal on the farm mortgage.

That principal payment is not an expense since it is money that is going back into the growth of the farm business. Yet the principal payment causes a cash flow problem even if the farm is profitable.

On the reverse side of the coin is the farmer with a substantial net worth created by the inflationary market value of assets or by a previous period of prosperity. With a large credit reserve, the farmer continues to borrow more and more operating money each year to finance the operation and to support the family. There is no cash flow problem here because of the ample credit reserve, yet the farm is not profitable and may lose its net worth in the long run.

A similar example is that of the farmer who does not set aside money for replacing equipment as it wears out. Even if the value of the equipment is depreciated when calculating profit, if that amount is not set aside and is used instead for family consumption or other expenditures, the farm could run into cash flow problems when a piece of machinery needs to be replaced. The farm may be generating a profit, but the family is living off the depreciation value of the equipment. In other words, the family is spending at a level that is out of line with the level of profit generated by the farm.

Going for Help

Maryland Cooperative Extension is a good source of information about farm financial analysis. Extension agents in all 23 Maryland counties are available to help and answer your questions about the financial analysis of your farm. Their knowledge is reinforced by regional and state specialists who have expertise in this area. You also can attend educational seminars, sponsored by Extension, on the subject. Computer programs, such as the FINPACK farm financial planning and analysis program, improve the financial analysis of the farm business. Publications, such as those mentioned in this fact sheet, provide useful information and are available at county Extension offices.

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