PURDUE EXTENSION
pork industry handbook

Fiscal Fitness: Liquidity

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Introduction

Businesses all across the country have a need to be able to generate a cash flow to operate on for the year or period being looked at. At any given point in time we have measures that give us an exact position of the business. One of the measures is liquidity, which has two key component measures. These are working capital and current ratio, which are measures at a given point in time. In many businesses there are times when it may be difficult to meet all financial obligations due during the period being looked at. Good financial managers want to know about these points in time to be able to have made product sales or an operation loan to handle it. The use of these measures will help producers to better understand the financial position he is at a given time. This fact sheet will help a producer to interpret their liquidity using both measures, working capital and current ratio.

Liquidity

Liquidity is the ability of the farm business to generate sufficient cash flow for all farm expenses to be paid; the remaining net cash farm income should be sufficient to provide for family living, pay the taxes and all loan payments in addition to providing adequate capital to replace machinery and equipment.

Liquidity is the ability of the business to generate cash to meet its financial obligations as they come due during the year. Liquidity implies the ability to convert assets into cash or obtain cash. Liquidity refers to less than one year or the normal operation cycle of the business, whichever is longest. The two measures most often associated with liquidity are the amount of working capital and your business's current ratio. Many managers feel a business should have enough cash available in working capital to cover 5-8 months of operations expenses; this will vary with the type of business. The business should generate enough cash flow to pay family living, business expenses, taxes, capital items, and debt payments on time. This should be viewed on both the cash and accrual basis of the business. As a business is growing oftentimes the liquidity on a cash basis may seem weak, but the accrual position, adjusted for the increase in inventories will show a more accurate picture. Unanticipated events such as adverse weather or price conditions which produce economic losses or new investment opportunities may make it difficult to meet cash demands. Timely payment of the obligations of the business, including principal and interest on debt without disrupting the normal operation, is an indication that the business is liquid.

Current Ratio Is a Measure of Liquidity; What Does the Ratio Mean?

This ratio shows the value of current assets relative to current liabilities. One should remember that this is the inverse of the current percent in debt measure when looking at solvency measures. It is a relative measure rather than an absolute dollar measure. The higher the ratio the greater the liquidity of the business.

Current Ratio

Calculated as (total current farm assets) / (total current farm liabilities). This measure of liquidity reflects the extent to which current farm assets, if sold tomorrow, would pay off current farm liabilities.

This ratio shows the value of current assets relative to current liabilities. It is calculated by dividing the total current farm assets by the total current farm liabilities. One should remember that this is the inverse of the current percent in debt measure when looking at solvency measures. It is a relative measure rather than an absolute dollar measure. The higher the ratio the greater the liquidity of the business.

Calculate: Current Ratio

Total Current Farm Assets/Total Current Farm Liabilities = Current Ratio

$322,014 / $246,712 = 1.30522

Current Ratio is expressed as 1.31 : 1

My Farm _____ / _____ = _____

My Farm Current Ratio is _____ : 1

Working Capital Is a Measure of Liquidity; What Does It Tell Me About My Business?

This tells us the amount of operating funds we have available to meet the normal monthly expenses of the business. You can calculate how many months your business can function from funds from within the business. The amount of working capital considered adequate must be related to the type and size of the business. Seasonal borrowings and repayment of credit lines will cause this measure to fluctuate in value during the year.

Current farm assets normally include cash, marketable securities, accounts receivable, and inventories. Current farm liabilities include accounts and short-term notes payable, interest and principal payments on long-term debt, accrued income taxes and other accrued expenses. The ratio indicates the extent to which current farm assets, if liquidated, would cover current farm liabilities. If the ratio is greater than 1.0, the farm is considered liquid. The higher the ratio, the greater the liquidity. If less than 1.0, the farm is considered not liquid, indicating some degree of cash flow risk. A more careful evaluation of the cash flow statement would be appropriate, given this indication of a possible liquidity problem.

Including deferred taxes is a conservative approach to calculating the current ratio; however, it recognizes that if all current farm assets are sold during the next year, the deferred taxes would be owed. It is better for the producer and lender to be aware of the contingent liability and to determine its potential impact, than to ignore the tax implications of selling assets. Generally, lenders and analysts like to see a current ration of 1.5 to 2.0, when using the market value approach, excluding deferred taxes.

The preferred current ratio varies by type of business. If the objective is to maximize profitability, a high current ratio might indicate the business is sacrificing income by emphasizing low-yielding current assets, such as cash or savings account.

Working Capital

Calculated as (total current farm assets) – (total current farm liabilities). This measure represents the short-term operating capital available from within the business.

Working capital is calculated by subtracting total current liabilities from current farm assets, and is expressed as an absolute dollar amount. It is the amount of cash left to purchase inputs and inventory items if the business sold all current assets and paid all current liabilities. Generally, working capital should be positive, but the amount needed depends upon the type and size of business. Seasonal borrowing and

repayment of credit lines or operating notes will cause this measure to fluctuate in value during the year. Because current farm liabilities include liabilities due within the coming year, and some farms have relatively few current assets, operations generally can be maintained even with negative working capital. Nevertheless, negative working capital indicates a potential liquidity problem that should be subject to further evaluation.

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Balance sheet measures of liquidity, such as working capital and current ratio, cannot totally evaluate the ability of a business to meet cash commitments. To overcome the limitations associated with a liquidity measurement at a point in time, these ratios should be used with repayment capacity measures and the cash flow statement. This allows a more complete analysis of the liquidity position of the business.

Calculate: Working Capital

Total Current Farm Assets – Total Current Farm Liabilities = Working Capital

$322,014 - $246,712 = $75,302 Working Capital

My Farm _____ - _____ = _____ Working Capital

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