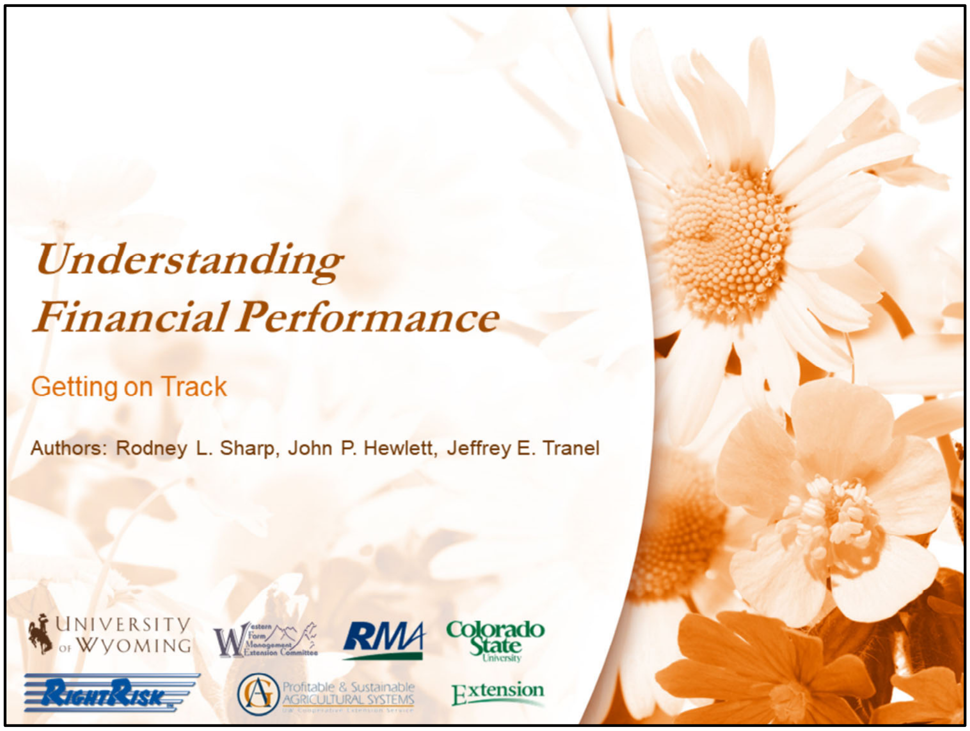
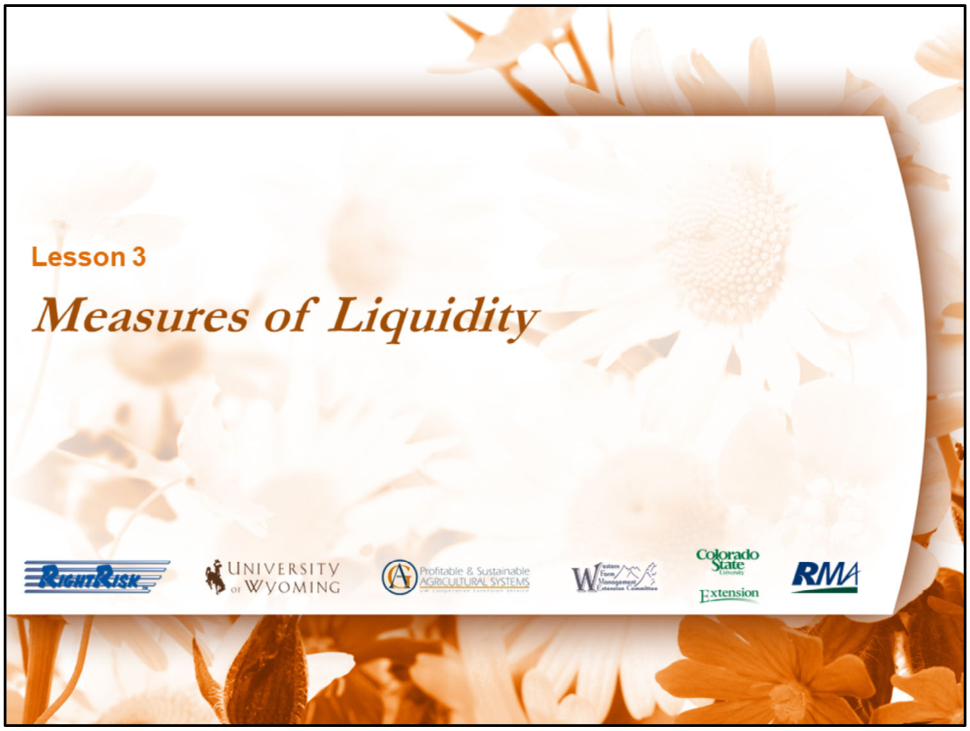
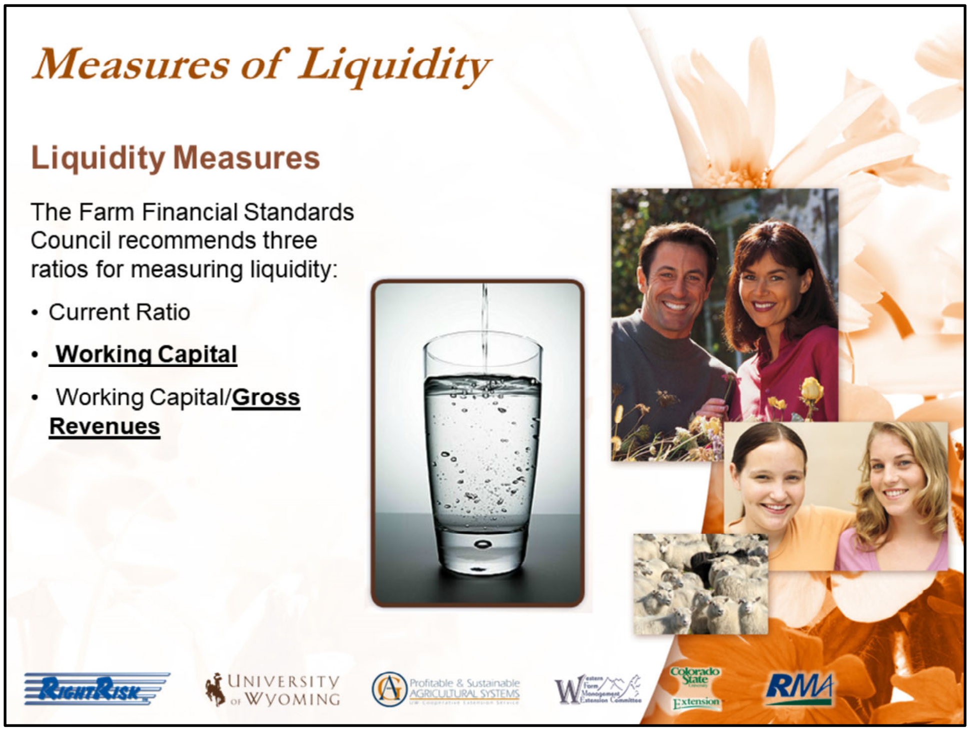


Audio:

Welcome to Getting on Track: Understanding Financial Performance. In this course you will learn how to analyze the health of your business using financial ratios.

Click the next arrow to start at the beginning of the course or click the Menu link to select a lesson from the Main Menu. We recommend that you view the lessons in order the first time through the course.


Lesson 3
Measures of Liquidity



Audio:

Liquidity refers to your ability to maintain cash flow and pay your bills on time.

The Farm Financial Standards Council recommends three ratios for measuring liquidity: the Current Ratio, Working Capital, and the Working Capital to Gross Revenues ratio.

In this lesson, you will learn how to calculate and evaluate the Current and Working Capital ratios.

Measures of Liquidity

Liquidity Measures

The Farm Financial Standards Council recommends three ratios for measuring liquidity:

- Current Ratio
- **Working Capital**
- Working Capital/**Gross Revenue**

Working Capital is a measure of the amount of funds available to purchase inputs and inventory items after the sale of current farm assets and payment of all current farm liabilities.

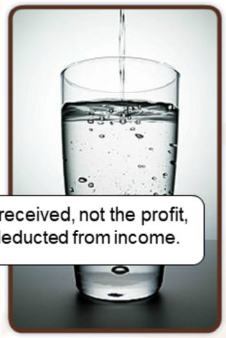
Measures of Liquidity

Liquidity Measures

The Farm Financial Standards Council recommends three ratios for measuring liquidity:

- Current Ratio
- **Working Capital**
- Working Capital/**Gross Revenues**

Gross Revenues are the total received, not the profit, and does not show expenses deducted from income.



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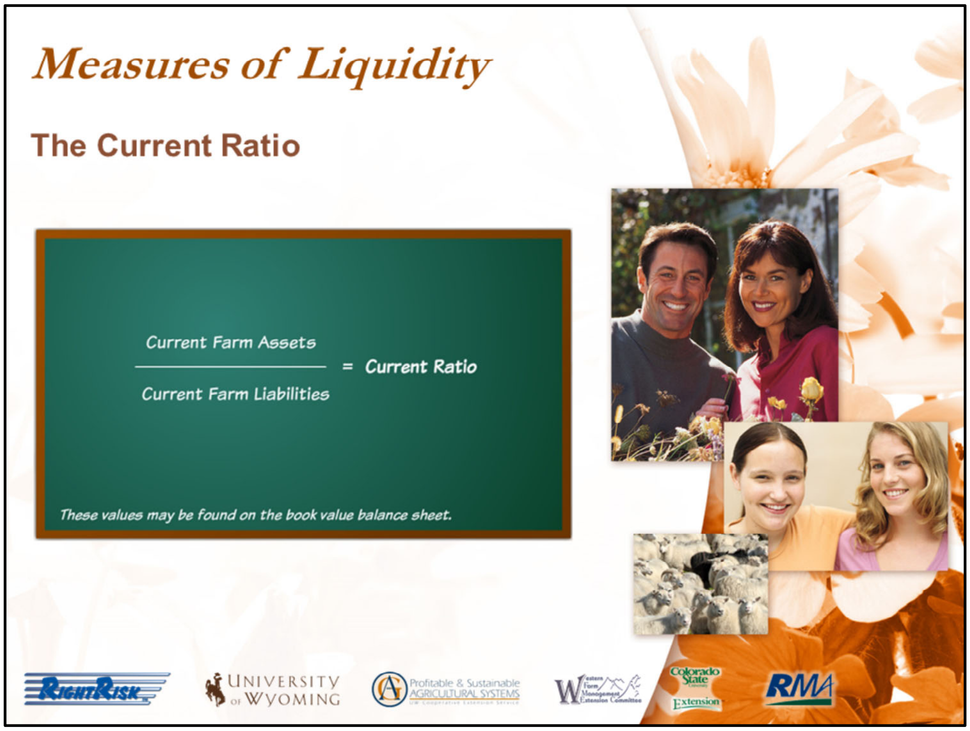
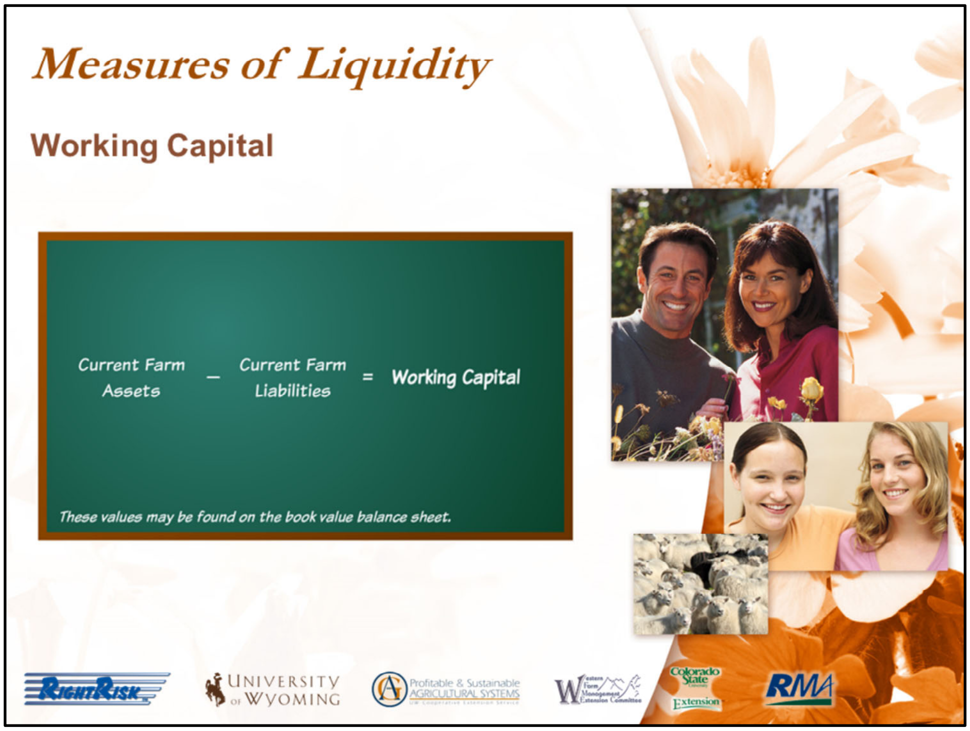


Audio:

The Current Ratio is calculated by dividing current farm assets by the current farm liabilities.

Both of these values can be found on the balance sheet.

The results of this calculation will help you determine if there is sufficient cash flow in your business to meet all short-term financial obligations; in other words, to pay bills on time without disrupting the normal operations of the business.

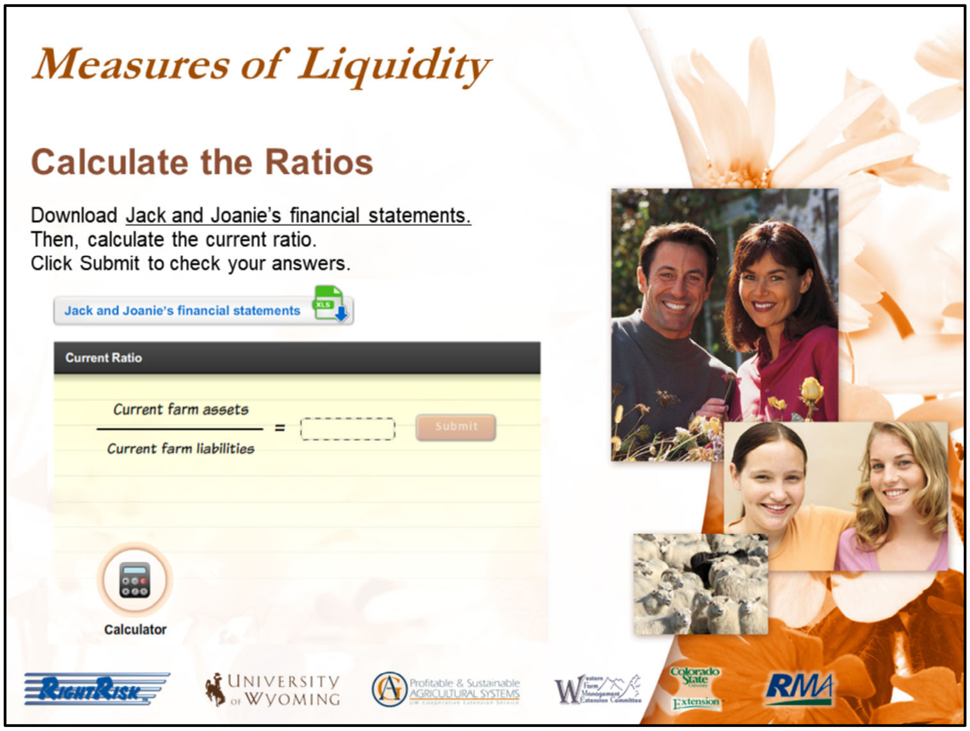


Audio:

The Working Capital ratio is similar to the Current Ratio and uses the same values. However, it is calculated by subtracting current farm liabilities from current farm assets.

Both of these values can be found on the balance sheet.

The Working Capital ratio provides another way to determine if there is sufficient cash flow to meet all short-term financial obligations.



Audio:

Now, try calculating the ratios. Click on the link to download Jack and Joanie's financial statements. Then, calculate Jack and Joanie's current ratio for example year 10 using book value sheet information.

Click the calculator icon to access a calculator tool.

Click Submit to check your answer.

Measures of Liquidity

Calculate the Ratios

Download Jack and Joanie's financial statements.
Then, calculate the current ratio.
Click Submit to check your answers.

Jack and Joanie's financial statements

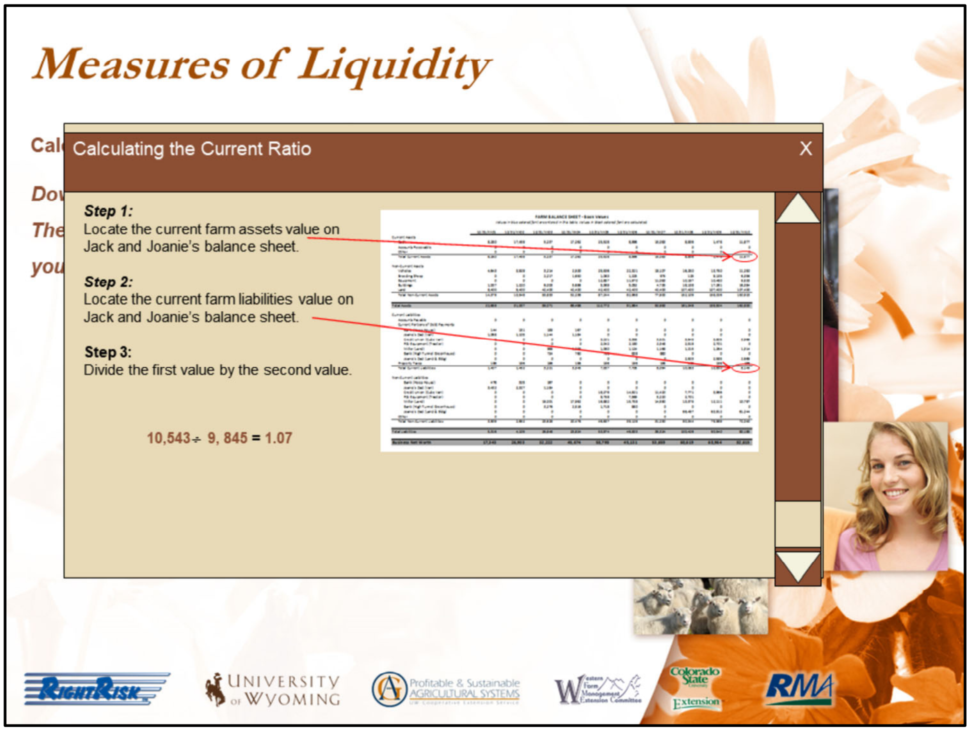
Current Ratio

$$\frac{\text{Current farm assets}}{\text{Current farm liabilities}} = 1.07$$

Submit

That's correct!. You have correctly calculated Jack and Joanie's Current Ratio.

Calculator



Measures of Liquidity
Calculating the Current Ratio
X
Step 1:
Locate the current farm assets value on Jack and Joanie's balance sheet.
Step 2:
Locate the current farm liabilities value on Jack and Joanie's balance sheet.
Step 3:
Divide the first value by the second value.
10,543 ÷ 9, 845 = 1.07
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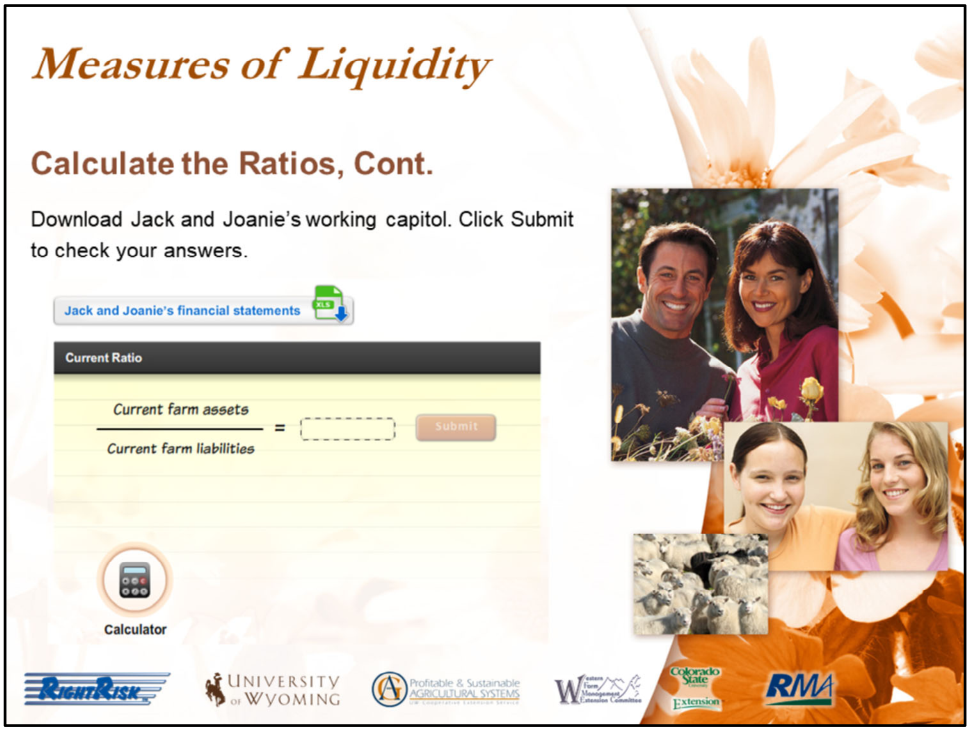

Audio:

Now, try calculating Jack and Joanie's working capital. Click the calculator icon to access a calculator tool.

Click Submit to check your answer.

Measures of Liquidity

Calculate the Ratios, Cont.

Download Jack and Joanie's working capitol. Click Submit to check your answers.

Working Capital

Current farm assets – *Current farm liabilities* = 698 Submit

That's correct!. You have correctly calculated Jack and Joanie's Current Ratio.

Calculator

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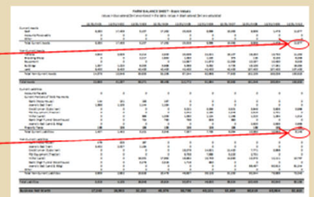
Measures of Liquidity

Calculate the Ratios, Cont.

Calculate Jack and Joanie's working capital. Click Submit to check your answers.



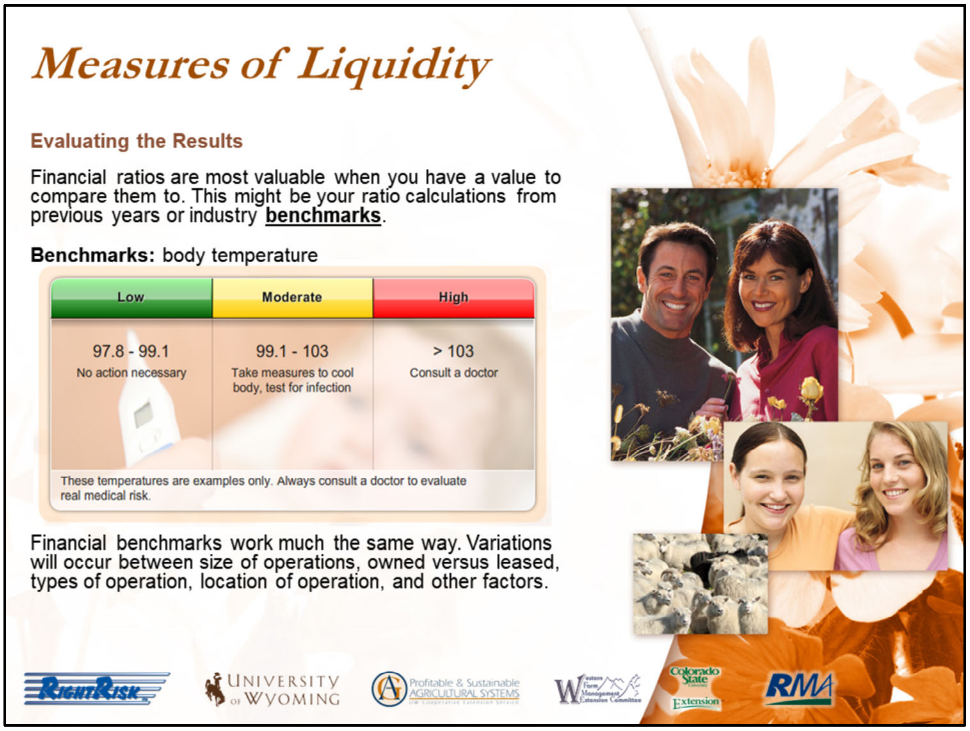
Calculating Working Capital

Step 1:
Locate the current farm assets value on Jack and Joanie's balance sheet.

Step 2:
Locate the current farm liabilities value on Jack and Joanie's balance sheet.

Step 3:
Subtract the second value from the first value.

10,543 - 9,845 = 698



Audio:

Financial ratios are most valuable when you have something to compare them to. This might be ratio calculations from previous years or industry benchmarks.

Benchmarks are guidelines or general rules of thumb related to a specific industry. For instance, a normal body temperature is between 97.8 and 99.1 degrees F.

However, body temperature can vary with age, geographical location, sleep/wake cycles and other variables. Thus, there is no single temperature that can be considered normal. The benchmark range simply allows a doctor to interpret the measurement and to decide if further action is required.

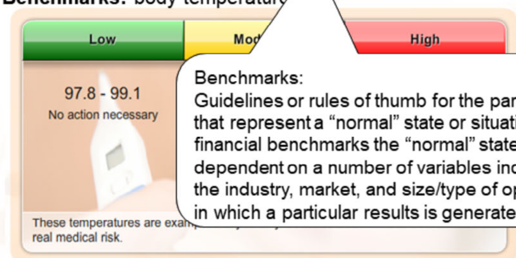
Financial benchmarks work much the same way.

Measures of Liquidity

Evaluating the Results

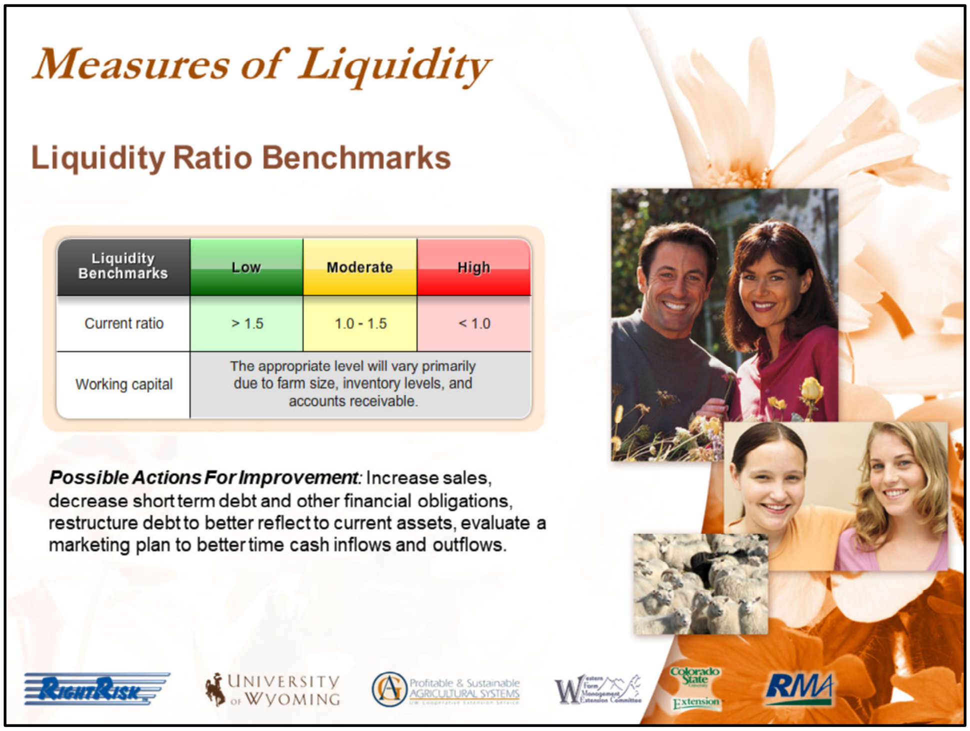
Financial ratios are only valuable when you have a value to compare them to. This might be your ratio calculations from previous years or industry **benchmarks**.

Benchmarks: body temperature



Benchmarks:
Guidelines or rules of thumb for the parameters that represent a "normal" state or situation. In financial benchmarks the "normal" state is dependent on a number of variables including the industry, market, and size/type of operation in which a particular results is generated.

Financial benchmarks work much the same way. Variations will occur between size of operations, owned versus leased, types of operation, location of operation, and other factors.

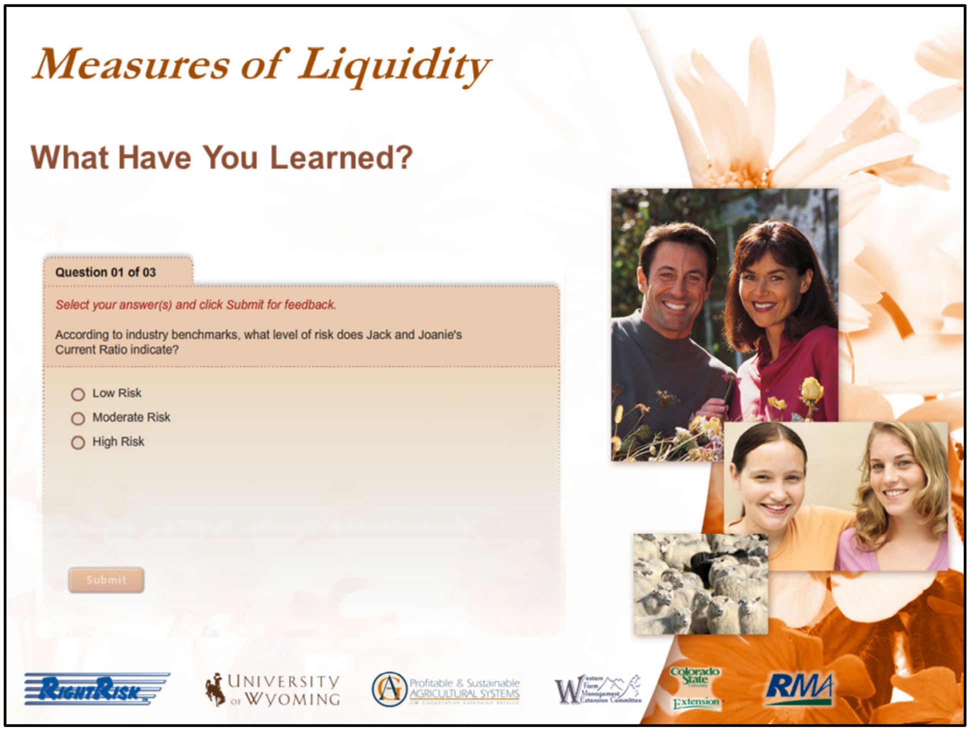


Audio:

Some benchmarks for liquidity ratio values are shown on screen.
The benchmarks are meant to be only a guideline for comparison purposes.

The correlated benchmarks are presented in terms of green, yellow, and red lights. A green light represents a financial strength with low risk. A yellow light corresponds to moderate risk, and a red light means weakness and high risk. A green light doesn't guarantee success, nor does a red light imply failure. A weakness in one area may be overcome by strengths in other areas.

Each farm operator should establish specific benchmarks for their specific farm situation.



Audio:

Check what you have learned about measures of liquidity by answering the questions on screen. Click Submit to check your answers.

Measures of Liquidity

What Have You Learned?

Question 01 of 03

Select your answer(s) and click Submit for feedback.

According to industry benchmarks, what level of risk does Jack and Joanie's Current Ratio indicate?

- ○ Low Risk
- ✓ ◉ Moderate Risk
- ○ High Risk

Submit   Next Question

That's correct!
Jack and Joanie's Current Ratio is in the moderate risk range.

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Measures of Liquidity

What Have You Learned?

Question 02 of 03

Select your answer(s) and click Submit for feedback.

What can Jack and Joanie do to improve this ratio?

- ☐ Increase the value of current assets
- ☐ Increase operating debt
- ☐ Decrease operating debt
- ☐ Decrease the value of inventories

Submit

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Measures of Liquidity

What Have You Learned?

Question 02 of 03

Select your answer(s) and click Submit for feedback.

What can Jack and Joanie do to improve this ratio?

- [x] Increase the value of current assets
- [ ] Increase operating debt
- [x] Decrease operating debt
- [ ] Decrease the value of inventories

Submit

Next Question

That's correct!
Increasing the value of current assets or decreasing the operating debt will improve the current ratio.

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Measures of Liquidity

What Have You Learned?

Question 03 of 03

Select your answer(s) and click Submit for feedback.

What actions can you take to increase the value of current assets or decrease operating debt?

- [ ] Renegotiate short-term debt interest rates
- [ ] Reduce account payables over time
- [ ] Buy supplies with a credit card
- [ ] Take cash out of the business for personal use

Submit

Measures of Liquidity

What Have You Learned?

Question 03 of 03

Select your answer(s) and click Submit for feedback.

What actions can you take to increase the value of current assets or decrease operating debt?

- [x] Renegotiate short-term debt interest rates
- [x] Reduce account payables over time
- [ ] Buy supplies with a credit card
- [ ] Take cash out of the business for personal use

Submit

That's correct!
Renegotiating interest rates or reducing account payables will achieve these results.