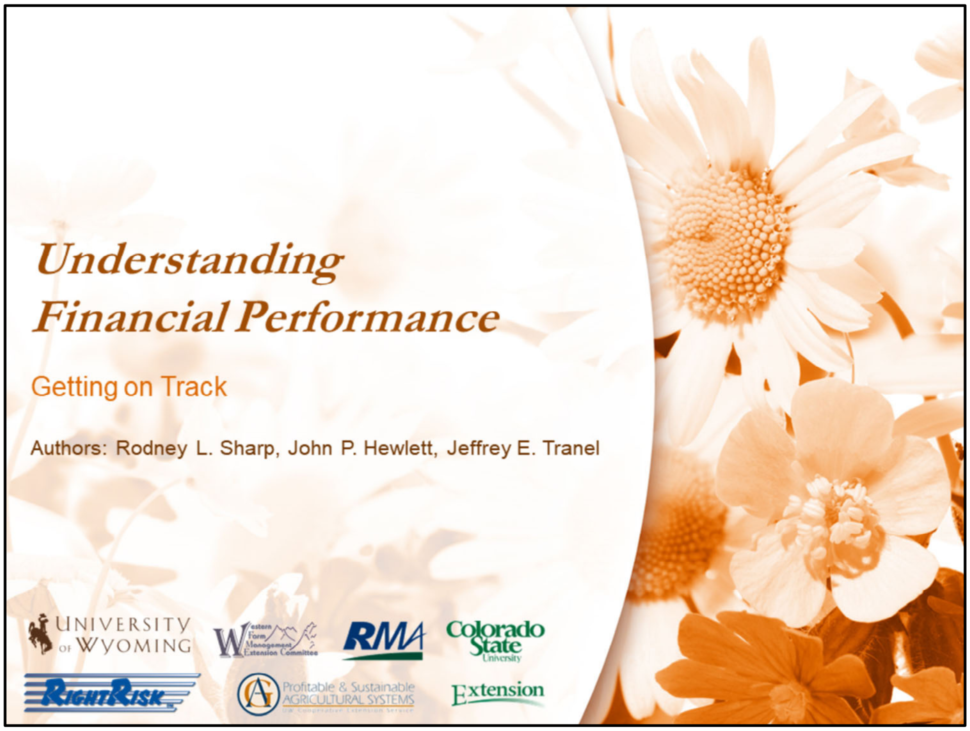


Audio:

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 7

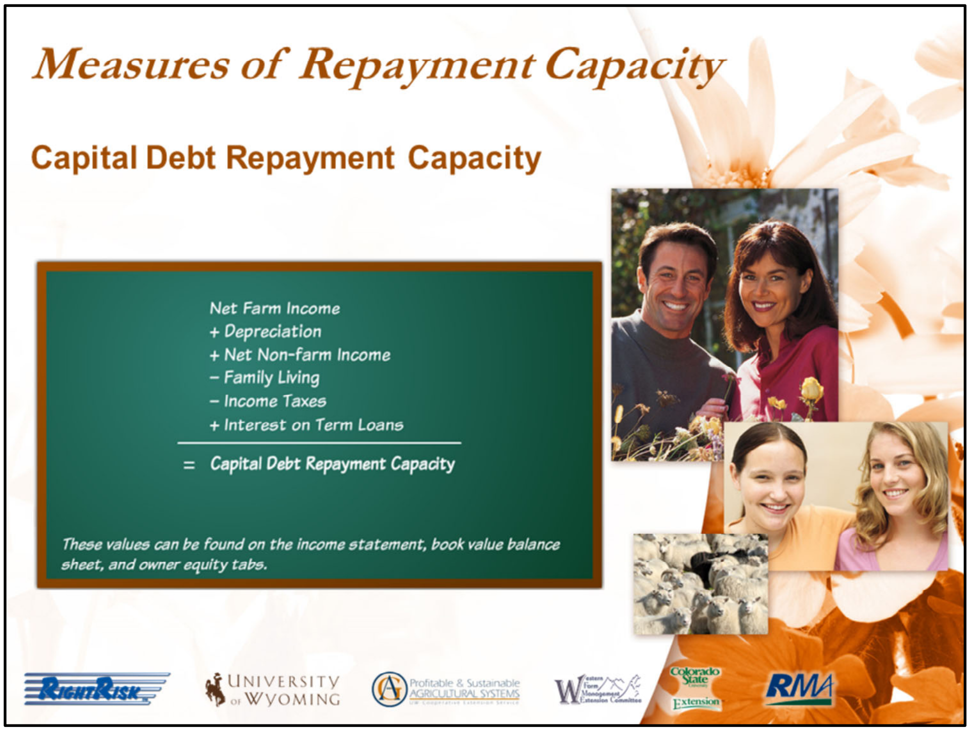
Measures of Repayment Capacity

Audio:

Repayment capacity refers to the ability of a borrower to repay term farm debt from farm and non-farm income.

The Farm Financial Standards Council recommends five ratios for measuring repayment capacity: Capital Debt Repayment Capacity, Term Debt and Capital Lease Coverage Ratio, Capital Debt Repayment Margin, Replacement Margin, and Replacement Margin Coverage Ratio.

In this lesson, you will learn how to calculate and evaluate the Capital Debt Repayment Capacity and Term Debt and Capital Lease Coverage ratio.

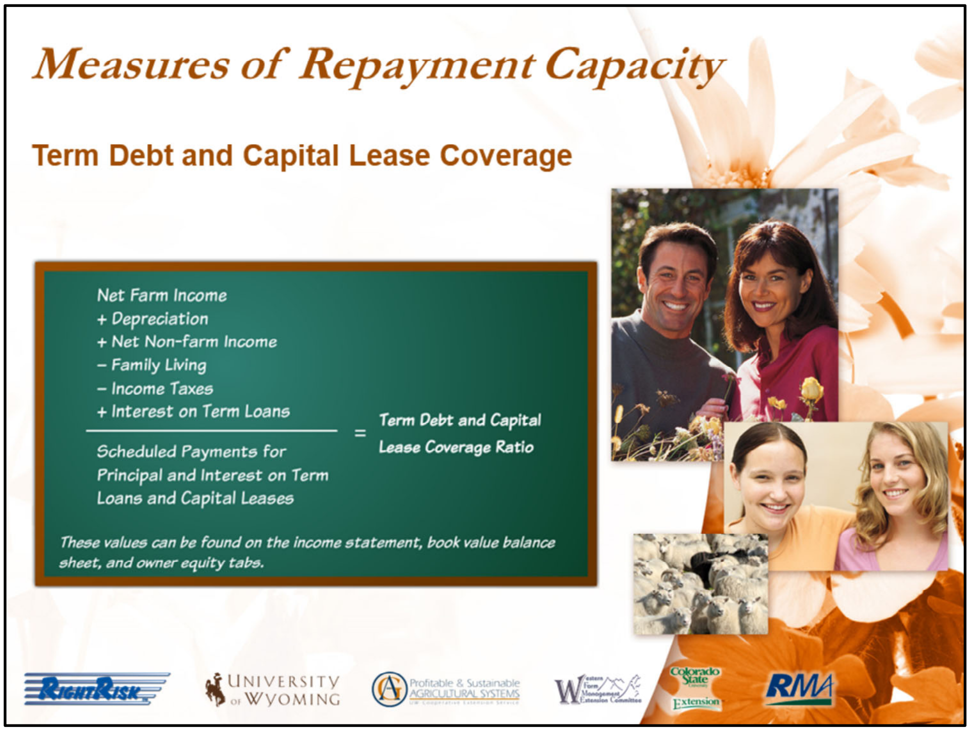


Audio:

Capital Debt Repayment Capacity is calculated with the formula shown on screen.

These values can be found on the income statement, balance sheet, and family financial records.

The results of this calculation indicate the amount of funds available to cover debt and lease payments or to make alternative investments.

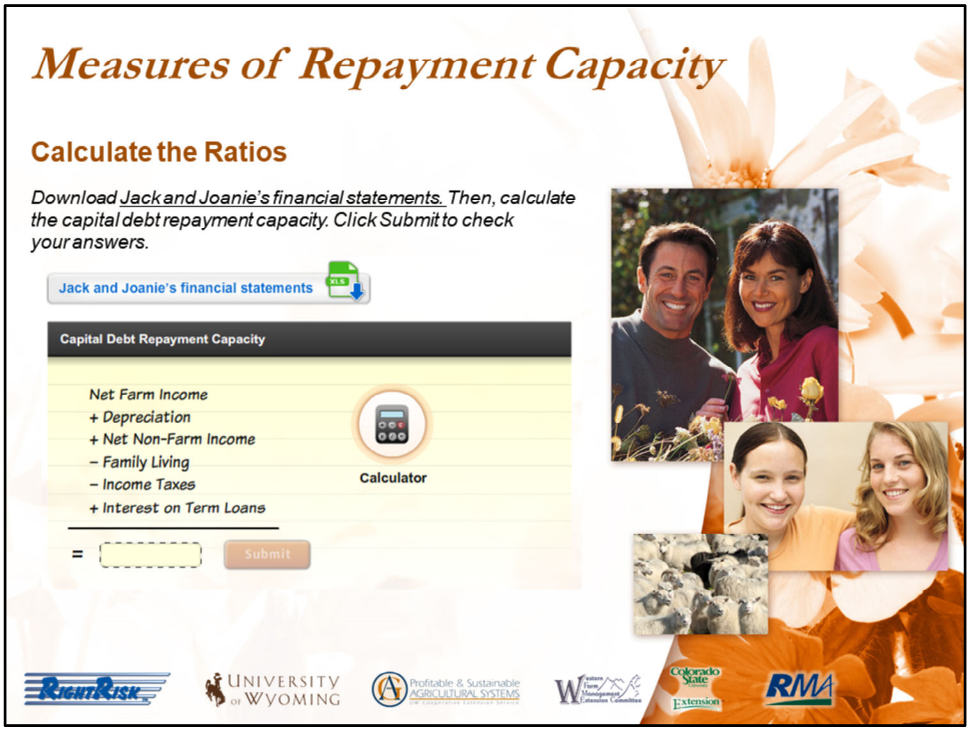


Audio:

The Term Debt and Capital Lease Coverage ratio is calculated with the formula shown on screen.

These values can be found on the income statement, balance sheet, and family financial records.

The Term Debt and Capital Lease Coverage ratio measures the ability of the business to cover debt and lease payments, replace assets, or make alternative investments.



Audio:

Now, try calculating the ratios. Click on the link to download Jack and Joanie's financial statements. Then, calculate Jack and Joanie's capital debt repayment capacity. Click the calculator icon to access a calculator tool.

Click Submit to check your answer.

Measures of Repayment Capacity

Calculate the Ratios

Download Jack and Joanie's financial statements. Then, calculate the capital debt repayment capacity. Click Submit to check your answers.

Jack and Joanie's financial statements

Capital Debt Repayment Capacity

Net Farm Income
+ Depreciation
+ Net Non-Farm Income
– Family Living
– Income Taxes
+ Interest on Term Loans

= 20136 Submit

Calculator

That's correct!. You have correctly calculated Jack and Joanie's capital debt repayment capacity.

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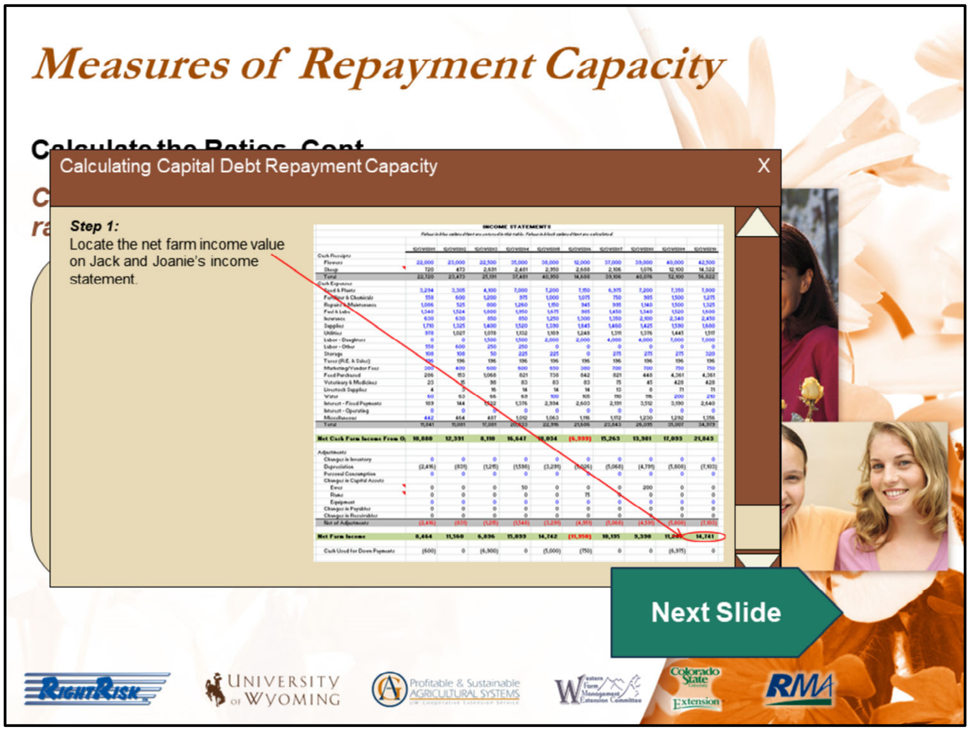
Measures of Repayment Capacity
Calculate the Ratios, Cont.
Calculating Capital Debt Repayment Capacity
X
Step 1:
Locate the net farm income value on Jack and Joanie's income statement.
INCOME STATEMENTS
Next Slide
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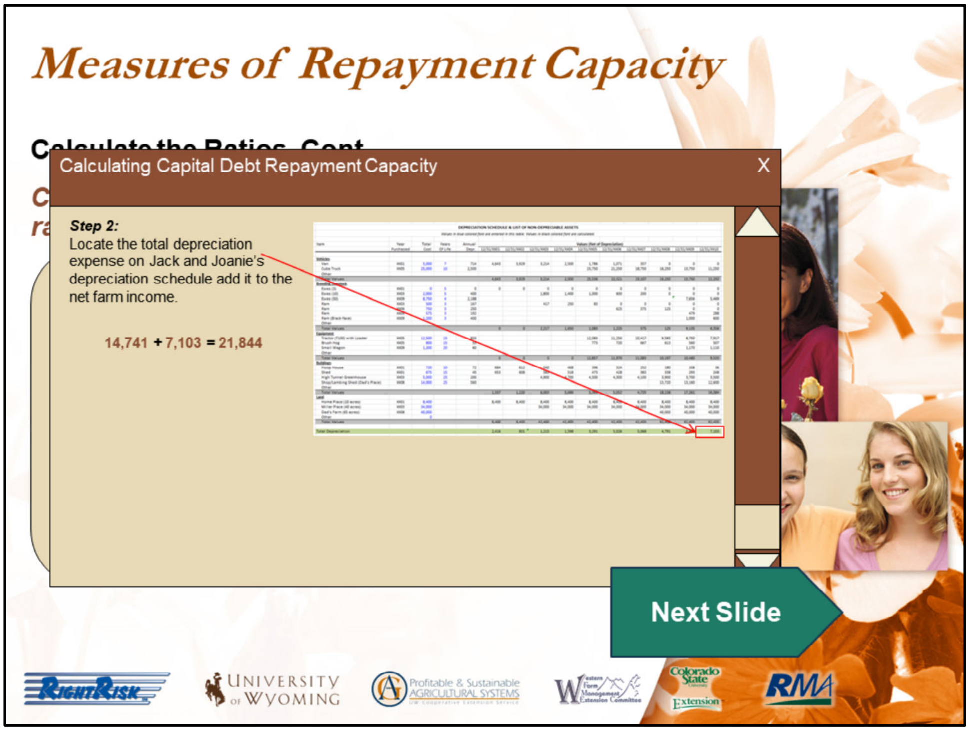

Measures of Repayment Capacity
Calculating Capital Debt Repayment Capacity
X
Step 2:
Locate the total depreciation expense on Jack and Joanie's depreciation schedule add it to the net farm income.
14,741 + 7,103 = 21,844
Next Slide

Measures of Repayment Capacity

Calculate the Ratios, Cont.

Calculating Capital Debt Repayment Capacity

X

Step 3:
Locate the non-farm income value on Jack and Joanie's statement of owner equity and add that to the previous total.

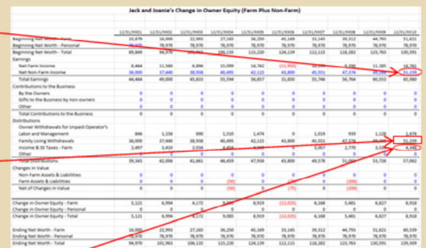
21,844 + 51,239 = 73,083

Step 4:
Locate the total family living expenses on the statement of owner equity and subtract it from the result of Step 3.

73,083 – 51,239 = 21,844

Step 5:
Subtract the amount recorded for income taxes from the total.

21,844 – 4,348 = 17,496



Next Slide

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Measures of Repayment Capacity

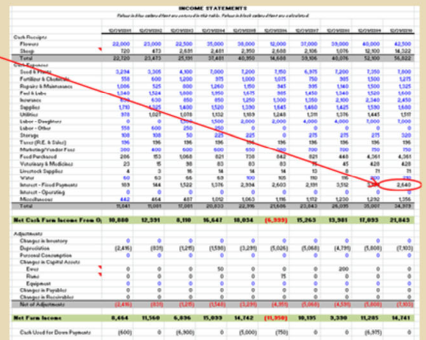
Calculate the Ratios, Cont.

Calculating Capital Debt Repayment Capacity

Step 6:

Add the amount for interest on long-term debts on Jack and Joanie's income statement to arrive at the capital debt repayment capacity.

17,496 + 2,640 = 20,136



Audio:

Now, try calculating Jack and Joanie's term debt and capital lease coverage ratio using information from the income statement, book value balance sheet, and family financial records for example year 10.

Click the calculator icon to access a calculator tool.

Click Submit to check your answer.

Measures of Repayment Capacity

Calculate the Ratios, Cont.

Calculate Jack and Joanie's term debt and capital lease coverage ratio. Click Submit to check your answers.

Term Debt and Capital Lease Coverage

Net Farm Income
+ Depreciation
+ Net Non-Farm Income
− Family Living
− Income Taxes
+ Interest on Term Loans

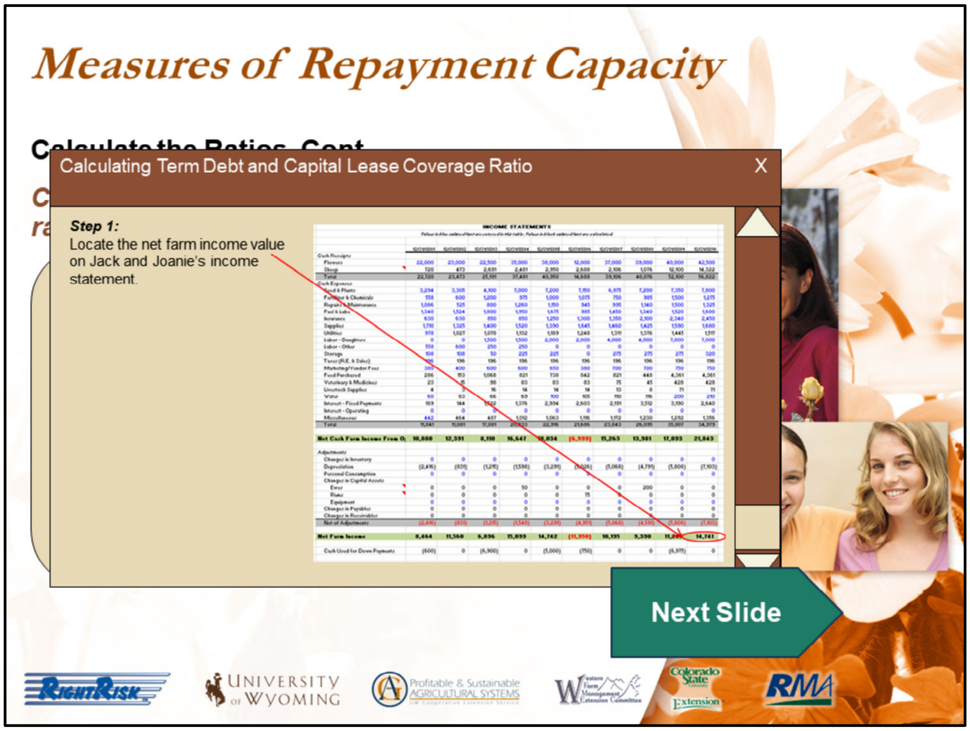
Calculator

divided by

Scheduled Payments for Principal and Interest on Term Loans and Capital Leases

= 1.64 Submit

That's correct!. You have correctly calculated Jack and Joanie's term debt and capital lease coverage.


Measures of Repayment Capacity
Calculating Term Debt and Capital Lease Coverage Ratio
X
Step 1:
Locate the net farm income value on Jack and Joanie's income statement.
INCOME STATEMENTS
Net Farm Income
Next Slide
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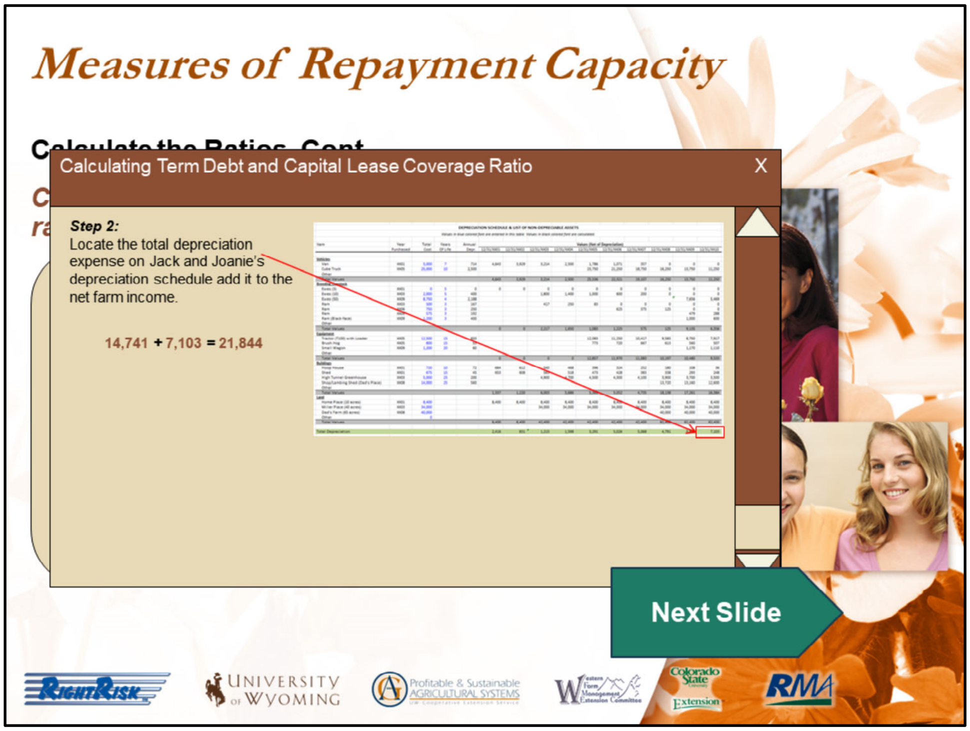
Measures of Repayment Capacity
Calculate the Ratios, Cont.
Calculating Term Debt and Capital Lease Coverage Ratio
X
Step 2:
Locate the total depreciation expense on Jack and Joanie's depreciation schedule add it to the net farm income.
14,741 + 7,103 = 21,844
DEPRECIATION SCHEDULE & LIST OF NON-DEPRECIABLE ASSETS
Next Slide
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Measures of Repayment Capacity

Calculate the Ratios, Cont.

Calculating Term Debt and Capital Lease Coverage Ratio

Step 3:
Locate the non-farm income value on Jack and Joanie's statement of owner equity and add that to the previous total.

21,844 + 51,239 = 73,083

Step 4:
Locate the total family living expenses on the statement of owner equity and subtract it from the result of Step 3.

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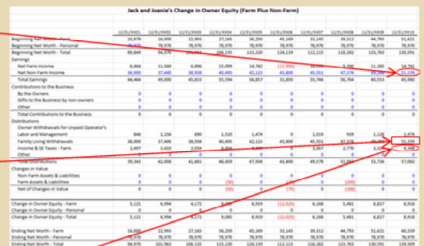

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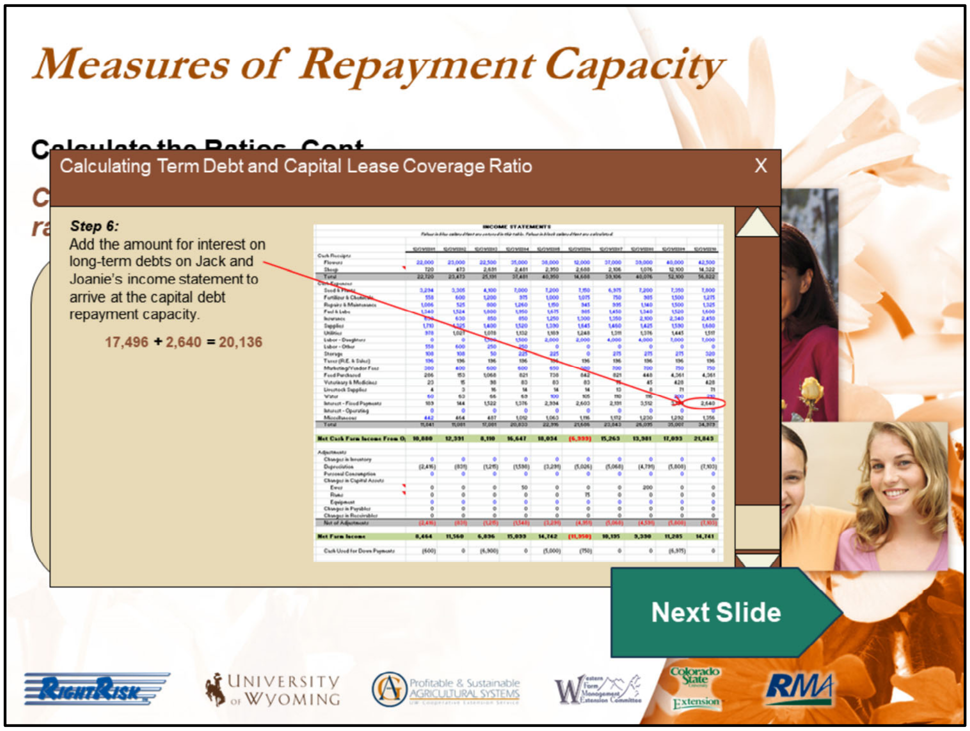
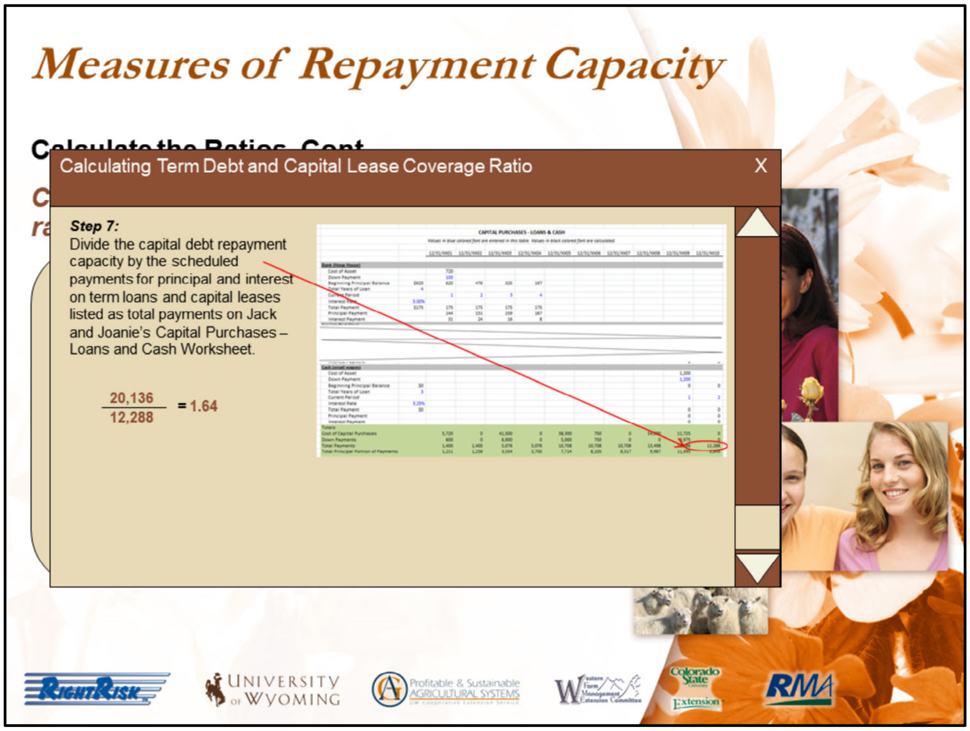

Measures of Repayment Capacity
Calculating Term Debt and Capital Lease Coverage Ratio
X
Step 6:
Add the amount for interest on long-term debts on Jack and Joanie's income statement to arrive at the capital debt repayment capacity.
17,496 + 2,640 = 20,136
INCOME STATEMENTS
Next Slide


Measures of Repayment Capacity
Calculating Term Debt and Capital Lease Coverage Ratio
X
Step 7:
Divide the capital debt repayment capacity by the scheduled payments for principal and interest on term loans and capital leases listed as total payments on Jack and Joanie's Capital Purchases – Loans and Cash Worksheet.
20,136
12,288
= 1.64
CAPITAL PURCHASES - LOANS & CASH
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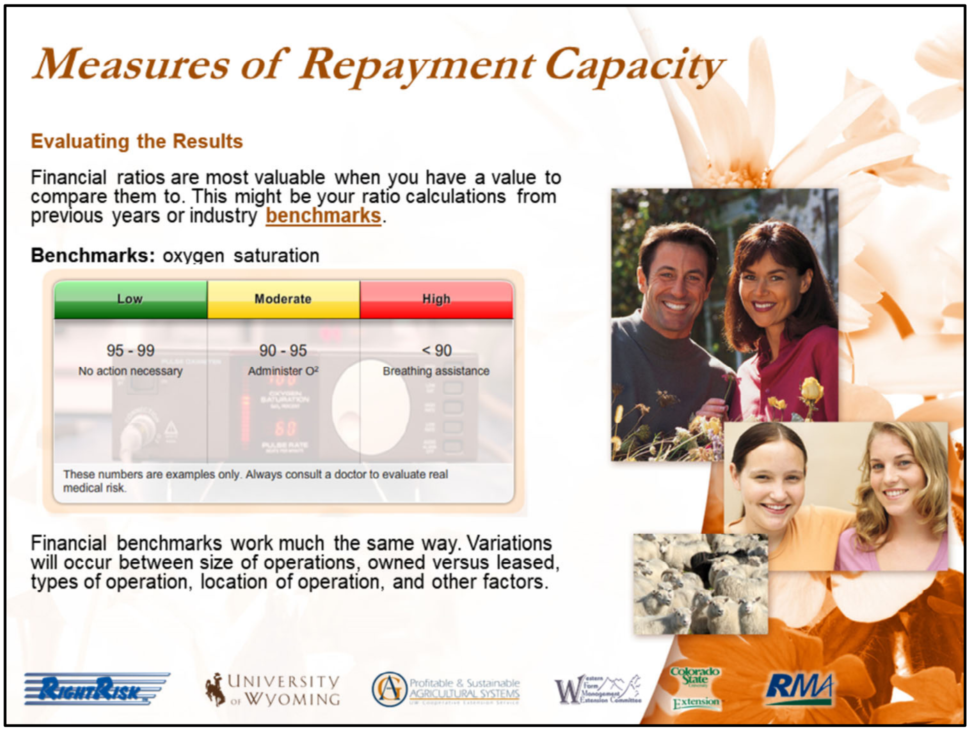


Audio:

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 oxygen saturation level is between 95-99 percent. However, the level can vary with age, general health, and other variables. Thus, there is no single oxygen saturation percentage that can be considered normal. The benchmark range simply allows a doctor to interpret the measurement and to decide if further action is required.

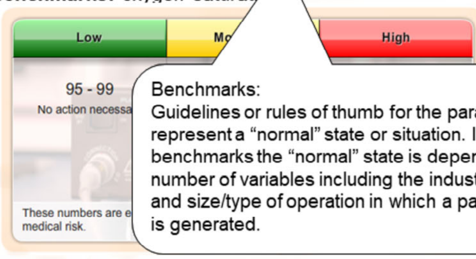
Financial benchmarks work much the same way.

Measures of Repayment Capacity

Evaluating the Results

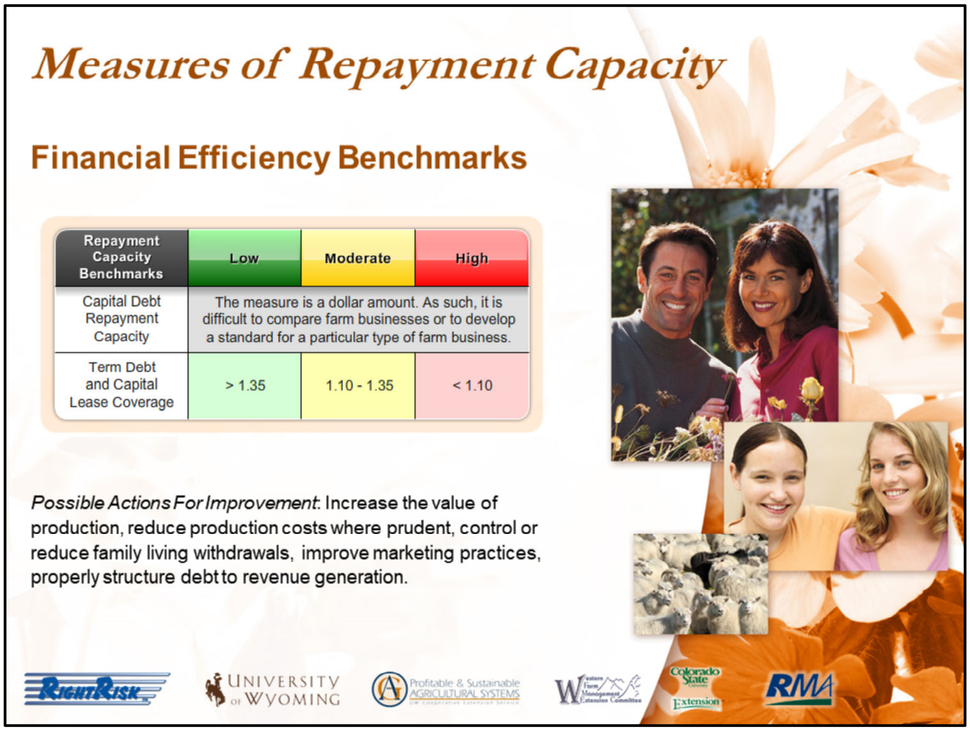
Financial ratios are most valuable when you have a value to compare them to. This might be your ratio calculations from previous years or industry **benchmarks**.

Benchmarks: oxygen saturation



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 result 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.



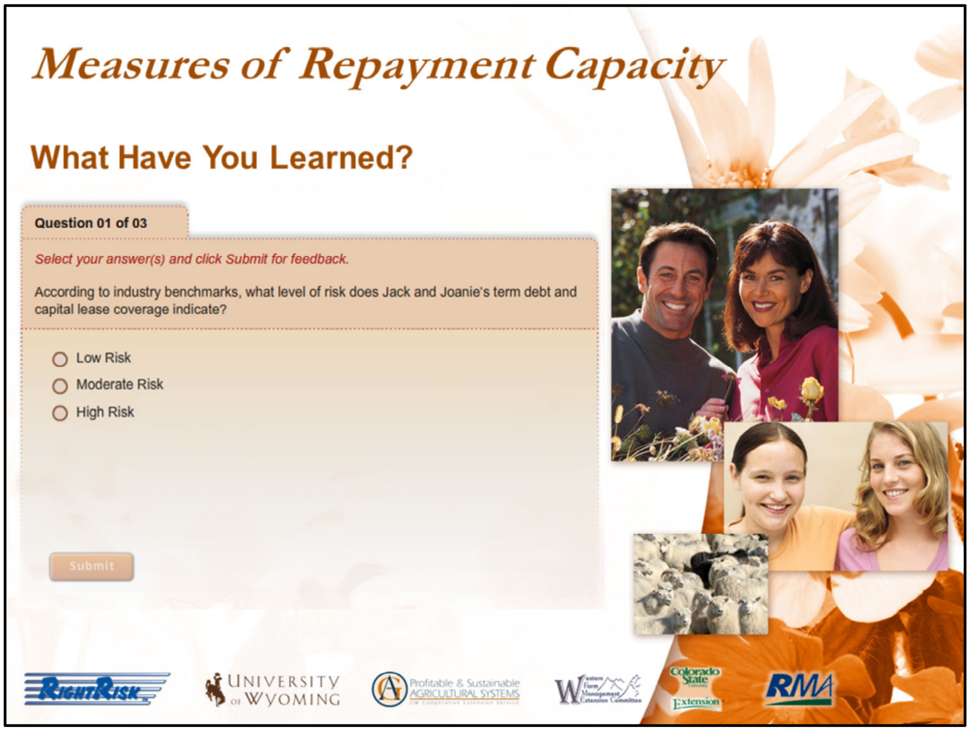
Audio:

Some benchmarks for financial efficiency 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 operation.



Audio:

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

Measures of Repayment Capacity

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 term debt and capital lease coverage indicate?

- ✓ (●) Low Risk
- ( ) Moderate Risk
- ( ) High Risk

Submit | Next Question

That's correct!
Jack and Joanie's term debt and capital lease coverage is in the low risk range.

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Measures of Repayment Capacity

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 their term debt and capital lease coverage ratio?

- ◯ Decrease net farm income
- ◯ Increase principal and interest payments by taking on more debt
- ◯ Increase depreciation expense
- ◯ Reduce family living withdrawals

Submit

Measures of Repayment Capacity

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 their term debt and capital lease coverage ratio?

- ○ Decrease net farm income
- ○ Increase principal and interest payments by taking on more debt
- ○ Increase depreciation expense
- ✓ ◉ Reduce family living withdrawals

Submit

Next Question

That's correct!
Reducing family living withdrawals will improve the term debt and capital lease coverage ratio.

Measures of Repayment Capacity

What Have You Learned?

Question 03 of 03

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

What actions can you take to reduce the impact of family living withdrawals on term debt and capital lease coverage?

- ☐ Borrow money to purchase unnecessary or unprofitable assets
- ☐ Increase expenses while reducing revenues
- ☐ Limit family living withdrawals to better match business profitability goals
- ☐ Better manage to reduce expenses

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Measures of Repayment Capacity

What Have You Learned?

Question 03 of 03

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

What actions can you take to reduce the impact of family living withdrawals on term debt and capital lease coverage?

- [ ] Borrow money to purchase unnecessary or unprofitable assets
- [ ] Increase expenses while reducing revenues
- [x] Limit family living withdrawals to better match business profitability goals
- [x] Better manage to reduce expenses

Submit

That's correct!
Reducing expenses and limiting family withdrawals will reduce the impact on term debt and capital lease coverage.

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