

Understanding and Maintaining Farm Working Capital

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Anyone involved with operating a farm or ranch will have encountered the terms working capital and current ratio. Lenders probably spend more time talking about working capital than any other part of the balance sheet and for good reason. What is it and why is it so important?

Working capital can be described as a farm's financial shock absorber. It gives us a cushion or margin of error for years of financial stress. It also gives us flexibility and agility to take advantage of opportunities that pop up. Let's look at some of the terminology and what they tell us.

Working capital is simply current assets minus current liabilities. It is an indication of liquidity of the business. The numbers can be found on the top third of your balance sheet. Current assets consist of cash on hand, crops and feed on hand, market livestock, growing crops, hedging accounts, prepaid expenses, and accounts receivable--basically any asset that can be converted to cash within 12 months. Current liabilities are accounts payable, operating loans and lines of credit, along with accrued interest and principal due on term loans within 12 months. We want current assets to be greater than current liabilities, indicating that we have the resources to service any debts payable within the current year.

Working capital is expressed in terms of dollars but that number does not give us any context as to the size of the operation. One farm with \$100,000 of working capital may be in great shape but a larger farm may be in a precarious position with the same amount of working capital. Other measurements of liquidity give us a clearer indication of a farm's position. The current ratio is current assets divided by current liabilities and is expressed as a ratio such as 2:1 or 1.5:1. We can also look at working capital as a percentage of total dollars that flow through the business over the course of a year by calculating working capital to gross revenues and working capital to farm expenses on a percentage basis. Typical standards for adequate liquidity are a 2:1 current ration and 30%-35% for working capital to gross revenue or working capital to farm expenses. State averages compiled by North Dakota Farm

Management Education programs show the average current ratio for the last five years (2012-2020) was 1.72. The 20% most profitable farms had an average current ratio of 2.17 while the 20% lowest profit farms averaged 1.09. Average working capital to gross revenues was 33.8%, high profit farms 46.7% and low profit farms 5.9%.

Improving your liquidity to an acceptable level should be a goal for all farms and ranches. What can you do to accomplish that? Ultimately cash reserves are driven by profitability. But there are additional things to watch for. Proper structuring of debt between current, intermediate, and long term can reduce annual payments. In some cases, refinancing and consolidating term debt is necessary. Be wary of using cash to purchase capital assets. Although not a part of the business analysis family living, and other non-farm expenditures are cash flow issues that need to be monitored. Selling assets and refinancing operating shortfalls into term debt can solve current issues too but a plan must be put into place to avoid the same problem down the road.

Constant monitoring of your current position is critical. Update your balance sheet as least yearly if not quarterly. Detailed cash flow plans are needed to determine periods of cash shortfalls. Update them quarterly. Make sure your business and personal goals are well articulated so you can plan accordingly. Your local farm management education program can assist you in putting these together.

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.gov or 701-328-3162 for more information. The ND Farm Management Education Program is sponsored by the North Dakota Department of Career and Technical Education.