

Describe and Measure Liquidity

The second financial management measure is for liquidity. Liquidity is defined as having enough current assets on hand to cover all of the current liabilities on hand at any given point in time. This information is reported on the net worth statement. If a farm business cashed in all of its current assets will it have enough to pay off all of its current liabilities? If it does, the farm is said to be in a liquid position.

As was the case with solvency, the amount of liquidity is also important for the long-term survival of a farm business. One measure for liquidity is the amount of working capital a farm business has on hand at any given point in time. Working capital is calculated as follows:

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

In the example in Figure A1-1 the current assets were \$ 335,000 and the current liabilities were \$ 175,000. With the formula above we find that the working capital is \$160,000. Is this good for a large feedlot operation, or for a small farm? As was the case for the solvency test we must have something to compare this amount to. Dr. Kohl has a "California Working Capital Ratio" which is calculated by dividing working capital by gross farm expenses. He states that this ratio should be > 0.50 which means one should have enough working capital on hand to cover approximately 6 months worth of expenses.

The more common test that Financial Institutions use to calculate liquidity is done with the Current Ratio. The current ratio is calculated as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

In Figure A1-1 the current assets divided by the current liabilities was \$ 335,000 / \$ 175,000, which meant that the current ratio for this farm at this time was 1.91. Is this good or bad? Again we must compare this number to industry benchmarks. The benchmarks suggested by Dr. Kohl are as follows:

> 1.50 is low risk, 1.0 – 1.50 is medium risk, and < 1.0 is high risk

Comparing our result to the benchmarks indicates that this farm has a low liquidity measure at this point in time. Figure A1-4 has a current ratio of 1.60. This ratio has dropped over the course of the projected year from 1.91. This is due to the current principal portion of the new loan, and the increased operating loan balance in the current liabilities. This farm is still doing okay in the area of the liquidity measure, as 1.60 is at the low measure benchmark level.

Table A1-1. Opening Net Worth Statement Ratios:

Current Ratio = CA / CL	1.91
Leverage Ratio = L / E	0.12
Net Worth Ratio = E / A	0.89

Table A1-2. Closing Net Worth Statement Ratios:

Current Ratio= CA / CL	1.60
Leverage Ratio= D / E	0.16
Net Worth Ratio= E / A	0.86

As can be seen from the tables above, the example farm lost a little ground over the past year, but is doing okay in the solvency and liquidity financial management parameters.

Authored by: Ron Lyons P. Ag.