



Assessing Financial Management Skills

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Introduction

As farms continue to consolidate it becomes increasingly important to assess a farm's management skills. At a certain farm size, it is no longer easy or feasible for the manager or managers to wear every management hat. How does the management team determine when to focus on professional development, delegate management tasks among managers, and seek outside assistance? This is the second article in a series of articles pertaining to the assessment of management skills. The first article discussed production management skills (*farmdoc daily* September 28, 2018). The topic of this article is the assessment of financial management skills.

Per-unit costs and financial performance measures vary widely among farms. For example, a recent article by Langemeier and Yeager (*farmdoc daily* August 24, 2018) indicated that Kansas Farm Management Association farms in the bottom and top profit margin quartiles during the 2008 to 2017 period had an average operating profit margin ratio of -0.099 and 0.234, respectively. Unlike farms in the bottom quartile, farms in the top quartile covered operator and family labor, and had money available to expand their operations. Though not discussed in the article, part of the difference between profit margins was due to differences in technical efficiency or the ability to produce the highest output level given specific input levels. Technical efficiency is related to production benchmarks which were discussed in the first article in this series (*farmdoc daily* September 28, 2018). In addition to production problems, farms with lower levels of financial performance may be using an inappropriate input or output mix, or not be large enough to capture economies of scale.

Financial Management Skills Assessment

Table 1 presents important financial management skills. Skills listed include keeping accurate and updated records; generation of financial statements and key performance measures; utilizing partial budgeting techniques; tracking enterprise, field level, and livestock herd profitability; optimizing capital purchases; and developing policies pertaining to retained earnings (i.e., profit kept in the business) and owner withdrawals. Each farm operator should rank their ability with respect to each skill using a 1 to 5

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scale with 1 being relatively weak and 5 being relatively strong with respect to that skill. The idea behind checklists such as the one presented in table 1 is to assess whether a farm has a skills gap, which is defined as the difference between skills that a farm needs and the skills of their current workforce (operators and employees). Conducting a skills gap analysis helps a farm to identify skills that will be needed to become more efficient and expand. It can also be an important input into hiring programs, employee development plans, or hiring outside consultants.

Table 1. Financial Management Skills

	Weak to Strong				
	(Check the Appropriate Box)				
	1	2	3	4	5
1 Records are updated and circulated on a monthly or quarterly basis to appropriate employees and owners.					
2 Balance sheets and income statements are prepared at least annually on a calendar/tax year basis.					
3 Cash flow budgets are prepared at beginning of the year and comparisons of actual cash flow to projections are made at least monthly or quarterly.					
4 Key performance measures and ratios are calculated for all critical production, marketing, financial, and capital performance areas and compared annually to historical trends.					
5 Partial budget techniques are understood and utilized when evaluating partial shifts in the business.					
6 Enterprise profitability and cost center tracking can efficiently be derived from farm records.					
7 Field and livestock herd records for production inputs, applications, and resource use are complete and accessible.					
8 Financial tools and expertise for optimizing capital acquisition decisions are accessible and used regularly.					
9 Negotiate competitive terms for farm loans, including interest rates, repayment terms, and collateral requirements versus taking what is offered.					
10 Policies for investment and withdrawal of capital, including minimum capital levels and revenue sharing arrangements are defined, clearly understood, and followed.					
11 Policy for dividing earnings due to owners versus management is defined and consistently followed.					

Though all of the financial management skills listed in table 1 are important, we will elaborate on the importance of managing capital purchases, owner withdrawals, and retained earnings. One the most critical measures for a farm to track is the change in retained earnings. Capital purchases may reduce retained earnings in the short-run, but to be beneficial they must increase retained earnings in the long-run. Owner withdrawals have a direct impact on retained earnings. If owner withdrawals are a large proportion of retained earnings, the farm will have difficulty expanding.

The checklist in table 1 does not include a final tally score, nor does it address tradeoffs in various skill or ability areas that may lead to success. Rather, the checklist helps farm operators evaluate their skills and abilities in areas critical to long-term financial success. As farm operators fill out the checklist, they

should try to determine which of the skills listed are most essential to improving efficiency and expansion plans.

Key Performance Indicators

A recent *farmdoc* article (*farmdoc daily* [September 7, 2018](#)) discusses the importance of benchmarking production and financial measures. In this article, the focus is on financial management benchmarks. The Farm Financial Standards Council categorizes financial measures using the following breakdowns: liquidity, solvency, profitability, financial efficiency, and repayment capacity. At least one measure per category is discussed below.

Commonly used liquidity measures include working capital to gross income, working capital per acre, and the current ratio. Threshold levels for working capital to gross income and current ratio are 0.35 and 2.0, respectively. If liquidity is below these thresholds, a farm may have trouble repaying loans.

Solvency is typically measured using the debt to asset ratio. How much debt can a farm business carry with reasonable safety? Although this question is too general for a specific response, some guidelines can be provided for certain debts where repayment plans are known. Important factors to be considered when estimating the amount of debt that can be repaid and the amount of debt that a farm is comfortable with include income available annually, length of repayment period, interest rate, current liquidity and solvency position, stability of income, skill and experience of operator, age and health of operator, and an operator's risk aversion level. Debt is one of the largest sources of risk (i.e., volatility of income). For this reason, among others of course, operators that are averse to risk tend to have lower debt to asset ratios.

The operating profit margin is one of the most important financial measures. This ratio is computed by adding interest expense and subtracting unpaid family and operator labor from net farm income and dividing the result by value of farm production. Farms in the top quartile in terms of the profit margin, typically have a long-run average operating profit margin ratio above 0.20 or 20 percent.

Financial efficiency can be measured using expense ratios and the asset turnover ratio. The asset turnover ratio measures how efficiently farm assets are being used to generate value of farm production, and is computed by dividing value of farm production by average total assets (*farmdoc daily* [April 8, 2016](#)). In terms of the profit margin, farms in the top quartile have a long-run asset turnover ratio of at least 0.25 or 25 percent.

Repayment capacity measures include the capital debt repayment capacity, capital debt repayment margin, and replacement margin (*farmdoc daily* [September 20, 2018](#)). The capital debt repayment margin evaluates whether a farm has sufficient income to cover principal and interest payments on term debt. The replacement margin enables a borrower to evaluate a farm's ability to repay debt and replace assets. In the long-run, a farm has to have a positive replacement margin.

Concluding Comments

Assessing management skills is an important part of benchmarking farm performance and figuring out where improvements may be needed. If the operators on the farm identify management areas which are not currently being addressed, they will need to determine whether someone is going to get up to speed with regard to these areas or outside help is going to be sought to address weaknesses.

Utilizing key performance indicators is an important ingredient in creating an environment that stresses continuous improvement. The right set of key performance indicators help a farm evaluate performance and highlight areas that need more attention. Key financial performance indicators include the current ratio, the debt to asset ratio, the operating profit margin ratio, the asset turnover ratio, and the replacement margin.

References

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