Importance of Financial statements

The development of accurate financial statements is an important process for the farm/ranch manager. Financial statements not only help in meeting the documentation requirements for loan requests, but are also valuable management tools. Using financial statements, the manager can examine the financial health of the operation.

From the balance sheet, the financial position of the operation can be determined by examining the relationships between assets, liabilities, and owner’s equity. The income statement indicates the performance of the operation by showing how much income was generated, how expenses were incurred, and how well debt payments were met. The cash flow statement indicates future cash surpluses and shortfalls that are necessary for planning.

Sources of Financial Information

The first step in completing financial statements is knowing where to find the financial information that is needed. Several possible sources of information are listed below. However, each individual manager may have a better idea of where to look for the appropriate information.

- Income tax returns
- Recordbooks or accounting systems
- Depreciation schedules
- Bank statements
- Financial lenders
- End of year inventories

The Balance Sheet

The balance sheet is a financial statement that provides information about the producer’s assets (what is owned), liabilities (what is owed), and equity (net worth) and their relationships with each other at a specific point in time.
**Assets** are those items that are owned and provide a beneficial economic resource to the farm operator. They are normally classified as either current or non-current.

**Current assets** are composed of cash and items that can be converted into cash with little difficulty. They also include items that will turn into cash within the normal operating cycle of business, which is usually one year. Current assets are listing according to their liquidity (how easily they are converted to cash) with the most liquid, cash and checking, appearing first. The following is a description of several common categories that make up the current assets in the balance sheet.

*Cash and checking* – consists of a physical count of cash on hand and checking account balance assuming all checks written have cleared as of the date of the balance sheet.

*Savings and time deposits* – includes all savings accounts and certificates of deposit (CD’s).

*Investments and securities* – includes stocks, bonds, and mutual funds.

*Accounts receivable* – refers to any money owed the farm operator from others.

*Feed and supplies* – includes feed, hay, grain, fertilizer, medicine, etc. that has been purchased but not used.

*Livestock to be sold* – includes livestock that will be sold in the next 12 months.

*Growing crops* – should equal the costs that have been spent on a crop that has not yet been harvested.

**Non-current assets** are things that are owned having economic lives greater than one year. All depreciable assets are considered non-current. The following is a description of common non-current assets that are found on the balance sheet.

*Breeding livestock* – includes bulls, cows, and replacement heifers for cattle and the same equivalents for other species of livestock.

*Machinery and equipment* – includes tractors, trucks, farm implements, etc.

*Buildings and improvements* – includes buildings, drainage systems, fences, storage bins, etc.

*Real estate* – includes all land that the producer is the titleholder of or land that the producer is making payments to acquire the title.
Liabilities represent everything that the farm operator owes whether in the form of cash, products, or services. Like assets, liabilities are categorized as being either current or non-current.

Current liabilities are those liabilities that will become due within one year and will be paid with a current asset or the creation of another current liability. The following is a description of common current liabilities that are found on the balance sheet.

Accounts/notes payable – includes the amounts owed to creditors (banks, credit cards, and charge accounts) for goods or services provided but not paid for.

Current portion of non-real estate loans – includes the principal and interest due in the upcoming year on loans that are for longer than one year.

Current portion of real estate loans – same as for non-real estate loans.

Non-current liabilities are those liabilities that have a maturity greater than one year. Only the principal balance of non-current loans needs to be included because the accrued interest was included in the current section. The main categories of non-current liabilities are the principal balance on non-real estate and real estate loans.

The owner's equity or net worth is calculated by taking total assets minus total liabilities. Equity represents the portion of the farm operator’s ownership in the business. If assets increase more than liabilities, equity will increase in value. In a balance sheet, the assets must equal liabilities plus equity.

The Income Statement

The income statement (also called a profit and loss statement) is a summary of income and expenses for the fiscal year normally matching the tax year. It includes both cash and non-cash values and is used to help analyze the financial performance of the business. It is used as a means by which to measure profit for a business in a given year.

The income statement is divided into revenues and expenses. Farm revenues are derived from the normal operations of the business. Such items might include the sale of crops, feed, livestock, livestock products, and government payments. Farm expenses are also derived from the normal operations of the business. The cash operating expenses are broken down into a number of different categories. Most common expense categories correspond to the list of expenses on Schedule F of the IRS tax form.

Net farm income is what is left after subtracting total expenses from total revenue. It is the amount of income made from farm production for the year.

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Cash Flow Statement

The cash flow statement is a recorded projection of the amount and timing of all cash inflows and outflows expected to occur throughout the planning period, usually one year. Inflows and outflows can be projected on a monthly or yearly basis. Breaking the cash flow statement into months will identify which months have cash surpluses and deficits and enable the manager to predict future operating loan needs.

Importance of Financial Analysis

Over time, agriculture has changed from subsistence production to modern, sometimes complex businesses utilizing land, labor, and capital with the expectation of making a profit. The need to measure financial position and performance increased when agricultural producers began to rely more on capital and less on labor and land.

Financial measures enable farm operators to analyze past performance versus present performance, present performance versus budgeted performance, and a multi-year performance trend. The user must identify which measures are most beneficial to their own situations.

Ratio Analysis

Financial ratios are an excepted method to measure both financial position and financial performance. Financial ratios are simply the result of a comparison using two elements of financial data. They can be expressed as either a percent or as a comparison to one.

There are several reasons why ratio analysis is commonly used to analyze financial data. A few of these reasons are:

- Easy to calculate
- Easy to make comparisons with other business’s
- Simple to interpret
- Understood by others outside of management

Ratio analysis also has some limitations. Unfortunately, a farm business does not exist in a perfect world where everything can be quantified precisely. Consequently, reliance upon financial measures as a sole determinant of financial position and performance is cautioned. Some common limitations of ratio analysis are:

- Ratios can warn you of a problem, but they can’t specifically identify the problem.
- Ratios are only as good as the data source. Ratios derived from poor financial statements can be misleading.
- Ratios should not be a substitute for good judgement and common sense.
Financial Measures Categories

There are four broad categories of financial measures that will be discussed: Liquidity, Solvency, Profitability, and Financial Efficiency. All measure either financial position or financial performance. For each category, there will be an explanation of what is being measured, a commonly used ratio, and an interpretation. All of the data needed for the ratios are found on either the balance sheet or the income statement.

Liquidity

Measures the ability of a farm business to meet financial obligations as they come due in the ordinary course of business.

**Current Ratio = Total Current Assets / Total Current Liabilities**

This ratio indicates the extent to which current farm assets, if liquidated, would cover current farm liabilities. The higher the ratio, the greater the liquidity. A ratio of 1:1 is marginal. A ratio of 2:1 is considered good.

Solvency

Measures the amount of debt relative to the amount of owner’s equity in the business. It provides an indication of the firm’s ability to repay all financial obligations if all assets were sold. This measure is very important to lenders.

**Debt/Equity Ratio = Total Liabilities / Net Worth**

This ratio measures financial position and reflects the extent to which farm debt is being combined with farm equity. This ratio should be less than 1:1. Lower ratios represent increased solvency.

Profitability

Measures the extent to which a business generates a profit from the use of land, labor, capital, and management.

**Return on Assets = Net Income / Total Assets**

This ratio measures the rate of return on farm assets and is often used as an overall index of profitability. This ratio is normally expressed as a percent. The higher the value, the more profitable the farming operation.
Efficiency

Measures the intensity with which a business uses its assets to generate gross revenues.

**Turnover Ratio = Total Revenue / Total Assets**

This ratio is a measure of how efficiently farm assets are being used to generate revenue. The higher the value, the more efficiently the assets are being used.

Analyzing Trends

Trend analysis is another simple and expected way to measure financial performance. A trend indicates a direction or movement over time. To determine a trend, you make a comparison of the same measure over a period of time. In terms of financial analysis, this time period is two or more years.

Trends can be used to analyze ratios and data from past, present, and future financial statements. The following is a list of data that is commonly analyzed using trends:

- Total assets
- Total liabilities
- Net worth
- Total revenue
- Total expenses
- Net income
- Liquidity ratios
- Solvency ratios
- Profitability ratios
- Efficiency ratios
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