CHAPTER 9
Owning and Owing: The Balance Sheet

Key questions addressed in this chapter:

Why is the balance sheet useful?

What goes into making a balance sheet?

How do you determine and track the items that make up a balance sheet?

Your balance sheet is the most basic financial statement for your farm operation. Simply put, your balance sheet is a snapshot of your farm's financial position at a particular point in time. It's sort of a financial report card. It contains everything you own, everything you owe, and what would be left if the farm had to be sold.

All of the things that you own as part of your farm business are categorized on the balance sheet as "assets." All of the dollars the farm business owes to others, or would have to pay out if the farm were to be sold, are considered to be "liabilities." The difference between assets and liabilities is considered to be "owner's equity" or "net worth." It represents your investment in the farm.

The balance sheet is useful for a number of reasons. First, it shows the farm's "solvency," or the extent to which the farm's assets would be able to pay its liabilities if everything was sold. If there would not be enough farm assets to cover all of its liabilities, the farm would be considered to be "insolvent."

Second, the balance sheet allows you to calculate your farm's "liquidity" and net working capital position. Liquidity is the ability of the farm to cover the financial obligations that are due right now, or that will come due within a year, using only the farm's cash or other short-term assets. Liquidity is an important indicator of the farm's financial strength. Strong liquidity allows you to withstand unexpected setbacks or to take advantage of unexpected opportunities that might pop up from time to time.

Third, comparisons of balance sheets from different periods can be used to monitor the farm's financial progress over time. This lets you know if the value of your investment in the farm is growing or shrinking.

Fourth, the balance sheet can be used in combination with other financial statements to evaluate many different aspects of the farm's financial performance. Put the balance sheet and the income statement together and you can calculate a series of profitability ratios which will tell you if the farm is generating an adequate return on the capital invested in the farm. The balance sheet combined with the statement of cash flows allows you to determine the farm's "capital debt repayment capacity," which is an important indicator of the farm's ability to handle financial risk, and important when you approach a lender to ask for a loan.

Finally, the balance sheet shows some key relationships between assets and liabilities. For example, it indicates how the farm's debt is structured, which is very useful in troubleshooting cash flow problems.

We'll start our balance sheet discussion with an overview of the document and the parts that make it up, and then give you detail on how to create your own balance sheet.

Farm Balance Sheets are Different From Other Business' Balance Sheets

Farm balance sheets look different than those from other businesses due to some differences in the way farm financial status is tracked. In agriculture, assets are usually listed on the balance sheet at their current market value, or what somebody would pay for those assets if they were sold today. It doesn't matter what you paid for that tractor; if you could sell it today for $2,000, it appears on the balance sheet with a value of $2,000. This is called a "market value" balance sheet.

Most other businesses use a "cost basis" balance sheet. Each asset is listed on the balance sheet at its original cost minus the amount that the asset has depreciated during the time the business has owned it. It doesn't matter what that tractor is worth today; if it was purchased eight years ago for $5,000 and depreciated $500 each year since (for a total depreciation to date of $4,000), it appears on the cost basis balance sheet with a value of $1,000.

There are logical reasons why a market value balance sheet is used in agriculture. It is simpler to develop, since you don't have to keep track of when each asset was purchased and how much it has depreciated over the years. Also, the balance sheet is often developed at the request of the farm's lender, who needs it for credit analysis purposes. The lender needs to know what the farm assets are worth right now as collateral to support a loan request, not what they cost ten or fifteen years ago.

Finally, a market value balance sheet allows for a more accurate comparison of one farm's financial performance to another's. For instance, one farmer may have purchased her land 40 years ago for $300 per acre while her neighbor purchased his land last year for $4,000 per acre. It would be impossible to make a reasonable comparison of the two farms' financial performance unless asset values were assigned comparable values.

At Times a Cost Basis Balance Sheet is Useful

Even though it is much more common to use a market value balance sheet in agriculture, there are good reasons to use a cost basis balance sheet, too. A cost basis balance sheet takes market value changes out of the equation, which allows you to see how the financial performance of the farm business alone, rather than broad market trends such as real estate values, impact your owner's equity. If the farm was profitable and the profits were kept in the farm business, your owner's equity will have increased. If the farm was unprofitable and you took on debt to cover the shortfall, your equity will have decreased.

Similarly, a cost basis balance sheet allows you to more accurately track your farm's financial performance from year to year. It takes into account the fact that rust and rot will cause machinery and buildings to depreciate in value over time. It does not hide poor financial performance behind a screen of rapidly rising land values. A cost basis balance sheet will give you a truer picture of your farm's financial performance.

A cost basis balance sheet allows you to account for a purchased asset that doesn't add any marketable value to the farm. For example, you might spend $10,000 for pasture fencing but, if the farm were to be sold, the new fence may not be worth anything to a potential buyer. In fact, the fence might even lower the value of the farm if the new buyer has to pay to have it removed. However, you made the initial investment in fencing with the intent of generating profits from grazing livestock. You want to track that investment on your balance sheet as long as it still has useful value to you.

Deciding Which Balance Sheet to Use

Many farm balance sheet forms allow you to develop a market value and a cost basis balance sheet side-by-side on the same form. It is ideal to do it this way. However, don't let the perfect get in the way of the pretty good. It is most important to pick the style of balance sheet that you're comfortable assembling each year and then stick with it.

OTTO'S TIP:

If you don't make market value adjustments into your computer bookkeeping program for your assets, the reports function will generate a cost basis balance sheet.

Update Your Balance Sheet Every New Year's Day

It is important to complete your balance sheet on the same date each year. Doing so takes seasonal variations out of the picture and allows for valid comparisons from year to year. This is especially important for farm operations, as assets such as crop inventories can vary widely across seasons. You can certainly update your balance sheet more often, even quarterly or monthly, if you find the information useful.

To accurately assess financial progress, you need a beginning and ending balance sheet for each year. If you complete your balance sheet as of January 1 every year, you will have what you need. A January 1 balance sheet also corresponds with the tax year. You can put your beginning and ending balance sheets together with the Schedule F (Profit or Loss from Farming) from your federal tax return, and with those documents do a full financial analysis of your farm. The federal government will force you to complete your Schedule F; if you can force yourself to update your balance sheet you'll have the two key documents you'll need to analyze your farm's financial performance.

Tracking Asset Value Changes in Your Bookkeeping System

Changes in value of assets, such as adjusting for market value changes or depreciation, can be made in your computer bookkeeping program on an annual basis. Doing these adjustments will assure that your balance sheet and other reports will reflect your most current information.

Your tax accountant can give you a depreciation table for your assets. He or she can recommend a monthly or annual "depreciation expense" that can be entered by using the General Journal function in your bookkeeping program.

If you enter depreciation into your program, it will show up in your generated reports. You will have to keep in mind that depreciation, although real, is not a cash transaction, and so, though it will show on a profit and loss statement as an expense, will not actually be dollars out the door for that year.

For this reason, many people choose not to track depreciation through their bookkeeping program, but make adjustments only in the balance sheet and tax records.

There's an old joke about the perfect hog building. It should pay for itself in five years and self-destruct in ten.