



Economic Toolbox

The Balance Sheet

Lenders across the nation will soon be asking farmers to once again update their year-end financial statements. In early January, farmers can be found standing by their mailboxes eagerly awaiting the forms needed to record inventories, accounts payable and bank balances. If you fit into this category, then this column is not for you.

Many farmers I have met feel they have better things to do than make life easier for their banker by providing this information in an accurate and timely fashion. The real problem is that many farmers do not understand what a balance sheet is or how they can benefit from it. At Empire Farm Days this past August, less than 20 farmers out of 500 correctly identified the parts of a balance sheet when given a choice between assets, liabilities, equity, income or expense. If you cannot identify them now, read on.

The *Balance Sheet* is the single most important of the four financial statements necessary to fully describe and analyze a farm business. The other three financial statements include the Income Statement, the Statement of Cash Flows, and the Statement of Owner Equity. These will be covered in future columns. The Balance Sheet is a snapshot of the business as of a certain date, commonly the last day of the fiscal year. If your fiscal year-end (the date your business year ends) coincides with the calendar year-end, then you should date the balance sheet as of *December 31, 19xx*. If you are applying for credit in say July, you may be asked for a current balance sheet. Then, you may have to provide another snapshot of your business as of *June 30, 19xx*.

Balance sheets can be made for any day of the year and be accurate. But for business analysis, the balance sheet date needs to be consistent with the time covered by other financial statements. For example, it is not possible to accurately analyze a business with balance sheets dated January 31 and an income statement for the twelve months ending on December 31. Also, it is not recommended to create a December 31 balance sheet sometime in March, April, or later as accuracy suffers greatly. Accuracy counts because to determine accrued net income (which is more accurate than cash net income), good balance sheets are needed at the beginning and ending dates of a fiscal year. Even if you do not plan on developing an accrued

income statement now, or you do not have a lender asking you for one, you should make an annual balance sheet. It is virtually impossible to explain to a potential lender that those historical losses on your *Schedule F* were made to look that way to avoid income taxes without a year-end balance sheet.

Assets, Liabilities and Equity

The Balance Sheet consists of **Assets** (cash, inventory, growing crops, supplies, livestock, machinery, land, buildings and more), **Liabilities** (accounts payable, notes payable, real estate debt and more) and **Equity** (the term net worth is used interchangeably to mean the value of the assets beyond what is owed on them). The relationship among the three types of accounts is $Assets = Liabilities + Equity$. Assets and Liabilities are further segregated into Current and Non-Current categories. Current assets are items that are normally used during the current year - such as feed and supplies. Current liabilities are debts, including the portion of long-term debt, that will be paid during the current year. Non-Current assets and liabilities will be used or paid some point after the current year.

To make matters more confusing, there are two ways to value assets, and thus, two types of balance sheets. Agriculture traditionally uses the Fair Market Value (FMV) method while the rest of the business world uses Net Book Value. Net book value is how accountants value a business's assets. It is based on real numbers and no guesswork is involved. Net book value is the cost of the asset less accumulated depreciation of that asset. A fully-depreciated tractor that cost \$60,000 new is worth nothing using the net book value though you know it would sell for \$30,000 (FMV) at any auction. The problem with net book value is even greater when one considers land values measured at cost 40 years ago versus today's fair market value. The difference in owner equity between the two methods is usually hundreds of thousands if not millions of dollars.

Why do you need to know this? Many farmers do not, but those who are serious about farming in the future should be ready to submit both types of balance sheets to get and keep good financing. The Farm Financial Standards Council (FFSC) has recommended that farms may use a FMV balance sheet as long as it is submitted with a net book value statement. It will be slow to catch-on, but eventually, if you want to play with the big boys, you'll have to act like one.

Just Do It

If you really hate completing your *market value balance sheet*, do it the day after your fiscal year ends (ok, January 2 if you were three sheets to the wind at your New Year's party). That way you have 364 more days before it needs to be done again. The first thing to do is to take an accurate count of everything you own. Estimate quantities of all feed on hand (purchased or grown), supplies and bedding, fuel, growing crops and livestock. According to FFSC recommendations, value purchased inventory at the price paid to acquire the item. Inventories of harvested crops and raised livestock held for sale, should be valued at market value less the cost of disposal. Growing crops should be valued at the estimated cost invested into the crop as of the date of the balance sheet, not what the crop will be worth if and when it is harvested. For breeding livestock, market values can be used less the cost of disposal. Accuracy really does count when taking inventory.

Machinery and equipment lists need to be updated. Don't forget to walk around the shop. \$300 "here and there" tools really start to add up. Value these items at market value less the cost of selling them. Better yet, get an auctioneer or equipment dealer to make an unbiased opinion of the value of your equipment. The same goes for land and buildings. Now you're ready to do the easier, but less enjoyable side of the balance sheet - your liabilities.

Liabilities

First, gather your bills - all of them, for your accounts payable listing. There are two methods most farmers use to conveniently exclude accounts payable from their balance sheet. One is thinking that bills under \$500 don't count. Then they discover that there are 15 bills under \$500 that amount to \$6,000 or more. Another popular excuse is saying "I'm going to pay that one in a few days, so I won't count it." Sorry... the only allowable excuse I can think of is when you receive a bill and the product has not been delivered. Here, you could include the bill in your accounts payable *and* include the product in your inventory as if you had received it, *or* exclude the bill. Please do not exclude the bill from liabilities and include the inventory in assets as if you had received it! That's being too creative.

Getting loan balances on machinery notes with creditors such as John Deere, Clark or Ford Credit has never been easier thanks to computer technology. Simply dial the 800 telephone number, use the phone's touch-tone keypad to enter your loan identification number and presto, a computer tells you everything you need about balance and payments. Bank loan balances are usually found in monthly statements. Your loan officer can also help you in this area. Do not

forget to list rent, property taxes or payroll taxes that still need to be paid.

Finally, what has been left out of this discussion is how to handle capital leases and deferred taxes on the balance sheet. Information on these and other areas can be found in the recommendations developed by the Farm Financial Standards Council, 1163 E. Ogden Avenue, Suite 103-051, Naperville, IL Tel.630-637-0199.

Now Use It

Once you have completed your balance sheet, compare your farm's financial progress to previous years. Use it to develop an accrual income statement on your own or with the help of a professional. Most important, keep a permanent copy stored for future reference. Next to your income tax return, it is the most important document that your farm business can maintain.

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