

Risk Management

Balance Sheet — A Financial Management Tool

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A balance sheet is a statement of the financial condition of a business at a specific time. It is one of the principal reports provided by a good accounting system. The balance sheet shows what is owned by a business, what is owed, and the owner's equity (or net worth) of the business. By comparing past balance sheets with the present balance sheet, the growth or decline of assets, liabilities and net worth can be determined.

The balance sheet shows the amount of funds the owner has in the business. To determine this amount, the assets owned are listed and a value is placed on them. Liabilities and their values also are listed. The difference between assets and liabilities equals net worth, or the owner's equity in the business. The balance sheet is often called a net worth statement. The net worth is the value that would be left if all of the business's debt obligations were paid in full.

Assets may include cash on hand, bank accounts, accounts receivable, feed supplies, livestock, equipment, buildings, land and other items. Although each asset may not be completely paid for, its full value is listed. The unpaid accounts, notes and mortgages are listed as liabilities.

In many farm businesses, there is no sharp distinction between business and family assets and liabilities. This is particularly true where the farm and family expenses are paid for out of the same bank account. Funds may flow back and forth from farm to nonfarm items. In this

situation the balance sheet may include both farm and nonfarm items.

The relationship of assets, liabilities and net worth is expressed as follows:

$$\text{Assets} - \text{Liabilities} = \text{Net Worth (Equity)}$$

OR

$$\text{Assets} = \text{Liabilities} + \text{Net Worth (Equity)}$$

This accounting equation is expressed in the example balance sheet.

A current asset is cash or other assets that can be quickly converted into cash in the normal business processes within 1 year. The value of current assets may vary greatly over time. Crops may be harvested but held for a better market. Feeder livestock may be purchased or sold, resulting in a continual cash flow of funds into the business and out again.

Noncurrent assets are those resources that are used mainly to support farm production. Unlike current assets, they are not expected to be sold in the normal operating cycle. These assets have a more permanent value. They are needed to produce income, but may not be converted to cash easily. They include breeding livestock, machinery and equipment, buildings and real estate.

Current liabilities include notes payable within a year, accounts payable, accrued interest and other accrued expenses, income taxes payable, and the current portion of deferred taxes. When they become due, they are usually paid from



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cash on hand, from the sale of current assets, or by creating another loan.

Noncurrent liabilities include the noncurrent portion of notes payable, as well as land contracts and mortgages on land and buildings/improvements. Portions of the noncurrent liabilities that are due within 12 months are current liabilities because they are due in the current year of the business.

From the example balance sheet statement, it may be noted that some of the assets are either in the form of cash or can be quickly converted to cash. Others would be more difficult to convert to cash. Some of the liabilities are debts that must be paid in a short time. Others, such as mortgages, are due over a period of years. Classifying assets and liabilities according to time helps in planning purchases and payments.

Uses of the Balance Sheet

The balance sheet has many important uses. Lenders use balance sheets to evaluate the financial position of most loan applicants. The balance sheet statement also can be extremely useful to the owner of the business because it indicates the business's net worth. Comparing balance sheets over time shows how much the business net worth is growing or decreasing. A balance sheet can be used by the owner of a business to support a request for borrowed funds.

The balance sheet gives information on how best to meet liabilities. If liabilities are due in a short time, cash will be needed to pay them. If the sale of current assets will not raise sufficient funds and the loan cannot be renewed, then the owner may need to negotiate a long-term loan on the basis of noncurrent asset values.

Comparing total current assets to total noncurrent assets helps determine whether too much or too little capital is tied up in permanent investments. A farm business, consisting primarily of noncurrent assets, has less flexibility than one that has sufficient current assets. Some flexibility in the business should be maintained. A balance sheet provides the information for making these comparisons.

Asset Valuation

One of the most important issues in completing and using the balance sheet is the method used to value assets. The two most common are current market value and cost. Market value is the estimated amount the asset would sell for on the date of the statement, less selling costs. Cost is the original cost or basis of the asset, less any accumulated depreciation. The method used to determine asset value affects financial ratios derived from the balance sheet and the amount of deferred taxes. Most importantly, it affects farm equity.

The National Farm Financial Standards Council recommends that the balance sheet be prepared on both a market and a cost basis. The cost basis indicates the amount of earned and contributed owner equity. The market value also indicates the additional amount of equity that has resulted from the change in asset values due to inflation or deflation. The portion of total equity that has resulted from market value changes is the difference between the market value and cost basis owner equity.

Evaluating the Balance Sheet

A balance sheet of a farm business can be evaluated by:

- Comparing it to balance sheets of the same business in previous years
- Comparing it to balance sheets from other farms
- Using ratios
- Using a "common-size" statement

Comparison to Previous Years

One of the most effective methods of evaluating the balance sheet is comparing one year to previous years for the same business. Comparing balance sheets between years directs attention to changes that have occurred in the relationship between assets and liabilities and the resulting growth or decline in the net worth of the business.

**Example Balance Sheet (farm business only) and
Common-Size Statement of a Farm Business**

John P. Recorder
December 31, 20X1

	<u>Amount</u>	<u>Percent</u>		<u>Amount</u>	<u>Percent</u>
ASSETS:			LIABILITIES:		
Cash on hand	0	0.00	Accounts payable	0	0.00
Cash on deposit in bank	31,140	3.97	Notes due within one year	118,975	15.18
Marketable securities	0	0.00	Current portion of term debt due within 12 months	11,125	1.42
Market livestock	232,650	29.67	Accrued interest	8,500	1.08
Crops held for sale and feed	17,980	2.29	Income taxes payable	3,200	0.41
Fertilizer and supplies on hand	7,625	0.97	Current portion-deferred taxes	55,910	7.13
Accounts receivable	10,000	1.28	Other accrued expenses	4,000	0.51
Prepaid expenses	0	0.00	Other current liabilities (list)	0	0.00
Cash investment in growing crops	9,000	1.15	TOTAL CURRENT LIABILITIES	\$201,710	25.73
Other current assets (list)	645	0.09	Noncurrent portion-notes payable	20,790	2.65
TOTAL CURRENT ASSETS	\$309,040	39.42	Noncurrent portion-real estate debt	83,025	10.59
Breeding livestock (market)	25,500	3.25	Noncurrent portion-deferred taxes	71,275	9.09
Auto-trucks (market)	13,520	1.72	Other noncurrent liabilities	0	0.00
Motorized equipment (market)	70,700	9.01	TOTAL NONCURRENT LIABILITIES	\$175,090	22.33
Machinery and equipment (market)	37,605	4.80	TOTAL LIABILITIES	\$376,800	48.06
Investments in capital leases	0	0.00	Retained earnings and contributed capital	280,160	35.73
Investments in other entities	6,000	0.76	Valuation equity	127,105	16.21
Investments in cooperatives	18,000	2.30	OWNER EQUITY	\$407,265	51.94
Real estate (market)	198,750	25.35	TOTAL LIABILITIES AND OWNER EQUITY	\$784,065	100.00
Buildings-improvements (market)	104,950	13.39			
Other assets (list)	0	0.00			
TOTAL NONCURRENT ASSETS	\$475,025	60.58			
TOTAL ASSETS	\$784,065	100.00			

RATIOS:

Current ratio = Total current farm assets ÷ Total current farm liabilities = $\$309,040 \div 201,710 = 1.53$

Debt/asset ratio = Total farm liabilities ÷ Total farm assets = $376,800 \div 784,065 = 0.48$

Equity/asset ratio = Total farm equity ÷ Total farm assets = $407,265 \div 784,065 = 0.52$

Debt/equity ratio = Total farm liabilities ÷ Total farm equity = $376,800 \div 407,265 = 0.93$

Working capital = Total current farm assets – Total current farm liabilities = $309,040 - 201,710 = 107,330$

Comparison to Other Farms

Comparing the balance sheet of a farm business to the balance sheets of successful farms of a similar type may give evidence of weak or strong points in the business.

Use of Ratios

Ratios may be used in evaluating balance sheets. A ratio is a comparison of two numbers expressed as a numerical ratio of one number to the other or as a percentage of one to the other. Examples of balance sheet ratios are:

Current ratio = Total current farm assets ÷ Total current farm liabilities

Debt/asset ratio = Total farm liabilities ÷ Total farm assets

Equity/asset ratio = Total farm equity ÷ Total farm assets

Debt/equity ratio = Total farm liabilities ÷ Total farm equity

Working capital = Total current farm assets – Total current farm liabilities

In the example balance sheet, the current ratio of the farm business is 1.53 (\$309,440 to \$201,710). The debt/asset ratio is 0.48 or approximately 1 to 2.1 (\$376,800 to \$784,065). The debt/equity ratio is 0.93 or approximately 1 to 1.1 (\$376,800 to \$407,265). Expressed in another way, the example balance sheet shows \$1.53 of current farm assets for each \$1 of current farm loans, \$0.48 of total farm liabilities for each \$1 of total farm assets, and \$0.93 of farm liabilities for each \$1 of farm equity.

Some ratios compare an item from the balance sheet to a measure of new income:

Return on equity = Net farm income ÷ Total farm equity

Return on assets = Net farm income + Interest expenses ÷ Total farm assets

Common-Size Statement

When different size operations are compared, using percentages rather than actual dollars has some advantages. This approach is called a common-size statement. Each farm is put on a “common-size” basis; that is, the various assets, liabilities and equity are expressed as percentages within the business.

An example of data for a common-size statement is shown in the example balance sheet on page 3, where the individual assets are listed as a percent of the total assets and the individual liabilities and equity are listed as a percent of the total liabilities plus equity.

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