Underappreciated: The balance sheet

The balance sheet deserves as much attention as its more popular neighbour, the profit and loss statement

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When you receive your yearly farm accounts around the annual income tax pay and file tax deadline, you will see included a statement entitled 'balance sheet'. This statement often gets barely a second glance. This is understandable, since some of the figures in the balance sheet report can be hard to relate back to the day-to-day situation for the farm.

Also, the terms used in the balance sheet are less familiar than some of those on the profit and loss statement. Put simply, the balance sheet shows what you own and what you owe at a point in time – usually the end of the accounts year.

That end-of-year position is your starting point for the next accounts year, so it is like a financial line in the sand – showing your finishing position after the last financial year, and giving the starting point for the next year.

The balance sheet is like a photograph of the business's financial status on a particular date. If you compare the "before" photograph (i.e last year's end-of-year balance sheet) to the "after" balance sheet (current end-of-year balance sheet), the differences can be identified and teased out.

The balance sheet gives you an indication of what changed financially on the farm during the year. The changes are partly reflected in the profit and loss statement, which shows what was produced and sold off the farm as well as the costs.

There will be changes from alterations in the value of machinery and buildings. This could be due to new investments, perhaps some sales of assets and the depreciation (or wearing out) of the assets that you held onto.

Just looking at a single end-of-year balance sheet can reveal some useful information. The balance sheet lists your assets showing all items that are owned by the farm business.

This could include land, buildings, machinery, direct payment entitlements, livestock, stocks of feed, fertiliser and unsold farm products on hand, and cash and money in the bank at the balance sheet statement date.

The balance sheet list of liabilities, shows debts owed by the business to lenders, suppliers of farm inputs and others.

These liabilities are usually taken on in order to finance the purchase of some of the previously mentioned assets, or to cover a cash shortfall during the year.

Taking the value of the liabilities from the value of the assets gives the net value of the business that is owned, debt-free. This is known as the net worth of the business.

An awareness of the business net worth figure at a given point in time could be regarded as just a 'nice to know' figure, as it doesn't mean a lot unless you are going to 'cash out' – that is, sell everything, pay off what is owed and exit the business.

A much more valuable exercise is to take the net worth figure from the most recently completed year end and then compare that with the net worth for the year end of the previous year.

A quick subtraction will give the change in net worth. This change is a useful indicator of the direction of

Figure 1:

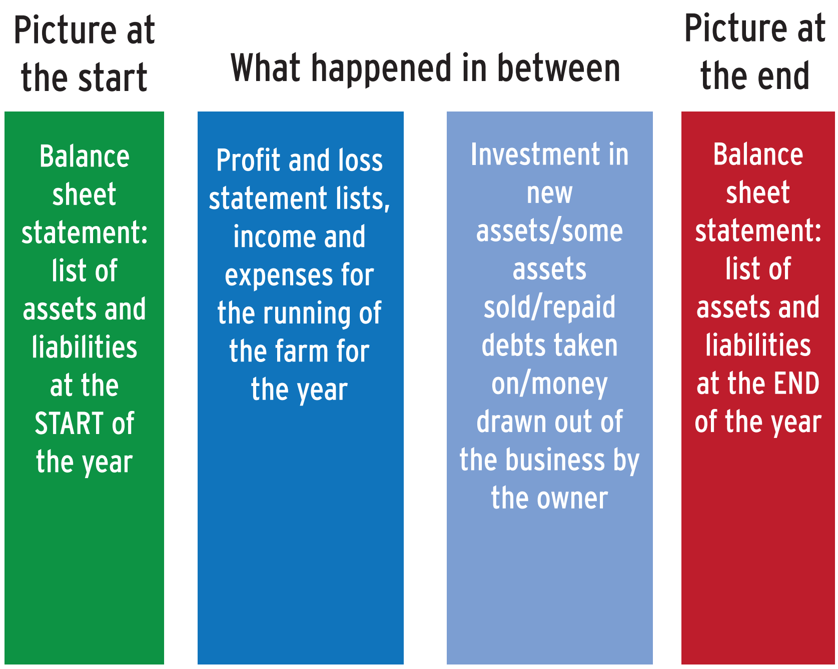
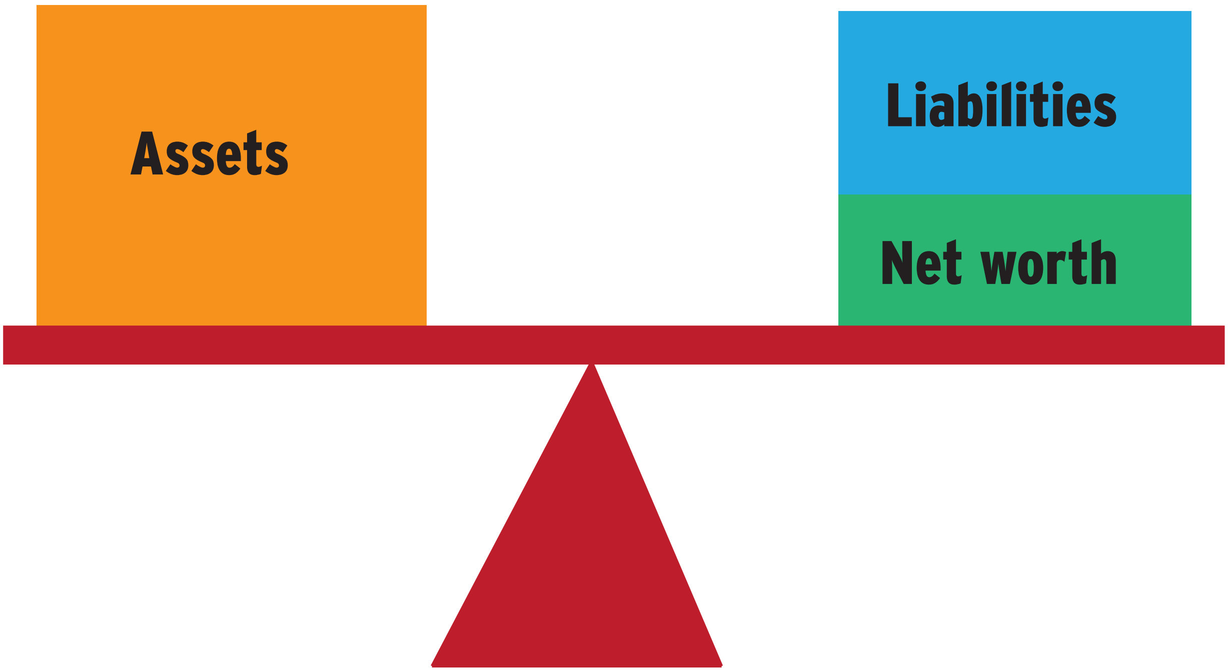


Figure 2: Assets = liabilities + net worth



the business – is it growing or shrinking, adding value for the owner or destroying wealth?

Once the change in net worth is established, then the next obvious question is – what is driving the change? The first place to look for an answer is the profit and loss statement. A profitable business has a greater chance of showing a positive change in net worth, as profit will feed through to the balance sheet.

There could be extra cash in the bank, increased investment in assets such as land, buildings, machinery or livestock, or decreasing overall farm debt levels through reducing short-term creditor debt or paying off bank loans.

A declining net worth could be traced to a low profit year, where there was no scope to replace assets that were wearing out, or where cash reserves had to be tapped into to partly cover the running expenses for the farm for the year. It's worth finding out what is driving the change in net worth and deciding whether it is something that can be sustained or needs to be corrected.

The balance sheet can also give valuable insights on issues such as the farm's ability to cover its obligations in the short-term (referred to as business liquidity) and in the long-term (referred to as business solvency) – these measures will indicate whether the business could withstand a downturn.

The balance sheet can be used to examine total farm assets and total farm liabilities per hectare, per cow or per livestock unit.

These can be used as gauges of how the business is structured or funded – again. a useful indicator of whether the farm's financial foundations are solid.

Teagasc upgrades Profit Monitor benchmarking system for 2022

For 2022, Teagasc has upgraded its Profit Monitor financial analysis tool. The revamped system will allow a more comprehensive analysis of the balance sheet.

This will require some extra farm financial detail to be captured for the Teagasc Profit Monitor analysis, but the information to be recorded will be minimal once the initial position on the farm assets and liabilities is established.

As part of the regular inputting of costs, which Profit Monitor users will be familiar with, the calculation of depreciation of machinery and buildings can now be carried out by putting values on some of the main machinery and building assets on the farm and letting the Profit Monitor system calculate a depreciation figure.

This has the advantage of giving a more accurate calculation of the depreciation cost and has the added benefit of building up a picture of the value of the investment in machinery and building assets.

These asset values automatically feed into the balance sheet, along with information on livestock assets and detail on the liabilities or farm debt.

Stacking the income and expense information alongside a full balance sheet will give you a clearer indication of the farm business's financial status.

The Teagasc Profit Monitor Balance Sheet Report will compare your last two balance sheets, calculate some important measures, such as any change in net worth, and present some of the main ratios using figures from both the balance sheet and the profit and loss statements.