

FARM FINANCIAL TOOL: BALANCE SHEET FACT SHEET

SOUTHERN REGION

HOW SECURE IS YOUR FARM BUSINESS?

Many farmers ask why they need a business balance sheet, as they are not selling any land. The reality is that the balance sheet is the only record that **indicates the growth in wealth** of the business over time, and hence indicates a farming business's performance and ability to **manage risk**.

KEY POINTS

- ▶ **Net Worth** is the most important benchmark of a business.
- ▶ Undertaking the annual review of the balance sheet will give a greater understanding of the **health of the business**.
- ▶ Even if you never intend to sell the farm, it is important to **know what the business is worth**.

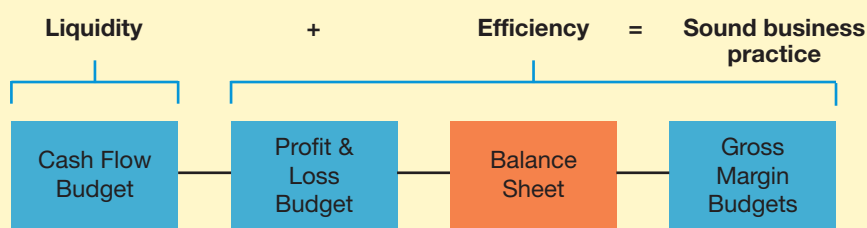
Key Management Concepts

When managing any business, it is good to have both of the following concepts in mind:

- Liquidity** – This refers to cash flow which should be managed to ensure more cash comes into the business than goes out.
- Efficiency** – This addresses the issue of whether the farm business is getting the best return on the capital being managed, and is measured through both a profit and loss and a balance sheet budget.

By managing both of these concepts (see Figure 1), the farm business will have a greater ability to be sustainable.

Figure 1 Liquidity and efficiency



Source: P2PAgri Pty Ltd

What is a Balance Sheet?

A balance sheet lists the value of the various saleable assets of the business and the various liabilities. Its main aim is to measure the net worth of the business, which is the difference of the total assets and total liabilities.

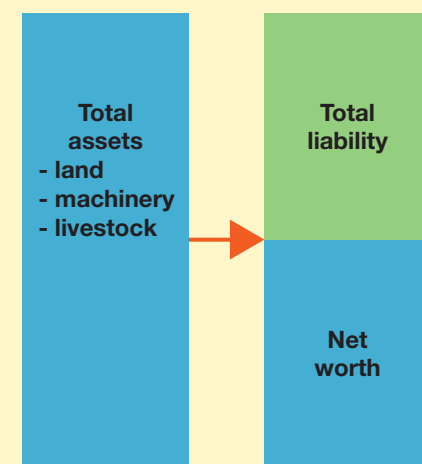
Figure 2 illustrates the major components of a balance sheet. The key to any farm balance sheet is its **Net Worth**, sometimes referred to as 'equity', although equity more commonly measures net worth as a percentage of the total assets. As a general rule, the smaller the total liability is relative to the total assets, the safer is the business.

The two main pieces of information from a balance sheet are shown below, with the formula of how they are calculated:

- **Net Worth = Total Assets – Total Liabilities**
- **Equity = Net Worth / Total Assets**

A sample farm is used to illustrate a balance sheet in Table 1. This indicates that this farm has a total of \$1,944,022 in assets and \$498,888 in total liabilities. This means this farm's net worth is \$1,445,134 (\$1,944,022 - \$498,888) and

Figure 2 A Balance Sheet



Source: Assoc. Prof. Bill Malcolm, 'Pursuing Growth without Regret in Risky Crop-Farming'

the equity, expressed as a percentage, is 74% (1,445,134 / 1,944,022). For dryland farmers, a sound equity is one that is above 70%, so this farm's equity is in the 'safe zone'.

Assets

The different classes of assets (most of which are shown in Table 1), and how they can be valued, include:

Current Assets – These are assets that are easily sold, and because of this, banks dislike taking security for lending against these assets. Examples of current assets are:

Livestock – Livestock can be bought and sold easily, so their value is generally not difficult to determine. Recent market sales can be used as a guide to value livestock. It is important to value each class such as ewes, ewe hoggets and

Table 1 Sample balance sheet

Current Assets:	
Livestock	137,200
Cash	55,000
Other (Grain pools & Grain-on-hand)	59,200
Total Current Assets	251,400
Non-Current Assets:	
Machinery (Written down value)	480,000
Land	1,212,622
Total Non-Current Assets	1,692,622
Total Assets (Farm)	1,944,022
Current Liabilities:	
Overdraft + Stock mortgage	21,949
Non-Current Liabilities:	
Land related	400,000
Machinery related	76,939
Total Liabilities (Farm)	498,888
Net Worth (Farm)	1,445,134

Source: P2PAgri Pty Ltd

lambs. Note when valuing breeding ewes, prices will be higher than sale yard prices as breeding ewes are generally not sold as they are needed for the farm's self-replacing flock.

Cash – This asset is simply the farm's cash being held in a bank deposit or farm management deposit.

Other – These assets could include unsold grain or wool, the value of grain sold into grain pools but yet to be paid and fertiliser on hand that can be sold. Value these items at market rates

Non-current Assets – These are assets that generally take longer to sell, and because of this, banks favour taking security for lending against these types of assets.

Machinery – To estimate the value of all the machines that your business owns (including machines with finance loans), give them a 'clearing sale value'. If you haven't undertaken a recent machinery valuation, it is recommended that you take the time to list all the machinery and give them a sale value. Experience shows that if farmers haven't done this recently, they tend to under-value their total machinery value.

Land – Land is generally the most difficult asset to value and there are three ways to go about obtaining a valuation for land:

- (1) Use council rates as a guide. However, these are generally based

on official valuations from the respective state Valuer Generals Departments, and may not reflect recent changes in market values;

- (2) Employ a professional valuer who will use a variety of information to come to a valuation, or
- (3) Make your own judgement, taking recent land sales in the district and making an adjustment depending on the soil type and infrastructure benefits your land provides.

Whichever method you use to value the various asset classes, record the method so that a similar standard can be used each season to ensure consistency in assessing the total assets.

Liabilities

Liabilities are generally easier to assess as they are what is outstanding on the various business loans the farm has:

Current liabilities – These are loans that are expected to be paid back within 12 months, typically an overdraft facility.

Non-current liabilities – These are loans that are expected to be paid back over a period of years, or could be interest only loans that may not get paid back for some time. Such loans include:

Land related liabilities – These could be either interest only loans, or loans that are being paid back over a longer time period.

Machinery replated liabilities – These can be lease or hire purchase loans

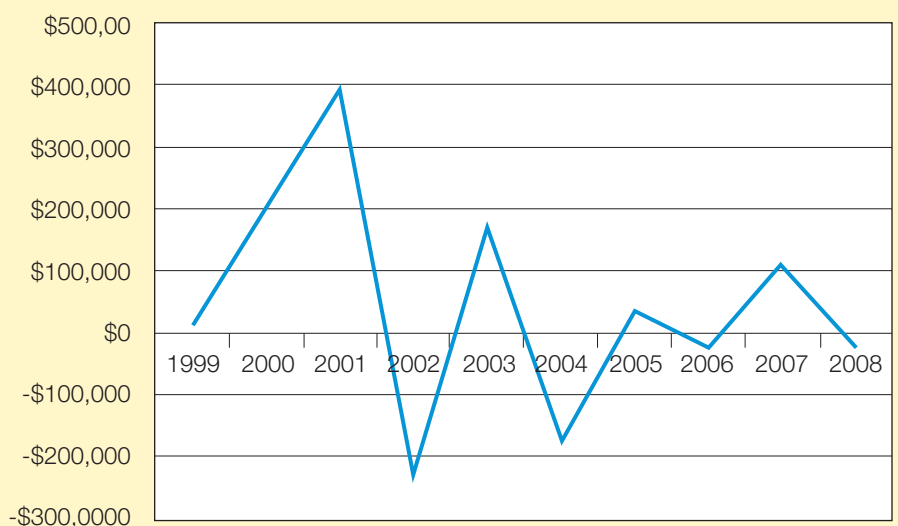
taken out to purchase large machinery items such as tractors, trucks, boom sprays and headers.

Other liabilities – These could be a number of loans which include vendor finance (the person who has sold land but left some equity in the land to be paid back at a later time), or loans from sources outside lending institutions, such as solicitors or relatives.

Case Study: Value of a balance sheet budget to a farm business

The balance sheet is perhaps seen by many farmers as the least important budget to complete, unless they are considering selling land. However, the benefit of using balance sheet budgeting is illustrated in this case study of a Mallee mixed farmer who survived the prolonged poor seasons from 1999 - 2008. During this time, the average growing season rainfall was well below average (averaged Decile 3 growing season rainfall), which included a number of droughts and only a few above average seasons.

Figure 3 gives a unique view of the net profits of this business over this challenging period. While 2001 gave significant profits, most other seasons gave poor or negative profits. If the business net profits were the only measure monitored over this period, the farmer would no doubt have been experiencing considerable stress and concern. This, incidentally, was the experience of most farmers in the district throughout this period.

Figure 3 Farm Case Study Net Profit Records

Source: P2PAgri Pty Ltd

As is usual through these periods, it is only the support of the bank that allows farmers to continue to farm. Figure 4 shows the resultant increase in debt through this period - when the previous season's crop had failed to deliver enough profits, the farm needed continual increases in overdraft to put in the following season's program. This farm's starting debt in 1999 was \$159k and the debt in 2008 was \$801k, a significant increase.

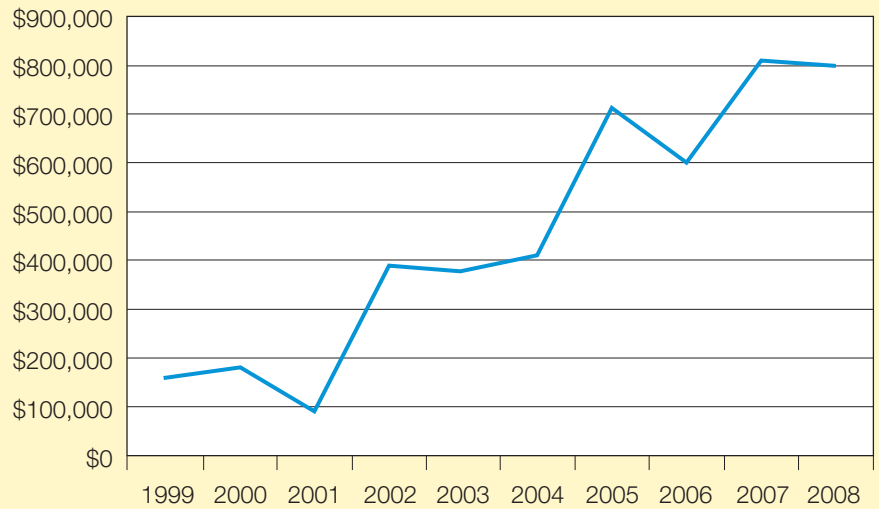
In the face of this run of poor seasons, how did the bank have confidence to continue to extend the lending? Some of the answer lies in the bank's confidence that the management was doing all it could do to manage the risk, but also there was an unprecedented increase in land values at this time. From 1999 – 2008, the land value increased by about 90%, which had a significant effect on improving the land asset values in this farm's balance sheet. As banks like land as a security for lending, they are happy to extend the lending where they have adequate security. Figure 5 clearly illustrates that although the net profit performance was indifferent, the farm's net worth grew considerably through this period. That is, this growth was not from good net profit performance, but rather from the growth in land value.

So, as this farmer was focused on the important indicators of both net profits and net worth, the bank could see that the business was still viable, and capable of continuing to farm even though the run of seasons though this period was unusually poor.

Another very important point to note here is that this farmer had a significant history of correctly recording the business financial performance with cash flow, profit and loss and balance sheet budgets. This gave the farmer added confidence in the business performance, where other farmers in the district who did not keep these types of records suffered significantly with mental stress. The added value was that at no time through this period did the bank refuse the necessary increase in lending, as they had a clear picture of the whole business performance. This was not the case for many other farmers in the district who were experiencing similar seasons but had poor financial record keeping.

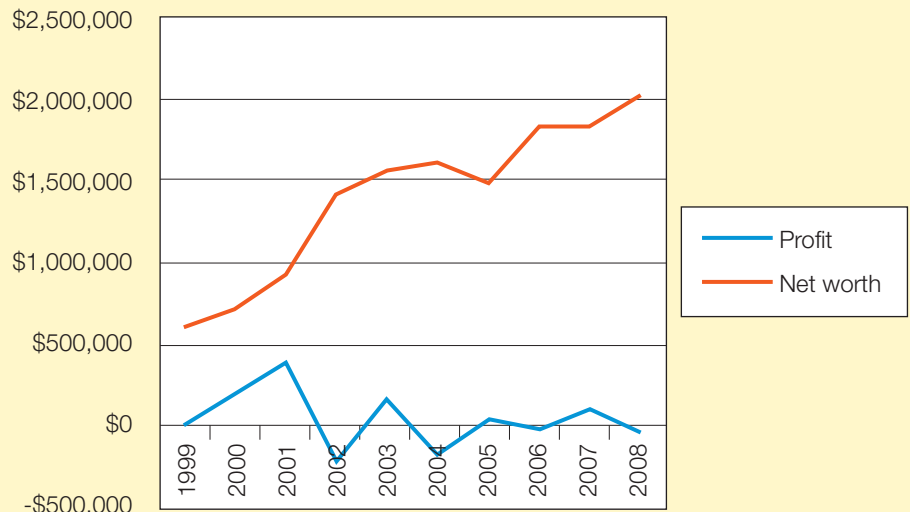
The management of equity through this period is shown in Figure 6. The starting equity was 79%, which increased to 91% at the end of the good 2001 season, but

Figure 4 Farm Case Study Total Liability Trend



Source: P2PAgri Pty Ltd

Figure 5 Farm Case Study Net Profit and Net Worth Record



Source: P2PAgri Pty Ltd

stayed generally above 70% throughout the remainder of this period, that is, the 'safe zone' for dryland farming. In the last year of this period, the equity level was 72%. These are important numbers to help keep the bank comfortable re its lending, and hence maintain business viability.

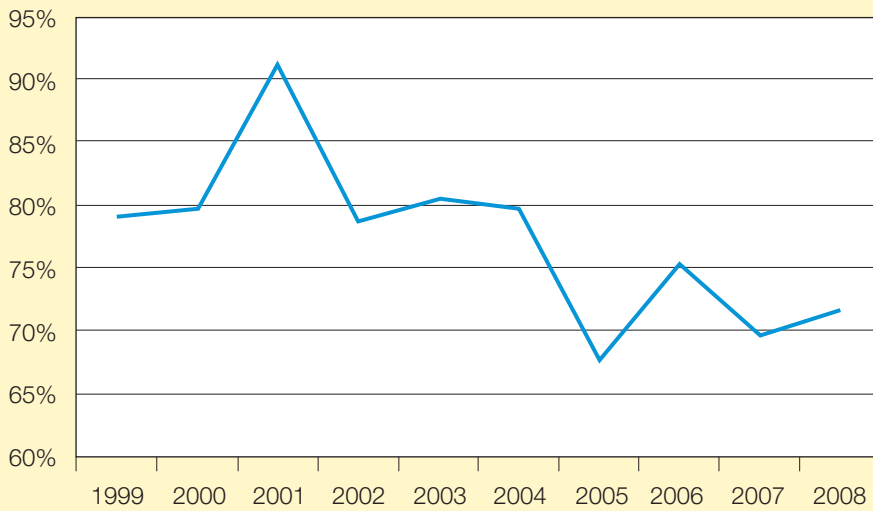
The actual case study farm provides a valuable lesson of why it is important to keep sound financial records, including a record of the balance sheet. It also provides an essential example of how risk can be better managed.

Interestingly, through the period of late 1980s, farmers in the Eyre Peninsula area of SA experienced a similar period of poor seasons and at the same time land values

fell. In this situation, the banks were not happy with both the decline in profits and net worth and foreclosed on a number of farm businesses. So, in very poor situations it is difficult to maintain viability, but if the financial records are maintained, there is an improved chance the business can trade out of its difficulty.

When do you record a balance sheet?

The numbers in the balance sheet can change throughout the year, especially the amount of the overdraft being used. So, when is the best time to take a record of the balance sheet? The answer here is, it depends on what questions you are looking to answer:

Figure 6 Farm Case Study Equity records

Source: P2PAgri Pty Ltd

- **Is the information for your business records?** If you wish to keep records so you can also produce the time-series data similar to the case study farm in this fact sheet, we suggest you pick the time of year when you are least using the overdraft. This is because the level of overdraft does not distort the balance sheet. For most mixed farmers in southern Australia, this would be early March, so we suggest the 1st March each year.
- **Is the information for a bank?** If you are requesting additional lending from a bank, then you should be looking to revise the balance sheet just before you begin talking to the bank.

FAQs

What degree of accuracy do I put on the valuation?

Valuations are estimates at the best of times, because we really don't know the true value until we test the market by offering the asset for sale. We suggest you provide 'conservative estimates' for all of your valuations. In this way, you are more likely to have some confidence in the values in the balance sheet and the information you are looking to obtain from the balance sheet. Establish the basis of your valuations

and use this guide each year, so you get consistency across the years when you want to assess business trends.

How should I store these records?

You can store these records in a note book. However, a spreadsheet will allow you to graph the trends as you record the results each year. Spreadsheets, such as Excel, provide an excellent platform for farm business data filing, management and analysis. You could also use a specific farm program like Plan2Profit (P2P) software.

Is the balance sheet in my tax return useful?

The tax return does include a balance sheet record, but be careful how you use this information as it does not give an accurate balance sheet view of the business. This is for two reasons:

- The assets used in a taxation balance sheet do not record the 'market value' of the assets, but rather the ATO approach to valuing assets. So, commonly land does not have its recent market value in the tax balance sheet, which means the main asset to the business is missing.
- The liabilities in the tax balance sheet are records as of the 30th June each

year, which does not line up with the 1st March, as recommended for dryland farmers.

Valuing land is tricky at the best of time. How accurate do I need to be?

The value of land is important as it generally has the largest share of the total assets of the farm business, and it is therefore recommended that land value estimates be as accurate as possible. Use a 'conservative estimate' approach using recent land sales in the district as a guide.

USEFUL RESOURCES

Related GRDC Fact Sheets

Other fact sheets in this Farm Business Management series provide further detail on farm financial tools: Farm Business Overview (Order Code: 909), Cash Flow Budget (Order Code: GRDC913), Profit and Loss Budget (Order Code: GRDC916), Crop Gross Margin Budget (Order Code: GRDC914) and Livestock Gross Margin Budget (Order Code: GRDC915).

Copies of all the above fact sheets are FREE plus P&H and available from: Ground Cover Direct Freephone: 1800 11 00 44 or email: ground-cover-direct@canprint.com.au These can also be downloaded from www.GRDC.com.au/fbm

Plan to Profit (P2P), a whole-farm financial management program that can help calculate a farm's financial budgets: www.P2PAgri.com.au

MORE INFORMATION

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