Understanding Financial Statements

Rodney Armstrong-North Dakota Farm Management Education Program Instructor, Dakota College-Bottineau

We are well into the season of setting up operating loans and lines of credit with our lenders. North Dakota Farm Management Education Program enrollees are working with their instructors to complete balance sheets, financial analyses and cash flow projections for 2021. At the same time, everyone has held numerous appointments with their income tax preparers. How well do you understand the terminology that is used by your loan officer? Do you know what the various financial statements are used for and how they are put together? Let's do a very basic review of some of the common documents you should be familiar with.

Balance Sheet

One of the first things I do with a new student in our program is to put together a balance sheet which is simply a list of all your assets and liabilities. From that your net worth can be calculated—total assets minus total liabilities. A balance sheet may include just farm assets and liabilities or may also list personal items depending on what the document is used for. The term "balance" comes from the typical format used that has assets on the left side with liabilities and net worth on the right side. Total assets will always equal total liabilities plus net worth. The important thing to remember about a balance sheet is that it is a snapshot of your assets and liabilities at the time it is put together. Your balance sheet may be obsolete and inaccurate tomorrow so your lender will always need an updated balance sheet. Liquidity and solvency ratios are calculated from this statement

Income Statement.

Note that the balance sheet has nothing to do with income and expenses. Those are found on the income statement. It answers the question "was it a profitable year for my farm/ranch?"

The income statement which we utilize in our farm business management program has three sections to it. First it lists all cash farm income and all cash farm expenses for the year. The difference is our net cash income. These are the numbers that are typically used on your Schedule F tax form. That, however, is an incomplete picture of what happened during the past year. To make what we call an accrual-based income statement, we need to consider changes in inventory items. I like to explain that concept using grain inventories as an example. Grain on hand at the beginning of the year is not really this year's income even if it was sold this year—that was last year's business—so we exclude that from the income statement. But grain on hand at the end of the year, even though it has not been sold, is part of the current year's income picture so we place a value on that unsold grain and include it on the income statement. The same principal applies to a number of asset and liability item changes to make it a true picture of the current year. Adding those inventory changes to net cash income gives us net operating profit. The third part of our income statement is depreciation on our capital assets which when subtracted from the net operating profit gives us our true net farm income for the year. The income statement is used to determine profitability and efficiency ratios.

Cash Flow Projection

The third important financial statement that you will likely complete with your lender is a cash flow projection. This is your farm or ranch's financial plan for the coming year and usually includes personal income and expenses. You will plan your crop acres, livestock production, capital purchases, family living—anything that involves cash inflows or outflows for the coming year. The cash flow is used to determine feasibility of your operation. Does your plan produce enough cash income to cover all expected cash outflows? If not, what can we change to make it work? It is important to note that the cash flow projection does not determine true profitability.

It is only looking at cash in and cash out. A farm or ranch can be profitable and not cash flow (high family living costs, large principle payments on loan?). Conversely the business can show a loss but still be able to cash flow (personal wages/salary, other outside income).

There may be other forms and statements particular to each lender, but most all of the information will flow from these three basic financial statements. Learn the terminology. Understanding what they are, how they are generated and what they are used for will make for a more productive, informed relationship with your lender.

The North Dakota Farm Management Education Program provides lifelong learning opportunities in economic and financial management for persons involved in the farming and ranching business. Visit ndfarmmanagement.com, Facebook @NDFarmManagementEducation, or contact Craig Kleven, State Supervisor for Agricultural Education, at crkleven@nd.gov or 701-328-3162 for more information. The ND Farm Management Education Program is sponsored by the North Dakota Department of Career and Technical Education.