UNDERSTANDING FINANCIAL STATEMENTS

by John Ritten and Bridger Feuz

The success of your ranch can be measured many ways, but the longevity of your enterprise is most likely to be determined by its financial success. Knowing how to measure financial success can help guide management decisions you are contemplating.

There are three essential statements that should be examined on at least an annual basis. They are the Balance Sheet, Income Statement, and Cash Flows. These three statements should be viewed as a group, as each analyzes different aspects of the financial health of the operation. An accountant or financial professional already employed by the ranch should be able to prepare them.

Balance Sheet

The primary purpose of the Balance Sheet is to show the balance of ownership of your ranch. The balance sheet defines the business in terms of assets, liabilities, and equity at a point in time (usually January 1 or whenever your fiscal year ends). Assets are any part of the business that can be sold to generate cash or used to produce a good that can be sold for cash in the future. Assets are basically anything owned for the purpose of conducting ranch business.

Liabilities are obligations the ranch owes to outside interests. Liabilities can be thought of as the part of your ranch that someone else owns (for example, through loans). The general equation for Ranch Equity or Owner Equity is Assets = Liabilities + Owner Equity. The difference between assets and liabilities is the amount of your ranch that you actually own or Owner Equity (sometimes referred to as Net Worth).

The balance sheet further separates assets and liabilities by time, current and non-current. Current assets and liabilities are those assets that will be used or debt due within the next production cycle, which is usually one year. This differentiation helps measure an operation's solvency and liquidity. A ranch is liquid if it has enough current assets to cover current liabilities. In other words, is the ranch able to cover its financial obligations in the short term? For example, is it able to cover feed requirements and this year's debt payments?

Solvency, on the other hand, takes a long-term look at the operation. A ranch is solvent if it has enough assets to cover all liabilities. In other words, if you quit ranching and sold everything today, would you end up with money in your pocket after paying off all creditors? If liabilities are greater than assets, then you don't actually own any of your business. In this case, Owner Equity is zero or negative. If assets do

UW | EXTENSION

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outweigh liabilities, the remainder is how much of your ranch you actually own, or your equity.

Again, the Balance Sheet only describes who owns your business at a given point in time, not whether it is profitable. The balance sheet offers insights into the ability of the ranch to continue to conduct business, as well as how much of the ranch is owned by you and your creditors.

The Income Statement

The Income Statement describes profitability. Unlike the Balance Sheet, which provides information about the ranch at a specific point in time, the Income Statement looks at a period of time, usually a year. The Income Statement shows if the ranch made money over a period of time, but it does not show who owns the ranch.

The Income Statement can be very detailed but generally describes the ranch's operations in terms of revenues and expenses. Furthermore, it differentiates between normal business operations and capital operations.

The Income Statement should give two numbers of importance, Net Farm Income from Operations (NFIFO) and Net Farm Income (NFI). The Income Statement usually follows the following format:

> Net Farm Income from Operations (NFIFO)
> (which is Revenues – Expenses)
>
> less Gain/Loss on sale of Capital Assets,
>
> which equals Net Farm Income (NFI).

Many people jump straight to NFI to determine if a ranch is profitable, as this is generally what you pay taxes on. This number, however, includes capital gains and losses. Therefore, it is important to look at NFIFO, as this number represents income from the base operations of the ranch.

For example, a tractor collector may spot a specific piece of equipment on your ranch that hasn't run for years and buy it for $10,000, but this is a revenue stream that 1) is unlikely to occur annually, and 2) probably isn't in your key business strategy. Therefore, it shouldn't be used in looking at profitability of the ranch, especially when comparing profits over time.

Keep in mind not all inventories will be sold every year. For example, if a ranch that uses a cash accounting system retains extra heifers to expand the herd, the income statement would likely show more expenses than revenues, suggestinging the ranch was not profitable that year. The increase in inventory, however, would impact the assets used in the balance sheet, resulting in increased owners' equity. Therefore, it is recommended that the Income Statement of any ranch using a cash accounting system be adjusted to an accrual basis to show the impact of changes in inventories and that liabilities be included in revenues and expenses to give a better picture of true profitability. For an example of how to make this conversion, see https://www.extension.iastate.edu/agdm/wholefarm/pdf/c3-26.pdf

Where to find examples of financial statements

Balance Sheet:
www.ksre.ksu.edu/bookstore/pubs/mf291.pdf

Income Statement:
www.ksre.ksu.edu/bookstore/pubs/mf294.pdf

Cash Flow Projection:
www.ksre.ksu.edu/bookstore/pubs/mf275.pdf

Cash Flows

Two statements should be generated in regards to cash flows. The first should cover the same period as the Income Statement and is often referred to as the Statement of Cash Flows. This statement shows all the sources and uses of cash in the last accounting period. If you are seeking to reduce costs, you need to know where your money is going before you can begin looking for areas to cut. This statement is also used to help prepare the Statement of Cash Flow Projection.

The Cash Flow Projection Statement essentially recreates the Statement of Cash Flows but is forward looking, forecasting cash sources and uses for the coming account period. This statement is useful because it can help show months when inputs need to be purchased but cash reserves may be low. A good projection of cash flows can help in securing a loan, particularly an operating note. This exercise is especially useful for producers who are new to managing an operation.

Whether you are new to ranching or have just taken over a new operation, this statement makes you plan for the coming year in detail. It is also an important step when considering any change to the current operation, as forecasting the stream of revenues and expenses forces you to think through all the expenses incurred with any alterations to the current business model.

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