The basics to understanding your financial statements

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Learning how to run a dairy operation is much harder than learning how to read a financial statement. Trust me; I remember working on my family's dairy, and I saw firsthand all the work involved in making sure the milk goes into that bulk tank each day. For dairymen who have dedicated their whole life to the farm, it is in your best interest to take a few hours to read your financial statements. It could make a big difference in solidifying everything you work so hard to accomplish.

There are four main financial statements: the balance sheet, the income statement, the statement of equity and the statement of cash flows. In addition, dairy financials usually include supplementary schedules such as a schedule of farming operations, operating expenses and statistical data. It is important to understand how each of these relate to each other and what information to take away from each of them.

First, let us investigate the balance sheet. The assets are the economic resources the company owns that can be sold or used to generate cash. Current assets such as cash, accounts receivable and inventories are the assets that can be converted to cash within 12 months to pay the company's debts, purchase inventory or purchase capital expenditures. Long-term assets include buildings, equipment, land and intangibles (e.g., capital retained by the creamery, pool quota, etc.).

Liabilities are the amounts a company owes to others. Current liabilities are due within 12 months of the balance sheet date and include items such as accounts payable owed to feed and trade vendors, payroll taxes, wages and the operating line or feed line owed to the bank. Bankers typically compare the total current liabilities to total current assets to assess current liability coverage.

Long-term liabilities are those due over 12 months and include the real estate and equipment loans. Lastly, the equity amount is what is left over if the company were to sell all of its assets and pay all of its liabilities. Keep in mind that equity is at cost for a financial statement, which means that if some of the assets are worth more than their adjusted costs, then the fair-value equity would exceed the amount on the financial statement. This is particularly true for older operations with self-raised animals and appreciated land.

Next, we will cover the income statement. An important distinction is that the balance sheet is presented at a point of time (e.g., 12/31/XX), whereas the income statement shows the business activities over a period of time (e.g., 1/1/XX through 12/31/XX). Milk income is shown as a gross amount, which means it does not take into account creamery deductions. This allows the reader to evaluate the changes from one period to another purely based on the market prices and production without factoring in changes in the creamery deductions.

Over the last few years, feed costs have dramatically increased and should be an area the producer looks at to save money, which could mean altering rations with your nutritionist or hedging future costs. Additionally, if the dairy has a heifer operation, you will see that the feed costs attributable to raising heifers are capitalized and taken out of feed costs because these animals are considered a work-in-progress and not contributing to the production of milk revenue yet.

Herd replacement costs include the cost of depreciation plus the loss on the sale of cows. The industry standard for herd replacement cost in the past has been $1.20 per hundredweight, but recently due to rising beef prices and heavy culling rates, many operations have been breaking even or recognizing gains on the sales of their cows.

This cost is driven by factors such as the age of the herd, herd turnover rates, beef sales prices, replacement purchase prices and if the operation is expanding. In the operating expenses, look for large fluctuations in the line items. Specifically, compare expenses to the previous year for repairs, supplies and veterinary breeding, as these are the most common fluctuations. Finally, the total expenses are subtracted from total revenues to arrive at the overall net income or loss (aka the bottom line). If you are not happy with your bottom line, take control of your costs and use your financials to find areas you can save. There is always somewhere to improve.

The equity statement, although a small statement, may provide vital information. It adds the net income or loss from the income statement and owner contributions, and subtracts owner withdrawals. If profits have been good over the life of the company, but equity is small, the owners need to ask themselves if they are withdrawing excessive amounts of cash from the company. From talking with bankers, they are hoping to see borrowers build up equity for the next downturn and are looking at owner withdrawals more closely.

The statement of cash flows reports the company's cash inflows and outflows for the period. While an income statement tells you whether the company made a profit, the statement of cash flows can tell you whether the company generated cash. It tells you the total inflow or outflow by activity type. The first activity is operating activities, which reconciles net income to the actual cash used or provided adjusted by operating assets and liabilities.

The second activity shows the cash flow from investing activities, such as the purchase of cows, equipment and the inflows of cash from the proceeds when they are sold. It also presents changes in the investment held by the creamery, purchases of pool quota, the amount of heifer capitalization and other investing activities. The last part of the cash flows is the financing activities, which shows how much cash was borrowed from the bank and repaid in addition to cash withdrawn or contributed by the owners. Bankers look at the cash flows to see what type of funds the company is relying upon to fund losses or an expansion. Is the company borrowing term or operating debt, selling assets, borrowing from related parties, etc.?

The footnotes are also important. They provide a description of your operations, the accounting policies used to prepare the financials and more detail on certain items like feed inventory, herd inventory and a long-term debt repayment schedule. Milk production per milking cow per day is a footnote to pay special attention to. A banker once told me the footnotes is where he starts when he opens the financials, as it is the foundation for how the statements come together.

Supplementary schedules like the statistical data provide vital information including average cull prices, herd turnover, component prices, testing and milk pounds produced along with milk price by month. If you grow your own feed, the financial statements should include a supplementary farming schedule that is similar to the income statement, where the crops harvested by the company are reported as income and the expenses associated with growing and harvesting of those crops.

A line item usually misunderstood on the farming schedule is the investment in growing crops. This amount represents the capitalization of farming expenses incurred to date that are applicable to crops harvested in the future. This is because the matching principle requires expenses to be recognized in the same period the revenue is recognized.

In these uncertain times, financial statements are one of your most valuable tools as they can help you identify problem areas. If you have questions or concerns about your financial statements, do not be afraid to ask your CPA. That is why you pay us. Bankers are examining financials with a fine-tooth comb these days, so it is imperative you give them the most accurate representation of your company. ***PD***

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