

# THE IMPORTANCE OF DAIRY FINANCIAL STATEMENTS

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There's an old joke about keeping separate sets of books – one for the bank, one for the IRS, and one to really understand what's going on in your business. While typically brought up tongue-in-cheek, different rules of accounting actually allow a business to do this. The focus of this article will be the books for the bank, why they are important, and how they can convey the actual financial position of your dairy.

Most accountant-prepared dairy financial statements use generally accepted accounting principles (GAAP). These principles require financial statements to be presented on the accrual basis, which is an accounting method that tracks income and expenses as they are earned and realized. This differs from the cash basis method that is accepted by the Internal Revenue Services for tax reporting in that cash basis tracks income and expenses as they are received and paid.

Banks usually require financial statements when making lending decisions. Banks want to see a financial statement, generally prepared by an independent accountant, to ensure that the dairy has the ability to repay the loans that have been requested. The bank may use the financial statement to do additional calculations such as EBITDA (earnings before interest, taxes, depreciation, and amortization) or cash flow projections. The bank will

also want to compare the dairy to industry averages and benchmarks.

There are specific guidelines for the preparation of financial statements that may differ by industry. Examples are the use of hundred-weight calculations and herd replacement cost.

## HUNDREDWEIGHT, FAT AND ENERGY CORRECTION, AND COMMON SIZING FINANCIAL STATEMENTS FOR COMPARISON

Since milk production is the main driver of any dairy operation's profitability, milk production is used as a complementary method of measuring a company's breakeven and cost of production and making operations of different sizes comparable. Income and expenses are presented per hundredweight of milk produced, which allows a 500 cow dairy to compare relevant financial data with a neighboring 5,000 cow dairy.

Another useful metric as more herds are bred and fed for components is fat or energy correction. There are different formulas that have different uses, but typically fat or energy correcting milk means giving weight to the fat and protein content in the milk. This is useful when comparing a Holstein herd's financial statement to a Jersey herd's financial statement.

## HERD REPLACEMENT COST AND CAPITALIZATION OF HEIFER RAISING COSTS

Herd replacement cost is a metric that estimates the cost to keep the dairy full. Included in the herd replacement cost is depreciation of dairy cows and the gain or loss on sale of cows. Dairy cows are either purchased or raised through a heifer raising program. On accrual basis financial statements the value of the animal is treated as a long-term asset. Once the heifers reach maturity and are moved into the milking herd (first lactation), they begin to be depreciated over their useful life. Depreciation is calculated using the straight-line method over an estimated useful life of five or seven years.

The other part of the herd replacement cost is the gain or loss on sale of cows. The gain or loss on sale of cows is calculated as the sales proceeds over the net basis of the cow at the time of sale. The gain or loss would also include the net basis of any animal that died during the period. The net basis is derived by subtracting the total depreciation taken over the life of the asset (accumulated depreciation) from the original purchase price or raised value. Below is an example of the loss on sale of a cow assuming the herd has a 40% turnover rate:

Purchase price	\$2,000
Accumulated depreciation (30 Months)	(715)
Net basis	1,285
Sales proceeds	(800)
(Gain) loss on sale	\$485

Since it can be difficult to calculate the actual cost to raise an animal to maturity, generally an estimate is used. That estimate should consider direct and indirect costs and is the negative number that typically appears under feed costs and, in some cases, under operating expenses. Some direct costs include feed, veterinary services, and breeding services. Indirect costs include land rent, irrigation, utilities, and labor. These costs are tracked and depreciated as the heifers give birth and enter the milking herd.

## BENCHMARKING AND THE USEFULNESS OF A DAIRY FINANCIAL STATEMENT

Dairy financial statements are used to estimate the financial health of a dairy, and therefore the risk to the bank of loaning money to that dairy. Management can use the financial statements as a tool to understand the company's breakeven and cost of production, and make informed decisions when buying feed, expanding, or hedging milk or feed. By evaluating income and expenses on per hundredweight of fat or energy corrected hundredweight bases, lenders, management, and owners have the ability to benchmark operations against peer groups, even if the peer groups are of different size and different breeds. There are several published sources for benchmarking. One very useful tool is Frazer, LLP's Dairy Operating Trends, published semi-annually. This publication can be found at [www.frazerllp.com/resources/dairy-farm-operating-trends/](http://www.frazerllp.com/resources/dairy-farm-operating-trends/)

If you'd like additional information regarding the operating trends, you may visit our website at [www.frazerllp.com](http://www.frazerllp.com) or contact me at [bodell@frazerllp.com](mailto:bodell@frazerllp.com).

