Ag Decision Maker

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Understanding Net Worth

A net worth statement or balance sheet is designed to provide you with a picture of the financial soundness of your business at a specific point in time. Net worth statements are often prepared at the beginning and ending of the accounting period (i.e. January 1), but can be done at any time.

The statement records the assets of the business and their value, and the liabilities or financial claims against the business (i.e. debts). The amount by which the value of the assets exceed the liabilities is the net worth (equity) of the business. The net worth reflects the amount of ownership of the business by the owners.

The formula for computing net worth is
Assets – Liabilities = Net Worth

Likewise, the following formula helps explain the interaction of the elements of the statement.

Assets = Liabilities + Net Worth

Sample balance sheet (net worth statement).

Assets	
Current	$10,000
Intermediate	$40,000
Long-term	$200,000
Total Assets	$250,000
Liabilities	
Current	$5,000
Intermediate	$30,000
Long-term	$65,000
Total Liabilities	$100,000
Net Worth	$150,000
Ratios	
Current Ratio	2.00
Debt to Asset Ratio	.40

Classifications of Assets and Liabilities

Assets are often divided into three categories; current, intermediate and long term. In some situations the intermediate and long-term asset categories are combined into one category called fixed assets.

- Current assets consist of cash and near cash assets. Current assets often contain assets that will be sold and converted to cash during the upcoming accounting period. Crops and livestock held for sale are typical current assets for a farm business.
- Intermediate assets have a useful life of more than one year. Typical farm intermediate assets are machinery, equipment and breeding livestock.
- Long-term assets include real estate such as land, buildings and facilities. These are assets commonly referred to as real estate.

Liabilities are usually classified the same way assets are classified.

- Current liabilities consist of payments that are due during the upcoming accounting period. This includes accounts payable and interest and loan payments due during the accounting period.
- Intermediate liabilities consist of outstanding debt against intermediate assets and often have a term of three to seven years. Interest and principal payments due within the coming year are included in current liabilities. Only the amount of debt remaining after the current year's principal payment is deducted is included in intermediate liabilities.
- Long term liabilities consist of outstanding debt against long term assets and may have a term of twenty or more years. Interest and principal payments due within the coming year on this debt are included in current liabilities. Only the amount of

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debt remaining after the current year's principal payment is deducted is included in long-term liabilities.

Current assets and current liabilities provide an indication of the cash flow of the business during the coming year. Subtracting current liabilities from current assets determines the amount of working capital in the business. Working capital is the amount of money used to facilitate the operations of the business.

Dividing current assets by current liabilities provides a ratio indicating the amount of cash available per dollar of current liabilities. For example, a current ratio of 2 indicates there are $2 of cash (or near cash assets) available for every $1 of liabilities due during the coming year.

Valuing Assets

A value is placed on assets on the day the net worth statement is created. There are two methods for valuing assets. The market approach is commonly used in a simple net worth statement for small businesses. The cost approach is a more sophisticated method often used for large and complex businesses. Both methods may be used in the same statement showing two estimates of net worth.

Market Approach

The market approach involves valuing an asset based on its current market or sale value. For assets with a ready market (i.e. corn) the current market price is used. Other assets (i.e. equipment and real estate) may have to be appraised or valued with some other method. The market approach provides an estimate of the value of the net worth if the business is liquidated (assets sold and liabilities paid) on the date of the statement. Over time, the value of the net worth using this method will change based on changing asset prices and the amount of profits retained in the business.

The market approach often uses a net market value of the assets. For example, if the sale of an asset will trigger income tax liability, the value of the asset is adjusted for the tax liability.

A net worth statement using the market valuation method measures the solvency of the business. As long as net worth is positive, the business is solvent. If liabilities exceed assets and the net worth is negative, the business is insolvent and bankrupt.

Solvency can be measured with the Debt to Asset Ratio. This is computed by dividing total liabilities by total assets. For example, a ratio of .4 means that, if the liabilities are paid, it would require the liquidation of 40 percent of the assets. The larger the ratio, the larger the amount of assets needed to be liquidated.

Cost Approach

Another method of valuing assets is the cost approach. It involves valuing an asset based on its original purchase cost, less depreciation, plus improvements to the asset. For example, equipment can be valued by subtracting accrued depreciation from the original purchase price of the equipment. Real estate can be valued based on the original purchased price of the real estate, less depreciation on buildings and facilities, plus any improvements to buildings and facilities.

The cost approach provides an accurate assessment of the value of the net worth based on the profitability of the business. However, it may not provide an accurate sale value of the business.

Over a period of time, the net worth of a profitable business will tend to grow if profits are retained in the business. The profits retained in the business (not distributed to the owner's of the business) are often listed in a special line item in the net worth (equity) section called retained earnings.

Other Financial Statements

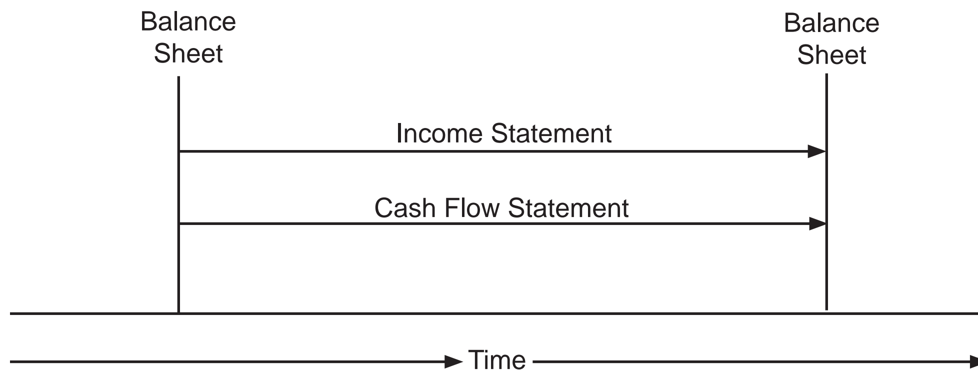
A net worth statement is only one of several financial statements that can be used to measure the financial strength of a business. Other common statements include the **Cash Flow Statement** and the **Income Statement**, although there are several other statements that may be included.

These statements fit together to form a comprehensive financial picture of the business. The balance sheet or net worth statement shows the solvency of the business at a specific point in time. Statements are often prepared at the beginning and ending of the accounting period (i.e. January 1).

The Income Statement is a dynamic statement that records income and expenses over the accounting period (between the two net worth statements). The net income (loss) for the period increases (decreases) the net worth of the business (as shown in the ending balance sheet versus the beginning balance sheet).

The Cash Flow Statement is also a dynamic statement that records the flow of cash into and out of the business. A positive (negative) cash flow will increase (decrease) the working capital of the business. Working capital is defined as the amount of money used to facility business operations and transactions. It is calculated as current assets (cash or near cash assets) less current liabilities (liabilities due during the upcoming accounting period – i.e. year).

Figure 1. Integrated financial statements.



A Complete set of **Financial Statements,** including the beginning and ending net worth statements, the income statement, the cash flow statement, the statement of owner equity and the financial performance measures is available to do a comprehensive financial analysis of your business.

To help you assess the financial health of your business, **Financial Performance Measures** allows you to give your business a check-up. **Interpreting Financial Performance Measures** helps you to understand what these performance measures mean for your business.

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