Glossary of Business and Financial Terms

Accounts payable: Money you owe others, usually trade suppliers.

Accounts receivable: Money owed to you by others, usually customers who you sell to on credit terms.

Accrual: A method of accounting that matches expenses with revenues. Under accrual accounting, inventory purchased in one season, but not used until the next, will be expensed only when used, even though it might have been paid for in the previous year. Conversely, expenses are recorded when incurred, even if cash does not change hands until later.

Amortization: Similar to depreciation, this is the erosion in value over time of an asset. Usually used for intangible assets including prepaid expenses, patents, loans, and the like.

Assets: Assets are things of value owned by individuals, corporations or public entities. They may be tangible or intangible. Examples include cash, land and client lists.

Balance Sheet: This statement details a company's financial position at a specific point in time, usually at the end of the quarter or year. The balance sheet includes assets, liabilities, and equity and follows the accounting equation: ***Assets = liabilities + equity***

The left side includes all your assets (whether you have a loan against them or not); the right side shows what you owe (debts, bank loans, etc.). The amount left after subtracting your liabilities from your assets is your equity. Your asset values should equal those of your liabilities and equity.

Basis: The cost of an item, for tax purposes. This may be different than the actual purchase price. Often comes into play in an estate tax or capital gains situation.

Budget: A spending plan based on estimated income and expenses over a set period of time.

Business Plan: A plan for what type of business you want to build, and how you plan to make money. Broadly speaking this is a statement of your vision, and how you plan to get there. The goals included are entirely up to you, the only rule is that it must be economically viable. All businesses should have one.

Capital Gains: A type of income generated when an asset is sold for more than its basis (usually its purchase price). This can include land, stocks, or other appreciating assets not part of the business's core operations and held for an extended period. It does not include inventory. Capital gains are generally taxed at a lower rate than ordinary income.

Capital Spending or Capital Investment: Spending on an item or an improvement to an item that is expected to last more than one year. Capital investments are typically depreciated over time, rather than fully expensed in one year.

Cash-Basis Accounting: A method of accounting that recognizes revenues and expenses when cash changes hands, regardless of when that revenue or expense may have actually been earned. This can

distort income, but there can be tax advantages here. Many farms use modified cash-basis accounting for tax filing.

Channels, or Marketing Channels: Avenues of selling your product. Channels for a greenhouse would include: Direct wholesale to stores, wholesale through brokers, sales to landscapers, retail store, or farmer's markets.

Collateral: Property pledged to secure a bank loan.

Compound Interest: The concept that interest earned gets added to the balance and will earn interest itself in the future. i.e. a dollar earning 5% is worth $1.05 the first year, $1.103 the second, and $1.158 the third. See time value of money. The higher the rate, and the longer the period, the more powerful the effect.

Corporation: A legal entity established to operate a business. Many farms operate as Subchapter-S Corporations or LLCs. There can be tax, liability, and legal advantages to forming a corporation.

Current ratio: The ratio of your current assets (cash or will be converted to cash within one year) compared to your current liabilities (obligations due within one year). Measures solvency.

total current assets / total current liabilities

Goal > 1.5:1. When this dips below 1, you may be in trouble.

Debt-to-asset ratio: Measures total liabilities to total assets.

total liabilities/total assets

Goal: < 50%. This measures the long-term solvency of the business.

Depreciation: The loss of value in an asset over time. i.e. a $10,000 tractor that is 3 years old might now be worth only $5,000. The $5,000 in value lost is depreciation. Often farmers will use accelerated depreciation methods, as permitted by the IRS, for tax purposes. But it is better to use a realistic depreciation method for your internal income statements.

Diversification: A strategy to reduce the risk of farming. Some farmers use this concept to diversify their investments between on- and off-farm assets, such as an IRA, or stocks. Others take this idea and decide to grow multiple crops or market to multiple channels. The downside to diversification is that it adds complexity to your operation, making it harder to manage, and sometimes requires greater capital investment.

EBITDA: Earnings Before Interest, Taxes, Depreciation and Amortization. A value often used to measure the basic profitability and ability to cover debt service payments of a company when comparing one business to another.

Equity-to-asset ratio: Measures the % of business assets that you own, net of any borrowing.

total equity/total assets

Goal: > 50%

Financial Statements: The trio of: Balance Sheet, Income Statement (accrual basis), and Statement of Cash Flows

Futures: Broadly speaking, a contract to deliver a commodity at a future date. Farmers often use futures and options to hedge against risk of commodity fluctuation. A dairy farmer, for example, might open a futures contract for milk to lock in a favorable price, and reduce the risk of the price dropping. The catch is that that farmer may not benefit if prices increase further, but they are protecting themselves against market volatility.

Gross Margin: The money left over after your variable costs (the direct costs of producing your product or service). In the case of a store, gross margin is revenue less cost of goods sold. In the case of a dairy, gross margin might be milk revenue less feed costs and labor. The money left over, or *margin* is what the business has available to cover overhead (fixed costs) and profits. Margin is calculated by working back from the selling price, so an item that costs $0.50, and sells for $1, would have a 50% margin.

Income Statement: The income statement shows the business's performance over a period of time, such as a month or year. Focusing on revenue and expenses, the income statement depicts a company's profit or loss.

Intangible Assets: Things of value that are not physical property. Examples include a brand name, a patent, the name of a business, a customer list, or other intellectual property. Intangible assets are generally valued only when they change hands.

JIT – Just-in-Time: A concept in inventory management, that the less inventory held, the better. There can be substantial incentives to buy inventory ahead of need, but always consider that holding inventory entails cost and risk. The savings must outweigh these factors.

Joint Tenants, or Tenants by the Entirety (Joint Tenancy): This type of ownership is often used by married couples. At the death of one owner, the property passes to the surviving owner. There is a high degree of certainty associated with this type of ownership. All the ownership will pass to the survivor regardless of what is in the will. Tenants by the entirety is specific to married couples.

Leverage: How much your business is working with borrowed money. A farm with a lot of debt is said to be highly leveraged. Leverage is ok, even preferable sometimes, but increases risk.

Liabilities: A: Debts, or things that you owe. Examples include payables to suppliers, loans, and other obligations. B: Legal obligations or risks. Liability insurance is an important risk management strategy. Business structures like Limited Liability Companies (LLCs) and Corporations can protect you personally from business liabilities.

Lien: A security interest in a property. Liens must generally be satisfied before a property can be sold. An example is a financed tractor. If that tractor is to be sold, the bank lien must be paid off for legal title to be released.

Liquidity: The measure of a business' cash position or the ability of an asset to be converted to cash. Stocks, and other financial investments are generally highly liquid. Inventory, crops, or livestock may be of intermediate liquidity. Real estate is often highly valuable, but not very liquid (may take a long time to sell).

Lost Capital or Sunk Capital: The investment in something that is unlikely to be recoverable. Generally, the more specialized, and harder to move something is, the more lost capital it will have. An item like a forklift, which can be easily sold to another business, will have little lost capital beyond its depreciation. An investment like a greenhouse, which is very difficult to move or resell once it's built, has tremendous lost capital. This doesn't mean that a greenhouse is a bad investment, only that the money put into it can't easily be recovered if circumstances change.

Margin: See Gross Margin

Marketing: Often confused with sales, marketing encompasses evaluating and considering the 4 "P's"; Product, Price, Place, and Promotion. What product will you grow and/or sell? How will it be priced? What channel will you sell it through? How, if at all, will you promote it, and who will you sell it to?

Markup: The inverse of margin. Markup is determined based on the cost of an item, and how much you are marking it up. An item that costs $0.50, and sells for $1, would have a 100% markup.

Net Income from Operations Ratio:

Net earnings/gross accrual income

Goal > 20%

Net Present Value: A method of evaluating the present-day value of an investment. Future costs and benefits are plotted out on a timeline, then discounted by taking the time value of money into account (the loss in value of future returns due to interest costs and inflation). Generally speaking, the projects with the highest NPV are the ones to do first.

Operating Expense Ratio: Shows expenses in relation to gross income.

(gross accrual expense – interest – depreciation)/gross accrual income

Goal < 70%

Operating Profit Margin: This measures how much your farm is earning on operations.

(net earnings + interest expense)/gross accrual income

Goal > 20%.

Operations: The core activity of your farm. This term is used to distinguish your growing or inventory selling activity from other income-generating activity such as, sale of assets, investment income, rent, or other extraneous or unusual events.

Opportunity Cost: The potential revenue forgone when you choose one investment over another. For example, an investment that yields 2% would have an opportunity cost if you could have invested that money instead at 6%.

Overhead or Fixed Costs: Costs other than direct inputs to a product or service that is sold. In other words, the general costs of running a business. For example, these costs include; utilities, insurance, interest, and office expenses.

Partial Budget: A method for evaluating the cost and benefits of a new investment. Rather than draw up a complete budget for the business, you just measure the marginal, or additional costs and benefits to this new investment.

(added returns + reduced costs) - (Reduced returns + added costs)

= net change in farm income

Payback Period: The length of time required for an investment to earn back its initial cost

ROA, or Return on Assets: A measure of how efficiently you are using the assets of the business to generate income. ROA is a useful measure to compare the performance of your farm to others, or to alternative investments.

(net earnings + interest expense)/average total assets

ROE, or Return on Equity: Measures how efficiently your farm is generating income from your equity in the business. Ideally this % should exceed ROA, showing that you are earning income on borrowed money.

net earnings/average total assets

ROI, or Return on Investment: The amount of money a given investment is projected to yield.

Net earnings/value of investment

Situational Leadership: The concept that different people in different situations deserve different styles of leadership. Sometimes you have to be hard. Sometimes you have to be collaborative.

Sole Proprietorship: The basic form of business structure under which most farms operate. Under this legal form, all income and obligations of the farm flow through to the owner.

Solvency: A measure of how much net worth a business has (assets minus liabilities). Most farms use some borrowed money, but a business that becomes insolvent (debts exceed assets) may not survive. Solvency refers to the value of assets in relation to debt, as well as the ability of the business to generate positive cash flow. Ratios include; debt-to-asset ratio, and equity-to-asset ratio.

Statement of Cash Flows SCF: Because an accrual income statement may differ substantially from when cash actually changes hands, the SCF shows cash coming into the business, and cash going out of the business. Important for maintaining the ability to cover liabilities.

Sunk Costs: Money that already has been spent and cannot be recovered and/or assets that already have been purchased and are difficult or impossible to resell. Examples include buildings and facilities, specialized equipment and other items with little resale value once placed into service.

Tangible Assets: Tangible assets are physical property that companies or individuals own that have monetary value. Examples include land, buildings, and equipment.

Tenants in Common: This type of ownership indicates that each owner owns an undivided interest. In the case of husband and wife, the husband owns one-half interest, and the wife owns one-half interest. The undivided one-half interest can be willed to the surviving spouse, or to someone else, or to a trust.

It can also be gifted during their lifetime. It does not automatically pass to the surviving spouse. This form of ownership is also available to unrelated parties.

Term Debt & Capital Lease Coverage Ratio (TDCR): The ability to repay debt is the lifeblood of any business. This measure is a key metric to determine the ease with which a given business and repay debt.

> ***(net earnings + nonfarm income + depreciation + interest – family living – income tax) / annual scheduled debt payments (principal + interest)***

Goal > 125%.

Time Value of Money: The concept that a dollar today is worth more than a dollar tomorrow. Future revenues and costs should be discounted by an appropriate factor, often the cost of borrowing money, or the rate of return of an alternative investment.

Working Capital: Available cash that can be used to fund day-to-day operations of your farm.

> ***Total current assets-total current liabilities***