

# Farm Finances Glossary



## Accounts payable/receivable

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Accounts payable is a liability account on the balance sheet. It includes all invoice payments due to your vendors for products/services already received.

Accounts receivable is an asset account on the balance sheet. It includes all cash due to your business by its customers for products/services already provided.

## Accrual accounting

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Sometimes the exchange of cash does not time up with an economic event that needs to be accounted for. Some examples: Do you account for the purchase of livestock feed when you buy a pallet of bulk feed, or as your animals consume it? Do you record a sale when you deliver your products, or when you receive payment from your customer?

There is no *right* way to account for these events, as long as you do it consistently.

There are two methods of accounting: cash or accrual. In an accrual accounting system, transactions are considered to have happened when the economic

event occurs, rather than when the cash changes hands. The accrual method is preferred if you want your income statement to best reflect your current financial situation. In the feed example, a farm practicing accrual accounting would record a feed expense as their livestock eat it, not when they buy a pallet-load of feed. Accrual method adherents prefer that their financial statements reflect economic activity, instead of cash changing hands.

The accrual method is more complicated than cash accounting. It requires maintaining accounts payable, accounts receivable, and prepaid expenses accounts to track transactions that are recorded without an exchange of cash, and exchanges of cash that have not been recorded.

## Amortization

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Farmers will most often hear amortization used to describe the span of time over which a loan is to be repaid. A thirty-year mortgage, for instance, is amortized over 30 years. For a given loan amount and interest rate, a longer

amortization period will lead to smaller monthly payments but a larger total payment.

## Appraisal

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A formal valuation, usually of a piece of property prior to purchase. A lender usually orders a property appraisal before formally offering you a loan, to ensure the property is truly worth what you (and therefore they) are paying for it.

You will run into problems buying property if the property's appraised value is less than its purchase price. Lenders secure your loan by issuing a lien against the property in case of default, so they will not offer a loan if seizing your property would not recover their full investment. In these cases, a large down payment or additional collateral will be required to get a loan.

## Assets

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Assets are a type of account included in the balance sheet. There are many asset accounts, such as cash, land, equipment, and accounts receivable. Asset accounts

# Farm Finances Glossary



can include an individual item – a potential example is land, if you own one property – or many items – supplies, for instance, may include all of your greenhouse and office supplies.

On the balance sheet, asset accounts should be listed at their book value. The asset account for your farm, if you own it, should be listed at the price you paid for it; any appreciation to the property value is not realized unless you sell it. It is OK, even common, for market value and book value of an asset to differ.

If you have a loan for a particular asset, you would still list the full cost of that asset in its asset account. You will have a separate liability account for the loan associated with that asset, which will decrease as you pay back the loan.

There are both long-term and short-term (or current) asset accounts. (See current assets.)

## Balance sheet

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The balance sheet is a summary of your farm's assets, liabilities, and owner's equity at a given point in time. Contrast

that with the income statement and statement of cash flows, which document a *span of time*, usually a year.

Lenders rely on your balance sheet to determine your creditworthiness.

Analyzing your balance sheet alone allows them to understand your current indebtedness and what kind of collateral you own. When your balance sheet is analyzed along with an income statement, lenders can calculate financial ratios to understand your business's ability to pay back a loan. Often lenders will require you to share a personal balance sheet in addition to your business balance sheet.

## Book value

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The value of an asset on your balance sheet ("on the books"); usually the purchase price minus any accumulated depreciation. Book value does not always, or even usually, match the market value of an asset.

If you sell an asset with a higher market value than book value, such as farmland that has increased in value over time, you will "realize" a capital gain. This type of

gain is taxed at lower rates than ordinary income – possibly not at all, for people in lower tax brackets.

## Business plan

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A business plan is a document that communicates the future goals of an enterprise and how they will be achieved. Usually created for a loan application, a business plan is a useful tool for anyone starting or changing an enterprise, especially when management is shared with a team. Overall, a business plan is a stated goal, or series of goals, for the business, supported by pro forma financial statements, and an explanation of how the goal(s) will be accomplished.

Business plans should contain the following information:

- Overview/description of the company and its owners
- Stated goals of the company
- Value proposition
- Market analysis
- Risk analysis
- Capital plan
- Current financial position and historical financial statements



# Farm Finances Glossary

- Projected financial information

There is no standard format or required length for a business plan. It can be one page for a simple operation, or one hundred for a complicated enterprise. Ask your loan officer if they have a business plan format that they prefer. An internet search will yield many templates.

## Capital expenses

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Certain assets which give a long-term benefit to the farm, such as equipment and buildings, can be depreciated over the “useful life” of the asset. Purchasing these assets is considered a capital expense, in contrast to an operating expenses, which offer a shorter-term benefit and are therefore written off immediately.

Note that land is not considered a capital expense, and is not a depreciable asset.

## Capital gain (loss)

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A capital gain occurs when an asset’s market value increases over its book value and is sold. The capital gain is not “realized” and therefore not recorded in

income or (potentially) taxed unless the asset is actually sold.

Capital gains are subject to lower tax rates than other income, or for those in lower tax brackets, not at all.

## Capital plan

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A capital plan should be included in a business plan, especially if that business plan is part of a loan application. The capital plan schedules the capital expenses you intend to make. It can be as simple as a list of items along with their prices and the year in which you plan to purchase them.

## Cash accounting

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For context on accounting methods, see our entry for accrual accounting.

When accounting on a cash basis, transactions are reported whenever a cash transaction is made, no matter when the actual economic activity occurs. For example, if you deliver to a customer on December 30, 2017, but they do not pay their invoice until January 10, 2018, that sale would be

booked to your 2018 revenue if you practice cash accounting.

Small businesses without dedicated accounting staff are more likely to practice cash accounting. It is easier to manage and, arguably, easier to understand.

## Cash flows

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Cash flows are the dollars coming into and going out of your business. The statement of cash flows is one of three main financial statements. When created as a historical financial statement, the statement of cash flows shows how business activity over a certain period affected your company’s cash reserves.

Every business plan should include a pro-forma statement of cash flows, which is a future projection of how cash will enter and exit your business. For farm businesses, it is helpful to look at monthly, rather than annual, cash flows because farm expenses and incomes vary with the seasons. A pro forma statement of cash flows acts like a budget, telling you (or your loan officer) whether you will have sufficient cash to continue

# Farm Finances Glossary



operations each month. It will also communicate the assumptions you are making to reach these conclusions. It is always helpful to have a more experienced farmer check your projected cash flows to ensure that your assumptions are reasonable and that you haven't forgotten any cash outflows.

The statement of cash flows is divided into three sections:

- Cash flows from operations – inflows and outflows from your usual course of business
- Cash flows from investing – for farmers, this section usually contains outflows from making capital investments in your business, such as buying machinery or a building; it also includes any cash you receive from selling these kinds of assets
- Cash flows from financing – includes inflows from loans or investments and outflows from paying back loans, or outflows from paying a draw to owners or dividend to investors

Add up all three sections and you have your net change in cash flows for a given period.

Understanding your business's usual cash flows cycle, and being able to predict future cash flows, are essential to becoming a successful business manager. Cash flows projections will tell you when your business might need operating financing, or when it's the right time to hire a new employee or buy new equipment. Once you feel confident in predicting future cash flows for your business, it becomes easier to plan for changes or growth.

## Chattel

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The property or products that one owns, usually moveable and not attached to real estate. Examples include: equipment, livestock, stored grain or vegetables, or vehicles. They're often used to secure a loan.

## Closing costs

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Costs associated with borrowing money and buying land may include loan fees, which are charged by the lender for completing the process of originating a loan to the borrower; broker and attorney fees, which are charged for

services provided while conducting and negotiating the transaction; as well as various recording, inspection, and appraisal costs. These costs vary widely, but can amount to 5% of the purchase price of the property.

FSA and some other lenders can finance closing costs with your loan, allowing you to pay them over time, but usually closing costs must be paid upfront in cash at the time of purchase. Along with a down payment, closing costs present one of the biggest obstacles to farmers buying land.

## Collateral

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Collateral is an asset pledged to back your loan, which would be forfeited in the event of a default. Collateral can be any valuable asset, from your car to your house to your livestock. A common problem for beginning farmers is a lack of collateral that can be pledged to secure a loan. (See secured loans.)

If you borrow from FSA, FSA officials may make regular "chattel checks" at your farm to make sure that the equipment or livestock you have pledged as collateral for your loan is in good shape.

# Farm Finances Glossary



Unsecured loans, such as credit cards and some personal loans, do not require you to pledge collateral.

## Conservation easement

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A conservation easement is a voluntary legal agreement between a landowner and a land trust or government agency that permanently limits uses of the land in order to protect its conservation value.

Selling an easement on land with development value can drastically reduce the cost of purchasing farmland, either at the time of purchase or afterward.

Negotiating an easement is a long process, requiring planning, relationship building, and fundraising – but can create amazing land access opportunities.

Read NYFC's [Farmer's Guide to Working with Land Trusts](#) to learn more about land trusts and conservation easements.

## Cosign(er)

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Someone, in addition to farm owners, who signs your loan, promising to help pay it back (usually only in case of default).

## Cost of goods sold (COGS)

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Sometimes called variable costs, the cost of goods sold are operating expenses directly related to the production of the products/services you sell. COGS should include the cost of labor, inputs and materials used, and the portions of overhead related to production.

Small farms are complicated businesses for COGS calculations, since there are few clear distinctions between production, sales, management, etc. For example, in any given day your own labor might be split between harvesting, selling at market, and bookkeeping – but only the cost of your harvesting labor is included in COGS. It can also be difficult to allocate overhead costs between production and other business functions. You might pay one electric bill for the whole farm, so how can you differentiate between what you use in the milking parlor vs what you use in the office?

Even professional accountants use assumptions to calculate COGS, so don't worry too much about perfect accuracy. Define some rules (i.e. 80% of the electric bill is allocated to production, 20% to

general overhead) and keep them consistent.

Understanding and reviewing your COGS is imperative to sound business management. Gross profits equals revenue minus COGS; so COGS is one of two areas you can improve to better your gross profits – which is your business's main indicator of profitability.

## Credit report

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A credit report is a long list of your credit history. It shows your debts, how much you've paid back, and if you've paid late or defaulted. It may include student loans, mortgages, credit cards, medical payments, car loans, and any other loans. Your credit report does not always include your credit score. Your credit score, sometimes called your FICO score, is a number that represents this long history and other factors, like the length of your credit history and the diversity of types of credit.

## Current assets/liabilities

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The word 'current' implies that an asset

# Farm Finances Glossary



or liability will be converted to cash or paid in cash, respectively, within one year. Current assets include assets like inventory or supplies, even annual crops in the ground or feeder livestock ready for processing. Examples of current liabilities are the portions of loans that you expect to pay in the next year, or accounts payable due to vendors.

## Current ratio

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Your current ratio is calculated as current assets divided by current liabilities (See current assets/liabilities.)

For every dollar of obligations due in the next year, the current ratio tells you how many dollars of liquid assets you have. This helps lenders understand if your business is maintaining enough liquidity to prepare for unexpected events.

A farm's target Current Ratio depends on its industry. A stable operation with low inventory and recurring income, like a wholesale dairy, can get by with a lower current ratio than a business with more volatility, like a diversified farm with a seasonal retail store.

## Debt

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Debt is the sum of money that you or your business owes: to lenders, vendors, or anyone else.

On the balance sheet, debts are usually separated into long-term and short-term portions, with short-term portions coming due within a year.

When seeking a loan, lenders will consider both your business and personal indebtedness. Personal debts that show up on your credit report, such as student and car loans, can prevent you from qualifying for a loan.

## Debt-to-asset ratio

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Calculated as total debts divided by total assets. The debt-to-asset ratio tells you what proportion of your assets are owed to lenders. The less stress you place on your personal income to pay debts, the more flexibility you will have to take risks.

## Debt-to-income ratio

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Calculated as current liabilities divided by total personal income. Depending on

who is calculating the ratio, they may include income from your spouse and off-farm jobs, or they may limit income strictly to farm income.

The debt-to-income ratio suggests if financing a property will be affordable for you at your current income. Speak to a lender to find out what their institution deems to be 'affordable'.

New businesses often need to take on debt in order to grow their earnings. In these cases, the debt-to-income ratio will improve over time, as debt payments remain constant and your earnings, and hopefully income, increase.

## Default

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A default occurs when a business fails to meet the legal obligations of debt repayment. In cases of default, the lender usually has some recourse to reclaim funds or collateral from the borrower. The possibility of default is what drives lenders to take caution in issuing loans, and why they usually ensure their lenders have assets that can be seized in case of default. (See secured loans.)

# Farm Finances Glossary



## Depreciation

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For accounting purposes, it is helpful (for accountants and the IRS, at least) to think of certain assets as having a useful life, and for their value to decline over a fixed schedule during that useful life. (See capital expenses.) The accounting method of writing off an asset's cost over its useful life is called depreciation. Depreciation rates do not, and do not have to, reflect how market prices change over time or even the state of repair of your particular asset.

The most common method for calculating depreciation is the straight-line method. Determine the useful life of the asset (some web research or an accountant can help with that) and divide the asset's cost by that useful life. The result is the annual depreciation expense.

Annual depreciation is an expense that can be written off your tax bill every year you own the asset during its useful life. Contrast that to operating expenses, which must be written off entirely in the year they are purchased.

On your balance sheet, asset accounts for your depreciable assets have a corresponding accumulated depreciation asset account. As the asset depreciates, its asset account decreases and its accumulated depreciation account increases. The original cost of the asset should always equal the sum of these two accounts.

Note that land is not considered a capital expense, and is not a depreciable asset.

## Dividends

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Also called draw or owner's draw, a dividend is a distribution of cash to the owner(s) of a business. Some farmers choose to pay themselves with a dividend instead of a salary, but a dividend is not the same thing as a salary. Salaries have payroll taxes deducted and are included as a business expense on the income statement. Dividends do not have payroll taxes deducted – so farmers choosing to pay themselves this way must be careful to avoid tax problems – and they do not show up on the income statement because they are not part of the operations of a business. Dividends paid

out will show up on the financing section of the statement of cash flows.

If you do not pay yourself a salary, but you make an income from your farm, then you are paying yourself in dividends. This is fairly common for farmers, but if you are new to owning a business, be sure to consult an accounting professional to determine if you are paying income taxes properly.

## Down payment

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A cash payment made to a lender at the time of a property transaction. Traditional lenders will always require a down payment to qualify for a mortgage, often as high as 20% of the property value. This is one of the biggest barriers to farmers buying land.

USDA's Farm Service Agency, a farm lender, does not require down payments for several of its farm ownership loan programs. (See FSA.)

## Draw

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See dividend.

# Farm Finances Glossary



## Easement

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See [conservation easement](#).

## EBITDA

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Literally “earnings before interest, taxes, depreciation, and amortization”. EBITDA is calculated as net profit + interest + taxes + depreciation + amortization.

Why use this complicated figure instead of plain old net income? Mainly, it is easier for [lenders](#) to compare businesses this way. For instance, an upstart farm which recently purchased land may have a large debt burden with high interest expenses; the upstart will look weaker than an established farm with no property debt. Yet by ignoring interest expense – which doesn’t really indicate anything about the efficiency of a farm – the lender may learn that the upstart is actually more profitable than the established farm.

Our [Land Affordability Calculator](#) uses EBITDA to calculate some of the financial ratios presented in the tool, just like your lender will.

## Enterprise budget

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An enterprise budget is just like a [pro forma statement of cash flows](#), but for one particular part of your business, rather than for your whole business. An enterprise budget is used to estimate the costs and benefits of undertaking a new project, such as growing a new type of crop or building a creamery. If you are seeking a loan or investment in your new project, you will certainly need to make an enterprise budget, but even if you are financing it yourself this is a useful tool.

Examples of enterprise budgets for different crops and projects can be found on [Farm Answers](#) and through your local USDA Extension office.

## Equity

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*For accounting/bookkeeping purposes:* Equity, which is often listed as one of three main sections of the [balance sheet](#) as Shareholder’s Equity or Owner’s Equity, is calculated as a company’s total [assets](#) minus total [liabilities](#). Equity is similar to a company’s net worth, and is sometimes referred to as the [book value](#)

of a company: what is left when you subtract its liabilities from its assets.

*For finance purposes:*

The word equity is used in financial lingo to represent the value a person has accrued in a [mortgaged](#) property. In line with the accounting definition, equity is the net worth invested in an asset, like land. You earn equity with payments toward [principal](#), not [interest](#), and can also earn equity if your property value increases.

Building equity is the primary financial reason to own, rather than rent, farmland. With enough equity, you can qualify for [operating loans](#) at better rates, allowing your business to invest and grow when it needs to. Just as important, building equity is like using land to store value. Though your equity may not be as [liquid](#) as an investment account, it still has value which can be sold for cash if and when needed. Equity in land, to a farmer, can be like a retirement account.

## Expenses

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There are two categories of expenses: [capital](#) or [operating](#). All expenses for a



# Farm Finances Glossary



given period are summed up on the income statement.

Almost any outflow of money from a farm business can be considered an expense. One major exception is the owner's draw/dividend, which should not be considered a business expense and is not included on the income statement.

## Farm Credit

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Farm Credit is a nationwide network of customer-owned lending institutions, specifically for agricultural finance. Learn more and identify your local branch at their website.

## Farm Service Agency (FSA)

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The Farm Service Agency (FSA) is a part of the USDA tasked with providing a wide range of services to farmers in America. One of their core offerings is a robust, low-interest farm loan program that is accessible even to farmers who cannot access credit elsewhere (technically *only* to farmers who cannot access credit elsewhere).

Learn more about FSA and their loan programs in NYFC's FSA Loans Guidebook or on their loans webpage.

## Financial ratios

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Financial ratios are equations used by lenders and investors to judge the creditworthiness of businesses and business plans. They are also valuable tools for business managers to help understand the success of their business or the viability of their plans.

Scoring "well" on any particular financial ratio should not be the goal of any business or business plan. Good loan officers and investors take time to understand businesses and the people behind them. They can tell you which ratios your business scores well on, and how to improve the financial outlook in those areas that need improvement.

## Financial statements

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The three most common financial statements that you will be expected to create and understand are the balance sheet, income statement (also called P&L

or profit & loss), and statement of cash flows. Each statement is a report containing different financial information about your company. Financial statements can be historical, looking backward at your business finances; snapshots, looking at your finances at a particular moment in time; or projected, looking forward to estimate future financial scenarios.

## Fixed interest rate

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In contrast to a variable interest rate, a fixed interest rate remains the same over the amortization period of a loan.

## Graduation

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A term FSA uses when a farmer refinances their FSA loan with a loan from a traditional lender, with or without a guarantee from FSA. Graduation is the FSA's goal for their farm ownership loans.

## Gross income / Gross profit

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You may hear it called gross income or gross profit, but it's the same concept. Though easily confused with both gross

# Farm Finances Glossary



revenue and net income, gross profit is not the same as either. Gross profit is gross sales minus the cost of goods sold associated with those sales.

Note that the sales side of the equation does not include non-operating revenue, such as that earned by selling off old equipment or income from loans. It should only include revenue from your operations. Similarly, the cost side only includes cost of goods sold, not other cash outflows, like capital expenses or dividends.

Why look at gross profit separately from net income?

Looking at a business's gross profit should help you understand the profitability of its core enterprise(s), independent of other factors, such as its debt load. It's a subtle difference, but important to grasp.

Think about a famous corporation like Amazon. Amazon is notorious for turning out very little profit, despite its enormous operation. When someone says that Amazon has low profit or no profits, the person is talking about net income, not gross income. For instance, in 2016, with

\$136 billion in revenue, Amazon booked a gross income of over \$47 billion and a net income of about \$2 billion. So, Amazon's core operations are profitable, with a gross margin of 35%, but they must be using those profits to support other big expenses outside of their main operation, such as R&D. Investors trust that Amazon's huge expenses outside its costs of goods sold will lead to future profits, so they continue to salivate over this growing company. However, without the context of knowing that Amazon was reinvesting its profits into creating new business enterprises, by the numbers alone Amazon might look like a bad bet, with a profit margin of 1-2%.

For your own purposes, remember: while both gross profit and net income are important, net income is primarily built on gross profit.

## Gross margin

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Calculated as gross profit divided by gross revenue. Gross margin is the percentage of your revenue that can be used to pay back loans, pay for overhead expenses, reinvest in the business, or take an

owner's draw. Note the difference between gross margin and profit margin.

Gross margin can be used in tandem with profit margin to analyze your business. If your profit margin is low, is it because your gross margin is also low? If so, you should focus on increasing revenue and/or reducing production costs. If profit margin is low but gross margin is high, then you should focus on reducing overhead, debt expenses, or dividends.

Work with your lender or another business advisor to determine what a "good" gross margin for your business should be. This is highly variable based on what you're producing, where/how you sell it, your debt level, how you pay yourself, and your business's scale.

## Gross revenue

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Gross revenue is the total money generated by the farm. It includes all sales receipts from operations, as well as cash inflows from loans and non-farming sales, such as selling off old equipment or renting out on-farm housing.

# Farm Finances Glossary



Looking at a farm's gross revenue can tell you something about its size, but nothing about its profitability. Both are important to lenders and investors (and certainly to the farmer). Make sure you know the difference between gross revenue, gross income, gross margin, and net income; they may sound similar, but these figures all represent something different.

## Guaranteed loan

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A loan guarantee is an insurance-like arrangement that one lender can offer to another lender to build a loan package. Farmers will encounter this arrangement most often when borrowing from FSA.

FSA offers several guaranteed loan programs. In each, a USDA-approved lender offers financing at reasonable interest rates to the farmer in exchange for a guarantee from FSA that it will compensate the lender in case of default.

Guaranteed loans allow lenders to share risk and expand the pool of funding available for farmers to borrow.

## Income statement (P&L)

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Also called a P&L, for 'profit and loss', this financial statement reports on a business's performance over a given period, usually a year.

Income statements cover a business's entire finances – revenues from selling products/services and operating expenses like cost of goods sold, along with non-operating income and expenses, such as income from a loan or the investment in a new facility. These sections should be separated so that the reader can understand your business's operational profitability, or gross income, versus your overall profitability, represented by net income.

Some lenders will use your tax records (Schedule E) as a replacement for an income statement. This workaround can be fine for their needs, but not necessarily for yours. The income statement is formatted for business analysis. Use your income statement to learn where your biggest income and expenses come from; it will help you make better planning decisions.

## Interest

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What a lender charges its borrowers. Interest and principal payments are bundled together in each loan payment. Interest represents a larger portion of your loan payment early on in the loan, decreasing as you make payments. In this way, you earn equity slowly at first, then quickly later in the amortization period.

## Interest-only loan

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Conventional loans are structured with equal, usually monthly, installments of principal + interest paid over the amortization period. Interest-only loans differ from convention by requiring the borrower to pay only the interest portion of the loan for the first several years, with a large "balloon payment" scheduled for the end of the interest-only period. Instead of actually paying the balloon payment, often lenders plan for you to refinance the loan at that time.

Interest-only loans are helpful financing tools for borrowers who cannot handle monthly payments now, but will be able to in the future. Some FSA loans are

# Farm Finances Glossary



designed this way to help farmers align their loan payments better with agricultural [cash flows](#).

## Land trust

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Land trusts are non-profit organizations founded to protect natural resources, such as farmland, from development or damage. Land trusts may be able to help farmers locate land, provide them with a secure lease, or reduce the cost of land ownership by purchasing an easement.

Read NYFC's [Farmer's Guide to Working with Land Trusts](#) to learn more about land trusts and conservation easements.

## Lease-to-own

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A lease-to-own scenario can be a good option if you want to own property in the future, but cannot access sufficient financing now. In this land acquisition model, the farmer leases the farm they want to buy until they are able to purchase it. These are usually complicated transactions that should involve legal assistance, and probably also guidance from a farm service

provider familiar with lease-to-own transactions.

There are many ways lease-to-own can be structured. The farmer can hold an option to purchase, sometimes until a particular date or for a particular amount, or the farmer could just have the right of first refusal, meaning the landowner would have to offer the purchase opportunity to the farmer before putting it up for sale. The lease-to-own arrangement can be between the farmer and previous landowner, or a third-party investor can act as an intermediary, buying the property from the previous landowner and leasing it to the farmer until the farmer can make the purchase.

## Lender

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Lenders vary greatly in their experience offering farmers loans. [Farm Credit](#) and the USDA [Farm Service Agency](#) are the primary farm loan providers in the US. Other worthwhile local lenders include banks, credit unions, or community development financial institutions.

To learn more, speak with local farm service providers or read NYFC's guide,

[Farm Service Agency Loans: The Ins and Outs of Growing a Farm with Federal Loans](#).

## Leverage

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Leverage is the amount of debt a business is using as a tool to increase growth, like using a crowbar as a lever to open something. (See [Solvency](#).)

## Liabilities

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Liabilities are debts or any other kind of financial obligation incurred by your business. They are one of the three major sections of the [balance sheet](#). Some examples of liability accounts include notes payable, [accounts payable](#), and long term mortgage payable.

Liabilities can be considered either long-term or [current](#)/short-term. Current liabilities need to be paid within a year. For a long-term debt like a [mortgage](#), you would treat the next 12 months' amount due as a current liability and the rest as a long-term liability. Separating short-term from long-term liabilities on the balance sheet helps the reader understand if your business is able to pay off its current



# Farm Finances Glossary

liabilities with its liquid assets, such as cash.

Liabilities should not be confused with expenses. Liabilities are part of the balance sheet, while expenses show up on the income statement. Expenses show the costs you have incurred, while liabilities are future obligations incurred. Indeed, by incurring some liabilities, your business actually receives cash – like when you receive a loan.

## Lien

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The legal claim that a lender has on real estate or other property until a debt has been repaid. For example, in a traditional mortgage, the bank has a lien on the property. If you default on your loan, the lender may have a legal right to seize your liened asset. (See secured loans.)

Sometimes a particular asset can have multiple liens against it, with a priority order of which lender would be paid back in case of default. Different lenders have different rules regarding their lien rights, so be sure to be upfront with your loan officer if there's a chance that an asset you're pledging as collateral might

already have a lien against it. For instance, if you're paying off a car loan, you might not be able to pledge that car as collateral when applying for an FSA loan.

## Liquidity

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Liquidity describes an asset's degree of transferability. Cash is perfectly liquid – you can use it to buy anything. That's why we set our prices in dollar units. Your walk-in refrigerator may be a valuable asset, but is less liquid than cash because it would be difficult to exchange it for another asset.

Liquidity can be used to think about a business in general, rather than a specific asset. Even a profitable business could be illiquid. For example, maybe you make plenty of restaurant sales, but your customers have not paid their invoices. Your income statement would show a healthy gross income, but a look to the balance sheet might show a big accounts receivable account and no cash.

Unfortunately, you can't use accounts receivable to pay your bills! No matter how profitable a business is in theory, it

must be liquid day-to-day to continue operations.

## Market analysis

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The market analysis section of your business plan describes your customers and the market they comprise. You can focus on the size and characteristics of the market itself, or on describing your target customer specifically, or more likely, both.

Your market analysis might include:

- Statistics about the size, growth rate, and trends in your market
- Details about your target market, including their average income levels, shopping preferences, motivations, and the size of this subset of the market
- Any market research you've done, or can find about your industry
- Analysis of your competition
- Barriers to entry into this market, such as regulatory requirements

# Farm Finances Glossary



## Microloan

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A small loan (FSA's microloan program maxes out at \$50,000), often provided with looser eligibility requirements or less paperwork, and sometimes coupled with technical assistance. Micro-lenders can be community based, though the term is also used to describe crowd-sourcing platforms, like Kickstarter, or peer-to-peer lenders, like Kiva.

## Mortgage

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A legal agreement in which the lender agrees to give the borrower money to purchase an asset, and the borrower agrees to pay the lender back over a fixed amortization schedule. Each loan payment includes a portion of principal and a portion of interest. Mortgages are secured loans in which the lender can seize the asset in case of default.

To get a mortgage from a traditional lender, you will likely need to contribute a down payment and pay closing costs at the time of the transaction. Different lenders vary greatly in their eligibility criteria for loans; check your credit report

before applying for a loan to learn more about your creditworthiness.

Some lenders, like FSA and Farm Credit, are more familiar with farm mortgages.

## Net income

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Net income equals gross revenue minus total expenses. It is the bottom line of the income statement.

Note the difference between net income and gross income, which only describes a business's income from operations. There are other expenses that affect your bottom line, such as taxes, an owner's draw, or interest payments – none of which is reflected in gross income, but all of which are included in net income.

Take caution: a positive net income alone does not prove a profitable business operation. Net income includes revenues from financing and non-operational revenue, such as from selling property. Just because a business shows a positive net income does not mean the business operation was successful for the period under observation.

## Operating expenses

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Operating expenses are those expenses incurred through "normal business operations". This is a more expansive definition than cost of goods sold, which only represents the costs related to production. Indeed, operating expenses are usually considered the sum of COGS; selling, general, and administrative expense (or overhead); and depreciation expense.

Contrast capital expenses with operating expenses. The two are generally treated differently by the IRS because of the long-term nature of some assets. Operating expenses are written off of your net income in the year you make the purchase because operating expenses are for items or services that are consumed within a year. Capital expenses are made on long-term assets, and so are generally written off over time by deducting a depreciation expense each year until the asset depreciates to nothing. That's why, in our operating expenses formula, we include depreciation expense – to write off the portion of depreciation on capital assets

# Farm Finances Glossary



along with all the operating expenses made that year.

## Operating loan

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Agricultural businesses generally incur operating costs before a product can be sold – often years in advance. An operating loan can cash flow your operation in advance of sales. Some farm businesses, especially those growing commodity crops, rely on seasonal operating loans to buy seed, fuel, fertilizer, and other inputs before the growing season; then they pay back their loans with proceeds from the harvest.

Operating loans generally have short amortization periods, often as short as one year.

CSA is a sort of informal operating loan, in which the farm’s customers pay for products in advance of receiving them.

A business with a strong credit history can qualify for a line of credit at a bank, which pre-approves the business to take out an operational loan from the bank at any given time.

## Overhead

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Overhead is a catch-all term that generally covers any operating expenses not included in cost of goods sold and depreciation expense. You might also hear the term ‘fixed costs’ used for overhead. Examples of overhead include utilities, rent, and insurance expenses – but even those are not always overhead. For instance, if you track your electric bills by building, the creamery’s electric bill would be part of COGS while the office’s electric bill would be overhead.

Think of overhead as what you would still have to pay for even if your business produced a very low volume of product.

## Owner-operator

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One who owns the farm business and the farmland, and contributes to the management, labor, and capital to run the farm. A tenant-operator is the same, but leases the land instead of owning it.

## Owner’s draw

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See dividend.

## Principal

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Principal is the face value of a mortgage, or of any loan. It is the original amount borrowed from the lender. The more principal you pay back, the more equity you earn.

Loans are usually structured to be paid back in equal monthly or annual installments. But since interest is charged on outstanding principal, as you pay back the loan, even though each payment is constant, an increasing amount of your payment goes towards principal. That means you build equity faster later in the amortization period, because more of each payment is devoted to principal.

That is a complicated concept, but even if at first glance you don’t grasp how it works, you should know why it’s important. Making extra principal payments on a loan is the best way to reduce the total cost of that loan because an extra payment toward principal also reduces the interest you would have been charged for that principal. For people who don’t invest in stock markets, an extra mortgage payment is often the best investment you could make.

# Farm Finances Glossary



## Profit margin

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Profit margin equals net income divided by gross revenue. Profit margin can also be calculated on an enterprise basis if you wanted to analyze the profitability of one particular line of business.

Remember that profit margin suffers the same limitations of net income as a measure of farm success. Since the calculation includes all revenue, not just operating revenue, profit margin alone cannot tell you whether the business had a successful year, or just happened to receive financing revenue from a loan that year.

## Pro forma

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This term refers to the manner in which a financial statement is prepared, implying the statement is future-looking. Pro forma statements rely on estimates to show how a business decision would impact the finances of a business in the future. Contrast these with ordinary financial statements, which document historical financial data.

## Promissory note

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A document that promises payment of a debt by a certain date. Also just called a note.

## Refinance

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Refinancing is replacing one loan with a new loan, for any reason. First-time buyers might not have had great credit or weren't able to make a large down payment, so they only qualified for a loan with a high interest rate. After additional years of making on-time payments, they may qualify for a better, cheaper rate by refinancing.

You can work with some lenders to take advantage of refinancing as an affordability tool. For instance, if you need a loan to grow your operation, you can start with an interest-only loan, and plan to refinance with a conventional loan once your business grows and you can afford the payments.

Refinancing can also be a way to access the equity you've earned, to use towards other investments.

## Repayment capacity

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Repayment capacity is your ability to support your business/living expenses and debt payments while reasonably saving for the future. The debt-to-income ratio is one way of measuring repayment capacity.

## Return-on-assets ratio

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Return on assets measures net income (adjusted for certain factors) divided by total business assets. It tells you how efficiently you are utilizing your assets to turn a profit. It is one of many financial ratios used by lenders to assess your creditworthiness.

Agriculture tends to be an asset-heavy industry. However, not all farms require loads of assets to turn a profit. Smaller scale direct-marketing farms, especially those that rent land, will have small asset bases and therefore should target a higher return-on-assets ratio if they want to be competitive with more asset-heavy farms.



# Farm Finances Glossary



## Schedule F

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Also called Form 1040, this is the IRS form for reporting farm income and expenses. It is similar to an [income statement](#), but specifically formatted for tax reporting purposes.

## Secured loan / Unsecured loan

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A loan is considered secured if the [lender](#) has a [lien](#) on the borrower's property, which can be seized in case of [default](#). In an unsecured loan, the borrower pledges no [collateral](#); unsecured loans are usually only offered in small amounts or to borrowers with very good credit. A [mortgage](#) is a type of secured loan; a credit card is a type of unsecured loan.

## Security

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Property of any type that is pledged to back your loan. Also called [collateral](#).

## Seller financing

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Instead of getting a farm ownership loan from a [traditional lender](#), you may be able to find a landowner willing to offer

you financing to buy their property. This arrangement can work well for a retiring farmer transitioning their land to a younger farmer. The buyer and seller would execute a promissory note detailing all the major aspects of a loan: [interest rate](#), [amortization period](#), payment schedule, and consequences of [default](#). As may be obvious, these agreements require a high level of trust and legal assistance.

For farmers having trouble accessing land to start or grow their business, short-term seller financing can help you get started until you can qualify for a loan and [refinance](#) with a traditional lender. Compare this strategy with [lease-to-own](#).

[FSA](#) offers a loan [guarantee](#) program for seller financing transactions.

## Solvency

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A solvent business has enough assets to cover its debts. (See [Leverage](#).)

## Traditional lender

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Banks, [Farm Credit](#) institutions, credit unions. This term is used to contrast with

[FSA](#), the "lender of last resort" which is often the farmer's "lender of first opportunity."

## Value proposition

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This is the core of your [business plan](#) and strategy. Your value proposition is the value you're promising to deliver to your customers. It should summarize why a customer would want to purchase something from your specific business, rather than a competing offering.

## Variable interest rate

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The interest rate on a loan could be [fixed](#) for the entire [amortization period](#), or set to change along with a benchmark market rate. In these variable interest rate loans, your loan payment will change if the benchmark rate changes.

[Mortgages](#) with variable interest rates are usually called 'adjustable-rate mortgages'.

Whether or not choosing a variable rate loan turns out to be a good deal for the borrower simply depends on how the benchmark rate changes over time.

# Farm Finances Glossary



## Write off

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This phrase is thrown around often, and is frequently misunderstood. ‘Writing off’ an expense means subtracting it from your revenue when determining your taxable income. Writing off an expense does not make it free; rather, if you have taxable business income, it reduces your tax burden by your tax rate multiplied by the amount of the expense.

Operating expenses and capital expenses are meant to be written off differently. Operating expenses get written off in the year in which they are incurred; capital expenses are depreciated across their useful life, then a correlating depreciation expense is written off each year until the asset is fully depreciated. However, in recent years the IRS has allowed businesses to fully depreciate qualifying capital expenses (up to \$500,000) in the year in which they are incurred to stimulate business investment – even in a very profitable year, an investment like that could write off your entire tax bill. Make sure you work with an accounting professional,

especially when considering large capital investments.

‘Write-off’ can be used somewhat interchangeably with the term ‘deduction’. Usually, deduction is used in the context of personal tax filings, whereas write-off is used for business accounting and taxes. Both write-offs and deductions are different from tax credits, which directly reduce your tax burden and can even result in tax refunds. Write-offs and deductions only reduce your taxable income, indirectly reducing your tax burden in profitable years, but never triggering a refund.

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