

# Important Farm Business Terms Defined — Finance

Department of Agricultural Economics — [www.agmanager.info](http://www.agmanager.info)



Kansas State University Agricultural Experiment Station and Cooperative Extension Service

**Michael R. Langemeier**  
Professor, Agricultural Economics

**Rodney Jones**  
Extension Agricultural Economist  
Livestock Production

A clear understanding of terms used in discussing farm business operations is important. The following terms are among those that are often used; although there are many others that could be discussed. The terms are grouped by type rather than alphabetically. Additional information on financial performance measures can be found in MF-470, *Financial Ratios Used in Financial Management*.

## Cash

**Cash:** Refers to cash and funds in checking accounts, savings accounts, and certificate of deposits.

**Cash Available:** The amount of cash that the business has for meeting cash flow requirements.

**Cash Required:** The amount of cash that is needed to meet all of the cash expense needs of the operation, which include operating expenses, interest expense, debt payments, capital purchases, and family living withdrawals.

**Net Cash Flow from Farm Operations:** The amount of cash that is available after cash operating expenses are subtracted from cash operating income.

**Repayment Capacity:** Measures the ability of the business to generate sufficient receipts to meet its debt and capital replacement obligations. Income available for capital replacement and term debt obligations is equal to net farm income from operations plus net nonfarm income plus depreciation minus taxes paid minus unpaid family labor or family living withdrawals.

**Statement of Cash Flows (Historical):** A financial statement that shows the dollars flowing in and out of the business. The cash flow statement is often divided into operating, investing, and financing activities. Cash flows can be presented by week, month, quarter, or year for each income and expense category.

**Statement of Cash Flows (Projected):** An estimate of the cash inflow and outflow for a business for some future time period.

## Income

**Accrual Basis of Accounting:** A method of accounting under which revenues are recognized in the accounting period when earned regardless of when cash is received; and expenses are recognized in the accounting period when incurred regardless of when cash is paid.

**Cash Basis of Accounting:** A method of accounting under which cash receipts are recorded when cash is received and cash expenses are recognized when cash is paid.

**Income Statement:** A financial statement that provides a summary of accrual income and expense for a specific time period, such as a calendar or fiscal year. The income statement is useful in analyzing the financial performance or profitability of the business. An income statement is sometimes referred to as a profit and loss statement.

**Profitability:** The ability of the business to generate income in excess of expenses. Profitability can be analyzed using the income statement, the balance sheet, and financial ratios.

## Gross Income

The measures discussed below; gross farm income, gross revenue, and value of farm production; represent three distinct accounting methods. All three measures are computed on an accrual basis. The method used in measuring gross income should also be used in expense and net farm income computations.

**Gross Farm Income (GFI):** The income to the business based on sales plus other receipts minus cost of items purchased for resale, such as feeder livestock, plus or minus changes in operating inventories.

**Gross Revenue (GR):** The income to the business based on sales plus other receipts plus or minus changes in operating inventories.

**Value of Farm Production (VFP):** The income to the business based on sales plus other receipts minus costs of items purchased for resale, such as feeder livestock, minus cost of purchased feed plus or minus changes in operating inventories.

## Expenses

There are numerous expense or cost values used in economics and accounting. The definition, and thus derivation, will depend on the financial statement being developed and in what context the business is being analyzed. The discussion below focuses on some commonly used expense or cost values.

**Variable Costs:** Expenses that vary with output for the production period under consideration. Examples include hired labor, seed, fuel, feed, herbicide, insecticide, and fertilizer.

**Fixed Costs:** Expenses that do not vary with changes in output for the production period under consideration. Examples include real estate taxes, depreciation, and interest on land.

**Cash Costs:** Expenses that result in an actual payment of cash.

**Noncash Costs:** Expenses that do not result in an actual payment of cash. Examples of noncash costs include depreciation, changes in operating inventories, and accrued interest.

**Direct Expenses:** Expenses that are directly related to a production activity such as seed.

**Indirect Expenses:** Expenses that are not directly related to a production activity such as depreciation.

**Accrual Farm Expense:** The amount of expense, even if not paid, that is associated with production in the current accounting period.

**Depreciation:** The allocation of the original cost of a capital asset over the useful life of the asset.

**Financial Costs:** Includes all expenses recorded in an accrual income statement. Expenses include cash and noncash costs.

**Prepaid Expenses:** Expenditures made in the current accounting period for items that will be used in a future period to realize income.

**Total Operating Expenses (GFI):** The sum of cash and noncash expenses plus or minus accrual and expense inventory adjustments. Includes cost of purchased feed, but does not include purchases of items purchased for resale and interest expense.

**Total Operating Expenses (GR):** The sum of cash and noncash expenses plus or minus accrual and expense inventory adjustments. Includes cost of purchased of feed and purchases of items purchased for resale, but does not include interest expense.

**Total Operating Expenses (VFP):** The sum of cash and noncash expenses plus or minus accrual and expense inventory adjustments. Does not include cost of purchased feed, purchases of items purchased for resale, and interest expense.

**Total Expenses (GFI):** Total operating expenses (GFI) plus interest expense.

**Total Expenses (GR):** Total operating expenses (GR) plus interest expense.

**Total Expenses (VFP):** Total operating expense (VFP) plus interest expense.

## Net Income and Returns

**Net Farm Income from Operations (GFI):** Gross farm income (GFI) minus total expenses (GFI).

**Net Farm Income from Operations (GR):** Gross revenue (GR) minus total expenses (GR).

**Net Farm Income from Operations (VFP):** Value of farm production (VFP) minus total expenses (VFP).

**Net Farm Income:** Net farm income from operations plus (minus) the gain (loss) from the sale of capital assets and change in base values of breeding livestock. Net farm income is an accrual measure, and represents a return to operator's labor, management, and equity capital.

**Net Profit Margin:** The portion of gross income, gross revenue, or value of farm production the business receives as profit.

**Return to Capital:** A measure of the operator's capital earnings from the business. The measure is equal to net farm income plus interest expense minus a charge for unpaid family labor.

**Return to Management:** A measure of the operator's management earnings from the business. This measure is equal to net farm income minus a charge for unpaid family labor and equity capital.

**Return to Labor and Management:** A measure of the earnings to labor and management from the business. This measure is equal to net farm income plus hired labor expense minus a charge for equity capital.

**Return to Capital, Labor, and Management:** A measure of the earnings to capital, labor, and management from the business. This measure is equal to net farm income plus hired labor expense plus interest expense.

## Balance Sheet

**Balance Sheet:** A financial statement that shows the financial condition of the business at a specific point in time. A balance sheet lists all assets and liabilities and the resultant owner equity. Both book value and fair market balance sheets should be derived to analyze changes in owner equity.

**Statement of Owner Equity:** Reconciles the change in owner equity between the beginning and ending balance sheets.

**Accumulated Depreciation:** The amount of depreciation expense taken on machinery, equipment, and buildings from their acquisition date to the balance sheet date.

**Book Value:** This value is equal to original cost or basis of an asset minus any accumulated depreciation.

**Market Value:** The value that would be received for the farm's assets if the business was liquidated on the same date for which the balance sheet was prepared.

**Liquidity:** The ability of a business to generate sufficient cash to meet total cash demands without disturbing the ongoing operation of the business. Liquidity is examined by comparing current assets to current liabilities. A business that is relatively more liquid has a relatively higher ratio of current assets to current liabilities.

**Solvency:** Related to the dollar value that would remain if all assets were converted into cash and all debts paid. A business is solvent if total assets are greater than total liabilities and insolvent if liabilities exceed assets.

**Leverage:** The relationship between debt and equity, or debt and assets. Earnings on debt must be greater than the cost of debt to have a positive effect on business performance.

## Assets

**Assets:** Resources owned by or owed to the business. Examples include cash, accounts receivable, crop inventories, livestock inventories, machinery, equipment, buildings, and land.

**Current Assets:** Cash and assets that can be readily converted to cash with little loss of value. Current assets include cash, accounts receivable, marketable securities, crop inventories, feeder livestock inventories, and cash invested in growing crops.

**Noncurrent Assets:** Assets that would be more difficult to convert to cash and that are used to generate long-term profits. Noncurrent assets include breeding livestock, machinery, equipment, buildings, and land.

**Total Assets:** Equal to the sum of current and noncurrent assets.

**Operating Inventories:** Include crop inventories, feeder livestock inventories, and supply inventories.

## Liabilities and Owner Equity

**Liabilities:** Debts owed by the business.

**Deferred Taxes:** Taxes contingent on the sale of a farm's assets. Deferred taxes are separated into current and noncurrent portions. Deferred taxes are relevant to a market value balance sheet and irrelevant to a book value balance sheet.

**Current Liabilities:** Liabilities that will come due within one year. Current liabilities include accounts payable, accrued expenses, principal payments on current loans, principal payments on noncurrent loans, and deferred taxes on current assets.

**Noncurrent Liabilities:** Liabilities that will come due in a time period longer than one year. Noncurrent liabilities include the principal balance of noncurrent loans and deferred taxes on noncurrent assets.

**Total Liabilities:** Sum of current and noncurrent liabilities.

**Owner Equity:** The difference between total assets and total liabilities. This value provides an indication of the dollar amount of assets actually owned.

**Net Worth:** Another term for owner equity.

**Retained Earnings:** A measure of the real growth in the business. Retained earnings are equal to the change in owner equity adjusted for inflation or deflation in asset values. The adjustment for inflation or deflation in asset values applies to the market value sheet, but not the book value balance sheet.

## Budgeting vs. Cash Flow

**Budget:** A budget is a systematic way of organizing relevant farm management information by listing expected income and expenses.

**Partial Budget:** Many changes in a farm business do not require a complete reorganization. The partial budget is an appropriate tool in analyzing these kinds of changes. Examples where partial budgeting is useful include an examination of the addition of an enterprise, an examination of a change in enterprise size, or an examination of asset purchases.

**Short-Run Feasibility:** The income-generating ability of a business or segment of a business in the short-term (1 to 5 years). Short-run feasibility is usually studied through the use of a projected cash flow. Actual cash inflow and outflow during the period is compared, and reflects payment requirements to credit institutions as well as projected income and expenses.

**Long-Run Profitability:** The income-producing ability of a business or a segment of a business in the long-run (more than 5 years). Long-run profitability is usually studied through the use of budgets.

## Miscellaneous

**Family Living Withdrawals:** Cash withdrawals paid by the business to cover family living expenses. These withdrawals can be viewed as compensation for owner's management and labor.

**Opportunity Cost:** The income that could have been received if a resource had been used in its most profitable alternative use. The opportunity cost for noncurrent assets is typically difficult to estimate. For nonland costs, a long-term interest rate could be multiplied by the asset values to obtain an opportunity cost. For land costs, cash rental rates could be used.

**Unpaid Family Labor:** Represents an opportunity cost on the family's and operator's time spent operating the farm.

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