SECTION B: SUMMARIZATION AND ANALYSIS

This section of the Oklahoma Farm and Ranch Account Book provides for the summarization and analysis of the farm or ranch's financial and production data for the current year. Completing this section accurately and thoroughly will provide information to facilitate evaluation of the business' overall performance as well as that of individual enterprises. Additionally, accurate and complete records are becoming an increasingly important tool in securing and maintaining an adequate line of credit.

The following definitions of terms and terminology may be helpful in the completion of this section. For additional discussion of financial statements and ratios, see: FS-751, Developing a Cash Flow Plan, http://agweb.okstate.edu/pearl/agecon/tax/f-751.pdf ; FS-752, Developing a Balance Sheet, http://agweb.okstate.edu/pearl/agecon/tax/f-752.pdf ; FS-753, Developing an Income Statement, http://agweb.okstate.edu/pearl/agecon/tax/f-753.pdf .

ACCRUED INTEREST: Accrued interest reflects the interest expense that has been incurred but has not been paid as of the balance sheet date.

ASSET TURNOVER RATIO: This ratio is a measure of how efficiently the business assets are being used to generate revenue. A farm business has two ways to increase profits – either by increasing the profit per unit produced or by increasing the volume of production (assuming the business is profitable). The higher the ratio, the more efficiently assets are being used to generate revenue.

AVERAGE EQUITY: Average equity is calculated by dividing the sum of the beginning and ending equity amounts by two.

AVERAGE TOTAL ASSETS: Average total assets is calculated by dividing the sum of the beginning and ending total assets by two.

BALANCE SHEET: The balance sheet is a powerful tool in decision making because it shows what is owned, what is owed, and the owner's equity. A basic accounting rule exists for these relationships: ASSETS = LIABILITIES + OWNER EQUITY. This equality always holds since any transaction which causes a change in value to one side of the equation will cause an identical change to the other side. The balance sheet provides information to determine the liquidity and solvency of the business at a specific point in time. A detailed explanation of the balance sheet appears in OSU Extension Facts 752, http://agweb.okstate.edu/pearl/agecon/tax/f-752.pdf.

BOOK VALUE: In financial planning and analysis, assets are frequently valued at book value which is cost plus improvements minus accumulated depreciation assets such as machinery, purchased breeding livestock, and buildings.

CASH FLOW STATEMENT: The cash flow statement is used to identify all sources and uses of cash going into and coming out of the business. The review of historical cash flow statements provides the user with an estimate of how much annual operating debt will be required, when the loan can be repaid, and loan repayment capacity for longer term debt obligations. A detailed explanation of a cash flow statement appears in OSU Extension Facts 751, http://agweb.okstate.edu/pearl/agecon/tax/f-751.pdf.

COST OF GOODS SOLD: The cost of any items purchased for resale must be inventoried (not considered an operational expense) at their purchase price. The cost of items purchased for resale are used in calculating the "cost of goods sold". For income tax reporting, the deduction of the cost of these items is allowed in the tax year the items are disposed of – not in the year acquired.

CURRENT ASSETS: Current assets include cash and other assets which are reasonably expected to be sold or consumed during the normal operating cycle of the business. A normal operating cycle is generally one year.

CURRENT LIABILITIES: Current liabilities are obligations that are due on demand or will become due within one year of the balance sheet date. Common current liabilities are accounts payable, notes payable, taxes payable and interest payable.

CURRENT PORTION OF TERM DEBT: The payments which will become due on non-current liabilities are reported as a current liability since they will be due within one year.
CURRENT RATIO: This ratio (current assets) current liabilities) indicates the extent to which current assets, if liquidated, would cover current liabilities. If the ratio is greater than 1, the business is considered liquid. The higher the ratio, the greater liquidity. For a farm or ranch operation, this ratio will vary substantially throughout the production

period. Thus, financial analysis should be reviewed at comparable times from year to year.

DEBT TO ASSET RATIO: This ratio, equal to total liabilities divided by total assets, is a means of expressing the risk exposure of the farm. The higher the ratio, the greater the financial risk exposure.

DEBT TO EQUITY RATIO: Also known as the leverage ratio, this ratio measures financial position. The ratio reflects the extent to which debt capital is being combined with equity (net worth) capital. The higher the value of the ratio, the more total capital supplied by the creditors and the less supplied by the owner(s).

INVESTMENT IN COOPERATIVES: There are three major types of cooperatives that have substantial dealings with farmers: supply cooperatives, the Farm Credit System, and marketing cooperatives. In general, investments in these cooperatives should be reported on the balance sheet at cost as a non-current asset. The cost investment should be increased for additional cash investments or declarations of noncash patronage distributions and decreased for cash distributions for the redemption of stock or for the allocation of cooperative losses to patrons.

INCOME STATEMENT: The income statement, or profit and loss statement as it is frequently called, measures the profitability of a business over a specific period of time, generally, a calendar year. The primary purposes of an income statement are to 1) determine the profitability of a business, 2) identify sources for profits or losses, and 3) show the disposition of receipts. A detailed explanation and illustration of an income statement appears in OSU Extension Facts 753, http://agweb.okstate.edu/pearl/agecon/tax/f-753.pdf .

INVESTMENT IN GROWING CROPS: For valuing growing crops, the balance sheet should reflect the cash investment in those crops, including the direct cost of seed, chemicals, fertilizer, and fuel up to the date the balance sheet is prepared.

OWNER EQUITY: Net worth or owner equity is determined by subtracting total liabilities from total assets. Equity is a residual estimating the owner's claims against the business after all debts are satisfied. Owner equity and net worth are used synonymously within the accounting profession.

NET FARM INCOME: Net farm income is computed by netting the following items: 1) net cash income from operations, 2) adjustments for accrued expenses, 3) depreciation, 4) adjustments for changes of inventory and cash investment in growing crops, 5) capital gains (losses), 6) value of farm products used in the home, and 7) value of raised livestock added to the breeding herd during the year.

PREPAID EXPENSES: As the name implies, a prepaid expense is a production cost that has been paid for in advance of its use. To properly reflect income, at the time of prepayment an asset is recorded and as the item is used or consumed, it becomes an expense. Examples of expense items which are occasionally prepaid include feed, fertilizer, and fuel.

RETURN ON ASSETS: This ratio measures the rate of return on assets and frequently is used as an overall index of profitability. The higher the value, the more profitable the business. The rate of return on farm assets may seem low when compared to non-farm investments. However, it should be recognized that unrealized capital gains and losses on farm real estate and other capital assets are not included as income.

RETURN ON EQUITY: The return on equity is computed by subtracting the value of unpaid family labor and the opportunity cost of the operator's labor from net farm income. The opportunity cost of the operator's labor is that return (amount) that the operator could earn if his or her labor was employed in an alternative way. The return on equity can then be compared to the return possible in alternative investments.

UNPAID LABOR AND MANAGEMENT: Many farm operations are organized as a sole proprietorship or partnership and do not pay compensation to the operator(s) and family members for labor and management. A charge for unpaid operator and family labor and management must be subtracted from net income from operations to calculate the return on assets and/or equity. This amount can either be determined based on 1) an opportunity cost or 2) the withdrawals for family living.

WORKING CAPITAL: Working capital is the dollar difference between current assets and current liabilities. The desired minimum level for this financial analysis measure will vary given the type of enterprises and the growth stage of the business.