Understanding the Accounts: Terminology

National Advice Hub
T: 0300 323 0161
E: advice@fas.scot
W: www.fas.scot

The farm accounts provide lots of useful information about how your business is performing, and where you can look for improvement. Often the accounts include terminology which can be confusing but this guide tells you what you need to know.

Gross Output

It takes time for crops or livestock to be ready for sale. The accounts don't just reflect the actual sales that took place during the year, they also consider the change in the value of the stock during that time. For example a new entrant sheep farmer whose financial year ends in June may not have any sales of livestock in their first year of trading, but there could be a near -market crop of lambs on the ground which have taken care and money to produce. To provide a **fair and true** reflection of the business performance the increase in value of the sheep flock is included as the business output.

Gross output = Sales—Purchases + Closing Stock—Opening Stock

You aren't the only possible audience for this information—they must also consider that others may place reliance on the farm accounts, e.g. lenders. When preparing your financial statements the accountant must present a **fair and true** picture of the business performance. Thinking about this need to be fair and true helps us to understand why accounts present your information in the way they do.

The **Profit & Loss (P&L)** account shows how much profit (or loss) the business has made during the year. It shows the income and expenditure. It reflects what has happened **during the financial year.**

Not all the money that goes in or out of the business bank account will be 'income' or 'expenses'. Money a sole trader or partner puts in (**capital introduced**) or takes out (**drawings**) do not appear in the P&L account. Some other spending is also excluded, including capital spending (e.g. on purchase of machinery) or the capital element of loan finance repayments.

Total Output

Total output is the gross output, plus the other **trading** income e.g. wool, subsidies, wayleaves, rents, and miscellaneous other income.

Variable Costs

Variable costs are expected to change up or down proportionately as the scale of the operation is changed. For example if you have more crop in the ground you'll use proportionately more seed, spray and fertiliser. If you reduce the number of stock you'll expect your vet bill, feed bill or bedding cost to reduce in roughly the same proportion. Common variable costs include feed, seed, sprays, fertiliser, vet & medicine, knackery, commission and levies, and livestock and crop sundries.

You can express your variable costs as a proportion of your total output and compare with other businesses—a benchmarking tool is available here: https://www.fas.scot/rural-business/business-tools/whole-farm-benchmarks-tool/

Gross Margin

The gross margin is the output of the business, less the variable costs.

This guide does not constitute advice— for advice about your business finances contact your accountant.

@FASScot

The European Agricultural Fund for Rural Development
Europe investing in rural areas

Fixed Costs

Fixed costs, also known as 'expenses' or 'overheads' are things which generally won't change if you make minor changes to the area of cropping, or your livestock numbers. For example, if you go from having 200 dairy cows to 210 dairy cows your variable costs will increase (you're feeding an extra 10 cows) but your fixed costs probably won't—you will use the same machinery and labour (significant changes to an enterprise may well change your fixed costs, but in the accounts these costs are still known as 'fixed'.

Depreciation

Depreciation is the portion of the cost of capital assets (e.g. plant, machinery, buildings) that is considered, in the interests of presenting a fair and true picture of the business performance, to be attributable to the current year's profit. For example a new shed costing £80,000 and with an estimated lifespan of 40 years might be depreciated at £2,000 per year on the 'straight line method' and instead of showing a large loss in the year the shed is first built, this smaller amount is accounted for each year over it's lifespan.

Machinery and equipment is often depreciated in a slightly different way—the 'reducing balance method' - which recognises that the machine's reduction in value is most significant when it is relatively new, and as it ages the reduction in value is less. For instance a new tractor reduces a lot in value in the first year of ownership, whereas after owning it for 15 the reduction each year might be relatively modest.

Fixed & Current Assets

Fixed assets are things the business owns, e.g. plant, machinery, land, buildings. Fixed assets include 'improvements' or 'tenant's improvements' - these relate to things built on the farm.

Current assets include:

- **Trading stock** (e.g. livestock, crops in store)
- **Cash** in the bank
- **Debtors** (or 'accounts receivable') - these are monies owed to the business at the year end, for instance if you sell something just before the accounting year end, but hadn't yet received the money. You might also have a 'VAT Debtor' - this reflects the amount of VAT that would be reclaimable at the year end.
- **Prepayments**—things you have paid for in advance, e.g. farm insurance is paid in advance, but one payment will include more than one financial year.

You might think the 'heritable property' figure in your accounts looks low. This figure is often a historic value, and is only increased if the farm is re-valued. The farm itself won't always appear on the balance sheet. The balance sheet represents the assets **owned by the business**, but often the farm is owned by one of the individuals in the business (e.g. one of the partners), rather than by the business itself.

Current & Non-Current Liabilities

Liabilities are things the business owes. These are divided into non-current liabilities (e.g. fixed term loans and things which are not payable for at least 12 months) and current liabilities (things which in theory are payable in less than 12 months). Current liabilities include:

- **Trade creditors**—these are monies the business owes to others at the year end, e.g. a bill is received just before the end of the year, and at the year end is still outstanding.
- **Accruals**—these are the opposite of prepayments, they are expenses incurred in the financial year which are billed in arrears, and where the bill won't be presented until after the year end (e.g. electricity, accountancy).
- **Hire purchase**—this is the balance owing on all the hire purchase agreements as at the year end.
- **Overdraft**—a bank overdraft is 'repayable on demand' so is included in the 'current liabilities'.

Whilst the Profit & Loss (P&L) accounts show the things that have happened **during the year**, the balance sheet shows the financial position at the **end of the year**.

In the UK businesses can choose their own year end date. This is discussed and agreed with the accountant on commencement of trading.

Net Worth

The **net worth**, which you might see as 'Total assets less total liabilities', is effectively what would be left were the business liquidated, i.e. if everything the business owned was sold, debts paid, owed monies recovered, all loose ends dealt with. This amount also appears in the **capital accounts**.

Capital Accounts

The capital accounts are normally shown in one of the 'Notes to the Accounts' and show you the wealth held in the business, i.e. what you would be left with if you were to wind up the business, and how this is divided amongst any partners. It also shows how the profits of the business are divided. The balance of the capital account at the year end will match the net worth as shown on the balance sheet.

5 Partners' Current Accounts

	At 1 October 2017	Funds Introduced	Share of Profit	Drawings	At 30 September 2018
	£	£	£	£	£
James Brown	277,710	-	16,126	6,285	287,552
Margaret Brown	208,451	-	16,126	21,511	203,067
	486,161	-	32,253	27,795	490,618

The capital accounts also show the 'funds introduced' (or 'capital introduced') and drawings of the individual members of the business.

Funds introduced (or capital introduced) - this is investment in the business by the owners, it might take the form of cash put into the business bank account, or things which have been purchased by the individual using their own funds, and which are made available for the business to use.

Drawings—this is money taken out of the business by the owners, it might be in cash but it commonly includes an individual's private expenses paid for out of the business account e.g. a tax bill, life assurance payments. It will also include **private uses** i.e. the private element of any joint expenses e.g. the private share of farmhouse running costs or motor expenses.

Were the business wound up the capital account shows how the net proceeds would be shared amongst the partners bearing in mind how much they have put into, and taken out of the business. It recognises the different investment/drawings of each member of the business.

For more information about farm accounts and bookkeeping there are a range of resources at:

https://www.fas.scot/rural-business/business-tools/