THE carrot PROJECT

Creating small-farm financing solutions

Borrower's Financial Glossary

The Carrot Project

These terms are used throughout the application. You may find this list helpful as you organize your financial information.

Assets

Assets is a class of accounts listed on the Balance Sheet.

Valuable property owned by a person, assets can include your home, car, land, building, large farm equipment. Typically, the value of assets listed should be greater than $1,000 and have a useful life of longer than 1 year. The full value of the asset should be declared even if you have debt associated with it. The value of the loan associated with the asset is declared separately in the liabilities section. You may also include in your list of assets both inventory and account receivable (money that customers owe you for products already sold). *(See also: Balance Sheet, Liabilities)*

Balance Sheet

The Balance Sheet offers a summary of the farm's financial position at a given point in time (usually at the end of your fiscal year)– detailing assets, liabilities and owners' equity. The Balance Sheet tells what you have (assets) and how you got it… whether it's a loan (liability) or through earned income and owners' investment (owners' equity). The Owners' Equity can be calculated by subtracting liabilities from total assets. *(See also: assets, liabilities)*

The Balance Sheet represents a single moment in time, whereas an Income Statement, also called P&L Profit and Loss, represents a period of time.

Benchmark

A marker or 'line in the sand' you establish to track business progress. Initially determined through budgeting. For example, how many customers you need to gain to turn a profit.

Business Plan

A document prepared by the farmer/entrepreneur detailing the past, present and intended future of the enterprise. It explains the farm's strategy to achieve certain goals.

For the purpose of our application, we ask for a business plan only from new operations or when there is a significant change in business direction.

Here is a sample business plan outline:

1. ***Company Overview***
   a. Company description
   b. History and current status (stage of development)
   c. Product/Service overview

2. ***Market Analyses***
   a. Market analysis, including sales strategy and customers
   b. Target market

3. ***Capital Plan***
   a. Plans for expansion and growth
   b. Capital expenditures… costs and 3 year time-line of purchases

4. ***Management***
   a. Management team & bios

5. ***Critical Risks***
   a. SWOT Analysis

6. ***Financial Projections***
   a. 2 years of historical financials
   b. 2 years of projections to include
      i. Monthly cash flow statement
      ii. Balance Sheet pre-loan and post loan
   c. Detailed financial assumptions
   d. Optional: Income Statement and debt-service coverage

Capital Expenses (CAPEX)

Expenses are either classified as Capital or Operating, for budgeting and tax purposes. Capital expenses refer to money spent on purchasing or upgrading physical assets such as equipment, buildings or machinery. Capital expenses differ from operating expenses in that the purchase gives long-term benefit to the farm and is not an on-going annual cost. The cost (except for the cost of land) will then be charged to depreciate the expense over the useful life of the asset.

By contrast, routine repairs and annual expenses are considered operating expenses. *(See also: expenses, assets, depreciation)*

Capital Plan

This is a list of capital expenses you intend to make *(See also: Capital Expenses)*

Here is a sample capital plan:

In order to grow our business to meet our goals, we expect the following capital expenses:

2009 - $13,000
Basket weeder
Planet Jr. Seeder
Tractor
Hay rake
Winstrip trays.

2010 - $16,000
Mulch layer
Water wheel transplanter
Diesel pickup truck
High Clearance Cultivating Tractor

2011 $ $30,000
Green house (30 by 96 feet)
Large Tractor with creeper gear, loader and pallet

In the following two years, we will need to raise capital for the purchase of the current farm location from the owner, which is $100,000, or an existing farm in a new location.

Cash Flow Budget / Cash Flow Projection / Statement of Cash Flows

Cash Flows refer to both inflow (money that comes in to you) and outflows (money you spend). It is one of the financial statements that you will need to include in your application. A cash flow projection is your best guess at how things will go during the year.

A cash flow budget is similar to an operating budget. For the purposes of the loan application, we prefer to see a cash flow budget. The cash flow budget tells if you have sufficient money to pay your bills at the end of the month. A cash flow budget is a chronological overview of expected income and expenses over a given period of time. The cash flow budget has many of the same categories as the operating budget. Both provide an overview of the costs of running your business, but the cash flow budget shows the specifics of how cash flows in and out month by month and can forecast lows and highs over the year.

For the loan application expect to show projected monthly expected cash flows for 12 months from the loan start date, and yearly cash flow projections for 1-2 years following. While the overall cash flow for the year may be positive, it's important to recognize that during the slow periods it may be negative (meaning more cash is going out of the business than is coming in), and you should plan for those periods. It's also important to recognize that startup businesses may have negative cash flow from operations for a number of years, i.e. a business may not make money in the initial years, and in turn, and profit may be reinvested in the business rather than the owner taking a salary or owner's draw.

The Cash Flow Budget includes into three types of income & expense categories – operating, investing and financing.

- Cash Flows from Operations include cash inflows from revenues and outflows for operating expenses.
- Cash Flow from Investing includes cash inflows from the sale of equipment or other assets, and outflows from the purchase of equipment or other assets.

- Cash Flow from Financing includes cash inflows from grants and loans, and outflows from the repayment of debt or the distribution of dividends.

Collateral

An asset pledged as security for a loan.

When borrowing money, the borrower provides specific property as repayment if unable to repay the debt with cash. If collateral is unavailable, a co-signer who guarantees the loan can also be used.

Depreciation/Amortization:

This refers to the decline in value of an asset, and the process of allocating that amount as an expense on the income statement. Depreciation is used for tangible assets such as a car or equipment. Amortization is used for intangible assets like a patent.

All assets, except for land, have a limited life and decline in usefulness and value over time. When an asset is purchased, the annual depreciation is calculated based on the expected life of the asset.

Expressed as a formula: Annual Depreciation = (Purchase Price – Salvage Value)/Expected Useful Life, where salvage value is the amount the asset is worth at the end of its useful life.

Each year, annual depreciation will be recorded on your income statement. In addition, you will record the book value of your assets on your balance sheet. The book value of the asset is calculated by subtracting the total (accumulated) deprecation from the original purchase price.

Expected Useful Life is based on the asset type[1]:

- 3-year: breeding animals
- 5-year: cars, pickups, breeding cattle and sheep, dairy cattle, computers, trucks
- 7-year: most farm machinery and equipment, fences, grain bins, silos, office furniture
- 10-year: single purpose ag/hort structures
- 15-year: wells, paved lots, drainage tiles
- 20-year: general purpose buildings

View this presentation for more information on calculating depreciation:
agecon2.tamu.edu/people/faculty/conner.../ppch.4.ppt

(See also, Balance Sheet, Assets, Net Income)

Dividends

Distribution of net income to the business owners. This is different than salary: it does not appear on the income statement and does not have payroll taxes deducted. Dividends are listed on the statement of cash flow.

[1] Based on information from: *agecon2.tamu.edu/people/faculty/conner.../ppch.4.ppt*

Enterprise Budget

A startup budget that includes both upfront costs *(see Capital Expenses)*, and ongoing costs *(see Operating Expenses).* Enterprise budgets are designed for looking a particular crop or idea at the implementation point, and are not the same as your operating budget. Well researched enterprise budgets for common crops are widely available on the web through Extension and other similar services. If you wish to grow an unusual crop, or undertake a unique business idea, you may need to come up with your own estimates.

Expenses

The outflow of cash or goods as a result of the ordinary course of running the farm such as for the purchase of fuel and top soil, or payment to employees.

Financial Statements

For the purposes of our application process, *"Financial Statements"* encompasses the following documents:

(1) Balance Sheet
(2) Income Statement / Profit and Loss Statement (P&L)
(3) Cash Flow Statement (Statement of Cash Flows)

Fixed Interest Rate

An interest rate that does not change over the course of the loan.

Gross Revenue

Total sales receipts (money) generated from the farm operations on an annual basis.

Income Statement / Profit and Loss Statement (P&L) (Also: revenue statement, statement of financial performance, earnings statement, operating statement or statement of operations)

A company's financial statement that indicates how the revenue (money received from the sale of products and services before expenses are taken out, also known as the "top line") is transformed into the net income (the result after all revenues and expenses have been accounted for, also known as Net Profit or the "bottom line").

It displays the revenues recognized for a specific period, and the cost and expenses charged against these revenues, including write-offs (e.g., depreciation and amortization of various assets) and taxes. The purpose of the income statement is to show managers and investors whether the company made or lost money during the period being reported.

The important thing to remember about an income statement is that it represents a period of time such as a year. This contrasts with the balance sheet, which represents a single moment in time.

Liabilities

Future obligations as the result of a past transaction. Liabilities are debts that a person or business owes.

One of the three categories on the Balance Sheet, the liabilities section includes loan or other debts due. This may include car loans, mortgages, credit card debts, as well as outstanding payments due to vendors and suppliers. In the case of mortgages and other loans, only include the amount currently owed, not the original amount borrowed.

Net Income

Net Income (also referred to as net profit) is total operating revenues <u>less</u> total operating expenses, and is detailed on the Income Statement. Annual net income is the amount of profit earned for one calendar year. Total expenses include interest expense on debt, depreciation and amortization. Expenses do not include repayment of principal on debt. *(See also: annual revenues, operating expenses, principal)*

Strengths and Weaknesses and the Opportunities and Threats (SWOT Analysis)

Often referred to as SWOT analysis, this analysis addresses the farm's internal strength and weakness as well as external factors that provide opportunities or pose threats to the business.

When doing a SWOT analysis, it's important to be realistic about your strengths and weaknesses.

Examples of strengths include:

- Our low employee turnover leads to higher labor efficiency.
- Ability to meet demands of the growing market.

Examples of weaknesses include:

- Lack of equipment means the farm does not utilize labor as efficiently as it could
- Do not own land.
- Dependency on other farms to produce our "value-add" products

Examples of Opportunities

- Growing public interest in local and organic products.
- Several new farmers' markets are opening in our region providing more venues to sell our products

Examples of Threats

- US economy is unstable, and consumers may be less willing to pay a premium for local and organic products.
- The severe weather (rains of last year, drought of this year) diminishes yields.
- The price of grain is rising which will directly increase the cost of animal feed.

Advanced Terms

Contingent Liabilities

A financial obligation that may result, though not likely. For example, the award from a lawsuit against a firm is a contingent liability for the defendant if there is little likelihood the plaintiff will recover the award.

Current Maturity of LTD

Long Term Debt (LTD) is any loan that is not due to be repaid in full for at least one year. For many loans, such as car loans or mortgages, a portion of the principal is due to be repaid each year. The amount of principal that is due within the next 12 months is the current maturity of LTD. *(See also: Interest Expenses)*

Debt Service

The amount of cash required to pay principal and interest on all loans over a certain period of time.

For example, let's say you take out a loan for $50,000 loan with 5% interest rate for X years. The monthly payments on the loan will be $943.56. Annual Debt Service is $11,148.18 (monthly payment $943.56 * 12)

(See also: Interest Expense, Principal)

Debt Service Coverage

The amount of cash available, after paying annual operating expenses, to meet debt service obligations *(see also EBIDA).*

Debt Service Coverage Ratio

Expressed as a formula – net annual income/total annual debt service. Ideally, the ratio is greater than 1.2. This means you earn enough money in your business to pay your annual debt obligations

The following information will need to be completed for the application as part of Step 3 and you will be assisted with this portion. However, all applicants are encouraged to determine this ratio for themselves to help them understand how easy it will be for them to pay off the debt.

(see also EBIDA).

EBIDA

Earnings **B**efore **I**nterest **D**epreciation and **A**mortization. Net Income is calculated to include interest, depreciation and amortization, EBIDA offers a better sense of operating cash flow and the borrower's ability to repay the debt.

EBIDA = Net Income + Interest Expense + Depreciation Expense + Amortization Expense

Interest Expense

Shown on the income statement, interest expense is the amount of interest paid on debt owed for a specific period of time. This does not include repayment of principal.

For example, let's say you take out a loan for $50,000 loan with 5% interest rate for 5 years. The monthly payments on the loan will be $943.56. A portion of the payment is allocated to pay down the principal, and a portion is allocated to pay interest expense. At the end of the first year, you will have paid a total of $11,148.18 – $2,294.98 in interest expense and $9,027.13 in paying down the principal.

- Annual Interest Expense: $2,294.98
- Annual Debt Service: $11,148.18 (monthly payment $943.56 * 12)
- Principal on the Loan at the end of the year: $40,972.87
- Amount Recorded on the Liabilities Section of your year-end Balance Sheet: $40,972.87

(See also: Principal, Debt Service)

Principal

The amount of money borrowed that is still owed on a loan. This is separate from interest expense.

For example, let's say you take out a loan for $50,000 loan with 5% interest rate for 5-years. The monthly payments on the loan will be $943.56. A portion of the payment is allocated to pay down the principal, and a portion is allocated to pay interest expense. At the end of the first year, you will have paid a total of $11,148.18 – $2,294.98 in interest expense and $9,027.13 in paying down the principal.

- Annual Interest Expense: $2,294.98
- Annual Debt Service: $11,148.18 (monthly payment $943.56 * 12)
- Principal on the Loan at the end of the year: $40,972.87
- Amount Recorded on the Liabilities Section of your year-end Balance Sheet: $40,972.87

(See also: Interest Expense, Debt Service)

Survival of Representations

The information the applicant provides in the application is important in the decision to make the loan. If it was discovered at some later date that that information was untrue at the time application was signed (of course financial data will change over time) that could be a reason to declare a default under the loan documents.

Treasury Rate

The Treasury rate refers to the current interest rate that investors earn on debt securities issued by the U.S. Treasury. U.S. Treasury securities are considered to be the safest debt investment. The interest rate paid on Treasuries sets the benchmark for all other loans.

For The Carrot Project's MA Loan Fund only, MassDevelopment and The Carrot Project set interest rates at 2.75% above the current 5-year treasury rate, or 6.5%, whichever is higher. Once the interest rate on the loan is determined, it is fixed and will not change through the term of the loan, no matter the fluctuations in the Treasury Rate. *(See also: fixed interest rate)*

Yearly Debt Service

The amount that you pay each year in principal and interest for outstanding loans. *(See also: debt service, interest expense, principal)*