



# Owner Equity Section

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**Owner equity** is a residual value of assets which the owner has claim to after satisfying other claims on the assets (liabilities). Owner equity is, therefore, a basic measure of the financial strength of a business. Traditionally, owner equity is divided into **Contributed Capital** and **Retained Earnings**. Contributed capital represents investments by the owner(s), or by stockholders if the business is a corporation. Retained earnings are an accumulation of net earnings which have not been withdrawn or distributed and provide a strong historical representation of the ability of the business to earn profits. Thus, retained earnings for a business give an indication of the success of management.

The valuation of assets owned by a non-farm business usually follows Generally Accepted Accounting Practices (GAAP). Capital assets are generally valued at cost less accumulated depreciation while inventories and some other assets are valued at the lower of cost or market.<sup>1</sup> This results in a conservative estimate of retained earnings and of owner equity in total.

The Farm Financial Standards Council (FFSC) has adopted the position that most assets should be valued at current market with full disclosure of the cost basis.<sup>2</sup> The difference between market value and cost less accumulated depreciation (book value) creates another division of owner equity which has been termed **Valuation Equity**. This helps to retain a conservative measure of retained earnings which is similar to GAAP, yet also gives the user of financial statements an estimate of the market value of assets relative to cost.

Historically, many farm financial statements disclosed only the total owner equity based on market value and omitted the division into contributed capital, retained earnings and valuation equity. As market values for farm assets increased in response to inflation and other economic forces during the 1970s and early 1980s, the change in total equity seemed to justify increased lending for agricultural operation and expansion. Increases in retained earnings from year to year probably did not support increased lending in most cases, but since changes in retained earnings were not reported

separately from total changes in owner equity, this fact was not obvious. When market values of agricultural assets contracted in the 1980s, it became apparent that much of the lending was secured by valuation equity and many loans became partially or totally unsecured. The FFSC position of disclosing contributed capital, retained earnings, and valuation equity separately gives the user of farm financial statements far more insight into the strength of the business.

This OSU Fact Sheet defines some accounting terms which are used in conjunction with owner equity. Methods used to identify contributed capital, retained earnings, and valuation equity are followed by an example from the Madison case farm.<sup>3</sup> Some problems which might be encountered in determining the division of owner equity are discussed.

## Definitions

**Contributed capital:** The amount of money which has been invested in the business by the owners. This includes the initial cash investment, subsequent investments, gifts, inheritances, and other contributions to the business from sources outside the accounting entity.

**Retained earnings:** The accumulated net earnings of a business or other entity which have not been withdrawn or distributed as dividends.

**Valuation equity:** The difference between the book value and balance sheet value of farm assets, net of the non-current portion of deferred taxes. In cases where the balance sheet includes personal assets and liabilities, the resulting equity from personal items is also included in the valuation equity component.

**Book value:** The net value of an asset which is recorded on a cost basis. This is generally the lower value of cost or market for inventories and cost less accumulated depreciation for capital assets.

**Accounting entity:** An entity is defined as a thing that has real and individual existence, in reality or in the mind. The accounting entity (or reporting entity) is a descriptive term to denote the scope of the entity for which financial state-

<sup>1</sup> The entire set of rules for valuation of assets as prescribed by GAAP is beyond the scope of this fact sheet.

<sup>2</sup> Financial Guidelines for Agricultural Producers: Recommendations of the Farm Financial Standards Council (Revised), January 2008.

<sup>3</sup> For more information on the Madison case, see OSU Extension Fact Sheets AGEC-751, Developing a Cash Flow Plan; AGEC-752, Developing a Balance Sheet; and AGEC-753, Developing an Income Statement.

ments are prepared. For example, the “farm business” would be the accounting entity if no non-farm (personal or other) business activities were included in the statements. In addition, the accounting entity could be the “farm business,” which prepares a consolidated report for the farm operation, and includes another business in which the farm business has a controlling interest but does not include personal earnings and personal equity. The accounting entity, however, would be the “farm business owners” if personal and other non-farm interests and activities were included.

## Determining Owner Equity

The accounting equation  $\text{Assets} = \text{Liabilities} + \text{Owner Equity}$  makes determination of total owner equity simple:  $\text{Assets} - \text{Liabilities} = \text{Owner Equity}$ . The division of total equity into Contributed Capital, Retained Earnings, and Valuation Equity is an important part of analyzing the progress of the business. This discussion focuses on the farm business as the accounting entity. Problems associated with including personal income and personal equity will be discussed later.

### Contributed Capital

Identifying Contributed Capital is a simple matter if detailed records have been kept to show the initial investment in the farm business, additional investment in the farm by the owners from personal or other non-farm sources, gifts made to the farm, and inheritances which identify the farm business as the beneficiary. Any withdrawals from the farm business in excess of the amount which would reduce retained earnings to zero must be subtracted from contributed capital.

Often, farm records do not provide adequate information to precisely identify contributed capital. When preparing an initial set of financial statements for a farm business that was established several years previously, the owners should approximate contributed capital by referring to any documents that are available and adjusting for other contributions and withdrawals that they remember, but can't document.

The initial purchase of land or other major capital asset to start the farm business may represent both contributed capital and retained earnings. For example, if the owner used personal savings to pay the entire purchase price for land, the total amount would be contributed capital. But if a down payment was made from personal savings and annual payments were made from profits earned by operating the farm business, only the down payment would be contributed capital. The remainder would be part of retained earnings.

### Retained Earnings

Retained Earnings, like contributed capital, may be totaled from existing records if an accurate accounting was made from the inception of the farm business to the date of the balance sheet. Retained earnings for any given year will equal net farm income less withdrawals and/or distributions. This amount may be positive or negative for any given year, but the net accumulation over the life of the business to the balance sheet date is the amount to be entered in the balance sheet as retained earnings.

Farm business records are often inadequate to ascertain retained earnings when the business has been in operation for several years. In this case, retained earnings may be

estimated by subtracting contributed capital and valuation equity from total owner equity. We can calculate, or at least estimate, two parts of total owner equity and the third part is calculated as the difference. Once a measure of retained earnings is established for a balance sheet date, changes may be accurately calculated for future balance sheets by subtracting withdrawals and distributions from yearly net income.

### Valuation Equity

Valuation Equity is calculated by subtracting the book value of assets from the market value and adjusting for non-current deferred taxes. Deferred taxes are discussed further in OSU Extension Facts AGEC-939. Valuation equity is the amount of owner equity which is derived from a change in market value from the original cost less any applicable accumulated depreciation. Valuation equity may be positive or negative.

### Madison Case Example

James and Dolly Madison initially invested \$93,500 in the farm business in 1977. Since their financial statements consolidate the farm business and personal inputs, this amount is considered the total amount of contributed capital.

Retained earnings (line 54 of the balance sheet, OSU Extension Facts AGEC-752) include accumulated net earnings of the farm, accumulated net wages from non-farm jobs, and accumulated net changes in value of owned assets. On March 1, 2010 retained earnings was \$852,188. During 2010, the Madisons project Net Farm Income of \$94,860 (Income Statement), Non-Farm Income of \$20,853, and Tax Expenses of \$9,025 for a Net Income of \$98,782. They plan to withdraw \$53,000 for family living expenses which leaves a net increase in retained earnings of \$46,943 for the year 2010 and a total retained earnings of \$899,131 on February 28, 2011.

### Defining the Accounting Entity

Unlike other businesses, farm financial statements are often prepared for the farm owner(s) as opposed to the farm business in isolation. This means personal and other non-farm income, assets, and liabilities are consolidated with the farm financial data when preparing the statements. This method of reporting has an advantage in giving a more complete disclosure of the financial position for the owners overall and may be pertinent information for lenders in addition to aiding in operational decisions.

Businesses are often combined through acquisition, merger, or consolidation and GAAP provides detailed guidance for financial reporting. Each of the businesses was a separate accounting entity before the combination and will usually continue to prepare separate financial statements for internal use. The parent company, after being combined, will consolidate the statements in reporting for the expanded accounting entity which encompasses both original businesses. Most significantly, transactions between the two companies are eliminated so that only transactions external to the entity are reported. For example, the parent company may contribute capital to the subordinate company, a transaction that would be recorded by both companies. But this is only a shifting of capital within the accounting entity, which resulted from the combination of businesses and will remain part of consolidated retained earnings in the combined statements.

The same logic may be applied when preparing farm and personal financial statements. The farm owners could be one accounting entity with assets (including net equity in the farm), liabilities, income, and expenses. The farm business would be a separate entity and each would record financial transactions between them as well as with other entities. When preparing consolidated financial statements, the farm owners would be the “parent company” and the farm would be a “subordinate company.” Other non-farm “subordinate companies” would also be included. This combined reporting format will result in a good overall presentation of the owner’s financial position. Analysis of the farm business will be hampered more or less by the degree to which non-farm activities and interests affect the division of owner equity.

### Identifying Farm vs. Non-Farm Assets

When preparing financial statements for the farm business, many assets will be readily identifiable as farm assets. Savings accounts and marketable securities, however, could be farm assets or personal assets, depending on the intent of the owner and the customary use of the assets. Investment in other entities may include common stock which is owned by the farm business and is intended to be held as a long-term investment, or could be a wholly owned local business such as a feed and seed store. When defining the accounting entity, it is necessary to ascertain whether the farm business owns the investment in other entities or if it is considered a personal holding by the farm owners.<sup>4</sup>

### Contributed Capital in Consolidated Statements

For many family operated farms, it may be difficult to differentiate between contributed capital (funds provided from outside the accounting entity) and retained earnings which are attributable to the accounting entity. It may be difficult to establish the exact date that the accounting entity came into being. For example, assume that a person works at a non-farm job for ten years and then purchases a farm with savings earned by this work. If a consolidated financial statement is prepared immediately after the purchase, one could argue that the capital, which was contributed to the farm business, is retained earnings of the combined entity, since purchase is actually an acquisition by the owner who is the “parent company” in the new accounting entity.

Perhaps a more practical perspective may be realized by establishing the origin of the accounting entity as of the date of purchase and classifying the purchase price as contributed capital. From that point forward, changes in contributed capital would come from outside the combined entity and other changes in owner equity would fall into the category of retained earnings or of valuation equity. For example, an inheritance or a gift would be classified as contributed capital while investing income from a non-farm job in the farm would be retained earnings.

### Retained Earnings in Consolidated Statements

The accumulated net earnings for all parts of the combined accounting entity will accrue to retained earnings. This presents a good indication of the earning capacity and quality of management for the combined entity as a whole. But

it does not provide a measure of the relative profitability for each of the parts. Since the profitability of the farm is usually the greatest concern when making decisions regarding the entity, it would be desirable to sub-divide retained earnings on the balance sheet into farm and non-farm sub-categories. The FFSC has recommended that financial ratios use farm data only. For many entities, the financial ratios may provide adequate information about the farm, making a separation on the balance sheet unnecessary.<sup>5</sup>

### Valuation Equity in Consolidated Statements

Valuation equity is calculated by subtracting the book value of assets from their current market value. The FFSC recommends one difference in calculating valuation equity for consolidated statements compared to farm-business-only statements. No book value for personal assets is subtracted from the current market value when preparing consolidated business and personal statements. Thus, consumer items which the owner has accumulated will not be included in retained earnings. The total market value of the assets, net of personal liabilities, is recorded as part of valuation equity.

### FFSC Recommendations

The owner equity section of the balance sheet should contain at least two components - a valuation equity component and a retained earnings/contributed capital component. The valuation equity component represents the difference between the net book value (cost or other basis not charged as an expense) and the balance sheet value (net of deferred taxes) of all farm assets whose value changes are not reflected on the income statement - breeding stock, machinery, real estate, etc. The retained earnings/contributed capital component - retained earnings in the business plus capital contributions of the owners - represents the remainder of owner equity. If possible, this component should be further segregated and the amounts attributable to contributed capital and retained earnings separately identified.<sup>6</sup>

### Summary

The division of owner equity on the balance sheet into contributed capital, retained earnings, and valuation equity can be extremely useful when analyzing the progress and viability of a farm business. Contributed capital is a measure of the value of cash and other assets which were invested in the business by the owners and, in some cases, others. Retained earnings represents a measure of growth for the farm business. This is possibly the most important measure of owner equity. It shows what the business has contributed to owner equity after providing for family living expenses or other withdrawals and dividends. The amount for retained earnings shows the total progress of the business from the inception to the balance sheet date. The change in retained earnings from year to year is a good indication of the ability of the business to continue to compete in current economic conditions.

Valuation equity is the “paper value” part of owner equity. When the market values of assets increase, there is a potential

<sup>4</sup> For further information, see OSU Extension Fact Sheet AGEC-937, Consolidated Financial Statements.

<sup>5</sup> For further information, see OSU Extension Fact Sheet AGEC-790, Evaluating Financial Performance and Position.

<sup>6</sup> Financial Guidelines for Agricultural Producers, FFSC, 2008.

increase in realizable owner equity. The owner could sell the assets and realize a monetary gain. If the owner does not exercise this option at the right time, the market value may decline. The result would be a reduction in gain or even a

monetary loss. Valuation equity, however, can be a useful measurement if the user understands the long-term trends in market value for the type of asset and the volatility of the market.

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