Developing an Income Statement

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The income statement indicates whether a business has earned money or suffered a loss. Actual financial statements help evaluate past performance so that improvements can be made as needed. Projected financial statements allow for evaluating options from production to marketing strategies to risk management. It is important to keep good farm records throughout the year to help ease the burden of financial statement preparation and planning.

To be useful, analysis needs to be done at regular intervals using consistent reporting techniques. Annual reviews should be standard, but for some businesses monthly, quarterly, and/or semi-annual evaluations are necessary. Most people prepare tax information on a calendar year. Therefore, financial planning is often done on the same calendar year basis. The balance sheet, cash flow, and income statement planning periods need to align to be effective. The instructions that follow are generally consistent with the Farm Financial Standards Council recommendations.[1]

The Income Statement

The income statement shows whether the farm operation returns a profit or a loss to unpaid labor, management, and equity. Profitability is defined as the extent to which an entity generates revenue over and above expenses with the available assets. Assets include land, capital, labor and management. Information from the income statement is also used to evaluate repayment capacity, capital investment potential, and financial efficiency (see OSU Extension Fact Sheet F-790, Evaluating Financial Performance and Position).

This OSU Fact Sheet explains how to prepare the income statement. Information, like that found in balance sheets and a cash flow statement, is required to develop the income statement.[2] The cash flow statement should cover the same accounting period as the income statement. Balance sheets are required for the beginning and ending of the accounting period.

Two basic accounting methods exist for determining net income. Both the cash and accrual methods are acceptable in tax reporting for farmers, and each has its advantages and disadvantages. Most farmers use cash accounting to compute income taxes. Cash accounting requires only single entry record keeping, which is achieved through maintaining receipts for income and expenses. Under the cash method, receipts and expenses are reported for the period during which cash or money actually changes hands. If feed is purchased and used during one accounting period, but not paid for until the next accounting period, the feed expense is not recorded until it is paid in the next accounting period. Here, profits are overstated during the first period and understated during the next accounting period. Reliance on cash income figures can delay recognition of financial problems.

The accrual method more accurately reports net income and is better for financial analysis. However, accrual accounting requires double-entry bookkeeping, which is more complicated. Accrual accounting "matches" associated expenses to revenue as they are earned. The Farm Financial Standards Council recommends that farm financial statements be developed using "accrual adjusted" accounting, a compromise between cash and accrual methods. Accrual adjusted financial statements are based on cash records with accrual adjustments to revenue (e.g., changes in inventories, accounts receivable, and prepaid expenses) and expenses (e.g., accounts payable, accrued taxes, and interest).

Example

A case study involving Jack and Julie London is used in the examples of this fact sheet.[3] The accrual adjusted income statement is being prepared for the fiscal year February 2004 through January 2005. The primary sections of the income statement are Gross Farm Revenue, Total Operating Expenses, Interest Expense, Net Farm Income From Operations, Gain/Loss on Sale of Farm Capital Assets, Gain/Loss Due to Change in General Base Values of Breeding Livestock, Net Farm Income, Nonfarm Revenue, Nonfarm Expenses, Gain/Loss on Sale of Capital Assets and Marketable Securities, Income Before Taxes and Extraordinary Items, Income Tax Expense, Extraordinary Items, and Net Income. Some key components for evaluation are Gross Revenue, Total Expenses, Net Farm Income From Operations, Net Farm Income, and Net Income.

Note: The most efficient way to develop an accrual adjusted income statement is to have a completed cash flow

1 "Financial Guidelines for Agricultural Producers: Recommendations of the Farm Financial Standards Council (Revised)," July 1995.
2 OSU Extension Fact Sheets F-751, Developing A Cash Flow Statement and F-752, Developing a Balance Sheet, discuss information requirements and include sample statements.

3 The FFSC recommends that income from nonfarm sources should not be shown on the farm income statement. Because the OSU forms are used for a variety of purposes, we have chosen to include them.

statement and balance sheets for the beginning and end of the accounting period at hand. References to line numbers in the OSU Cash Flow and Balance Sheet forms (Extension Fact Sheets F-751 and F-752) are given both in the text that follows and on the income statement forms. For instance, CF 1 means information can be transferred from line one of the cash flow; BS 6 C means numbers can be taken from the balance sheet, line 6, column C.

Warning: If you customize the cash flow statement lines, be careful when transferring information to the appropriate lines in the income statement.

Revenue

Revenue is income generated by the farm operations. Not all cash inflows are income. Cash proceeds from an operating loan are an example of a cash receipt that is not income. Revenue includes proceeds from the sales of market livestock, livestock products and crops, plus government payments. Changes in inventories of market livestock, raised crops, and feed, gains or losses from the sale of culled breeding stock, changes in accounts receivable, and prepaid expenses are also recorded in the revenue section.

Gross Revenue from Market Livestock Sales. Sale of raised market livestock, livestock purchased for resale, and livestock products are recorded in the Gross Revenue section. Raised market livestock may include stockers, feeder pigs, and broilers. Livestock purchased for resale may include purchased stocker steers and heifers or feeder pigs. Examples of livestock products are milk, eggs, wool, and mohair. Note that sales of breeding livestock are not included in this section.

In the London example, Market Livestock Sales (raised livestock) are $31,064 (CF 1), sales of livestock purchased for resale are $121,643 (CF 3), and Livestock Product Sales are zero (CF 4). The accrual adjustment to livestock sales is the difference in the value of market livestock inventories at the beginning and ending of the accounting period. In other words, this is the change in Market Livestock Inventories (BS 6 C). Since the value of market livestock at the end of the year is lower, the change in market livestock inventories for the London example is negative $5,671. Decreases in inventory are subtracted from the cash sales figure when calculating gross revenue. This adjustment to revenue may result from either a decrease in the market value of livestock, a reduced number of animals, or both. Increases in market livestock inventories are added to the cash sales figures, increasing gross revenue. A positive change in inventory would suggest that more revenue was generated either due to an increase in market value and/or an increase in the number of livestock on hand. Gross Revenue from Market Livestock/Products is found by adding lines 1 through 5 on the Income Statement. The Londons have gross revenue from market livestock products of $147,036 (calculated from 31,064 + 121,643 - 5,671).

Gross Revenue from Crops. Total crop sales should be broadly interpreted to include income from the sales of raised crops: wheat, corn, soybeans, fruits and vegetables, as well as hay, straw, and silage. Revenue from sales of crops or feed purchased for resale would also be included in this section. The Londons have Crop Sales of wheat, $59,077; and milo, $18,038 (CF 5 and CF 6). The Change in Stored Crop and Feed inventories is an accrual adjustment to the crop revenue (BS 7 C), summarizing the differences between beginning and ending values of raised crop and feed inventories. The Londons recorded a decrease in the value of inventories of $590. Again, a decrease in inventory decreases revenue for the accounting period. Gross Revenue from Crops sums the lines 7, 8, and 9 of this income statement section. The London total is $76,525 which is 59,077 + 18,038 - 590.

Other Revenue and Accrual Adjustments to Revenue. Government payments, cash rent for farm property, crop insurance claim proceeds, interest earned from farm savings and loans, patronage dividends from farm related entities (cooperatives, rural electric cooperatives, etc.), and custom work are other sources of farm revenue. Government Payments, on line 11, include deficiency, CRP, disaster, and diversion payments (CF 7). The total for Other Farm Income is entered on line 12 (CF 8). Patronage dividends from farm-related entities are entered on line 13 (CF 9). Custom work is farm-related use of machinery, equipment, or labor for pay (e.g., baling hay, harvesting wheat, hauling grain). The Londons have government program payments of $13,677, other farm income of $23,640 from custom work, and a $400 patronage dividend.

Gain/Loss from the Sale of Culled Breeding Stock sums gains and losses from sales of raised and purchased breeding animals culled (line 14). For raised breeding livestock, the gain/loss is calculated by subtracting the base value from the sale proceeds; for purchased breeding stock, subtract the cost basis from the sale proceeds to determine the gain or loss.[4] A positive number indicates a gain on the sale; a negative number indicates a loss on the sale. Only the gain from the sale, not the gross revenue, is recorded; otherwise, the revenue will be overstated. The Londons plan to cull a purchased bull and eight raised cows from the breeding herd. The purchased bull with a book value of $1,000 is expected to sell for $960, a loss of $40 (960 - 1,000), and the raised cows are expected to net $3,510, a loss of $290 when compared to their base value (Table 1). Thus, the total gain/loss on culled breeding stock is negative $330 (-290 + -40). If a material downsizing or complete liquidation of the herd occurs, the gain/loss on sale should be recorded on the income statement after Net Farm Income from Operations and before accrual adjusted Net Farm Income (line 62).

Change in Value Due to Change in Quantity of Raised Breeding Stock is the sum of the changes in value of raised livestock that are being retained for possible future use in the breeding herd, but for which the related cash costs have been expensed in the income statement.[5] Raised livestock for breeding are not depreciated if using a base-value method.

Table 1. Gain or loss on Sale of Raised Breeding Stock.

Animals Sold	Number of Animals	Base Value	Total Base Value	Total Cash Recieved	Net Gain/Loss
Cows	8	$475	$3,800	$3,510	-$290

4 See OSU Extension Fact SheetF-791, Schedules of Assets, for more information on valuing assets and calculating gains and losses when assets are sold.

5 Changes in the value of purchased livestock (calves, chicks, etc.) that are purchased young to be raised for breeding should also be included.

Instead, revenue is recognized each period when the animals are at a transfer point such as changing from market livestock to replacement heifer, replacement heifer to bred heifer, or bred heifer to cow. The value recorded on line 15 of the income statement is the gain in value (no cash exchanged) of market livestock as they change livestock classes within the breeding herd.

Table 2 (columns 1 through 10) summarizes the Londons raised breeding stock activities for the year and lists the base values (group approach) used for livestock.[6] Replacement heifers are assigned a base value of $190; bred heifers, $380; and cows, $475. This year the Londons will transfer eight calves into the raised replacement heifers class, nine replacement heifers into bred heifers, and eight bred heifers into cows. Table 3 summarizes the Change in Value Due to Change in Quantity of Raised Breeding Stock. The eight replacement heifers gain $190 in value per head or $1,520; nine bred heifers gain $1,710; and eight cows gain $760 for a total of $3,990.

The **Change in Accounts Receivable** (BS 3 C) is an accrual adjustment to the cash revenue, where accounts receivable represent the value of cash not yet received for sales made or custom work done during the accounting period that are likely to be collected. During the year, accounts receivable might increase as a result of the increase in money due from the sale of hay. Income due from the sale of livestock products, crops, supplies, or perhaps machine work could also be recorded. The net change in accounts receivable (BS 3 C) is reflected on line 16 of the income statement.

Accrual adjustments to other assets are recorded on lines 17 through 22 of the income statement. The values of these items are adjusted similarly to other inventories. The change in values (ending values minus beginning values) for prepaid expenses, cash investment in growing crops, supplies, other current assets, contracts and notes receivable, and investments in cooperatives can come from corresponding lines of the balance sheet. Prepaid Expenses include production input items or services paid for during the accounting period, but not yet received. The change in Prepaid Expenses (BS 4 C) is recorded on line 17 of the income statement.

Inventory changes associated with Cash Investment in Growing Crops, Supplies, or Other Current Assets can result from changes in quantities or prices. Inventory changes (ending values minus beginning values) are recorded on lines 18 to 20 of the income statement. All inventory adjustment figures are computed from the current asset section of the balance sheet.

Contracts and Notes Receivable might include farm rent on a long-term lease or income from a land sale that is expected to be earned in future years. The change in Investment in Cooperatives is the change in the value of stock owned in cooperatives (BS 20 C).

Gross Revenue is the total farm revenue including accrual adjustments. Gross Revenue from Market Livestock and Products (line 6) and Gross Revenue from Crops (line 10) is summed with Other Farm Revenue (line 23) to determine Gross Farm Revenue. The London farm has gross revenue of $264,925.

6 See OSU Extension Fact Sheet F- 323, Valuation of Raised Breeding Livestock, for more detail.

Table 2. Schedule of Raised Breeding Livestock, 1/31/2005.

	1	2	3	4	5	6	7	8	9	10	11	12
Raised Description	Number of Animals 2/1/04	Base Value per head	Total Base Value 2/1/04	Transferred In	Transferred Out	Sold	Died	Number of Animals 1/31/05	Base Value per Head	Total Base Value 1/31/05	New Base Value per Head Inventory	New Base Value of Beginning (Col. 1xCol.11)
Repl. Heifers	9	$190	$1,710	8	9	0	0	8	$190	$1,520	200	$1,800
Bred Heifers	8	$380	$3,040	9	8	0	0	9	$380	$3,420	400	$3,200
Cows	60	$475	$28,500	8	0	8	0	60	$475	$28,500	500	$30,000
			$33,250							$33,440		$35,000

LONDON INCOME STATEMENT

Business ☐	Actual ☐	For the period: Feb 1, 2004 through Jan. 31, 2005	
Consolidated ☒	Projected ☒		
Personal ☐			

REVENUE				
Sales of Market Livestock (not breeding livestock)				
a. Raised livestock	CF 1	1	31,064	
b.	CF 2	2	0	
c. Purchased for resale	CF 3	3	121,643	
Livestock Products	CF 4	4	0	
Change in Market Livestock Inventories	BS 6 C	5	(5,671)	
Gross Revenue from Market Livestock and Products		6	(1 +2+3+4+5)	147,036
Crop Sales				
a Wheat	CF 5	7	59,077	
b. Milo	CF 6	8	18,038	
Change in Stored Crops/Feed Inventories	B5 7 C	9	(590)	
Gross Revenue from Crops		10	(7+8+9)	76,525
Government Payments	CF 7	11	13,677	
Other Farm Income	CF 8	12	23,640	
Patronage Dividends	CF 9	13	400	
Gain Loss from Sale of Culled Breeding Stock		14	(330)	
Change in Value Due to Change in Quantity of Raised Breeding Livestock		15	3,990	
+/-Change in Accounts Receivable	BS 3 C	16	0	
+/- Change in Prepaid Expenses	BS 4 C	17	0	
+/- Change in Cash Investment Growing Crops	BS 5 C	18	0	
+/- Change in Supplies	BS 9 C	19	(65)	
+/- Change in Other Current Assets	BS 10 C	20	0	
+/- Change in Contracts & Notes Receivable	BS 19 C	21	0	
+/- Change in Investment in Cooperatives	BS 20 C	22	52	
Other Farm Revenue		23	(Sum11 through 22)	41,364
GROSS FARM REVENUE		24	(6+10+23)	264,925

NONFARM REVENUE				
Wages, Salaries	CF 15	63	8,712	
Other Non-Farrn Income	CF (16+17)	64	7,536	
+/-Change in Nonfarm Assets	BS (12+13+25) C	65	2,401	
Total Nonfarm Revenue		66	(63+64+65)	18,649

Name: Jack and Julie London
Date Prepared: Feb. 1, 2000

EXPENSES

Purchased Market Livestock	CF 39	25	86,088	
Car, Truck	CF 19	26	0	
Chemicals	CF 20	27	821	
Custom Hire	CF 21	28	0	
Purchased Feed/Grain	CF 22	29	3,545	
Fertilizers, Lime	CF 23	30	16,591	
Freight, Trucking	CF 24	31	400	
Gas, Fuel, Oil	CF 25	32	8,113	
Insurance	CF 26	33	3,847	
Labor Hired	CF 27	34	7,921	
Rents, Leases	CF 28	35	8,559	
Repairs, Maintenance	CF 29	36	8,483	
Seeds, Plants	CF 30	37	1,334	
Storage, Warehousing	CF 31	38	0	
Supplies	CF 32	39	486	
Taxes (Ad Valorem)	CF 33	40	2,872	
Utilities	CF 34	41	1,174	
Vet, Breeding Fees, Medicine	CF 35	42	2,879	
Miscellaneous	CF 36	43	2,488	
Marketing Expenses	CF 37	44	2,822	
Other	CF 38	45	1,824	
+/- Change in Purchased Feed Inventories	-BS 8 C	46	(68)	
+/- Change in Accounts Payable	BS 30 F	47	(1,827)	
+/- Change in Ad Valorem Taxes	BS 34 F	48	0	
+/- Change in Employee Payroll Withhold'g Taxes	BS 35 F	49	0	
+/- Change in Other Accrued Expenses	BS 38 F	50	0	
+/- Change in Other Current Liabilities	BS 39 F	51	0	
+/- Change in Other Non-Current Liabilities	BS 46 F	52	0	
Depreciation Expense		53	22,164	
Total Operating Expenses		54 (Sum lines 25 through 53)		180,516

Cash Interest Paid	CF (48+50+63)	55	24,589		
+/- Change in Accrued Interest	BS 33 F	56	3,591		
Total Interest Expense		57	(55+56)	28,180	
TOTAL FARM EXPENSES		58		(54+57)	208,696
NET FARM INCOME FROM OPERATIONS		59		(24-58)	56,229
Gain/Loss on Sale of Farm Capital Assets		60			(500)
Gain/Loss Due to Change in Base Values of Breeding Livestock		61			0
NET FARM INCOME, Accrual Adjusted		62		(59+60+61)	55,729

NONFARM EXPENSES					
Cash Interest Paid	CF 52	67	324		
+/- Change in Accrued Interest	BS 41 F	68	(3)		
Depreciation Expense		69	386		
Other Cash Payments	CF 47	70	1,200		
Total Nonfarm Expenses		71	(67+68+69+70)	1,907	
Gain/Loss on Sale of Nonfarm Capital Assets & Marketable Securities		72		0	
Total Nonfarm Income		73		(66-71+72)	16,742
INCOME BEFORE TAXES & EXTRAORDINARY ITEMS		74		(62+73)	72,471
Cash Income Taxes Paid	CF 46	75	10,000		
Change in Accrued Income Taxes	BS 56 F	76	5,000		
Change in Current Portion of Deferred Taxes	BS 37 F	77	(3,187)		
Total Income Tax Expense		78	(75+76+77)	11,813	
INCOME BEFORE EXTRAORDINARY ITEMS		79		(74-78)	60,658
Extraordinary Items (Net of Tax)		80		0	
		81		(79+80)	60,658

INCOME STATEMENT

Business ☐ Consolidated ☐ Personal ☐ | Actual ☐ Projected ☐ | For the period:

REVENUE			
Sales of Market Livestock (not breeding livestock)			
a. Raised livestock	CF 1	1	
b.	CF 2	2	
c. Purchased for resale	CF 3	3	
Livestock Products	CF 4	4	
Change in Market Livestock Inventories	BS 6 C	5	
Gross Revenue from Market Livestock and Products		6	(1 +2+3+4+5)
Crop Sales			
a Wheat	CF 5	7	
b. Milo	CF 6	8	
Change in Stored Crops/Feed Inventories	B5 7 C	9	
Gross Revenue from Crops		10	(7+8+9)
Government Payments	CF 7	11	
Other Farm Income	CF 8	12	
Patronage Dividends	CF 9	13	
Gain Loss from Sale of Culled Breeding Stock		14	
Change in Value Due to Change in Quantity of Raised Breeding Livestock		15	
+/-Change in Accounts Receivable	BS 3 C	16	
+/- Change in Prepaid Expenses	BS 4 C	17	
+/- Change in Cash Investment Growing Crops	BS 5 C	18	
+/- Change in Supplies	BS 9 C	19	
+/- Change in Other Current Assets	BS 10 C	20	
+/- Change in Contracts & Notes Receivable	BS 19 C	21	
+/- Change in Investment in Cooperatives	BS 20 C	22	
Other Farm Revenue		23	(Sum11 through 22)
GROSS FARM REVENUE		24	(6+10+23)

NONFARM REVENUE			
Wages, Salaries	CF 15	63	
Other Nonfarm Income	CF (16+17)	64	
+/-Change in Nonfarm Assets	BS (12+13+25) C	65	
Total Nonfarm Revenue		66	(63+64+65)

Name:
Date Prepared:

EXPENSES

Purchased Market Livestock	CF 39	25		
Car, Truck	CF 19	26		
Chemicals	CF 20	27		
Custom Hire	CF 21	28		
Purchased Feed/Grain	CF 22	29		
Fertilizers, Lime	CF 23	30		
Freight, Trucking	CF 24	31		
Gas, Fuel, Oil	CF 25	32		
Insurance	CF 26	33		
Labor Hired	CF 27	34		
Rents, Leases	CF 28	35		
Repairs, Maintenance	CF 29	36		
Seeds, Plants	CF 30	37		
Storage, Warehousing	CF 31	38		
Supplies	CF 32	39		
Taxes (Ad Valorem)	CF 33	40		
Utilities	CF 34	41		
Vet, Breeding Fees, Medicine	CF 35	42		
Miscellaneous	CF 36	43		
Marketing Expenses	CF 37	44		
Other	CF 38	45		
+/- Change in Purchased Feed Inventories	-BS 8 C	46		
+/- Change in Accounts Payable	BS 30 F	47		
+/- Change in Ad Valorem Taxes	BS 34 F	48		
+/- Change in Employee Payroll Withhold'g Taxes	BS 35 F	49		
+/- Change in Other Accrued Expenses	BS 38 F	50		
+/- Change in Other Current Liabilities	BS 39 F	51		
+/- Change in Other Non-Current Liabilities	BS 46 F	52		
Depreciation Expense		53		
Total Operating Expenses		54 (Sum lines 25 through 53)		
Cash Interest Paid	CF (48+50+63)	55		
+/- Change in Accrued Interest	BS 33 F	56		
Total Interest Expense		57	(55+56)	
TOTAL FARM EXPENSES		58		(54+57)
NET FARM INCOME FROM OPERATIONS		59		(24-58)
Gain/Loss on Sale of Farm Capital Assets		60		
Gain/Loss Due to Change in Base Values of Breeding Livestock		61		
NET FARM INCOME, Accrual Adjusted		62		(59+60+61)

NONFARM EXPENSES				
Cash Interest Paid	CF 52	67		
+/- Change in Accrued Interest	BS 41 F	68		
Depreciation Expense		69		
Other Cash Payments	CF 47	70		
Total Nonfarm Expenses		71	(67+68+69+70)	
Gain/Loss on Sale of Nonfarm Capital Assets & Marketable Securities		72		
Total Nonfarm Income		73		(66 -71+72)
INCOME BEFORE TAXES & EXTRAORDINARY ITEMS		74		(62+73)
Cash Income Taxes Paid	CF 46	75		
Change in Accrued Income Taxes	BS 56 F	76		
Change in Current Portion of Deferred Taxes	BS 37 F	77		
Total Income Tax Expense		78	(75+76+77)	
INCOME BEFORE EXTRAORDINARY ITEMS		79		(74- 78)
Extraordinary Items (Net of Tax)		80		
		81		(79+80)

Table 3. Change in Value Due to Change in Quantity of Raised Breeding Livestock.

	Transferred In	Base Value Increase	Net Gain/Loss
Repl. heifers	8	$190	$1,520
Bred heifers	9	$190	$1,710
Cows	8	$ 95	$ 760
Total Revenue from increase in quantity		$3,990	

Expenses

Operating Expenses are those expenses incurred to generate revenue. An expense is the amount of goods or services (cash or non-cash) used to produce a revenue generating item or service. Cash expenditures do not always constitute an expense. For example, principal payments on farm loans are cash expenditures and are recorded on the Cash Flow Statement; however, they are not operating expenses. Only the interest portion of a loan payment is recorded as an expense for the income statement.

The cost of Purchased Market Livestock such as stocker steers and feeder pigs purchased for resale are recorded on line 25 of the income statement. The Londons purchased stocker steers for $86,088 (CF 39).

Other cash operating expenses (lines 26 through 45) include costs associated with operating the farm business such as car/truck; chemicals; gas/fuel/oil; insurance; and utilities. Purchased Feed/Grain is the value of supplements, hay, corn, silage, etc. purchased during the reporting period (CF 22). Labor hired includes all employer costs: wages, social security, unemployment taxes, medical premiums, and pension costs. Repairs and maintenance should not include items that are a capital improvement. Capital improvements should be capitalized and be expensed through a depreciation schedule. Rents and leases record payments made under an operating agreement. If a capital lease is made, the depreciation expense and the interest portion of the capital lease payments are recorded.[7] The line item for taxes is for personal property and real estate taxes only. (Taxes related to labor hired are recorded on line 34, as stated above.)

Accrual adjustments (lines 46 through 52) record differences in beginning and ending balances of an asset (purchased feed) and several liabilities (accounts payable, ad valorem taxes, and so on). The Change in Purchased Feed Inventories (BS 8 C) adjusts the cash expense (an increase in inventory is a negative expense, hence the negative sign) to better match feed purchases to the time period in which they are used to generate revenue.

The value of stored crops and feed owned by the Londons increased by $68 during the year. Since the increase in inventory should not be charged as an expense this period, it is listed as a negative adjustment. Accounts Payable include the value of accounts payable to others for operating inputs purchased on credit, accrued property tax, accrued interest, and other expenses such as unpaid cash rent. During the year the Londons had net changes in only one expense payable category, as reflected on line 47 of the income statement. Accounts payable decreased $1,827 (BS 30 F).

7 See OSU Extension Fact Sheet F-935, Capital Leases.

Ad valorem taxes include property and real estate taxes due (BS 34 F). The amount of Other accrued expenses payable did not change from the previous years levels, hence no adjustment is necessary. Note again that changes in operating loan principal balances, personal and self-employment tax due is not recorded on the income statement. These items are not farm production expenses.

Depreciation is considered an operating expense and it is reported on a separate line (line 53) in the income statement. Economic depreciation is used for the income statement because it tends to better estimate the useful life of assets.[8] It differs from depreciation used for tax purposes. Economic depreciation is a systematic and rational method of allocating the non-recoverable cost of breeding stock, machinery, and buildings over the estimated number of years that the item will generate revenue. Economic depreciation is based on a known quantity and cost, an estimate of the useful life of an asset, and the salvage value at the end of the useful life. As an example, the Londons have a chisel bought in March 2000 at a cost of $10,285. The estimated useful life is 16 years, and the estimated salvage value is $3,500. The annual depreciation expense, calculated using the straight line method, is:

$$\text{Depreciation } \frac{\$10,285 - \$3,500}{16} = \$424 \text{ per year}$$

Only the appropriate amount of depreciation for the reporting period is recorded. For instance, if a new piece of equipment is purchased mid-year, only one-half the annual depreciation is recorded. The Londons have several pieces of equipment and machinery. For the Londons, the total depreciation expense for this time period is $22,164. Only the depreciation expense for farm assets is recorded on this line. Land is not depreciated, since it is assumed that land will not be depleted and will continue to generate revenue.

Interest Expenses include cash interest expenses plus the change in accrued interest. Cash Interest Paid on line 57 is the sum of cash interest payments for farm loans, including operating notes, line of credit, machinery and equipment notes, and real estate loans (CF 48, 50, and 63). Accrued interest is the amount of interest outstanding at the reporting date from all farm notes and loans. The Change in Accrued Interest is the accrued interest at the end of the accounting period minus the accrued interest at the beginning of the accounting period (BS 33 F). Principal payments are not a farm operating expense; rather they are repayment of cash that was received from loan proceeds and so are not included on the income statement. (Principal payments are a cash expenditure on the cash flow statement.) The Londons project cash interest payments of $24,589 plus an increase in interest accrued of $3,591; thus, total interest expense is $28,180.

Total Farm Expenses are the sum of operating expenses (line 54) and interest expenses (line 57). In the London case, total expenses equal $208,696.

Net Farm Income From Operations (NFIFO) is the amount of profit (loss) strictly from the farm operations not

8 More information on valuing assets and estimating depreciation is in OSU Extension Fact Sheet F-791, Schedules of Assets.

including gains or losses on the sale of farm capital items or personal and income tax. Thus, net farm income from operations equals Gross Farm Revenue (line 24) minus Total Farm Expenses (line 58). NFIFO is useful for comparisons over time periods as it focuses on the net returns to normal farm operations (capital sales are expected to be occasional).

Gain/Loss on Sales of Farm Capital Assets (line 60) sums gains and losses from the sale of farm vehicles, machinery, equipment, buildings, etc. While not a routine operating item, sales of capital assets and marketable securities are used to determine the overall farm profit or loss for the accounting period. The difference between the value for which the item is sold and the adjusted cost or basis is the amount of depreciation that was over or under expensed in previous time periods. The Londons plan to sell a combine and expect a $500 loss.

Gain/Loss Due to Change in Base Values of Breeding Livestock sums changes in the base values of the raised breeding livestock from the beginning to the end of the accounting period if the base value method has been used. Base values are expected to remain constant for several years, but when costs of raising livestock change significantly, an adjustment in base values is appropriate. The adjustment to income for the change in general level of base values of one or more of the age categories will be based on the change in value of the raised breeding livestock on hand at the beginning of the accounting period. For example, if the base values of raised livestock increased to the values shown in column 11 of Table 2, the herd would have a beginning value of $35,000 (column 12) rather than $33,250 (column 3). The difference between these two values ($1,750) would be entered as the gain/loss due to change in general base values of breeding livestock in the income statement (line 61). Because the Londons did not change their values, zero is entered in line 61 of their income statement.

Net Farm Income is a standard measure of profitability for a farm business, calculated by matching revenue with expenses incurred to generate the revenue, plus the gain or loss from the sale of farm capital assets, before taxes. It is a residual return to the unpaid labor and management and owner equity. Net Farm Income equals Net Farm Income from Operations (line 59) plus/minus Gains or Losses on Sales of Farm Capital Assets (line 60) and Gains or Losses Due to Changes in Base Value of Breeding Livestock (line 61). Net farm income must be positive for the farm to be profitable. A profit shows that operating expenses and debt interest are paid and that owner and family labor and management have earned a positive return. Generating profits over time allows the farm business to expand, replace capital, and reduce debt. The London net farm income is $55,729.

Nonfarm Revenue includes all sources of cash and non-cash income attributable to something other than farm production: income from wages or salaries, interest, dividends, rents and cash profits realized from nonfarm businesses, changes in the cash value of the life insurance policy, gifts and inheritances, nonfarm capital gains and losses, and accrual adjustments.

Change in Current Assets (line 65) includes changes in the value of marketable stocks, bonds, securities, and other personal assets.

Although farm creditors may focus on net farm income as they prefer to lend to farms able to generate a profit, they may also be interested in the net income to further validate the borrowers ability to repay. Nonfarm income is often looked at as a source of funds for family living which can supplement the farm if necessary. The Londons have off-farm wages of $8,712. Other nonfarm income is $7,536 from monthly rental house and royalty payments received. The nonfarm accrual adjustments are an increase in savings of $2,138 (a change in current assets plus the change in cash value of life insurance, $263 (a change in noncurrent assets)).

Nonfarm Expenses are the expenses incurred to generate the nonfarm revenue. For the Londons, items that must be deducted from nonfarm income are a depreciation expense of $386 from a rental house, cash interest paid on the rental house of $324, a decrease in interest accrued of $3, and cash withdrawals from savings of $1,200.

Gain/Loss on Sale of Nonfarm Capital Assets and Marketable Securities (Line 72) sums gains and losses from the sale of nonfarm assets (home, rental houses, stocks, bonds, etc.). As with farm capital assets, the difference between the value for which the item is sold and the adjusted cost or basis determines the gain or loss and reflects the amount of depreciation that was over- or under-expensed in previous periods.

Income Before Taxes and Extraordinary Items (line 74) is the sum of net farm income (line 62) and nonfarm income (line 73). The Londons' income before taxes and extraordinary items is $72,471.

Total Income Tax Expense is then subtracted from the income before taxes and extraordinary items. Income taxes are based on the profit (loss) of the reporting entity. The Londons have a cash income tax expense of $10,000. As with interest, accrual adjustments must be recorded to note changes in accrued income taxes (BS 36 F) and the current portion of deferred taxes (BS 37 F) and the non-current portion of deferred taxes (BS 45 F). The Londons have an increase in income taxes payable of $5,000 and a decrease in the current portion of deferred taxes of $3,187. Thus, the total income tax expense is $11,813 (line 78).

Income Before Extraordinary Items is the income before taxes and extraordinary items less income tax expense.[9] In the London example, income before extraordinary items is $72,471 - $11,813 = $60,658.

Extraordinary Items are revenue or expenses that are unusual in nature and infrequent in occurrence. Both criteria must be met to qualify as extraordinary. The amount is net of tax because the tax liability should have been accounted for earlier. An example of extraordinary items would be the gains or losses from an extinguishment of debt or proceeds from winning the lottery. Extraordinary items should be noted. Losses are entered as a negative number and will be added to the previous section to arrive at Net Income. The Londons do not have any extraordinary items.

Net Income (line 81) is calculated by subtracting extraordinary items (net of tax) (line 80) from Income Before Extraordinary Items (line 79). Net income is the amount of income available for paying personal income and social security taxes, family living expenses, and reinvesting in the business. The amount of income reinvested in the business is equal to retained earnings on the balance sheet. A

9 Note that a reduction in accured taxes could result in a negative tax expense. Subtracting a negative tax expense is equivalent to adding the amount to income before taxes and extraordinary items.

reduction in owner equity occurs when Net Income (line 81) is not adequate to pay the combined taxes and family living expenses. The Londons have a net income of $60,658.

The income statement is one of the most commonly used financial tools. The income statement indicates the progress of the business for a particular period of time, usually a year, and is used to analyze the financial success of the business. It summarizes the effects of activities, transactions, and events on the business. The income statement (also known as profit and loss statement or operating statement) measures profitability.

Computerized Farm Financial Statements

An OSU spreadsheet program, "Integrated Farm Financial Statements (IFFS)," facilitates calculation of farm enterprise cash flows, balance sheets, and income statements. The computer program utilizes data from farm enterprise cost and return budgets and additional information from input forms completed by the farm or ranch operator. For additional information, contact the Department of Agricultural Economics, Room 515 Agricultural Hall, Oklahoma State University, Stillwater, Oklahoma 74078-6026 or the local Cooperative Extension area agricultural economics specialist.

Related Publications

F-752, Developing a Balance Sheet
F-751, Developing a Cash Flow Statement
F-302, Farm Record Systems Available to Oklahoma Farmers

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The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

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- It is administered by the land-grant university as designated by the state legislature through an Extension director.
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- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
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- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Robert E. Whitson, Director of Cooperative Extension Service, Oklahoma State University, Stillwater, Oklahoma. This publication is printed and issued by Oklahoma State University as authorized by the Vice President, Dean, and Director of the Division of Agricultural Sciences and Natural Resources and has been prepared and distributed at a cost of 56 cents per copy. 0404