



# Heart of the Farm

## Financial Management Factsheet Series



### Understanding the Farm Income Statement Part II: Accrual Adjustments and Interpretation

Accrual adjustments are made in the Income Statement.  
How are these adjustments made?  
What do the Income Statement calculations tell us?

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**Accrual adjustments are made on the income statement to better reflect earned profitability performance of the farm business. This factsheet provides more detail about the non-cash accrual adjustments, introduced in Part I of this series.** Net Farm Income from Operations (NFIFO) is calculated once these adjustments are made and depreciation is accounted for. Calculation of Net Farm Income (NFI) is calculated after changes in capital assets are accounted for.

#### Adjustments to Income

Two primary adjustments made to income include inventory changes and changes in accounts receivable. *Inventory changes* reflect the change in value (by some combination of quantity and price) of grown crops

held for sale or feed, and market and raised breeding livestock. Subtract beginning of the year values of these inventory items from the end of year values to determine the net adjustment. Ending year inventory that is smaller than beginning year inventory is accounted for as reducing this year's income. Larger ending inventory is recognized as increasing income.

*Breeding livestock* raised but not sold during the year are accrual-adjusted to the current year. Production from these animals contributes to income; however, their change in value also affects income.

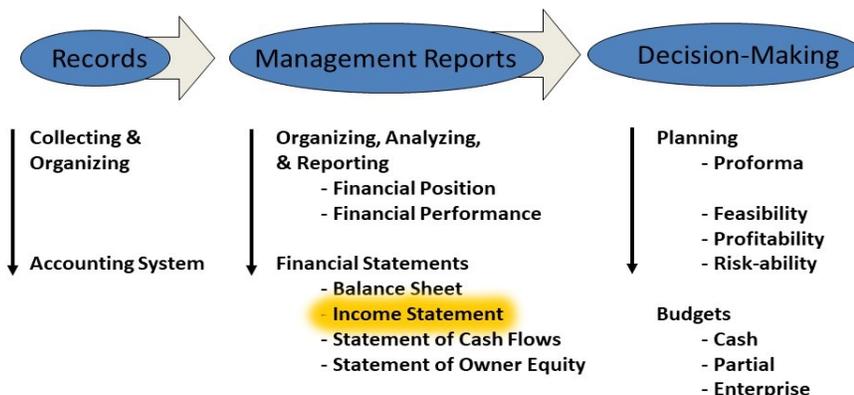
Changes in *accounts receivable* reconcile between the year when products are sold and when they are

paid for. Products sold this year but payment not received this year, create an account receivable. Cash income received for the product, plus the account receivable amount, reflect the value of the product produced for the year.

#### Adjustments to Expense

Two primary adjustments made to expenses include changes in purchased inventory and prepaid expense, and changes in accounts payable. Purchased inventories (i.e., seed) this year that will be used next year, are reflected as an increase in cash expense for this year. The *change (increase) in purchased inventory* is therefore subtracted from cash expense (an accrual adjustment) to accurately align the expense with the year the item was used.

### Farm Business Financial Management Model



The **Financial Model** illustrates the management-to-decision-making process, and the tools used to make decisions. Beginning with collecting and organizing financial information (records) through an accounting system, the information is then transformed into financial statements for analysis and interpretation of the farm's financial position and performance. Through the budgeting process, analysis for feasibility, profitability and risk-ability, allow for making the best decisions for the farm business.

*Prepaid expenses* are accounted for in the year they were used for production. If the item was purchased this year (to be used next year), then make an accrual adjustment by reducing this year's expenses by the amount of that prepaid expense.

*Accounts payable* represent unpaid bills. The amount of the unpaid bills at year end reflect expenses incurred for the year that are not reflected as cash expense, and therefore, the *change (increase) in accounts payable* is added to cash expenses (an accrual adjustment) to accurately align the expense with the year in which it occurred.

Within accounts payable, or recognized separately, *accrued interest* represents the year's accumulated interest that has not yet been paid. It is accounted for as an increase to this year's expenses.

### **Depreciation and Sales of Capital Assets**

*Depreciation* is a non-cash expense (neither a cash expense or accrual

adjustment) and is included on the income statement. It represents how and the annual amount, as expense, of a capital asset as it is used up in service to the farm business.

Net Farm Income from Operations (NFIFO) reflects profitability of a typical year for the farm business. In contrast, Net Farm Income (NFI) reflects this specific year and includes "extraordinary" ways the farm generated profit during the year. For example, the farm sold a combine (capital asset) this year, which is not typical every year. Therefore, additional (extraordinary) income was earned this year, which is then accounted for on this year's income statement.

***Gain (loss) on sale of capital assets*** represent extraordinary items (beyond normal production) that impact the profitability of the business. Machinery, equipment, buildings and land are occasionally sold, and are recognized in the year when the sales are made.

### **The Bottom Line**

NFIFO and NFI are used to calculate several ratios and benchmarking these ratios to industry guidelines provides insight to your farm's performance. These ratios include Rate of Return on Farm Assets (ROA), Rate of Return on Farm Equity (ROE) and Operating Profit Margin Ratio. These ratios are discussed next in this series of factsheets, *Understanding Profitability using the Balance Sheet and Income Statement*.

To be successful, the farm business NFI should be positive. The business should return a profit to the money (yours and others), labor and management invested in it. Benchmarking your profitability measures to previous years and to other similar farms indicates your performance. Understanding your current profitability gives insight to farm business decisions.

*Next up....*

*Understanding Profitability using the Balance Sheet and Income Statement*

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The Heart of the Farm – Women in Agriculture program addresses the needs of farm women and men by providing education on pertinent topics, connecting them with agricultural resources, and creating support networks. <http://fyi.uwex.edu/heartofthefarm>

For other farm financial information and resources contact: Center for Dairy Profitability: <http://cdp.wisc.edu>

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