When Is A Profit Not Profit?

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Tax time is here again. Most Kentucky crop farmers should have had a good year last year, unless they were hit by either the spring freeze or the summer drought. We have certainly had good crop prices the last while. Therefore, if you had anything to sell, you should have had a good income year. Livestock producers did not have a similar experience. Last year's good crop prices resulted in higher feed costs for livestock producers. Regardless of your income situation, you still have to file an income tax return.

All farmers filing income tax returns with the Internal Revenue Service (IRS) file a Schedule F as part of their income tax return. The Schedule F is the form on which you report your farm business income and production expense items, all broken down by category. For many producers, the IRS Schedule F is the only indicator they have of the profitability of their farm business. The reason for this belief is simply because the last line of the Schedule F carries the title of: "**NET PROFIT** or (loss)". However, the IRS Schedule F is a poor indicator of the farm business's ability to generate a profit.

Most farmers file income taxes on a cash basis. The Schedule F is a cash basis income statement for the farm business. As such, it is a good summary of all Cash Inflows, Cash Outflows, and an allowance for depreciation. But, it is not a good indicator of farm profitability.

An example of this situation could be a crop farmer that could not pay his fertilizer bill or a dairy farmer that could not pay their feed bill for the year. Both may have had good product sales for the year, but since they did not pay these bills, they could not claim the fertilizer or feed bill as a tax deductible expense. The resulting Schedule F would have income from the sale of grain or milk. It would not show the production expenses for fertilizer or feed, since they were not paid. The resulting **NET PROFIT** would have been large even though the farm business may have been losing money.

Agricultural lenders always request three to five years of income tax returns when farmers apply for a farm loan. Farm lenders know a favorite farm management strategy is to reduce income taxes. To do this, farmers have to reduce farm income. They use various methods of "moving" cash income and cash expenses around over time. This is a well known management practice; however, it results in an understatement of actual farm income for any single year. Farmers can only disguise the true profitability of their farm business, good or bad, for a limited number of years. Eventually, in three to five years, the actual income earning capacity of the farm business will be revealed.

The income shifting conundrum finds the farm manager trying to convince the lender that the farm business is very profitable and well deserving of the loan for which he is applying using the exact same evidence he has used to convince the IRS the farm business earns very little income. The solution to this problem and a way to avoid a misstatement of the profitability of your farm business as demonstrated with the Schedule F is the **Accrual Adjusted Income Statement**.

The IRS requires most main street businesses to do their accounting and file income taxes on an accrual basis. This simply means financial transactions are accounted for when they occur. Farmers are not required to file income taxes on an accrual basis. They are allowed to file income taxes on a cash basis, which simply means they are allowed to account for financial transactions only when "cash actually changes hands." This results in an important income tax management tool. It also results in the IRS Schedule F being a poor indicator of a farm's profitability. An Accrual Adjusted Income Statement will solve this problem and eliminate farm business managers' income taxes versus credit worthiness conundrum.

The Accrual Adjusted Income Statement combines information from the IRS Schedule F (cash basis income statement) and the farm's Balance Sheet to provide a more accurate estimate of farm profitability. Examples of the types of problems an Accrual Adjusted Income Statement will solve are:

• Selling only part of a year's production or selling two years production in one year

• Failure to pay all production expenses during the year they were incurred or paying bills from last year during the current year

• Failure to collect all income when it was earned All of these situations are quite common for the typical farm business. They all result in a distorted estimate of profit using the IRS Schedule F. Use of an Accrual Adjusted Income Statement will correct this distortion.

Putting together an Accrual Adjusted Income Statement is not difficult. It just takes a bit of time and some adding and subtracting of appropriate account values. You are essentially combining the cash basis income statement information put together for the IRS Schedule F with adjustments taken from both the Beginning and Ending Balance Sheets for the farm business. The forms for both a Balance Sheet and an Accrual Adjusted Income Statement are available as part of the **Kentucky Farm Record Book,** which is available from any University of Kentucky Cooperative Extension Service County Office.

Basic instructions to help fill out and complete the forms are included. They provide a good "cook book" approach to putting together both the Balance Sheet and the Accrual Adjusted Income Statement.

Preparation of a Balance Sheet will provide an accurate financial picture of your farm business. Preparation of an Accrual Adjusted Income Statement will more accurately estimate the ability of your farm business to earn a profit than does the Schedule F. It will also eliminate the possibility that you might misinterpret a Schedule F PROFIT when there is no real profit! Δ

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