OTHER INCOME AND EXPENSE ANALYSIS

Some companies have income sources in addition to sales and expenses other than those included in cost of goods sold or operating expenses. After evaluating the operating profit or loss of a business, a lender should look at these income and expense items that lie outside of the business' normal operations. This enables the business banker to determine if these items significantly affect the overall net profit or loss of the business, and whether or not they are consistently recurring items.

Other Income

Other income is income generated outside the normal operating activities of the business. This income does not result from sales of the firm's products or services, but from other, unrelated activities. Some businesses have a dependable source of other income that should be analyzed as recurring income. Other income that is non-recurring is often labeled *extraordinary income*. Typical sources of other income include the following:

- **Rental income—**It is often generated from excess building facilities or equipment. Renting or leasing excess capacity without interrupting operational efficiency is a prudent action. However, the lender needs to consider whether the income will continue or if the company will soon need to use the space or equipment and thereby, stop this income source
- **Interest income—**It can be generated from excess cash placed in bank accounts or other investments, or perhaps from a loan to another business. If such investments recur, the level of market interest rates will affect the level of income generated over time
- **Gain on sale of fixed assets—**A business can generate income by selling its excess fixed assets at a profit. For instance, after upgrading its fixed assets with more efficient equipment, a company may want to sell its used equipment. A gain results when the sale price exceeds the net book value (asset's cost less accumulated depreciation) of the asset sold
- **Dividend income—**Businesses may own stock in related operating companies or in publicly traded companies. Any dividends received constitute a source of non-operating income. Because dividends are based on the profitability of another company, without first analyzing the other company, a business banker should not assume that the dividends constitute a dependable source of income in the future. A lender also might investigate the reason for the investment. Was it a temporary use of excess funds, some form of speculation, or to gain a business advantage?
- **Extraordinary recurring and nonrecurring income—**If other income constitutes a significant portion of the total income of a company, the business banker determines the sources of the other income and whether it can be relied on in the future. For example, Dry Supply rents extra office space to another business for $3,000 per year. Alternatively, income from interest is usually recurring, although the amount may fluctuate depending on market interest rates. Dry Supply earns $2,000 in interest income each year. Besides helping a business banker anticipate future profitability, information about other income can present a portrait of a company's operations. An increase in income from renting excess facilities or equipment or by selling fixed assets, for example, may indicate a business has excess capacity

Business bankers also should examine Schedule M-1 of a business tax return to locate other income recorded on the books of the business, but not included in the amounts shown in the tax return's income statement that is usually the first page. An example of tax-exempt income is interest income on certain state and municipal bonds. If material, these amounts shown on Schedule M-1 should be added to the amount shown for *other income* on the first page of the tax return.

Note also that in business tax returns *other income* is included with gross profit to derive "total income."

Other Expenses

A business may have other expenses (also called nonoperating expenses) as well as nonoperating income. Similarly, these expenses arise outside of the normal business operations, and may be recurring or nonrecurring in nature. Typical sources of other expenses include the following:

- **Loss on sale of fixed assets—**If a business sells any of its fixed assets below book value, the loss associated with the sale is recognized as a non-operating expense. When such losses show up on the income statement, a business banker needs to determine if additional losses are expected. Additional losses are more likely if the company has consistently underestimated depreciation on the used equipment by overestimating its useful life. If a sudden jump in technology has rendered just a few assets obsolete, continued losses on the sale of fixed assets are unlikely
- **Loss on discontinued operations—**It occurs when certain undertakings have not been as profitable as management would like, and the assets could be more efficiently used in some other area of the business. When it decides to discontinue an operation, a business usually establishes a reserve on the balance sheet to cover estimated losses related to liquidating the assets and contracts. The analytical challenge is to determine whether the business will face additional losses in the future on other undertakings—some that might not be within management's control
- **Interest expense—**It is shown as a non-operating expense because not all companies borrow money, or at least, not the same amount at the same time. Because it is related to a discretionary source of funding, interest expense is listed separately from other expenses. The cost of borrowing money depends both on the company's overall level of borrowings and whether debt is at fixed or floating rates. In the latter case, the market interest rate at any particular time can have serious consequences. Therefore, depending on the company's borrowing requirements and interest rates, interest expense can fluctuate dramatically
- **Extraordinary recurring and nonrecurring expenses—**Just as with other income, any significant other expenses should be identified as recurring or nonrecurring. Losses from selling fixed assets, from stock or from discontinued operations do not occur regularly. Even so, the business banker should ask whether any future sale of assets is contemplated or whether any additional losses from discontinued operations will be forthcoming. Interest expense, which is a recurring expense, fluctuates along with market interest rates and the amount of company debt. In 20xy, Dry Supply's interest expense increased to $11,000. The company either used its credit line more or underlying interest rates increased

Business bankers also should examine Schedule M-1 of a business tax return to locate *other expenses* recorded on the books of the business, but not included in the amounts shown in the tax return's income statement that is usually the first page. Some of the expenses listed on Schedule M-1 should be included in the appropriate operating expense categories and will have been handled already. If material items remain that match the *other expenses* discussed in this reading, these amounts should be added to the amount shown for *other expenses* on the first page of the tax return.