



Recasting the Financial Statements

Before a discounted cash flow method, or any other method within the income approach can be applied, the first thing the valuer needs to do is recast the financial statements. This is a critical step in the valuation process, and one which, if ignored, can lead to a significantly flawed valuation conclusion.

“Recast earnings” is a term that is often used interchangeably with the terms “normalized earnings” and “economic earnings.” The goal of this process is to determine that level of earnings that an arms-length, hypothetical buyer would be able to enjoy from the business for some period of time into the future. It removes not only one-time or extraordinary income and expenses, but also adjusts for accounting anomalies as well as owner perquisites that are so common in the closely held business.

Earnings are normalized for two reasons: first, to provide a basis for comparison to others in its industry, and second, for arriving at an appropriate cash flow or other measure of income to discount or capitalize. This section will discuss each of these reasons to normalize earnings, as well as the typical normalization adjustments that are necessary for most valuations.

The first of these is done for purposes of assisting the valuer in assessing the risk of the company, and therefore its discount or capitalization rate. When the valuer compares the

earnings, balance sheet, and financial ratios of the Subject Company to others in the same industry, he is doing that as a part of his assessment of the relative risk of the company. Such analysis provides an overall view of the Company's operations and insight into the potential for future earnings and the risks pertaining thereto.

In order to make a meaningful comparison, it is often necessary to state the financial statements on a basis as close as possible to the source that you are comparing to.

For example, if the valuer were to compare the Subject Company to financial data obtained from RMA Annual Statement Studies, he should be aware that their data, which is provided to them by bankers, comes from a combination of CPA-prepared financial statements, tax returns, and "other" (presumed to be internally-generated financial statements). The breakdown of where the financial data comes from is provided for each Standard Industrial Classification ("SIC") code. If the data in a particular SIC were primarily from audited financial statements, then he would probably want to convert his statements to be in conformance with Generally Accepted Accounting Principles ("GAAP").

However, if the valuer were to compare to the Almanac of Business & Industrial Financial Ratios, then he would need to be aware that the source of that data is from federal income tax returns. Such adjustments may not be necessary to this data—because such adjustments are not reflected in the data found in the Almanac. The key is to know the source of the data being used for comparison, to be sure that an "apples to apples" comparison is accomplished.

The second reason for normalizing is to arrive at an appropriate measure of income to discount or capitalize. Here, we are trying to estimate that level of income that a new owner could expect to receive from the business for some period of time into the future. There are three basic types of adjustments that are made to the income or cash flow statements:

- Removal of one-time, extraordinary, or non-operating income or expenses;
- Accounting adjustments; and
- Removal of owner perquisites.

Each of these will be discussed in the following sections, along with examples of the types of adjustments the valuer will typically see.

It should be noted that the first two of these types of adjustments are typically made for every valuation. However, the third type of adjustments, removal of owner perquisites, will usually only be made only for a valuation of a controlling interest in an entity. That is because a minority owner cannot compel the control owner to “give up” the perks that they enjoy. In that instance, the minority owner’s value is found in the cash flow currently being produced by the company.

Removal of one-time, extraordinary, or non-operating income or expenses:

These adjustments are meant to remove items that appear in the subject company’s financial statements, and are either unlikely to be repeated in the future, or are unrelated to the company’s business operations. Examples of such adjustments include:

- Realization of a one-time \$500,000 contract payment from a new client;
- Payment of a \$200,000 lump sum bonus to an employee;
- \$1,000,000 expended on a new plant facility for expanded operations;
- \$250,000 capital gain realized on the sale of corporate-owned publicly traded stock.

Clearly, any of these items, if left in the earnings to be capitalized, would result in a significantly flawed valuation conclusion. That is because a new owner of the business would not have these unusual items of income, nor would he have to pay these extraordinary expenses.

Unfortunately, it is not altogether uncommon for some appraisers and brokers to take this to the extreme, looking for every penny of expense that might not be repeated in the future to add back to cash flow, so as to bolster up the profits of the company. This process leads to misleading results and a general distrust of the valuer. A healthy dose of realism should be injected into this process.

Accounting adjustments:

These types of adjustments restate the subject company's financial statements on a basis that is similar to that of the companies that the subject is being compared to. They are also done in order to reflect a more accurate picture of the economic reality of the company. Most appraisals are prepared using either accountant-prepared financial statements or tax returns. We need to be careful to make adjustments that reflect the financial reality of the company, as opposed to accounting and tax rules, which may bear little or no relationship economic reality.

Types of adjustments commonly found here include:

- Adjustments from LIFO (“last in / first out”) basis of inventory accounting: The LIFO method is a special tax method of accounting for inventory that serves to reduce inventory on the balance sheet, while overstating cost of goods sold and thereby reducing profit, and therefore taxes, on the income statement. A switch to FIFO (“first in / first out”) would be more reflective of the current worth of the inventory, and would provide a more meaningful comparison to comparative company data.
- Depreciation methods: Depreciation of capital assets is often done using accelerated methods that tend to write off the acquisition of an asset faster than the true useful life of that asset would dictate. Here, at the very least an adjustment should be made to reflect a write off over the useful life of the asset, or, more appropriately, to account for an adequate fixed asset replacement reserve.
- Unreported sales: The valuer may need to make an adjustment to reflect the reality of sales that were made, but ultimately not reported on the company’s tax returns—noting that such reporting may have implications with regard to the evaluation of the company’s risk and potential tax exposure.
- Timing differences: If the date of the valuation and the date of the last financial statements are different, you may need to adjust the statements to account for such differences.

- Matching of income and expenses: You may want to either accrue, or reflect as prepaid expenses, items that do not properly relate to the year in which they were paid or deducted. Assuming an accrual basis taxpayer and accountant-prepared financial statements, this will already have been done for you in the financial statements issued by the outside CPA.

All of these adjustments are meant to get you back to the same thing: the economic future prospects of the company, from which a valuation conclusion can be drawn.

Removal of owner perquisites:

This is perhaps the most fertile ground for appraisers, because it is common for the owner of a closely held business to take benefits beyond his “fair market value” compensation from the company. Here, as with the other areas, we are trying to arrive at an amount of cash flow (or other measure of income) that the new business owner could expect to enjoy from the business for some period of time into the future.

Some of the most common of these adjustments are as follows:

- Owner compensation: In closely held companies, owner/managers have the discretion to pay whatever they think is appropriate to meet their goals. Payments may or may not be at market rates. The goal of these types of adjustments is to restate owner / manager salaries to that amount which a new owner could reasonably expect to pay an individual filling whatever capacity the old owner/manager filled. There are many sources of such

comparable data available to the valuer, some from purchased sources, and some from free sources found on the Internet.

- Other owner/manager benefits: Owners may have their business pay for benefits that may not be considered business expenses. Examples may include a rich life insurance contract or pension plan. Such expenses should be scrutinized to determine the likelihood that a new owner would have to continue such payments.
- Related-Party transactions: Many small business owners own not just one, but two or more businesses, some of whom transact business together and among each other. In these cases, the prices paid for goods or services among the companies are often determined for purposes relating more to estate and intra- or inter-family planning than they are to the economic worth of the good or service. The valuer needs to carefully assess the value of such transactions, and state them at an arm's-length price.
- Personal-use assets, such as ski condos and automobiles: Many small business owners have assets in the company that are available for their personal use. These assets should be treated as non-operating assets of the business, and any financial statement impact removed.

It sometimes takes a bit of detective work to uncover where these expenses are hidden, for it is uncommon that such personal benefits of the owner are clearly laid out for you. In some instances, nothing short of going through the income statement line by line to gain an understanding of what lies behind the numbers will do.

Failure to appropriately consider each of these areas of financial statement adjustments can result in a significantly flawed valuation conclusion. However, being overly zealous in our analysis can lead to an equally flawed result.