

## **Lesson 4. Series: How to Determine the Value of Your Business**

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### **Course Four: Financial Statement Recasting.**

As we saw in the last session recasting or restating financial information is an important part of determining the value of a small business. That is usually due to the type of situation we described in the previous session, where the owner is being paid half of a normal managers wages and consistently working 70-hour workweeks. And usually the small business owner will be taking out additional compensation in ways other than as a salary. The owner in our previous example was deducting expenses for several automobiles through the company and was “writing-off” a business trip to Hawaii every year. This often becomes the biggest challenge of the business valuator; what is the actual reward that this business is generating to the owner?

In our previous example the reward or return was recalculated to be:

Business Income	\$100,000
Less Adj to owners comp	
To equal normal salary	- 50,000
Cost to replace add'l	
Time by owner	- 20,000
Plus Owners “perks”	<u>+ 15,000</u>
Business Return	\$ 45,000

After restatement (recasting) the business is generating a return (pre-tax) of \$45,000 for the capital invested. We went from a \$100,000 return to a \$45,000 return by understanding what is a reward and what is an investment.

The owner of a small closely held business has many “opportunities” to affect the financial performance of his or her business. To understand value it is imperative that the financial data and operational data be examined to recognize adjustments that need to be made. Sometimes this is called “normalizing” earnings. To adjust the actual financial data to reflect the operation without the “unusual” items that might effect in particular period.

This is an area of much confusion and disagreement. Often a seller of a business will identify one-time operational issues that have had a negative impact on the business and want them adjusted back into the profit mix. A buyer will say that those so-called one-time expenditures are really just a normal cost of business and should be deducted to determine profits. This can create a wide difference of opinion as to what “normalized earnings” actually should be.

This process of recasting financial statements is a major element in determining value of most closely held small businesses. Large companies and especially public companies are subject to exacting standards on how they keep their books. Larger companies must adhere to a set of standards referred to as Generally Accepted Accounting Principles or GAAP. These standards are devised by the accounting gurus and monitored by auditors. All public companies and most larger organizations have their financial information examined by independent auditors who state whether those statements adhere to GAAP and present fairly the financial condition of the company.

Small business is a different story. As a consulting firm it is the area of consistent weakness we see in small businesses. A lack of quality financial information to make decisions. This is usually due to budget considerations and quite often just a lack of understanding by the business owner of the dire consequences of not dedicating adequate resources to this vital function. A small business owner will often maintain records primarily to file income tax returns. So one of the big challenges in determining value is to have a good set of financial statements that reflect the financial condition of the business.

Since few small businesses share their financial information with anyone other than maybe a banker and the IRS they will often maintain their records on a tax basis. This usually means that they are keeping their books on a cash basis.

Cash basis financial statements present a very incomplete picture of the financial conditions of most small businesses. Now if you happen to be a service business with no inventory who only does business for customers on a cash basis and pays all of your bills when you receive the service or product then maybe the cash basis statements accurately reflects your business. However for most businesses these statements are incomplete and occasionally misleading.

Another factor in small businesses is that the business owner is usually motivated to minimize taxes. As a result the owner may make decisions based on the tax timing or tax consequences as opposed to decisions to maximize profits. This can result in the understatement of earnings by the business or at the very least a cloudy picture as to the earnings potential of the business.

For these reasons most small businesses need to have their financial data restated or recasted to establish a more accurate picture of the financial performance of the business. This recasting requires analysis and interpretation. This can be and often is a point of contention between parties with different interests.

If you are a seller of a business trying to establish value you will want as many dollars as possible added-back to your financial statement to improve your companies profitability and thus its value. On the other hand if you are a buyer you will question all add-backs and look for items that should be deducted from earnings and thus lowering value. This tug-of-war is usually part of the negotiation process in buying and selling a business.

Someone independently placing value on a business must use their best judgment to determine what should be adjustments to the financial statements of the company being valued. There can be significant disagreement between valuers regarding the legitimacy of these types of adjustments with dramatically different results.

There is not a standard list of items that should or should not be added-back or considered adjustments to financial statements. Some of these we have already discussed related to owners compensation and perks. Some items that might need to be examined:

- Owner's salary. This can be where the owner is withdrawing excess compensation and understating profits or where the owner is contributing his services below "normal" wages and overstating profits.
- Owner's perks and discretionary expenditures. Some items could be add-backs because they are not considered part of the business operations (a Hawaii vacations) while others could be adjustments because they were excessive and discretionary (such as luxury vehicles as company cars).
- Unusual and/or one-time expenditures. If you are trying to determine "normal" earnings than anything that occurred in the based year you are examining that is not "normal"

could be an adjustment. This can also be an unusual or one-time occurrence that is beneficial to the company. Such as a gain on the sale of an asset or receipt of insurance proceeds.

- Interest expense. In most cases small business valuations are made on the basis of a debt free analysis. Therefore interest expense (if deducted from operations) is added back.

Also in many valuation models depreciation and amortization are added back. These models look at these “expenditures” as non-cash outlays during that period.

Hopefully you are starting to see that the valuation of a small business involves many variables. We must assess risk and then be able to measure reward or return. These simple concepts can become very complicated in the real world with real businesses.

**Next: Course Five: Methods of Income and Benefit used in Analysis.**