Recasting Financial Statements

Buyers of private companies purchase businesses for the profit they generate, or can generate. They look at the past as an indicator of the business' ability to generate cash or profits. They also look at the value of the assets, liabilities and equity of the business. For private companies, the financial statements often do not reflect the true profitability and asset values of the business. This is because:

- Accrual accounting can distort the reported profits and balance sheet values.
- Lack of conformity to generally accepted accounting principles (GAAP)
- Tax-reduction strategies used to reduce reported profit.
- Value of assets and liabilities on the balance sheet can change over time and may not be reflected on the balance sheet.

Therefore, to obtain an accurate estimate of value, one must adjust the income statements and balance sheets to show the true profitability of the business and the true value of the assets and liabilities.

Income Statement Adjustments Common income statement adjustments include the following:

- *Owner compensation:* compensation that deviates from what it would cost to hire someone to perform the duties of the owner or owners
- *Expenses not necessary for the ongoing operation of the business*: may include expensive cars or trucks, excessive travel, etc.
- *Non-recurring expenses:* such as one-time bad debt write-offs, non-recurring operating losses, legal fees, etc.
- *Non-cash expenses:* depreciation and amortization

See the accompanying income statement for XYZ Company

Although it is the future income that buyers of the business are considering when assigning value, it is the historical performance that provides the basis for the projection. This is the reason historical income statements should be adjusted.

XYZ Company Historical Income Statements (with Adjustments)

$000's	2002	2003	2004	2005
Revenue	$1,000	$1,200	$1,150	$1,400
Cost of Goods	($600)	($720)	($700)	($840)
Gross Profit	$400	$480	$450	$560
Operating Expense	($364)	($409)	($371)	($467)
Operating Profit	$36	$71	$79	$93
Taxes and Other	($11)	($21)	($21)	($28)
Net Income	$25	$50	$58	$65
Adjustments				
Excess Owner Compensation	$100	$110	$110	$125
Depreciation	$50	$50	$50	$50
Non-Recurring Legal Fees	$0	$50	$0	$0
Owner Benefits in Excess of Market	$50	$50	$70	$70
Taxes	$11	$21	$21	$28
Total Adjustments	$211	$281	$251	$273
Adjusted Pre-Tax Net Income	**$236**	**$331**	**$309**	**$338**

XYZ Balance Sheet – Actual and Adjusted

$000's	YE 2005 Actual	YE 2005 Adjusted
Cash	$100	$0
Receivables	$400	$375
Inventory	$400	$350
Other Current	$50	$0
Total Current Assets	*$950*	*$725*
Furniture, Fixtures and Equip. Net of Depr.	$200	$400
Real Estate	$250	$400
Other Fixed Assets	$40	$0
Total Long Term Assets	*$490*	*$800*
TOTAL ASSETS	**$1,440**	**$1,525**
Trade Payables	$300	$300
Other Current Liabilities	$100	$100
Total Current Liabilities	*$400*	*$400*
Long Term Debt	$650	$650
Note Payable To Owner	$50	$0
Total Long Term Debt	*$700*	*$800*
TOTAL LIABILITIES	**$1,100**	**$1,050**
Equity	$340	$475
TOTAL DEBT AND EQUITY	**$1,440**	**$1,525**

Balance Sheet Adjustments Common balance sheet adjustments include:

- *Accounts receivable:* to reflect the actual collectable amount
- *Inventory:* to reflect the value of the inventory that is actually sellable, and at a cost that will allow for it to be sold, over a reasonable amount of time, at normal profit margins
- *Cash:* exclude cash that will not be sold with the business
- *Other assets:* any asset that will not be sold with the business, or would not have real value to a new owner, should be excluded
- *Fixed assets and real property:* should be listed at their current fair market values
- *Depreciation:* should be eliminated altogether
- *Debt:* should reflect the actual payoff value of the obligations of the company, or at least those that a prospective new buyer would assume

The standard of value which should be used for the adjusted balance sheet is fair market value. Because fair market value can only be truly determined in an actual sale, these values are estimated. And although there will be no liquidation of assets in a sale of a business as a going concern, the true market value of such assets is important to both the buyer and seller. This is because the lowest price a buyer should accept is the sum of the values of the underlying assets themselves, less the cost that would be incurred to liquidate them (i.e., sell them off piecemeal).

Restating the assets and liabilities of the business provides an accurate picture for the buyer and seller, which eliminates uncertainty. In addition, it will help the buyer estimate the amount he or she can borrow against the assets to apply toward the purchase. The higher the amount that can be borrowed, the higher the purchase price that can be paid.