BUSINESS VALUATION
RECASTING THE FINANCIAL STATEMENTS

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When someone asks me why a forensic valuation of a company in a litigation setting costs so much money it is because very few litigants are going to be honest about their business operations in terms of unreported income, personal expenses, etc. It is understandable because the business owner has a motive to minimize the value of the business. Therefore, a fair amount of forensic digging needs to be performed. Whenever I hear from a non-titled spouse or their attorney that the business owner is doing this and that to cheat the government (or them) and cashing checks and not depositing them, etc., I always warn them that these types of investigations cost significantly more money than a straight valuation and that the costs relative to the value may be prohibitive. Unfortunately, reality sometimes hurts. Those attorneys that work with me know I try to avoid adding unnecessary costs to an assignment, but once we start down the path of looking for significant fraud, the costs start to mount.

Very few active closely held businesses do not have expenses on the financial statements that are either non-recurring or non-operating and are for the benefit of the owners or their families. In other words, there is generally a significant amount of hidden compensation. The financial statements almost always need to be adjusted to reflect true owners' income, without which a fair value cannot be estimated. This article is not designed to belabor the tax implications of some of the creative ways owners compensate themselves but rather adjust the financial statements to present them in a more normalized and comparative manner in order to determine the income that is used to value the company.

The recasting of the financial statements or adjusting the tax return income and expense items is one of the most important steps towards determining the value of a company. One cannot determine the value of a "bricks and mortar" business without starting with the correct amount of income. In a litigation setting, it is important for the appraiser to ferret out the creative and the obvious ways personal expenses get buried (or income that never finds its way) into the income statement.

At the end of this exercise we want to be able to determine and calculate growth and other statistics for a three to five year history based on the following <u>adjusted</u> numbers:

- Earnings before Income Taxes (EBIT)
- After Tax Net Income
- After Tax Cash Flow
- Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)
- Owners Income (Income before owners compensation)
- Owners Cash Flow (EBITDA before owners compensation)
- Adjusted revenues
- Adjusted Gross Profit
- Tangible Net Book Value

Each one or only a few of the above profit categories may be used in the valuation of a company.

Over the years, we have seen so many different adjustments to expenses and income. The most common are as follows:

Excess Owners Compensation

The owners can pay themselves whatever and however they want – all compensation is initially added back and a fair compensation, one that a company would have to pay a non-owner in the same position, is later subtracted. The fair compensation topic is a whole article in and of itself.

Large pension contributions may also be made for the owner. This needs to be adjusted, as well.

Fair Market Rent

Many times the owners of a business or the business itself own the facility where the business operates. As such, the rent can be set at any rate much like the salary. The rent has to be adjusted to reflect the rents paid to an unrelated person. Where the business owns the building and no rent is charged all of the expenses related to the building ownership such as depreciation and landlord required maintenance and repairs are added back to income and fair market rent is subtracted. The value of the real estate net of mortgages is then added to the determined value of the business operations to yield the value of the entire business.

Tax Depreciation

The depreciation on a financial statement or a tax return generally is not an economic rate of depreciation. For instance, a well maintained forklift can last 15 years, yet for tax purposes it is depreciated over 7 years and with bonus tax depreciation, the entire cost could be depreciated in one year. This category of adjustment is most important for capital intensive companies.

Personal Expenses

The most common categories business owners deduct personal expenses are payroll non-working family members, personal insurance, automobile expenses, personal telephone and cell phones, home utilities, legal and professional fees, supplies and anything else on can think of.

Travel and Entertainment

This is generally the most infamous and abused category of burying personal expenses. It is the main reason why Congress decided to take the sails out of this deduction and only allow 50% of meals and entertainment. Many IRS general audits of businesses concentrate on this deduction.

Cash Basis to Accrual Basis Adjustments

There are many profitable service companies that do not prepare annual financial statements and the only statement they have for an outsider to measure their performance is a tax return. There are two basic methods of tax reporting – cash basis and accrual basis. The cash method of reporting tax information reflects only cash received (not billed) as income and cash payments made for expenses.

The accrual basis of tax reporting reflects income as billed or incurred and expenses as incurred. You can generally tell the difference by looking at a balance sheet. If trade accounts receivable and accounts payable are present, the company is likely reporting on an accrual basis. The accrual basis of accounting generally gives the best accounting measure of profits for the business, but cash basis, if it can be used, generally provides the best tax advantage. Many times a fast growing cash basis business's tax return reflects losses because of the timing of expense payments and collections.

With some exceptions, only service businesses are allowed to be on a cash basis for tax purposes. One of the methods to defer taxes that cash basis businesses do is delay depositing income checks in the bank prior to the end of the tax year. Unfortunately, this gives the effect of a poor economic performance on a cash-in cash-out basis when in reality the company may be doing very well. This is why working with an experienced forensic accountant who knows how to adjust the books to reflect proper economic performance is imperative to valuing the business.

It is generally my preference to adjust cash basis books to accrual for comparative purposes. It is especially important for growing businesses because the growth increases the need for working capital and hence makes cash basis businesses look anemic when in fact they may be performing very well.

Revenues

For accrual basis goods companies, one of the ways a company defers tax revenues is delaying shipping of their products to the next fiscal year. This needs to be adjusted for in a sale since it distorts economic performance.

Unreported Income

This is the area of greatest cost to uncover. Many times the non-titled spouse has some sort of proof of fraud activities, sometimes lifestyle has to uncover this and that is very expensive. If there is a second set of books or paid invoices that are shown not to have been deposited and the non-titled spouse has a copy of this second set of books, then they have just saved a fortune in professional fees. There are many methods of looking for the unreported income, and unfortunately, none of them are foolproof.

Non-Recurring Expenses

Any significant expenses that are not a regular event in a company's history are adjusted to reflect comparative ongoing economic performance. A perfect example is excessive legal fees related to a lawsuit that is not expected to recur or be ongoing.

Once the above categories are adjusted for a three to five year historical period, the adjusted historical income statements and balance sheet can be used as a basis to estimate a value.

An example of an adjustment to income schedule may look as follows. This schedule is generally footnoted with explanations:

XYZ COMPANY
Adjustments to Reported Income

	Adjustment	2005	2004	2003
Income Before Taxes and Adjustments		$ 290,021	$ 810,970	$ 1,136,286
Officers Salaries	1	666,609	155,530	157,500
Non-recurring Cost of Sales	2	700,000	-	-
Inventory Adjustments	3	(264,000)	83,000	(52,000)
Unreported Income	3	220,000	220,000	200,000
Travel and entertainment	4	10,000	10,000	10,000
Related Party Rents	5	-	-	350,000
Fair Management Salaries	1	(167,092)	(162,225)	(157,500)
Fair Rent	5	(350,000)	(350,000)	(350,000)
Interest	8	77,415	90,717	
Other Income	6	-	(32,265)	(9,872)
Officers' Life	7	27,000	15,000	-
Adjusted Pretax (debt free) Income		1,209,953	840,727	1,284,414
Depreciation	8	141,801	258,882	50,000
Adjusted EBIDTA		1,351,754	1,099,609	1,334,414
Ongoing purchases of Equipment (depreciation)		(50,000)	(50,000)	(50,000)
Debt Free Income (adjusted)		1,301,754	1,049,609	1,284,414
Corporate level income taxes		(520,702)	(419,844)	(513,766)
Adjusted net income		$ 781,053	$ 629,765	$ 770,648

Adjustment Explanations

1 - Officers salary needs to be adjusted for a replacement non-owner executive salary. We have estimated that an executive director can be hired with benefits for approximately $150,000 for 2000. We have increased this by 5% for 2003-2005.

2 - Capitalizable Costs related to the building and other non-recurring costs are adjusted for.

3 - Inventories were adjusted for certain differences between actual counts and computer totals. It was also determined that $200,000 to $220,000 per year of additional income was not reported.

4 - It was determined that $10,000 of Travel and Entertainment were excessive in each year.

5 - The owner personally owns the real estate where the company operates. Therefore the rent needs to be adjusted to reflect market rates. The facility is approximately 50,000 square feet and the fair rent is estimated to be $7 per square ft. For 2004 and 2005, the real estate entity is included in the financial statements under accounting rules for FIN 46 and thus rent expense was eliminated.

6 - Other income is adjusted from income.

7 - Officers life insurance is added back to income.

8 - Interest and Depreciation are added back mostly related to the buildings. 50,000 per year of Capital Expenditures is subtracted as reasonable per year.

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