



## Economic Financial Statements

Regardless of the approach(s) and method(s) used, an important step in performing the appraisal is to “normalize” or “recast” the financial statements. By normalizing the accounting financial statements, we adjust them to reflect the economic financial statements. There are many causes that drive the need for the normalizing adjustments. A couple of such causes are elections made to minimize taxes and inclusion of nonoperating and nonrecurring items.

### Normalizing the Balance Sheet

The main purpose of making normalizing adjustments to the balance sheet is to reflect the market value of the assets and liabilities. When making these adjustments, we need to be aware that a business can have both controlling and minority interest. Depending on what interest is being appraised will affect which normalizing adjustments are made. An example of a controlling interest adjustment would be to assets owned by the business but not needed for the operation of the business. An adjustment for minority interest would be to accumulated depreciation. To help determine if it is a controlling or minority interest adjustment, ask yourself, is there cash leaving the business.

**Cash and Accounts Receivable** – If the appraisal is done for an actual sale, accounts receivables are not usually included in the assets sold with the business. If they are not included, an adjustment is made to zero them out.

**Inventory** – Depending on the industry, retail, wholesale, or manufacturing, the business could have raw materials, work in progress, and finished goods. Raw materials are listed using a number of methods. Most appraisers will adjust raw materials to FIFO if the inventory is valued using one of the other methods. This is done to reflect the most recent cost of inventory on hand. It does depend on the industry and the business. Work in progress should be valued at actual cost, direct labor, and applicable overhead. Finished goods should be equal to total cost to produce the product or replace in inventory.

**Fixed assets, real estate, and intangible assets** – Should be adjusted to reflect fair market value of the assets. Any assets that are not necessary for the business to operate should be removed from the balance sheet. Remember, this is would be done only if a controlling interest is being appraised.

**Loans to and from Shareholders** – should be removed and reflected in equity

The above are by no means all adjustments that can be made to a balance sheet. However, they do represent some of the most common.

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