



## Economic Financial Statements

As mentioned in the last education piece, a major cause that drives the need to normalize adjustments is the fact that small businesses are managed to minimize taxes and not necessarily profits. An excellent example of this is to take a Section 179 election on equipment. This is a tax driven decision and does not reflect the actual life used or remaining in the asset. If the owner wanted to maximize the profits of the business, he/she would not have taken this accelerated form of depreciation.

### Normalizing the Income Statement

As with the balance sheet adjustments, the adjustments to the income statement are partly made dependent on what basis is being appraised. Control adjustments will not be the same as minority adjustments. Some appraisers will making adjustments that only affect control basis and apply a minority discount. Either way is correct. My opinion is that to calculate a minority discount allows the cross examining attorney another opportunity to shoot holes into my appraisal. It is much more difficult to support the discount than it is the adjustments that affect the basis being appraised.

Since the adjustments could be unlimited, depending on the condition of the business' financial statements, we will go over some of the more common areas that require adjustments.

*Revenue* – Income that is not considered reoccurring or not related to sales of products or services are removed from gross revenue. If the revenue is not considered sales related revenue, such as interest, it is not removed but simply separated from operating gross revenue. This is done mainly to be able to perform industry comparison.

*Cost of Goods Sold* – The largest adjustment is when the inventory valuation method changes from previous methods. This might have been done for tax purposes and we are trying to reach or obtain the economic profit.

*Operating Expenses* – This is the section of the income statement that could have many adjustments. Here are several of the most common adjustments: adjusting the owners/manager salary to market rate, removing non-operating items such as unjustified salary paid to a family member, excessive depreciation that does not reflect the true wear of an asset, and adjust rent to reflect the market rate, etc.

These, by no means, are all of the possible adjustments. However, they are some of the most common. Obviously, adjustments to the income statement could affect the balance sheet such as the adjustment to Cost of Goods Sold.

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