Where's the Beef?

By: Mike Costello

Adjusting the Income Statement Can Turn Loss into Profit

The sales of a family-owned niche retailer were growing. Thanks to its successful catalog division, the company controlled much of the market nationwide. The company's owners, brothers Jim and John Smith, were both living comfortable lifestyles.

John and Jim decided that it was time to think about retiring. Because no one in the family had shown an interest in taking over the business, the brothers decided to sell. They needed to determine an asking price for the business. However, when their business valuation analyst sat down with them to determine their company's value, he saw that even though the company was growing, the books indicated the company was losing money.

Was the company's alleged prosperity really all smoke and mirrors? Actually, the situation is one that can be found in many small businesses. A company's financial statements are governed by many different things, and often need to be adjusted to reveal the true value of the company. These adjustments are often referred to as normalizing adjustments. Let's look at some of the normalizing adjustments that were made to the income statements of the brothers' company.

Method of accounting: Businesses not using a CPA may report earnings on a basis of accounting that doesn't properly measure their economic performance. The Smiths' company, for example, was still reporting on the cash basis. As a starting point, the valuation analyst converted the company income statement to an accrual basis by properly recording accrual assets (such as accounts receivable) and liabilities (such as accounts payable).

Salaries to officers and related individuals: As is typical in many family-owned and closely-held businesses, the company paid generous salaries to the brothers. For example, the company paid a large annual bonus to John and Jim each year to avoid paying corporate taxes. While the company may have had a perfectly valid business purpose for doing this, these expenses don't necessarily represent normal expenses for the business in the eyes of a hypothetical willing buyer. The valuation analyst adjusted compensation expense back to amounts reflected in the market for similar services performed.

Employee benefits: A certain level of employee benefits is probably a reasonable expense for any business. However, companies can also offer many perks to their employees that aren't seen as normal. In the case of this company, many of its employees were given company luxury cars, deluxe accommodations during company travel and mobile phones, which they were allowed to use without restrictions. In addition, the company threw excessively expensive holiday parties for its employees. The valuation analyst adjusted these expenses to more normal levels, based on what typical companies may spend in these areas.

Method of inventory: The method of accounting for inventory can affect the value recorded. For example, assume the Smiths' company uses the last-in, first-out (LIFO) method for income tax purposes to value its inventory. It had a LIFO reserve of $400,000 at the beginning of the year and $500,000 at the end. The valuation analyst would adjust the income statement to reflect this $100,000 difference. *

Related-party transactions: If a company is doing business with customers or vendors who are related to the owners, the transactions need to be examined to determine whether they are at arms-length. In looking at the Smiths' company, the warehouse space is leased from a company owned by a sister, Jenny Smith, at a rate of $1.50 per square foot above the market price. The valuation analyst adjusted the rent expense downward to reflect the market rate.

Turning Loss Into Profit

After considering the various income statement line items and method of accounting, the valuation analyst made the normalization adjustments (as discussed). Those adjustments showed that the Smiths' company was indeed profitable. The result of this analysis provided the owners a defendable and reasonable asking price for the company.

When looking at a company's income statements to determine the appropriate earnings for valuation purposes, some adjustments (like the ones mentioned above) are not difficult. Others determinations on adjustments require professional judgment as to whether they should be made and in what amount.

Potential Impact of Management Fees and Other Expenses

In another example, a company paid a related individual's company a management fee considered to be excessive after considering what a typical owner's compensation for the business would be. In addition, the firm's net income increased dramatically after country club, entertainment and other expenses of a personal nature were added back to income. These adjustments had the effect of increasing the selling price of the business, which was determined using a market approach (taking a multiple of EBITDA).

We Can Help!

Business valuation information can be a powerful tool if owners have it in hand and are looking at the right opportunity. Elliott Davis Decosimo has the expertise to assist business owners in the process of conducting a thorough and independent valuation process. Our team of experienced professionals understands the many intricacies involved with conducting a comprehensive valuation process. To learn how we can assist in evaluating your strategic needs, contact Elliott Davis Decosimo Shareholder Mike Costello.

* NOTE: *The Smiths' company should have been reporting on the accrual basis because inventory was a substantial aspect of their business.*