

# *“Financial Statement Normalization: A Simple Case Study”*

Presented by

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# About Anthony

*I am a dynamic figure, often seen scaling walls and crushing ice. I have been known to remodel train stations on my lunch breaks, making them more efficient in the area of heat retention. I write award-winning operas, I manage time efficiently. Occasionally, I tread water for three days in a row.*

*I woo all people with my godlike trombone playing, I ride bicycles up severe inclines with unflagging speed, and cook Thirty-Minute Brownies in Twenty minutes. I am an expert in stucco, a veteran in love, and an outlaw in Peru.*

*Using only a hoe and a large glass of water, I once single-handedly defended a small village in the Amazon Basin from a horde of ferocious army ants. I play bluegrass cello, I bat .400 and was scouted by the Mets, and am the subject of numerous documentaries. When I'm bored, I build large suspension bridges in my yard. I enjoy urban hang gliding.*

*I am an abstract artist, a concrete analyst, and a ruthless bookie. Critics worldwide gush over my original line of corduroy evening wear. I don't perspire. I am a private citizen, yet I receive fan mail. I have been Caller Number Nine and have won the weekend passes. Last summer I toured New Jersey with a traveling centrifugal-force demonstration.. My deft floral arrangements have earned me fame in international botany circles. Children trust me.*

*I balance, I weave, I dodge, I frolic, and my bills are all paid. On weekends, to let off steam, I participate in full-contact origami. Years ago I discovered the meaning of life but forgot to write it down. I breed prizewinning clams. I have won bullfights in San Juan, cliff-diving competitions in Sri Lanka, and spelling bees at the Kremlin. I have played Hamlet, I have performed open-heart surgery, and I have spoken with Elvis.*

*And I am a fair accountant.*



# Ascendeus

- On-call CFOs and solutions provider for finance, accounting, and tax strategies for SMEs
- Founded 2001
- Serve all company life cycles from start up, growth, stabilization, mergers, turn-around and sales
- Certified Public and Management Accountant, Master degrees in International Management (Thunderbird), Accounting (EMU), and Finance (St. Andrews, Scotland)



# Today's Objective

- Obtain a basic understanding of financial statement (FS) normalization and its role in corporate purchase/sale.
- Review a limited case study of FS normalization.



# Normalization Defined

- Changing the values on financial statements retrospectively in order to adjust them for non-economic or non-recurring items, non-operating assets or liabilities, and other anomalies or unusual items.



# Purposes of Normalization

- Creates a presentation of the entity's financial performance in a "what-if" scenario of optimal (normal) operation.
- Useful for comparing to similar entities in similar industries.
- Useful for benchmarking the entity against industry standards (obtained from Hoovers and the like).
- Useful for calculations of value for purchase/sale purposes as well as obtaining investment or debt capital.





# Balance Sheet Normalizations

- Non-operating or other assets retained by sellers
  - Excess cash which would not go with a sale
  - Impaired or non-performing equipment
  - Inventory
  - AR
  - Goodwill, or investment in another entity
- Non-GAAP presentation
  - Incorrect booking of an asset when it should be an expense/cost
- Reclassification of debt to equity
  - Typically owner debt is never considered debt to the company



# Income Statement Normalizations

- Incorrectly presented Gross Margin
- Tax depreciation/depletion used for presentation rather than GAAP for that industry.
- Unusual costs or expenses due to outside factors
  - Lawsuits
  - Gains/losses on asset sales
  - Expedited freight due to short working capital impeding delivery
  - Higher than normal borrowing costs such as PO financing or factoring
  - Large AR write off due to major customer BKY





# Other Normalizations

- Comparability adjustments
  - Company does not present FS in accordance with industry norms
  - Executives may be paid above or below norms for that industry
    - Use of year end bonuses, other accruals/transactions for tax benefit
  - Higher or lower than market rent for facilities from owner



# Relevant Time Frame

- Used to see five years back but Great Recession changed that
- Now it is usual go back three years
- Trailing twelve months is also a reasonable alternative but may not present enough information for users of the report
- Could be determined by user of the report



# A Simple Case Study

- Strange Code Software, Inc.
  - Software development company, C-corporation, two majority shareholders, one is the CEO, the other is non-participating
  - Wishes to obtain a working capital line from a bank, has never had one before now.
  - FS are recorded in QuickBooks



# Assets As Reported

| ASSETS                   | 2010    | 2011    | 2012    |
|--------------------------|---------|---------|---------|
| Current Assets           |         |         |         |
| Checking/Savings         | 306,134 | 155,367 | 34,408  |
| Accounts Receivable      | 102,765 | 271,867 | 430,133 |
| Other Current Assets     | -       | 12,800  | -       |
| Total Current Assets     | 408,899 | 440,035 | 464,540 |
| Fixed Assets             |         |         |         |
| Office Equipment         | 18,593  | 1,360   | 1,360   |
| Fixtures & Furniture     | 16,440  | 16,440  | 16,440  |
| Total Fixed Assets       | 35,033  | 17,800  | 17,800  |
| Accumulated Depreciation | -30,468 | -14,539 | -15,735 |
| Net Fixed Assets         | 4,565   | 3,261   | 2,065   |
| Other Assets             | 11,000  | 11,000  | -       |
| TOTAL ASSETS             | 424,464 | 454,295 | 466,605 |



# Liabilities and OE As Reported

| LIABILITIES & EQUITY |                              |         |         |         |
|----------------------|------------------------------|---------|---------|---------|
| Liabilities          |                              |         |         |         |
|                      | Current Liabilities          |         |         |         |
|                      | Accounts Payable             | 25,435  | 99,116  | 48,114  |
|                      | Credit Cards                 | 3,497   | -       | -       |
|                      | On Demand LOC                |         | 50,000  | 80,000  |
|                      | Other Current Liabilities    | 37,269  | 19,803  | 25,838  |
|                      | Total Current Liabilities    | 66,200  | 168,918 | 153,952 |
|                      | Long Term Liabilities        |         |         |         |
|                      | Note Payable Stockholder     | 30,000  | 30,000  | 50,656  |
|                      | Note Payable Stockholder     | 84,647  | 84,647  | 89,037  |
|                      | Note Payable Stockholder     | 20,849  | 10,786  | -       |
|                      | Total Long Term Liabilities  | 135,496 | 125,433 | 139,693 |
|                      | Total Liabilities            | 201,696 | 294,351 | 293,645 |
| Equity               |                              |         |         |         |
|                      | Treasury Stock               | -       | -15,522 | -15,522 |
|                      | Capital Stock                | 3,914   | 3,809   | 3,809   |
|                      | Additional Paid in Capital   | 144,832 | 149,931 | 149,931 |
|                      | Prior Year Retained Earnings | -38,501 | 74,022  | 21,727  |
|                      | Current Year Net Income      | 112,523 | -52,295 | 13,016  |
|                      | Total Equity                 | 222,768 | 159,944 | 172,960 |
|                      | TOTAL LIABILITIES & EQUITY   | 424,464 | 454,295 | 466,605 |



# Normalizations

- Stockholder debt is considered equity, so reclass all to Equity as Paid in Capital
  - Reduces Debt to Equity (leverage) ratio
- Accrued Stockholder interest due booked to Current Liabilities, so reclass
- Interest paid on the debt reclassified from Interest Expense to Dividends
  - No effect on EBITDA but does increase Net Income
- No adjustments on Assets/Depreciation
  - Deprecation was tax basis but difference last three years is very minor so will not have material impact





# Income Statement As Reported

|                     |                                       | 2010      | 2011      | 2012      |
|---------------------|---------------------------------------|-----------|-----------|-----------|
| Income              |                                       | 2,096,973 | 1,733,832 | 1,703,866 |
| Gross Profit        |                                       | 2,096,973 | 1,733,832 | 1,703,866 |
|                     | Expense                               |           |           |           |
|                     | Payroll Expenses                      | 0         | 0         | 0         |
|                     | 5500 · Direct Supplier Expenses       | 769,026   | 547,474   | 566,939   |
|                     | 5510 · Sweepstaked Winner             | 4,000     | 0         | 0         |
|                     | 5600 · Marketing                      | 18,880    | 11,330    | 2,742     |
|                     | 6000 · Staffing/Wages                 | 932,469   | 922,802   | 859,033   |
|                     | 6001 · Insurance                      | 59,885    | 60,625    | 77,345    |
|                     | 6200 · Technology                     | 40,447    | 87,494    | 53,928    |
|                     | 6270 · Professional Fees              | 6,308     | 10,282    | 3,325     |
|                     | 6300 · Office Expenses                | 61,634    | 59,066    | 64,326    |
|                     | 6350 · Travel & Entertainment         | 41,093    | 40,691    | 31,779    |
|                     | 6600 · Automobile Expense             | 9,392     | 12,200    | 11,467    |
|                     | 6718 · Depreciation Expense           | 1,826     | 1,304     | 1,196     |
|                     | 6765 · Trade Show Fees                | 0         | 0         | 1,295     |
|                     | 6785 · Outside Conference room rental | 0         | 0         | 358       |
|                     | 6790 · Miscellaneous                  | -606      | 273       | 1,076     |
|                     | Total Expense                         | 1,944,354 | 1,753,541 | 1,674,809 |
| Net Ordinary Income |                                       | 152,619   | -19,709   | 29,057    |



# Normalizations

- Gross Margin not calculated properly
  - Vital for industry benchmarking
- Operations, Sales, and Admin salaries all in one line item
  - Another comparability issue
- Business and health insurance combined in one line item
  - Comparability issue
- Company hired sales person who did not perform
  - Cannot adjust revenue but can adjust Salary and Benefits expenses to account for underperformance
- Officer Compensation not broken out
- EBITDA not calculated



# Assets Normalized

## Normalized

|                             | 2010           | 2011           | 2012           |
|-----------------------------|----------------|----------------|----------------|
| ASSETS                      |                |                |                |
| Current Assets              |                |                |                |
| Checking/Savings            | 306,134        | 155,367        | 34,408         |
| Accounts Receivable         | 102,765        | 271,867        | 430,133        |
| <b>Other Current Assets</b> | <b>20,722</b>  | <b>62,907</b>  | <b>77,891</b>  |
| Total Current Assets        | 429,621        | 490,142        | 542,431        |
| Fixed Assets                |                |                |                |
| Office Equipment            | 18,593         | 1,360          | 1,360          |
| Fixtures & Furniture        | 16,440         | 16,440         | 16,440         |
| Software                    | -              | 20,640         | 20,640         |
| Accumulated Depreciation    | -30,468        | -14,539        | -22,615        |
| Net Fixed Assets            | 4,565          | 23,901         | 15,825         |
| Other Assets                | 11,000         | 11,000         | -              |
| <b>TOTAL ASSETS</b>         | <b>445,186</b> | <b>525,042</b> | <b>558,256</b> |

## As Reported

|                          | 2010           | 2011           | 2012           |
|--------------------------|----------------|----------------|----------------|
| ASSETS                   |                |                |                |
| Current Assets           |                |                |                |
| Checking/Savings         | 306,134        | 155,367        | 34,408         |
| Accounts Receivable      | 102,765        | 271,867        | 430,133        |
| Other Current Assets     | -              | 12,800         | -              |
| Total Current Assets     | 408,899        | 440,035        | 464,540        |
| Fixed Assets             |                |                |                |
| Office Equipment         | 18,593         | 1,360          | 1,360          |
| Fixtures & Furniture     | 16,440         | 16,440         | 16,440         |
| Total Fixed Assets       | 35,033         | 17,800         | 17,800         |
| Accumulated Depreciation | -30,468        | -14,539        | -15,735        |
| Net Fixed Assets         | 4,565          | 3,261          | 2,065          |
| Other Assets             | 11,000         | 11,000         | -              |
| <b>TOTAL ASSETS</b>      | <b>424,464</b> | <b>454,295</b> | <b>466,605</b> |



# Liabilities and Equity Normalized

Normalized

| LIABILITIES & EQUITY  |                                       |                |                |                |
|-----------------------|---------------------------------------|----------------|----------------|----------------|
| Liabilities           |                                       |                |                |                |
|                       | Accounts Payable                      | 25,434         | 67,464         | 73,916         |
|                       | Credit Cards                          | 3,497          |                |                |
|                       | <b>Working Line of Credit</b>         | -              | <b>50,000</b>  | <b>25,365</b>  |
|                       | Other Current Liabilities             | 16,547         | 1,347          | -              |
|                       | <b>Total Current Liabilities</b>      | <b>45,478</b>  | <b>118,811</b> | <b>99,281</b>  |
| Long Term Liabilities |                                       |                |                |                |
|                       | Note Payable                          | 20,849         | 10,786         | -              |
|                       | <b>Total Long Term Liabilities</b>    | <b>20,849</b>  | <b>10,786</b>  | <b>-</b>       |
|                       | <b>Total Liabilities</b>              | <b>66,327</b>  | <b>129,597</b> | <b>99,281</b>  |
| Equity                |                                       |                |                |                |
|                       | Treasury Stock                        | -              | -15,522        | -15,522        |
|                       | Capital Stock                         | 3,914          | 3,809          | 3,809          |
|                       | Additional Paid in Capital            | 144,832        | 149,931        | 149,931        |
|                       | <b>Shareholder Debt</b>               | <b>114,647</b> | <b>114,647</b> | <b>139,693</b> |
|                       | Prior Year Retained Earnings          | -38,501        | 108,488        | 149,293        |
|                       | Dividends Paid                        | -              | -6,713         | -18,891        |
|                       | <b>Current Year Net Income</b>        | <b>153,967</b> | <b>40,805</b>  | <b>73,882</b>  |
|                       | <b>Total Equity</b>                   | <b>378,859</b> | <b>395,445</b> | <b>482,195</b> |
|                       | <b>TOTAL LIABILITIES &amp; EQUITY</b> | <b>445,186</b> | <b>525,042</b> | <b>581,476</b> |

As Reported

| LIABILITIES & EQUITY  |                                       |                |                |                |
|-----------------------|---------------------------------------|----------------|----------------|----------------|
| Liabilities           |                                       |                |                |                |
| Current Liabilities   |                                       |                |                |                |
|                       | Accounts Payable                      | 25,435         | 99,116         | 48,114         |
|                       | Credit Cards                          | 3,497          | -              | -              |
|                       | On Demand LOC                         |                | 50,000         | 80,000         |
|                       | Other Current Liabilities             | 37,269         | 19,803         | 25,838         |
|                       | <b>Total Current Liabilities</b>      | <b>66,200</b>  | <b>168,918</b> | <b>153,952</b> |
| Long Term Liabilities |                                       |                |                |                |
|                       | Note Payable Stockholder              | 30,000         | 30,000         | 50,656         |
|                       | Note Payable Stockholder              | 84,647         | 84,647         | 89,037         |
|                       | Note Payable Stockholder              | 20,849         | 10,786         | -              |
|                       | <b>Total Long Term Liabilities</b>    | <b>135,496</b> | <b>125,433</b> | <b>139,693</b> |
|                       | <b>Total Liabilities</b>              | <b>201,696</b> | <b>294,351</b> | <b>293,645</b> |
| Equity                |                                       |                |                |                |
|                       | Treasury Stock                        | -              | -15,522        | -15,522        |
|                       | Capital Stock                         | 3,914          | 3,809          | 3,809          |
|                       | Additional Paid in Capital            | 144,832        | 149,931        | 149,931        |
|                       | Prior Year Retained Earnings          | -38,501        | 74,022         | 21,727         |
|                       | Current Year Net Income               | 112,523        | -52,295        | 13,016         |
|                       | <b>Total Equity</b>                   | <b>222,768</b> | <b>159,944</b> | <b>172,960</b> |
|                       | <b>TOTAL LIABILITIES &amp; EQUITY</b> | <b>424,464</b> | <b>454,295</b> | <b>466,605</b> |



# Income Statement Normalized

|                                   | 2010      | 2011      | 2012      |
|-----------------------------------|-----------|-----------|-----------|
| <b>SALES</b>                      | 2,096,973 | 1,733,832 | 1,703,866 |
| <b>COST OF SALES</b>              | 781,339   | 606,841   | 582,783   |
| <b>GROSS MARGIN</b>               | 1,315,634 | 1,126,991 | 1,121,083 |
|                                   | 62.7%     | 65.0%     | 65.8%     |
| <b>OPERATING EXPENSES</b>         |           |           |           |
| OPERATIONS                        | 672,434   | 634,560   | 656,125   |
| SALES AND MARKETING               | 127,765   | 103,471   | 73,029    |
| ADMINISTRATION                    | 131,329   | 120,105   | 122,197   |
| OFFICER COMPENSATION              | 198,616   | 209,218   | 184,192   |
| <b>TOTAL OPERATING EXPENSES</b>   | 1,130,145 | 1,067,355 | 1,035,543 |
| <b>EBITDA</b>                     | 185,489   | 59,636    | 85,540    |
| <b>OTHER INCOME</b>               | -         | 148       | (245)     |
| <b>OTHER EXPENSE</b>              |           |           |           |
| DEPRECIATION                      | 1,826     | 1,304     | 8,076     |
| TAXES                             | 24,891    | 16,162    | 1,513     |
| INTEREST                          | 4,805     | 1,512     | 1,824     |
| <b>Net Other Income/(Expense)</b> | (31,522)  | (18,830)  | (11,658)  |
| <b>NET INCOME</b>                 | 153,967   | 40,806    | 73,883    |

|                                       | 2010      | 2011      | 2012      |
|---------------------------------------|-----------|-----------|-----------|
| Income                                | 2,096,973 | 1,733,832 | 1,703,866 |
| Gross Profit                          | 2,096,973 | 1,733,832 | 1,703,866 |
| Expense                               |           |           |           |
| Payroll Expenses                      | 0         | 0         | 0         |
| 5500 · Direct Supplier Expenses       | 769,026   | 547,474   | 566,939   |
| 5510 · Sweepstaked Winner             | 4,000     | 0         | 0         |
| 5600 · Marketing                      | 18,880    | 11,330    | 2,742     |
| 6000 · Staffing/Wages                 | 932,469   | 922,802   | 859,033   |
| 6001 · Insurance                      | 59,885    | 60,625    | 77,345    |
| 6200 · Technology                     | 40,447    | 87,494    | 53,928    |
| 6270 · Professional Fees              | 6,308     | 10,282    | 3,325     |
| 6300 · Office Expenses                | 61,634    | 59,066    | 64,326    |
| 6350 · Travel & Entertainment         | 41,093    | 40,691    | 31,779    |
| 6600 · Automobile Expense             | 9,392     | 12,200    | 11,467    |
| 6718 · Depreciation Expense           | 1,826     | 1,304     | 1,196     |
| 6765 · Trade Show Fees                | 0         | 0         | 1,295     |
| 6785 · Outside Conference room rental | 0         | 0         | 358       |
| 6790 · Miscellaneous                  | -606      | 273       | 1,076     |
| Total Expense                         | 1,944,354 | 1,753,541 | 1,674,809 |
| Net Ordinary Income                   | 152,619   | -19,709   | 29,057    |



# Conclusions

- Normalization is essential to business brokers
  - It allows them to better understand the financial performance of the entity vis-à-vis the industry
  - It allows for more accurate calculations of value on either side of the transaction





# Q & A

