The Market Approach to Valuing Businesses
(Second Edition)

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Chapter 7

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Summary

If using public guideline companies, we usually collect five years’ worth of annual statements plus whatever interim statements are available for the subject and/or guidelines companies between their respective latest fiscal years and the valuation date. If using the private guideline companies in the transaction method, usually only the latest year’s statements are available.

While five years’ statements are the typical time period, there is nothing magic about five years. In a highly cyclical industry, one might want statements for a full cycle, which could be as long as 10 years. On the other hand, if the subject company is only three years old, or if there was a major change in the industry or subject company operations three years ago, it may be relevant to analyze and compare only three years’ statements. The main criterion is to compare the subject and guideline company statements for a relevant time period.
For the purpose of this chapter, we will generally assume that we have five years of statements for both our subject and guideline companies, plus, in some cases, latest partial-year interim statements.

**CHOOSING THE TIME PERIODS FOR COMPARATIVE STATEMENTS**

One of the most crucial decisions is getting the best match of time periods between the subject and guideline companies that will produce the most meaningful market approach estimate of value. There are almost an infinite number of possible scenarios. We will examine a few of the most common, and hope that the principles suggested will help the reader to make good decisions for other scenarios.

**Valuation Date at Fiscal Year-end**

The simplest scenario usually is when the valuation date is at the subject company’s fiscal year-end. The general rule is to use fiscal year-end financial statements. A few analysts would say that they should not be used because they were not compiled as of the valuation date. However, the rule is to use information that was “known or reasonably knowable” as of the valuation date. Most agree that year-end financial information meets this criterion, even if it were not yet compiled. In the world of transactions, many take place as of fiscal year-ends. Almost always, the final price is subject to adjustment if the final statements show results significantly different from expectations.

Guideline companies in the same industry often do have the same fiscal years as the subject, and the general rule is to use matching year-end statements for the guideline companies. If the guideline companies’ fiscal years end one month following or one or two months before the subject company’s fiscal year, the closest matching year-end statements usually are used. This presumes, of course, that results do not deviate significantly from what would have been predicted at the valuation date.

**Valuation Date Removed from Fiscal Year-end**

If the valuation date does not coincide with the subject company’s fiscal year-end, then the analyst is faced with making a judgment concerning what statements to rely on. This judgment involves assessing several factors:

- How far removed the valuation date is from the fiscal period
- What interim statements are available, and how complete and reliable they are
- The extent to which operations have varied or significant events have occurred since the latest available statements
• If the guideline company’s financial statements are as of a single month after the subject company valuation date, then most analysts use the post valuation date statements of the guideline companies. This seems to be consistent with the “known or knowable” rule, in that in most cases, company officials would have a pretty good idea of the expected results for the coming month, and, for most public companies analysts forecasts would be available.

If the valuation date is within a month before the fiscal year-end, the general rule is to use the latest fiscal year data. Exceptions would be if

• Waiting for the year-end data would unduly delay completion of the valuation
• The company had unusually complete and reliable monthly statements
• Significant events occurred between the valuation date and the fiscal year-end that should not be reflected in the valuation

If the valuation date is removed three months or more from the fiscal year-end, then the most meaningful comparison usually is created using interim statements. For example, a September 30 year can be created by using the first nine months of the latest year combined with the last quarter of the previous year. The feasibility of this procedure depends on the availability of adequate interim data.

The procedure could be carried back for five or more years of financial data. However, this is cumbersome. Usually analysts use the reconstructed year for the latest 12 months and actual fiscal years prior to that. Note that this procedure results in double counting the last quarter of the previous full year. That generally is not a serious problem unless that particular quarter was abnormal for some reason, which would have the undesirable result of double-counting an abnormal quarter.

Whatever periods are chosen for the subject company, the same should be chosen for the guideline companies, or as close a time period as fiscal periods are available. It is essential that the subject and guideline company financial statement periods match as closely as possible, or a meaningless or misleading comparison could result.

OBJECTIVES OF FINANCIAL STATEMENT ADJUSTMENTS

The objectives of financial statement adjustments in the context of the market approach to valuation is to put them on a comparable basis to assess the relative strengths and weaknesses of the subject versus the guideline companies.

Assess Relative Growth Prospects

Growth prospects are a major factor in estimating appropriate market multiples. Whatever growth is reflected in projections in the discounted cash flow
method in the income approach should also be reflected in the market value multiples in the market approach (described in some detail in Chapter 15).

One should carefully compare the growth trends between the subject company and the guideline companies. At the same time, it is not appropriate to blindly assume that the past relative growth trends will continue. The analyst’s reading about the guideline companies, site visits, and interviews with management should provide insight about the extent to which the future growth will parallel, exceed, or underperform that of the guideline companies. This comparison will impact valuation multiples neutrally, positively, or negatively relative to the guideline companies’ observed market multiples.

Assess Relative Risk

Another important factor that affects the levels of market multiples chosen is the relative degree of risk. The extent to which the subject companies’ operating results have equal, greater, or less volatility than the guideline companies is an important indication of similar, greater, or less risk inherent in the subject company relative to the guideline companies. It is important to have the financial statements on a comparable basis for this comparison to be meaningful. To the extent that volatility of the subject company’s operating results (e.g., operating margin, return on sales) are about equal, greater, or less than the guideline companies, this risk comparison would lead to a similar, lower, or higher market value multiple. Thus, the assessment of risk will lead to adjustments to the observed market multiples. In this sense, the risk that is reflected in the discount rate in the income approach is reflected in the market value multiple in the market approach.

ADJUSTMENTS FOR NONOPERATING OR EXCESS ASSETS

Unless the subject is an asset holding company, the usual objective of guideline company analysis is to compare operating companies. Therefore, at least for valuations of controlling interests, the subject and guideline company statements should be adjusted to remove nonoperating items.

Process for Handling Nonoperating Items

At least for valuations of controlling interests, nonoperating assets should be removed from the balance sheet. Frequently this also involves removing related income or expenses from the income statement. If income or expenses are removed from the income statement, the items should be adjusted net of their tax effect.

Let us suppose that most companies of the same size in the same industry do not use corporate planes, but our subject company has one. Although it survived an
Internal Revenue Service (IRS) audit, no buyer of the company would buy the plane, much less pay the operating expenses. The balance sheet is adjusted to remove the cost of the plane and the related depreciation. The income statement is adjusted for the cost of operation of the plane net of the tax effect, often adding whatever commercial airline costs that would be incurred if the company did not have the plane. At the end of the valuation procedure, the liquidation value of the aircraft would be added back to the indicated value of the company on an operating basis.

When valuing a minority interest, minority stockholders generally do not ascribe very much value to nonoperating assets. Therefore, for a minority interest valuation, the amount added back usually should be net of a minority interest discount.

## Controversies over Nonoperating Assets

Whether to classify certain assets as operating or nonoperating often is a major controversy that affects the value. If the asset produces little or no revenue, classifying it as nonoperating and adding its value to the value of the operating company would tend to result in a higher value. Leaving it as an operating asset would tend to result in a lower value.

A parking lot would be a good example. Those seeking a low value would argue that it is a necessary operating asset because the employees need parking. Those seeking a high value would argue that its value as a parking lot is nowhere near the highest and best use of the land, and the land’s value should be added to the operating company’s value.

There are no hard and fast rules governing these controversies, and the analyst must use the most objective possible judgment in deciding how to treat each item. However, the question of whether the value is on a controlling or minority basis may determine the treatment. A control owner has the power to redeploy the nonoperating assets, while a minority owner does not. Therefore, the nonoperating assets are more likely to be treated as an add-on to value in a control valuation. The public markets often give little value to nonproducing assets. In a minority valuation, they may be ignored or reflected by a slight increase in the market value multiple to reflect the strength of extra assets.

## Excess Assets or Asset Deficiencies

A similar controversy may surround the question of the adequacy of assets to support the company’s operations. The most common example of this controversy is the proper level of net working capital.

In the market approach to valuation, the analyst has the advantage of observing the amount of working capital as a percentage of sales for each of the guideline companies. If the subject company’s net working capital is out of line as a percentage of sales compared with the guideline companies from which market multiples
are derived, then it often is appropriate to adjust for excess or deficient working capital.

Again, the question of a control or minority valuation may come into play. The control owner has the power to change the working capital policy, while the minority owner does not. Some managements may observe a conservative fiscal policy that includes what many analysts may regard as more than adequate working capital. If doing a minority valuation of an interest in such a company on a going concern basis, no adjustment may be appropriate because no change will be made.

**NONRECURRING ITEMS**

It is preferred that the statements of both the subject and guideline companies represent ongoing operations. Therefore, the analyst should consider removing nonrecurring items on the income statements of the subject and/or the guideline companies.

It is important for the person adjusting the statements to realize that many items that could be considered nonrecurring from a financial analysis point of view are not necessarily “extraordinary” from a GAAP (generally accepted accounting principles) point of view. A good example would be gains and losses on the sale of assets. For example, if a company sells its only corporate plane, the gain or loss is ordinary income from a GAAP viewpoint, but nonrecurring from a financial analysis viewpoint. This is one reason to use original financial statements rather than secondary sources if one wishes to be totally accurate. Secondary sources usually report on a GAAP basis, and there usually would be no way to know about an item that was nonrecurring but not extraordinary.

Other common nonrecurring items could include:

- Costs of strikes
- Costs of other business interruptions
- Recovery of insurance proceeds
- Gains or losses from discontinued operations or closing of facilities
- Write-downs in connection with acquisitions
- Costs, recoveries, and losses from lawsuits
- Costs associated with environmental problems
- Payments on covenants not to compete and employment contracts
- Effects of abnormal market conditions (occasionally)
- Abandonment losses

**ADJUSTMENTS FOR ACCOUNTING COMPARABILITY**

For the market value multiples to be meaningful, they should be computed from financial figures that are compiled on a comparable basis. Because GAAP
allows a wide latitude of accounting treatments and measurements of amounts, it often is necessary to make adjustments to achieve comparability of accounting treatment. There are many examples, but we will discuss just four:

1. Cash versus accrual accounting
2. Inventory accounting
3. Depreciation accounting
4. Intangibles accounting

**Cash versus Accrual Accounting**

Cash basis accounting means that revenues are recorded on the financial statements when they are received, and expenses are recorded when they are paid. Accrual basis accounting means that revenues are recorded when they are earned and expenses are matched to the time period in which they are used to create revenue; that is, they are recorded when the item of expense (e.g., rent, insurance) is used in the course of the company’s operations.

Absent some agreement to the contrary, valuation usually is based on accrual accounting. Therefore, if a company’s financial statements are on a cash basis, they usually need to be adjusted to an accrual basis for the comparison with the guideline companies to proceed.

Using accounts receivable as an example, the adjustment from cash to accrual accounting would involve bringing the accounts receivable onto the balance sheet as of the end of each fiscal year (or other fiscal period). Then the income statement for each period would have to be adjusted for the difference between products or services billed and accounts receivable collected. Income taxes applicable, if any, should also be reflected in both the balance sheet and income statement adjustments.

**Inventory Accounting**

There are many ways to account for inventory, but the only “common denominator” for comparative financial purposes is first in, first out (FIFO). Therefore, if there is any difference in inventory accounting between the subject and any of the guideline companies, it may be appropriate to adjust all to a FIFO basis.

**Depreciation Accounting**

Companies have wide discretion in both methods of depreciation accounting and the length of the estimated useful lives over which they depreciate some assets.
If there is a difference in the depreciation method between the subject company and any of the guideline companies, the most expeditious procedure is to adjust all the companies’ statements to the depreciation method most commonly used. However, this can be a cumbersome and time-consuming process, so it usually is undertaken only when the differences are significant.

Occasionally, depreciation lives are a factor. For example, the author encountered a company that used an eight-year life for a major asset class when the industry standard was six years. Even though the actual useful life probably was eight years, I adjusted the company statements to a six-year life. Of course, this lowered both the book value of equity on the balance sheet and the earnings on the income statement. However, as we were deriving market value multiples from companies that depreciated over six years, we had to use the six-year basis for comparability. Otherwise, we would be applying the multiples of book value and earnings from the guideline companies to subject company figures that were compiled to get a higher base, thus inflating the indicated values.

Intangibles Accounting

If a company purchases an intangible asset, it places the asset on its balance sheet at cost and amortizes it over time. If the company develops the intangible asset internally, then the cost usually is expensed as incurred.

Therefore, if either the subject company or the guideline companies have intangible assets, they usually are removed from the balance sheet so that the asset multiple relating to book value will be comparable between the subject and the guideline companies, either

- MVIC/TBVIC (tangible book value of invested capital)
- Price/TBV (tangible book value) of equity

It would also be ideal if the income statements were adjusted to remove the amortization for those companies with purchased intangibles so that market value multiples such as price/earnings can be calculated on a comparable basis. If there is not sufficient information to make this adjustment but the analyst believes that it would be significant, then the solution might rely more heavily, or even exclusively, on cash flow rather than earnings-based market multiples (e.g., MVIC/EBITDA versus MVIC/EBIT or price/gross cash flow versus price/earnings).

ADJUSTMENTS FOR “INSIDER” ANOMALIES

Many private companies have expenses that would not be typical of the guideline companies in the industry. That is, the controlling stockholders cause or allow
expenditures that deviate from the norm that one would find in most guideline companies. Examples of such items would be

- Excess compensation and other perquisites
- Lease or other special transactions with company principals or relatives
- Entertainment expenses for employees or customers
- Charitable contributions to company principals’ favorite charities

If valuing a controlling interest, these items normally would be adjusted to conform to the policies of the industry, often as evidenced by the guideline companies.

If valuing a minority interest by the market approach, there are two schools of thought. The most typical is to not adjust for such items, because they are going to continue in any case. The second procedure would be to make the adjustments to put the subject and guideline companies on a comparable basis for the purpose of calculating and applying market value multiples, and then take the anomalies into consideration through some amount of lack of marketability and/or minority interest discount from the value indicated by applying the market value multiples from the guideline companies.

An alternative, of course, to making detailed adjustments is to use a pricing multiple such as price to revenue where one does not have to contend with deciding if adjustments are appropriate.

**ADJUSTMENTS FOR INCOME TAXES IN PASS-THROUGH ENTITIES AND S CORPORATIONS**

Valuation of Subchapter S corporations and other pass-through entities is a controversial issue that has been very difficult to resolve, as divergent, complex, and competing financial theories have been formulated to attempt to address this issue. For the valuation practitioner, the application of reasoned financial theory has proven to be an extremely difficult undertaking, given the multitude of viewpoints and uncertainties of the IRS audit process.

There are four key Tax Court opinions, one of which was affirmed on appeal by Court of Appeals, that suggest S corporation earnings should not be tax-affected for valuation purposes:

2. *Estate of John E. Wall v. Commissioner*²
4. *Estate of Richie C. Heck v. Commissioner*⁴

Each of these opinions is a “T.C. Memo.” Such opinions are case-fact specific and do not necessarily reflect the opinion of the Tax Court as a whole on a particular topic.
The more general, traditional approach is to fully tax-affect the S corporation’s earnings as if it were a C corporation. Prior to Gross, the IRS had supported the traditional approach it opposed in Gross. These rejections of the traditional valuation approaches have left business valuation analysts searching for an acceptable method. The cases point to a rejection of the traditional valuation practice of automatically income tax-affecting S corporation pretax income when valuing an interest in an S corporation or other pass-through entity. Instead, what is indicated is a wholly fact-driven inquiry when valuing minority interests, taking into consideration the facts and circumstances in each case. Under this imprecise standard, the choice between methods thus remains with the analyst, who must be guided by the facts of the case and perceived appropriateness of each model. The subject is beyond the scope of this text, but an excellent and extensive discussion by leading analysts is found in Laro and Pratt’s Business Valuation and Taxes: Procedure, Law and Perspective.5

See the discussion of these cases in Chapter 8 in the context of calculating the return on equity ratio, and whether the analyst should impute entity-level taxes.

SUMMARY

The market approach to valuing businesses or interests in businesses uses market value multiples derived from the prices of actual observed transactions relative to underlying financial fundamentals of the companies in those transactions. To make the market valuation multiples meaningful, the underlying financial variables must be compiled on a basis that is comparable from one to another. It is also important that the statements’ time periods be comparable between the subject and the guideline companies.

For various reasons, it is often necessary to make certain adjustments to the financial statements of the subject or guideline companies to achieve this comparability. Although analysts routinely adjust the subject company statements, they frequently overlook adjustments to the guideline company statements that would be necessary to put them on a comparable basis.

Once the statements are on a comparable basis, the analyst can compare them in various respects to assist in choosing market value multiples to apply to the subject company. If the subject company appears to have higher growth potential than the guideline companies, that would tend to raise the multiples relative to the guideline companies, and vice versa.6 To the extent that the subject company appears to have more risk than the guideline companies (as evidenced by higher volatility of margins, for example), that would tend to lower the multiples relative to the guideline companies, and vice versa.

The subject company may have various financial characteristics that differ from the guideline companies that augur for adjustments other than to the choice of multiples, such as treating nonoperating or excess assets or asset deficiencies.

Some of the most common adjustments could be for
• Nonrecurring items
• Differences in accounting policies
• Insider factors (e.g., excess compensation)

Financial statement adjustments take many forms, and this chapter has presented a few of the most common for purposes of valuation within the market approach.

Notes
