Balancing the Balance Sheet

Even a completely clean set of books, even an audited financial statement, can require adjustments in order to properly reflect the balance sheet as well as the income statement of the business entity for the purpose of valuation. Many times these adjustments have nothing to do with suggestions of wrongdoing, distortions, or any other heinous actions by the business owner or his/her accountant. The purpose of this article is to give the reader insight into some of the commonly done balance sheet adjustments.

Briefly, a balance sheet is a snapshot of a business at a point in time – typically at the year-end (i.e. December 31), though often at other financial statement dates (i.e. mid-year or quarterly). If one were to present the balance sheet of a business the day before or the day after, there would be differences – in some accounts no difference, in other accounts very minor differences, and perhaps in some accounts (typically cash in the bank) there might be significant differences. That is because a business is an operating entity, one which has changes/transactions occurring on a daily basis. That does not invalidate yesterday's balance sheet – rather it indicates that today the business is slightly different than it was yesterday, and one can expect that tomorrow, it will again be slightly different.

Most of the time, these differences, from a day-to-day basis, are insignificant. For instance, a typical change is a bill is paid that was a liability the day before. In a properly recorded set of books, all that does is reduce cash in the bank, evidencing the payment, and at the same time, reducing what was a liability (often a trade payable). The actual financial position of the company hasn't changed at all – it has somewhat less cash (reduction in its assets) and the same amount less in payables (a reduction in its liabilities). There are a multitude of other possible transactions and changes.

The following gives you some ideas as to where even a "clean" set of books may require adjustments to its balance sheet:

1. **Accounts Receivable (and reserve for bad debts)** – typically, a business builds up receivables over time, and (hopefully) collects them. What also typically happens is that some of those receivables take a long time to be collected, some can't be collected at full face, and some have to be written off. If we have a receivables schedule (and it is always preferable to get an aged schedule), it may be obvious that some of those receivables aren't being collected as rapidly as they should be, and perhaps some reserve (which is a precursor to actually writing off – and for economic purposes is really the same thing) may be necessary to reflect the doubtfulness as to collectability. This type of reserve might take the form of writing off part or all of a receivable, or writing off a percentage of all those over 120 days, or similar steps.

This process is supposed to be done by the accountant (or the business) in the preparation of the financial statements. If a business is having a bad year, there is perhaps no motivating tax reason to take additional write-offs – so that bad receivables continue to be carried. Alternatively, when a business is having a good year, writing off receivables may take the opposite (generous) tack, with past sins being written off, and even (often merely for tax reasons) other receivables being written off which perhaps are not quite that bad, and which perhaps will be collected in a subsequent period. Therefore, when we do our job in trying to determine the accuracy of a presented balance sheet, it may be necessary for us to allow for more doubtful receivables (provide for a larger write-off) recognizing that some of those being carried are questionable; or perhaps the opposite, concluding that there was an aggressive position taken as to the writing off of receivables, and we need to put some back onto the company's books.

2. **Inventories** – this is one of the most commonly abused areas in altering balance sheets, and also one of the most difficult for an outsider (i.e. the investigative accountant) to correct. Sometimes businesses overstate their inventories – typically we'll find these on financial statements for the purpose of misleading (defrauding?) lenders or potential investors. More commonly, particularly with closely-held businesses, and particularly for tax reasons, we see businesses understating inventories. Understating an inventory means overstating the cost of goods sold – resulting in the reflection of higher costs and a lower profit. Overstating an inventory means reducing the cost of goods sold, and as a result increasing profits. Typically, adjusting the inventory also means adjusting the income statement – often for a several year period, inasmuch as correcting an inventory usually involves spanning more than one year of operations.

3. **Fixed Assets (often referred to as Property, Plant & Equipment) and Accumulated Depreciation** – closely-held businesses, even when they prepare financial statements, usually reflect depreciation on a tax (rather than economic) basis. As a general rule, the Tax Code permits faster write-offs of assets than is warranted on a true economic life basis. Therefore, many times it is necessary to reduce the accumulated depreciation account (wherein the past depreciation taken is reflected as an accumulation of same – applied against the cost of the assets), as well as make the appropriate adjustments to the depreciation expense taken on an annual basis. For some small businesses, this need not be done because it is simply immaterial. However, it can amount to significant sums, especially where a businesses is growing, and especially where it has heavily invested in machinery and equipment. While it is the rare accountant who is also an equipment appraiser, the practical reality of appraising many small

and even medium-sized businesses is that there may be severe reservations as to the economics of engaging an equipment appraiser for what might perhaps only be $50,000 to $100,000 of equipment at cost, and likely less value currently. A common alternative is for the accountant to make whatever adjustments are necessary, based on established guideline lives or, in some situations, with the benefit of published books (i.e. for automobiles) that are in the public domain.

The above are just a few illustrations of balance sheet areas commonly needing adjustments. There can be many others, particularly in a larger and more complex business, especially one which has been in existence for a number of years.