Pro Forma Results

By Kenneth B. Collins

The past is often the best guide to the future – but unless past results are made clear, they cannot provide a realistic vision of the future.

The value of any business enterprise rests on its ability to produce future earnings. Its past performance may guide us in assessing its future performance, but if those past results are muddied, then the future is, at best, unclear.

Hence the term *pro forma* – which in Latin literally means 'in the form of' – but which in finance means based on financial assumptions or projections ***as if*** such assumptions or projections had been or will be in effect for the past or future period.

As a practical matter, it means excluding extraordinary or one-time sales and expenses (as from acquisitions or restructuring) – in order to present a clearer picture of a company's normalized financial results. Hence the term, "*Pro Forma* Earnings" or "*Pro Forma* EBITDA" (Earnings Before Interest, Taxes, Depreciation and Amortization).

Here was a classic example. ABC Company reported sales last year of $28 million and operating earnings of $1 million. Not very exciting results – and not much of a basis for anyone to appreciate the real value of the business.

Until, that is, we took a deep dive into the financial results. We discovered:

- Included in sales was a one-time sale of old, written-off inventory for $1 million
- A new product was launched that year that yielded just under $1 million in sales – but the launch costs were well over $2 million
- The owner's compensation was $1.5 million – more than $1 million above market rates
- The owner's sister owned the building and was charging the company rent at more than twice the market
- And so forth and so on

When we finished adjusting the company's financials – on a *pro forma* basis, to adjust out those one-time and extraordinary items – we had a clearer picture of the real earnings and potential of the company. *Pro Forma* sales were $27 million; and *Pro Forma* earnings were $3.2 million.

We sold that business for just over $20 million – almost 7 times *pro forma* or adjusted earnings – and more than 20 times the unadjusted earnings as they were reported in the company's Reviewed Financial Statements.

It's not so much a matter of proper accounting as it is a matter of understanding how businesses really work, where to probe – knowing the right questions to ask, and understanding which points are most likely to afford negotiating leverage with the ultimate buyer.

Relatively straightforward in running the business day to day – but when it comes time to analyze the market value of an enterprise, assessing all of these factors and their inter-relationships is best done with the help of an experienced investment banker.

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