

# Leveraging Tax Data in Financial Diligence and Modeling



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When small, and even some mid-sized businesses need to sell or be appraised, there often is no more formal financial document available than the tax returns produced after each year end.

## **Did you know that business tax returns provide a thorough foundation of financial statement data?**

Business owners and potential business buyers can lift all four basic financial statements (balance sheet, income statement, statement of cash flows, and changes in shareholders' equity) off of the various schedules of business tax returns. Tax-centric disclosures such as ordinary income, and special deductions might cloud the view of broader book-based data, but in this article we will help you understand the key components of the tax return that can help you shape the tax data into basic financial statements per the books.

## **Lifting the Full P&L Off Returns**

Starting with profit and loss ("P&L") data, page 1 of a Form 1120, 1120-S, or 1065 typically include revenue, certain other income items, ordinary deductions, and the resulting ordinary income. However, these ordinary items of income and expense don't tell the whole story. On each return, you should be able to find the "Net income (loss) per books" on the Schedule M-1 (note: sometimes it is blank due to certain threshold requirements). The Schedule M-1 is a roadmap to finding differences between taxable income and book income, often with reference to numbered statements which provide more detail on later pages of the tax return.

In addition to reconciliation items on Schedule M-1, there are also items of taxable income and deductible expenses that fall outside of ordinary income. For example, on a Form 1120-S or Form 1065, you can also find a Schedule K disclosure which more thoroughly disclose additional elements of taxable income (e.g., interest income), and deductions beyond ordinary items (e.g., Section 179 write offs of fixed assets and charitable contributions).



Using the Schedule M-1 and Schedule K to lay out and understand the underlying company's book net income every year is a great starting point to viewing this data over time. Using the data, one can begin to ask questions about items that appear unusual or identify items worthy of further due diligence. Furthermore, the full profit and loss statement is also a jumping off point from which to make normalizing or pro-forma adjustments for analysis purposes. This last part helps chart out a clearer picture of the owner's economics in a transactional context, dispute, or other advanced applications of the tax return data.

### **Balance Sheets**

In addition, Form 1120, 1120-S, and 1065 returns also clearly display a balance sheet on Schedule L – typically only a few pages into each tax return document. This is a book-basis balance sheet. Unlike the income statement, which required the analyst to reconcile tax income versus book income, there is no need to reconcile the balance sheet from tax-basis to book-basis.

However, Schedule L (balance sheet) can sometimes be itemized further by reference to additional attached statements which may appear later in the return document. For example, other current assets, other investments, other assets, other current liabilities, and other liabilities – when reported more than zero – often will refer you to a more detailed statement or schedule later in the return. (Don't worry, they are frequently numbered, for ease of reference.)

In addition, the tax returns will sometimes have an itemized depreciation and amortization report somewhere in the middle or later in the document so that you can identify the components that are included in the fixed and any reported intangible assets. If this report cannot be identified within the tax return copy you are working with, the company's CPA's office should be able to retrieve it.

Breaking down the balance sheets in detail can help the reader understand important concepts such as working capital levels, historical capital expenditures, any acquired intangibles, and how

the underlying company is financed. Not only do these reports show the reader information on what the underlying company owns and owes, but it also gives clues about how the organization has evolved over time, and critical information on items influencing the cash-generation cycle.

### **Other Statements**

Once the profit and loss statement and balance sheets are assembled using the tax return, an analyst will often have the data to then assemble a statement of cash flows. However, this is an advanced topic, which will not be discussed in detail in this article. Common challenging aspects of assembling the statement of cash flows include properly computing capital expenditures, acquisitions, and properly tracking changes in equity accounts.

The fourth financial statement that can be extracted from a business tax return is the statement of changes in shareholders' equity. The beginning and ending balances of the company's equity accounts can be found toward the bottom of the balance sheet (Schedule L). Starting with the total beginning balance of all equity accounts, the reader might first add net income or loss per books, as you should have already found that figure on Schedule M-1. Then, other changes in equity such as new capital, and distributions/dividends must be identified. On a Form 1065, for example, major components such as capital contributions, and distributions, show up on Schedule M-2. On a form 1120-s or 1120, you can also see distributions on Schedule M-2.



However, if capital contributions are not as obvious on these latter two forms, you still can see changes in capital stock and additional paid-in capital year-over-year by examining the changing balances on the balance sheet. Sometimes the balance sheet references a statement number that will help identify the changes in retained earnings. Using the areas described, the reader can view changes from the beginning balance of equity to the proper ending balance of equity without a hitch.

### **Navigating Complex Returns**

In some instances, business returns may be inaccurate, too complex for the reader, or lack sufficient data to generate the four basic financial statements. When in doubt, it is important to consult with a financial expert that can help decipher critical data that will help move your matter forward. Financial experts can identify potential issues, ask appropriate questions to the persons responsible for assembling the tax return (accountant and/or business owner), and help guide you through complex financial matters.



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