

Leveraging Tax Data: Tracing Income Statement Adjustments



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Back in the fall of 2025, Strive Partners posted an article about how to leverage business tax filings for financial due diligence and modeling. We illustrated how various types of business tax returns could be leveraged to peel the basic business financial statements data out of them. Much of the use of that financial data centers around understanding earnings and cash flow generation. In addition to building a financial history, understanding trends, and benchmarking performance, one can also normalize the data.

This article will focus specifically on normalizing income statement (“P&L”) data.

An Overview of Normalizing the P&L Data

The purpose of normalizing the profit and loss statements of a business is to provide a better picture of the business’s stable economic earning capacity. This requires removing or adjusting items that would otherwise distort the true earnings picture.

For example:

- Eliminating one-time, nonrecurring, and/or infrequent items
- Implementing control adjustments such as adjusting compensation to reasonable rates, normalizing related-party transactions to market rates, and other discretionary items
- Removing nonoperating items
- Making adjustments to facilitate comparisons (e.g., adjusting the accounting convention used)



Tracing Data to Incorporate Normalizing Items

In order to normalize the financial earnings data, one needs an awareness of what is contained within the profit and loss data in the first place. So, if one wants to add back an owner's personal expenses to determine their business's true income, be sure to determine whether those personal expenses were ever deducted from the income in the first place.

In many of the legal matters in which we are professionally engaged, lawyers and their clients will inform us of a knowledge or belief that personal expenses are paid by a business associated with their case. While this may be true in many instances in which it is alleged, mere payment of personal expenses does not automatically mean that business income is understated. Here's why: not all transactions are recorded in accounts that impact earnings.

For example:

Owner distribution transactions are a type of transaction that reflect the outflow of resources to a company's owners, but these transactions are not "expenses" per the accounting records. Generally, the outflow of resources via distributions does not affect the P&L at all.

When the basic source of income data comes from a business tax return, some tracing is involved to confidently adjust those records.

The most immediate backup layer for a tax return should be documents such as company-prepared (e.g., QuickBooks, or other internal accounting system) financial reports and ledgers.

For example:

If a business takes a deduction for rent expense of \$100,000, you will hope to see that the supporting company-prepared financial data has one or more rent accounts, and those accounts have transactional ledgers adding up to \$100,000. If the transactional ledgers reveal \$40,000 paid by the business throughout the year for its office, and \$60,000 paid by the business for the owner's personal, residential mortgage, you can confidently remove the effect of the personal component.

However, the fact pattern of the data is sometimes more complicated.

For example:

- Multiple accounts in the financial system rollup into one line item of the tax return – can you confidently ascertain which component accounts are involved or do you need the tax preparer’s help to identify the mapping?
- The totals in the tax return line items agree with the totals of corresponding accounts in the accounting system ledger, however, the transaction details in the system might not create a substantive picture (e.g., an expense recording the outflow of funds under certain account, but not memorializing the vendor those funds are paid to or any other substantive memoranda for the entry)
- The tax return bears little resemblance to the underlying bookkeeping totals

At the end of the day, the adjustment of profit and loss data requires a reasonably informed understanding of what is and is not embedded in that data.



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