Implementing Normalization Adjustments

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The valuation of a closely held business or security typically involves analyzing historical financial statements to estimate a normalized level of expected cash flow. Analysts generally adjust certain expenses to facilitate comparison to similar publicly traded companies and to provide a picture of the normal operations of the subject company. The following discussion addresses the application of these income normalization adjustments.

Introduction

A fundamental premise of the business valuation income approach is that the value of an investment is equal to the present value of its future benefits.[1] Future benefits, or future cash flow associated with a financial investment in an operating company, are estimated under the assumption of normal operating conditions. Normal operating conditions are subjective for any given company, but could be considered the conditions in which the managers of the enterprise expect to operate.

The circumstances that determine "normal" conditions are based primarily on consideration of historical results, given industry and economic conditions at the time. Therefore, the valuation analyst ("analyst") should look at historical financial statements to determine which reported items are representative of an entity's expected normal operations, and how these items compare with the results of similar public companies or relevant industry indexes. This is the foundation for the income normalization process.

The American Society of Appraisers *Business Valuation Standards* define normalized earnings as, "economic benefits adjusted for nonrecurring, non-economic, or other unusual items to eliminate anomalies and/or facilitate comparisons."[2]

Normalized earnings are essentially a rendition of the financial statements with adjustments, inclusions, or exclusions of certain items. Within the business valuation market approach, normalization adjustments are made to enhance comparability. Thus, changes are made to reflect the true economic benefits of a company's operating activities from a fair market value perspective. There is a systematic approach to provide a reasonable basis for a normalized level of cash flow.

This discussion (1) presents these circumstances and procedures involved in making normalization adjustments and (2) provides examples, caveats, and exceptions to such normalization adjustments.

Normalization adjustments are adjustments made to the amounts reported in financial statements such as the balance sheet and income statement. Financial statement adjustments can be distinguished by two primary types:

1. Normalization adjustments
2. Control adjustments

Normalization adjustments are changes made to a private company's earnings to translate to a "reasonably well run, public company equivalent basis."[3] In other words, these adjustments indicate how a private company's earnings would look to a sophisticated outside investor using data from public companies as a reference point to estimate the fair market value of the subject company.

Control adjustments are made "for (1) the economies and efficiencies of the typical financial buyer and (2) the synergies or strategies of particular buyers."[4] The second type of control adjustments are more relevant to investment value (i.e., value to a specific buyer) and will not be covered in this discussion. Although both types of adjustments ultimately will affect value, this distinction provides a framework to consider why a particular adjustment should be made.

Normalization adjustments, based on the definition provided, are made to enhance comparability between the subject company and comparable public companies. Unusual, extraordinary, and nonrecurring items are eliminated. This is because these item may distort the earnings resulting from the normal operations of the subject company.

Nonoperating assets, and their associated income and expenses, are also removed. This is because analysts often seek to compare only the operating activities of companies within the market approach. Adjustments are also made to present financial data in conformance with industry accounting standards.

Control adjustments are implemented when estimating the value of a controlling ownership interest in a company relative to the value of a noncontrolling ownership interest. These adjustments are necessary because a potential buyer obtaining a controlling interest, unlike a noncontrolling shareholder, may be able to directly affect various company policies and practices (e.g., compensation and distributions), thus affecting cash flow.

Most companies produce some form of an income or profit and loss statement, whether internally or through an auditor. These statements should be analyzed thoroughly to understand historical operating results and the conditions under which they were achieved, accounting methods, and asset functions. This is generally the first step in the normalization process: holistically understanding normal operating conditions of a company and the relevant, associated industry.

It may be appropriate to interview company management or industry experts during this process. Characteristics of the subject interest may also be analyzed for the purpose of establishing the relevance and magnitude of control adjustments.

Only after the analyst has completed the due diligence required to understand the nature of a company's operations and the industry in which it operates, can relevant and appropriate adjustments be made.

The following section discusses the broad categories of normalization adjustments.

Adjustments for Unusual, Extraordinary, and Nonrecurring Items

During January 2015, the Financial Accounting Standards Board (FASB) issued an amendment to Accounting Standards Codification (ASC) topic 225-20, regarding accounting for "extraordinary and unusual items" in an income statement. Essentially, this update no longer requires items considered "unusual" or "extraordinary" to be reported separately in an income statement.

According to the ASC, "unusual" and "extraordinary" items are items that have one or both of two characteristics, "infrequency of occurrence" or an "unusual nature."

The former is defined as: "The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates."

The latter is defined as: "The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates."

Such items can now be "presented within income from continuing operations or disclosed in notes to financial statements."[5]

Although this may simplify accounting practices and financial statement presentation, it may require more effort on the part of the analyst to identify and account for such items. These items may still be mentioned within notes to the financial statements, but the changes in presentation within the income statement increase the importance of interviewing management to identify these items.

The objective of adjusting for unusual, extraordinary, and nonrecurring items is to present the financial results associated with normal operating conditions that can be indicative of future operating performance and benefits under similar operating circumstances. Additionally, these adjustments enhance comparability among the subject company and guideline public companies, assuming consistent accounting practices and industry impacts.

Items typically included in the unusual, extraordinary and nonrecurring category include events such as damage from fires, hurricanes, and other natural catastrophes, or human events such as a labor strike. Additionally, insurance claims and benefits related to such items may also require adjustments.

For example, assume a plant fire destroys the factory of a manufacturing company. However, the company owned an insurance policy covering part of the costs to repair the plant. Any reported loss resulting from the destruction of the asset, and the income recognized from the insurance recovery, should be removed from the normalized income statement. Additionally, adjustments may be required to reflect some portion of cash, representing unusual insurance proceeds, as a nonoperating asset.

Events such as the incurrence of major repairs or capital maintenance to a facility may also be normalized based on the significance and circumstances regarding the event. Although such an item—maintaining infrastructure—typically would seem to be a part of normal operations, if the expense can be categorized as a significant, nonrecurring, one-time expenditure that yields no easily quantifiable increase in future productive capacity or benefits, it may be excluded from the normal operating cycle.

For example, a manufacturing company has several factories, one of which is an old facility that is derelict and inefficient. The company undergoes significant expense to repair and update this factory, which it regards as a one-time expense. The company management believes this renovation will not increase production capacity, but rather, will enable the factory to perform at an efficiency level comparable to the other factories. Adjusting expenses, and operating results, by excluding or reducing the one-time expenditure, may provide a better picture of future operating results for the purpose of completing a valuation analysis.

One could argue such an expense would likely provide future benefits in the form of increased efficiency or profitability. However, the nonrecurring nature and significance of the expense clouds the picture of normal operations by significantly increasing expenses during the period the expense is incurred.

It is possible, depending on the accounting methods employed, that this expenditure will be capitalized and added to the value of the factory. In this case, the expense will be recognized over time as the utilization of the enhanced productive capacity resulting from the expenditure is recognized in the form of depreciation expense in the income statement. The treatment of this depreciation expense, when compared with other firms, is a matter of accounting normalization, which will be discussed below.

On the other hand, a significant capital expenditure, such as the building of a new factory, should not be considered for adjustment. This is because such an investment would lead to quantifiably enhanced capacity and is well within the normal operating nature of a manufacturing company. In this example, the business cycle may also be considered.

During the analysis of an industry and its corresponding business cycle, the analyst may find it is common for a manufacturing company to update its productive equipment every five years. Thus, these updates could be considered "normal" capital maintenance or capital investment, and would, therefore, not need to be adjusted or excluded.

Adjusting for significant revenue or expense items that appear to be related to the operating interests of a company requires the informed judgment of the analyst.

Adjustments for Nonoperating Assets

According to the *International Glossary of Business Valuation Terms*, the definition of a nonoperating asset can be summarized as an asset that is "not necessary to ongoing operations of the business enterprise."[6] Nonoperating assets typically are excluded and added back to the estimated operating value of a company after the operating assets and associated cash flow have been separately analyzed and valued.

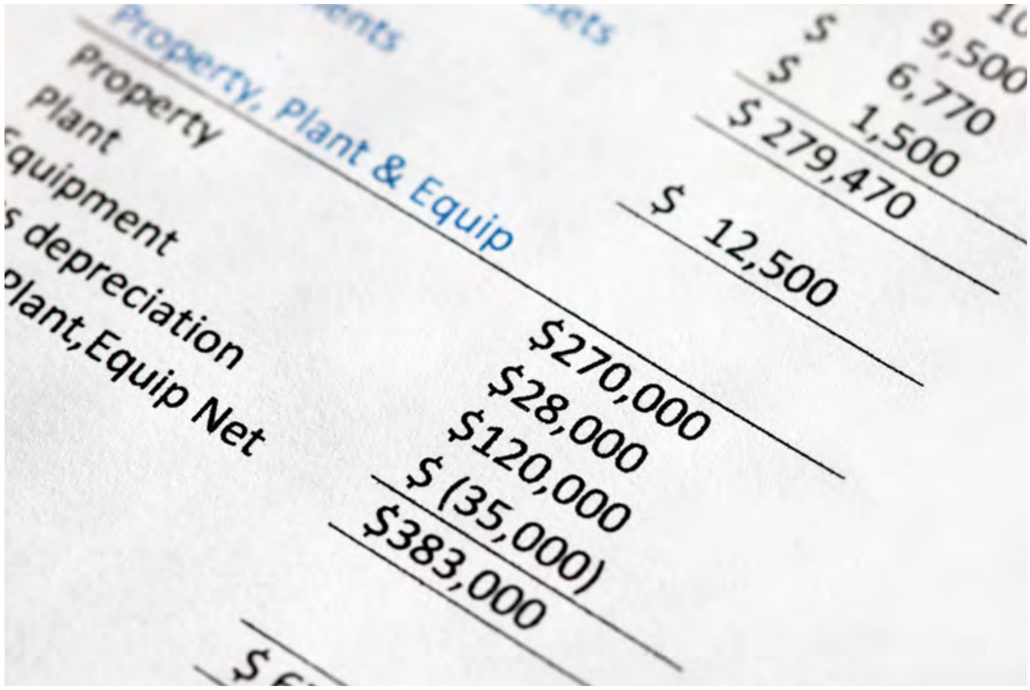
A common example is an investment in an unrelated company. Although this investment may provide an income stream, such as dividends, this income typically would not be considered to represent a normal part of the investor company's normal operations. As a result, the income stream could be reasonably excluded from normal operating income. This investment would be valued separately, with the fair market value of the investment added to the estimated operating value of the subject company.

Within many family enterprises, it is not uncommon to see real estate held for investment purposes within an operating entity. Such real estate, though often a source of rental or lease income, should be excluded from normalized earnings if the company's operations are not focused primarily in real estate investment. Furthermore, these adjustments eliminate income that is not earned from operations, thus facilitating a better comparison with the operating results of similarly focused public companies or relevant industry indexes.

Adjustments for Accounting Conformity

Privately held companies often deviate from industry standard accounting methods. Normalization of accounting methods is appropriate within the business valuation market approach. This is because it allows for easier comparison between the incomes of the subject company and the comparable publicly traded companies.

A private company may account for inventory using the first-in, first-out (FIFO) method, while many comparable public companies use the last-in, first-out (LIFO) method. These methods typically result in different values for inventories and cost of goods sold, thus could exert an impact on the subject company value. Therefore, and for consistency purposes when implementing the market approach, the operating results of a subject company using the FIFO inventory method typically are adjusted to reflect operating results and its financial position as if using the LIFO inventory method.



The following list contains financial statement items that may be subject to accounting method normalization:[7]

- Allowance for doubtful accounts (corrected for historical results and management interviews)
- Pension liabilities
- Inventory accounting methods
- Write-down and write-off policies for inventory
- Depreciation and depletion methods
- Leases (adjusted to market value)
- Intangible assets
- Policies regarding the capitalization or expensing of various costs
- Timing and recognition of revenue and expenses
- Net operating losses carried forward
- Treatment of interests in affiliates
- Adequacy or deficiency of assets (such as cash or working capital)

The last item, the adequacy or deficiency of assets, generally relates to what could be considered excess or insufficient balances in certain asset accounts based on normal operating needs, or relative to normal industry (or guideline publicly traded company) standards. For example, if analysis indicates that the subject company is carrying significantly more cash as a percentage of assets relative to comparable publicly traded companies, some portion of the cash may be determined to represent "excess," or "nonoperating," cash.

The operating value of the subject company typically would be increased by the estimated level of nonoperating cash on hand. Estimated interest income attributable to the nonoperating cash would need to be removed from historical earnings during the normalization process.

The following section refers to controlling ownership interest adjustments.

Controlling Ownership Interest Adjustments

Controlling and noncontrolling ownership interests are often treated differently in the normalization process. The differences are most evident regarding operating expenses and shareholder distributions, as controlling interests often have the ability to directly control both.[8]

When valuing a controlling ownership interest within the income or market approaches, there are several scenarios in which earnings may be adjusted in order to make comparisons of historical earnings and operating results for the subject company with earnings and operating results reported by public companies more relevant and meaningful.

For example, the owner of a car dealership, who also functions as a salesman for the dealership, owns a controlling interest in the subject company. He or she may take a salary above what a competitive market rate may be for his or her given level of responsibility and productivity. The average salary, based on publicly available data, is $100,000 per year for a comparable salesperson at a comparable dealership. The owner of the subject company receives a salary of $150,000 per year.

The analyst, in order to better reflect comparable economic benefits, may reduce salary expense by $50,000 (i.e., the difference between the actual compensation level/expense and the market-based compensation level/expense), thus increasing net earnings and cash flow from operations. The additional $50,000 in income from operations reflects what a competitively and economically motivated company, effectively managing expenses, potentially could generate. Because only a controlling ownership interest has the authority to influence compensation expense, and assuming no unusual or contractual circumstances, adjusting compensation typically is limited to the valuation of controlling ownership interests.

The following equations illustrate the potential impact that the previously discussed compensation adjustment could exert on the fair market value (FMV) of the subject company when the analyst relies on the income approach direct capitalization method:

- Net cash flow (NCF), is estimated at $950,000 based on analysis of the subject company's historical income statements and operating outlook
- Excess compensation, or difference in net cash flow, is $30,000; or the excess of actual compensation expense relative to market-rate compensation, or $50,000, reduced by a 40 percent tax rate
- $d - g$ = 10% (discount rate – expected long-term growth rate = direct capitalization rate)

$$\text{FMV} = \frac{NCF}{d - g}$$

$$\text{Noncontrolling interest} = \$9.5 \text{ million} = \frac{\$950{,}000}{10\%}$$

$$\text{Controlling interest} = \$9.8 \text{ million} = \frac{(\$950{,}000 + \$30{,}000)}{10\%}$$

Based on the direct capitalization method, the value of a controlling ownership interest would be more valuable, on a relative basis, than the value of a noncontrolling ownership interest based on a controlling owner acquiring the authority to affect salary expense. Absent consideration of this adjustment, and all other factors remaining the same, the value of the subject company would be the same to both controlling and noncontrolling investors.

Compensation adjustments typically are appropriate when (1) the value of the subject company is being estimated from the perspective of a controlling owner and (2) sufficient diligence has been performed to establish a thorough understanding regarding the scope of responsibilities attributed to the position(s) being analyzed and a sound foundation for the relevant level of market-based compensation.

The analyst will establish solid justification for any adjustments to the reported historical earnings of the subject company. For example, an analyst notes that no other companies in an industry offer health care benefits to their employees other than the subject company. Is it appropriate, then, to add back this expense to increase operating cash flow? This adjustment requires careful consideration.

An argument could be made that the health care benefits allow the subject company to recruit and retain unique talent, providing a competitive advantage and future economic benefits. However, such a claim would be subject to the immediate counterpoint that, were such benefits necessary, clearly other companies within the industry would offer them. Operating results of the subject company reflecting margins that are superior to those of the industry, would serve as strong support for the economic benefit attributable to the expense, eliminating the need for adjustment.

Professional service firms, or industries heavily reliant on human capital and the retention of human capital, may reflect benefits packages that warrant expenses that otherwise may seem excessive. As is the case with normalizing adjustments, the analyst should exercise prudence and decide what best reflects the economic reality of the subject company from a fair market value perspective.

Other noteworthy items often subject to adjustment when valuing a subject company from the perspective of a controlling owner include the following:

1. Travel and entertainment expenses
2. Transactions with related companies or parties
3. Legal expenses
4. Restructuring fees

These items are commonly considered when normalizing the earnings of family-owned enterprises.

A controlling shareholder or partner may expense all personal travel and entertainment (T&E) to the firm. Unlike compensation, it is not necessarily the amount of T&E expensed, but rather the nature of the expenditure.

For example, a controlling shareholder expenses all of his family's vacations to the firm, as well as work-related travel. Typically, it would be appropriate for an analyst to exclude all non-business-related T&E expenses from operating expenses.

In a family law context, and regarding the division of business interests includable in the marital estate, personal travel typically is excluded from reported operating income during the income normalization process.

Often, family-owned businesses operate within a group of related companies and partnerships with overlapping ownership. A valuation analysis often is required to estimate the stand-alone value of a particular operating entity, holding company, related partnership, and so forth. However, the operations of each company may include the impact of activity with related entities, such as lessors, customers, or suppliers.

For example, a residential construction company buys gravel and sand from a mining company. Both companies have the same controlling shareholder, a family-owned holding company. The mining company sells its raw materials to the construction company at prices well above the market spot rate. For simplicity, assume the sole customer of the mining company is the construction company. This situation would lead to normalization adjustments for both companies in the case of a divestiture of the controlling interest of either entity.

The mining company would have a revenue adjustment, as the per-unit sales price should be adjusted to the historical market spot price. The construction company could then reduce its cost of revenue, as this figure would be lower if the company purchased raw materials on the open market.

It should be noted that such adjustments are not always appropriate and should be incorporated when the adjustment is objective and based on factual support. For example, Walmart enjoys lower costs than many of its competitors, but this is generally understood to be based on Walmart's ability to benefit from economies of scale rather than related-party activity.

Legal expenses are incurred for many reasons, with some being unique and circumstance-based, and others being recurring in nature. For companies that require the maintenance of patents and other assets protected by law, a regular legal expense is often incurred. In such a circumstance, recurring legal expenses would be normal. However, a lawsuit often results in significant, one-time legal costs. The fees associated with such suits, including legal fees and related expenses, typically would be excluded from reported expenses when normalizing earnings.

Restructuring fees often are incurred in order for a company to reorganize in some capacity. Typically, restructuring activity is completed in order to reorganize a company's operations in a more productive and cost-effective manner in anticipation of improving long-term profitability.

A common example includes discontinuing a product line. In such a circumstance, costs associated with discontinuing the product line from the production process and revamping existing capacities to create a different product may need to be adjusted. Due to the nonrecurring nature of such an expense, it may be appropriate to remove certain historical operating expenses, and nonrecurring restructuring expenses, during the income normalization process.

Conclusion

Income normalization is a common procedure in estimating the fair market value of a subject company. Within the business valuation income approach, the normalization process enables the analyst to develop a better picture of the expected, true economic benefits of operations for the subject company under normal operating conditions. Within the business valuation market approach, the normalization process eliminates the impact of unusual and/or nonrecurring events, resulting in an estimated earnings level for the subject company reflective of a "reasonably well run, public company equivalent."

In one regard, normalized earnings may seem to be a distortion of actual financial results. However, if executed carefully and sensibly, the normalization process—and resulting normalized earnings—should provide a better indication of sustainable economic benefits for the subject company. Such a level of economic benefits provides a solid foundation for a value conclusion.

Notes:

1. James R. Hitchner, "Income Approach" (Chapter 4) in *Financial Valuation: Applications and Models* (New York: John Wiley & Sons, 2003), 87.
2. Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-sized Businesses*, 4th ed. (New York: American Institute of Certified Public Accountants, 2012), 22.
3. Ibid., 204.
4. Ibid.
5. FASB, Accounting Standards Codification (ASC), Topic 225-20, Income Statement—Extraordinary and Unusual Items (Norwalk, CT: Financial Accounting Standards Board, 2015).
6. "International Glossary of Business Valuation Terms," SSVS (New York: American Institute of Certified Public Accountants, 2007).
7. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*. 5th ed. (New York: McGraw-Hill, 2008), 131-32.
8. Hitchner, *Financial Valuation: Applications and Models,* 89.

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