

VALUATION observations



Normalization Adjustments and Their Effect on Business Valuation

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We are occasionally asked by business owners: what is the biggest mistake I need to avoid when looking to sell my business? One piece of advice we always give: do not reveal the company's financial performance (usually, financial statements) to prospective buyers without first consulting with a qualified valuation expert, M&A advisor, or investment banker. Why? The company's financial statements, even if they are GAAP-prepared, may not properly reflect the company's "normal" performance capabilities, and may not present an accurate indication of future potential.

What Financial Statements Don't Say

One of the most important aspects of assessing the value of a company is fully understanding its historical financial performance, particularly as it relates to its prospects for the future. No documents are more critical to this process than a company's financial statements, which attempt to portray the company's operating performance over a period of time (income statement) and its current condition (balance sheet). I say "attempt" because financial statements are often

encumbered by non-recurring income/expenses, outdated asset values, and other factors that distort the company's performance and condition. Having an understanding of all potential normalization adjustments to the financial statements (and when to adjust for them) allows all parties to best use these essential documents to help determine the value of a business.

An Example

The best way to highlight how a company's value can be impacted by normalization adjustments is through an example. Let's suppose that a company's reported annual cash flow of \$1.5 million includes \$500,000 in various non-recurring expenses. Further, let's suppose that the income statement includes \$600,000 in discretionary expenses, or other administrative expenses that could be eliminated by a specific type of buyer. As presented on the accompanying table (see the following page), a necessarily simplified portrayal of a valuation, the concluded value of the enterprise can differ markedly depending on the estimated sustainable cash flow level.

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Effect of Normalization Adjustments			
Standard of Value: Financial Statements:	Fair Market Value / As Stated	Fair Market Value / Normalized	Strategic Value / Normalized
Sustainable Cash Flow x Valuation Multiple ¹	\$ 1,500,000 <u>6.67x</u>	\$ 2,000,000 <u>6.67x</u>	\$ 2,600,000 <u>6.67x</u>
Enterprise Value	\$ 10,000,000	\$ 13,333,333	\$ 17,333,333

¹ - Equivalent to a 15% cost of capital

What are Common Adjustments?

Normalization adjustments to the balance sheet are typically made to adjust assets and liabilities to fair market value (or whatever is the appropriate standard of value). This could mean writing off the value of goodwill, or marking-to-market the value of an appreciated building. Normalization adjustments to the income statement are made for innumerable reasons, including but not limited to the following:

- Accounting changes
- Bad debt expenses/recovery
- Discontinued operations
- Litigation or government action
- Asset impairment charges
- Discontinued/normalized compensation
- Realized capital gains or losses
- Owners' compensation/perks

Different Adjustments for Different Valuation Purposes

Experienced valuation experts or M&A advisors will be able to not only identify the normalization adjustments listed above, but also when to account for them. When valuing a 1% interest in a company, the valuation expert should likely only consider the first type of adjustments described below. However, when valuing a business for a potential sale, a valuation expert usually considers all three types of adjustments. The three main types of valuation adjustments are:

- 1) *Non-Recurring Adjustments* – These adjustments should nearly always be made due to their non-recurring nature. The goal of the valuation expert is to distinguish between past earnings that represent ongoing

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earning power, and those that do not (examples: extraordinary bad debt, discontinued operations).

2) *Control Adjustments* – Controlling interest shareholders often have the luxury of being able to run their companies as they see fit, and in their best interest. Often, these shareholders exercise their ability to extract additional salary or run personal expenses through the company (examples: excess owners' compensation, discretionary auto expenses). When valuing the cash flows available to a minority-interest shareholder, it would be inappropriate to eliminate these expenses because a minority interest shareholder is not in a position to do so. The difference in cash flows highlights the disadvantage of being a non-controlling interest shareholder.

3) *Buyer-Related Adjustments* – These are adjustments made to a company when contemplating its sale, and consider the company after its integration with a potential buyer (allowing for elimination of administrative expenses, a buyer's market advantage, etc.).

Adjustments Not Always “Cut and Dry”

Bad debt and litigation-related expenses are two of the most common valuation adjustments. However, there are many industries where these are normal operating expenses, the “cost of doing business.” Experienced valuation experts, especially those with experience in valuing companies in the subject company's industry, often have a better idea of what is normal and what is extraordinary. They may also have a better feel for normal levels of owners' compensation, which is beneficial when considering control-related adjustments.

Who Else Benefits From Normalized Financial Statements?


Normalization of the financial statements is a necessary step in business valuation and M&A planning, but it can also be a useful tool for corporate strategic planning. In many of our valuations, CEOs and CFOs have reflected that normalization adjustments uncovered during our due diligence process have allowed them to evaluate and analyze their company's performance in a more meaningful way, which can be invaluable when constructing forecasts or during capital budgeting.

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Summary

Failing to properly account for normalization adjustments can lead to an inaccurate business valuation. This can be regrettable, especially when an owner puts his business up for sale, and the failure to normalize financial statements leads to the undervaluation of the company. An experienced valuation expert is often in the best position to uncover potential normalization adjustments, and determine their appropriateness for the situation at hand. 

ABOUT US

GBQ Consulting specializes in Business Valuation, Transaction Advisory Services, ESOP Consulting, and Dispute Advisory and Forensic Services. Our Business Valuation group is one of the largest and most experienced in the Midwest. Professionals at our offices in Columbus (OH) and Indianapolis (IN) provide valuation services in the following contexts:

- Transaction Support & Opinions
- ESOP Valuation & Consulting
- Succession & Wealth Planning
- Financial Reporting
- Corporate Planning & Assistance
- Expert Opinions & Disputes

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