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Normalizations: Why We Do It

During one of my first engagements representing a seller (many years ago), the partner I worked for was discussing some financial analyses with a potential buyer. Finally, we came to the page that included our normalization of earnings analysis. The buyer had a number of questions and became more irritated as we went down the lengthy list. Suddenly he burst-out, “This is all garbage! If any of it were real, we’d all be rich!”

A little later I worked on another project for a different seller where the buyer was open and willing to consider all the normalizations we initially presented (a longer list than the angry buyer’s, above); in addition to newly identified normalizations as we continued our discussions. The buyer didn’t accept all our normalizations, but they did accept many of them. So why is there such a difference between these buyers?

Prophecy

I don’t pay for the earnings a company has generated in the past. If that were the case, there would be no argument about valuation. What I pay for are the earnings a company will generate in the future. That is why we say valuation is a prophecy of the future, and that is what makes it so difficult.

When we value a company, we go through a process of studying historical financial results to try to get some idea about what will happen in the future. Two of the things we look for are current profitability and trends in income and expense. If we understand current profitability and the trends that affect a company’s financial performance, we can make a better estimate of the company’s **future** earnings. Sometimes income or expense items can mask current profitability and/or underlying operating trends in the business. So, we make normalization adjustments to re-state earnings to exclude income and expense items that are masking current profits and/or operating trends.

“The good news is, you’ll be spending Thanksgiving with a large group of happy people.”

Normalizing

Normalization adjustments generally fall into one of 4 categories (although there are other categories you could use):

Non-recurring income/expense: These are income or expense items that we don’t expect to continue in the future. Common adjustments would be for officers’ life insurance or for salaries for employees that aren’t expected to be with the company in the future.

Unusual income/expense: These are one-off income or expense items that are unusual in nature. Legal fees for fighting a lawsuit would be a common example, as long as lawsuits are an uncommon occurrence for the company. In some industries (such as construction) lawsuits are common, so you would be less likely to normalize legal fees.

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I wish you a safe and happy
Thanksgiving Day.

Owner-influenced transactions: These are transactions where the company is dealing directly with the owner. The most common examples are wages (for the owner and family members) and related company real estate rents. Our job is to try to figure out if the owner-influenced transactions are done on terms that we would see in arm's-length dealings in the market. If the transactions are high or low, a normalization adjustment could be needed.

Strategic adjustments: These are improvements in earnings (and cash flow) that a strategic buyer can put in place, and can be significant. Some examples are: selling a new product to an acquired customer base, consolidating operations, and improving labor productivity with a unique scheduling and planning software package.

It's in the Eye of the Beholder

I always say that value is like beauty – it is in the eye of the beholder. The same can be said of normalization adjustments. What seems perfectly reasonable to you could be seen as insulting by someone else. The stories I started with show the different reactions you can get. It is important to remember to carefully study your normalization adjustments from your perspective and your counterpart's perspective, to make sure you can support them. But be prepared for questions, because the people you are dealing with could have a completely different view of things.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

Corporate Value Partners is a corporate finance consulting firm. Services include:

- Preparing business valuations
- Assisting with the acquisition or sale of a business, business unit or product line
- Assisting with corporate performance measurements
- Assisting with the placement of debt financing
- Assisting creditors in corporate bankruptcies
- Assisting attorneys with the financial aspects of lawsuits