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ACCOUNTING & AUDIT

Tips On Normalizing Adjustments to Income Statements

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May. 13, 2016

Valuation experts know that normalizing is an important and sometimes challenging step in the business valuation process. Business owners themselves may not realize how their own efforts can incorrectly inflate or deflate their sense of the valuation. Other owners may provide limited information on which to base the valuation, which can result in issues of bias and ambiguity. At larger companies with higher earnings, seasonal swings in revenue could alter a valuation dramatically unless normalizing adjustments are made.

For example, if a particularly big account was won last month, the valuation may seem high, but without consistent wins at this level or re-occurring revenue from the customer, the valuation itself might not be affected. Chris Mercer states in his article on normalizing adjustments that:

"Normalizing adjustments are made in valuations to separate unusual or non-recurring or management discretionary items of income or expense on the income statement. The objective of normalizing adjustments is to develop historical, adjusted income statements and percentage income statements that can be used in the valuation process." – Chris Mercer

Business owners may not keep thorough records, and they may not realize that adjustments will be made during the valuation process. It's the task of the valuation professional to explain the process in a way that the business owner understands.

"Remember your big win last month?" the valuation expert might say. "During the valuation process, that win will be normalized so that we can understand the company's true value." Or, in a buy/sell situation, one might say "fair value". Educating the client about how valuations can drive their business, how your firm can advise the business owner and ultimately how the valuation process is handled will make the client comfortable and will open the door to your opportunity to sell more services down the road.

Of course, each industry has its own characteristics and areas ripe for adjustments. In retail, your firm might watch for inventory cost fluctuation. The first step is to determine whether the business is using LIFO (last in, first out) or FIFO (first in, first out) to account for inventory costs. As Mercer points out, "If the difference between LIFO and FIFO pricing is significant, the appraiser may need to make appropriate normalizing adjustments."

Other tips to ensure that you're making the appropriate normalizing adjustments include asking for the right documents and simply asking the right questions. When you see anything out of the ordinary that might be a one-time item of income or expense, find a way to ask the owner about it. Dig into historical records to ensure that there aren't red flags that might surprise both the current and any future owner.

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