The Advisor – Summer 2017

Income Normalization

In our last newsletter, we briefly discussed the concept of "normalizing" EBITDA or income for the purposes of valuing a business. In this newsletter, we will discuss this in more detail so that business owners have a general idea of the types of adjustments that will be made by buyers as part of the sales process.

The basic concept of income normalization is the adjustment of all one-time or unusual items from earnings to arrive at an income number that would be expected to be generated in the future had the one-time or unusual items not occurred. Normalization also refers to the adjustment to income of items of a personal nature for owner managed businesses.

Some of the more common normalization adjustments are discussed below:

1. **Fair Market Executive Compensation.**

   Quite often, owner managers will pay themselves salaries or bonuses that are different than what they would pay a professional manager to run their business. Any compensation taken out of the business in excess of what they would pay a manager would be added back to income. On the other hand if an owner pays himself less than what a manager would command, the difference in salaries would be deducted from income.

   Any variable compensation (such as a bonus) is added back to income since there are no guarantees that a bonus would be paid out in the future. Also, any salaries paid to spouses or children are normally added back assuming they (or their) positions would be eliminated on the sale of the business.

2. **Owner Manager Perks.**

   Items of a personal nature that are paid by the company are normally added back to income. Typical items include:

   a) Travel and meals and entertainment of a personal nature;
   b) Club dues and memberships;
   c) Rent in excess of fair market value paid to a related landlord or company;
   d) Professional or consulting fees relating to personal matters;
   e) Car lease payments for multiple vehicles; and
   f) House repairs.

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3. Gains or Losses on Sales of Assets.

The sale of assets used in the business normally does not occur on a regular basis. As such, any gains on sale would be deduced from income and any losses would be added back.

4. Start-Up and Disposal Costs.

If the company branches out into a new business line and incurs costs with minimal revenues while the new business ramps up, these start-up costs would be added back to income. The same applies to costs incurred in shutting down a non-performing division.

5. Bad Debts.

Write-offs of uncollectible accounts would be added back to income assuming they don't occur on a regular basis.

6. Other Adjustments.

Environmental cleanup costs that are one-time in nature are expensed when incurred per accounting rules. But for valuation purposes, they would be added back to income.

The same would apply to items of a capital nature that are expensed such as a roof repair that extends the life of a building. The repair would be added back to income on the basis that this expense only occurs once every 10 to 15 years.

These are just a few of the adjustments that would be contemplated as part of a business valuation. Other adjustments would apply depending on the particular circumstance of the business.

Aries Advisory Group has extensive experience in assisting owners with the valuations of their businesses. If you would like to get an idea of what your business is worth as part of an eventual exit strategy, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

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