



## **What's normal? - The ins and outs of business valuation adjustments**

To create an accurate picture of a company's finances, a business valuation expert likely will need to make various adjustments to "normalize" earnings. These adjustments may include removing unusual events from the company's financial statements and adjusting the company's historical results for discretionary spending.

But determining what's normal isn't necessarily easy. It involves detailed analysis, as well as an understanding of the company's current and future operations, to help ensure the numbers more accurately reflect how much hypothetical investors can expect to earn.

### **Income stream revisions**

When applying the income or market approach, an appraiser derives a company's value from its earnings using capitalization (or discount) rates or pricing multiples, respectively. But before jumping headfirst into this basic math, he or she asks whether a company's past earnings represent its future earnings potential to a hypothetical buyer. If it doesn't, the valuator considers revising the company's income stream to better reflect the future cash flow a prospective buyer could generate from its operations.

Discretionary adjustments are the first subset of income stream adjustments. These modifications are intended to bring a company's expenses in line with industry norms.

Discretionary costs that commonly require adjustment include owners' compensation and perks and related-party transactions.

In addition to changing the expenses the current owner controls, the valuator asks whether the historic income stream includes any unusual or nonrecurring expenses, such as startup costs or legal fees associated with a pending lawsuit. Because these items aren't expected to continue in the future and thus have no value to a potential buyer, the valuator removes (or adds back) them from the company's earnings.

### **Balance sheet alterations**

After a valuator makes a preliminary estimate of a company's value, he or she considers additional fine-tuning. Before finalizing the conclusion, the valuator assesses exactly what the preliminary value estimate includes. If anything is missing, the valuator makes a balance sheet alteration.

Balance sheet alterations include changes to excess or deficit working capital (compared with the company's normal operating needs), contingent or unrecorded assets and liabilities, nonoperating assets, and real estate (if most industry participants rent their facilities).

## Discount adjustments

Among the most common valuation discounts are minority interest and lack of marketability. Minority interest discounts reduce an interest's value to reflect its inability to control the company's management and policies. When quantifying this discount, a valuator considers several factors — such as levels of control and associated benefits, whether the appraiser revised the company's income stream for discretionary items, distribution of the other shares, and contractual agreements among the owners.

On the other hand, lack-of-marketability discounts reflect the relative difficulty (in terms of liquidity, time and transaction costs) an investor in a private company would have selling his or her shares. Factors that affect an interest's marketability include size of the subject business interest, transfer restrictions, dividend-paying policy and financial performance.

The flip side of discounts is valuation premiums. Rather than reduce a company's value, premiums increase its value. The two most common premiums are the control premium and the swing vote premium. The former is the mathematical inverse of the minority interest discount, and it's designed to increase a minority basis value to a controlling basis value, considering the economic value of benefits to be recognized through the elements of control. The control premium is especially relevant in merger-and-acquisition valuations.

A swing vote premium reflects the ability of a minority shareholder to side with another owner to affect decision-making. For instance, a 2% interest might be subject to this premium if two other individuals equally owned the remaining shares.

## A more accurate picture

Because a valuation adjustment requires a valuator to use his or her professional expertise and experience, it may become contentious between parties and even lead to a lawsuit.

Business owners and attorneys can prevent this outcome by understanding the reasoning behind valuation adjustments and how valutors use them to create a more accurate financial picture.

Do you have a  
**Question?**  
or want to speak to  

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