

Normalization of Income

How Normalization of Income helps you establish a value for your company.

To determine an expression of value of the net worth of shares or assets of a company, the first exercise is to analyze and normalize the company's financial performance as if it were a company being run "By the Book".

Today, the most common "thumbnail" valuation methodology is based on a multiple of normalized EBITDA. (Earnings Before Interest, Taxes, Depreciation, and Amortization)

EBITDA is the approximate measure of a company's operating cash flow based on the company's financial statements, before charging, interest, income taxes, depreciation and amortization, plus all other normalizing adjustments; some of the more common being described below.

Common items requiring a normalization adjustment to net income include, but are not limited to:

- **Management Salaries** – Careful consideration should be given to what a normal management salary, or salaries, would be for the new owners to operate the company effectively. Net income should be adjusted accordingly.
- **Unique Operating Expenses** - Costs that would not exist under new ownership. Automobiles, cell phone, gas cards, car insurance, internet home office costs etc,
- **Family and Relative Expenses** - Family members or others on the books, who draw a salary or receive other benefits but do not actually perform work for the company.
- **Commercial Facility Costs** - Commercial rent or property costs should always be adjusted to reflect actual market costs that would be incurred if the business premises were to be leased by the new owner at prevailing market rates.
- **Owner's Privileges** - Perks that will not exist under new ownership. Examples are personal meals, entertainment and memberships.
- **Owners benefits** - Owners benefits such as key man insurance or personal term or whole life insurance, as well as pension or RRSP contributions being paid for by the company.

Each individual company may have other costs or revenue adjustments that may be required; the above are the most common.

A review of the Balance Sheet should then be conducted to determine what the true retained earnings or net worth of the company is. This exercise helps identify other assets or liabilities that may impact on the valuation of the company. In the case of a share sale, this review will also help determine how much cash will be required to be left in the business as "working capital".

Other important shareholder items of concern are loans to, or advances from, the company, and capital gain taxation considerations

The final factor to be determined is appropriate multiple of EBITA; essential to establishing a provisional value of your company.

Sample Normalization Reports

ABC, Inc. Control Adjustments (\$000's)	As if Publicly Traded	Financial Control		Strategic Control	
		Type 1 Control	As Adjusted Type 1	Type 2 Control	As Adjusted Type 2
		Normalized			
Sales	\$10,000	\$0	\$10,000	\$0	\$10,000
COGS	\$5,800	\$0	\$5,800	(\$200)	\$5,600
Gross Profit	\$4,200	\$0	\$4,200	\$200	\$4,400
Litigation Settlement	\$0	\$0	\$0	\$0	\$0
Selling	\$700	(\$150)	\$550	\$0	\$550
G&A	\$1,500	\$0	\$1,500	(\$250)	\$1,250
Owner Comp	\$300	\$0	\$300	\$0	\$300
Chalet	\$200	\$0	\$200	\$0	\$200
	\$2,700	(\$150)	\$2,550	(\$250)	\$2,300
Operating Profit	\$1,500		\$1,650		\$2,100
Operating Margin (No debt)	15.0%		16.5%		21.0%

ABC, Inc. Normalizing Adjustments (\$000s)	Normalizing Adjustments			
	Reported	Type 1	Type 2	Normalized
		Nonrecurring Items	Normalize to Public Equivalent	
Sales	\$10,000	\$0	\$0	\$10,000
COGS	\$5,800	\$0	\$0	\$5,800
Gross Profit	\$4,200	\$0	\$0	\$4,200
Litigation Settlement	\$200	(\$200)	\$0	\$0
Selling (Cousin Joe)	\$800	\$0	(\$100)	\$700
G&A (Cousin Al)	\$1,800	\$0	(\$100)	\$1,700
Owner Comp (Big Daddy)	\$900	\$0	(\$600)	\$300
Chalet (Big Daddy's Vacation Home)	\$200	\$0	(\$200)	\$0
	\$3,900	(\$200)	(\$1,000)	\$2,700
Operating Profit	\$300			\$1,500
Operating Margin (No debt)	3.0%			15.0%

Standard Normalization Form

EBIT/ EBITDA Worksheet	Company Name	Current Year period	Previous Year	Forecast for Next Year
A worksheet to determine the real earnings and value of the company.				
Fiscal year end				
Sales				
Pretax Earnings from Inc. Statement.				
<i>Normalizing adjustments:</i>				
Interest paid (+)				
Principal's salary (+)				
Principal's perks, pension (+)				
Principal's profit sharing (+)				
Principal's insurance (+)				
Related party salary/div/bonus (+)				
Other - non-business related exp. (+)				
Rent adjustment (if +/- norm)				
Nonrecurring <u>extraord.</u> loss (+)				
Replacement manager(s) salary (-)				
Total of adjustments				
EBIT normalized				
EBIT as % of sales				
+Depreciation & Amortization				
Cash flow (EBITDA)				
Notes:				
EBIT: Earnings Before Interest & Tax				
EBITDA: Earnings Before Interest & Tax, Amortization & Depreciation				
Multiple of EBITDA – Value				

Source: <http://www.mercantilemergersacquisitions.com/business-valuations/ebit-ebitda-worksheet.html>