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Normalized Earnings Tell You How Profitable a Company Really Is

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Normalizing earnings can provide insight into a company's history and future. Performing this step is key in valuing a business, but it's also difficult work that involves more than merely reading the company's financial statements. Normalizing earnings require detailed analysis as well as an understanding of the company's current and future operations. Once you have that knowledge at your disposal, however, you can begin to see the true picture.

Adjustments to normalize earnings typically fall into three categories, economic, discretionary and nonrecurring.

Economic Adjustments

Economic adjustments relate to items affected by a company's accounting methods. For instance, the most common economic adjustment is for the basis of accounting. Many small businesses use the income tax basis. In addition to accelerating expenses such as depreciation, it also can ignore expenses (such as vacation pay and bad debts) or defer revenue (such as completed contracts.)

Other companies use the simple cash basis of accounting. This method records income only when cash is received and records expenses when they're paid. An analyst typically converts earnings to an accrual basis, which records income and expenses in the period earned or incurred, to determine normalized earnings.

Inventory also is important to examine. Some businesses record inventory on a last-in-first-out (LIFO) basis, which often understates inventory value and depresses earnings. Converting to first-in-first-out (FIFO) may provide a clearer picture of the company's balance sheet (financial position) but might not be the best picture of the cost of sales (earnings.)

Businesses should determine depreciation and amortization of their fixed or intangible assets by allocating the cost over the estimated lives of the assets. But many companies use lives and methods that have little, if any, relation to an asset's economic use and reduction in value. For example, a business may use accelerated tax methods to depreciate its fixed assets. These methods may allow it to depreciate equipment over five to seven years even though it may use the asset for 10 to 15 years.

Even more drastic, the company may elect IRC Section 179, which allows for immediately expensing the asset in the year acquired. Intangible assets may be amortized over 15 years as allowed under the tax method, or not amortized at all, as allowed under a new proposal for generally accepted accounting principles.

Discretionary Adjustments

Discretionary adjustments relate to items that are incurred or recorded at management's discretion. The most common discretionary adjustments are to the salaries, wages, and bonuses paid to owners and their family members and friends. These may be unnecessary business expenses (for example, payments to children who supposedly work for the company but really don't) or unreasonable in amount (say, a year-end bonus equal to 100% of regular salary). Estimating what the market would pay as reasonable compensation for such services and adjusting from the amount actually paid creates more representative, normalized earnings.

Another important issue relates to related-party transactions or business with customers or vendors who are related to the owner. An analyst will determine whether these transactions occurred at arm's length. An owner or a relative might, for example, own a building that's leased to the company. Does the rental rate reflect fair market value, or is excess rent a disguised dividend? Similarly, a company may buy or sell products or services from a related party. In this case, it's worth asking if the company is paying too much, or even too little. If so, an adjustment could be necessary.

Perquisites and benefits should be counted as discretionary adjustments. In fact, in this area, owners have maximum flexibility to disguise a business's true costs. Often, these expenses are difficult to uncover because the owner engages in "creating accounting", such as the burying expenses in payroll taxes, employee benefits or "miscellaneous operating expenses."

In addition to accelerating expenses such as depreciation, the income tax basis can ignore expenses or defer revenue. Or the owner might assert that these are reasonable and necessary business expenses such as pension/profit-sharing/401(k) matching; auto expenses (lease payments, gasoline, insurance and repairs and maintenance); insurance (life, disability and health); or travel and entertainment (country club dues and costs, vacations, sporting event tickets, personal meals, and other personal expenses). Professional fees (financial planners, legal and accounting) and utilities (cell phones and long-distance charges) also may fit within this category.

Nonrecurring Adjustments

Nonrecurring items typically are unusual in nature, such as a lawsuit settlement. They are onetime income or expenses included in the company's income statement that isn't expected to recur in the future. These items may come up in the ordinary course of business, but are unlikely to happen again. They may include a change in the company commission policy or a reduction of lease payments after the lease has expired.

Unexplained Uncertainties

If a company's financial statements show that it lost money this year, but the owner has just bought a vacation home in Hawaii, you need to know why. Perhaps the answer requires an adjustment to determine the company's normalized, or true, earnings.

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