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TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Normalizing Adjustments —Time to Revisit

By Rod P. Burkert, CPA/ABV, CVA

For most valuations, adjusting entity-level earnings to develop control and minority interest values has become a generally accepted business valuation practice. This is a good thing. It frees us from extrapolating data from questionable control premium studies that, in the aggregate, measure a combination of strategic control, financial control, and hubris and from interpolating implied minority interest discounts from those studies.[1] It's also a bad thing. Not all appraisers agree about the extent of the adjustments that should be made to entity-level earnings.

In adjusting entity-level earnings, appraisers make normalization adjustments. These adjustments reveal the base-level[2] earnings of the private company that is (a) the source of *realizable* value to a control interest buyer who will gain control over the benefit stream; and (b) the source of *potential* value to a minority interest buyer who must make decisions about how and when future value will be realized.

Understanding this is key, because it shows that normalization adjustments are required to develop an entity-level (not an interest-level) minority, marketable value, that is, an "as-if freely traded" value. This terminology in our various levels of value charts emphasizes that earnings are normalized to where they would be if our private company were public; it does not require that the private company have the potential to go public.

Most appraisers have little difficulty identifying and making the relatively "easy" normalization adjustments. Such adjustments remove the effects of unusual, nonrecurring items and the income and expense associated with nonoperating assets and liabilities. Rarely is there any debate about the propriety of making these adjustments.

The real controversy involves normalization adjustments that reduce officer/owner salaries to market levels and remove other discretionary expenses that would not exist in a well-run public company. Many appraisers do not make these adjustments when valuing a minority interest because they assert that a minority interest lacks the power to make such changes. These appraisers argue that these adjustments are "control" adjustments and that not adjusting for these items serves as a proxy for a minority interest discount. This position is not defensible, as can be seen from these related arguments[3]:

1. Minority shareholders in public companies also lack control over officer salaries and discretionary expenses. But they expect normalized operations, and generally, they get them.

1 A minority interest discount is derived from control premium information using the formula $MID = 1 - [1/(1 + CP)]$.

2 I say "base-level" benefit stream because in the valuation of a control interest, the buyer can make further adjustments that reflect his ability to run the company "better" (financial control) or operate it "differently" (strategic control).

3 As far as I know, Chris Mercer was the first to raise this issue and argue these points. See Mercer Capital, Sept. 24, 2004 and *Business Valuation: An Integrated Theory, 2nd Edition*, John Wiley & Sons Inc., 2008.

2. Using inadequately adjusted earnings implies, vis-à-vis a terminal value calculation or market pricing multiples, that a minority shareholder will be disenfranchised into perpetuity and never receive his/her pro rata value—even if/when the company is sold.

3. Discount rates based on market data and multiples obtained from guideline public companies are derived from normalized earnings and, therefore, should be applied to private company earnings that are similarly adjusted to a public equivalent basis.

4. Items 1, 2, and 3 place our private company at the minority, marketable level of value. If we start with adjusted earnings that are less robust, we are at some make-believe level of value—call it the "being taken advantage of minority, marketable" level of value.

5. Discounts for lack of marketability based on restricted stock studies and pre-IPO stock studies are deducted from the minority, marketable level of value, not a "being taken advantage of" level of value.

6. And finally, couldn't a rational hypothetical investor sue under a state's shareholder rights statutes if it was being permanently deprived of its pro rata value because of egregious owner salaries and discretionary expenses?

Let's face it, excessive owner compensation comes up more often in businesses that are "family-owned" and less often in those that are "closely held." In the family-owned cases, there seems to be a "nod-nod, wink-wink" atmosphere where control and minority owners know the compensation is excessive or that discretionary expenses exist, but no one questions the practice because it's mom or dad. Thus, it can be easy to rationalize not making an adjustment if the purpose is to value a minority interest in that business.

But I have a problem with this. At the extreme, what if excessive compensation and discretionary expenses take the cash flows of the company down to zero. Would we submit a report to the IRS claiming a zero value for the minority interest?

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Few, if any, appraisers would. So where do we draw the line as to when an adjustment needs to be made? Because once we admit that a line needs to be drawn, we might as well adjust for excessive compensation and discretionary expense in all cases.

Suboptimal earnings are transitory in the real world—the one that is being mirrored by the minority, marketable level of value. And normalizing officer salaries and discretionary expenses correctly reflects the fact that these items do not affect the value of the enterprise at the minority, marketable level of value. If we need to consider the impairment of value that owner salaries and discretionary expenses have on the value of the minority interest, we should consider it in our determination of the appropriate discount for lack of marketability.

It is often said that valuation is as much an art as it is a science; however, no one said anything about make-believe. If we do not make adjustments to normalize officer salaries and remove discretionary expenses, our conclusion cannot be at a minority, nonmarketable level of value. The result will be at some other level of value that is neither supported by valuation theory nor recognized in the valuation community.

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