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## MATRIMONIAL

## NEWSLETTER

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### THE NORMALIZATION PROCESS

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#### Introduction

Valuation analysts are required to obtain and analyze financial information in accordance with appraisal standards, including the Uniform Standards of Professional Appraisal Standards issued by the Appraisal Standards Board. In addition, if the valuation professional is a certified public accountant, he is required to follow Statements on Standards for Valuation Services issued by the AICPA.

#### Procedures

The first step is to obtain historical financial information of the subject business for a relevant period of time. Most analysts will request five years of historical financial information, but there is no rule.

Next, an analytical review is performed to determine trends and which income or expense accounts require additional scrutiny. Analytical techniques include ratio analysis, common size analysis, and identification of significant variances from averages and prior years.

Expenses are reviewed for their conformity with generally accepted accounting principles (GAAP) and industry practice.

Expenses that provide a direct financial benefit to the owner(s) are identified for substantive analysis. The following accounts are normally reviewed:

- Owner salaries
- Employee benefits
- Automotive expenses
- Travel
- Meals
- Entertainment
- Office supplies
- Computer expenses
- Credit card purchases, regardless of expense category

Discretionary expenses are also identified for substantive analysis. Discretionary expenses are defined as costs which are either non-essential or more expensive than necessary. Adjustments for discretionary expenses may not be appropriate for a minority interest. However, for 100% controlling interests, an analysis of discretionary expenses is required. The following accounts are normally reviewed:

- Payments to related parties, regardless of expense category
- Advertising
- Charitable donations



Once expenses have been identified for substantive analysis, general ledgers are reviewed to determine the need for normalization adjustments. Normalization adjustments include the elimination of non-recurring and non-operating expenses in addition to adjustments for discretionary items and non-GAAP amounts.

The standard used for appraising discretionary and non-operating expenses is consistent with the Internal Revenue Service (IRS) standard of “ordinary or necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” Ordinary expenses are those which are common to and accepted in the industry of the subject business. Necessary expenses are those that are appropriate and helpful to the subject business to maintain profitability at current levels.

Valuation professionals also follow the IRS substantiation rules for supporting documentation. Generally, adequate documentation includes cancelled checks, invoices, and receipts with written description of business purpose including date, place, amount, people in attendance, and reason for expense.

### Due Diligence

The analysis that is required by appraisal standards promotes a certain degree of due diligence on the part of a valuation professional. An appraiser cannot develop a credible appraisal if adequate information about the relevant characteristics of the subject business is not available. Generally, an appraiser is required to analyze information that is available to the appraiser in the normal course of business. The normal course of business is determined by the actions of an appraiser’s peers and by the expectations of the intended users.

For a valuation prepared in connection with a matrimonial action, the intended users are attorneys and judges who expect appraisers to review the documentation required by the internal revenue code. Brisbane Consulting Group is engaged on more than 200 valuation assignments each year, the majority of which are for matrimonial litigation matters. Because of the nature of our work and potential for trial, we require adequate documentation to support all business expenses and use the IRS standards.

### Summary

The objective of any valuation engagement is to develop a credible report which provides sufficient information to enable the intended users to understand the rationale for the appraiser’s opinions and conclusions. If information supporting the expenses of a subject business is unavailable, an adjustment is required to prevent report bias.

In practice, appraisers often utilize a risk-based approach to evaluate normalization adjustments. For private companies, the primary risk is understatement of income and overstatement of expenses. Accordingly, if supporting documentation for an expense is not provided by the business owner, it is presumed to be overstated.



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