

Normal is as Normal Does

In virtually any financial investigation of a business, where the ultimate goal is to value that business, it is almost always necessary to make adjustments – generally called “normalization adjustments” (to the reported income/expenses). This is also the case where valuation may not be the goal, but rather instead it is solely the determination of income that is at issue. The ultimate conceptual need – an understanding of the normalized level of income for the business – remains the same. For this purpose, normalized essentially has the same meaning as adjusted. In the broad sense, there are two types of normalization adjustments – the more benign adjustment is where there is no suggestion that anything was done incorrectly, but rather that the timeframe investigated had in it certain items (whether income or expense) that were abnormal, not expected to continue etc. An example of that would be where a business moved, and for a period of time had duplicative or overlapping rent. There is certainly nothing improper about that, the owner did not benefit from it, it was real – it is just not a normal expense and would not be anticipated to continue. Thus, the financial operational results need to be adjusted to reflect what would be a normal expected expense structure.

The other type of adjustment is the one more typically thought of, certainly by legal counsel and usually also by accountants. If we were to consider the previous example as a benign adjustment, this other type would be classified as a malignant adjustment. This includes a wide variety of items such as unreported income, family vacations run through as expenses, multiple cars on the books without business purpose etc. This type of adjustment suggests some level of taking advantage of the system, or wrongdoing.

Included in the former, benign type of adjustment, is reasonable compensation – which is often the largest adjustment, and which will not be addressed in this article. That area is worthy of its own separate article and full-fledged discussion. What is also not covered in this article, and an area that warrants multiple articles on its own, is unreported income. This article’s focus will be on selected types of “malignant” adjustments – typically where we find them to be large. These type of adjustments are also the type that tend to have a significant impact on the income taken (or available to be taken) by the business owner.

- **Income Shifting** – This type of adjustment generally means that near the business year end (typically December 31st) tax planning type attention is given to the income/sales so as to not recognize revenues at that time, but rather push them back into the following month, which therefore means the following year. There are essentially two ways this is

done, and the choice of which generally depends on the manner by which the business reports its revenues – cash basis or accrual basis.

- ⊕ **Cash Basis** – This means that income is recognized when received (rather than when earned) and expenses are deducted when paid (rather than when incurred). This is the typical fashion by which most small business (other than those with inventories), as well as virtually all professional practices, report their income and expenses, how they file their tax returns. In concept, deferring income in a cash basis business is easy, and is practiced all the time. All that is involved is that when monies are received from customers/clients, the money is held back and not deposited until a later point in time. Typically what we have is a professional practice reporting on a December year end, which does not timely report the money it receives for the last week or two (or more) in December. Checks are held back, put in a drawer, and deposited in early January.
- ⊕ **Accrual Basis** – This type of record keeping or reporting means that income is recognized when earned (generally meaning when billed) rather than when received; and expenses are recognized when incurred, rather than when paid. This type of system, as a result, requires the recording of accounts receivable (billings that have yet to be collected). Using a law firm as an example, this also includes work in progress (WIP) – which is income that has been earned but not even billed. Also taken into account are accounts payable or accrued expenses (which means expenses that have been incurred by the business but as yet remain unpaid). Most medium and larger businesses report on this basis – and even those that report on a cash basis, may maintain (or have the ability to maintain) internal records on an accrual basis.

The income deferral game here is a little more sophisticated than that practice previously discussed as to a cash basis business. With a business on an accrual basis, whether or not the funds are received, whether or not the funds are deposited, is irrelevant. The issue here is whether the funds have been earned (understand that we are allowing for an appropriate estimate of a reserve for collectability – the discussion here is assuming good receivables). Thus, if we had a situation where in the last week of December a customer paid a \$100,000 outstanding bill, for our purposes it would not matter at all whether or not that \$100,000 was deposited. If it was, cash revenues would increase by \$100,000 but receivables would decrease by \$100,000. On the other hand, if the money was not deposited, the books and records of the business would still reflect a \$100,000 receivable – which got on

the books and records by recording a sale in that amount. Thus, the deposit or non deposit for a business on an accrual basis has no bearing on its income. The way “the game is played” in such a situation, is by holding back billings.

- **Payroll** – As referenced above, we are not going to be addressing reasonable compensation for the owner, but rather payroll expenses for other than the owner that are inappropriate, excessive or otherwise crying out for rectification. Adjustment in the payroll area usually takes one of two forms:

- ⊕ **The really good friend on the books** – Classically, this is a paramour of one form or another, a girlfriend or a boyfriend (or both for the truly modern sybaritic business owner). Many times, the adjustment required here is not simply adding back the payroll of this paramour, but the more complex issue of determining reasonable compensation because in many cases the paramour truly works in the business, but is getting paid considerably more than a fair compensation. Unlike a reasonable compensation adjustment for a business owner (which does not change the amount of money earned or available/taken by the business owner at all), an adjustment here is a determination by the accountant that the owner is earning (and usually in one form or another realizing) additional compensation/income by virtue of diverting some of what would otherwise be his/her income, giving it unreasonably and without justification to someone else.

- ⊕ **Family on the payroll** – The other common payroll adjustment does not involve putting a big red letter A across the front of the Company’s books and records. Rather it is a consequence of the business owner having one or more family members (typically a spouse or children) on the books. These are generally easier to adjust, because usually these people are not really working, or if they are it tends to be nominal, and the adjustment is often the payroll they receive in its entirety, or close to it.

- **Depreciation** – First, let us briefly define depreciation and address a certain semi-myth. Depreciation is the paper write off of the cost of long term or fixed assets over their expected useful lives. What this means – in a very oversimplified fashion – is that if a business spends \$100,000 for a conveyor belt system for the factory, and that system is expected to have a 10-year life, the Company will take a depreciation deduction of, will write off as an expense, \$10,000 per year for 10 years. The semi-myth is that depreciation is not a real expense. It is a real expense, it is just one that may not necessarily show up as an expense in lockstep with the expenditure of funds. Assume that \$100,000 conveyor belt was

purchased in 2013, but is written off over the 10 years 2013 through 2022. In years 2014 forward, there is a depreciation expense deduction by the Company for which there is no directly connected cash outlay. That is because the cash outlay was \$100,000 in the year 2013. There was a real cash outlay, it's just that the depreciation expense may not be in the same year. Since this conveyor belt system will be used up (meaning it will need to be replaced), the expense is very real, and the purpose of depreciation is to provide a mechanism by which a business can write off a long term asset over its life expectancy.

What was just described is all well and good in theory – but the tax law often plays havoc with economic reality. If you have quality financial statements (at least a review if not an audit level), you very well may have depreciation expense that can be relied upon without further adjustment – not necessarily, but in theory yes. However, for many businesses, you will have only tax returns (which we all know are tax motivated) or you may have compilation financial statements that are not required to be consistent with good accounting principles. In those cases, you are probably looking at depreciation that was tax determined rather than economically determined. This is especially the case in the past several years as a result of the massive changes in depreciation tax law brought about as an outgrowth of the reactions to September 11th.

The above briefly highlights some of the typical critical large adjustment areas. There are many other potential areas of adjustment, some of which can be substantial depending upon the particular situation. These include, by way of example, travel and entertainment, meals, office supplies, repair and maintenance – virtually anything. The reality is that the need for normalization adjustments can arise in any income or expense category. For instance, in many manufacturing businesses, the largest single expense is cost of goods sold. In theory, this is where the Company reflects its direct costs, those related directly to the products sold. In a retail clothing business, costs of goods sold would represent the cost of the clothing that was purchased wholesale, which then in turn is to be sold retail. For a manufacturing operation, costs of goods sold would include the raw materials (and various other items depending on the level of accounting sophistication) that are used to manufacture the specific product. By its very nature, because it tends to be a very large dollar value account, and often one with a high volume of transactions, it is also at times used as a dumping ground for almost anything that the business owner wants to bury. It does not matter that what is being run through this expense category has absolutely no relationship to costs of goods sold. It is simply a convenient place to bury an expense where it is less likely to be uncovered. In one particularly egregious situation we handled, the owner treated the purchase of \$400,000 of raw land (a personal investment) as if cost of goods sold for his business.

Because there are so many ways to bury expenses, to distort (generally meaning reduce) a business's income, the normalization process which the investigative accountant needs to apply in order to preserve the American way of life and to right those terrible wrongs, must be applied uniquely in each and every case.