

## Benchmarking: Why Normalizing Adjustments are Essential

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Financial statements aren't particularly meaningful without a relevant basis of comparison. There are two types of "benchmarks" that a company's financials can be compared to — its own historical performance and the performance of other comparable businesses.

Before you conduct a benchmarking study, however, it's important to make normalizing adjustments to avoid any misleading comparisons. This is especially important when looking at periods that include atypical financial results due to the novel coronavirus (COVID-19) pandemic. But there are a variety of factors that require normalizing adjustments.

### Nonrecurring Items

Some normalizing adjustments are needed to distinguish between historical results that represent potential ongoing earning power and those that don't. A one-time revenue (or expense) or gain (or loss) will temporarily distort the company's results. To more accurately reflect the company's future earnings potential, you would add back expenses and losses (or subtract the revenues and gains) that aren't expected to recur.

For example, if a retailer temporarily closed its brick-and-mortar stores during the COVID-19 pandemic, you'd add back the temporary losses to get a clearer picture of operating performance under normal conditions. Likewise, if a company won a \$10 million lawsuit, you'd subtract the gain. Other nonrecurring items might include discontinued product lines or expenses incurred in an acquisition.

### Accounting Norms

Other normalizing adjustments compensate for the use of different accounting methods. Because companies' accounting practices vary widely, comparing them without adjusting their financial statements is like comparing apples to oranges.



Even within the broad confines of Generally Accepted Accounting Principles (GAAP), it's rare for two companies to follow exactly the same accounting practices. When comparing a company's results to industry benchmarks, you need to understand how they report transactions.

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### Accounting Norms (continued)

A small firm, for example, might report earnings when cash is received (cash basis accounting), but its competitor might record a sale when it sends out the invoice (accrual basis accounting). Differences in inventory reporting, pension reserves, depreciation methods, tax accounting practices and cost capitalization vs. expensing policies also are common.

### Related-Party Transactions

Another type of normalizing adjustment focuses on closely held businesses. They often pay owners based on the company's cash flow or the owners' personal needs, not on the market value of services the owners provide. Small businesses also may employ family members, conduct business with affiliates and extend loans to company insiders.

To get a clearer picture of the company's performance, you'll need to identify all related-party transactions and inquire whether they occur at "arm's length." Also consider reconciling for unusual perquisites provided to insiders, such as season tickets to sporting events, college tuition or company vehicles.

### We Can Help

To complicate matters, normalizing adjustments can affect multiple accounts. While most normalizing adjustments are made to the income statement, some may flow through to the balance sheet. Our accounting professionals can help with these critical adjustments to a company's financial statements, enabling you to make better-informed business decisions. [Contact us](#) if you have any questions.