Case Study - My Business is Worth More than That!!

Now I would hazard a guess that the typical business owner has never heard the term Seller Discretionary Earnings. If you want to sell your business in the future then this is a term you should become familiar with. Related terms include cash flow (an erroneous term for our purposes here), EBITDA, adjusted EBITDA or net profit. The closest of these to a correct definition of Seller Discretionary Earnings would be adjusted EBITDA or Earnings Before Interest Taxes Depreciation and Amortization adjusted for seller economic benefits often buried in the profit and loss statement.

We could write a book on this topic but suffice it to say for this brief introduction that, at its core, what any acquirer of a business is purchasing is a future stream of income. And the more certain, and well documented, that future stream of income, the more an acquirer will pay for your business. Therein lies the significance of Seller Discretionary Earnings. Businesses are valued taking into consideration many factors – asset quality, industry segment, duration in business, operating structure to name but a few – but the core of any valuation is going to be the economic benefit the current owner derives from the business - otherwise known as Seller Discretionary Earnings. From this number a multiple is applied to arrive at a market value. Again, we could write a book on this topic but for purposes of this writing let's just say that if you are going to sell your business you should clearly document Seller Discretionary Earnings.

Let me give a couple of examples. While sitting at the closing table – and you just can't make this stuff up – my seller casually mentioned to the buyer "and you get the bonus of knowing that $25,000 of the cost of goods was paid to me." Wow. Trading at two times Seller Discretionary Earnings this seller just left $50,000 on the table. Her bookkeeping was less than adequate and despite our request for her to identify all monies paid to her on the profit and loss statement somehow this significant detail was not relayed to us until it was too late. On another occasion our seller was forthright with us and relayed to us that a significant amount of money for the construction of his new house could be found in the cost of goods for the year. The bad news is we had to print a twenty page detailed General Ledger report on his cost of goods and dig in line by line to extract those expenditures which was very time consuming. The good news is that the $80,000 we identified and supported with documentation supported a value almost $175,000 more than originally anticipated.

Lesson Learned

If a business owner does not clearly document Seller Discretionary Earnings then they are leaving money on the table when it is time to sell. If automobile expenses, cell phones, and other payments are made by the business on behalf of the owner or family members that have no economic benefit to the company then those expenses should be added back to an EBITDA calculation as an economic benefit the owner derives from the business. The failure to do so can be costly. For example, a business trading at three times Seller Discretionary Earnings with, say, $40,000 in unidentified personal expenditures has just left $120,000 on the table at closing.

TIP (Thoughtful in Preparation)

First, identify those expenditures that are not necessary for the operation of your business. Secondly, identify those expenditures that are a direct benefit to you, the owner. Those would be salary, health insurance, cell phone, automobile expenses, life insurance and other deductible expenses paid for your benefit by the company. Once those are identified meet with your accountant to properly code those expenditures as a subaccount. In that manner you can easily isolate and document those expenditures. To make it even easier for coding purposes consider utilizing separate credit cards for personal expenditures for you or your spouse such as gas, auto maintenance and other expenses. Doing this makes it much easier for your accountant to code these expenses in the proper subaccount as they will immediately know that charges on a certain card are for your personal benefit. Finally, once this is in place, organize a filing system with receipts that document the individual line items on the subaccounts. If you will take these three small steps you will be assured that you will not leave value (i.e. money) on the table when you sell. And a side benefit of this is when reviewing financial statements you can easily remove these expenditures when measuring company performance.

Charleston BUSINESS BROKERS PLAN • PREPARE • MAXIMIZE VALUE ***Established 2000. Experience matters.. especially when you are entrusting the sale of your most valuable asset, your company, to a third party intermediary. Put a system in place to accurately record your Seller Discretionary Earnings and reap the benefits when it is time to sell. Experience in dealing with the complexities of the business sale process really does matter. Receive the results you deserve by starting with the right intermediary. Call us at (843)601-5030; Email us at info@charlestonbusinessbrokers.com; or visit us on the web at www.charlestonbusinessbrokers.com.***