What is <u>Discretionary Earnings</u>, and Why is it the Most Important Driver of Small Business Value?

DEFINITION: Discretionary Earnings (DE) is an estimate of the total financial benefit a full time owner-operator would derive from a business. It is also referred to as Discretionary Cash Flow, Total Owner Benefit, or Normalized Earnings.

Business owners and their accountants employ various tax strategies intended to keep reported net profit as low as possible, in order to save taxes. Identifying and accounting for those tax strategies to accurately reflect the real earnings history of the business is therefore critical in determining the value of a business. In fact, the amount of the real, total benefit produced by a business for its owner in the past is the most important piece of information for a buyer to know with certainty. It helps answer the question, "If I buy this business, how much can I make?"

The term *discretionary* is used to indicate that this is the amount of cash flow produced by the business after all expenses which could be used in any way the owner might choose. The three primary uses of Discretionary Earnings are to 1) service the debt incurred to purchase the business; 2) provide the business owner a salary for managing the business; and 3) provide the owner a return on the investment (down payment) made to purchase the business.

CALCULATION: Discretionary Earnings are not the same as net profit, but the net profit of a business is the starting point for determining DE. According to the International Business Brokers Association, which provides guidance in the proper procedures for determining Discretionary Earnings to lenders, accountants, business intermediaries, and business owners, nine types of adjustments must be made to net profit to arrive at Discretionary Earnings:

1) Any non-recurring income that is included in net profit, such as gain from the sale of a piece of equipment or interest earned on investments, must be subtracted from the net profit.

2) Any expenses that are direct owner benefits, such as owner salary or fringe benefits, must be added back to the net profit, since they are non-recurring (a buyer will not pay them in the future).

3) All non-recurring expenses that are deducted and are unlikely to recur must be added back to net profit. These might include a one-time purchase of an alarm system, or point of sale system, or lawsuit expense.

4) Any non-cash expenses such as depreciation or amortization must be added back, since no cash was expended for these expenses.

5) Any discretionary expenses that the owner might have deducted are added back to the net profit. These are expenses deducted by the business that were not strictly necessary for its successful operation, and which a new owner might choose not to incur. Business trips for which the primary purpose is a vacation with the family, or country club membership or luxury car leases are examples. Deducting these items may be appropriate perks of owning a business, but not required for the business to succeed. To qualify as discretionary, the expense must meet all of the following criteria:

a) It must primarily benefit the owner, and not materially benefit the business or its employees
b) It must be paid for by business and included as a deduction on the tax return/income statement
c) A prospective buyer must be able to document the expense and verify it as discretionary

6) An adjustment must be made to historical statements for any expense or income item which will be higher or lower in the future. For example, if rent will increase $500 in September of the current year, all statements prior to then must have the extra $500 per month imputed as an expense. Because the purpose of looking at historical statements is to obtain an idea of what future earnings may be, all known changes in the business model affecting future earnings should be included as adjustments in the recasting process.

7) If one of two owners, typically a spouse, has been performing duties for the business without pay, an amount of additional wages must be imputed to account for hiring someone to perform those duties.

8) Discretionary Earnings must be calculated on the basis of the owner being an owner/operator.

9) Occupancy Cost: The Occupancy Cost is the rent being paid, if the business rents the space from which it operates. If the rent is currently market value, no adjustment is necessary. If the rent is under market, an adjustment must be made adjusting the rent expense to what the buyer will pay if they buy the business.

If the space from which the business operates is owned by the seller of the business and is for sale with the business, an adjustment must be made to account for the Occupancy Cost the buyer will incur if they buy the business and real estate. An adjustment must be made to adjust Occupancy Cost to the rental market rate of the real estate, or to the estimated debt service on the real estate the buyer will incur if they purchase it.

The intent of the process of calculating Discretionary Earnings, called *Recasting* or *Normalizing* the financials, is to determine the amount of cash flow a business has provided its owner in previous normal time periods, with no non-recurring income received, nor unusual or unnecessary expenses incurred. Buyers use the calculated Discretionary Earnings as an indication of how much cash flow the business might provide them in the future, if they operated it no better and no worse than the current owner.

The calculations determining the DE of a business are based on its historical results, which are often the best available indicator of future profitability. However, the actual results achieved by a new owner could be different because of a change in economic conditions, the new owner's management style, and a myriad of other factors.