Review of Business Brokerage and Business Sales

Nevada requires a Business Brokerage permit to engage in the sales activities directly sounding the sale of a business. Nevada real estate licensees who wish to add this permit must first complete a 24 hour Business Brokerage permit course and then pass a state licensing exam to add the permit to their license. Once the permit is active, the licensee can practice business sales. The million dollar question remains, what is considered a business under said licensing law?

When the Nevada legislator passed original regulations pertaining to Business Broker licensing and permitting in 2007, many questions remained about the requirement and what entities were classified as a business. Specifically, what could a real estate licensee sell without the permit and when is a permit required.

The licensing law was further defined within the 2009 legislative session to illustrate what is now known as the 50/50 rule. In summary, if an entity reports at least 50% of its profit or loss as a direct result of real property, the entity is not considered a business and therefore a business brokerage permit is not required to sell the real property. Examples of such entities that report a profit as a result of the real property are:

- Apartment Complexes
- Hotels
- Ranches
- Mining Claims
- Rental Properties
- Commercial Shopping Centers
    - Any other real property wherein the profit or loss generated is a result of the real property (At least 50% of the margin)

As redefined within the 2009 revisions, entities that generate their profit as a direct result of a product or service are defined as a business and therefore require the business brokerage permit to sell the business. Examples of such businesses are:

- Restaurants
- Bars
- Casinos
- Gas Stations
- Professional Businesses
- Medical Practice
    - Any other business that generates a profit as a result of a product or service.

Business Brokerage

Many states, including Nevada, require that anyone engaged in the practice of business brokerage be a licensed real estate agent or licensed real estate broker. The logical conclusion that one may draw from this requirement is that business brokerage is much like real estate brokerage. Making such an assumption is largely incorrect. Some of the differences between real estate sales and business brokerage are:

Real Estate Brokerage	Business Brokerage
The average home sale price is around $200,000 to $300,000 in this area	About 54% of all businesses in the US gross less than $325,000 per year and have little or no market value. The vast majority of business that are sold each year occur at transaction prices less than $100,000
Almost any home that is priced reasonably in this market will sell.	Only about 1 out of 5 businesses put up for sale will sell
The principal focus on the sale of residential property are its location and features	The principal focus on the sale of a business opportunity is its historical and expected future financial performance.
The fact that a home or commercial property is for sale is widely publicized	That fact that a particular business is for sale is generally a highly guarded secret
The more people a sales agent can get to pass the word that he or she has a listing on a property, the better.	It is a universal practice in business brokerage to require any prospective buyer who is shown the business to sign a formal agreement promising not to disclose to anyone that they know the business is for sale or any facts about it they learned from the sales agent, seller or seller's employees.
Within any given region of the country, most real estate agents use the same listing form and Offer and Acceptance contract	Typically, the listing agreements sales agreements and most other business forms used by business brokers are unique for each office (and often quite dissimilar)
The commission a real estate agent charges is generally stated as a certain percentage of the selling price, e.g., 5% or 6%, etc.	The commissions charged by business brokers are often based on a sliding scale such as 10% of the 1st $100,000 in selling price, 8% of the next $500,000 in selling price, etc.

Real estate sales agents generally do not charge a minimum commission	In business opportunities, a minimum commission is almost always a condition of a listing contract
Real estate sales agents generally do not charge an advance fee for service in this market	It is a very common practice for business brokers to charge a non-refundable advance fee or non-refundable “retainer” to list a business for sale
It is unheard of for a real estate agent to charge a client an hourly, non-refundable fee for the service they provide rather than a commission at closing.	Although not highly prevalent at this time, there is a growing tendency for business brokers to offer clients the option of paying them an hourly, non-refundable fee for service, generally above $100 per hour, with a small—say 2 or 3 percent—commission, called a “success fee” upon closing.
The amount of time a real estate agent must spend preparing sales and marketing material for a home is generally not more than a couple of hours	Properly developing the marketing material for a business opportunity (regardless of size) can take anywhere from 20 to 40 hours.
With the exception of the cash buyer, homes sales are financed via a home mortgage lender. In every case, this lender will require an appraisal of the real estate as a condition of sale.	Seldom does a formal appraisal by a professional business appraiser accompany the sale of a small business. In fact, even when there is third-party SBA financing, the lending bank often does not require an appraisal of the business
Because the purchase of a home almost always includes a formal, professional appraisal, buyers seldom end up over-paying for a property (or significantly so)	Because the purchase of a small business almost never includes a formal, professional appraisal, buyers often over-pay for the acquisition (sometimes by as much as double or even triple the value an appraiser would likely ascribe to it).
The cost of a professional home appraisal is around $350 plus or minus a little	The cost of a professional business appraisal will run between $5,000 and $12,000 regardless of the business’s size. Most business appraisers will accommodate small business buyers or sellers with so called “limited” or “ball park” valuation analyses for around $2,500. However, “quick-and-dirty” business “valuations” may be obtained via the internet for as little as $200, but the accuracy of such work is questionable.
Every state in the country requires that real estate appraisers be certified (and regulated) by the state. Accordingly, a consumer can safely assume that a real estate appraiser’s work product is reasonably accurate.	There are only 5 things that an individual *must* have to become a business appraiser anywhere in the country: (1) a shingle; (2) a can of paint; (3) a paintbrush; (4) a hammer; and (5) a nail. For this reason, there are many

	charlatans and con artists representing themselves as “business appraisers” whose work product is pure garbage. What’s worse, some of them actually possess some kind of business appraisal certification. It is difficult for the average business owner or business opportunity broker to know if any particular business appraiser and his or her work product is credible. Business Appraisal is a totally unregulated profession in the U.S.
Most owner/sellers of real estate have a fairly realistic idea of what their property is worth—say within 10 to 15% plus or minus.	It is very common for small business owners to believe their businesses are worth anywhere from twice to five times their most likely selling price
Real property sellers generally will not partially finance the sale of their property by taking back a second mortgage or promissory note from the buyer	In about 70% of all small business transactions, sellers partially finance them by carrying some portion of the selling price in a promissory note, known as a “seller carry-back note” from the buyer
Typically, most real property is advertised for sale through the MLS	Most business brokers will have nothing to do with the MLS. By far, the most common way to advertise a business for sale is via the internet
Co-brokerage is common in real estate sales. In fact, it is mandatory for real estate advertised in the MLS	It is common for business opportunity brokers to refuse to co-broke a deal and split their commission with the buyer’s agent
When selling real estate, the sales agent is selling only one thing—the real property	Many business owners also own the real property within which their business is operated. In these situations, the best practice is to list, price and advertise the business and the real property separately (and typically, altogether differently or not offer the real property for sale at all)
Real estate is seldom if ever sold as a “sale of company stock” The real property is sold as a single asset of the seller.	In some business transactions, the seller sells and the buyer buys the corporate stock (as opposed to the company’s assets). In this case, the buyer gets all of the seller’s assets and assumes all of the seller’s liabilities. The liabilities the buyer assumes includes *all* debts of the seller whether disclosed or not. This also means that if the business is sued for any reason for something the seller did before the transaction closed, that lawsuit becomes the buyer’s problem in a stock sale upon close of escrow and the seller walks

	away scott free.
When selling real property, that which is offered for sale is offered in its entirety. Seldom do buyers assume any outstanding debt on the property. All debt on the property owed by the seller is paid off at close of escrow	Most small business are sold as "asset sales" (as opposed to "stock sales"). In an asset sale, the seller never intends to sell all of his assets. He will keep some and sell some. Likewise, it is common—even an absolute necessity in some instances—for the buyer to assume some of the seller's liabilities (debts) as a condition of sale.
Because the sale of real property is a sale of the property in its entirety and the buyer will not be assuming any of the seller's debts, there is only one selling price. (i.e., you don't selectively buy certain parts of a home and excluded others. E.g., I'll buy everything except the doors, windows and light fixtures. The seller can keep those and I won't pay for them).	The specific assets a seller will keep and which he will sell and which debts he will pay off at close of escrow and which the buyer may (or must) assume are all open for negotiation. Thus there are potentially dozens of "deal structure" combinations that may be considered by the negotiating parties and hence dozens of possible asking/selling prices for a business at a single point in time.
A real estate appraiser researching the selling prices of homes or commercial property comparable to a property he is appraising would never select a similar structure located in another state and/or use as a comparable a transaction that occurred four or five years ago. The selling price per square foot for similar structures situated in different regions of the country (or even different regions of the same town) often are significantly different. Likewise the selling price per square foot for a structure today in this market is almost certainly going to be significantly higher than the selling price per square foot for a similar structure five years ago. Moreover, during downturns in the economy—i.e. during recessions and high unemployment—both the selling price per square foot for homes and the selling price to earnings ratios for shares of stock in publicly traded companies tend to decline measurably	Statistical studies of the selling price to earnings ratios, and selling price to gross sales ratios for small businesses have demonstrated that there is no measurable difference in these selling price ratios for businesses in different parts of the country and/or for businesses sold years earlier. Thus it is an acceptable and common practice for a business appraiser to rely on a statistical sample of selling price to earnings ratios for similar businesses—say pizza parlors—that sold several years ago on the opposite end of the country to base an opinion on the fair market value today for a pizza parlor in Reno or Las Vegas. Likewise, the selling price to earnings ratios for small businesses tend to remain quite stable during periods of recession in the economy. Indeed, it is believed by many business brokers that periods of high unemployment—especially in "white-collar" employment—may actually cause a slight *increase* in the selling price to earnings ratios for small businesses due to an increase in demand caused by a increase in the number people who have lost their jobs but have enough money (or credit) available to buy a

	small business.
There is a legally required “Sellers Disclosure Statement” that a residential home seller must complete and deliver to the buyer. This statement is comprised of around a dozen questions regarding the condition of the home.	A business owner is not legally required to disclose anything about his business to a buyer (with the exception of any real estate that is included in the transaction). It is entirely up to the buyer to ask the right questions about the business—and the questions that should be asked are numerous. The “Seller’s Disclosure Statement” included in this training manual as an example and reference for students is 61 pages long.

Understanding Financial Statements

By far, the single most important attribute of a business that a buyer considers is its expected future profit generating capability. The principal "language" of business brokerage is the language of finance and financial analysis and it is virtually impossible for anyone to competently represent business sellers or buyers without the ability to read and understand a business's financial statements. It is impossible for a sales agent to formulate a reasonably accurate opinion of a business's likely selling price, how best to market it and what advice to give a client regarding a buyer's offer and/or the terms of sale a seller demands if that agent has little or no financial analysis skill.

Thus a compelling argument can be made that a licensed real estate agent representing business opportunity buyers and sellers who cannot properly interpret financial statements is not competent to pursue that line of work. To engage in business brokerage despite the inability to interpret financial statements is a high-risk endeavor and one that will eventually result in mistakes of judgment and advice to clients that can cause them great financial harm. Licensed agents should keep in mind that NRS 645.633 (h) specifies that gross negligence or incompetence in performing any act which requires a real estate sales license is grounds for disciplinary action.

NRS 645.633 notwithstanding, you can talk to any competent business opportunity broker who has worked with another agent unskilled in business opportunity brokerage that was representing either the seller or buyer client in transaction negotiations regarding a business listing and you are likely to hear a horror story.

The ability to read and understand a business's financial statements and draw reasonably correct impressions and conclusions about the business from them *does not* mean one must possess the knowledge and skill to *create* financial statements. In other words, a sales agent does not have to be a bookkeeper or accountant and therewith be able to *prepare* financial statements in order to interpret them. However having or acquiring those skills will often prove beneficial to an agent and his or her business opportunity clients.

An introduction to the interpretation of financial statements

The practice of management is embodied in five fundamental tasks: planning, organizing, staffing, controlling and leading. To some degree, well-developed financial statements assist in all of those activities. However, a firm's financial statements are among the principal tools required for effective planning and control. Thus, the better the quality of a firm's financial performance reporting, the better the owners can be at those tasks.

A company exhibiting excellent financial reporting will routinely (generally, monthly) produce three reports: the Profit & Loss Statement, the Balance Sheet and the Cash Flow Statement. From my experience, I can say that the Profit & Loss Statement is the report small business owners tend to rely on the most, and it is certainly the most important report that a prospective buyer wants to see.

The Profit & Loss Statement is comprised of rows and columns of information. The rows are the descriptions of revenue and expense accounts, subtotals of various account categories and, of course, the quintessential bottom line: "net profit," which is the difference of revenue minus expenses. The order in which revenue and expenses are arranged on the P&L and the kinds of subtotals appearing on this report greatly affect its usefulness.

The standard practice for every type of business is to report sales revenue first. For most small businesses, the area with the most room for improvement is how a business's various expense accounts, account categories and subtotals appear on the P&L.

Every business's operating expenses are comprised of two fundamental types: variable costs and fixed costs. Variable costs are those that vary nearly directly with a business's sales volume. The best example of a variable cost is the cost of goods sold. When sales volume goes up, so does the cost of goods sold. Conversely, if sales volume drops, so does this cost. If sales volume is zero, the cost of goods sold would also be zero. In other words, it is the level of business activity that drives a business's variable costs.

Fixed costs, on the other hand, are not directly determined by the level of business activity (over the short run). Good examples of fixed costs are rent, depreciation, interest on fixed debt and liability insurance premiums. Obviously, none of these fixed costs remains the same indefinitely; the term "fixed" only means that they do not rise and fall proportionally with the ebb and flow of sales volume from month to month.

Grouping variable and fixed costs separately on the P&L is central to effective planning and control. This is because the way in which this cost data is employed in planning and analyzed for the purpose of control is different. It is standard practice to report variable costs first, then fixed costs. Thus, the basic structure of the P&L should look like this:

Sales Revenue	$
Variable Costs:	
Cost A	$
Cost B	$
Cost C	$
Total Variable Costs	$
Contribution Margin	$
(Sales Revenue minus Total Variable Costs)	
Fixed Costs	
Cost D	$
Cost E	$
Cost F	$
Total Fixed Costs	$
Total Costs	$
Net Profit	$
(Sales Revenue minus Total Costs)	

It is also standard practice to report the Cost of Goods Sold as the first variable cost for businesses that sell merchandise and to report the difference between this cost and sales revenue as the Gross Margin. For such businesses, the first part of the P&L should look like this:

Sales Revenue	$
Cost of Goods Sold	$
Gross Margin	$
(Sales Revenue minus COGS)	
Other Variable Costs:	
Cost A	$
Cost B	$
Cost C	$
Total Variable Costs	$
Contribution Margin	$
(Sales Revenue minus Total Variable Costs)	

Additionally, all costs, in particular variable costs, associated with one fundamental cost category should be grouped together and subtotaled. For example, Cost A above could be Direct Labor Cost. Thus, on your P&L, Cost A should look something like this:

Direct Labor Cost	
Straight time pay	$
Overtime pay	$
Vacation pay	$
Sick pay	$
Employer payroll taxes	$
Total Direct Labor Cost	$

The order in which the variable cost categories (i.e., Direct Labor Cost, Marketing, Repairs & Maintenance and so forth) appear on the statement is not critical. I recommend they be presented in descending order of magnitude, but that's just my preference. Additionally, the types of cost categories that should be established for a business depend on the type of business. Here I recommend using categories that are the standard practice within a particular business’s industry.

And finally, as you focus on various costs to determine if they are variable or fixed, it will become evident that many of them contain elements of both; they are hybrid costs, so to speak, and it's not obvious in which category they most appropriately belong. It may be best to allocate them to a variable or fixed category, depending on what they are most nearly like. Or, you may allocate some subjectively determined portion to variable costs and the balance to fixed costs. Similarly, there may be a fixed cost, for example Yellow Page Advertising, that you feel should be more appropriately included within the Marketing category as a sub-component of that variable cost. Ultimately, it's all a matter of judgment about which way will best facilitate useful interpretation. Creating excellent financial statements is as much an art as it is a science.

Billy Bob's Barbecue

INCOME STATEMENT

For the Year Ending 12/31/05

Gross Sales	$1,073,348	107.2%
Less Sales Tax	-$72,091	-7.2%
Net Sales	**$1,001,257**	**100.0%**
Cost of Goods Sold	$433,248	43.3%
Gross Margin	**$568,009**	**56.7%**
Variable Costs		
Labor		
Direct Labor	$185,324	18.5%
Overtime Labor	$5,560	0.6%
Vacation Pay	$7,413	0.7%
Employer's SSN	$14,316	1.4%
State Unemployment Insurance	$954	0.1%
Federal Unemployment Tax	$954	0.1%
Worker's Comp Insurance	$12,407	1.2%
Total Labor Cost	**$226,929**	**22.7%**
Marketing		
Newspaper Ads	$22,000	2.2%
Radio	$18,000	1.8%
Yellow Pages	$500	0.0%
Direct Mail	$3,542	0.4%
Total Marketing	**$44,042**	**4.4%**
Other Variable Costs		
Cleaning Materials	$6,500	0.6%
Small wares	$2,800	0.3%
Outside Maintenance	$7,500	0.7%
Repairs	$9,500	0.9%
Charitable Contributions	$3,000	0.3%
Total Other Variable Costs	**$29,300**	**2.9%**
Total COGS & Variable Costs	**$733,519**	**73.3%**
Contribution Margin	**$267,738**	**26.7%**
Fixed Costs		
Rent	$120,000	12.0%
Depreciation & Amortization	$27,895	2.8%
Utilities	$17,000	1.7%
Property & Liability Insurance	$5,000	0.5%
Interest on Bank Loan	$12,345	1.2%
Automobile Expenses	$5,400	0.5%
Travel & Entertainment	$7,564	0.8%
Dues & Subscriptions	$650	0.1%
Owner's Salary	$55,000	5.5%
Overhead on Owner's Salary	$1,155	0.1%
Owner's Health & Life Insurance	$6,500	0.6%
Total Fixed Costs	**$258,509**	**25.8%**
Net Profit	**$9,229**	**0.9%**

Definitions of Earnings:

Pre-Tax NOI =	**Pre-Tax Net Operating Income** = a.k.a Pre-Tax Net Profit or Earnings Before Taxes (EBT)	**$9,229**
NOI =	**Net Operating Income** = a..k.a. After-Tax Net Operating Income, After-Tax Net Profit, **Subtract state and federal income taxes From pre-tax Net Operating Income**	**$9,229**
ODCF=	**Owner's Discretionary Cash Flow** = a.ka. Owner's Discretionary earnings, Seller's Discretionary Earnings (SDE), Seller's Discretionary Cash Flow (SDCF), Discretionary Earnings. **Net Operating Income + all compensation and perquisites for *one* owner/manager + interest on debt + depreciation & amortization expense**	**$100,843**
EBITDA[1]	**Earnings before Interest, Taxes, Depreciation & Amortization** = **Net Operating Income +interest expense on LT debt + depreciation & amortization expense + state and federal income taxes**.	**$49,469**
EBIT	**Earnings before Interest & Taxes** = **Add back interest expense on LT debt to Net Operating Income.**	**$21,574**
Net Free Cash Flow to Invested Capital	**Net Free Cash Flow to Invested Capital** = **Net After-Tax Operating Income + Depreciation & Amortization + Interest Expense – Expenditures For capital assets – increase in net working capital**	
Net Free Cash Flow to Equity	**Net After-Tax Operating Income + Depreciation & Amortization – Expenditures for capital assets - increase in net working capital** (This definition of earnings is generally less than after-tax net profit)	

[1] Earnings defined as EBITDA, EBIT, Net Free Cash Flow to Invested Capital and Net Free Cash Flow to Equity require that owner(s) compensation be presented on the Income Statement at fair market value.

Introduction to the Balance Sheet (a.k.a. the "Position Statement")

Based on my experience, I have found that the Profit & Loss statement is the financial report which small business owners best understand and examine with the most care. On the other hand, I have generally found that small business owners have difficulty understanding the significance of the Balance Sheet (a.k.a. Position Statement) and how to use it for the purpose of financial planning and control.

Indeed, I recently spoke to one small business owner who openly confessed that he had no idea how to use the information appearing on his balance sheet and another owner who said his bookkeeper does not even bother to produce one because he's never looked at it. If these confessions sound familiar, don't feel alone. Again, based on my experience, I believe that these confessions fairly well reflect the feelings of the majority of small business owners.

Okay, here we go. I'm going to start with some basic concepts about the preceding balance sheet with which you may already be familiar but stay with me because we'll get down to the brass tacks shortly.

First of all, note that the title of the report indicates that this statement is "as of December 31, 2005." What the balance sheet is showing is the financial "position" of the company for one moment in time, in this case the close of business on the last day of 2005 (hence the term "position statement"). Think of it as a "snapshot." In contrast, the Profit & Loss statement is a summary of all the financial activity that occurred each day for the preceding accounting period, be it the last month or last year - more analogous to a fast-forward video review of all the financial activity that occurred.

The basic format of the balance sheet is the same for every type and size of business. There are three fundamental sections: Assets, Liabilities and Owner's Equity. Assets and liabilities are further divided into "current" and "long-term." "Current" means either assets that will be (or can be) turned into cash within 12 months (or bills, wages and other debts that must be paid in cash within 12 months). Also, "Total Assets" must always be equal to "Total Liabilities" plus "Owner's Equity." They must be in balance, hence the term "balance sheet." For now, don't worry about why this is. Just accept this requirement and move on

The preceding hypothetical balance sheet is a highly "compressed" example, meaning there is little line-item detail within each asset or liability category. For a real business, each line-item may well be comprised of several sub-categories. For example, "cash" may actually be comprised of cash in the cash register, checking accounts, savings account and CDs. Likewise, many businesses will itemize their fixed operating equipment on their balance sheet by various sub-categories such as machinery, office equipment, vehicles and so forth. Whether you want to list each of those asset sub-categories on your balance sheet or just show the consolidated totals is all a matter of one's personal preference. When I owned my business, I established a fairly long list of asset and liability categories. However, I produced two balance sheets: one that was highly compressed, where very few of the sub-categories appeared, and another one that listed them all.

Now, with those housekeeping matters out of the way, let's begin the journey of considering how to interpret and use this financial statement. Basically what you have here is a simple list (somewhat consolidated, perhaps) of a description and value for the stuff the business owner owns, the amount of money owed various people, bills and debts that must be paid sooner or later and the owner’s "net worth." So what? With the exception of the "Owner's Equity" or "Owner's Net Worth" section of the balance sheet, many small business owners already have a pretty good idea in their head of what's on that list and don't need a balance sheet to keep those facts straight.

The first thing to realize about the balance sheet is that, apart from confirming what the owner probably already knows regarding what he owns and how much he owes, it doesn't tell you much of anything! The initial confusion regarding this statement lies in the mistaken assumption that there is supposed to be some important information there and you just can't see it. The balance sheet is really just a presentation of "raw data" that needs to be further processed and evaluated. The informational benefits derived from the balance sheet come from the wide array of ratios that can be calculated based on that raw data. That is, dividing one number on the balance sheet into or by other numbers either on the balance sheet or the Profit & Loss statement. A ton of useful information can be gleaned through this process.

There are just a couple of things I want to touch on briefly here before I call it a day. First, to alleviate your possible confusion about what the term "Owner's Net Worth" means on the balance sheet, the short answer is that it doesn't mean what it says. That number has no bearing whatsoever on what price a business could fetch if the owner wants to sell it or how much the owner could net on sale. I hope that helps.

And finally, I strongly recommend that the business owner routinely validates or "ties down" the balance sheet. By this I mean substantiating the line-item totals with documentation. The balance sheet put on my desk at the end of each month was accompanied by supplemental documentation, such as a reconciled bank statement with a highlighted balance in agreement with what appeared on the statement, the ending inventory physical-count worksheet, an accounts payable printout and so forth. Without committing to this degree of administrative discipline, it's easy for what appears on the balance sheet and what really exists to drift apart - sometimes a long way apart - and that's very dangerous.

BALANCE SHEET
As of 12/31/05

ASSETS

Current Assets	
Cash on Hand	$2,000
Checking Account	$49,561
Inventory	$11,589
Pre-Paid Insurance	$3,578
Other Current Assets	$2,368
Total Current Assets	**$69,096**
Fixed Assets	
Operating Equipment at Cost	$168,847
Less Accumulated Depreciation	-$78,201
Net Value of Operating Equipment	**$90,646**
Leasehold Improvements at Cost	$45,000
Less Accumulated Depreciation	-$28,000
Net Value of Leasehold Improvements	**$17,000**
Vehicles	$25,648
Less Accumulated Depreciation	-$8,547
Net Value of Vehicles	**$17,101**
Total Fixed Assets @ Net Value	**$124,747**
Total Assets	**$193,843**

LIABILITIES

Current Liabilities	
Accounts Payable	$3,587
Wages Payable	$2,692
Employment Taxes Payable	$57
Sales Tax Payable	$6,008
Current Portion of Long-Term Debt	$13,258
Other Payables	$1,258
Total Current Liabilities	**$26,859**
Long Term Liabilities	
Long Term Debt due beyond 1 year	$49,873
Total Long Term Liabilities	**$49,873**
Total Liabilities	**$76,732**

OWNERS NET WORTH

Owner's Invested Capital	$50,000
Retained Earnings	$67,111
Total Net Worth	**$117,111**
Total Liabilities & Owner's Net Worth	**$193,843**

Accrual Accounting vs. Cash Accounting

The cash method of accounting is very simple to use, because it's usually obvious when you receive money from a customer or other payer, or when you pay an expense with cash, credit card or a check. When money comes in or goes out, it's recorded and recognized for tax purposes.

Under the accrual method, you record business income when a sale occurs, whether it is the delivery of a product or the rendering of a service on your part, regardless of when you get paid. You record an expense when you receive goods or services, even though you may not pay for them until later.

To be more precise, under the accrual method you recognize an item of income when all the events that establish your right to receive the income have happened, and when the amount of income you are to receive is known with reasonable accuracy. If you estimate an amount due to you with reasonable accuracy and record it as income, and the amount you eventually receive differs from your estimate, you should make an adjustment to your income in the year you actually receive the payment.

The accrual method also says that you recognize an item of expense when you become liable for it, whether or not you pay for it in the same year. Becoming liable means that all events have occurred that establish your obligation, you can determine the dollar amount with reasonable accuracy, and "economic performance" has occurred. Economic performance means that the property or services have been provided or the property has been used.

Accrual accounting is the preferred method for almost all types of businesses. The only exception is small professional practices. The reason for this preference is that financial statements prepared using this methodology are far superior for the purpose of financial planning and control. The one caveat to this preference is that reported “net profit” does ***not*** necessarily mean “cash in the bank.” Rather, the term “net profit” means “some cash in the bank now and some cash that will get there later.” Indeed, it is entirely possible and quite common for a company to report a positive net profit for a month and end up with less money in the bank that it started with at the beginning of the month.

For this reason, it is necessary to produce a third financial statement known as the “cash flow statement.” This statement identifies the actual change in a company’s cash in the bank

Cash Flow Analysis

BALANCE SHEET As of 12/31/05 ASSETS		BALANCE SHEET As of 12/31/04 ASSETS			CASH FLOW STATEMENT For the Year Ending 12/31/05
Current Assets		**Current Assets**		**Current Assets**	**Current Assets**
Cash on Hand	$2,000	Cash on Hand	$2,000	Cash on Hand	
Checking Account	$49,561	Checking Account	$43,654	Checking Account	
Inventory	$11,589	Inventory	$10,058	Inventory	-$1,531
Pre-Paid Insurance	$3,578	Pre-Paid Insurance	$4,203	Pre-Paid Insurance	$625
Other Current Assets	$2,368	Other Current Assets	$1,987	Other Current Assets	-$381
Total Current Assets	**$69,096**	**Total Current Assets**	**$61,902**	**Total Current Assets**	
Fixed Assets		**Fixed Assets**		**Fixed Assets**	
Operating Equipment at Cost	$168,847	Operating Equipment at Cost	$161,258	Operating Equipment at Cost	-$7,589
Less Accumulated Depreciation	-$78,201	Less Accumulated Depreciation	-$59,035	Less Accumulated Depreciation	$19,166
Net Value of Operating Equipment	**$90,646**	**Net Value of Operating Equipment**	**$102,223**	**Net Value of Operating Equipment**	
Leasehold Improvements at Cost	$45,000	Leasehold Improvements at Cost	$45,000	Leasehold Improvements at Cost	$0
Less Accumulated Depreciation	-$28,000	Less Accumulated Depreciation	-$21,104	Less Accumulated Depreciation	$6,896
Net Value of Leasehold Improvements	**$17,000**	**Net Value of Leasehold Improvements**	**$23,896**	**Net Value of Leasehold Improvements**	
Vehicles	$25,648	Vehicles	$25,648	Vehicles	$0
Less Accumulated Depreciation	-$8,547	Less Accumulated Depreciation	-$6,514	Less Accumulated Depreciation	$2,033
Net Value of Vehicles	**$17,101**	Net Value of Vehicles	**$19,134**	Net Value of Vehicles	
Total Fixed Assets @ Net Value	**$124,747**	**Total Fixed Assets @ Net Value**	**$145,253**	**Total Fixed Assets @ Net Value**	
Total Assets	**$193,843**	**Total Assets**	**$207,155**	**Total Assets**	
LIABILITIES		**LIABILITIES**		**LIABILITIES**	
Current Liabilities		**Current Liabilities**		**Current Liabilities**	
Accounts Payable	$3,587	Accounts Payable	$7,695	Accounts Payable	-$4,108
Wages Payable	$2,692	Wages Payable	$3,967	Wages Payable	-$1,275
Employment Taxes Payable	$57	Employment Taxes Payable	$83	Employment Taxes Payable	-$27
Sales Tax Payable	$6,008	Sales Tax Payable	$6,987	Sales Tax Payable	-$979
Current Portion of Long-Term Debt	$13,258	Current Portion of Long-Term Debt	$14,054	Current Portion of Long-Term Debt	-$796
Other Payables	$1,258	Other Payables	$2,614	Other Payables	-$1,356
Total Current Liabilities	**$26,859**	**Total Current Liabilities**	**$35,400**	**Total Current Liabilities**	
Long Term Liabilities		Long Term Liabilities		Long Term Liabilities	
Long Term Debt due beyond 1 year	$49,873	Long Term Debt due beyond 1 year	$63,873	Long Term Debt due beyond 1 year	-$14,000
Total Long Term Liabilities	**$49,873**	**Total Long Term Liabilities**	**$63,873**	Total Long Term Liabilities	
Total Liabilities	**$76,732**	**Total Liabilities**	**$99,273**	**Total Liabilities**	
OWNERS NET WORTH		**OWNERS NET WORTH**		**OWNERS NET WORTH**	
Owner's Invested Capital	$50,000	Owner's Invested Capital	$50,000	Owner's Invested Capital	$0
Retained Earnings	$67,111	Retained Earnings	$57,882	Retained Earnings	$9,229
Total Net Worth	**$117,111**	**Total Net Worth**	**$107,882**	**Total Net Worth**	
Total Liabilities & Owner's Net Worth	**$193,843**	**Total Liabilities & Owner's Net Worth**	**$207,155**	**Total Liabilities & Owner's Net Worth**	
				Changes in Cash	$5,907

For all assets, subtract the balance for FY 05 from FY 04

Cash increases when non-cash assets decrease and cash decreases when non-cash assets increase

For all liabilities, subtract the balance for FY 04 from FY 05

Cash increases when liabilities increase and cash decreases when liabilities decrease

Examples of poorly formatted financial statements

Central to the process of assisting folks in the buying, selling or appraising of small businesses is the need to analyze the business's financial statements. Over the years, I have examined many financial statements from all kinds of small businesses. These statements range in quality from next-to-useless to pretty good. However, I have yet to see the financial statements for a small business that I think couldn't be improved.

I'm not talking about the accuracy of the statements - that is, whether or not revenue and expenses are reported correctly. I'm talking about the format of the statements - how well-organized the statements are and how readily one can interpret the financial performance and financial condition of the business by examining the profit and loss statement (P&L) and the balance sheet.

First, having excellent financial reports and the ability to interpret what they're saying is critically important for the ambitious business owner who wants to grow his or her business. Beyond a certain level of business activity and complexity which varies from one type of business to another, poor financial reporting can likely be the kiss of death. Second, having excellent financial statements is a key ingredient in an ability to sell one's business for the best price possible.

Nowadays, all of the statements I see are computer-generated. Manually produced statements are pretty much a thing of the past. But even so, the computer will only do what the bookkeeper tells it to do. The following are examples of really poor report formats that I have come across in my work as a business broker and appraiser.

My first example is the P&L for a restaurant. The operation's expenses were presented first, and gross sales revenue was the last line item on the statement. All expenses were reported in perfect alphabetical order. So, the first expense to appear was advertising. Then came bookkeeping, cleaning supplies, cost of goods sold, depreciation and so on. It's common for me to see P&Ls where the report format is based solely on the alphabetical order of revenue and expense descriptions. The P&L example above contains a couple of glaring problems. First, there are several ways to organize the expense section of a P&L. Alphabetical order is perhaps the most thoughtless, and least enlightening way. The real problem with the example above is that they've tossed the cost of goods sold in with their regular expenses. The standard way to do a P&L is to report gross sales revenue first, and then list cost of goods sold, and subtract the cost of goods sold from the sales revenue to show the operation's gross profit margin.

The next example of a poor report format is when there are way too many revenue and expense descriptions, often with no account category subtotals. I once had the opportunity to examine the P&L for a retail business that was three pages long. The statement had about a hundred revenue and expense line item descriptions and no category subtotals. In fact, some expense accounts had the same description (e.g., "miscellaneous expenses") with different account numbers. When the business owner ran out of new descriptions to use, he just reused ones already appearing on the statement but with different account numbers. This owner explained to me that even though the expense accounts had the same description, they really were for different kinds of expenses; it's just that the differences were subtle. He also said he was having a hard time finding and holding on to a good bookkeeper. Little wonder. There is no "correct" number of revenue and expense accounts that should appear on the financial reports. Having too few can be as bad as having too many. It's a matter of judgment, and establishing a good report format - including meaningful account descriptions - is more an art than a science.

And finally, I want to tell you about the P&L for a retail business I visited that the owner was preparing to put up for sale. In this case, the business owner also owned the real estate on which his business was situated. This is not uncommon. The principal weakness in this owner's P&L stemmed from the fact that he included the real estate as one asset of his business. In cases where the business owner also owns the operation's real property, it's best for a number of reasons to hold title to that property within a separate legal entity and charge the business fair-market-value rent. From a financial reporting perspective, the reason to do this is so that you can clearly distinguish between the profit and loss, as the case may be, from business operations and the income from the investment in real estate.

In the case of this example, the owner was showing a "profit" of around $30,000 a year. However, it was my guess that the fair market value rent his property could generate was around $60,000 a year. Thus his business was actually losing about $30,000 a year, and the owner would have been that much better off by closing the business and leasing his property to someone else. I honestly don't think he realized this fact. When I looked at the trend in his business's profitability - or lack thereof, to be more precise - it was evident to me that his cash flow would turn negative within 18 to 24 months and that his business (excluding the real estate) was worthless. I tried to explain this to the owner as delicately as I could but, alas, not delicately enough. He ran me off, and that was that. However, true to my prediction, the business went dark about 20 months later.

I selected the preceding examples of poor financial reporting because they boldly illustrate the weaknesses I see in many small business' financial statements but generally not to the same degree. Even so, most small business' financial reports can stand improvement

Commonly formatted Income Statement

Billy Bob's Barbecue
INCOME STATEMENT
For the Year Ending 12/31/05

Gross Sales	$1,073,348
Cost of Goods Sold	$433,248
Gross Margin	**$640,100**
Other Expenses	
Automobile Expenses	$5,400
Charitable Contributions	$3,000
Cleaning Materials	$6,500
Depreciation & Amortization	$27,895
Direct Labor	$185,324
Direct Mail Advertising	$3,542
Dues & Subscriptions	$650
Employer's SSN	$14,316
Federal Unemployment Tax	$954
Interest on Bank Loan	$12,345
Newspaper Ads	$22,000
Outside Maintenance	$7,500
Overhead on Owner's Salary	$1,155
Overtime Labor	$5,560
Owner's Health & Life Insurance	$6,500
Owner's Salary	$55,000
Property & Liability Insurance	$5,000
Radio Advertising	$18,000
Rent	$120,000
Repairs	$9,500
Sales Tax	$72,091
Small wares	$2,800
State Unemployment Insurance	$954
Travel & Entertainment	$7,564
Utilities	$17,000
Vacation Pay	$7,413
Worker's Comp Insurance	$12,407
Yellow Pages	$500
Total Other Expenses	**$630,871**
Net Profit	**$9,229**

All of the expense accounts are listed in alphabetical order. There is no attempt to categorize expenses in logical groups such as “Labor Cost” “Marketing Expense,” etc. with sub-totals. Neither is there a separation of variable and fixed costs.

It is not at all unusual to see a small business’s financial statements presented in this format. A statement formatted this way is of little use and generally indicates that the business owner does not use it for planning, control or decision making.

Introduction to Recasting the Financial Statements

There is a fundamental difference between one of the principal objectives of financial performance reporting among publicly traded corporations and privately owned businesses. Within the limits of *generally accepted accounting principals (GAAP)* publicly traded corporations strive to report the greatest net profit possible. They do this because reported earnings drive the value of their stock and maximizing their stock's selling price—i.e., maximizing shareholder wealth—is the single most important financial objective of those firms. Privately owned businesses on the other hand strive to report the lowest profit possible (generally within the legal limits established by the Internal Revenue Service but not always) in order to minimize their income tax liability and thereby maximize after-tax cash flow to the owner, which is to say, maximize owner wealth.

The preceding notwithstanding, the almost universal propensity among the owners of privately owned business to intentionally distort the reportable "real" earnings of their companies creates something of a dilemma when it comes to estimating their companies' value because, axiomatic within the business appraisal profession, the business brokerage industry and the Internal Revenue Service, "a business's recent historical financial performance is the best indication of its expected future performance."

In addition to intentional reportable-profit-reducing tactics, there are uncontrollable, unplanned events that negatively affect a business's real earnings from time to time. A business may suffer a significant non-recurring decline in sales revenue or increase in expenses for such reasons as perhaps a flood, fire, a law suit, employee theft, a serious on-the-job accident, a labor strike, etc. On the other hand, businesses occasionally experience abnormal, non-recurring surges in sales revenue and earnings.

Regardless of whether the expenses (and occasional earnings) of the types described above are attributable to the proactive actions and decisions of the business owner or were attributable to abnormal, non-recurring events beyond the owner's control they all have the same things in common. They obscure what the earnings of the company would have been absent such expenses and revenue and complicate one's ability to envision a company's expected future earnings—and it is *expected future earnings that drive market value.*

Thus, for the purpose of envisioning a privately owned business's expected future earnings, the historical Profit & Loss statements must be reconstructed by re-stating all non-essential business "expenses" (which are generally owner perquisites) as profit, and eliminating all non-recurring expenses and income. This reconstruction of a business's financial statements is known as "recasting," or "adjusting" or "normalizing" the statements.

There are many discretionary tactics owners of privately owned businesses use to minimize their reported earnings. For example:

- It is very common for small business owners to charge all costs associated with their personal automobile such as fuel, repairs and maintenance and interest on their purchase loan as a business expense even though that auto serves very little or no legitimate business purpose.

- All donations to charitable causes a small business owner makes are generally made by that individual's company and charged off as a business expense.

- Newspaper and magazine subscriptions of personal interest to the business owner are paid for by the business.

- Much travel, meals in restaurants and entertainment expense for the owner and the owner's entire family as well that can only remotely be considered a "necessary cost of doing business" are routinely charge off as a business expense.

- Small business owners gravitate toward using the most aggressive depreciation expense method approved by the IRS.

- Major equipment or facility repair costs that should appropriately be capitalized and expensed gradually over several years via depreciation expense are instead written off entirely in the year they are incurred.

The way recasting is done is to present in columnar format, a business's actual reported revenue and expenses, a second column showing the amount by which a line item is being adjusted and a third column showing the adjusted amount plus a brief but sufficiently descriptive explanation for the adjustment at the bottom of the page. For example:

Actual Reported Revenue & Expenses		Adjustments	Footnotes	Recast Revenue & Expenses	
Other Variable Costs				**Other Variable Costs**	
Cleaning Materials	$6,500.00			Cleaning Materials	$6,500.00
Outside Maintenance	$7,500.00			Outside Maintenance	$7,500.00
Repairs	$9,500.00	-$6,000.00	1	Repairs	$3,500.00
Charitable Contribtions	$3,000.00	-$3,000.00	2	Charitable Contribtions	$0.00
Total Other Variable Costs	$26,500.00			Total Other Variable Costs	$17,500.00

Footnotes
1. This expense reduction is for the extradrdinary one-time cost to repair a broken sewer line under the floor in the storage room
2. This is a voluntary non-operating expense for an annual contribution that the owner makes every year to the Red Cross

And finally, for the purpose of estimating a business's market value and establishing an asking price, there are some special adjustments that serve that purpose alone that must be made to the actual P&Ls. There are four categories for these special adjustments:

1. Owner salary and perquisites;
2. Facility occupancy costs;
3. Depreciation & Amortization expense
4. Interest expense on long-term debt

Special Adjustments to Owner Salary & Perquisites

The necessary adjustments to Owner Salary & Perquisites vary, depending on the definition of earnings used to estimate a business's value and to market the business. In small business transactions the three most commonly encountered definitions of earnings (among 7 alternatives) are:

1. Seller's Discretionary Earnings (SDE) also known as Owner's (or Seller's) Discretionary Cash Flow, Discretionary Cash Flow and Discretionary Earnings.

2. Earnings Before Interest, Taxes, Depreciation & Amortization (EBITDA)

3. Earnings Before Interest & Taxes (EBIT)

When developing a recast P&L so the "bottom line" is *Seller's Discretionary Earnings* then *all* of the reported salary, bonuses, life insurance and health insurance premiums plus any other perquisites or fringe benefits attributable to ***one*** owner are converted to earnings in the recast statement. However, if there are other working owners and/or family members earning wages in the business, then only the amount *above* their fair market value wage and fringe benefits should be eliminated in the recast statement. Moreover, if any of those other working owners and/or family members are paid something below a fair market value wage, then the difference between a fair market value wage and what they were paid must be added to the recast P&L. For further explanation of this issue, see "Why Owner's Discretionary Cash Flow includes the salary of only one owner" on page 45.

In those cases where the owner does not pay him or herself a salary at all—i.e., does not show any wages on the P&L, but instead takes a "draw" which is booked as a debit entry to the equity section of the balance sheet, then the only adjustments to the P&L would be the owner's perks and fringe benefits plus the same adjustments described above for all other owners and/or family members.

For *all* other definitions of earnings, the recast P&L should reflect the fair market value wage for all owners and family members. For example, if an owner paid himself an annual salary of $100,000 and the wage he would have to pay a non-owner manager to perform all of his job responsibilities would be $65,000 a year, then the actual salary expense on the P&L should be adjusted down by $35,000 so that the recast P&L shows a management salary of $65,000 and profit is increased by $35,000. Likewise, if the owner only paid himself $40,000 for the year, then the actual P&L should be adjusted upward by $25,000 and profit reduced by $25,000. If it is customary for professional non-owner managers in a business's industry to also receive paid health insurance benefits, then that cost should be carried over from the actual to the recast P&L.

Special Adjustments to Facility Occupancy Costs

If the business owner leases the business's real property facility, then generally, no adjustment should be made to this expense. However, just like any other revenue or expense item, if there is something unusual about the lease—for example an automatic rent escalation clause that the sale of the business would precipitate, or perhaps the lease is near the end of its term and it is expected the owner will increase the rent for the next term—then an adjustment would be appropriate.

On the other hand, if the business owner also owns the land and building in which his business operates, then an adjustment to this expense is almost always necessary. In some cases, the owner will hold possession of the real property asset in a separate entity and charge his business rent. If the owner intends to hold onto the property and lease the facility to whomever buys the business, the rent the owner intends to charge the business buyer needs to be substituted in the recast P&L.

In those cases where the business owner holds possession of the land and building within the same legal entity as the business operated thereon, and does not have a rent expense on the P&L, then a *phantom rent expense expressed as the higher of fair market value or the rent the owner will charge the buyer* must be added to the recast P&L and all building depreciation expense and debt service attributable to any real property purchase loans needs to be removed. This is necessary because in *every* case, the procedure for estimating the value of a small business is to *exclude all real property* owned by the business, which is to say in every case the business is valued under the presumption that the business leases its operating premises. Then, if the owner wants to also sell the real property, it is similarly valued separately (based on rental income equal to the business's phantom rent expense) and the sum of the two independent valuations is the value of the whole. Breaking out the real property from the business for purposes of valuation is necessary because the capitalization rates, discounts rates and earnings multiples applied to an operating business are *substantially* different from those used in the valuation of real property.

When it comes to building maintenance and repair costs, and property taxes the easiest way to deal with this aspect of real property ownership is to carry all of those costs over from the actual to adjusted P&L and insert a fair market value triple-net rent expense. (A "triple-net" lease requires that the tenant pay *all* costs associated with the property including all repair and maintenance costs and property taxes).

<u>Depreciation & Amortization Expense Adjustments</u>
Depreciation and amortization expenses are different from all other types of expenses because they are "non-cash" expenses. That is, no money is paid out to anyone for these expenses. They are accounting tools used to estimate the "wearing out or wasting away" cost or declining value if you will of the businesses fixed assets. When using Seller's Discretionary Earnings or EBITDA to estimate a business value or as the earnings being advertised, then all depreciation and amortization expense is eliminated on the recast P&L. However, when using the EBIT definition of earnings, depreciation is not removed. However, when using EBIT it is advisable to adjust the depreciation expense from an accelerated bases to straight-line.

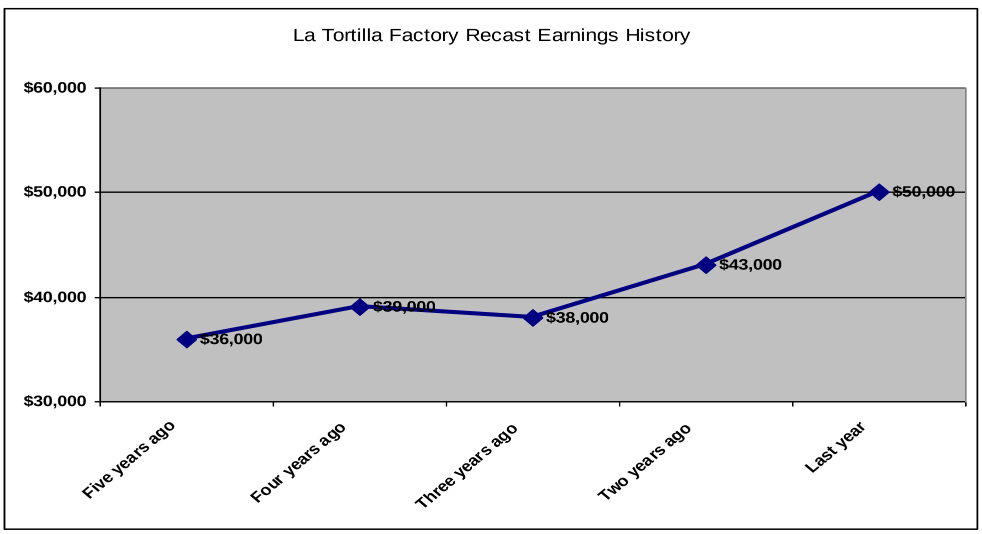
<u>Interest expense on long-term debt</u>
The interest expense on long-term debt is known as a "discretionary, non-business expense." Interest is the money the business owner pays a lender for borrowed money. It is not a cost of doing business per se, but a "cost of capital." In theory, a business owner can make this expense disappear by paying off the loan. Thus when comparing the "profit from business

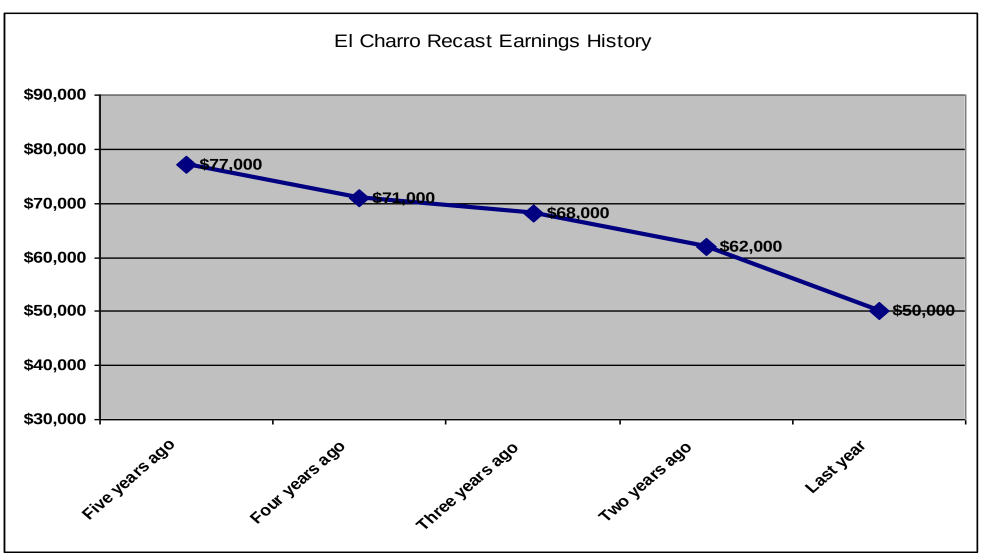
operations" among different business opportunities, the cost of debt is excluded because it is not a cost of doing business.

As stated earlier, "a business's recent historical financial performance is the best indication of its expected future performance." We can now restate this proposition as "a business's recent *recast* historical financial performance is the best indication of its expected future performance." This raises the question of what is meant by "recent?" There is no universal consensus on this issue, however all business appraisers and most business brokers agree it should be more than just the last completed year's performance. This is so for two key reasons:

1. <u>The necessity to identify revenue, cost and profit *trends.*</u>

For example, consider two very similar businesses, for example two Mexican restaurants, both of which have identical recast earnings—say $50,000—for the most recently completed year's operations. Would a prospective buyer be indifferent as to which of these two business opportunities is most attractive if they are both for sale for the same price? Perhaps. But, which business do you suppose is the most attractive opportunity when their past five years' of recast earnings are considered:

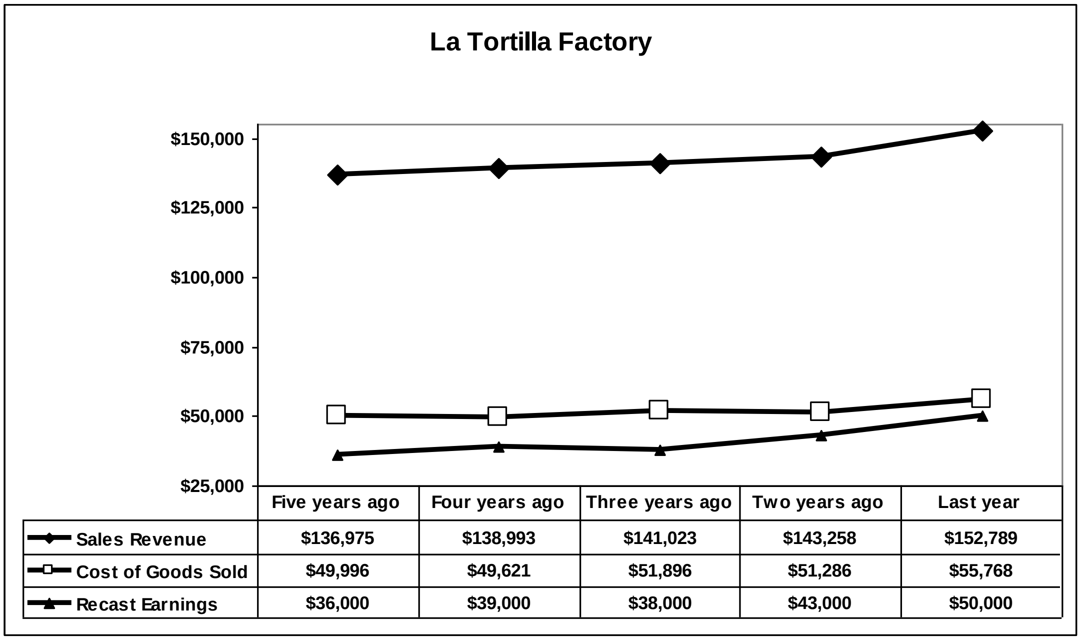




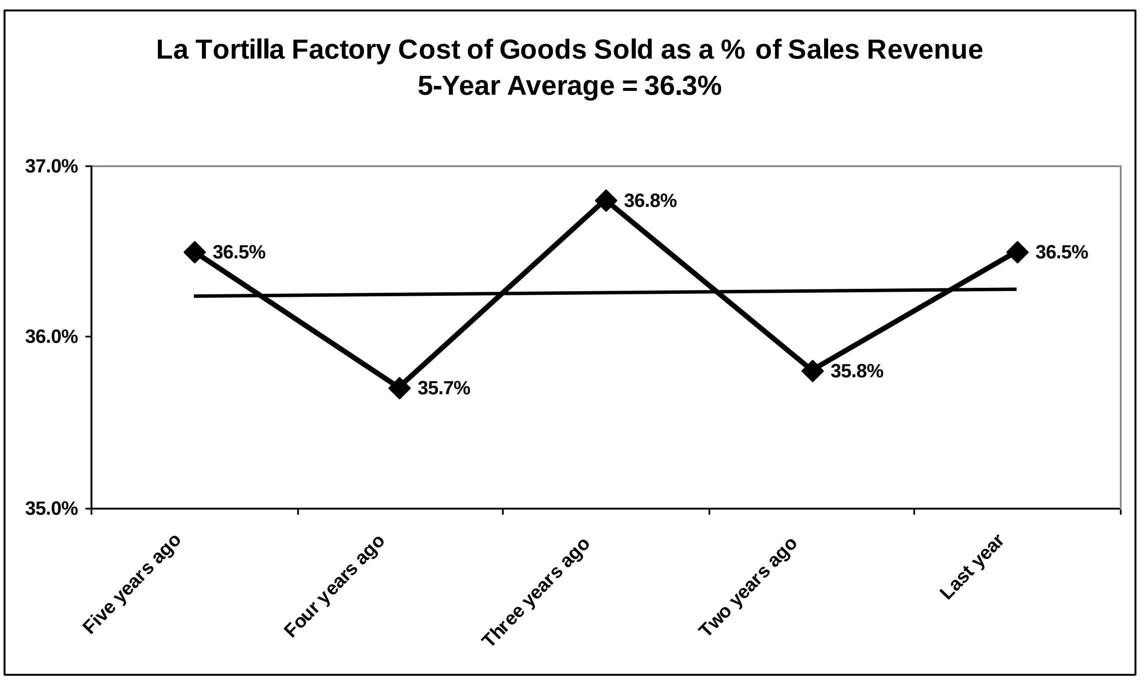
The analysis of recast revenue, cost and earnings *trends* is a critically important element in the task of estimating a business's market value.

2. <u>The need to smooth random fluctuations in historical financial performance.</u>

All businesses experience more or less random fluctuations in most operating costs from year to year. For example, consider the Cost of Goods Sold for the *La Tortilla Factory* Mexican restaurant for the past five years both in absolute terms and as a percentage of sales revenue:



	Five years ago	Four years ago	Three years ago	Two years ago	Last year
Sales Revenue	$136,975	$138,993	$141,023	$143,258	$152,789
Cost of Goods Sold	$49,996	$49,621	$51,896	$51,286	$55,768
Recast Earnings	$36,000	$39,000	$38,000	$43,000	$50,000



> In this example, we can see that the cost of goods sold in absolute dollars is trending approximately the same as sales revenue and earnings—but not identically. When this cost is analyzed in terms of its percentage of sales revenue for the past five years, a zigzag "trend" or more appropriately, "behavior" is evident. A "trend line" projected through the data points is nearly flat. What this is telling us is that this cost is reasonably "stable." In this example, therefore, for purposes of anticipating what this cost is most likely to be in future years, using the 5-year average percent of sales revenue of 36.3% is reasonable.

In the preceding examples, recast financial performance data for the past 5 years was presented. For the purpose of a business appraisal, it is customary to recast the most recent five years' of these statements. Typically within the small business opportunity brokerage profession, the most recent three years of Profit & Loss statements are recast. For purposes of trend analyses and the smoothing of random fluctuations, a three-year history is generally considered the bare minimum necessary to obtain a reasonably accurate sense of what the future holds in store for the performance variable under study. On the other hand, it is generally believed that when analyzing performance history older than five years, the analyst is delving into ancient and therefore irrelevant history.

These generally accepted practices notwithstanding, it is not uncommon to encounter listings where the broker only recast the preceding year's statement—which is unprofessional in my opinion. Moreover, anyone who *buys* a business based on the merits of just the most recent year's recast performance data has made a *very* serious mistake of judgment—again, in my opinion.

Personally, I think that the last five years of Profit & Loss statements should be recast for every business opportunity listing. However, this first step in preparing a business for sale is a big one. It requires a careful and thoughtful effort to study a business's actual financial statements and then *appropriately* develop recast P&L's. This is a very time-consuming project, and requires a careful application of commons sense, reasonableness and informed judgment. This process is as much an art as it is a science. Preparing five years' of recast financial statements takes anywhere from 10 to 20 hours of work—seldom less than that but frequently much more.

It is also necessary, in my opinion, to recast the most recent Balance Sheet, but only the most recent one—although many small business opportunity brokers don't do this. There are four reasons why it is a good idea to recast the balance sheet:

1. According to GAAP, balance sheets are developed on a "cost" basis, meaning the value of all assets is stated at cost. For purposes of estimating a business's value, marketing a business opportunity, negotiating price and negotiating the allocation of the purchase price, the assets should be re-stated at their estimated fair market value. A balance sheet recast in this way is known as an "economic" balance sheet or "true value" balance sheet.

2. Also, according to GAAP, the business owner's "good will" value or value of the "intangible assets" are never reflected on a cost basis balance sheet. Including this value on the "true value" balance sheet can be very helpful in understanding how that value relates to the asking price for all of the assets to be included in the sale.

3. It is very common for business owners to make improvements to rented facilities—known as "tenant improvements" and they are often quite substantial. On a cost based balance sheet, all costs associated with these improvements are booked as fixed assets and depreciated. However, by operation of state law in every state and also typically stated specifically in most commercial leases, all leasehold improvements or tenant improvements *become the property of the building owner upon completion.* Thus, without regard to how much a business owner has invested in tenant improvements or when they were made, he doesn't own them and they should be eliminated from the true-value balance sheet. Since a business owner cannot sell what he does not own, in order to avoid confusion and conceivably future litigation, it is best, I believe, to not represent any tenant improvements as part of what is being offered for sale.

   This is not to say however, that the business owner will not recover all or some of the costs for those improvements. Presumably all of those improvements were made for the purpose of either improving the business's operating efficiency and effectiveness or imparting some other form of competitive advantage all of which are embodied in that business's "good will" value. Thus, without regard to what any tenant improvements may have cost the business owner, all of their "true economic value" will be included in the selling price.

4. It is also very common for small business owners not to record all of their current assets and current liabilities on their balance sheet. This fact can lead to post-transaction arguments between the buyer, seller and possibly the broker. By the process of carefully and thoughtfully recasting the balance sheet (and asking the seller a lot of questions along the way) most of these omissions can be discovered and post-transaction problems of non-disclosure avoided. Here are some examples:

   - Most commercial leases require the up-front payment of a lease deposit. Typically, this money is held by the property owner until the end of the lease. As often as not, a small business owner will charge this deposit off as an expense early in the term of the lease rather than record it as an asset on the balance sheet. Then, when the business is sold, the property owner returns the deposit to the seller and looks to the buyer to pay a new deposit. This is an expense the buyer probably never considered or just as likely assumed that the purchase of the business included this asset.

   - Most dry cleaning businesses require customers to pay for their cleaned clothes when they pick them up. However there are some that require payment in advance. Typically, most dry cleaners to not adhere to GAAP accounting principals and this can create a problem. If the business owner uses proper financial accounting methods, and requires payment upon pickup, then as each garment that was taken in for cleaning is cleaned and readied for pickup, the owner would credit the "Revenue from Dry Cleaning" account on his P&L and debit Accounts Receivable on the balance sheet. Then, when the customer pays for the cleaning, Accounts Receivable would be credited and Cash on Hand debited. This means that the amount due from customers for clothes that have been cleaned but not yet picked up will appear as a current asset on the balance sheet. But, if the dry cleaner owner does not adhere to this accounting principal, then the amount owned him by customers for cleaned clothes is not reflected on the balance sheet and quite possibly not addressed during purchase negotiations. So, upon sale, who is entitled to that money, the seller or the buyer?

- Or, to stick to the dry cleaning business, suppose the owner requires customers to pre-pay for their dry cleaning. In this case, proper accounting requires that the Cash On Hand account be debited and the *current liability* account Clothes Held For Cleaning be credited when the clothes are left off. If this accounting principal is not followed, then this liability will not appear on the balance sheet. Then, when the buyer takes over the business, for the first week or so, the buyer won't be paid for any of the dry cleaning that is being picked up because the customer already paid the seller. If this fact was not considered during purchase negotiations and reflected in the purchase price, do you suppose the broker involved in the deal might hear from the buyer?

- I once had a listing on a publishing business. This company published a weekly newspaper. The owner sold subscriptions to the paper as most periodical publishers do. The owner had sold many 1-year, 2-year, 3-year and 5-year subscriptions. However, all cash received from these sales was booked at Sales Revenue when the subscription was purchased. Those proceeds should have been booked as a *liability* on the balance sheet as "Issues to be Delivered." Then, as each month's issue was published and delivered then 1/12 of a 1-year subscription payment should have been moved from the balance sheet liability account "Issues to be Delivered" to "Sales Revenue" on the P&L. Without recasting the balance sheet to reflect the paid-for-but-yet-undelivered future subscriptions, this fact could have been missed during purchase negotiations. I pointed this out to the seller and said that this is a liability the buyer *must* assume and be subtracted from the purchase cash the seller would receive. The seller didn't like this idea, stating that when he bought this publication many years ago, he failed to consider this fact and ended up delivering hundreds of issues of the publication over several years without getting paid for them because the seller kept that cash. The current owner felt it was now his turn to get pay-back from the next buyer for this oversight by doing the same thing. I cancelled the listing.

Other Important Considerations

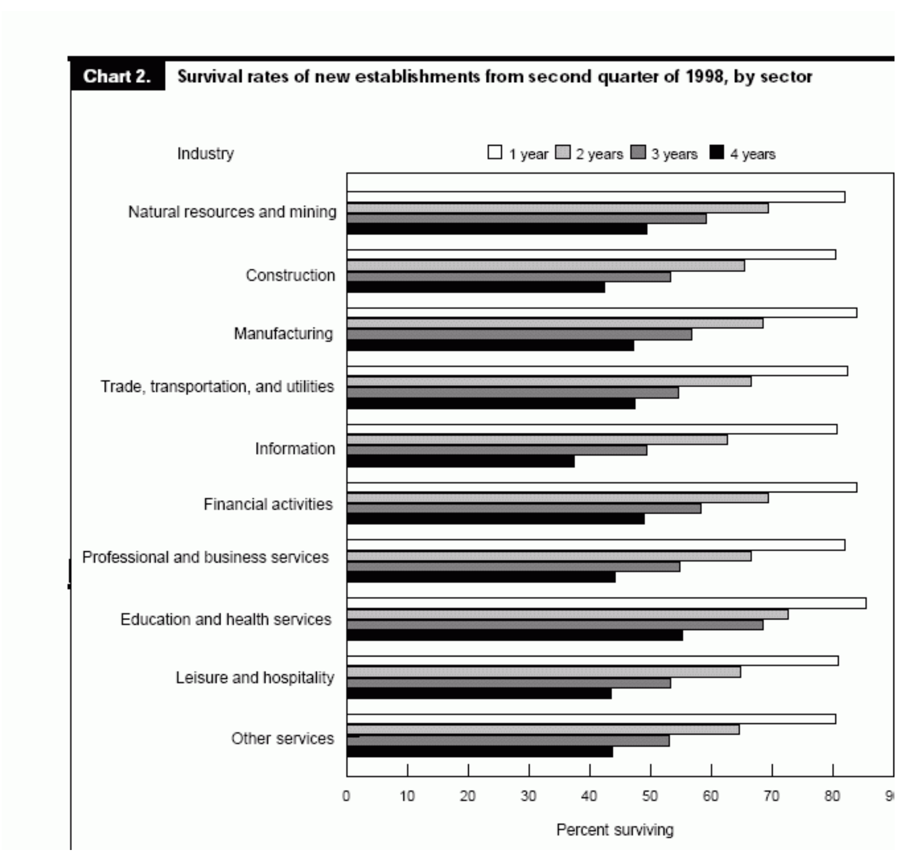
Skimmed Cash

There are three final issues that should be addressed before doing a recasting exercise. The first has to do with the fact that some small businesses owners do not report a material portion of cash sales. Instead, the owner pulls cash out of the cash register and sticks it in his or her pocket—frequently on a daily basis. This is known as “skimming” and, of course, is tax evasion pure and simple. As such, it is illegal. Business owners are understandably extremely secretive about this activity and in some cases do not even tell their spouses they are doing it.

However, when it comes time to sell the business, it seems the more cash the owner has skimmed from the business over the years, the quicker he confesses all of this to a business broker on a listing call. That’s because the seller now wants to sell his business for a price that reflects *all* of its earnings—both reported and unreported. The smart thing to do, in my opinion, is to tell the business owner that only reported earnings will be advertised and the asking price of the business will be based only on reported earnings. If the owner is not agreeable to this, then again in my opinion, it is time to walk away from this deal—don’t take the listing. However, this is a decision each broker must make for him or herself. Be aware though that brokers who take listings on business like this and disclose the skimmed cash to prospective buyers are traveling in very dangerous territory.

Startup Businesses

Another challenge a broker is likely to encounter from time to time is the very young business—one that has only been operating a couple of years. Obviously, in this case, there will only be a couple of years of financial performance data to analyze. Without regard to how promising the future earnings prospects may appear for a start-up business, the fact that the owner wants to sell it is, in-and-of-itself, a red flag. The owner may have a truly profitable business with very rosy prospects for the future, but the fact remains that the mortality rate for start-up businesses is quite high. Research from the U.S. Bureau of Labor Statistics show that the survival rates for almost any type of



business is *less than 50%* beyond 5 years.

Chart 2, illustrated here shows new establishment “survival rates.” For example, the survival rate for businesses in the Other Services category is 42% by the 4th year. This means the failure rate for this category is 58% within the first four years. The reasonable conclusion to draw from this is that buying a fairly young business is a much more risky venture relative to buying a business with a 5-year or greater history and it is a wise business broker that is sensitive to this fact.

Division Splits, Carve-Outs and Transfer Pricing

A somewhat infrequent but not uncommon occurrence is the business owner who wants to sell only a part of his entire business—not a partial ownership interest in the whole thing, but 100% ownership in some part of it that logically can be split off or carved out to become a stand-alone business. This sort of situation needs to be handled very carefully because recasting the financial statements for this scenario can be quite challenging, in particular due to “transfer pricing” considerations.

“Transfer pricing” refers to the pricing of goods and services within a multi-divisional organization. For example, goods from the production division may be sold to the retail sales division and the price at which they are sold affects how the total profit for the company is allocated between divisions. Moreover if the “transfer price” is anything other than fair market value, then the profit for one division will be understated and profit for the other division will be over stated. Thus, when recasting the financial statements for the division to be sold, historical revenue, costs and profit must all be reconstructed to show what those revenue, costs and profits would have been, had the transfer pricing been established at fair market value and operating costs allocated accurately at fair market value.

If this sounds like something one is only likely to encounter in big, multi-million dollar businesses, think again. I once went on a listing call to a very small mom-n-pop “coffee bar,” essentially an independent replica of a Starbucks. The business occupied about 1500 square feet, had about 10 tables in the dining room and an equal number of stools at the bar. The products for sale were pretty much the same that Starbucks offers. The one big difference is that the owner of this business bought green coffee beans from around the world and roasted them on the premises. The coffee roaster was about the size of a 55-gallon drum and stood in one corner of the dining room. As part of this element of his operation, he had a customer base to whom he delivered freshly roasted coffee.

In this case, the owner wanted to sell his coffee bar business but retain the coffee roasting & delivery operation and retain all customers to whom he delivered freshly roasted coffee.

The owner bought the raw coffee beans for around $2.00 a pound. He did not keep separate books on the coffee bar business and the coffee roasting & delivery business. There was only one Profit & Loss statement for the entire operation. For this reason, the “transfer price” for the roasted coffee from the production “division” to the “retail division” was $2.00 a pound. However, the fair market value for imported roasted coffee beans was $8.00 a pound, and this is the price whomever bought the coffee bar division would have to pay for them.

Thus, the cost of goods sold for the coffee bar had to be recast under the assumption that the wholesale cost of coffee was $8.00 a pound, not $2.00 a pound. Additionally, all revenue—actually the estimated or "best guess" for the revenue from the coffee delivery operation had to be removed from the P&L.

Needles to say, under this recast scenario, the coffee bar as a stand-alone business was a money-looser, even with a significant reduction in utility costs attributable to the coffee roaster. The only way this business was saleable was in its entirety and the owner didn't want to do that.

The foregoing vignette is one example of the challenges involved in the analysis, pricing and marketing of a proposed division split or carve out. Each situation like this will have its own unique set of circumstances that are up to the business broker to identify and incorporate into the recast financial statements and marketing function. And, as one last tip on this scenario, generally business owners have a pretty good idea of which side their bread is buttered on, accurate financial reporting or not, and it is typically the side without butter they want to sell. Be careful!

Recasting the Income Statement

1. Recasting for Net Profit

Billy Bob's Barbecue **INCOME STATEMENT** **For the Year Ending 12/31/05**			Adjustments	Footnotes	**Billy Bob's Barbecue** **RECAST INCOME STATEMENT** **For the Year Ending 12/31/05**		
Gross Sales	$1,073,348	107.2%			Gross Sales	$1,073,348	107.2%
Less Sales Tax	-$72,091	-7.2%			Less Sales Tax	-$72,091	-7.2%
Net Sales	**$1,001,257**	**100.0%**			**Net Sales**	**$1,001,257**	**100.0%**
Cost of Goods Sold	$433,248	43.3%			Cost of Goods Sold	$433,248	43.3%
Gross Margin	**$568,009**	**56.7%**			**Gross Margin**	**$568,009**	**56.7%**
Variable Costs					**Variable Costs**		
Labor					**Labor**		
Direct Labor	$185,324	18.5%			Direct Labor	$185,324	18.5%
Overtime Labor	$5,560	0.6%			Overtime Labor	$5,560	0.6%
Vacation Pay	$7,413	0.7%			Vacation Pay	$7,413	0.7%
Employer's SSN	$14,316	1.4%			Employer's SSN	$14,316	1.4%
State Unemployment Insurance	$954	0.1%			State Unemployment Insurance	$954	0.1%
Federal Unemployment Tax	$954	0.1%			Federal Unemployment Tax	$954	0.1%
Worker's Comp Insurance	$12,407	1.2%			Worker's Comp Insurance	$12,407	1.2%
Total Labor Cost	**$226,929**	**22.7%**			**Total Labor Cost**	**$226,929**	**22.7%**
Marketing					**Marketing**		
Newspaper Ads	$22,000	2.2%			Newspaper Ads	$22,000	2.2%
Radio	$18,000	1.8%			Radio	$18,000	1.8%
Yellow Pages	$500	0.0%			Yellow Pages	$500	0.0%
Direct Mail	$3,542	0.4%			Direct Mail	$3,542	0.4%
Total Marketing	**$44,042**	**4.4%**			**Total Marketing**	**$44,042**	**4.4%**
Other Variable Costs					**Other Variable Costs**		
Cleaning Materials	$6,500	0.6%			Cleaning Materials	$6,500	0.6%
Small wares	$2,800	0.3%			Small wares	$2,800	0.3%
Outside Maintenance	$7,500	0.7%			Outside Maintenance	$7,500	0.7%
Repairs	$9,500	0.9%	-$6,000	1	Repairs	$3,500	0.3%
Charitable Contributions	$3,000	0.3%	-$3,000	2	Charitable Contributions	$0	0.0%
Total Other Variable Costs	**$29,300**	**2.9%**			**Total Other Variable Costs**	**$20,300**	**2.0%**
Total COGS & Variable Costs	**$733,519**	**73.3%**			**Total COGS & Variable Costs**	**$724,519**	**72.4%**
Contribution Margin	**$267,738**	**26.7%**			**Contribution Margin**	**$276,738**	**27.6%**
Fixed Costs					**Fixed Costs**		
Rent	$120,000	12.0%			Rent	$120,000	12.0%
Depreciation & Amortization	$27,895	2.8%			Depreciation & Amortization	$27,895	2.8%
Utilities	$17,000	1.7%			Utilities	$17,000	1.7%
Property & Liability Insurance	$5,000	0.5%			Property & Liability Insurance	$5,000	0.5%
Interest on Bank Loan	$12,345	1.2%			Interest on Bank Loan	$12,345	1.2%
Automobile Expenses	$5,400	0.5%	-$5,400	3	Automobile Expenses	$0	0.0%
Travel & Entertainment	$7,564	0.8%	-$4,500	4	Travel & Entertainment	$3,064	0.3%
Dues & Subscriptions	$650	0.1%			Dues & Subscriptions	$650	0.1%
Owner's Salary	$55,000	5.5%	-$10,000	5	Owner's Salary	$45,000	4.5%
Overhead on Owner's Salary	$1,155	0.1%	$210	6	Overhead on Owner's Salary	$945	0.1%
Owner's Health & Life Insurance	$6,500	0.6%	-$2,000	7	Owner's Health & Life Insurance	$4,500	0.4%
Accounting & Tax Return Prep.	$0	0.0%	$4,000	8	Accounting & Tax Return Prep.	$4,000	0.4%
Total Fixed Costs	**$258,509**	**25.8%**			**Total Fixed Costs**	**$240,399**	**24.0%**
Net Profit	**$9,229**	**0.9%**			**Recast Net Profit**	**$36,339**	**3.6%**

Footnotes

1. This expense reduction is for the extraordinary one-time cost to repair a broken sewer line under the floor in the storage room
2. This is a voluntary non-operating expense for an annual contribution that the owner makes every year to the Red Cross
3. This is an owner prequisite. The company buys and maintains his personal auto which is not a necessary operating expense
4. The owner tries to go to the annual Restaurant Association convention every year. He also takes his wife and they generally stay a couple of extra days in whatever city the convention is held. This reduction reflects the extra amount paid for his wife to go with him and for the additional two days' stay.
5. This adjustment is made to reflect the fair market value salary the owner would have to pay a full-charge manager to take over his job.
6. To reflect the reduction in the owner's salary
7. It is customary in this region for salaried restaurant managers to receive health insurance benefits in addition to their salary. However it is not the custom to also receive a life insurance policy. Therefore this reduction is made to reflect the non-required annual life insurance premium
8. The owner's wife keeps the company's books and prepares all state and federal tax returns for the company and family. She is not paid for this work. This is an estimate of what it would cost to have an outside professional provide these services.

2. Recasting for Seller's Discretionary Earnings

Billy Bob's Barbecue INCOME STATEMENT For the Year Ending 12/31/05			Adjustments	Footnotes	Billy Bob's Barbecue RECAST INCOME STATEMENT For the Year Ending 12/31/05		
Gross Sales	$1,073,348	107.2%			Gross Sales	$1,073,348	107.2%
Less Sales Tax	-$72,091	-7.2%			Less Sales Tax	-$72,091	-7.2%
Net Sales	**$1,001,257**	**100.0%**			**Net Sales**	**$1,001,257**	**100.0%**
Cost of Goods Sold	$433,248	43.3%			Cost of Goods Sold	$433,248	43.3%
Gross Margin	**$568,009**	**56.7%**			**Gross Margin**	**$568,009**	**56.7%**
Variable Costs					**Variable Costs**		
Labor					**Labor**		
Direct Labor	$185,324	18.5%			Direct Labor	$185,324	18.5%
Overtime Labor	$5,560	0.6%			Overtime Labor	$5,560	0.6%
Vacation Pay	$7,413	0.7%			Vacation Pay	$7,413	0.7%
Employer's SSN	$14,316	1.4%			Employer's SSN	$14,316	1.4%
State Unemployment Insurance	$954	0.1%			State Unemployment Insurance	$954	0.1%
Federal Unemployment Tax	$954	0.1%			Federal Unemployment Tax	$954	0.1%
Worker's Comp Insurance	$12,407	1.2%			Worker's Comp Insurance	$12,407	1.2%
Total Labor Cost	**$226,929**	**22.7%**			**Total Labor Cost**	**$226,929**	**22.7%**
Marketing					**Marketing**		
Newspaper Ads	$22,000	2.2%			Newspaper Ads	$22,000	2.2%
Radio	$18,000	1.8%			Radio	$18,000	1.8%
Yellow Pages	$500	0.0%			Yellow Pages	$500	0.0%
Direct Mail	$3,542	0.4%			Direct Mail	$3,542	0.4%
Total Marketing	**$44,042**	**4.4%**			**Total Marketing**	**$44,042**	**4.4%**
Other Variable Costs					**Other Variable Costs**		
Cleaning Materials	$6,500	0.6%			Cleaning Materials	$6,500	0.6%
Small wares	$2,800	0.3%			Small wares	$2,800	0.3%
Outside Maintenance	$7,500	0.7%			Outside Maintenance	$7,500	0.7%
Repairs	$9,500	0.9%	-$6,000	1	Repairs	$3,500	0.3%
Charitable Contributions	$3,000	0.3%	-$3,000	2	Charitable Contributions	$0	0.0%
Total Other Variable Costs	**$29,300**	**2.9%**			**Total Other Variable Costs**	**$20,300**	**2.0%**
Total COGS & Variable Costs	**$733,519**	**73.3%**			**Total COGS & Variable Costs**	**$724,519**	**72.4%**
Contribution Margin	**$267,738**	**26.7%**			**Contribution Margin**	**$276,738**	**27.6%**
Fixed Costs					**Fixed Costs**		
Rent	$120,000	12.0%			Rent	$120,000	12.0%
Depreciation & Amortization	$27,895	2.8%	-$27,895	3	Depreciation & Amortization	$0	0.0%
Utilities	$17,000	1.7%			Utilities	$17,000	1.7%
Property & Liability Insurance	$5,000	0.5%			Property & Liability Insurance	$5,000	0.5%
Interest on Bank Loan	$12,345	1.2%	-$12,345	4	Interest on Bank Loan	$0	0.0%
Automobile Expenses	$5,400	0.5%	-$5,400	5	Automobile Expenses	$0	0.0%
Travel & Entertainment	$7,564	0.8%	-$4,500	6	Travel & Entertainment	$3,064	0.3%
Dues & Subscriptions	$650	0.1%			Dues & Subscriptions	$650	0.1%
Owner's Salary	$55,000	5.5%	-$55,000	7	Owner's Salary	$0	0.0%
Overhead on Owner's Salary	$1,155	0.1%	-$1,155	7	Overhead on Owner's Salary	$0	0.0%
Owner's Health & Life Insurance	$6,500	0.6%	-$6,500	7	Owner's Health & Life Insurance	$0	0.0%
Accounting & Tax Return Prep.	$0	0.0%	$4,000	8	Accounting & Tax Return Prep.	$4,000	0.4%
Total Fixed Costs	**$258,509**	**25.8%**			**Total Fixed Costs**	**$149,714**	**15.0%**
Net Profit	**$9,229**	**0.9%**			**Seller's Discretionary Earnings**	**$127,024**	**12.7%**

Footnotes

1. This expense reduction is for the extraordinary one-time cost to repair a broken sewer line under the floor in the storage room
2. This is a voluntary non-operating expense for an annual contribution that the owner makes every year to the Red Cross
3. Depreciation & Amortization is omitted when computing Seller's Discretionary Earnings
4. Interest on debt is omitted when computing Seller's Discretionary Earnings
5. This is an owner prequisite. The company buys and maintains his personal auto which is not a necessary operating expense
6. The owner tries to go to the annual Restaurant Association convention every year. He also takes his wife and they generally stay a couple of extra days in whatever city the convention is held. This reduction reflects the extra amount paid for his wife to go with him and for the additional two days' stay.
7. Owner's wages and prequisites are omitted when computing Seller's Discretionary Earnings
8. The owner's wife keeps the company's books and prepares all state and federal tax returns for the company and family. She is not paid for this work. This is an estimate of what it would cost to have an outside professional provide these services.

3. Recasting for EBITDA

Billy Bob's Barbecue			Adjustments	Footnotes	**Billy Bob's Barbecue**		
INCOME STATEMENT					**RECAST INCOME STATEMENT**		
For the Year Ending 12/31/05					**For the Year Ending 12/31/05**		
Gross Sales	$1,073,348	107.2%			Gross Sales	$1,073,348	107.2%
Less Sales Tax	-$72,091	-7.2%			Less Sales Tax	-$72,091	-7.2%
Net Sales	**$1,001,257**	**100.0%**			**Net Sales**	**$1,001,257**	**100.0%**
Cost of Goods Sold	$433,248	43.3%			Cost of Goods Sold	$433,248	43.3%
Gross Margin	**$568,009**	**56.7%**			**Gross Margin**	**$568,009**	**56.7%**
Variable Costs					**Variable Costs**		
Labor					**Labor**		
Direct Labor	$185,324	18.5%			Direct Labor	$185,324	18.5%
Overtime Labor	$5,560	0.6%			Overtime Labor	$5,560	0.6%
Vacation Pay	$7,413	0.7%			Vacation Pay	$7,413	0.7%
Employer's SSN	$14,316	1.4%			Employer's SSN	$14,316	1.4%
State Unemployment Insurance	$954	0.1%			State Unemployment Insurance	$954	0.1%
Federal Unemployment Tax	$954	0.1%			Federal Unemployment Tax	$954	0.1%
Worker's Comp Insurance	$12,407	1.2%			Worker's Comp Insurance	$12,407	1.2%
Total Labor Cost	**$226,929**	**22.7%**			**Total Labor Cost**	**$226,929**	**22.7%**
Marketing					**Marketing**		
Newspaper Ads	$22,000	2.2%			Newspaper Ads	$22,000	2.2%
Radio	$18,000	1.8%			Radio	$18,000	1.8%
Yellow Pages	$500	0.0%			Yellow Pages	$500	0.0%
Direct Mail	$3,542	0.4%			Direct Mail	$3,542	0.4%
Total Marketing	**$44,042**	**4.4%**			**Total Marketing**	**$44,042**	**4.4%**
Other Variable Costs					**Other Variable Costs**		
Cleaning Materials	$6,500	0.6%			Cleaning Materials	$6,500	0.6%
Small wares	$2,800	0.3%			Small wares	$2,800	0.3%
Outside Maintenance	$7,500	0.7%			Outside Maintenance	$7,500	0.7%
Repairs	$9,500	0.9%	-$6,000	1	Repairs	$3,500	0.3%
Charitable Contributions	$3,000	0.3%	-$3,000	2	Charitable Contributions	$0	0.0%
Total Other Variable Costs	**$29,300**	**2.9%**			**Total Other Variable Costs**	**$20,300**	**2.0%**
Total COGS & Variable Costs	**$733,519**	**73.3%**			**Total COGS & Variable Costs**	**$724,519**	**72.4%**
Contribution Margin	**$267,738**	**26.7%**			**Contribution Margin**	**$276,738**	**27.6%**
Fixed Costs					**Fixed Costs**		
Rent	$120,000	12.0%			Rent	$120,000	12.0%
Depreciation & Amortization	$27,895	2.8%	-$27,895	3	Depreciation & Amortization	$0	0.0%
Utilities	$17,000	1.7%			Utilities	$17,000	1.7%
Property & Liability Insurance	$5,000	0.5%			Property & Liability Insurance	$5,000	0.5%
Interest on Bank Loan	$12,345	1.2%	-$12,345	4	Interest on Bank Loan	$0	0.0%
Automobile Expenses	$5,400	0.5%	-$5,400	5	Automobile Expenses	$0	0.0%
Travel & Entertainment	$7,564	0.8%	-$4,500	6	Travel & Entertainment	$3,064	0.3%
Dues & Subscriptions	$650	0.1%			Dues & Subscriptions	$650	0.1%
Owner's Salary	$55,000	5.5%	-$10,000	7	Owner's Salary	$45,000	4.5%
Overhead on Owner's Salary	$1,155	0.1%	$210	8	Overhead on Owner's Salary	$945	0.1%
Owner's Health & Life Insurance	$6,500	0.6%	-$2,000	9	Owner's Health & Life Insurance	$4,500	0.4%
Accounting & Tax Return Prep.	$0	0.0%	$4,000	10	Accounting & Tax Return Prep.	$4,000	0.4%
Total Fixed Costs	**$258,509**	**25.8%**			**Total Fixed Costs**	**$200,159**	**20.0%**
Net Profit	**$9,229**	**0.9%**			**Earnings Before Interest, Taxes, Depreciation & Amortization--EBITDA**	**$76,579**	**7.6%**

Footnotes

1. This expense reduction is for the extraordinary one-time cost to repair a broken sewer line under the floor in the storage room
2. This is a voluntary non-operating expense for an annual contribution that the owner makes every year to the Red Cross
3. Depreciation & Amortization is omitted when computing Earnings Before Interest, Taxes, Depreciation & Amortization
4. Interest on debt is omitted when computing Earnings Before Interest, Taxes, Depreciation & Amortization
5. This is an owner prequisite. The company buys and maintains his personal auto which is not a necessary operating expense
6. The owner tries to go to the annual Restaurant Association convention every year. He also takes his wife and they generally stay a couple of extra days in whatever city the convention is held. This reduction reflects the extra amount paid for his wife to go with him and for the additional two days' stay.
7. This adjustment is made to reflect the fair market value salary the owner would have to pay a full-charge manager to take over his job.
8. To reflect the reduction in the owner's salary
9. It is customary in this region for salaried restaurant managers to receive health insurance benefits in addition to their salary. However it is not the custom to also receive a life insurance policy. Therefore this reduction is made to reflect the non-required annual life insurance premium
10. The owner's wife keeps the company's books and prepares all state and federal tax returns for the company and family. She is not paid for this work. This is an estimate of what it would cost to have an outside professional provide these services.

4. Recasting for EBIT

Billy Bob's Barbecue INCOME STATEMENT For the Year Ending 12/31/05			Adjustments	Footnotes	Billy Bob's Barbecue RECAST INCOME STATEMENT For the Year Ending 12/31/05		
Gross Sales	$1,073,348	107.2%			Gross Sales	$1,073,348	107.2%
Less Sales Tax	-$72,091	-7.2%			Less Sales Tax	-$72,091	-7.2%
Net Sales	**$1,001,257**	**100.0%**			**Net Sales**	**$1,001,257**	**100.0%**
Cost of Goods Sold	$433,248	43.3%			Cost of Goods Sold	$433,248	43.3%
Gross Margin	**$568,009**	**56.7%**			**Gross Margin**	**$568,009**	**56.7%**
Variable Costs					**Variable Costs**		
Labor					**Labor**		
Direct Labor	$185,324	18.5%			Direct Labor	$185,324	18.5%
Overtime Labor	$5,560	0.6%			Overtime Labor	$5,560	0.6%
Vacation Pay	$7,413	0.7%			Vacation Pay	$7,413	0.7%
Employer's SSN	$14,316	1.4%			Employer's SSN	$14,316	1.4%
State Unemployment Insurance	$954	0.1%			State Unemployment Insurance	$954	0.1%
Federal Unemployment Tax	$954	0.1%			Federal Unemployment Tax	$954	0.1%
Worker's Comp Insurance	$12,407	1.2%			Worker's Comp Insurance	$12,407	1.2%
Total Labor Cost	**$226,929**	**22.7%**			**Total Labor Cost**	**$226,929**	**22.7%**
Marketing					**Marketing**		
Newspaper Ads	$22,000	2.2%			Newspaper Ads	$22,000	2.2%
Radio	$18,000	1.8%			Radio	$18,000	1.8%
Yellow Pages	$500	0.0%			Yellow Pages	$500	0.0%
Direct Mail	$3,542	0.4%			Direct Mail	$3,542	0.4%
Total Marketing	**$44,042**	**4.4%**			**Total Marketing**	**$44,042**	**4.4%**
Other Variable Costs					**Other Variable Costs**		
Cleaning Materials	$6,500	0.6%			Cleaning Materials	$6,500	0.6%
Small wares	$2,800	0.3%			Small wares	$2,800	0.3%
Outside Maintenance	$7,500	0.7%			Outside Maintenance	$7,500	0.7%
Repairs	$9,500	0.9%	-$6,000	1	Repairs	$3,500	0.3%
Charitable Contributions	$3,000	0.3%	-$3,000	2	Charitable Contributions	$0	0.0%
Total Other Variable Costs	**$29,300**	**2.9%**			**Total Other Variable Costs**	**$20,300**	**2.0%**
Total COGS & Variable Costs	**$733,519**	**73.3%**			**Total COGS & Variable Costs**	**$724,519**	**72.4%**
Contribution Margin	**$267,738**	**26.7%**			**Contribution Margin**	**$276,738**	**27.6%**
Fixed Costs					**Fixed Costs**		
Rent	$120,000	12.0%			Rent	$120,000	12.0%
Depreciation & Amortization	$27,895	2.8%			Depreciation & Amortization	$27,895	2.8%
Utilities	$17,000	1.7%			Utilities	$17,000	1.7%
Property & Liability Insurance	$5,000	0.5%			Property & Liability Insurance	$5,000	0.5%
Interest on Bank Loan	$12,345	1.2%	-$12,345	3	Interest on Bank Loan	$0	0.0%
Automobile Expenses	$5,400	0.5%	-$5,400	4	Automobile Expenses	$0	0.0%
Travel & Entertainment	$7,564	0.8%	-$4,500	5	Travel & Entertainment	$3,064	0.3%
Dues & Subscriptions	$650	0.1%			Dues & Subscriptions	$650	0.1%
Owner's Salary	$55,000	5.5%	-$10,000	6	Owner's Salary	$45,000	4.5%
Overhead on Owner's Salary	$1,155	0.1%	$210	7	Overhead on Owner's Salary	$945	0.1%
Owner's Health & Life Insurance	$6,500	0.6%	-$2,000	8	Owner's Health & Life Insurance	$4,500	0.4%
Accounting & Tax Return Prep.	$0	0.0%	$4,000	9	Accounting & Tax Return Prep.	$4,000	0.4%
Total Fixed Costs	**$258,509**	**25.8%**			**Total Fixed Costs**	**$228,054**	**22.8%**
Net Profit	**$9,229**	**0.9%**			**Earnings Before Interest Taxes--EBIT**	**$48,684**	**4.9%**

Footnotes

1. This expense reduction is for the extraordinary one-time cost to repair a broken sewer line under the floor in the storage room
2. This is a voluntary non-operating expense for an annual contribution that the owner makes every year to the Red Cross
3. Interest on debt is omitted when computing Earnings Before Interest & Taxes
4. This is an owner prequisite. The company buys and maintains his personal auto which is not a necessary operating expense
5. The owner tries to go to the annual Restaurant Association convention every year. He also takes his wife and they generally stay a couple of extra days in whatever city the convention is held. This reduction reflects the extra amount paid for his wife to go with him and for the additional two days' stay.
6. This adjustment is made to reflect the fair market value salary the owner would have to pay a full-charge manager to take over his job.
7. To reflect the reduction in the owner's salary
8. It is customary in this region for salaried restaurant managers to receive health insurance benefits in addition to their salary. However it is not the custom to also receive a life insurance policy. Therefore this reduction is made to reflect the non-required annual life insurance premium
9. The owner's wife keeps the company's books and prepares all state and federal tax returns for the company and family. She is not paid for this work. This is an estimate of what it would cost to have an outside professional provide these services.

An alternative recasting format (Easier to do, but less helpful in my opinion)

Billy Bob's Barbecue
INCOME STATEMENT
For the Year Ending 12/31/05

Gross Sales	$1,073,348	107.2%	footnotes
Less Sales Tax	-$72,091	-7.2%	
Net Sales	**$1,001,257**	**100.0%**	
Cost of Goods Sold	$433,248	43.3%	
Gross Margin	**$568,009**	**56.7%**	
Variable Costs			
Labor			
Direct Labor	$185,324	18.5%	
Overtime Labor	$5,560	0.6%	
Vacation Pay	$7,413	0.7%	
Employer's SSN	$14,316	1.4%	
State Unemployment Insurance	$954	0.1%	
Federal Unemployment Tax	$954	0.1%	
Worker's Comp Insurance	$12,407	1.2%	
Total Labor Cost	**$226,929**	**22.7%**	
Marketing			
Newspaper Ads	$22,000	2.2%	
Radio	$18,000	1.8%	
Yellow Pages	$500	0.0%	
Direct Mail	$3,542	0.4%	
Total Marketing	**$44,042**	**4.4%**	
Other Variable Costs			
Cleaning Materials	$6,500	0.6%	
Small wares	$2,800	0.3%	
Outside Maintenance	$7,500	0.7%	
Repairs	$9,500	0.9%	1
Charitable Contributions	$3,000	0.3%	2
Total Other Variable Costs	**$29,300**	**2.9%**	
Total COGS & Variable Costs	**$733,519**	**73.3%**	
Contribution Margin	**$267,738**	**26.7%**	
Fixed Costs			
Rent	$120,000	12.0%	
Depreciation & Amortization	$27,895	2.8%	3
Utilities	$17,000	1.7%	
Property & Liability Insurance	$5,000	0.5%	
Interest on Bank Loan	$12,345	1.2%	4
Automobile Expenses	$5,400	0.5%	5
Travel & Entertainment	$7,564	0.8%	6
Dues & Subscriptions	$650	0.1%	
Owner's Salary	$55,000	5.5%	7
Overhead on Owner's Salary	$1,155	0.1%	7
Owner's Health & Life Insurance	$6,500	0.6%	7
Accounting & Tax Return Prep.	$0	0.0%	8
Total Fixed Costs	**$258,509**	**25.8%**	
Net Profit	**$9,229**	**0.9%**	

	$6,000	1. This expense reduction is for the extraordinary one-time cost to repair a broken sewer line under the floor in the storage room
	$3,000	2. This is a voluntary non-operating expense for an annual contribution that the owner makes every year to the Red Cross
	$27,895	3. Depreciation & Amortization is omitted when computing Seller's Discretionary Earnings
	$12,345	4. Interest on debt is omitted when computing Seller's Discretionary Earnings
	$5,400	5. This is an owner prequisite. The company buys and maintains his personal auto which is not a necessary operating expense
	$4,500	6. The owner tries to go to the annual Restaurant Association convention every year. He also takes his wife and they generally stay a couple of extra days in whatever city the convention is held. This reduction reflects the extra amount paid for his wife to go with him and for the additional two days' stay.
	$55,000	7. Owner's wages and prequisites are omitted when computing Seller's Discretionary Earnings
	$1,155	7. Owner's wages and prequisites are omitted when computing Seller's Discretionary Earnings
	$6,500	7. Owner's wages and prequisites are omitted when computing Seller's Discretionary Earnings
	-$4,000	8. The owner's wife keeps the company's books and prepares all state and federal tax returns for the company and family. She is not
Seller's Discretionary Earnings	**$127,024**	paid for this work. This is an estimate of what it would cost to have an outside professional provide these services.

Why Owner’s Discretionary Cash Flow includes the salary and perquisites of only *one* owner/manager

The value of a business is based on that business's earnings. For most small businesses with annual sales around $3 million or less, the level of earnings that I think is the most useful to estimate value is Owner's Discretionary Cash Flow.

Owner's Discretionary Cash Flow is all the owner's wages, bonuses and other non-cash benefits-i.e., owner perquisites-drawn out by the owner plus depreciation and interest on debt and pre-tax profit. Most of the time the selling price of small businesses ranges between 1.5 and 2.5 times Owner's Discretionary Cash Flow plus current assets such as cash, inventory and accounts receivable. I can say this with a great deal of confidence because it is based on the published selling price of several thousand small businesses.

Figure 1

Figure 1 shows the distribution of selling prices for 4,894 small businesses expressed in terms of their price/earnings multiples. The source of this data is the Bizcomps database. The average P/E multiple is 1.93, meaning the average selling price among all small businesses included in the data base was 1.93 times Owner's Discretionary Cash Flow (plus current assets included in the transaction). Keep in mind that this chart reflects actual P/E ratios which have not been adjusted to reflect their all-cash equivalent values. Most small business sales are transacted on terms requiring the seller to carry back a significant portion of the selling price in a promissory note that is paid off over time by the buyer. All-cash transactions tend to be consummated at selling prices generally ranging between 8% and 15% less than transactions involving seller financing.

The concept of "owner's discretionary cash flow" may at first appear simple enough. However, I have found on occasion that there is some confusion among business owners about how to compute this level of earnings. The confusion is centered on how to account for the owners' earnings when there is more than one working owner. The correct procedure is to include all the salary and bonuses of just ONE working owner and only the increment, if any, above the fair market value wage for any other working owners. (Or, subtract from actual cash flow an amount equal to the fair market value wage for anyone except the principal working owner who works in the business but does not draw a wage). The cash flow is computed in this way because that's how the earnings were computed for the published transaction data whence the average price/earnings multiple for small businesses was derived.

To include the actual wages paid to all working owners when computing owner’s discretionary cash flow and then multiplying that cash flow by a number ranging between 1.5 and 2.5 will produce an incorrect estimate of a small business's probable selling price.

Were this not so, consider the odd scenario that would result between two hypothetical restaurants, one owned by Bob and Carol and the other owned by Ted and Alice. Assume these two restaurants are identical in every respect including historical earnings and future earnings prospects. Let's say that both Bob and Carol and Ted and Alice all draw equal salaries of $30,000 a year. Let's further assume this is the fair market value wage each would have to pay an outsider to do their respective jobs. In both cases, the books show annual depreciation of $8,000, interest expense of $2,000 and profit of $10,000.

Thus, the operating statements for both restaurants show owners' combined salaries of $60,000 plus $20,000 in depreciation, interest expense and profit. Assuming in this instance that the appropriate earnings multiplier necessary to estimate the probable selling price of both businesses is 2.0 and further assuming all owners' salaries should be included in the calculation, then the value of each restaurant would be 2 x $80,000 or $160,000 (plus current assets)-right?

But what if Carol quits and an outsider has to be hired at $30,000 to do her job? If this were the case, owners' discretionary cash flow would decline to $50,000 a year, and the business would now be worth only $100,000 while Ted and Alice's identical restaurant is still worth $160,000.

But then let's say Carol has a change of heart and decides she wants to go back to work. Bob won't agree to this, but Ted and Alice invite her to become partners with them. So Carol buys a 1/3 interest in Ted and Alice's restaurant for $53,333 (i.e., 1/3 of $160,000) and replaces the former kitchen manager at that person's salary of $30,000 a year. Now we have three working owners in one restaurant with combined annual salaries of $90,000. Add depreciation, interest and profit of $20,000, multiply that sum by 2.0 and the new value for this business is $220,000-wow!

Bob has a change of heart and begs Carol to come back. Carol agrees, sells her 1/3 interest in Ted and Alice's restaurant back to them for $73,333 (1/3 the new value), pockets a cool $20,000 profit on the sale, rejoins Bob and is again making $30,000 a year. With this, Bob's restaurant, having been rejoined by Carol, now increases in value from $100,000 back up to $160,000, and the value of Ted and Alice's restaurant drops from $220,000 back down to $160,000. Alice finds this quite upsetting and leaves Ted. Ted becomes distraught, replaces Alice and himself with two hired managers, paying them each $30,000 a year, and sets out for places unknown on his Harley. Now his business has an annual cash flow of $20,000, making it worth only $40,000.

If all of this seems absurd, that's because it is. Both restaurants were always worth 2.0 times $50,000-i.e., the total of ONE owner's salary (plus perks) of $30,000 + $20,000 in depreciation, interest and profit or $100,000 (plus current assets).