Ask a VR Intermediary

What is meant by the cash flow of a business?

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Every first-time buyer faces a daunting challenge of determining fair market value, particularly understanding the concept of cash flow.

With cash flow, there is a broad-based agreement that it's equal to:

Net Income (per the books or tax returns)
+
Owner's Salary/Payroll Taxes (if deducted to arrive at net income)
+
Discretionary Expenditures (e.g. auto payments, travel and entertainment, personal insurance)
+
Depreciation and Amortization (non-cash expenses)
+/-
One-Time Expenses/Revenues (non-recurring, unusual expenses or revenues unlikely to occur)
+
Interest Expenditures (an add-back because we seek a bottom-line figure representing cash)

Understanding Cash Flow

Various brokers will refer to this amount using different terms besides cash flow such as:

- Net Operating Income (NOI),
- Discretionary Earnings (DE),
- Seller's Discretionary Cash (SDC).

NOTE: Cash flow does not refer to gross sales or revenues. Any VR Business Sales intermediary will explain that this is known as the ***seller's discretionary cash flows (SDC)***. This represents the amount of cash flow available to a new owner after all expenses, but before income taxes. This amount will accomplish three things:

1. Pay the owner-operator a reasonable salary;
2. Service the debt associated with the acquisition;
3. Earn a return on the cash investment.

Seller's Discretionary Cash (SDC)

Many disagree over what precisely makes up SDC. The general thought on SDC is we're seeking a figure that consistently represents the cash flow available to a new owner who will be working the business full-time – 40 to 60 hours a week.

Accountant and Attorney Fees

Where disagreements come about are over whether or not to include excessive payments to accountants or attorneys. The amount of fees could be reduced or possibly even eliminated, if you as the new owner will be preparing financial statements using software such as QuickBooks. If legal expenses were of a personal nature such as changing a will, they should be added back into cash flow in their entirety, as well as any other personal expenses.

Family Members
This is another common area of dispute over what makes up the SDC. Some family members will do a large amount of work without receiving a dime, while other family member may do very little work, if any at all, and receive large amounts of money or services.

The first situation will call for SDC reductions, whereas the latter will call for an increase – both will entail somewhat arbitrary assessments.

It is these types of adjustments that make it essential that buyer and seller be honest and forthright with each other from the very beginning. If there is trust and mutual respect, these issues are easily addressed. If not, each new issue which calls for judgment and/or concessions may become increasingly troublesome.

There is no substitute for mutual trust and respect when it comes to concluding the purchase to sale of a business, which requires literally hundreds of separate agreements within the agreement!

If You're Going to be an Absentee Owner
The cash flow available to you as the new owner must be reduced by the amount of a reasonable manager's salary if you are going to be an absentee owner instead of a full-time one.

If the current owner is an absentee one, the SDC will include the amount paid to the manager to arrive at the cash flow that would be available to you as the new owner if you're going to be a full-time manager of the business. The major advantage of calculating cash flow to a full-time owner-operator is that most purchases are made by people who will be exclusively devoted to the business – allowing useful comparisons of cash flow performance from one business to the next.