HAS SOLD MORE BUSINESSES IN THE WORLD THAN ANYONE.®

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What is Discretionary Earnings & Why is it the Most Important Driver of Small Business Value?

Definition

Discretionary Earnings ("DE") is an estimate of the total financial benefit a full time owner operator would derive from the business on an annual basis. It is also variously referred to as Seller's Discretionary Cash Flow, Adjusted Cash Flow, Owner Benefit, Recast Earnings or Normalized Earnings, although Seller's Discretionary Earnings is the official terminology advocated by the International Business Broker's Association (IBBA).

Calculation

The IBBA has defined how DE is to be calculated. A business's overall DE is generally calculated as an average of the DE for the 3-5 most recent years. If there is a strong trend in the earnings (up or down), much more weight tends to be placed on more recent years. DE is calculated for each year based on information from the business tax returns, the profit and loss statements (P&Ls), other financial records and owner estimates.

The DE for each year is calculated as follows:

* Owner compensation, salary, profit sharing, etc. (i.e., cash consideration) paid to all the owners, less the salary of any employee(s) needed to replace a 2nd or 3rd (etc.) owner, plus
* Employer portion of payroll taxes paid based on the W2 salary of one owner, plus
* Pretax net income, plus
* Interest expense (because business debt is a "non operating expense" and assumed to be paid off), plus
* Depreciation and amortization (non cash expenses), plus
* "Discretionary expenses" or perks that are paid by the business but really benefit the owner not the business. Common examples include owner's health insurance, personal use of automobiles, personal travel, personal meals and entertainment, etc.
* Adjustments for extraordinary, non recurring expenses or revenue (e.g., expenses from a rare lawsuit or flood damage would be added back; revenue and expenses from a major discontinued product would be removed)

Discretionary Expenses - Explained

Discretionary expenses are defined to be ones that the business paid for but are primarily of a personal benefit to the owner(s). Typical expense categories (places to check on your tax returns/ P&Ls) are owner medical or life insurance, travel, automobiles, meals and entertainment, dues and memberships.
To qualify as discretionary, each expense must meet all 4 of these criteria:
1) benefit the owner(s)
2) not benefit the business or the employees

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3) are paid for by the business and expensed on tax returns and P&Ls
4) be documented and verifiable by a prospective buyer as discretionary.

Illustrative examples of expenses that would **NOT** qualify would include:
* Medical benefits for an employee
* Counting all meal & entertainment expenses as discretionary even though dining with clients is a critical way of building relationships
* Counting all travel as discretionary, even though some travel is necessary for business (such as to a trade show)
* Counting all auto expenses as discretionary even though the vehicles are used to deliver products or by employees
* Any marketing or promotion related expense even if it "didn't work and it wouldn't be done again"
* Expenses for a Rotary or club membership if any clients are gained through such memberships
* Counting unreported cash sales unless the buyer has a straightforward means to verify such sales
* Counting dozens of personal purchases on a credit card where the card is also used for business purchases, or where the expenses are buried in a much larger expense category or several expense categories and therefore nearly impossible for a buyer to verify.

It is better to be conservative in your estimates than aggressive. If buyers believe you are exaggerating the discretionary expenses, they will conclude you are untrustworthy and likely making other misrepresentations and walk away. Worse, if they purchase the business based on your misrepresentations, you may be guilty of fraud. .

Extraordinary Expenses - Explained
Extraordinary expenses are defined to be ones that 1) the business paid for 2) are truly unusual or exceptional in nature; i.e., are very unlikely to reoccur, and 3) documented and verifiable as extraordinary. By their nature there are no "typical" extraordinary expenses. Examples might include expenses associated with natural disasters, a move of location, or a law suit out of the ordinary course of business. Examples of expenses that would not qualify would include a marketing campaign that failed, headhunter fees to replace a manager that quit, etc. Again, please be conservative. Note that most businesses list nothing here

Non Operating Revenue & Expenses - Explained
Non operating revenue is unrelated to the business operations, such as interest revenue, rent from a property owned through the business or sale of equipment or part of the business. Non operating expenses might include those to repair or fix up a building owned by the business.

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