HOW PERSONAL ADD-BACKS IMPACT EXIT VALUES FOR OWNERS

As a business owner who may be thinking about planning for your exit in the next two (2) to ten (10) years, it is important to know how your personal and one-time expenses in the business will impact the value that you will receive. Because the sale or transfer of a business is worth only what a future owner expects to receive in benefits from owning your business, it is important to consider what type of personal expenses you run through your business and which of those expenses you will need to illustrate to show the future owner the true future cash flow available to them. When you understand how your personal expenses and add-backs impact your exit value, you will be in a better position to have a successful exit transaction.

Owners Sometimes Treat Their Businesses Like Piggy Banks

Owners of privately-held businesses tend to treat their company cash flow as their own personal piggy bank. What this means is that extra cash at the end of each year is often distributed to the owners either as additional salary compensation or in the form of a distribution. The rationale that most owners have for this activity is that additional compensation is simply their benefit for working hard and successfully generating a profit for the year. Moreover, owners will often rationalize personal expenses as business expenses as well as put their spouses and/or children on the payroll (even though they do not work at the company), and expand their travel and expense budgets in order to further enjoy the fruits of owning their privately-held business.

Typical Personal and One-Time Expenses that Owners Have in Their Businesses

Every owner has a different view of what expenses they will deduct from their company each year. Moreover, many times a business will experience a legitimate business expense that is unlikely to repeat in future years. The general idea behind expensing these items is to reduce the 'net income' that the owner shows each year for tax purposes. However, it is important to understand that these expenses, similar to the personal expenses, may also work to reduce an owner's value at the time of exit because, without adjustments to your net income statement, your future owner will simply see a lower net income which will lead to a lower price that they are willing to pay for the business.

So, without some form of reliable accounting and explanation, in each instance where a personal expense or a one-time expense has occurred in the business, the owner is, in effect, reducing the value of their business at the time of exit.

The 'Normalization Process' to Get to the Company's True Cash Flow

The process of adding back these personal (and one-time) expenses is called a 'normalization' process. Done properly, this process will identify all of the personal and non-recurring expenses within the business and will add them back to show a future owner the true earnings potential of that privately-held business.

Here is an illustration of how add-backs are accounted for and demonstrated to a future buyer.

Sample Income Statement

	2011	Add-Backs	2011 (adj.)
Revenue	5,458,500		5,458,500
Expenses			
Salaries	2,154,654	300,000	1,854,654
Office Exp.	58,254	14,500	43,754
Trav. & Ent.	35,421	18,250	17,171
Utilities	31,224		31,224
Rent	124,556		124,556
Payroll Tax	48,525		48,525
Vehicle Exp.	22,134	11,450	10,684
Contributions	18,954	12,000	6,954
Other Exp.	1,134,546	100,500	1,034,046
Total Expenses	3,628,268	456,700	3,171,568
Net Income	**1,830,232**		**2,286,932**

Example

This example shows some typical personal and one-time expenses that an owner may have in their business. For instance, an add-back of $14,500 under office expense could represent the purchase of new computers for the work stations in your office, an expense that would not be recurring for a future owner.

The total add-backs are equal to $456,700 added back to the cash flow of the business. If the value of the business is estimated to be 4.5 times the cash flow, you will have increased the value of this business by approximately $2,000,000 by accounting for these expenses.

As the illustration shows, adding back the personal expenses and non-recurring expenses substantially increases the 'net income' that will be available to your future owner. When you detail these add-back items for the next owner of your business, you promote the value of your business by more accurately representing the true cash flow that will be available to that owner. Again, without this add-back / normalization process, your future owner would simply use the 'net income' that you provide to them as the most reliable indication of cash flow that will be available to them when they own your business.

Now that you have demonstrated the cash flow, you are in a position to require that your future owner compensate you for that cash flow when they come up with a value that they are willing to pay you for your business.

Concluding Thoughts

When considering an exit from your privately-held business, it is important to remember that it is your responsibility to demonstrate the future earnings power of your business to your future owner. By following a simple process that is illustrated in this newsletter you can normalize your cash flows and substantially improve the potential value that a future owner is willing to pay you for your business.

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