Valuation Guide

For the Lower Middle Market

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Earnings: EBITDA and SDE

The basis of a company valuation is earnings so we'll start there. As we'll see, there may some things that will pull the valuation up (or down), but the basic foundation of value is how much the company makes. However, there's a lot of confusion about different flavors of earnings, and what the phrase "adjusted earnings" really means. For example, I received an email about a business that was for sale and it said, "$800,000 EBITDA, a.k.a. seller's discretionary earnings." No, EBITDA is not also known as SDE. They are very different.

The term "seller's discretionary earning" (or discretionary earnings) is generally used for smaller companies with less than $500,000 in earnings that are typically owned by the manager. In this case, it can be hard to separate what the owner/operator gets compared to the earnings of the company. So we add them together into one number. Another way of saying this is that you're adding back one owner's salary (in addition to the interest, depreciation, etc. mentioned above). Thus, when you as a buyer are looking at a business that has an SDE of, say, $200,000, you know that you have $200,000 to spend on living, taxes, interest and capital expenditures. That way, if you historically have been living on a $120,000 salary, then you can think of the business as making $80,000 above that, and that $80,000 is available to service debt, enhance your savings account, and fill other needs.

The term "earnings before interest, taxes, depreciation, and amortization" (EBITDA) is typically used for larger companies, usually earning more than $500,000. The term is generally used to show an investor/buyer (vs. an owner/operator) how much a company is earning. The investor does not actively run the company, and must pay a professional manager to do that for him. Thus, the manager's salary has been expensed and not included in the earnings calculation. It is not added back as in the SDE calculation. Simply put, EBITDA is a way for an investor to measure the return on investment he will receive should he purchase a company.

I should mention that advanced investors go further than EBITDA and use discounted free cash flow or discounted cash flow (DCF) analysis. EBITDA is not a true cash flow, and really what an investor wants to know is how much cash a business will generate in the future. A DCF model includes taxes, working capital, growth, and anything else that impacts cash flow. It then discounts those future cash flows to a present value. DCF is pretty hard to do correctly because it can be very difficult to estimate future cash flows and to calculate a discount rate factor for risk, so it isn't used all that often.

Sometimes small businesses (typically those sold using SDE as the valuation metric) are sold with nothing left in the business – no cash, no payables, and no accounts receivables. The new owner needs to recognize that and leave themselves enough cash to fund the working capital needs of the business.

Larger companies (typically those that use EBITDA as the valuation metric), are sold with "gas in the car". That is, a new owner buys the company with the expectation that enough working capital (including cash, AR, AP, inventory, etc.) is left in the company to continue to run it.

That doesn't mean that all cash is always left in the business. Excess cash,

which would be the amount of extra cash on hand that isn't required to run the business, is taken out and "taken home" with the seller.

EBITDA attempts to standardize the earnings number by excluding items that are variable and discretionary from company to company. For example, one company may have a heavy debt load while another may have none. So we exclude interest expense from EBITDA. A buyer then calculates what his debt load will be and can adjust the earnings number to fit his situation. Same with taxes – some companies have different tax strategies, so we use a pretax earnings number. Depreciation and amortization are non-cash expenses, and also are more of an accounting method rather than real-world depreciation of assets, so we exclude that as well.

However, don't completely discount depreciation of assets. A smart seller will capitalize and depreciate assets (instead of expensing them) in the years before a sale to boost earnings. A smart buyer will remove depreciation, but then look at expected capital expenditures ("CapEx") so they know they will have the cash flow in the future to buy needed assets and continue to improve the business.

Deal Extracts

Sometimes sellers forget that earnings are the underpinnings of their company's value. I remember one situation where we had a deal in due diligence with a letter of intent and an agreement on price. The acquiring company sent in a team to look at the books. They spent a few days there and when they got back home, they called us and said they were "shocked" by what they found. The earnings number projected for the year was far below those presented to them previously. Uh-oh.

It turns out the audit team had used internal planning documents that were unadjusted and intended to look at a worst-case scenario. The owner had his personal airplane expenses included and some legal expenses that would not continue after a sale. In addition, the owner was an engineer, and in his mind (I'm an engineer too, so I can say this) he didn't count future sales for the year unless he had a firm, signed contract. If you asked him if he expected additional sales he would say, "Of course, but these with the signed contracts

are the ones we absolutely know we have."

So the expenses were too heavy and the revenue was too light. Once we pointed this out to the buyers they understood this, and a crisis was averted.

Adjusting earnings – Add-backs

The value of a business is almost always dependent on earnings. But it is adjusted earnings, called Adjusted EBITDA, that is used for the valuation. For instance, EBITDA is often adjusted to make sure it is before taxes, interest and depreciation. "Owner's benefit" can also be an adjustment, and that can be a tricky add-back.

Remember, EBITDA reflects the earnings flowing to an investor that owns a company. We will often work with an owner-operator that doesn't necessarily pay himself market rate – he pays himself what he wants to, or what he can. It may be far more than market rate, or often it is far less (for example, the owner takes out earnings via dividends or simply leaves it in the business to fund growth). A fair an accurate EBITDA number includes the market rate wages and benefits of a manager that doesn't own the company.

Often the easiest way to do this is to add back ALL the current owner's wages and benefits. Then you subtract out the market rate wages and benefit of a professional manager. Of course, it often isn't that simple. We'll see multiple owners of one company (such as a husband/wife team) and they don't work full time, yet they do completely different functions. How many people would the new owner have to hire? Two half-time workers? Sometimes we see a spouse working full-time in the company and not getting paid at all. In that case, we have to do a negative adjustment to account for the fact that a new buyer is unlikely to find someone to work for free.

Other add-backs for owner's benefit are health insurance, life insurance, pension and any owner perks, such as personal expenses written off as company expenses. We have even seen companies with 7 digit "charitable contributions" where their chosen charity project was a new house for themselves. The purpose is to try to determine what benefits a new owner would enjoy and what discretionary expenses a new owner may decide to spend according to his own taste.

Sometimes it gets awkward when the owner is taking so many perks that it really amounts to tax fraud. Everyone does some tweaking, such as putting the families' cell phones into the company, or writing off car expenses when the company doesn't really use the car. These are generally accepted as "legitimate" add-backs – even by the SBA, which is after all a part of the government. You can usually add back a few tougher items, like a son or daughter who is on the payroll but isn't actually working. But at some point you have to draw the line (or the buyer will draw one for you).

Other add-backs are one-time items such as moving expenses, some legal expenses or major repairs. Once you have the correct add-backs folded back into earnings, you then have your adjusted EBITDA, and this number can be used to compare the company to similar companies or even across industries for the purposes of valuation or showing a new buyer what he or she can make from the business.

Some M & A firms (and sellers) get very aggressive when it comes to adjusting financial statements. Beside automatic add-backs for taxes, depreciation and interest (these of course are added back by definition), you can also make adjustments for the aforementioned one-time expenses and discretionary expenses. But it isn't a cut and dried formula and it takes a little common sense to apply the rules. The basic premise of these adjustments is that you are trying to estimate what a buyer will experience in the future as the new owner. It is that simple.

If as an owner you are doing the work of two people the add-backs need to be adjusted to accommodate for potentially adding another employee. I have seen buyers trying to find ways to increase expenses and reduce the recast EBITDA. It is our job to make sure that in the initial presentation of the financials we have properly accounted for the proper

expenses on a go forward basis and not have any surprises from a buyer poking holes in the presentation.

I was reviewing a financial statement on behalf of a client who was looking to buy a high-end closet and garage-organizing business. Almost every account had an adjustment and I was having a hard time taking it all in. Why, for example, was there an adjustment of $6,500 for tools and equipment? I was told it was a one-time expense, and the tools purchased last a long time. OK, then why the adjustment the year prior? Different tools I was told. Wasn't it probable that each year there are tools to purchase? In other words, the M & A Advisor was saying that the new owner would not have to purchase any tools or equipment to sustain the business. That was probably not the case.

How about travel, in which almost everything was added back? Well, I was told, much of that was personal, and the remainder was to go to an industry convention that they go to each year. But, in a buyer/seller meeting, the seller told the buyer the convention was great and taught them a great deal about running the business. Therefore, going to the trade show is important to running the business and therefore not an expense that can be legitimately added back.

The financials were also packed with personal expenses, like airplane fares, phone bills, and undisclosed credit card purchases. You learn quickly in this business that adjustments for personal expenses that were run through the company for tax reasons are quite common. You often hear that "everyone does it" and practically everyone does. But there is a limit. The IRS has a limit, the lenders have a different limit, and the individual buyers also have a limit. At some point, the buyers start to wonder, "If the seller goes to great lengths to hide that much money from the IRS, might they also try to take a little extra money from me?"

That was exactly what I was thinking in the case of the closet company. I

asked to see the details of the personal credit card purchases. I was told no, and given the explanation that the card the owner's wife's personal credit card and that that should be enough evidence that the purchases were purely personal (but paid for by the company).

You know that a company's value is directly affected by earnings, more specifically, future earnings. It became apparent to me that a new owner would not enjoy the profits that the seller and advisor had calculated, and thus the business wasn't worth the asking price. We rejected some of the add-backs and came up with an offer based on the same multiple of earnings that the asking price used. The seller became quite angry – so angry, in fact, that we never heard from him again.

The seller did not sell the business that year. He is working with his third advisor, and as of this writing, the business is on the market again at a much lower price – well below our offer. Not that I was keeping track. Selling a business is about building trust between the buyer and the seller. If that trust is broken sometimes it is impossible to restore and the deal crumbles.

The Essence of Business Valuation

Deal Extracts

One thing I like about this job is visiting companies and seeing their operations. What I hate is delivering bad news. This trip had both.

The business owner called me and said he had around $5million in sales and just below $1 million in earnings. He started and operates a food distribution business. I headed out early, as it was a three-hour drive to get to his place. He gave me a tour of his facility. I was impressed with the cleanliness and organization, but it seemed small for a $5 million company.

When we sat down and started to go over the books, things didn't add up. It slowly dawned on me what was going on. The value of the products he distributed over one year added up to $5 million. The commission he earned on distributing that product was $1 million, which was really his revenue. His expenses (drivers, labor, rent, etc.) would be deducted from his revenue to get earnings, which netted out way below $500,000.

This owner had looked on a major business-for-sale web site and had seen a food distribution company that had sales of $5 million that was asking for $5 million. He thought, hey, I'd take that. Unfortunately he wasn't there yet. I felt

terrible delivering that news and you can imagine the disappointment he felt. However, it is a fine company, well-run and growing. He is going to keep the company and continue to grow it, and I'm confident in a few years he'll be above that $1 million in earnings mark.

Future earnings equal value

What is the fundamental value of a business? There are a lot of "rules of thumb" out there for business valuations. Multiples of earnings, multiples of revenue, discounted cash flow, book value, and so on.

It is easy to get caught up in all of this and lose sight of the reason you are going to all this trouble. You can often answer complex valuation questions by remembering the bigger picture and applying some common sense.

Valuation comes down to how much money the business will produce in the future. For larger companies, great effort is placed in modeling the future, then discounting that stream of cash to present-day dollars. Two valuation approaches based on this premise are the income approach and the discounted free cash flow approach. This can be incredibly complex, right down to calculating the discount rate to be used.

Small and mid-size companies also use future earnings. However, since it is too difficult and risky to predict the future, we assume the past will indicate what the future will bring. Thus, when a mergers and acquisitions firm or a business appraiser says you are worth four times your earnings, there is a big assumption that those earnings will continue into the future. Everything is based on that basic assumption.

Here are a couple real-world examples of how earnings impact valuations, based on my own experience. I once had a multimillion-dollar deal fall completely apart during due diligence (I was representing the buyer) because we found out at close of escrow that the seller was not going to pay off the long-term operating lease on a $300,000 computer-controlled milling machine. The problem was that the lease payments had been added back to the earnings used to price the business.

I didn't think it was a major issue, and I calmly laid out ways around this

problem. The seller could pay off the lease, or we could include the lease payments in the earnings number and recalculate the business price, or we could take the future lease payments and discount them to present-day dollars and use that for a price adjustment. I said we wouldn't pay for earnings that don't continue into the future. You see, the price of the business, in this case, was based on four times the historical earnings, but those historical earnings wouldn't continue into the future unless there was no lease payment. We were talking about a $200,000 difference in value for the business. The seller was furious and pointed to a document that said that lease payments should be added back to earnings calculations. However, those calculations were based on the assumption of a payoff of the lease. Unfortunately, that was the end of that deal.

It is customary for a seller to pay off long term debt and/or equipment leases at the closing. There are exceptions of course, for example if you bought brand new equipment that isn't being used to produce earnings. In this case it makes sense that the buyer pays for the equipment as an investment, just as the seller did (assuming the seller can convince the buyer the equipment will bring in new revenue and earnings).

Another example was a client with a combination brick-and-mortar/web business that had a great URL. After we supplied an estimate of the business value, he wanted to know why we forgot to value the web address, as it must be worth quite a bit. However, he had had that address for years, and thus its earnings-producing potential was already built into past earnings of the business, and the basis for predicting future earnings. In other words, there was no additional value. He then said "Oh well, then I'll let them have the website software, but I'll just keep the web address." I then had to explain why he couldn't keep the web address and still charge full value for the business. Those all-important historical earnings include the use of that web address, and without it, a new buyer could not produce those earnings. In fact,

without it, you are not even sure how much revenue and earnings will drop, and the valuation becomes much more complicated.

Why use Multiples of Earnings

It is common to hear M & A advisors say "That business is worth five times earnings." But what does that mean? We know that value is really based on future earnings. If you take a future earnings stream and discount that back to current dollars, that is vaguely similar to just taking past earnings and multiplying that by a factor (assuming that past earnings predict future earnings).

By the way, for very small companies (with an SDE less than $250,000), the average over the past 25 years has been about 2.5 times earnings. Why so low? At that level, the old saying rings true – you really are "buying a job." It may be a pretty good job with some nice benefits, but there isn't much left over for a true return on investment. Larger businesses truly spin off enough cash to provide return on investment, and the earnings multiples rise.

Multiples of EBITDA

Medium-size companies (above $500,000 in earnings) typically use a multiple of EBITDA for valuations, and these multiples are higher than multiples on SDE. They typically range from three to seven, with four to six being common

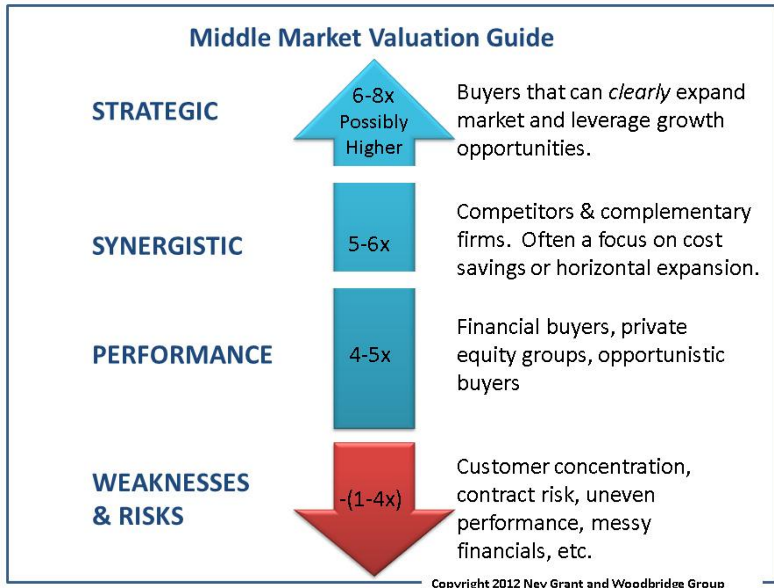
The valuation multiples of companies grow with size. For example, the multiple for a company over $500,000 in earnings will trend towards four, while companies over $5 million in earnings will trend towards 6 (other things being equal). In fact, you can pretty much trend the multiples right up into the large public company arena. The P/E ratio of a public company is roughly the same as an EBITDA multiple, although the main difference is P/E is based on after tax earnings so the multiple will naturally be higher. A quality public company's P/E ratio is typically between 10 and 20.

Larger companies with EBITDA more than $20 or $30 million can often be valued by comparing with similar public companies. Smaller ones generally have too many additional risk factors to be able to estimate value using this method.

Lower Middle Market Business Valuation

Valuation guide and chart

The following is a diagram summing up my variation on the EBITDA multiple valuation metric for lower middle market businesses (businesses with earnings between around $1 million and $20 million). The basic rule of thumb valuation for a company with about a million in earnings is a value of five times EBITDA. Why five? Simply because the average selling price for many businesses turns out to be five times EBITDA (As I mentioned, higher for companies with significantly more than a million in earnings). Do middle market buyers really just use a multiple of five when buying a business? No, they will perform extensive analysis and run financial models for every deal. However, after all the analysis and models are created and run, some deals end up below five, some above, and the average has remained around five.



This brings us to the valuation guide. What the chart says is that the five times base value assumes the company has a stable history of performance and no significant blemishes. A stable financial performance is the most basic component and the foundation of a valuation.

EBITDA can be enhanced by a buyer who can reduce costs and take advantage of other synergies, and because of that, the synergistic buyer can afford to pay a little more for the company. They will not want to, of course, but with a competitive situation and negotiation, the price can be driven up.

A strategic buyer who can go further, take the company to a new level of sales growth and open up new opportunities (usually as well as the cost synergies above) can afford to pay even more. Note that it still comes down to financial performance and earnings, but the strategic buyer is

betting they can pay now for later earnings. Unfortunately, the true strategic buyer who will pay a substantial premium is somewhat rare.

Interestingly, every buyer will come up with their own price and structuring of a deal. For as many years as I have been doing this I have never seen two offers that came in on a business that were the same. It is not uncommon to see a valuation range with as much as a 50% difference in value from the highest offer to the lowest offer. This is why it is so important to get multiple offers and understand how ***the market*** is valuing the company. We say if you have one offer you have no solid offers. Because, how do you know if that one offer is a good one or a bad one?

I've yet to run across the perfect company. There are always blemishes, and if they are serious enough to cause a risk that future earnings may not actually turn out as expected, these blemishes work to pull down the valuation. Do you have one customer (or supplier) who contributes more than 25 percent of your revenue? Messy financials? Lots of adjustments to the earnings? These can pull that five times multiple down to a three or lessen the cash at closing and increase a seller note or earnout. Or if you have a strategic buyer, perhaps they'll only pay five times instead of six.

A professional valuation uses a similar process to this guide by taking a close look at your fundamental performance and/or looking at whether your particular market has a history of strategic buyers, and then they discount the value based on the some of the risk factors they find. If you can stand back and take an objective look at your business, you should be able to estimate a multiple for your business.

Value premium for "quality" businesses

Let's say we have two companies – A, Inc. and B Co. – that each have $1 million in earnings for the past five years and are in similar industries. What could make A worth more than B? The answer will surprise many business owners.

Some may argue that if they both make the same in earnings and those earnings are stable, then, theoretically, they should be valued the same. However, quality does matter and quality companies can demand a

premium. But what does "quality" mean in terms of an increased purchase price?

Some attributes that don't define "quality"

Each year I get two or three business owners who believe they have such a great web presence, including a URL coveted in their industry, that they should get a premium for their company. Let's say B Co. has the URL "widget.com" for the widget industry. That is nice, but the fact is that B is earning $1 million annually partly because they already have that URL. That cool name is already built into earnings, and thus built into the sales price. The only bonus a buyer gets is that, if B Co. ever shuts down, you could sell the name "widget.com" to a competitor. In other words, having a great website doesn't mean quality in terms of purchase price. A great location, most patents, a talented workforce, and other positives about your business are already built into earnings and purchase price as well. It all boils down to: "what are the assets earning in profits?". They will pay you for what you have done but they will buy you because of their belief in the future potential of the business.

I also get owners who are proud of keeping their company debt free and believe someone should pay more for such a company. These owners should be proud and I'm always impressed when I witness what they have accomplished. But the fact is that, as a company grows, it will attract professional investors as buyers, and these investor/buyers will use some debt to grow the company – that is how you can use other people's money to leverage your return on investment. These buyers will also be impressed, but they will not care too much about keeping it debt free and will not pay a premium for that. That being said we like to see a debt free company because as a seller you will get to keep all the proceeds of the sale and not see the cash at closing reduced by paying off debt.

Attributes that define "quality"

A “quality” company is one that makes buyers comfortable. A “quality” company is one with low risk. What kinds of things am I talking about?

Clean financials: There is nothing more comforting to a buyer than knowing that $1 million in earnings really is $1 million in earnings. If the owner has been cheating heavily on taxes, the buyer's comfort level goes down. If the financials are messy and fuzzy, the comfort level goes down. Buyers also like to see consistency in the financials and stability with a long standing relationship with a noted accounting firm.

Management: Buyers focus on the continuity of the business, and management plays a key role in that. Is the business dependent on the owner? Is the owner staying? Is there a management team in place if the owner is leaving? If all the pieces are not in place, buyers start to feel uncomfortable. Buyers will pay a premium for a business in which the owner has built a solid management team and the business is not heavily dependent upon the owner/founder/entrepreneur.

Customers: Are the customers committed to buying in the future? Is any single customer responsible for more than 15 percent of revenue? Are they good at paying in a timely manner? Could a new owner expand the relationship with the current customer base? Strategic buyers are frequently motivated to acquire in order to obtain a new customer base.

The future: A smart buyer takes a look at the $1 million historical earnings over 5 years, but focuses on the future. They take a close look at booked orders, market trends, life stages of the company’s products and services, etc. Anything that can make the buyer feel comfortable that the $1 million in earnings is sustainable will move that company into the quality territory. The opportunity for the future and the buyer’s ability to tap into that potential will be directly reflected in the price they pay. That is why it is so important to identify the value drivers of the business and spend a lot of time talking about future growth potential.

All of the above: Although I said a web address or a talented team doesn’t matter, they do when taken together. A quality company has several characteristics that, when considered alone, wouldn’t bump up a price. But together, these characteristics cause a buyer to say, “There isn’t a lot to worry about with this company – I could imagine owning this.”

The purchase price of business still comes down to future earnings, but with a quality company those earnings have less risk associated with them and less risk commands a premium.

Note that we're talking about a quality company – not a perfect company, which doesn't exist. So if you are disappointed while reading this because you see problems and challenges in your business, don't despair. There are problems and challenges with every business, even a quality one.

Deal Extracts

Valuing companies is more of art than a science, and sometimes it gets a little confusing. We had a client who flipped homes, in a major way. His company was producing around $7 million in earnings, but he also had investment funds set up that he used as capital to buy the homes. He paid his investors a very healthy return on investment of about 40 percent per year.

At first, we tried to collapse the entire business model into something we were more familiar with, assuming one buyer bought the company and put up the money to fund the home purchases. This jacks up the EBITDA substantially – along with the value – but it also requires a hefty capital investment of around $50 million dollars onto the balance sheet as working capital. However, the principal amount of the working capital is not at risk like in other companies and it can be returned to the buyer at any time. It really is a different model and requires free cash flow analysis and ROI analysis to get a handle on it.

You could also take the simpler view that his earnings are $7 million, and that the returns provided to the investors are the cost of capital required to be able to use large sums of money that is required to execute his business model. Furthermore, you could say that the buyer of the company and the investor could be the same person. That is, a buyer could buy the company, kick out all

the existing investors and then use his own money to fund the company and thus capture the 40 percent ROI *himself.*

In the end, we did a combination of the two scenarios. The value, of course, is really the value perceived by the buyer. In this case, we presented the value both ways and it became obvious how this particular buyer perceived it. This buyer had a large amount of money he wanted to put to work and the notion of setting up an investment fund appealed to him. We had to convince him that paying a premium for this company was the price he had to pay to be able to do this.

An alternative to multiples – Return on investment

There is a staggering difference between the return on investment that a venture capitalist seeks (some more than 50 percent per year), the ROI that a private equity group seeks (between 25 and 30 percent) and the ROI that a large company may seek (some are at 10 percent per year) from a potential business acquisition. The difference often takes business sellers – and even M & A firms – by surprise, but it makes perfect sense when you take risk into account.

Although some acquirers speak in terms of multiples of earnings when they discuss pricing a business, in the end it all comes down to future earnings and how much of those earnings are available as a payback on the initial investment. Return on investment (or return on equity) is a method of measuring that payback and involves forecasting the cash flow of the acquisition compared with the initial investment and calculating the rate of return.

For example, we once estimated the value of a product line for which the most likely acquiring candidate would be a large company. Large companies typically have a fairly low cost of capital. They can raise money by selling stock or they can raise money using debt. An average of these sources is called the weighted average cost of capital, or WACC. When a company looks at a project, they often compare the rate of return to their internal cost of raising money – their WACC. If a project returns more than the WACC, it is considered a good investment, since the company can make more money with the project than it costs to get the money. A typical WACC for a large, mature company in a low-risk

area can be 7 or 8 percent.

However, risk raises the required ROI significantly. Private equity groups (PEGs) typically require 25 to 35 percent per year return on their investment (which, interestingly enough, often equals about a five times multiple of EBITDA). PEGs typically invest in mature, fairly stable profit-generating companies, as compared to venture capitalists (VCs) who invest in early stage, often pre-revenue, companies. VCs require 50 percent or more per year.

The difference is the risk. In fact, trained business appraisers will "build up" the discount rate (essentially ROI) used for valuations. They'll start with the low-risk discount rate – very similar to what a large, stable company uses – and add risk premiums. There are significant risk premiums added just by the fact that a company is small. In some high-risk tech areas, they end up with 50 percent discount rate after all the risk factors are added in.

That discount rate is applied to future estimated cash flows. A high-risk technology venture with huge future potential cash flows will be discounted heavily because of the risk premium associated with that industry. It makes sense when looked at as a portfolio. Some tech ventures have enormous payoffs (think Apple, Google and Cisco), but most don't. The high fliers cover the losers so the portfolio still makes a positive return. By requiring a 50 percent ROI, the VCs make sure that the upside is possible.

PEGs have an interesting business model. They generally raise money from wealthy individual investors or institutional investors (or larger PEGs), and typically try to produce an ROI of 15 to 20 percent for these investors. However they seek opportunities that produce 25 to 35% on their investment. The difference, of course, is how the PE fund managers make their money. Some managers will charge an annual

management fee, some will charge deal origination fees, but in the end their success is measured by how much they make for their investors.

Cash vs. accrual can affect business valuation

Some small companies use cash basis accounting, for the simple fact that it can more easily be manipulated for tax purposes. Larger companies are required to use accrual. The lower middle market is a free for all, with both cash and accrual being used.

You probably know the drill on cash accounting – you can pay bills or purchase items for cash at the end of the year to reduce earnings and reduce your taxes. Although you aren't supposed to, some business owners also hold checks into the new year, so the revenue falls into the next year.

For the same reasons, cash accounting is not a good basis for valuations. It often doesn't measure a business's true revenue and earnings power. Instead, it measures how creative or aggressive the owner was in minimizing his or her taxes.

Accrual accounting more accurately measures the true activity of a business. Revenue is recognized and is shown on the profit and loss statement when the work is completed, not when the money comes in. Similarly, cost is recognized when you buy something, not when you pay the bill.

For these reasons, business appraisers are taught to use accrual-based accounting for valuations, and to convert from cash to accrual when possible. Many M & A firms, however, are somewhat perplexed by the differences between cash and accrual accounting or don't want to spend time making the adjustments. Often, there isn't a significant difference. For a mature, stable business without a lot of tax manipulations they can be very close.

However, for some businesses there is a huge difference. For example, a growing business usually has growing receivables – sometimes a dramatic amount, since a high-growth period also can be a chaotic and challenging time with little focus placed on collections. Cash-basis accounting doesn't capture all of this growth.

I've seen three businesses that had significantly more revenue when adjusted from cash to accrual accounting. Growth in expenses is typically less than growth in income, and in all these cases that was true, so earnings were much higher. In one case the difference was more than $1 million dollars in company value.

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Ney Grant has been involved in buying and selling companies for 20 years. He bought his first company in 1987 and founded a technology company in 1989, which he grew and eventually sold to a public company in 1997. He then served as founder and vice president of acquisitions for a startup that raised $20 million in private equity to fund a series of company acquisitions. Grant executed 11 acquisitions in 18 months with the startup. He holds an engineering degree from University of California Santa Barbara and an MBA from University of California Davis.

In addition to his business background, Grant is an avid outdoor photographer. He's also a pilot who flies his Cessna around the west coast to visit companies and help get buyers and sellers together. You can visit Grant's personal flying and photography website at www.westcoastflyingadventures.com.

Question or comments? Grant's email address is

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