

**WHICH “EARNINGS” ARE WE TALKING ABOUT – NET INCOME, ODCF, EBITDA  
(OR SOMETHING ELSE)?**

The single most important factor in determining the price of a closely-held business is its earnings combined with an earnings multiple appropriate for its size, industry and other factors. You hear of companies selling for “7 times earnings” or “3.5 times cash flow” but there is no uniform industry standard quantifying these terms.

The inconsistency in calculating and presenting earnings results in buyer frustration and market place misinformation. The only agreement among practitioners is that the earnings figure should be before interest expense and income taxes but beyond that, practices vary widely.

Consider the alternative earnings descriptions for this consumer durables distributor. The owner’s wife works 20 hours weekly in bookkeeping activities. Here is a summary of the profit and loss statement:

	<b>Net Income Per Books</b>	<b>Owner’s Discretionary Cash Flow</b>	<b>EBITDA</b>	<b>EBITDA Less CAPEX</b>
Sales	2,675,000	2,675,000	2,675,000	2,675,000
Cost of Goods Sold	<u>1,825,000</u>	<u>1,825,000</u>	<u>1,825,000</u>	<u>1,825,000</u>
Gross profit	850,000	850,000	850,000	850,000
Expenses				
Owner and wife salaries	312,000	312,000	312,000	312,000
Depreciation	85,000	85,000	85,000	85,000
Amortization	5,400	5,400	5,400	5,400
Profit sharing (owner share)	21,400	21,400	21,400	21,400
Interest expense	19,000	19,000	19,000	19,000
All Other Expenses	<u>272,200</u>	<u>272,200</u>	<u>272,200</u>	<u>272,200</u>
Total Expenses	<u>715,000</u>	<u>715,000</u>	<u>715,000</u>	<u>715,000</u>
<b>Income before Taxes</b>	<b>135,000</b>	<b>135,000</b>	<b>135,000</b>	<b>135,000</b>
Owner and wife salaries	0	312,000	312,000	312,000
Depreciation	0	85,000	85,000	85,000
Amortization	0	5,400	5,400	5,400
Profit sharing (owner share)	0	21,400	21,400	21,400
Interest expense	0	19,000	19,000	19,000
Market owner & wife salaries	0	0	(151,000)	(151,000)
Normal capital expenditures	0	0	0	(35,000)
<b>VARIOUS “EARNINGS”</b>	<b>135,000</b>	<b>577,800</b>	<b>426,800</b>	<b>391,800</b>

**OWNER'S BENEFITS** or **OWNER'S DISCRETIONARY CASH FLOW**. This label is commonly used to describe the earnings of small businesses (less than \$2-3M sales) where the owner actively runs the enterprise.

This oft-used concept doesn't distinguish between the owner's return on their labor (a salary or wage) and on their capital (return on investment) nor does it address the capital expenditures nearly every enterprise requires. In the case above, **Owner's Discretionary Cash Flow totals \$577,800**.

**EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION & AMORTIZATION ("EBITDA")**. As we move up in transaction size, this accounting term becomes the norm for describing earnings. If owner and wife salaries are normalized (adjusted to market), this approach results in **an EBITDA of \$426,800**. This assumes market compensation for an owner is \$135,000 and for a part-time bookkeeper, \$16,000.

**EBITDA LESS CAPITAL EXPENDITURES**. At Becker & Beggs, we believe a third variation, EBITDA - CAPEX is the best measure of an enterprise's ability to service debt and provide a return on investment. Capital expenditures are real expenses and need to be addressed. Yes, they can be financed and the outlay spread over time and they can be deferred for a time. But every enterprise has to regularly replace or upgrade fixed assets to offset physical wear and tear, technological obsolescence, reduced productivity, and cosmetic appearances, or risk losing sales.

In our sample company, their primary fixed assets are delivery trucks and the \$85,000 depreciation expense was largely for the purchase of a new vehicle. Looking at the age of the other two trucks, how long the company keeps them, and their expected trade-in value, a \$35,000 annual charge for replacement is appropriate as a substitute for depreciation.

This approach results in an **EBITDA - CAPEX of \$391,800**.

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There you have it - **"earnings" ranging from Net Income of \$135,000 to ODCF of \$577,800**. Someone without explanation and inexperienced applying say, a four times multiple, ends up with values ranging from \$540,000 to \$2,311,200, a 328% variation!

Make sure you understand what earnings definition is used and that the multiples are appropriate for that particular earnings definition when determining the price of a closely-held business. Publishers of business sales statistics are not uniform in how they define earnings.