PRICING SECTION

The Profit and Loss Statement

Both the balance sheet and the profit and loss statement make up what is commonly called the financials. Let's move right on to that part of the financials that all buyers want to see, the profit and loss statement or, the income statement.

Sample Profit and Loss Statement (Billy Bob's Food Business)

Gross Sales		$	600,000
Cost of Goods		$	200,000
Gross Profit		$	400,000
Operating Expenses			
Owner's Salary		$	30,000
Other Payroll		$	156,000
Outside Labor		$	5,000
Payroll Taxes		$	30,000
Employee Benefits		$	10,000
Rent		$	42,000
Supplies		$	4,000
Telephone		$	2,500
Utilities		$	15,000
Auto Expense		$	4,800
Travel/Entertainment		$	8,000
Legal/Accounting		$	6,000
Postage		$	300
Licenses		$	500
Insurance		$	10,000
Interest Expense		$	2,000
Advertising		$	2,000
Repair		$	2,500
Maintenance		$	2,500
Laundry		$	3,000
Bank Charges		$	10,000
Dues/Subscriptions		$	100
Depreciation		$	10,000
Total Expenses		$	356,200

Oliver Wu 9/5/05 1:32 PM
Comment [1]: Why are some numbers indented?

Net Profit (Before Taxes)		$	43,800

The Profit and loss statement (also referred to as the income statement) is necessary for most valuation methods. Starting with the gross sales or gross income or gross revenue (the terms are interchangeable) and then subtracting the cost of goods, we end up with the gross profit. In this case:

Gross Sales:	$600,000
Cost of Goods Sold:	$200,000
Gross Profit	$400,000

In the example of the above business, the cost of goods sold represents the actual cost of the food that the owner purchased during the year. After arriving at the gross profit, the operating expenses are then listed, added together, and subtracted from the gross profit to arrive at the net profit. Before moving on to pricing and trying to put a reasonable selling price on Billy Bob's Food Business, look over the operating expenses of the business again. Later, you will see why these expenses play such an important role in arriving at a selling price for the business. We realize that much of this is an over simplification, but it's important that everyone understand what we are doing.

How much money is the business really making?

Let's see if we can figure out what a buyer might really earn from Billy Bob's Food Business. Let's take another look at the operating, or profit and loss, statement. According to this statement the profit of the business was $43,800. But you are really trying to find out what the seller actually made from the business, or better yet, what a new buyer could make. A new buyer might not need or want to spend the income from the business the same way as the seller. In addition, there are expenses that the seller is taking that are not pertinent to the operation of the business. You are not attempting to pass judgment on whether the taxing authorities would or would not allow all the deductions itemized on Billy Bob's Food Business Statement. You are only trying to find out how much actual cash the seller could pull out of his business, which is how much disposable or discretionary income or cash the buyer would have before debt service (and taxes, of course). The key word is discretionary income. This will become clearer as you look at the seller's statement. At first, you will only make notations, then you will have to contact the owner of Billy Bob's Food Business and get some answers to your little fact-finding analysis. It is important that this contact be in person. A frank face to face discussion is the best way to get appropriate answers to your questions. And keep in mind that sellers may be reluctant to answer all the questions depending on how the answers might conflict with the figures filed on their tax returns. Push for answers, but not hard – many of the areas in question are “gray” ones. You don’t want to force the seller to incriminate himself, or to take offense at your questioning.

Let us show you how we read a financial statement. This figuring is called “recasting” the statement. This same procedure is necessary to go through this exercise for many of the standard valuation methods that are based on earnings. Go through this section carefully, so you understand the recasting of the P&L statement. It is used for the discretionary earnings method that follows, as well as the excess earnings method and many of the rules of thumb or market guidelines. In fact, most of the valuation methods used by business appraisers require that the financial statements be adjusted.

Rent – $42,000

Not much here! The rent is fixed and will also be the same expense for a new buyer. Note: You may discover later that the rent will be increasing and you might have to raise this amount and adjust your figures.

Supplies–$4,000

You might find something here. Did the seller use any of these supplies for other than business use? Make a note to ask him. However, there are not a lot of dollars involved.

Telephone $2,500

You can be sure a lot of personal calls were made from the business, but you’re talking small change unless the home telephone bill is included in this figure.

Utilities – $15,000

Unless the seller has an extension cord from the business to his home, this is probably okay.

Auto Expense – $4,800

It’s hard to believe Billy Bob’s Food Business needs a company car. This is a benefit to the seller, and you should put this into the seller’s discretionary income.

Travel and Entertainment– $8,000

You’ll do the same with this. You will ask, more for curiosity than anything else, what this expense was for!

Legal and Accounting - $6,000

This is another item of concern. Probably okay, but you'll ask the seller anyway. There might be a one-time charge or fee in here that won't be repeated next year.

Interest – $2,000

This is most likely for the equipment loan and will be paid off at the time of sale. It is possible to have the buyer assume it, but at that point you'll cover it in the debt service. For now, you'll use it as part of the seller's discretionary income, for the sake of this example.

Postage – $300

The household mail is probably paid through this account but it is not big enough to worry about.

Owner's Salary -- $30,000

The $30,000 figure is what the seller pays himself and should be added back to the Seller's Discretionary Income.

Salaries – $156,000

This is a big item. Is he paying any family members who provide only token services? It can make a big difference in how much the seller is really making from the business. This will be a question you will ask the seller! However, for this example we'll assume that this is all paid to employees.

Outside Labor – $5,000

This is the same as the above. Again, for this example we'll assume that the owner is paying his spouse for banking and some routine bookkeeping. We will assume that an owner could handle these duties and add $5,000 to our SDE.

Employee Benefits –$10,000

$6,000 of this figure is medical, and life insurance for the owner and his family. Most business brokers build this into the SDE and we will also.

License – $500

No problem here!

Insurance – $10,000

This is a figure that may increase for a new buyer. You might want to find out what the renewal rate is for fire and liability, etc. However, $4,000 of this figure is for a disability policy for the owner and this should be added to the SDI.

Advertising – $2,000

You should be curious what this is. The expenditure is probably not enough to have done any good, but ask! We know of one business where the advertising expenses went to a child's high school yearbook ad. This was a one-time expense, however; better find out how many children the owner has before adding this back to SDI.

Repairs – $2,500

Again, no big deal!

Maintenance – $2,500

Same as above.

Payroll Taxes – $30,000

These are pretty well fixed, even if part of the taxes were on the owner's salary or that of family members. Unless, it's significant leave it alone.

Laundry – $3,000

You'll leave this alone, too. Cooks' uniforms, table linens, etc. aren't worth pursuing.

Bank Charges – $10,000

Pretty high so you might want to check out and see if this figure includes any MasterCard/Visa charges. If customers use these cards, the business pays a percentage and/or transaction charge for this privilege. However, you might want to check and make sure that the business didn't have a lot of "returned" check charges. That could indicate bad management or cash flow problems. In this case it was credit card charges, so we will leave it as is.

Dues and Subscriptions – $100

You could probably question this, but what's the point – too insignificant.

Depreciation – $10,000

This normally would be added right back to the seller's disposable income, because it is a non-cash item. It is a legally deductible expense, but not an expense in the traditional sense. The government allows this deduction, as does the accounting profession, as a means of providing credit for the businessperson to purchase new equipment when the old equipment is no longer usable. Keep in mind, however, that some businesses do need to invest in new equipment. Too many business brokers who are pricing a business want to take all of the depreciation and pass it on to the buyer and seller as disposable income. Experience, together with common sense, should indicate whether the business is going to need new equipment in the near future. For example, the washers in a busy coin laundry do have to be replaced about every five years, while the equipment in a restaurant might last much longer. The "economic life," however, of a restaurant is about five years. The equipment itself may last a lot longer than the five years, but the business will need a refurbishing just to stay in business. Economic life is the profitable life of the equipment. So, in some businesses, you should not necessarily add back all the depreciation.. But for now – for this example – use the total depreciation figure of$ 10,000.

So, where are we now? So far, we have:

- Net Profit $43,800
- Owner's Salary 30,000
- Outside Labor 5,000
- Employee Benefits 6,000
- Auto Expense 4,800
- Insurance 4,000
- Travel & Entertainment 8,000
- Interest 2,000
- Depreciation 10,000

Now you've got the owner's actual disposable cash or discretionary income to $113,600. However, you might want to deduct any increases that a new buyer might have for things such as rent, insurance or labor. You have to check on the travel and entertainment of $8,000, but a small restaurant cannot justify that kind of expense. A new owner will not spend $8,000 or at least, it will be his or her option. Now, you are going to ask the seller about any other areas on the statement that might reveal other one time expenses that might be added back to the owner's cash flow. However, you are not looking for personal items that the owner might have included as a personal expense or even any questionable expenses that are hiding in the statement. You only want to include legitimate business expenses in adding back to arrive at the owner's or seller's cash flow. For example, during a visit with the seller, you discover that the seller took his wife to a restaurant convention and that's the reason for the large and probably legally deductible travel and entertainment expense.

The owner of Billy Bob's Food Business, despite the actual net profit of the business on the profit and loss statement, is in reality making $113,600 from the business. One other major item that was not touched on, because it could place the owner in an embarrassing situation, is the whole area of "self-consumed food." As you can well imagine, anyone who owns a food-related business probably does not have to buy four steaks to take home. If you own a grocery store, chances are you don't shop at another market, and chances are that you don't pay when shopping at your own store. At the price of food today, 'self-consumed" food can be a major benefit to the new owner of Billy Bob's Food Business.

How did we get there?

Let's see how we arrived at the real cash flow of BBP Fast Food:

Net Profit *$43,800*

"Adjustments and/or Add Backs"

Owner's Salary		$	30,000
Outside labor		$	5,000
Depreciation		$	4,800
Travel and Entertainment		$	8,000
Interest		$	2,000
Employee Benefits		$	6,000
Insurance		$	4,000
Auto Expense		$	10,000
Total		$	113,600

Oliver Wu 9/5/05 1:32 PM
Comment [2]: Why are some numbers indented?

Summing up...

The business, based on your restructuring of the seller's profit and loss statement, would provide a new buyer $113,600 in disposable income – or would it? Almost all businesses are bought on terms, and Billy Bob's Food Business would be no exception. The buyer is going to make $113,600 only if he or she pays all cash, which is highly unlikely. Payments might be building equity, and the interest might be deductible, but the new owner won't be able to spend it. The payment is a real cash item. Most experienced business brokers allow 25 percent (in some cases a bit more) of the buyer's disposable income for debt service. Using that figure you now have:

$113,600 (100% less 25%) x 75% for debt service = $85,200

A new buyer would now have $85,200 as real disposable income. This also means that there is $28,400 allowed for debt service or $2,370 (rounded) including interest per month. You can see that the amount of the payment the seller expects on $43,800 the balance owed directly affects the amount of disposable income the buyer will have from the business.

The debt service is a key factor in analyzing the market value of a business. Using Billy Bob's Food Business, again, as an example: The seller is willing to accept terms, but wants a short-term payback that would make the payments $3,000 a month.

$3,000 x 12 = $36,000 a year debt service

$113,600 buyer's cash flow

$36,000 debt service

$77,600 disposable income for the new owner.