All Roads Lead to ACF

Given the critical role of ACF, further elaboration on its chief components is warranted. Proper calculation of ACF involves a careful inspection of the company's income statement and various peripheral circumstances. For purposes of introduction, however, note that ACF is calculated as the sum of pretax income and a series of addbacks including owners compensation and benefits, depreciation and amortization, interest expense, and any one-time, nonrecurring expenses (or revenues).

The basic formula once again is:

Pretax net income
+ Owner s salary and payroll taxes
+ Owner s perks
+ Depreciation and amortization
+ Interest expenses
+/- One-time expenses and revenues
Adjusted Cash Flow/Seller's Discretionary Earnings

In general, this figure represents the company's ability to generate cash- equivalent benefits for a single owner of a business working full-time.

Brokers and entrepreneurs commonly apply derived multiples to this figure for purposes of estimating business value. For purposes of perspective, note that the "average" multiple of ACF for the thousands of businesses sold through the VR Business Brokers network has consistently hovered around 2.3 times, i.e., from year to year, the average multiple has remained amazingly constant at or near 2.3 times ACF. It is also frequently used in rules of thumb and almost always used in assessing market comp data. From the buyers point of view; this figure can also be interpreted as the amount of cash flow available for debt service, the buyer's salary, and a return on the buyer's cash investment. Being comfortable with properly calculating this number is critical for effective business valuation.

Before we analyze its specific components, the formal working definition for ACF shall be presented once again:

ACF is the amount of pretax, cash-equivalent benefits accruing to a single owner working the business full-time.

At the same time:

ACF is the amount of pretax cash equivalent financial resources available to a new owner working on a full-time basis to use as deemed appropriate, i.e. to service debt, pay an owner salary, buy new equipment, etc.

This interpretation spells out the boundaries or rules for the calculation and provides a framework for evaluating and valuing companies. One of the most important guidelines to follow when valuing companies is to remain consistent in applying valuation techniques. . The importance of consistently using the approach for calculating ACF outlined in this section is found in tradition and in the way in which information is presented in market comp databases.

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Not only do most business brokers and many business owners rely on this approach, but most market comparable sales statistics are presented based on this specific formulation of cash flow (e.g., VR Business Brokers, BIZCOMPS®). Although different terms may be used to describe ACF (e.g., seller's discretionary cash flow [SDCF], seller's discretionary earnings [SDE} net, or simply cash flow), they all describe the same collection of components (pretax income plus addbacks). In addition, most SBA lenders utilize this same framework for evaluating the cash flow to debt service ratio involving business acquisition loans.

In other words, an important trait of various business valuation techniques involves the comparison of "apples with apples". Each specific method and each component within a method should be applied on a consistent basis, including the calculation of the all-important cash flow measure known as ACF.

Pretax Basis

As stated in our working definition, ACF consists of pretax, cash-equivalent benefits accruing to the owner of the subject business. Proper understanding of this framework calls for careful elaboration of its individual elements. The term pretax informs us that ACF is calculated before federal and state income taxes paid by the owner. Note that pretax does not refer to sales taxes on retail sales or other types of excise taxes. The meaning of pretax in this framework refers to income and payroll taxes as applied to the owner. Thus, ACF is calculated from a base of pretax income (also called earnings before taxes {EBT}). In other words, to properly calculate the ACF for a business, the addbacks are added to a base of income before income taxes or payroll taxes incurred by the owner of the business.

It is standard practice among most business brokers to use a pretax measure of income as the base for ACF calculations. The logic is found in the fact that each business owner faces a unique tax picture. Depending on the owners' other sources of income and modes of ownership, a given pretax income would result in differing tax burdens from one owner to the next. One owner may have several years' worth of tax loss carryforwards; another may have substantial income from other sources such that the subject business income would be pushed into the highest tax bracket. One owner may be subject to the double taxation associated with C corporations; another may be a sole proprietorship using a Schedule C on an itemized personal tax return.

In short, given the diverse nature of tax situations faced by business owners, cash flow calculations based on the current owners taxes probably would be irrelevant. On the other hand, certain other income approach valuation techniques (differing from the multiple of ACF method) call for application of an average or probable income tax burden (i.e., an after-tax cash flow measure is applicable). Notable among these other techniques is the discounted cash flow (DCF) technique, used primarily by professional appraisers with the time needed to generate this time-consuming valuation result and securities professionals involved in mergers and acquisitions (M&A).

In addition, the Small Business Administration (SBA) now requires business appraisals in support of the loan applications related to business acquisitions. These appraisals are based in part on formulas that use an after-tax measure of cash flow (as per SBA recommended valuation techniques), such as the discounted future earnings method. Finally, it is essential that the business owner attempting to value a given company for acquisition be able to distinguish

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between calculating cash flow for valuation purposes (ACF on a pretax basis) and forecasting cash flow for operational purposes.

In other words, forecasting taxable income and the corresponding tax liability are an important part of business management. Ignoring or underestimating income tax liabilities is a common cause of business failure. Just because income taxes often are ignored for valuation purposes does not mean they can be ignored in running a business or even evaluating a business for purchase. Income taxes are a real cost of doing business.

Cash-Equivalent Basis

The phrase cash-equivalent can be important in specific valuation environments. The relevance of this term is found primarily in cases where the business owners give themselves, family members, friends, and even other companies free products or services. Although these cash-equivalent benefits are a type of perk, they differ from other perks in that there is no direct monetary implication; that is, the perk consists of products or services given away that otherwise could have been sold for money.

A relevant question here is how to value such giveaways. For example, should a piece of manufactured furniture given away to a parent be counted at cost or at retail value? An argument can be made either way. To value the gift at cost would represent the actual out-of-pocket expense incurred by the owner, whereas valuing the gift at market value would represent the foregone profit as well. In most cases, brokers and business owners conservatively value the gifts at cost. Regardless, the challenge is to properly assess this area in light of certain documentation problems. The owner may not account for such gifts directly in the income statement or tax return, so a certain amount of “fishing” is necessary. In a buyer-versus-seller framework, the actual amount credited to ACF for such gifts is subject to debate and negotiation. In many cases, the dollar value of such gifts is small and can reasonably be ignored.

Another case in which a cash-equivalent estimate may be necessary pertains to the owners health care insurance package. If the owner is covered under a collective health insurance package with other employees, it is prudent to take a proportionate share of the actual dollar expense for such health care coverage. In some cases, however, the owner may have a health condition that necessitates more expensive coverage, and this costly coverage is grouped together with the health care insurance cost of the entire company. In other words, a proportionate share may not be a fair share in cash-equivalent terms. Fortunately, this situation is rare.

Single-Owner Basis

Next, note that the definition of ACF ALWAYS refers to a figure generated by a single owner working the business full-time. If two different businesses are operating under two different ownership configurations, the figure must be adjusted to facilitate comparisons. In other words, the concept of cash flow known as ACF and used by most professional business brokers always refers to the amount of cash flow which is available to a single owner working the business full-time.

This criterion has several implications for assessing a company’s ACF. First, a single owner working full-time is just that; it is not a single owner working part-time and it is not a husband-

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and-wife team working full-time. Adjustments must be made to bring the measure back to the full-time single-owner framework.

The general possibilities with respect to owner involvement include:

Single owner working full-time
Single owner working part-time or semi-absentee
Single owner who is absentee

Multiple owners working full-time
Multiple owners working part-time or semi-absentee
Multiple owners who are absentee

Each of these scenarios would require a different approach for finalizing the pertinent ACF results. The general solutions are highlighted next:

Single Owner Scenarios

Single owner working full-time………..
Include ALL actual compensation paid to the single owner-operator

Single owner working part-time or semi-absentee*……….
Include ALL actual compensation paid to the single owner-operator
Add back potential savings in labor costs as if owner were working full-time, e.g. add back one-half of the top manager's/employee's compensation

Multiple Owners Scenarios

Multiple owners working full-time……….
Include ALL actual compensation paid to a single primary owner-operator
Adjust all other owners by comparing their actual compensation with probable replacement cost by new owner at market level

Multiple owners working part-time or semi-absentee*……….
Include ALL actual compensation paid to a single primary owner-operator
Add back potential savings in labor costs as if owner were working full-time, e.g. add back one-half of the top manager's actual compensation
Adjust all other owners by comparing their actual compensation with probable replacement cost by new owner at market level

Multiple owners who are all absentee*……….
Include ALL actual compensation paid to a single primary owner-operator
Add back potential savings in labor costs as if a single (the primary) owner-operator were working full-time, e.g. add back the top manager's/employee's actual compensation
Adjust all other owners by comparing their actual compensation with probable replacement cost by new owner at market level

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*Note that situations wherein the ownership is partially or fully absentee, it is also reasonable to consider elevating the pertinent valuation multiple as well. All other things equal, a given amount of cash flow, say $200K per annum, is worth more if the owner is free to pursue other economic endeavors at the same time. It is not considered unreasonable to expect a 10% to 20% premium to the relevant multiple in those cases when the owner is not working at the subject company.

Following the steps outlined above will ensure that a correct final owner compensation entry will be made into the Five Page Tool as well as into the BizEquity online tool.

It may already be clear to you that such an adjustment is subjective to the extent that one must decide which owner to replace and what the appropriate replacement salary will be. A general guideline is for the buyer to subtract a replacement salary for the specific owner to be replaced with a new employee after purchase of the company. Once this decision has been made, the replacement salary level should be based on the hiring of a new employee to fulfill the precise function and provide the same services as the replaced owner. However, a common approach used by business brokers is to subtract a replacement salary tor the owner who can be replaced at the lowest cost (i.e., replace the owner who would generate the smallest reduction in the company's presented ACF). Current compensation levels by industry and geographic location are available at many Internet sites, including www.bls.gov. Other sources provide similar services on a fee basis, for example, unvw.salarysource.com.

Treatment of Family Members
A second common type of adjustment related to the single-owner premise concerns the treatment of family members. There are three general situations that necessitate such an adjustment.

Family members who are working but not being compensated……….
Determine the replacement cost for the family member(s') work contribution and subtract this from ACF.

Family members who are working but are being under-compensated………
Determine the differential between what they are actually being paid versus what they would be paid if market wages were required and subtract this from ACF.

Family members who are being compensated but not working……….
Determine the actual compensation which is being paid to the family member(s) and include this in ACF.

First, family members may be working substantial hours at the business without being compensated, particularly at family-run businesses such as restaurants, convenience stores, and car washes. In this case, as in the two-partner situation described earlier, a replacement salary must be subtracted from ACF to reflect the work effort and contribution made by these uncompensated family members.

Practically speaking, it may be difficult for a buyer to know for sure how many family members are involved and precisely how many hours they are working without proper compensation reflected in the books. For specific types of businesses, such as restaurants and convenience

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stores, it is prudent for the buyer to ask the seller how many employees are working at the business. Furthermore, it is prudent to ask this question more than once and to ask the owner whether all family members are being paid a fair market-based salary. The optimal approach may be to ask the seller to answer such questions in writing to solicit full disclosure. Although this approach may appear to be merely a due diligence tactic, it is important to realize that a buyers due diligence can lead to a reduced purchase price, reflecting discoveries that affect the company's ACT and hence its FMV.

A similar adjustment can be made for family members who are underpaid for their services. For example, if a family member is acting as a full-time night manager and is being paid only minimum wage, a new owner probably would have to pay a new employee a substantially higher wage. Obtaining this information is easier said than done, but such an inquiry is justifiable if the buyer's goal is to pay FMV based on a correctly calculated ACT' figure.

The third common adjustment related to the single-owner premise concerns family members who are being paid a salary and benefits without actually working at the business. In this case, the ACF should be increased by the amount paid to the phantom employee, including the cash-equivalent amount of any benefits accruing to this party. This practice is common in businesses in which the owner pays a son or daughter a handsome salary while the child is at college or pays his parents a salary after retirement. Most business owners volunteer this information to qualified buyers (after they have signed a confidentiality agreement) because of its favorable impact on the overall ACF generated by the company. The challenge for the buyer is to determine its validity by establishing that the family member is not working at the business.

It may also be the case that a family member is working at the business and is receiving compensation beyond the normal market level of compensation. In other words, certain family members may provide limited assistance while being paid a full-time salary. This assessment can be difficult, but an interpretation of the company's operations can generate material findings that aid the buyer in determining the company's true value.

Remember once again that the goal of such fact-finding analysis is to allow the buyer to use a framework that can be applied consistently from one business opportunity to the next. Without such consistency, the valuation results from company to company will be misleading.

Full-Time Basis

The next major premise of the ACF definition is that the owner is working full-time. One immediate challenge is quantifying exactly what is meant by "full-time". Whereas employees are generally considered full-time at 40 hours per week, certain salaried personnel may be expected to work as many as 50 to 60 hours or more per week. Finally, a full-time owner-operator can reasonably be expected to work 50 to 60 hours per week as well (if not more).

Again, if owners work less than full-time or on an absentee basis, the ACF figure, so important in estimating a company's worth, must be adjusted. For businesses with absentee owners, the most common adjustment is to add back the salary and benefits earned by and paid to the company's top manager (assuming that the manager is working full-time).

As noted earlier, a second approach for handling the absentee owner situation is to apply a higher multiple to the company's ACF - potentially without adding back the manager's compensation package or after adding back the manager compensation. The difficulty here lies

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in determining the appropriate increase in the selected multiple to be applied to ACF. Nonetheless, it is clear that businesses which are commonly owned on an absentee or semi-absentee basis will sell for higher multiples, e.g. coin-operated laundromats.

If the owner is working only part-time (in between full-time and absentee), the most common adjustment is to increase the cash flow by an amount representing the probable reduction in payroll expense associated with the new owner working full-time instead of part-time (i.e., if the new owner works full-time, it is possible that one of the current employees could be replaced or work fewer hours, thus decreasing payroll expense and increasing ACF).

ACF Component Analysis

The valuation mini-case studies presented in Tile 4 provided the learner with practice in calculating ACF under situation-specific circumstances (as does the “Capstone Case Study Analysis” which follows in Tiles 7 and 8).

At this juncture, it is useful to provide examples of where to locate the necessary information to generate estimates of ACF. Given our working definition of this commonly used measure of cash flow (e.g, it represents the pretax cash-equivalent benefits accruing to a single owner working the business full-time), we turn now to a closer look at each of the ACF components.

Pretax Income

The starting point for ACF analysis is the company’s pretax income. A measure of pretax income can be found on the company’s income statement or tax return. Recall that the BizEquity tool will direct you to the relevant tax return line depending on which type of entity you are evaluating, e.g. sole proprietorship and Schedule C or C/S-corporations and Form 1120 and 1120S.

For offline ACF calculations, the typical starting point may be the company’s income statement. For the BizEquity online tool, tax returns are typically utilized (but financial statements will also work). Given the variety of presentation formats accountants use to prepare compiled statements, it is important to carefully review the individual line entries near the bottom of the income statement. Many different headings and subheadings and different ordering of entries make interpretation of pretax income challenging in certain cases.

Make sure that your pretax income is in fact pretax. Occasionally one encounters federal and state income tax payments under the heading “Other Expenses.” Such payments should be added back to arrive at a true pretax income. Comparison of the income statement results with the federal income tax return data can also aid in determining the actual pretax income of the company (see Schedule M-l in corporate returns for complete insight into this calculation).

Accounting for Book Versus Tax Purposes

As elaborated on in Tile 2 at length, being aware of the differences between accounting for book purposes as opposed to tax purposes is essential for a full understanding of measures related to cash flow. Book accounting almost always differs from tax accounting because of differences in the manner in which revenues and expenses are recognized. For example, it may be possible to use straight-line depreciation of fixed assets for book purposes and some sort of accelerated depreciation for tax purposes (or vice versa), which would lead to two different bottom lines based on different depreciation deductions. In addition, there will often be revenues or expenses which are reported for book purposes but not tax purposes (and vice-versa), e.g. all

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travel and entertainment expenses will be deducted for book purposes but only a certain percent may be deducted for tax purposes.

In general, the goals of accounting for tax versus book purposes are conflicting: Most businesses would like to generate the maximum profit on the books (to impress a potential buyer, for example) while minimizing taxable income to reduce their tax obligations. In addition, it is common for companies to postpone recognition of substantial sales into the next tax year to reduce taxable income in the present year. For book purposes, the company may recognize the sale in the current year, thus conflicting with the reported revenues and profits on the tax return.

Business valuators should not be surprised if tax returns differ from financial statements. Attempting to learn why they differ is an important exercise in developing a full understanding of the company's ability to generate positive cash flow. Most federal income tax returns for corporations and partnerships contain a schedule that reconciles the difference between taxable income and book income (Schedule M-l). Review' this section carefully if it is available.

The next decision to make regarding pretax income (after deciding to use the income statement rather than the tax return) concerns which specific measure of pretax income to use. Realizing that each accountant may choose to organize a company's income statement in a slightly different fashion, there may be one or two different measures of pretax income. In other words, there may be a distinction between pretax operating income (EBIT) and pretax income overall (EBT), with the latter accounting for items such as gain or loss on the sale of assets and possibly interest income or dividend income from investments.

In most cases, the pretax income overall is greater than pretax operating income because of interest income or "other" income. The decision as to which measure of pretax income to use should boil down to whether the extra income or expense (or gain or loss) included in the overall pretax income is expected to continue for the new owner. If this extra income or expense is not expected to accrue to the new owner, then the pretax operating income figure should be used.

Owner's Salary and Payroll Taxes

Once pretax income is determined, the various other addbacks can be analyzed and included in the ACF calculation. The first and most important addback is normally the owner's salary and payroll taxes. As discussed earlier, this figure should reflect the owners compensation in the form of wages, salary dividends, bonuses, and related payroll expenses such as unemployment, Social Security, Medicare, and Medicaid for a single owner working the business full-time.

Note that for a sole proprietor there is no such addback because there is no salary paid to a sole proprietor (i.e., all profit flow's to the owner as compensation). On the other hand, S-corporation entities must pay the owner-operator a "reasonable salary" to prevent the company from avoiding payroll taxes. Because limited-liability company (LLC) members must pay tax on all distributions, high salary levels are less common. Most corporations (S and C) and LLCs pay their active owners a salary and incur payroll expenses.

The operational challenge in determining the precise amount of salary and payroll tax to add back is to be able to locate the line item on the income statement that contains the owner's salary (may also be called "officer salary"). There may be a clearly defined line titled "owners salary" or it may be buried in general salaries and wages.

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It is important to determine the precise amount because it often constitutes a large portion of the company's overall ACF. Calculating the amount of payroll tax paid in relation to the owner can be difficult if all payroll taxes are lumped together (for all employees, including the owner), and the sliding scale or ceiling (maximum payment) of FICA payroll tax compounds the difficulty. It is best to ask the company's accountant to provide this information precisely to avoid potential understatements or overstatements of ACF.

Hint: For annual salary levels up to around $125K per annum, use of an assumed 7% payroll tax burden against the known salary level would be a legitimate increment.

Owner's Perks
The next addback is owners perks, which can range from extremely important to practically nil, depending on the nature of the company and the aggressiveness of the owner in taking business deductions for discretionary or personal expenditures. Even though most perks are of a noncash nature (they are not received by the owner in the form of cash), they do represent benefits accruing to the owner that are paid for with cash. The decision as to whether a certain expense is considered an addback revolves around the nature of the expense: Is it of a personal or discretionary nature?

Personal expenses are expenditures that directly and exclusively benefit the owner, such as car payments for the owner's automobile.

Discretionary expenditures are those that are not directly related to the company's day-to-day business; that is, they are not needed to generate the revenues and profits that the company has earned. An example of a discretionary expenditure would be travel by a gift shop owner to a destination that is known for similar gift shops. Although the owner may pick up a useful idea or two, it is unlikely that this trip was necessary to generate the company's current level of revenues and cash flow' (as opposed to a trip to the industry's most important trade show where the bulk of purchasing for the upcoming Christmas season takes place). Of course, an expense may be both personal and discretionary, as this latter example illustrates. The travel was both personal and discretionary.

Further examples of typical perks include the following:

Personal auto expenses (monthly payments, gas, and repairs)
Insurance (auto, health, life)
Miscellaneous credit card purchases
Excessive travel and entertainment
Second home construction, boat, or plane
Payments to babysitters or nannies
Giveaway of company products or services as gifts
Contributions to charitable organizations
Purchase of computer, security system, furniture, and other home office expenses
Frequent flier mile benefits
Pension plan contributions
Bonus or incentive payments
When evaluating these perks, it is important to verify their existence as best as possible. It is easy to make a claim about a certain expenditure when it is not necessary to provide support (e.g., invoice, entry into general ledger), so the valuator must use caution and common sense in

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adding such expenses into cash flow. Recall that other addbacks or deductions may be necessary as they relate to family members. For example, it may be common to include payments to children who do not actively work or who are overpaid as perks. The specific categorization is not important, but proper calculation of the overall ACF figure is essential for proper valuation.

Depreciation and Amortization (Non-Cash Expenses)
In the typical evaluation of a company's ACF, it is the norm to add back the so-called "non-cash" expenses related to depreciation and amortization. Depreciation is to tangible assets as amortization is to intangible assets. In regard to calculating cash flow, the important point to consider is that both depreciation and amortization expenses are non-cash deductions against revenues; that is, they are not directly associated with a period-specific cash outlay. In other words, depreciation and amortization expenses reduce operating income but are not a use of cash in the relevant time period.

Some entrepreneurs may question the addback of depreciation because they recognize that there was or may still be a cash outlay associated with paying for the fixed asset. Despite this correct perception, it is standard valuation procedure to add depreciation back into cash flow for purposes of establishing the company's generation of ACF.

To the extent that all relevant market comparable sales statistic databases (BIZCOMPS®, VR Business Brokers, Pratt's Stats) use cash flow figures that include these addbacks, the valuator must also do so to ensure "apples to apples" comparisons despite any perceived shortcomings.

When using the transaction databases, there is one exception to the rule that ACF always includes non-cash charges. Specifically, the IBA database excludes depreciation and amortization expenses from its cash flow figure (for the reason just presented) and defines their cash flow figure as "annual earnings before owner's compensation expense, interest expense, and income tax expense.".

Irrespective of the need to include non-cash charges in calculating ACF for valuation purposes, the experienced entrepreneur recognizes that owners of asset-intensive companies such as manufacturing companies face annual expenditures necessary to maintain the productive capacity of the business or possibly augment its production capabilities.

Such capital expenditures must come out of the company's future cash flows (if not borrowed), so it is prudent from a planning perspective to incorporate future cash outflows associated with capital expenditures into the company's business plan or cash flow forecast.

Also note that the most sophisticated and academically correct valuation technique (discounted cash flow analysis) DOES directly account for capital expenditures in the cash flow analysis (as well as working capital infusions and corporate income taxes). The bottom line with respect to the use of the ARM Approach is that both depreciation and amortization are added back into cash flow in arriving at the company's ACF.

Regarding amortization expense, intangible assets such as software or patents may be relevant in evaluating cash flow. However, the most substantial impact of amortization expense is found when the subject company was acquired by the current owner as a sale of assets (as opposed to a sale of stock). In other words, if a company is purchased as an asset purchase, both buyer

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and seller must agree on an allocation of the purchase price to seven separate IRS-stipulated classes. Such allocation affects both the seller's immediate tax obligation and the buyer's future tax obligations.

In the case of an asset sale, the difference between the FMV of the identifiable tangible assets (accounts receivable, inventory, furniture, fixtures, equipment, land, and buildings) and the purchase price is allocated to one or more intangible accounts (e.g., goodwill, trade name, covenant not to compete, customer list) that are subsequently amortized.

Amortization Expense

This is another accounting issue that is handled differently for book purposes versus tax purposes. For tax purposes, all intangible assets must be amortized over fifteen years (the only exception is the covenant not to compete, but tax laws tend to change from year to year), whereas for book purposes they must be amortized over their useful lives (subject to the accountant's assumptions, ranging from as short as two years to as long as forty years). Miscellaneous startup costs may also be amortized, thus generating amortization expense.

Overall, the valuator typically must add back both depreciation and amortization expense to arrive at ACF. Noting that the valuation process is distinct from the operational process, savvy entrepreneurs will know to incorporate anticipated future expenditures related to capital goods such as furniture, fixtures, and equipment into their overall cash flow forecasting and analysis.

Another interesting topic related to amortization expense is goodwill. Many businesspeople think of goodwill in terms of a company's relationship with its customers; that is, a company with good service generates goodwill among its customers. Although this is an accurate interpretation of goodwill, there are several others. For example, under the so-called excess earnings method for estimating business value, a company is worth the sum of the FMV of its tangible assets and its goodwill. In this scenario:

Goodwill is calculated as the capitalized value of the company's "above-average" earnings or rate of return".

In other words, the goodwill is a reflection of the fact that the subject company is earning a return greater than the norm for investments of similar risk. Thus, goodwill in this instance is the company's ability to earn above-normal profits. Of course, these above-normal profits may arise from exceptional service, but in general these are two distinct interpretations of goodwill.

The final interpretation of goodwill relates to a company's balance sheet. GAAP does not allow a company to estimate the value of its goodwill and then place this figure on the balance sheet. The historical cost principle makes such an entry impossible under GAAP.

However, in the case of a business acquisition, goodwill can be placed on the post acquisition balance sheet, reflecting the excess of the purchase price paid over the FMV of the identifiable tangible assets. In practice, this excess may be allocated to other intangible assets as well besides goodwill (e.g., customer base, trade name).

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One thing is sure, however. If the asset called goodwill shows up on a company's balance sheet, this means that the subject company was purchased by its current owner rather than started from scratch or the company has purchased another company in its history and entered a portion of the purchase price as goodwill on its balance sheet for future period amortization.

In other words, if you encounter goodwill as an asset, you know that the current owner purchased the business from a prior owner or the company has purchased another company in the past via an asset acquisition. If nothing else, this should prompt you to discuss this transaction with the owner to gain information about its purchase price multiples.

Interest Expense
As explained earlier, each company has a unique capital structure (remember that capital in this sense refers to financial capital, not physical capital such as equipment) as evidenced by its combination of debt (liabilities) and equity (investment in stock and retained earnings). Recall that all of the firm's assets (A) must be financed with a combination of debt or liabilities (L) and retained earnings or equity (E) or:

Assets = Liabilities + Equity

Those providing debt financing (creditors) are paid interest expense (cost of debt) and those providing equity financing (investors) are paid dividends (out of profits). Together, the creditors and investors are considered interest holders or stakeholders and the measure of ACF reflects the amount of cash flow which remains for the single owner-operator AFTER the payment of all required and legitimate expenses (except for interest on debt and taxes on profit - and compensation to the owner).

Because of the unique nature of a given ownership's debt to equity relationship, it is standard valuation practice to add back all interest expense related to a company's debt (with the exception of interest expense directly related to the sale of product such as flooring/inventory costs for a car dealership).

The general idea is to determine the overall amount of cash flow (cash- equivalent benefits) accruing to the owner from which an owner-specific amount of interest expense may be supported in addition to paying a reasonable salary to the owner and earning a positive return on the invested cash. In this regard, the interest expense paid by the subject company is available to a new owner to use as she sees fit (she may pay all cash for the business and incur no debt or may borrow 90 percent of the purchase price and incur substantially more interest expense).

On the income statement, interest expense may be separated from other operational expenses (on income statements that include segments called earnings before interest and taxes [EBIT]) or included with all other operational (i.e., general and administrative) expenses (typically in alphabetical order) under the title "Interest Expense." Another common location is under the heading "Other Income and Expense." It may even be found under "Cost of Goods Sold" or under the heading "Credit Card Expense."

As mentioned earlier, there may be more than one way to handle interest revenue or interest income. To the extent that interest expense is added back, interest income or revenue should be subtracted based on similar logic. The key question is whether the interest revenue will continue

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under the new ownership. If a similar situation eventually will arise for the incoming owner, then it makes sense to include the interest income (i.e., do not subtract it from ACF). Professional business appraisers must be much more strict in handling this issue. For the typical entrepreneur seeking to establish a credible yet loose estimate of FMV, however, simply being consistent in handling the issue is sufficient. If the buyer expects a similar operating scenario after the purchase is concluded, keeping the interest revenue as part of ACF is a plausible assumption to make in reaching the final ACF result.

One-Time Expenses or Revenues

Next to the decision as to what constitutes a fair perk, the handling of one-time expenses (possibly one-time revenues) is one of the most controversial elements of calculating ACF. Generally speaking, if an expense or a revenue is of a one-time nature, it should not be included in the company's ACF. In the world of GAAP, these items are called "extraordinary" gains or losses and are defined as having the following two characteristics: '

Unusual in nature
Infrequent in occurrence

BizEquity Note

Users of the BizEquity online system may recognize these particular line entries on Step 3 (income statement entries) as they are labeled as:

One-Time/Non-Operating Expenses/Losses

Any amounts entered here have the effect of INCREASING the level of ACF (discretionary earnings) utilized to value the subject company and thereby RAISING the value estimate.

One-Time/Non-Operating Revenues/Gains

Any amounts entered here have the effect of DECREASING the level of ACF (discretionary earnings) utilized to value the subject company and thereby LOWERING the value estimate.

The term "unusual in nature" means that the event is highly abnormal and either unrelated to or only incidentally related to the ordinary and typical activities of the company given the environment in which the entity operates. The term "infrequent in occurrence" means that the event is highly unlikely to occur again in the foreseeable future, given the environment within which the company operates. What is extraordinary for one company may be ordinary for another; there is a subjective element involved in the final determination.

In the context of business valuation and business brokerage, inclusion of such expenses (or exclusion of revenues) is subject to debate and negotiation. In many instances, the buyer and seller of a business may agree that the subject company is worth a certain multiple of ACT (after assessing the unique characteristics and features of the company, the industry, and the economy in general) and then end up disagreeing on what the relevant or precise cash flow is because of items such as extraordinary expenses or revenues.

One example of a potential dispute might arise in the event of a flood. If the flood occurs along the Mississippi River in an area that is routinely flooded, such expenses should not be considered one-time expenses, whereas if this flood occurs in an area of the country where

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floods are extremely rare, the expenses may be considered one-time expenses and added back into the ACF calculation (similar to the impact of a blizzard in Arizona as opposed to northern Minnesota).

The following are further examples of such one-time expenses:

Repairs resulting from a customer driving a car through the front window of a retail company
Advertising flyers that were never delivered because of fraud or because the service provider filed for bankruptcy
Moving expenses for relocation of operations
Startup costs of second or new retail location
Embezzlement or theft of cash or major assets
In general, the expense must meet both criteria (i.e., unusual and infrequent) to be added back into ACF. Note that writing down accounts receivable year in and year out is not an extraordinary expense, but if one major customer accounting for 33 percent of total revenues files bankruptcy after ten years of steady sales, this may be an addback (provided that these lost revenues could be easily replaced by other customers, which typically would not be the case). Common sense and credibility should ultimately be the determining factor as to whether expenses such as these can be included in cash flow.

Another example concerns the gain or loss associated with the sale of company assets. Certain businesses routinely buy and sell assets as part of their normal operating procedures. For example, a company that continuously replaces equipment or trucks to maintain state-of-the-art capabilities will incur these gains and losses every year without fail. For such a company, these gains or losses are not extraordinary and should be included in the company's ACF results. Another company such as a small florist would not be buying and selling equipment regularly. Thus, if this company sold its truck for a substantial gain or a loss, these results should be taken out of the ACF calculation (i.e., pretax income should be adjusted accordingly).

On the revenue side, it is rare to see a business presented for sale at a price based on an ACF that includes a deduction of one-time revenues. Most sellers argue that there is always another customer that would make a similar purchase under similar conditions, thus precluding this type of subtraction from ACF. Examples of one-time sales include the following:

Dramatic sales increase resulting from a large one-time event such as retail sales for businesses located near the location of a Super Bowl or World Series
One-time contract of a magnitude equal to the entire amount of business conducted in the entire previous year
One-time, unique services provided by an attorney or accountant (e.g., an attorney helping a client file for bankruptcy or accounting services related to preparation of paperwork for terminating the operations of a company; in both cases, the relevant customer will no longer be around to generate revenues)

Unrelated Expenses and Revenues
This category is similar to personal expenses in that they are not directly related to the subject company and its generation of revenues and profits. It is not uncommon to see a business owner start a second business using the foundation of the first business to provide working capital and even employees. In such an event, it is helpful if the owner maintains a second set

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of books from the beginning. However, this does not always happen because of the associated costs (money and time).

Regardless of the circumstances, it is necessary to separate the revenues and expenses of the second company when evaluating the first company. If the second company is related to the first company or they could be sold together, there may be a rationale to keep their records in one set of statements. Even then, however, it is necessary to subtract the one-time startup expenses to generate the commonly accepted ACF measure.

Importance of the ACF Calculation
It should be clear now that there are numerous variations of cash flow measurements as used by business valuation professionals. In general, the term cash flow relates to some measure of net proceeds accruing to ownership, that is, a measure of spending power generated by the company for the owner. In practice, the actual measures of cash flow range from a bottom-line accounting measure such as net income (used in P/E ratios for publicly traded companies) to more inclusive measures such as EBIT or the complex measure known as net free cash flow- (used in discounted cash flow analysis, also typically for larger or publicly traded companies). This latter measure takes into account items such as working capital investments, capital expenditures and income taxes, whereas EBIT, EBITDA, and ACF do not.

As discussed later in this chapter, alternative interpretations of the general concept of cash flow also exist, such as cash flow from operations as found on a statement of cash flows (GAAP-required financial statement) and cash flow as calculated in cash flow forecasting for effective business and financial management.

For the typical business owner, however, ACF is the most pertinent and useful measure. Regardless of the term used to describe this measure (e.g., “net,” “sellers discretionary cash,” “annualized cash flow,” “recast earnings,” or “adjusted cash flow”), the calculation behind the term generally remains the same. ACT (as used throughout this book) is calculated as follows:

Pretax net income + Owners salary and payroll taxes + Owner’s perks + Depreciation and amortization + Interest expenses + /- One-time expenses or revenues = ACF

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