WALKING TO DESTINY

A SUMMARY OF THE ADJUSTMENTS TO DETERMINE YOUR REAL NUMBERS (VS. TAX NUMBER)

Adjustments to your tax number to determine your real number can be significant and can present a completely different look at the profitability of your company.

ADDBACKS AND TAKEBACKS

Adjustments to your net income to get to your real number, which is the number used to value your business, are called addbacks and takebacks. Addbacks are “added to” and takebacks are “subtracted from” your net income to determine Recasted EBITDA—what I keep referring to as your real number. I typically group them into four buckets:

- Standard addbacks,
- Normalization addbacks and takebacks,
- One-time nonrecurring adjustments, and
- Discretionary expenses.

STANDARD ADDBACKS

Standard addbacks are interest, taxes, depreciation, and amortization. These are added back to provide clarity on the operating profitability of a business. Standard addbacks disregard interest paid on debt financing and income taxes on earnings and eliminate the effects of financing and capital expenditures.

NORMALIZATION

The goal is to determine the best estimate of the ongoing operating profitability of your business. To do so, we need to normalize to market expenses that may not be in line with the standards in your industry. Two common normalization adjustments are officer salaries and rent. For example, if the standard salary for an officer of the company, the owner or CEO, for example, is $300,000 per year and you are paying yourself $500,000 per year, we need to normalize that back to $300,000 by adding back $200,000 to your net income.

Another common normalization adjustment is rent. Business owners sometimes use increases in rent charged to the business as another means for pulling cash out. If the business owner owns the real estate in which the company operates and is charging the company $22 per square foot, but the normalized market rate for this type of real estate/rent is $12 per square foot, we need to normalize it to $12 per square foot by adding back $10 per square foot to your net income. Remember that this can go the other way in the form of a takeback if the owner is paying a salary that is less than the market standard.

ONE-TIME NONRECURRING ADJUSTMENTS

These are on-time excessive expenses or income that does not reflect what the ongoing “normalized” expenses or income would be of the ongoing concern. Examples could include a one-time union dispute settlement, excessive one-time legal expenses from settlement of a lawsuit, a one-time safety or environmental penalty, a large capital expenditure that you decided to expense in one year versus doing it over several years, or a large additional one-time bonus you may have paid out over and above your normal bonus payouts. This may also include sales adjustments for sales that were pulled forward or pushed out or forward buys of raw materials or equipment. We want to add back or take back these from net income because they are not normal.

DISCRETIONARY EXPENSES

These are usually expenses the owner is charging to the business that are personal versus business-related. This could include things like your car, travel, real estate, country club memberships, charitable donations, and so forth. These addbacks really need to be managed because they can get excessive. I’ve seen owners adding back personal travel, their kids’ coaching camps, their homeowner association fees, electric bills, and tens of thousands of dollars in personal expenses. It’s really staggering sometimes. Be careful with these.

MANAGING ADDBACKS AND TAKEBACKS

Grossly excessive addbacks can be a deterrent. If the addbacks are too excessive, it raises a red flag in the eyes of the investment banker and buyer. Sometimes banks and buyers won’t accept all of them as addbacks. Plus, this is usually a sign that you may be undercapitalizing the business, severely hampering the probability of successfully transitioning it to family, employees, or management. If you are abusing addbacks, and use all of them, it usually means the recasted EBITDA used to value your business was too high. After being adjusted by the bank or buyer, it will reduce the valuation, and, in turn, lessen what a bank would be willing to finance or what a buyer would be willing to pay for your business.

You should note that adjustments go both ways. They are not always in your favor as the owner. If you are underinvesting in your business, a buyer will see that and adjust the number in their favor. I had this case a few years ago with a client working through Value Acceleration with the goal to sell to a strategic buyer. Sales were growing significantly. The owner’s net income was skyrocketing. But one thing I noted, from my benchmarking of the business, was that he was under-investing in the business. I deduced this because his SG&A (Selling, General, and Administration) as a percent to sales was much lower that the industry average. As a result, sales were growing at a much faster rate than costs and expenses. I asked him about it. He told me it was not intentional.

“The whole company is working so hard to keep up with sales, Chris,” he explained. “I haven’t had the time to even add the people I need to keep up, let alone make investments in my systems and facilities.” He was sitting on a house of cards. Any buyer looking at the business would see the same thing. When preparing his recasted income statement and balance sheet, I made adjustments indicating expenses as a percent to sales would likely increase rather than decrease in the future. This reduced his recasted EBITDA but produced a realistic recasted financial statement and corresponding valuation.

After reviewing the business’s financial statements, the strategic buyer commented that she was going to have to invest additional funds to sustain the present growth rate. I agreed and was able to show her how we had already planned for that and adjusted the historical and projected financial statements to account for that. This built a lot of credibility with the buyer. It also helped me manage my client’s (the seller’s) expectations by painting a more realistic picture of what he could reasonably sell the business for on the open market.

BALANCE SHEET ADJUSTMENTS

Bear in mind that the balance sheet should be recasted as well. If there is excessive working capital or retained earnings in the business, or inventory that has not been written off, or receivables that are not likely to be collected, you might pull those out. Or you might need to clean up intercompany and personal loans and other liabilities.