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# Cash Flow Add-Backs and Deductions
## for Business Sale Valuation and Financing

Generally, there are three kinds of cash flow figures used in selling a business: (1) Seller's Discretionary Earnings (SDE), which is used for valuing, or setting the price of a business, based on total returns to the owner; (2) Normalized (or Adjusted) Earnings before Interest, Depreciation, Amortization and Taxes (EBIDAT), which is used for valuation based on the return on investment from owning the business; and (3) Cash Available for Debt Service (CADS), used by lenders to calculate the maximum debt service (principle and interest) that a business can reasonably support.

**SDE** answers the question, "what is the total return of cash and benefits that historically flow to the owner—including non-essential (non-business) items paid for the owner's benefit, and extraordinary (non-recurring) costs that normally (and in the future) would have been cash available to the owner?"

**EBIDAT** ("normalized," like SDE, through the adjustments listed below) answers the question "what is the investment return to the owner for a cash purchase of the business, after a market rate of compensation for work that the owner performs in the business (or for hiring someone else to perform those functions) has been subtracted?"

**CADS** answers the question, "what is the total amount of cash that historically would be available for the purpose of paying debt service, after all normal business expenses have been paid, after an appropriate salary has been paid to owners (or their replacements) for work they perform in the business, and after normal perquisites of an owner (such as health insurance) and special costs required by lenders (such as keyman life insurance) have been subtracted?" Although CADS is not generally used by professional valuators, it is important because it is often used by lenders to estimate value, as well as to determine financing feasibility. Lenders often will not finance a business that they consider over-priced; and a business that cannot be financed is much more difficult to sell.

The following guidelines are primarily aimed at defining and documenting cash flow add-backs for calculating SDE, which is the broadest measure of cash flow to the owner, and yields the highest bottom-line figure. The comments for each item, below, indicate those which are typically eliminated or subtracted, for calculating normalized EBIDAT and CADS.

Note that unreported cash derived from the business (cash income not reported on the tax returns) can NEVER be added back by a lender for calculating CADS—since the primary form of validating historical income for lenders is the federal tax return. (Whether a buyer might choose to accept documentation of unreported cash is an individual decision.)

## 1. Adjustments requiring no or minimal documentation (other than tax returns).

a. **Income tax**. Pre-tax net profit is the starting point for the calculation, usually shown as net ordinary income, 1st page of the tax return. If working from an income/expense (profit and loss) statement showing net income after tax as the bottom line, add back state and federal income tax. (Property tax, sales tax and other licenses and taxes are NOT added back.) This is done to put everything on an even footing—since the tax situation of a buyer may be very different from that of a seller.

b. **Interest expense** (1st page of the tax return). Usually, 100% of interest expense is added back to cash flow. Exception: interest for types of financing that will continue after the acquisition. Normally, all debt is paid off in the transfer. However, some types of debt must continue after closing, such as flooring interest for a dealership, or any existing debt that is to be assumed by the buyer. To document continuing

interest expense (if necessary): provide monthly account statements (or annual summary statement) from lenders, showing interest and principal breakdown for any debt to continue after closing, for each historical year and the interim year-to-date. NOTE: only the interest portion of payments can be added back, since only interest (not principal payments) was deducted from net profit in the first place.

**c. Depreciation/amortization** (1st page of the tax return.) These are noncash "expenses" calculated for tax purposes, and thus are added back to cash flow. Sometimes depreciation may be found in Cost of Goods Sold on p. 2 of taxes, or in the itemization of COGS, in the Federal Statements attached to the return. Amortization is usually in the itemized "other deductions" shown in the Federal Statements.

*The sum of the above is unadjusted EBIDAT, which like SDE is "normalized" for valuation and investment purposes, by making the adjustments listed below.*

d. **Non-operating income/expense.** Shown in the "Income" section, top of 1st page of the tax return, are income/expenses from one-time, non-recurring sources, such as loss or gain from sale of assets. Other non-operating sources of income (such as dividends from investments) are also shown here. Valuators and lenders will add back expenses or deduct income from such sources.

Rent earned from leasing properties to 3rd parties should be deducted if those properties are not included in the sale, or if the leases are short-term. Such rents will usually be deducted for CADS by a lender, even if the properties are being transferred (unless there are long-term leases and a long-term history of payment from a highly reliable lessee.)

e. **Rent.** Normally, **rent for business-occupied real estate** shows on a separate line of the tax return. Even if paid out to a 3rd party (rather than to owner), historical rent expense is added back and then adjusted by subtracting future rent to be paid by purchaser, which usually will differ from historical rent. Even when the new owner will own the RE and be receiving the rent payments, a normal market rate of rent must be deducted from business cash flow—to equalize the valuation of businesses which own real estate with those which rent it (and to recognize the lost income, or "opportunity cost" of not earning rent on owned real estate, by renting it out on the market). In other words, rent is not "free," even when you own the real estate.

If real estate rent is not separately shown (i.e., if facility and equipment or other rent are mixed on one line of tax returns), to document: provide copy of current leases, and a recent monthly account statement, together with a record of payment for that month, for each lease.

f. **Equipment and other rent paid to owner**. If there is **rent for equipment or other items** paid to the owner, it's added back as an item of owner compensation. Normally, it appears on the tax return (often, in the itemization of the "other deductions" line in "federal statements"), but if not separately itemized on the return, to document: provide agreement showing monthly amounts due, and record of payment (bank statements, check copies, credit card statements); also provide evidence (such as General Ledger entries) showing in what category this is recorded on books or tax returns.

g. **Pension/profit share (retirement) benefits paid to owner.** Often on a separate line of tax return. If not separated (if included together with benefits paid to employees), to document: provide payroll summary report showing the benefit payments, OR account statements showing deposits made on behalf of owner, together with payment records showing these deposits were made by the company.

h. **Health and life insurance paid for owner.** (Generally, this is used only for SDE, not for EBIDAT or lender's calculations of CADS.) If not recorded on a separate line of tax return, to document: provide payroll summary report showing employer's contribution, OR account statements showing payments made on behalf of owner, together with payment records showing these costs were paid by the company, and General Ledger (GL) entry or other indication of what category this expense was entered in.

i. **Owner's compensation--salary/wages** (normally on a separate line of the tax return.) Sometimes, this item may not be separated from non-owner wages and salaries. If not shown on a separate line, to document: provide W-2 forms for historical years; provide a payroll summary report (printout from bookkeeping system) OR copies of pay stubs, for year-to-date interim period.

**j. Other payroll benefits paid for owner** (SSI, Medicare): If not shown separately on taxes or P&Ls, provide W-2 statements. Normally, only used for SDE calculation (not for EBIDAT and CADS).

k. **Capital replacement, or maintenance reserve**. This is a critical item of cash flow adjustment for some types of business (such as equipment rental companies, transportation and construction companies, and hotels/motels). Add back, for each historical year, the actual expenditure for replacing equipment (or furnishings/fixtures for a motel)–deriving this figure from the balance sheet (or other documentary records supplied by owner). Then, to "normalize," calculate a 3-year or 5-year average expense, and deduct this **allowance for reserves, or capital replacement ("capex") allowance** in each year. For extremely capital-intensive businesses that have grown rapidly, a more accurate allowance can be derived from the average of a 3 year or 5 year projection of actual anticipated capital expenditures, based on a detailed schedule of equipment age, annual usage, and projected year and cost of replacement, prepared in consultation with the owner.

l. **Distributions to owner** (recorded on balance sheet, not income/expense; sometimes identified as "bonus") **cannot be added back,** since distributions or bonuses shown on the balance sheet were not expensed to begin with. These payments to owners are already included in the net profit figure which is the starting point for the cash flow calculation; to add them back would be double-counting.

*The sum of net profit and the above adjustments is SDE. Following are further adjustments made to calculate normalized EBIDAT and CADS.*

m. **Owner's compensation adjustment--EBIDAT.** For calculating normalized EBIDAT, an average market salary (including payroll tax contributions, if those were included in SDE) for the job performed in the business by each departing owner is deducted from cash flow in each year. For EBIDAT, this separates out the compensation for owner's labor from a strict calculation of return to investment for a cash purchase of the business.

n. **Other adjustments for CADS.** Instead of an average market salary (above), lenders will typically deduct the **minimum required salary (and payroll contributions) for the new owner**, based on that person's level of personal debt and size of family, to calculate cash that will actually be available for repaying debt. If an owner has independent income and requires no salary, lenders will instead deduct an average market salary, or (depending on the lender) an arbitrary minimum salary.
In addition, to calculate CADS, lenders: (1) add back **real estate rent that is to be paid to the new owner** (when RE is included in the sale); (2) deduct **insurance payments** that the bank requires the new owner to carry (such as life or "key man" insurance); (3) deduct other **owner perquisites that they regard as normal for the owner of such a business**, and which they expect a new owner will continue (such as health insurance, cell phone); and deduct **perquisites or other minor add-backs that the bank regards as petty, or not worth the labor of documenting** (such as gas for personal vehicle, memberships, dues, subscriptions and the like); and deduct any **consulting or royalty payments** that will be made to the exiting owner. Finally, banks are highly likely to deduct **income from rent of properties to 3rd parties** (if these were included in SDE), unless long-established, with long-term leases to highly reliable parties.

2. Non-essential (non-business) and Non-recurring (extraordinary) items: defining and documenting.

For itemization/documentation of these categories of expense—which sometimes can be very large, and essential to demonstrate value and capacity of the business to carry debt—**we need concern ourselves ONLY with items that meet ALL 3 of the following criteria:**

i. Clearly non-business (non-essential) OR non-repeating (extraordinary);
ii. Documentable—EITHER reported separately, on a single line of the tax return or income/expense statement, OR otherwise documented, as described below;
iii. Significant enough, in dollar terms, to be worth the labor of documenting.

**A. Non-essential (non-business).** Typically, these are items of indirect compensation to the owner--costs that are paid on the owner's behalf, or in the owner's interest, for items not actually required to operate the business--such as excessively high wages paid to a spouse or relative.

i. Positive examples: **Clearly non-business, major travel**, such as skin-diving trip to Tahiti (for anything but a diving or travel company), or trip to a NASCAR event or an NFL game (for business not closely related to those kinds of activities, and if in fact no customers or business associates attended.) Documentation: invoices for the travel costs and event tickets, with matching payment records (check stubs or receipts), and with event dates matching up with dates of the travel expenses. Also, must show (from General Ledger entries) what category these expenses were entered in, on the books.

ii. Positive example: **expenses (lease, insurance, major repairs) for a vehicle that is clearly personal**—such as a luxury vehicle, or any vehicle used personally in a business that obviously doesn't require such vehicles for its operations. Interest on vehicle payments is already accounted for in the interest expense add-back, above. Minor expenses such as fuel are difficult to document (unless all charged on a single credit card for that vehicle).

iii. Positive example: **utility expenses at owner's residence**, paid by company IF invoices clearly show that utilities were provided to a non-business location AND payment records show matching payments by the company WITH GL entries or other documentation to show in what category of financials or tax returns this expense was entered.

iv. Postive example: **rent paid or payments made by the business on a personal vacation home** clearly not used for business purposes. Requires invoices or account statements or copies of leases, together with proof of payment (check stubs or receipts) and GL entries showing where recorded on books.

v. Positive example: **seller's son or daughter is carried on the payroll**, for a period when it can be documented that the child was out of the country, attending a foreign university or otherwise occupied in clearly non-business activity. OR, **non-working relative is on payroll,** during period when it can be documented the relative is fully employed in another, non-related business.

vi. Negative example: **credit card receipts for gas used in personal vehicle** (we know money was spent on gas, but difficult to prove it was strictly for personal, non-business uses.)

vii. Negative example: **personal meal and entertainment expenses** charged to the business (again, we know money was spent on meals; but it can be very difficult, and not worthwhile, to attempt to *prove* which meals or entertainment were actually for business purposes, and which were actually personal.) Since they were claimed on the taxes, the presumption is they were business expenses, unless proven otherwise.

viii. Negative example: **inventory items taken for personal use**. The expense of inventory is recorded in COGS, but usually it is impossible to document what specific items went for personal use, or that the use really was personal and non-business--except in rare cases, such as large items transferred to the owner, where an actual record of the transfer price and change of ownership (such as registration and bill of sale for a vehicle sold to owner at below cost) is available.

ix. Negative example**: advertising**. Owner may feel it is "nonessential" and that the business would have performed as well without it, but it's impossible to prove that removing advertising/promotional expenses would not have had a negative effect on historical sales. Usually, claims of advertising as non-essential will be disallowed. Exception: a very large campaign, tried for a limited time, with no positive effect on sales—when the ad budget for that period is clearly far higher than for years before or after.

**B. Non-recurring**. Significant, one-time cost items--expenses that are extraordinary, and not reasonably expected to recur in the years immediately following transfer of ownership.

i. Positive example: **major, one time capital expenditure** (e.g., replacing the roof) **that was expensed** on the income/expense statement (P&L). NOTE: such expenses that were capitalized (reported on the balance sheet, rather than expensed on the P&L or taxes) cannot be added back, since they were not deducted from profit in the first place.

ii. Positive example: **major bad debt in one year**, when there is no or very little bad debt in other years. When extraordinary bad debt is added back in one year, an allowance still must be made for the fact that large bad debt can, and did, occur.
**Adustment—bad debt allowance:** add back actual bad debt in each year; deduct in every year, as a bad debt allowance, the average of bad debt over 3 or 5 years.

iii. Positive example: **major employee theft or embezzlement** can be added back. If not shown on a separate line of P&L or taxes, document with court filings or other records, and GL entries showing where the expense was entered on the books.

iv. Positive example: **major loss from a lawsuit** (if business is not regularly involved in litigation). If not shown on a separate line of P&L or taxes, may require extensive documentation, such as billing records, to distinguish this cost from normal legal expense.

v. Positive example: **extraordinary insurance costs.** When, because of age or other reasons, seller has unusually high life or health insurance costs, the difference between current costs and the actual (quoted) coverage costs for the buyer can be added back. Add back actual owner insurance costs in each year; deduct quoted insurance costs for buyer.

vi. Negative examples: **equipment purchase or repair that is unique in itself, but just an example of a similar type of expense that occurs in many years** (e.g., replacing the lawn mower in 2009, replacing the weed whacker in 2011)**. Other "one-time" expenses that are really just single examples of a recurring type of expense** will also be disallowed, e.g.: cost of hiring and training a replacement for one particular staff person--when in fact employee turnover, in one position or another, is something that occurs in more than one year. *In general, any "non-recurring" expense proposed to be added back in 2 or more years is likely to be disallowed.*

C. **Fully documentable** means EITHER (i) it is reported separately, on a single line of the tax return or income/expense statement OR (ii) ALL of the following are available:

- Invoice or receipt, clearly showing what was purchased, from whom, and when
- Matching payment record (same $ amount & description on bank statement, check copy or credit card receipt; and other info – such as serial numbers – matches up with invoice)
- Matching GL entry, or a separate category of expense on tax return / income statement showing where the same exact $ amount or $ total was entered in the books.

D. Add-backs requiring the detailed documentation described above should ONLY be claimed if they are large enough to merit the labor of verifying them – definitely NO category under $1,000; ideally, not less than $5,000 per line item of "add-back".

Very often, the question whether an item is justifiable as a non-essential or non-recurring addition to cash flow is a judgment call, which may depend on the policies of a specific lender or the experience of a valuator or buyer's CPA. It's usually best to propose add-backs, providing an itemized list with a description of each item, its dollar amount, and indication of where the expense is shown on the financials or tax returns (or how it is otherwise documented). Seller's representative can review and discuss the list with buyer's advisors or with lenders, before the labor of gathering extensive documentation.

**Very occasionally, there are major expenses that can't be properly documented,** but which would have such a large effect on the valuation of the business that it is worthwhile for the seller to take extraordinary steps, such as to amend historical tax returns (and accept the additional taxes and penalties that may result). Example: building materials from inventory, and employee labor, are used for major improvements to personal real estate; but transfers of individual items of inventory were never recorded, and time sheets were not kept for labor on this specific project. Seller's broker may be able to suggest alternatives such as tax amendment, but will always recommend consulting with professional business advisors (such as seller's CPA) before steps of this magnitude are taken.

Again, always propose such an addback, and provide or list whatever documentation is available; advisors or lenders can review and suggest what might be done to make such an add-back allowable.

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