Using EBPIDT

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One of the most commonly used methods of business valuation is the capitalisation of earnings. There are eight good reasons why this method is used:

1. It is relatively straight forward in methodology
2. It uses simple arithmetic
3. It uses an annual or “single period” approach
4. The calculation does not explicitly have to consider inflation
5. It makes sense to both buyers and sellers, (& judges, lawyers, business brokers and others)
6. It does not require “pie in the sky” estimates of future income
7. It is accepted as an appropriate method of business appraisal, & taught internationally by major appraisal institutes
8. It does not require market data, although where data is available this can support the capitalisation rates used in this method.

There are a number of profit measurements, NPAT, EBT, EBIT, but for SME’s (Small – Medium Enterprises which in New Zealand accounts for 96% of all businesses) the most commonly used measure of profit is EBPIDT.

Earnings
Before
Proprietors Income
Interest
Depreciation & Amortisation
Taxation

EBPIDT measures the underlying cash generating capability of a business. It avoids debate about the appropriate level of remuneration for the owner(s), the impact of financial leverage, and non cash-costs. It is also known as **“Sellers Discretionary Cash-flow”.**

Financial statements will often provide the basic data needed to calculate EBPIDT. However these may employ aggressive approaches to minimize income taxes, and need careful scrutiny. It is also advisable to review not only the most recent set of accounts, but to review accounts and tax returns or the past 3 years and to identify significant trends in the financials.

Add-backs:

The financial statements of privately owned businesses rarely portray the true assets and earnings they generate. Pro-forma adjustments often referred to as “Add-backs” are used to adjust historically reported financial statements or a truer picture o the economic reality of the business.

Typically add-backs can include:

– Donations
– Bad Debts
– Rent Adjustments
– Adjustment for owners wages, superannuation or other remuneration.
– Hire Purchase and leasing charges
– Loss or gains on sales of fixed assets
– Interest paid or received
– Depreciation or amortisation.

Add-backs are an important tool for adjusting financial statements to show the economic reality of the business, but they are not tools that can alter history. They are not appropriate to depict how a business could have performed had the owners taken a different strategic direction or captured an opportunity that was missed. Add-backs are used to properly depict the earnings and assets of the business as it actually operated, and not how the owner should or could have operated the business. Several of these deserve special mention:

Owners Wage/Salary/Drawings/Superannuation: The majority of businesses are sold to "one working owner" who has sole discretion for his/her own remuneration. Some owners nominate incomes which minimize tax, rather than take a 'market' salary. To avoid debates about appropriate remuneration, the entire wages and superannuation of a single owner is added back when calculating EBPIDT.

Rent: If the business premises are owned by the business owner or a closely related party/trust, rents may be at a level which is not consistent with fair market rental. Or if the business is to be sold *without the freehold*, an adjustment may be needed to reflect an appropriate rental.

Depreciation: In most accounts the reported depreciation is at levels set by the IRD. This may or may not reflect the life of an asset. In some cases plant has been fully depreciated but is still in constant use, in other cases the IRD rate may not reflect the true rate of obsolescence. Depreciation is not a cash expense, and in arriving at the "Sellers Discretionary Cash-flow" non cash items need to be added back.

There are exceptions such DVD & Video stores which have 100% depreciation on inventory. Their purchases of inventory may be treated as an expense.

Other: There are a wide range of personal costs that manage to be incorporated in business accounts; maintenance of sports or stock cars, vehicles costs and telephone costs for other family members, – the list is endless. Costs which are not business related need to be identified and added back.

Future Maintainable Earnings:

Most buyers regard the most recent year's profits as the best indicator for the future. However (as the recent recession has shown) each year is not the same as the one before. Some assessors prefer to look at the pattern across three or more years. In assessing future maintainable earnings a weighted average (with more emphasis on the latest figures) may be applied.

There are no rules on this point. The assessor must make an informed judgement; not only based on the adjusted accounts, but also considering market, economic and other factors which do not appear in the financial statements.

Earnings Multiplier: This is where we may be able to help. Once EBPIDT has been established, Direct Market Data from BIZstats may assist the assessor to select an appropriate multiplier to arrive at an estimation of market value.

BIZstats data can also provide a 'sanity' check on valuations to ensure that they reflect market reality.

Call us on **03 962 0007** or contact us on our website: **www.bizstats.co.nz** We have details of many thousands of sales of SME' businesses in New Zealand.

Bibliography:
My special thanks to Blair MacDonald for allowing me to quote from his paper to the Perth University Valuation Course

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