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AAA – Not the Rescue

If the only way a buy-sell deal can be made to work is because of AAA, it's probably not worth doing. AAA stands for:

- Adjustments
- Assumptions
- Add-backs

In the world of privately held businesses it is common that the owner's goal is to pay as little tax as possible. When it comes time to sell however, they want to demonstrate that the business has more cash flow than the tax returns (and financial statements) show. Often it gets to the point of ridiculousness; I once saw a seller state that $250 of lunches were personal not business and should be considered profit.

In my world it's common to adjust the financial statements so they look as if the seller was trying to win bragging rights for high profit instead of minimizing taxes. Some of these adjustments are easily justifiable, such as adjusting the owner's salary to market rate or if the seller owns the real estate and pays more than market rent. But they often seem to stretch the limits of sanity and if that's the only way the deal can work it probably isn't worth doing.

Let's look at the AAA of buy-sell deals.

Adjustments, as in, "you can adjust some of our operations to make more profit." I've seen where the seller or their representative stated that the employee pension contributions that are $150,000 per year could be reduced to $50,000 per year. This means another $100,000 of profit (and this makes the company worth more). Never mind that employees will absolutely "love" the new owner who has just slashed their benefits.
Similarly, I once saw a deal where it was stated that if the buyer reduced the sales staffs' commissions from 10% to 8% this adjustment would create more profit. Think slashing benefits will demoralize employees, try cutting their earnings and see how happy everybody is.

Assumptions, as in, "let's assume X happens and you'll make a lot more money." Examples include:

- We're assuming that gross profit will be 42% in the future (even though it's been 39% over the last five years and never more than 40%).
- The company has too much space. We're assuming the buyer can lease a smaller space at a lower rate (and who exactly is going to pay the exiting landlord for the rest of the lease's term?).
- There are too many employees so our assumption is the buyer will let two people go, save that money and therefore should value the business based on that higher amount of profit. In one situation, one of the seller's reasons for selling was that she was tired of working 70-80 hour weeks. And the buyer is expected to reduce staff?
- We're assuming future growth at 12% a year for the next five years so pay us more for the business now (even though it's been flat to 3% growth over the past five years)

All of the above are real-life examples of assumptions made to try and increase the price of a business.

Add-backs, as in, "we wrote off a lot of expenses on our taxes that really aren't related to the business (and therefore we've mislead the IRS)." Now, some things are legitimate. A corporation can hold their annual meeting in Hawaii in January and write it off. It isn't illegal but it isn't a necessary business expense either. Other add-backs border on the ridiculous. Here are some from a recent deal (that didn't happen, one reason being the sellers wanted the price based on the following).

- Writing off (personal) Costco bills for all members of this multi-generation business.
- Deducting gas, repairs, insurance and more on all family members' (personal) vehicles.
- Receiving the annual rebate from their distributor personally, not to the company (think that got reported on their 1040?)
- (Supposed) personal travel, meals, etc. at such a high amount it meant that nobody did much work between trips and other entertainment.
- To balance this, there are legitimate add-backs to profit and could include:
- Life insurance on the seller
- Rent in excess of market (when the seller owns the building and will lease it for the lower, market rate)
- Adjustments to depreciation with the recent high levels of section 179 deductions (as long as anticipated capital expenditures are factored in)
- Owner compensation to market rate (this could make profit higher or lower depending on how the seller pays him or herself)

Conclusion

AAA in the world of driving a car is pretty cheap "insurance." And it truly can "save the day." (Excessive) AAA in the buy-sell world is akin to "putting lipstick on a pig." You can dress the business up but if it takes adjustments, assumptions and add backs to make the deal work, it's the wrong deal. If it's (sorry for all the clichés) "the icing on the cake" that makes the deal great instead of just good there's no problem.