



## Earnings Stream

### *Owner's Discretionary Income*

There are three primary earnings streams that are used for a business appraisal. Those are, Owner's Discretionary Income, Net Cash Flow to Equity, and Net Cash Flow to Invested Capital. Which earnings stream do you use? There are several factors that affect would affect your decision, such as the nature of the business and its capital structure, the purpose and function of the appraisal, and the particular subject of the valuation. You must also decide whether you will use pretax or after tax and debt or debt-free information.

As you will see below (in the formula) the earnings stream is not net income, rather net income is used to arrive at owner's discretionary income. This earnings stream, as is with the others, is based on the economic financial statements that are arrived at after adjusting the accounting financial statements. These adjustments will be covered in a later piece.

The first earnings stream we will discuss is the Owner's Discretionary Income. The owner's discretionary income is used primarily with small owner operated businesses. Think about it for a minute, what does someone looking to buy a business want to be able to do. Pay them a wage and have enough income left to make the loan payment if one exists. They generally are looking for a job to buy and not an investment. Below is the formula for Owner's Discretionary Income:

$$\begin{array}{rcl} & \text{Pretax Operating Net Income} & \\ + & \text{Depreciation (and other noncash charges which were expensed)} & \\ + & \text{Interest Expense (if deducted from operating net income/loss)} & \\ - & \text{Interest Income (if included in operating net income/loss)} & \\ + & \text{One Owner's Compensation and Benefits} & \\ = & \text{Owner's Discretionary Income} & \end{array}$$

This particular earnings stream is used primarily to find the enterprise value, the value of a 100% interest, or other control basis valuations.

Owner's discretionary income is used a lot among business brokers. Business brokers use this earnings stream when doing a market analysis. Usually the market analysis is based on the income approach, single period capitalization method and the market approach, direct market data method. They also supply information to The Institute of Business Appraisers database, which is the largest database of privately sold businesses. The database contains over 25,000 transactions. This same data base is accessed by them to perform the market approach in their analysis. As the revenue of the business increases and the business structure or sale becomes more complex, the use of other earnings streams prevails.

This is a monthly business appraisal educational piece. The purpose for the educational series is to introduce, educate, and serve as a source of information. The information contained is current with federal laws and regulations at time of printing. Such information is subject to change. This should not be used as evidence or fact in a court of law.