What is net profit in a business

ALL THINGS FINANCIAL

Paul Fyfe, an Independent Financial Advisor, Property and Business Broker explores what is really net profit in a business.

In small to medium sized businesses when we talk about net profit, what we really mean is, what are the total of all the perks that the owner derives from the business. Unfortunately, many of these perks are not legitimate business expenses and are therefore lumped together with other legal expenses in the income statement. These could include: home bond repayments, credit card purchases and vehicle costs. The list could be endless. So to determine the true net profit, a buyer would add together the net profit shown, the owners salary plus all the perks he gets that are not actual running expenses of the business.

In the case of a restaurant, the owner would pay for all his family's costs such as food and clothing. He would probably pay for the running of his car, his retirement annuity, home and life insurance, along with a host of other personal expenses. This is one of the benefits of being your own boss, an employee would have to cover all these costs out of the net salary he receives. The problem comes in verifying the actual net profit. Even when presented with an audited set of financials, a prospective buyer or his financial advisor may have to reconstruct the income statement removing the perks from the expenses to establish the net profit the seller claims he is making.

This is the easy part. The difficulty comes in verifying the cash sales the owner claims he is doing and not declaring. My feeling is that you can't have your cake and eat it. It it's not verifiable, then it should not be taken into determining the price. Confusion with what's included in the price often is a problem in business sales. So before a buyer gets his knickers in a knot, he should establish what the seller has included and how he came to that figure. He is then in the position to do his own assessment of what he would be prepared to offer for the business. All sellers are inclined to place a premium on the value of their businesses. What regularly happens is that a price is quoted which on the face of it sounds high but when broken down is not.

For example, lets say you come across a business that is just what you are looking for, but the price sounds excessive. Get the seller to give you a breakdown of the price as follows: fixtures and fittings, plant and equipment, goodwill, price plus stock (at cost) and debtors less creditors.

Now on closer examination you find that the seller intends to settle all the equipment leases/hp's of the business with the money he receives from the sale. That's fine, but in your case it may be far better to negotiate to take over these commitments, thereby reducing your capital outlay. You would then be able to decrease the price by what is still owning on the equipment bearing in mind that the monthly payments for these items are already included in the expenses of the business. The terms of payment for the business also raise issues for the buyer.

All sellers initially require cash but many end up accepting some sort of terms. Although there are no hard and fast rules, normally payment would be 60% in cash and the balance paid off over a period of 18 months out of earnings of the business. Obviously for both parties there are risks involved. From the seller's side he has no guarantees that the buyer will succeed in the business

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