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EBITDA Adjustment Considerations

THIS WHITEPAPER EXPLORES:

Eight critical EBITDA adjustment considerations that businesses should evaluate when analyzing or reporting financial performance. We'll provide a comprehensive examination of each adjustment, detailing how and why these factors can impact EBITDA calculations and interpretations. As you preview, please note that add-backs are not uniform and whether an add-back is used or not depends on the normal practice within a company's industry.

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EBITDA Adjustment Item Considerations

If you have ever had to assess the profitability of your business, it's likely you've heard of EBITDA. The EBITDA metric focuses on determining the core operating performance of your business by excluding the impacts of financing costs, taxes, and non-cash expenses. In addition to the items below, it may be appropriate to normalize for any one-time revenue or expense spikes.

1. Owner Compensation

An adjustment for owner compensation is typically made to normalize compensation to industry standards. Compensation above the industry standard (salary and bonus) is added back to the company EBITDA while compensation below the industry standard is deducted from EBITDA.

2. Owner Perks or Lifestyle Expenses

Expenses for items such as car allowances or car leases, special travel, medical benefits, and insurance that are above standard executive perks would be added back. Essentially, the question to ask when determining whether an add back is applicable is "would these expenses be necessary for a new CEO or other executive positions?" If the answer is no, then you would add-back the expense(s).

3. Related Party Revenue or Expenses

This adjustment refers to transactions with related parties that are above or below market rates. For example, if you were incurring operating expenses on items or services above market rates from a company owned by a shareholder, then an adjustment would be made to reflect the expenses at normal market rates. In the case of the above example, this would result in an increase to EBITDA.

4. Rents Above or Below Market Value

Similar to the related party adjustments, rents for facilities owned by related parties (or a related party's holding company) that are above market rates would be added back to EBITDA. On the other hand, if the company was paying rents below market rates, then the difference between the rents paid and market rents would reduce the EBITDA calculation.

5. Other Non-Recurring Expenses

Other potential add-backs include:

- Startup Costs
- Professional Fees
- Severance Expenses
- Reorganization Expenses
- Moving Expenses

The listed items above would be applicable EBITDA add-backs under the assumption that they are non-recurring expenses. If they are regular expenses that are necessary for company performance, then there would not be an adjustment for those expenses.

6. Expensing vs. Capitalizing

Investments that could be capitalized, such as improvements, equipment purchases, machine purchases, repairs, and other capital items that are expensed rather than capitalized can be recast as fixed assets. The purpose at the time of classifying the items as an operating expense is an effort to reduce taxable income. However, when it comes to estimating the value of the company, the expenses can significantly reduce the earnings-based value. Recasting the items as fixed assets would increase the stated earnings of the company.

7. Charitable Donations

Discretionary charitable donations that are made to reduce corporate taxable income and/or made to charities personally supported by owners may be added back to EBITDA. If the amount of the donation is unlikely to be continued by the new ownership group, then an adjustment to EBITDA would be applicable. Ask yourself the following question when evaluating charitable donations, "is this donation a necessary expense for the long-term profitability of the company?"

8. Inventory

If the company carries a general allowance of parts inventory, and if the purchase of these parts throughout the year are expensed rather than capitalized, then the amount above the general allowance could be added back. This adjustment is similar to the adjustment for capitalizing previously expensed items (refer to 6. Expensing vs Capitalizing above).

Also, adjustments may be made to inventory expenses depending on the accounting method used. If inventories are booked under the Last-In, First-Out (LIFO) method, then an adjustment to the First-In, First-Out (FIFO) method costs would be applicable. Also, if there are any extraordinary inventory write-offs, then those can potentially be added back as well. Keep in mind that writing off obsolete inventory is not considered an extraordinary write-off and therefore would not be an add-back.

Adjustment Considerations

When making EBITDA adjustments, it's important to carefully consider the type of adjustments and the respective cost of those adjustments. It's important to not be overly aggressive with the adjustments as doing so could undermine the credibility of the analysis and value determination.

Contact Us

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