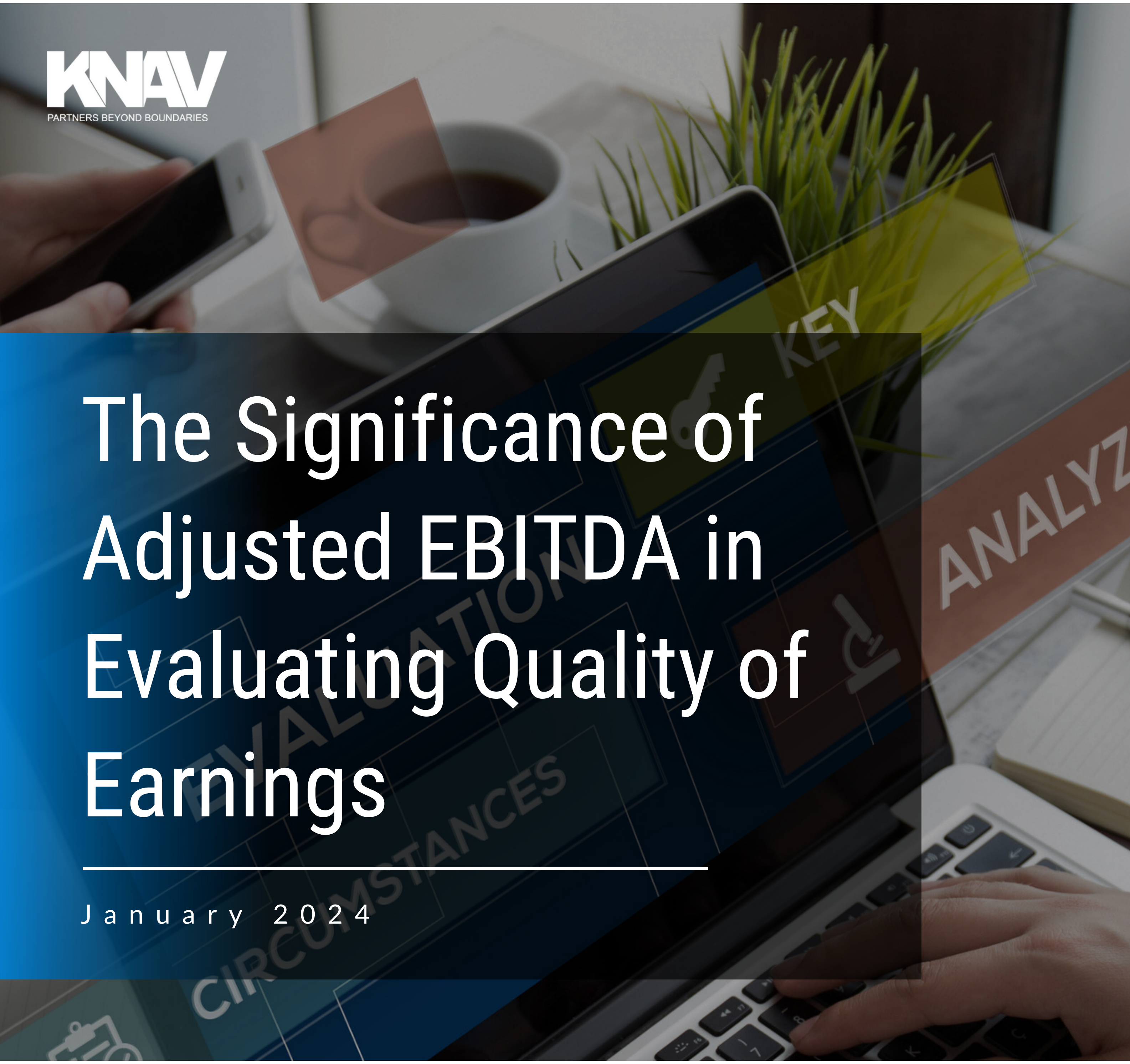

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The Significance of Adjusted EBITDA in Evaluating Quality of Earnings

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Emphasizing the essential operational and accounting-standard-compliant earnings of a business, EBITDA, short for earnings before interest, taxes, depreciation, and amortization, frequently serves as a stand-in for "operating" cash flow in M&A activities. Its widespread application in determining enterprise value stems from its ability to offer a clearer insight into a company's operating performance and profitability.

Understanding the pivotal role of EBITDA is crucial when assessing the quality of earnings. This financial metric holds significance in providing a clearer picture of a company's financial health and operational performance.

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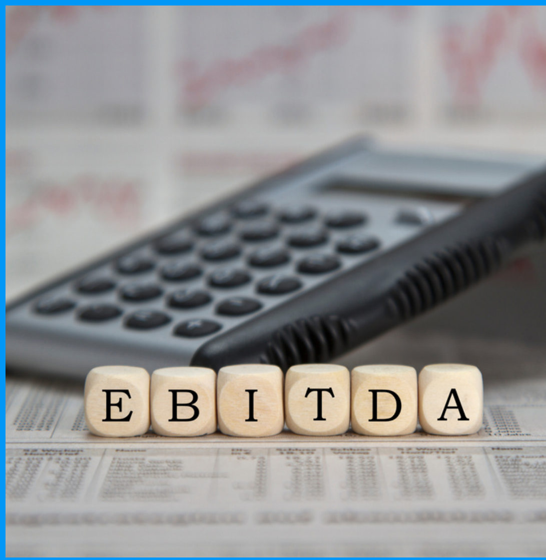
I.What is adjusted EBITDA?

EBITDA forms a fundamental financial metric. The adjusted EBITDA, a critical component of Quality of Earnings (QoE), provides an estimation of the annual cash flow a business will generate for its owner. The term "adjusted" comes into play as this measure eliminates one-time payments or non-recurring expenses that might impact EBITDA's accuracy.



II. Analyzing the adjusted EBITDA

You should always begin by examining the "EBITDA as reported by the management". Then, scrutinize the list of adjustments provided by the management to ensure they represent items that won't form part of normal operations of the business going forward. Ensure you are not responsible for items that are owner’s personal or discretionary in nature. Watch out for those items which are treated as one-time or non-operational but may not necessarily be one-time as the seller might represent. As part of your diligence, don’t forget to factor in the replacement cost for incoming management and new employees, if any and evaluate the impact of all the related party transactions had on the income statement (mainly rent expenses which is never at fair market value). Your sole focus should be on the adjusted/normalized EBITDA which forms the basis of your total purchase consideration.

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There are three adjustments categories to determine the adjusted EBITDA:

a) Management-Proposed Adjustments

As the name suggests, management-proposed adjustments are typically identified by the management and often includes the following:

- Definitional adjustments like Interest, Income taxes, Depreciation and Amortization.
- Owners' non-business-related expenses and incomes [addback or deductions to reported EBITDA]
- Owners' personal expenses included in operations [addback or deductions to reported EBITDA]
- Payments to family members who are not actively involved in the operations [addback to reported EBITDA]
- Extraordinary items such as non-recurring or non-operational items incurred by the business [often addback to reported EBITDA]

b) Due diligence Adjustments

These are adjustments identified by the advisory team during the diligence process and the nature of the adjustments can vary significantly depending on the Target's industry and more importantly the transaction team's experience. While it is difficult to put down all the type of adjustments under this category, but often diligence adjustments comprise of the following:

- Replacement costs (salary and bonus) of outgoing selling shareholders or key management personnel [often deduction to reported EBITDA]
- One-time or unusual expenses and incomes which are generally not expected to recur in the future identified during diligence [addback or deductions to reported EBITDA]
- Adjustments related to accounting errors during diligence period. [addback or deductions to reported EBITDA]
- Calculation of provision for warranty / inventory, any statistical provision for TTM period [often deduction to reported EBITDA]
- Calculation of provision for overdue receivables [often deduction to reported EBITDA]
- Year-end cut-off / Revenue and cost attribution [often deduction to reported EBITDA]
- Unrecorded expenses/liabilities [often deduction to reported EBITDA]
- Expenses charged below fair market value [often deduction to reported EBITDA]

c) Pro forma Adjustments

These are adjustments to past operating results, as if events that have already occurred or are expected to occur took place at the beginning of the period under diligence. They are expected to affect EBITDA on a move-forward basis. Such adjustments typically include the following:

- Factoring new product launched / product discontinued during the diligence period.
- In case of business combination in the books of Target, full year impact of that acquisition or divestiture.
- Changes in accounting policies during the diligence period.
- Factoring expected costs going forward.

Owners often value a company based on a multiple of its EBITDA, and the adjusted EBITDA comes into play to offer a more accurate depiction once these additional items are factored in (add-backs or deductions).

For instance, diligence adjustments that surface during the analysis can pertain to variations in month-end and annual closing procedures, discrepancies in revenue recognition, or improper inventory capitalization. To illustrate, if a company records an annual employee bonus or conducts a physical inventory count adjustment exclusively at year-end, it could result in an over or understatement of EBITDA depending on the trailing twelve-month period end when the closing happens.

One additional tip :

Beyond the quality of earnings analysis, it is customary to scrutinize monthly trends in net working capital and assess risks related to customer, product, and/or service concentration. Given that most transactions involve a net working capital mechanism, comprehending the target company's seasonal net working capital patterns becomes crucial. During the closing process, it becomes essential to assess if normalizing adjustments from the analysis of adjusted EBITDA should be considered when determining the adjusted Net Working Capital.

Conclusion

In the realm of quality of earnings analysis, Adjusted EBITDA emerges as a critical tool for stakeholders seeking a comprehensive understanding of a company's financial performance. Its ability to normalize financial statements, provide insights into core operational performance, and facilitate comparative analysis makes it an indispensable metric in making informed business decisions.

With the right deal team, you'll see all these critical adjustments getting factored in the reported EBITDA which can help you save millions

"Reach out at viraj.bhogle@knavcpa.com for sample redacted QoE report."

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