Net Income / EBITDA Definition

The recast income statement spreadsheet shows **"Earnings Before Tax, Interest, Depreciation and Amortization (EBITDA.)**
This is the benchmark for earnings of owner/operator businesses used by business brokers, appraisers, buyers, and sellers.

Comparable sale data uses SDCF in the Price/Earnings Ratio (Sale price of business divided by the SDE). Brokers recast income statements using standard methodology. This enables consistency in comparing small businesses and calculating values for buying and selling them.

Definition: The definition of EBITDA is: pretax net profit plus non-cash income and expenses, discretionary income and expenses, costs of financing, one-time expenses, and all compensation paid to a General Manager at Fair Market Value, less employee equivalent compensation to replace additional working owners and any known increases in fixed expenses.

Procedure:
The process to arrive at the EBITDA of the business is called 'normalizing' the financial statements and includes the following steps.

1. Non-cash items are added back to pretax net profit because this cash is available for the owner to spend.

2. Discretionary items are usually benefits to the owner. They could include, for example, a leased luxury car the owner mainly uses for personal purposes, or items a buyer could eliminate without affecting the business otherwise, such as contributions to a charity.

3. Financing costs are added back because the earning power of the business is independent of the method an owner chooses to finance the business. That is, the seller's debt payments are irrelevant to the buyer and the earning power of the business. Of course, a buyer should make a capitalization plan to see what his pretax, post-debt service cash flow will be. If a buyer contemplates taking over some of the seller's debts in acquiring the business, this does not affect the earning power or valuation of the business. Instead, this is just one of the forms of payment the buyer is using to pay for the acquisition of the business, much as in the purchase of real property where the buyer assumes the mortgage and gives the difference to the seller in cash.

4. One-time expenses are usually added back because the earning power of the business does not reduce by these one-time items going forward. A good example of a one-time expense is the expense of moving a business to a new location.

5. One General Manager or FTE: The standard for measuring business earning power assumes a General Manager at Fair Market Value or salary including normal market benefits. If there are other owners or family members working in the business, their compensation must be "normalized" by adding back all their compensation then

subtracting the cost for an unrelated employee to be paid at the market rate for the job they will perform.

6. Nonrecurring items of income

7. Non-operational items

Known increases in fixed expenses: Since the theory behind the EBITDA analysis is to estimate the earning power of the business going forward with the above assumptions, showing non-cash, discretionary and one-time expenses as earnings, it may be fair to reduce the EBITDA by known increases in fixed expenses going forward. A good example is a scheduled cost of living adjustment (COLA) in the premises rent.