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# Deconstructing 'EBITDA'

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SAN FRANCISCO (CBS.MW) - When a company announces its "EBITDA," investors needn't bother pawing through its financial statements looking for a line item marked Earnings Before Interest, Tax, Depreciation and Amortization. They won't find one.

**"If you were to apply multiples that you would normally apply to earnings, you would get a very misleading answer."**

Roy Smith,New York University

Yet companies will announce "E-BE-DA" results in their earnings press releases when it suits their purpose, which makes it confusing and even downright misleading for uninitiated investors.

"It's an analytical term. Accountants don't actually report EBITDA," said Roy Smith, a finance professor at New York University's Stern School of Business. "It's a much greater number than earnings, (so) if you were to apply multiples that you would normally apply to earnings, you would get a very misleading answer."

Without actually deconstructing a cash-flow statement, EBITDA is an imperfect substitute as gauge of a company's cash flow, or what comes in and what goes out.

## Breaking it down

Over the years, analysts and companies complained the bottom line on a cash flow statement -- the company's income -- doesn't always give an accurate picture of a company's ability to create value.

EBITDA was developed to try and solve this problem.

"The accounting-information system will generate net-income numbers from the income statement that (analysts) can use to capture this construct," said Reuven Lehavy, an accounting professor at University of California, Berkeley's Haas School of Business.

"However, some may argue there are components to the income statement that aren't necessarily related to the value of creation, and hinder the ability of the analyst to get to the true economic value."

Interest payments on loans, for example, might be excluded because a company's financing decisions aren't directly related to its profitability per se, Lehavy said.

Likewise, taxes are something that a company can't control and so they shouldn't be subtracted, as a punishment in a sense, from the bottom line.

## The shortened version

That leaves Earnings Before Interest and Taxes, or EBIT, a truncated version of EBITDA also used to approximate cash flow.

Still, some analysts choose to reconstitute the figures even further and give back depreciation of capital goods and amortization of good will to "get closer to some operating-income measure," Lehavy said.

In short, "We're trying to measure the total amount of cash pumping through the machine that has to then be redirected," Smith said.

Understandably, companies often report EBITDA to make their earnings look stronger than they actually are. That's especially true of technology companies whose earnings may be weak and also of companies growing through mergers and acquisitions that may be bursting at the seams with the highly subjective asset called "goodwill.

## One more time

EBITDA has almost become a surrogate for cash flow, which some experts say is an over-reliance. There's plenty of disagreement over how and under what circumstances EBITDA is used.

Lehavy noted that depreciation, for example, is a gauge of how much a company has to reinvest in its equipment to keep producing, an important measure by any standard.

"By excluding it, it means that you only get the revenues generated, but you don't reflect the expenses used to do that," he said.

Another problem is that different companies will report their earnings along the lines of EBITDA, but will select specific items to add back

That's the important lesson for investors.

EBITDA should never be considered the sole measure of a company's ability to generate revenue, but rather, it should be taken into consideration along with an actual cash flow statement to get a more complete picture of a company's health and efficiency. CBS MW

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