# EBITDA: Meaning, Formula, and History

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## What Is an EDITDA?

EBITDA, or earnings before interest, taxes, depreciation, and amortization, is an alternate measure of profitability to net income.

By stripping out the non-cash depreciation and amortization expense as well as taxes and debt costs dependent on the capital structure, **EBITDA attempts to represent cash profit generated by the company's operations**.

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## KEY TAKEAWAYS

- EBITDA is a widely used **measure of core corporate profitability**.
- EBITDA is calculated by adding interest, tax, depreciation, and amortization expenses to net income.
- EBITDA **lets investors assess corporate profitability** net of expenses dependent on financing decisions, tax strategy, and discretionary depreciation schedules.

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## EBITDA Formulas and Calculation

There are two distinct EBITDA formulas, one based on net income and the other on operating income. The respective EBITDA formulas are:

**EBITDA = Net Income + Taxes + Interest Expense + Depreciation & Amortization**

and

**EBITDA = Operating Income + Depreciation & Amortization**

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## Understanding EBITDA

EBITDA can be **used to track and compare the underlying profitability** of companies regardless of their depreciation assumptions or financing choices.

EBITDA is especially widely **used in the analysis of asset-intensive industries**, and correspondingly high non-cash depreciation costs.

In those sectors, the costs that EBITDA excludes may obscure changes in the underlying profitability.

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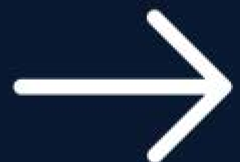

# History of EBITDA

EBITDA was **invented in the 1970s, to help sell lenders and investors on his leveraged growth strategy**, which deployed debt and reinvested profits to minimize taxes

Used in Leverage Buyouts in the 1980s, in estimating whether the targeted company will be profitable after the change in capital.

During the dotcom bubble, some companies used it to exaggerate their financial performance.

## Drawbacks of EBITDA

EBITDA's calculation can vary from one company to the next, as **companies can emphasize EBITDA over net income** as it makes them look better.

**Not reporting EBITDA can be seen a as red flag**. This can happen when companies have borrowed heavily or are experiencing rising capital and development costs.

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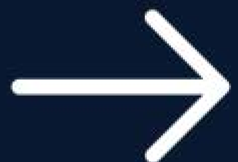


## Ignores Costs of Assets

A common **misconception is that EBITDA represents cash earnings**. However, unlike free cash flow, EBITDA ignores the cost of assets.

One of the most common criticisms of EBITDA is that it assumes profitability is a function of sales and operations alone almost as if the company's assets and debt financing were a gift.

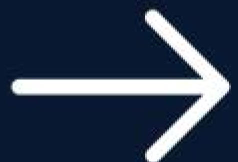
## What Defines Earnings?

While subtracting interest payments, tax charges, depreciation, and amortization from earnings, different companies use different earnings figures as the starting point for EBITDA.

**EBITDA is susceptible to the earnings accounting games** found on the income statement.

Even if we account for the distortions, the earnings figure in EBITDA may still prove unreliable.





## EBITDA vs. Operating Cash Flow

Working capital trends are an **important consideration** in determining how much cash a company is generating.

If investors don't include working capital changes in their analysis and rely solely on EBITDA, **they may miss clues**—for example, such as difficulties with receivables collection—that may impair cash flow.

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## What Is a Good EBITDA?

EBITDA is a measure of a company's profitability, so higher is generally better.

From an investor's point of view, a "**good**" EBITDA is one that **provides additional perspective** on a company's performance without making anyone forget that the metric excludes cash outlays for interest and taxes as well as the eventual cost of replacing its tangible assets.

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## The Bottom Line

EBITDA is a useful tool for comparing companies subject to disparate tax treatments and capital costs.
It also **omits non-cash depreciation costs** that may not accurately represent future capital spending requirements.

**Excluding some costs** while including **can open the door to the metric's abuse** by unscrupulous corporate managers. The best defence to this is to read the fine print reconciling the reported EBITDA to net income.

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