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Financial Statements

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Adjusted EBITDA Is in the Eye of the Beholder

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Long before the Orwellian-sounding phrase "alternative facts"[2] entered our political discourse as a means by which flimsy arguments could try to claim some credibility, there was adjusted EBITDA (earnings before interest, taxes, depreciation and amortization). Despite its detractors and well-documented inadequacies as a shorthand proxy for cash flow generated (or used) by business activities, EBITDA has been a widely used metric by companies, analysts and investors for several decades, and its popular offshoot, adjusted EBITDA, takes the concept a bit further into the wilderness.

Much has been written on this topic in recent years, and these critiques are as relevant today as ever given the growing number of companies that provide an adjusted EBITDA computation in their financial reporting, the wide discretion that companies have in deciding on addbacks to EBITDA, the frequent lack of line-item details in the adjusted EBITDA bridge from net income, the non-GAAP[3] nature of EBITDA and adjusted EBITDA, and management's inclination to present adjusted EBITDA as favorably as possible within some reasonable bounds.

An article published last year[4] documented wide-ranging differences between variations of EBITDA and adjusted EBITDA by reporting companies. It concluded that addbacks to EBITDA attributable to stock-based employee compensation (SBC) were materially (and perhaps deceptively) boosting reported adjusted EBITDA margins, especially among technology companies and smaller public companies. The article also discussed the pros and cons of treating SBC expense as an EBITDA addback, which has become a nearly universal practice by reporting companies and analysts.

In addition, the article noted that EBITDA addbacks aside from SBC had increased since 2020, mostly attributable to write-downs related to COVID-19 and other pandemic-related corporate actions. It concluded that highly leveraged companies were more likely to have larger EBITDA addbacks (unrelated to SBC) irrespective of industry sector or company size, and that these addbacks tended to understate leverage computations by boosting adjusted EBITDA. This article updates that analysis through 2022 and discusses changes in adjusted EBITDA trends across industry sectors now that COVID-related impacts on the corporate sector have subsided.

Adjusted EBITDA: Good Intentions Can Go Too Far

The intention behind a company's disclosure of adjusted EBITDA is to provide users with a convenient metric that *approximates* normalized cash flows resulting from regular business activities (*i.e.*, excluding capital structure impacts and nonrecurring items), even though EBITDA itself is not truly a cash-flow proxy given the accrual basis of accounting used for presenting GAAP-compliant financial statements. As such, noncash expenses and/or charges that reduce net income are treated as EBITDA addbacks, just as cash expenses often are considered one-time items or nonrecurring outlays unrelated to normal business activities. Most EBITDA addbacks are uncontroversial, such as noncash write-downs of assets due

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1 FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and not a certified public accounting firm or a law firm.

2 Mahita Gajanan, "Kellyanne Conway Defends White House's Falsehoods as 'Alternative Facts,'" *Time* (Jan. 22, 2017), *available at* time.com/4642689/kellyanne-conway-sean-spicer-donald-trump-alternative-facts (unless otherwise specified, all links in this article were last visited on April 28, 2023).

3 GAAP stands for "Generally Accepted Accounting Principles."

4 Carlyn Taylor & John Yozzo, "EBITDA Addbacks Have Become Problematic," XLI *ABI Journal* 2, 26-27, 46-48, February 2022, *available at* abi.org/abi-journal.

to value impairment or noncash losses on noncontrolling investments, or a one-time cash receipt or payment to settle a major legal dispute.

However, the appropriateness of other EBITDA addback items is not so clear. Instances of "recurring non-recurring charges" that some companies seem to incur with near regularity have previously been discussed within this publication, such as legal expenses that occur often enough to be considered "normal" and not added back to EBITDA (*e.g.*, a pharmaceutical company incurring litigation costs periodically to protect its drug patents).

Another ambiguous addback category is cash expenses attached to certain nonrecurring items, such as the severance payments portion of a restructuring charge, which some would argue should not be an addback to EBITDA, since it consumes cash and is business-related, while others would treat such an outlay as an addback because it does not result from *normal* business activities. For example, a leading provider of business products and services, struggling to confront the challenges posed by digital finance, incurred restructuring and integration charges totaling $122 million in 2020-21 pertaining to the realignment of its businesses, much of it requiring cash outlays and all of it added back to EBITDA in the company's presentation of adjusted EBITDA, boosting margins by nearly 300 basis points (bps) in each of those years. Arguably, these outlays should not be treated as addbacks to EBITDA because they are closely related to the company's primary business, are mostly cash-based expenses, and have been recurring for several years. There are no bright-lines here; these "grey area" decisions can materially impact the computation of adjusted EBITDA, and perhaps distort its perceived value as a summary measure of operating performance.

Underlying these decisions is an inherent temptation for companies to present adjusted EBITDA as favorably as possible, and this often entails shoehorning certain expenses into the "addback bucket" that arguably do not belong there, claiming them to be of an unusual, nonrecurring or nonoperating nature. This is a judgment call by management.

The determination of addbacks to arrive at adjusted EBITDA and their disclosure details are left largely to management's discretion. Unlike GAAP-compliant financial statements, there are no promulgated reporting requirements for EBITDA-related disclosures in periodic financial statement filings. Companies that report adjusted EBITDA in their Form 10-Q and 10-K filings will always provide ample cautionary language about reliance on non-GAAP financial measures, but often lack sufficiently detailed line-item disclosures of these addback amounts. Invariably, most users of financial statements tend to accept management's estimation of adjusted EBITDA without much scrutiny. The authors cannot recall many corporate earnings calls where equity analysts peppered management with questions about the composition of its adjusted EBITDA build-up.

Despite these potential pitfalls, more Securities and Exchange Commission filers are providing adjusted EBITDA estimates in their reported periodic financial statements than ever before. The authors queried the S&P Capital IQ database and identified 2,215 U.S.-based companies that publicly report periodic financial statements, excluding the banking and utilities sectors and companies with 2022 sales of less than $100 million or more than $50 billion. More than 40 percent of these companies reported adjusted EBITDA in their financial statement disclosures in 2022, a significant increase compared to prior years (see Exhibit 1), most notably in 2021, when COVID-related charges were commonplace and often material.

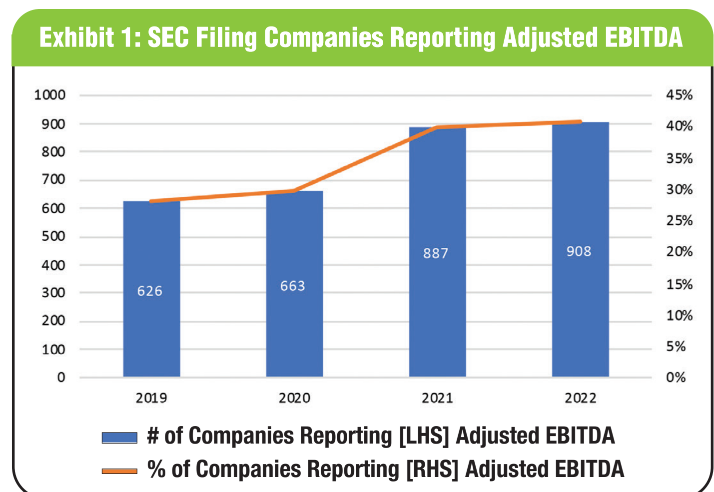
The appeal of presenting adjusted EBITDA for reporting companies is understandable. If EBITDA is a widely used proxy measure for operating performance by the investment community, which it is despite its flaws, then providing adjusted EBITDA allows companies to take control of the narrative to some degree, or at least set the tone of the discussion. It is widely recognized that adjusted EBITDA is a focal point for users of financial statement reporting data, and it behooves management to measure it as favorably as can be justified and to present it to investors in a consistent and transparent manner.

SBC Remains the Dominant EBITDA Addback

Three variations of EBITDA margin (EBITDA/revenue) were evaluated for 550 companies that reported adjusted EBITDA in each of the last four years and had a public-equity market capitalization of more than $100 million. These were (1) EBITDA margin as computed by S&P Capital IQ; (2) EBITDA margin excluding SBC expense; and (3) adjusted EBITDA margin as reported by these companies in their Form 10-K filings (sometimes called "as-reported EBITDA"). The three margins were annually compared for each company from 2019-22, then these margins (and their differences) were averaged by industry sector, giving equal weight to all companies. The results were highly consistent with those reported in the previous article.

By far, SBC expense was the largest addback to adjusted EBITDA over the entire four-year period but especially in the last two years, with SBC addbacks boosting adjusted EBITDA margins by approximately 400 bps annually in 2021 and 2022. Moreover, the SBC impact on adjusted EBITDA varied widely by industry sector, with the information technology (IT), health care (which includes many biotech and life-sciences companies) and communications-services sectors each showing far greater SBC impact than the overall average (see Exhibit 2). The IT sector alone had

Exhibit 1: SEC Filing Companies Reporting Adjusted EBITDA



an adjusted EBITDA margin boost of more than 900 bps in 2021 and 2022 due to SBC addback, more than twice the overall average of the data set. The SBC impact on adjusted EBITDA margin diminished slightly overall in 2022 vs. 2021 — by about 60 bps — but that was not true across all industry sectors, and SBC expense remains the primary addback to adjusted EBITDA.

SBC's overall impact on adjusted EBITDA margin was larger than in the previous analysis in February 2022 by approximately 100 bps due to a lower revenue threshold in this study ($100 million vs. $250 million). SBC expense, predominantly in the form of restricted stock awards these days, has become a hugely popular compensation component to attract and retain high-talent employees, particularly among smaller and mid-sized tech-driven companies that must compete with large tech behemoths for specialized talent, such as coders and engineers. Among smaller companies in the analysis with annual revenue between $100 million to $250 million, SBC expense added 1,000 bps to adjusted EBITDA margin in 2022. Conversely, mature industries and "low tech" companies, such as energy and materials, consistently show much lower adjusted EBITDA margin boosts from SBC expense (see Exhibit 2).

The treatment of SBC expense for the purposes of calculating adjusted EBITDA remains a lively discussion topic. For those who use adjusted EBITDA strictly as a proxy estimate of cash flow from business activities, SBC indeed is a noncash expense that merits its treatment as an addback. However, that does not mean that SBC is costless, which would be the inference if users utilized adjusted EBITDA for valuation purposes.

Applying a multiple to adjusted EBITDA to estimate an enterprise value is the equivalent of saying that SBC comes at no cost to the enterprise, and inappropriately inflates its valuation under such an approach. In practicality, SBC awards are a critical component of compensation expense for high-talent human capital, without which the enterprise could not function as effectively; consequently, it should be treated the same way as cash-based labor costs for purposes of estimating enterprise value. A hypothetical buyer of a business would certainly factor in recurring SBC expense as a business cost when valuing the enterprise.

Beyond SBC expense, other addbacks by reporting companies accounted for an additional 200 bps of adjusted EBITDA margin per this analysis, less than half the margin impact of SBC expense in 2021 and 2022. These additional addbacks have decreased in each of the last two years as COVID-19 impacts have waned. It should be noted that S&P Capital IQ takes the liberty of adding back certain other expenses to "plain vanilla" EBITDA it deems warranted from its reading of financial statement filings, so the difference in margins between company-reported adjusted EBITDA and EBITDA excluding SBC represent addbacks above and beyond those already made by S&P Capital IQ. In short, company-reported adjusted EBITDA margins are most often the more aggressive estimates, with company-reported adjusted EBITDA margins consistently exceeding S&P Capital IQ's EBITDA margins, excluding SBC more than 70 percent of the time in each of the last four years. That finding should not be surprising.

Ultimately, It Is Up to Users to Define "Adjusted EBITDA"

When it comes to working with adjusted EBITDA, we are reminded of an adage that says that even a data series that is *consistently* measured incorrectly has value to a user, meaning that the broad sweep or trend of that data series would still be directionally accurate and informative to a user — even if the underlying data points are consistently mismeasured. That is not a bad analogy, provided that company-reported adjusted EBITDA is mea-

Exhibit 2: SBC Impact by Sector

	EBITDA Margin (per Capital IQ)				EBITDA Margin excluding SBC				Adjusted EBITDA Margin (Company Reported)			
	2019	2020	2021	2022	2019	2020	2021	2022	2019	2020	2021	2022
Industry Sector:												
Communication Services	4.7%	-3.1%	10.8%	8.6%	11.6%	2.8%	16.8%	15.5%	14.3%	9.2%	20.1%	18.5%
Consumer	7.4%	-0.3%	6.0%	7.1%	8.9%	2.3%	9.6%	10.1%	9.8%	4.4%	10.5%	11.0%
Energy	30.1%	28.2%	24.6%	32.1%	31.2%	29.4%	25.7%	33.0%	33.6%	34.4%	31.3%	35.9%
Health Care	-1.7%	2.2%	0.2%	-1.1%	2.7%	9.2%	9.0%	5.9%	3.5%	11.2%	10.8%	8.4%
Industrials	12.6%	13.3%	13.8%	13.1%	14.2%	14.6%	15.5%	15.0%	15.9%	15.8%	16.8%	16.1%
Information Technology	1.2%	5.3%	3.4%	2.3%	6.7%	11.8%	13.0%	11.6%	10.3%	14.6%	15.9%	14.4%
Materials	17.6%	18.7%	19.0%	21.3%	18.3%	19.6%	23.6%	22.3%	19.3%	20.3%	23.9%	22.2%
Real Estate	35.0%	25.2%	34.2%	37.3%	37.2%	27.8%	37.1%	39.5%	40.7%	32.2%	41.0%	42.2%
Total	**11.1%**	**8.5%**	**11.6%**	**12.3%**	**13.9%**	**11.8%**	**16.0%**	**16.1%**	**15.7%**	**14.4%**	**18.0%**	**17.8%**

	Adjusted EBITDA Margin Attributable to SBC				Adjusted EBITDA Margin Attributable to Other Addbacks			
	2019	2020	2021	2022	2019	2020	2021	2022
Industry Sector:								
Communication Services	6.9%	5.9%	6.1%	6.9%	2.7%	6.4%	3.3%	3.0%
Consumer	1.5%	2.6%	3.6%	3.0%	0.9%	2.1%	0.9%	0.9%
Energy	1.1%	1.3%	1.1%	0.9%	2.4%	5.0%	5.5%	2.9%
Health Care	4.5%	6.9%	8.8%	7.0%	0.8%	2.0%	1.8%	2.5%
Industrials	1.5%	1.3%	1.7%	2.0%	1.7%	1.2%	1.2%	1.1%
Information Technology	5.6%	6.5%	9.6%	9.3%	3.6%	2.8%	2.9%	2.8%
Materials	0.7%	0.9%	4.6%	1.0%	1.0%	0.7%	0.3%	-0.1%
Real Estate	2.2%	2.6%	2.9%	2.1%	3.5%	4.3%	3.9%	2.8%
Total	**2.7%**	**3.2%**	**4.4%**	**3.8%**	**1.8%**	**2.7%**	**2.0%**	**1.7%**

sured in a consistent manner, even if some of those addbacks are questionable.

As imperfect as EBITDA and adjusted EBITDA are as summary measures of operating performance, these are embedded metrics within the finance and investment communities, so users should be ever mindful of their inherent shortcomings and susceptibility to being highly managed, and where possible impose their own judgment on its calculation. Credit and equity analysts should be more vigilant about questioning dubious addbacks where clarity is lacking.

The good news is that more companies are providing better detail in their adjusted EBITDA bridge from net income, giving users some ability to make their own "adjustment to the adjustments" where they deem necessary. There will never be universal agreement on what the exact components of adjusted EBITDA should be given the myriad possibilities, so users of financial statement data should be provided with sufficient line-item details to make their own estimations. abi

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