

# Why Earnings Before Income Taxes, Depreciation And Amortization (EBITDA) Is Not Always The Best Methodology For Professional Practice Business Appraisal

BY TIMOTHY A. BROWN

**T**he business appraisal community embraces certain pillars of evaluation as sacred and empirical. Perhaps it's time to challenge one of the entrenched beliefs? EBITDA is unquestionably a significant KPI but has its presence become less sacred and somewhat of a sacred cow...



Chartered Business Valuators (CBV) and business appraisal specialists like myself, invest considerable time and energy into determining and explaining EBITDA to those who are not familiar with the concept.

## Wikipedia:

*"A company's earnings before interest, taxes, depreciation, and amortization is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation, and amortization are subtracted, as a proxy for a company's current operating profitability (i.e., how much profit it makes with its present assets and its operations on the products it produces*

*and sells, as well as providing a proxy for cash flow). Though often shown on an income statement, it is not considered part of the Generally Accepted Accounting Principles (GAAP) by the SEC. [5]."*

## Investopedia:

*"EBITDA is one indicator of a company's financial performance and is used as a proxy for the earning potential of a business, although doing so can have drawbacks."*

In lay person's terms, we appraisers calculate EBITDA to arrive at an adjusted income figure to use for business valuation

purposes. There are numerous adjustments that can be made before EBITDA is found. Some are very discretionary and others are accepted, industry norm. The appraiser will look to industry data and search for standard operating ratios for fixed expenses and variable and semi-variable overheads and then adjust each to arrive at EBITDA.

## Does not need changes

In a small, closely held, personal service business or practice we add back non-recurring or discretionary expenses, such as extensive continuing education, personal medical expenses, family cell phone expenses, spousal or family wages

for those who do not work in the business full time, but may be paid above market rate, personal expenses related to hobby businesses that are not directly related to the income of the personal service practice itself.

It is a standard process that all business appraisers go through. However, there is a flaw in the methodology of using this for personal service businesses. The main reason being each professional will value his/her service at a different price.

For example, many people will deduct 40% of the production of a dentist as the doctor's salary and then they calculate the EBITDA. My argument is this: A new graduate doctor is probably willing to work for less than someone with 25 years of experience. Each of these buyers would then value themselves differently, which would result in a differing EBITDA, which results in a differing valuation for the business. The flaw in using this methodology is the assumption that every professional is worth the exact same rate. Once again, I refer to a new graduate versus somebody with 25 years of experience. Even if we judge things based on quality output alone, I am certain that a doctor with more experience feels he/she is worthy of making a higher per hour earning based on their experience. The example below shows how the valuation of a business can be substantially different based upon the earning expectation of the purchaser. It is a blunt approach for a business appraiser to use this methodology for small closely held personal businesses because it does not take into effect the unique perspective of each of the purchasers. It is prudent to value the cash flow of the business, which is the free cash available to service the professionals working in the practice before income taxes, depreciation and amortization. This allows each individual buyer to formulate his/her own tax plan, and his/her own estimation of what he/she is worth. This is normally done with the aid of the purchaser's accountant. Business appraisers and valuers should not be valuing all dental professionals at the same rate because it yields a flawed

valuation result.

Another shortcoming in the EBITDA formula is that earnings are not adjusted for fluctuations in labor supply and changes in the cost of engaging a professional to perform the service. A perfect example is that 15 to 20 years ago in certain parts of Canada, good dental associates were in short supply and owners were offering 45% of collections after laboratory costs had been deducted plus bonuses such as continuing education,

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uniforms, licensing and insurance allowances. Some would pay a signing bonuses or annual retention bonuses.


Today, in the Greater Toronto Area, for example, a dentist can be found for a substantially lower cost. Some principals are offering 25 to 30% as a starting commission with a scaled bonus system resulting in associates being paid a higher percentage as production and collections increase. The net average cost of these associates could be as low as 30 or 32.5%. This is the new effective rate of the cost of hiring a dentist and this is where the patent flaw of the EBITDA formula is revealed.

In the formulations I have seen where appraisers use EBITDA as a method for valuing a dental practice, I have never seen one above or below 40% as the "doctors salary". As well, I question whether these appraisers are deducting laboratory costs (which is required by the Dental Act). Are they adjusting for bad debts/collections, and for bonuses, which are paid in other expense categories such as continuing education? Any form of compensation paid to doctors has to be added back in their methodology for EBITDA to be true and accurate. Also, some of the practice expenses such as licensing, insurance and continuing education may be paid by the associate. These would normally be borne by the practice. Is that being considered? I have yet to see one document that includes these items.

In our methodology, which I consider to be empirical, none of these variables can have an impact on evaluation because we are using cash flow—not EBITDA. Sometimes referred to as "free cash" (to my mind) this is the purest figure to use for appraisal. Because we use free cash we also apply substantially a lower earnings multiple than those who use the EBITDA formula, but the net result is sound and distinctly more static, in that changes in labour supply and labour

costs, fluctuating variable and semi variable overheads and the short and long term effects of inflation and interest rates have little or substantially no bearing whatsoever on our methodology.

We have been using this methodology, with a few minor adjustments, for over 44 years. The banks understand and appreciate it. Accountants understand it. It does not try to attempt to appraise the value of any doctor and his/her skill set. Doctors do not want to be appraised. Business appraisers do not appraise people. We appraise businesses and businesses are measured on cash flow, not on "labour" value calculations that are subject to large and wide-ranging opinion.

**BOTTOM LINE:** In this column the author presents an alternative to EBITDA for doing a financial appraisal. 



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