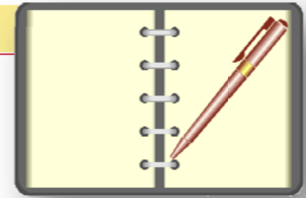

EBITDA

Just when you are starting to "get" these numbers, you'll encounter someone who speaks this financial language with ease and flair. He or she will throw in the term EBITDA (pronounced Ee-bit-duh).

This is an acronym that stands for **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation, and **A**mortization.

These four items (I, T, D, A) are additional expenses that are generally nonexistent for very small or new companies, but can grow as a company expands. EBITDA is a "pro-forma" (i.e., to serve as a model) measure of income that is generally used by bankers and investors to measure the core operating earnings and cash flow potential of a business.

In this lemonade stand example, EBITDA is not of much use, because the business presently has no meaningful *amortization* (repayment of a loan by installments), *depreciation* (allocation of the cost of an asset usable for a long term over the useful life of the asset), or *interest* (money paid to an institution, such as a bank, for loans to the company from that institution). However, more complex businesses will eventually need to know their EBITDA.

If you were to compare two essentially identical businesses, you would want to place them on an equal footing. Interest, taxes, depreciation and amortization are important in seeing the bottom line, but not in determining the profitability.

So by comparing the two businesses' EBITDA, you can get a truer comparison of their fundamental value.

For example, if Sally finances the business herself, but Susie borrows operating capital, Susie will pay interest and Sally will not.

When an outsider wishes to compare the basic businesses to each other, he will want to compare "apples to apples". To do this, he can look at the businesses' basic performance before these financing, taxes, and other costs, which have nothing to do with the core business results, are taken into account. This is what is meant by EBITDA.