

# If You Don't Know the Numbers, You Don't Know the Business

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## Understanding EBITDA and Why It Matters

A business can have the best sales team, the best product, or the best service in the world. But if someone in the business doesn't understand the finance function, the business is likely to fail.

A fundamental concept used to measure the financial health of a company is EBITDA- earnings before interest, taxes, depreciation, and amortization.

EBITDA, as the acronym suggests, measures a company's financial performance by excluding the effects of financing decisions (interest), tax obligations, and non-cash expenses like depreciation and amortization. This approach provides a clearer view of a company's operational profitability. It's not the only approach for such measuring (EBIT and EBITDAR are examples of competing approaches) but it is very widely used.

## Why Do People Use EBITDA?

[Terry Orr](#), a forensic accountant with HKA, points out that private equity firms favor EBITDA because it helps them quickly assess whether a company will be able to service its debt after an acquisition. Businesses, investors, and analysts utilize EBITDA for several reasons:

- **Comparability:** It allows for an apples-to-apples comparison between companies in the same industry, regardless of how they finance their operations.
- **Assessing Profitability:** EBITDA can indicate a company's operational performance by removing financing and tax decisions.
- **Mergers and Acquisitions (M&A):** Buyers often consider EBITDA to determine the price they should pay for a company.

## The Pitfalls of EBITDA

While EBITDA can be a useful tool, it has its drawbacks:

1. **It's Not GAAP-Defined:** EBITDA is not part of [Generally Accepted Accounting Principles](#)

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([GAAP](#)), meaning companies can adjust how they calculate it. GAAP is the standard endorsed [by the US Securities and Exchange Commission \(SEC\)](#) and serves as the default accounting standard for US-based companies.

2. **It Ignores Key Expenses:** Since it excludes debt payments and capital expenditures, EBITDA may present an overly optimistic picture of a company's financial health.
3. **It Can Be Manipulated:** Some companies adjust EBITDA with 'add-backs' to make their numbers look better. Attorney [Candice Kline](#) emphasizes that when examining 'adjusted EBITDA,' it's important to scrutinize the adjustments, as companies may be adding back one-time expenses in a way that stretches the definition of 'one-time.'

## Real-World Application: The Lemonade Stand Example

To illustrate how EBITDA works, consider two lemonade stands:

- **Lemonade Stand A** is funded entirely by equity.
- **Lemonade Stand B** is financed mostly by debt.

Both have the same revenue and cost of goods sold, but because Stand B has interest expenses on its debt, its net income is lower. However, their EBITDA is the same because EBITDA does not account for interest payments.

Professor [Steven Stralser](#) notes that EBITDA reveals how well the business itself is running, but not necessarily how well the owners or investors are doing.

## When to Use — and When to Question — EBITDA

- **Use EBITDA** when comparing companies within an industry, analyzing profitability trends, or evaluating a potential acquisition.
- **Question EBITDA** when a company uses it as the sole measure of success, when there are numerous 'adjustments,' or when debt and capital expenses are significant aspects of the business model.

## Final Thoughts

Understanding EBITDA can make attorneys, accountants, and business professionals more effective advisors to their clients. It's a useful tool — but like any tool, it needs to be used wisely. EBITDA is just one piece of the puzzle that should always be considered alongside other financial metrics to get the full picture.

To learn more about this topic view [MBA Bootcamp / EBITDA and Other Scary Words](#). The quoted remarks referenced in this article were made either during this webinar or shortly thereafter during post-webinar interviews with the panelists. Readers may also be interested to read other articles about [accounting and finance principles for business owners and investors](#).

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