THE ROLE OF THE ECONOMIC INDICATOR - EBITDA IN MEASURING THE FINANCIAL PERFORMANCE OF THE COMPANY

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Abstract:
Through this article, the author aims to present the role of the EBITDA indicator in measuring the financial performance of a company by analyzing its operational profitability. Both the advantages of using this indicator and the shortcomings of using its interpretations were pointed out. Since the method of determining the indicator does not take into account expenses related to debt financing, hence the acronym EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). EBITDA informs about the amount of profit earned by the company before paying interest, taxes, amortization and depreciation. The profitability of operating activity, quantified by gross operating surplus (EBE or EBITDA) is the most relevant measure of a company's performance, as it reflects its return on its core business, namely production of goods and/or provision of services and marketing activity. Although the financial result can have a considerable impact on the profitability of the firm, the basis of the company's earnings must be its operating activity, since it groups together the operations that the economic entity currently carries out in order to obtain profit.

Keywords*: financial performance, economic indicator, amortization, depreciation, taxes and duties, EBITDA*
JEL Classification Codes: G20, G32, M10, M21

1. Introduction

Monitoring financial performance at company level is vital as, adjusting strategies according to results is equally important. The explanation is simple, you can't improve what you don't measure. All bonuses are closely linked to performance indicators directly anchored in results.

In financial theory and practice, there are a lot of indicators to measure the performance of an economic entity. The vast majority of the tools used are relevant only under certain specific and limiting conditions and only a small part of them are really useful to the financial analyst in his approach to diagnosing the company's performance. Given the level of computing technology today, many analysts are tempted to calculate a larger number of indicators than is really necessary. This can induce ambiguity and difficulties of interpretation, thus unnecessarily complicating the diagnosis of enterprise performance.

An efficient financial management relies on financial analysis to use performance indicators specific to the field of activity it leads. Of these, net profit, gross profit, operating profit or gross operating surplus or profit related to financial activity could provide great support in knowing the entity's profitability. These indicators provide a true picture of the company, according to which operational decisions can be made that improve financial performance. The question is: "which of these indicators best reflects financial performance"? One of them is EBITDA, the acronym for Earnings Before Interest, Taxes, Depreciation and Amortization.

In 1970, US media billionaire John Malone invented the EBITDA indicator, using it to analyze the cash-generating capabilities of telecommunications companies. He argued that EBITDA was a better way to look at companies with high capital growth compared to the then popular EPS (Earnings per Share/net profit per share). The main source of growth for cable TV companies has been the acquisition of systems and investment in infrastructure expansion. Unfortunately, EPS did not reflect this growth. Later, in 1980, the metric was popularized through leveraged acquisitions targeting distressed companies. Companies used EBITDA to assess whether the target entity could service the debt used to fund transactions.

The purpose of this article is to emphasize the importance of the EBITDA indicator in conducting the diagnostic analysis of a company's financial performance. It was emphasized that EDITDA is that indicator that shows companies what profit they have, after paying the expenses with raw materials, materials, utilities, salaries with all contributions and related taxes, rents and other expenses specific to the activity carried out.

2. Research methodology

In carrying out this work, a classical methodological research strategy was followed, by using both the theoretical approach and the empirical approach to the research problem. Through this research activity, it was aimed to find a correct and complete answer to the question: "How important is the EBITDA indicator in performing the diagnostic analysis of a company's financial performance?"

The theoretical approach was based on the bibliographic study of the entire diagnostic analysis of financial performance. The main sources of theoretical data were represented by the authors' scientific papers and researches, such as: Vintilă (2005), King (2001), Vasile (2010), Petrescu (2008), Stancu (2007), Friedlob and Schleifer (2003).

The empirical approach is based on quantitative and qualitative analysis of studies and topical publications of professional bodies (publications of C.E.C.C.A.R., of A.N.E.V.A.R. etc.) on the analysis of financial performance indicators and their effect on financial decision-making.

The motivation for choosing the subject derives from the desire to document this topic because it is quite important at the level of economic entities because it was wanted to clarify the role of EBITDA by correctly knowing the financial performance at a certain moment, without being misled by the size of other performance indicators, such as profit from financial activity or gross profit.

In order to achieve the purpose of this article stated above, other research methods were used, such as the descriptive method by framing the financial performance indicator -EBITDA among the multitude of result indicators, the synthesis method for establishing causal links between indicators characterizing financial performance, the analytical method to obtain a complete analysis of the theoretical approach to financial performance diagnosis.

3. **What is the economic indicator – EBITDA- and who does it serve?**

EBITDA or earnings before interest, taxes, depreciation and amortization is an interim management balance that shows the gross profit realised by the entity from operating activities. The indicator does not take into account amortization, provisions, financial income and expenses, nor duties and taxes, which allows us to consider that EBITDA reflects the company's ability to finance itself but also its potential to remunerate those who entrusted it with capital, such as banks, shareholders, etc. In other words, EBITDA shows how much money the company has made before paying interest and taxes and after deducting depreciation and amortization, because these two expenses are not tangible from a cash point of view.

In the literature, EBITDA is also known as gross operating surplus when there is a positive result. The calculation of gross operating surplus is based on the value added created by the entity plus other operating income (e.g. income from donations and grants received, income from the sale of assets and other capital transactions, income from investment grants, etc.).) and from which are deducted staff costs (e.g. salaries and allowances and insurance and social security costs) and other operating expenses (e.g. maintenance and repair costs, royalties, management fees and rents, insurance premiums, bank charges, protocol, advertising and publicity costs and so on):

Added value (AV)

(+) Other operating income (OOI)

(–) Staff costs (SC)
(–) Other operating expenses (OOE)
= Gross operating surplus (GOS)/ EBITDA
Gross operating shortfall

Fig.1 - Cascading of gross operating surplus from value added

The table below shows how the EBITDA indicator for ALFA S.A. was calculated in the last two years of its activity:

AN	*N-1*	*N*
Added value (AV)	*215.410.507*	*166.000.479*
Other operating income (OOI)	*1.206.236*	*2.019.774*
Staff costs (SC)	*70.942.138*	*60.137.687*
Other operating expenses (OOE)	*88.171.921*	*106.392.337*
Gross operating surplus (GOS or EBITDA)	*57.502.684*	*1.490.229*
Net turnover (NT)	*684.060.774*	*709.301.253*
Share of EBITDA in turnover (EBITDA/CA)	*8.41%*	*0.21%*

Table 1 - Evolution of EBITDA at ALFA S.A. in the period N-1- N
Source: profit and loss accounts of ALFA S.A. for the period N-1 - N, own calculations.
Amounts are expressed in RON.

Interpretation of results:
Modest and fluctuating margins of accrual from operating activity achieved by ALFA S.A. during the period under review are observed. The decreasing evolution of the added value in conjunction with the increase of the other operating expenses caused the reduction of the EBITDA from 57.50 million RON in N-1 to 1.49 million RON in N, which meant the decrease of the EBITDA share in the turnover (from 8.41% to 0.21%). Last year's situation was the most unfavourable: as a result of extremely high operating costs, the company's operating activity had an extremely low profitability, with EBITDA amounting to RON 1.49 million (i.e. 0.21% of net turnover).
The evolution of EBITDA in the case of ALFA S.A. is an alarm signal regarding possible structural deficiencies in the company's operating activity.

In the case of a negative EBITDA result, there is a gross operating deficit.
The possibilities for improving EBITDA can be:
- increasing the company's revenue by increasing sales volume with a marketing strategy, adjusting prices or introducing new products or services to the portfolio.
- reducing costs by improving operational efficiency, identifying and eliminating unnecessary expenses, negotiating with suppliers to obtain better prices for raw materials and supplies.
- improving cash flow management by implementing a system to ensure timely collection of invoices issued. This can help increase liquidity.

Another way of calculating the EBITDA indicator is based on net profit plus taxes, depreciation and interest.

EBITDA = net profit + taxes+ amortization +interest

Using the following data of BETA SA, the EBITDA is determined as follows :
revenues 500.000 lei/year,
cost of goods 100,000 lei
operating costs 300.000 lei
amortization 25.000 lei/ year
taxes15.000 lei,
net profit 85.000 lei/ year
interest 0 lei

EBITDA =85.000 + 15.000+25.000+0 = 125.000 lei

EBITDA is a more relevant measure of a company's profitability than its net profit. Those who support this idea argue that EBITDA is the basis for the company's self-financing (through net profit for making new investments, depreciation for renewing worn-out fixed assets and provisions to cover possible risks and expenses) and the distribution of income to the state (through taxes, duties and contributions), creditors (through interest and earnings, but also through repayment of debts incurred) and shareholders (dividends).

On the other hand, EBITDA is notable for the fact that it is not influenced by the company's financial policy, i.e. by the company's decisions regarding money or financial market placements and those related to the financing of the activity such as bank loans, bond loans, etc.. Vintilă (2005) states that EBITDA is not influenced either by elements of a fiscal nature, by the company's dividend policy or by its unforeseen activity, faithfully reflecting the company's performance at the level of production and commercial activity and representing a fundamental financial resource for the company.

Despite these apparent advantages, King (2001) considers EBITDA to be one of the most flawed concepts ever adopted by the financial community. He argues that net profit is a more appropriate measure of company performance because financial expenses (interest) and tax expenses (taxes) are priority and unavoidable cash outflows, or ignoring them when discussing a company's profitability would be unrealistic.

According to Friedlob and Schleifer (2003), the use of EBITDA by some companies in their financial reporting is justified by their desire to mask their financial situation.

EBITDA is a very important economic indicator in diagnosing financial performance but on the other hand it can also be a misleading one when the company's management analyses the factors influencing financial performance. EBITDA is the expression of the gross cash accrual that the company achieves from its operating activity, determined as the difference between operating revenues receivable and operating expenses payable. The company's operating activity gives rise to a series of other calculated income and expenses which, even if they do not have a monetary backing and do not affect cash flow, nevertheless have an impact on the final result for the financial year. Therefore, in certain circumstances it is recommended to introduce a new indicator to analyse the performance of the operating activity, namely the operating result -EBIT.

This indicator, unlike EBITDA, is an interim management balance reflecting the overall net accumulation from operating activities without taking into account financing policy and income tax. In other words, while EBITDA is obtained as the difference between operating income receivable and operating expenses payable, EBIT is calculated by taking into account all income and expenses related to the entity's operating activity, both actual and calculated.

An example of calculated income would be income from the reduction of operating provisions and an example of a calculated expense would be expenditure on value adjustments on operating assets.

In the US, EBITDA is not a US GAAP accepted indicator and the US Securities and Exchange Commission regulator requires companies to reconcile EBITDA to net income in their periodic reporting to avoid misleading investors.

EBITDA is not disclosed in International Financial Reporting Standards (IFRS) nor are there clearly defined standards or literature that specify how adjustments to EBITDA are calculated. Changes in this indicator show improvement or deterioration in profitability over a period of time.

Despite the fact that there are no International Standards for calculation or adjustments, EBITDA is used quite often to estimate the market value of a company before it is acquired by another company.

One of the most widely used financial methods is based on the model:

Debt/EBITDA ratio

This ratio is used to assess a company's risk of default.
If the debt/EBITDA ratio is high, the company's ratings go down because it indicates a high degree of indebtedness and the company may have difficulty in honouring its debts.
A low debt/EBITDA ratio indicates the opposite. A company can pay its debts and is more likely to receive a higher rating.

The EBITDA indicator is used when an estimate of the value of the target company is desired as the starting point in negotiating the transaction price. The value of the target company can be estimated by multiplying EBITDA by a market multiple, which may differ depending on the industry, the specifics of the company or the geographic market in which it operates. Therefore, any adjustment to EBITDA may have a multiplier effect on the transaction price.

EBITDA is also used for the purpose of evaluating the company's performance using the ratio method. One of the financial ratios is the EBITDA margin which reflects the profitability of an entity's operating activity. EBITDA margin is calculated based on information contained in the related financial reports. The resulting value will be compared to the market average. Often, the value of an entity is estimated by multiplying normalised EBITDA by a multiplier obtained from the subject company's specific market.

EBITDA margin = EBITDA / Turnover

The EBITDA margin can indicate how much of the company's total revenue remains available to cover expenses and make investments. So the EBITDA margin can be interpreted as follows:

If the EBITDA margin is high, a higher level of profit is generated in relation to total revenue. This can be a positive sign for investors as it suggests that the entity has a high capacity to cover expenses and generate profit. In general, this capacity is acquired through efficient cash flow generation.

A low EBITDA margin can indicate a number of problems, such as high operating expenses compared to revenues. At the same time, a lower EBITDA margin can be a red flag for investors. It indicates the need for cost-cutting measures. EBITDA may also show a need to improve operational efficiency.

Therefore, if EBITDA is used to compare two companies, it is recommended that they operate in the same industry because some industries, such as those with a higher cost structure or longer production cycles, may have lower EBITDA margins than others.

4. Conclusions

After completing this article we can draw the following conclusions:

- **EBITDA is that economic indicator that** allows analysts to focus on results from operations, excluding the effects of non-operational decisions such as financing, taxation or non-cash costs (depreciation);
- Comparative analysis of operating profitability is important when comparing entities operating in areas with different tax regimes.
- EBITDA can be used to assess a company's ability to pay as it does not take into account interest expenses.
- EBITDA is the measure indicator of a company's value in the valuation and trading process, helping to determine its market price. There is no standard level for high or low EBITDA as the value of EBITDA can differ by industry.

It is therefore important to only make comparisons with EBITDA margins in the same industry. In this way, a clearer picture of the company's performance can be obtained.

- The biggest shortcoming of EBITDA is that it ignores the variations in working capital that are usually important in a growing company. For example, it does not take into account investments in equipment or technology, which can give a distorted picture of performance. It also ignores debts to the government and so may not reflect the true situation regarding the company's ability to pay.

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