The Oil&Gas Advisor™

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WHAT ADD BACKS ARE LEGITIMATE IN AN M&A DEAL?

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An *add back,* for the uninitiated in M&A numbers, is an expense that is added back to the profits (most often earnings before interest, taxes, depreciation, and amortization, or EBITDA) of the business for the express purpose of improving the profit situation of the company.
It's a bit of alchemy; when you toss in enough add backs to the profits of a company, you turn EBITDA into the mythical "adjusted EBITDA."

The theory behind these add backs is that these expenses are purported to be extraneous, one-time, and/or "owner's" expenses. In plain English, these add back expenses will either go away once the company is in the hands of the new owner or won't be incurred again.
Some legitimate add backs include the following:

- **Adjustments to owner's compensation:** Many owners of closely held companies, especially successful and highly profitable ones, give themselves outsized salaries and bonuses. Nothing is wrong with that, of course, but an acquirer is unlikely to pay that kind of compensation to the new president (and other execs).

- **Taxes and benefits:** If making add backs for adjustments to owner's compensation, make sure to add back the corresponding taxes, too. If an owner and/or other employees are leaving the company post-acquisition, the benefits these people were paid may be appropriate add backs, too.

- **Severance and lawsuit settlements:** Severance payments and lawsuit settlements may be cause for further due diligence on behalf of Buyer, but these payments can be another example of a legitimate add back, assuming these sorts of payments are truly rare and unusual for the company.

- **Personal expenses:** Running personal expenses through the company is a common occurrence in closely held companies. These companies often practice the so-called Family Accepted Accounting Principles, or FAAP (to use some slang), in addition to (or in replacement of) Generally Accepted Accounting Principles (GAAP)
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If an acquired company does utilize FAAP, these personal expenses are a legitimate add back because the new owner won't continue to incur these expenses. ***Note:*** FAAP is firmly a gray area for taxation, so speak with your accountant as to the proper treatment of these expenses.
Personal expenses may include the following:

- The clubs (hunting, country, health, and so on)

- Owner's car expenses (monthly payment, insurance, gas, and so on)

- Family members on the payroll
- Travel, meals, entertainment for personal use, not business purposes
- Any other expense that is personal in nature and not a business-related expense

So, what add backs aren't legit? This group is a little more difficult to quantify because types of expenses are virtually limitless. Instead, apply a simple two-part rule of thumb:

- If one-time-only expenses show up on a company's income statement year after year, they aren't one time; they're recurring and therefore not a legitimate add back expense.
- If the company will incur add back expenses post-acquisition, they aren't legitimate add backs.

Buyers, pay close attention to Seller's add backs. Don't be afraid to challenge Seller as to the legitimacy of the add back. And Sellers shouldn't try to add back expenses that will not go away post-closing. Add backs that aren't legitimate are expenses that the company will continue to incur, even after a sale transaction.

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