

M&A; EXECUTION PROGRAM

PART 04 OF 12 · PART 1: DEAL FOUNDATIONS & STRATEGY

PART 4

QUALITY OF EARNINGS: EXPENSES & ADD-BACKS

How to normalize owner compensation, identify and challenge add-backs, stress-test EBITDA, and build the final adjusted pro-forma income statement that drives the purchase price.

IN THIS PART

- Owner compensation normalization
- Non-recurring vs. recurring expense distinction
- Related-party rent and personal expenses
- Run-rate adjustments for new costs
- The EBITDA bridge from reported to adjusted
- Add-back quality and buyer challenges

THREE CASE STUDIES

Each session includes one fully worked case study with detailed calculations, negotiating dynamics, and CFO-level decision frameworks.

■ ■ SESSION 4: EXPENSE NORMALIZATION & EBITDA ADD-BACKS

The Art of the Add-Back

If revenue quality analysis is about finding what should not be in the numerator, expense add-back analysis is about finding what should not be in the denominator. The seller's goal is to add back every non-recurring, non-operating, and owner-specific expense possible — because each dollar added back to EBITDA multiplies by the deal multiple to create additional purchase price. At a 10x multiple, a \$500,000 add-back creates \$5,000,000 of additional enterprise value. The buyer's goal is to challenge every add-back that is not clearly non-recurring.

The Add-Back Framework: Four Categories

Category	Examples	Add-Back Legitimacy	Buyer Challenge Points
Owner Compensation Normalization	CEO paid \$800K; market rate \$350K; \$450K excess added back	High legitimacy if documented with comp benchmarks	Will buyer hire a replacement at market rate? Transition period costs?
Non-Recurring / One-Time Items	Legal settlements, storm damage, COVID relief, one-time ERP implementation	Medium — must prove it truly will not recur	Is the lawsuit pattern? IT capex ongoing? COVID 'one-time' items recurring?
Non-Cash Charges	Stock-based compensation, depreciation on fully-expensed assets	High — EBITDA already adds back D&A; SBC is legitimate	SBC will be replaced by buyer's equity grants — not a free add-back
Run-Rate Adjustments	New hires mid-year, new facility lease signed Q4	Medium — forward-looking cost increases must be modeled	Is new hire actually generating revenue? New facility needed?
Related-Party Normalization	Rent paid to owner-controlled entity above market; family member salaries	High if market rate documented	Buyer will inherit market-rate rent; ensure lease is assignable
Synergy Add-Backs	Eliminating public company costs, eliminating duplicate HQ functions	LOW — synergies are buyer value, not seller credit	Reject all seller-claimed synergy add-backs categorically

Building the EBITDA Bridge

The EBITDA bridge is the central analytical deliverable of the QofE process. It starts with reported net income and walks through every adjustment — revenue, cost of goods sold, operating expenses, and below-the-line items — to arrive at the adjusted EBITDA that the buyer will use as the valuation base.

◆ FULL EBITDA BRIDGE

EBITDA BRIDGE — SELLER'S CLAIM vs. BUYER'S ADJUSTED

Reported Net Income: \$1,840,000

Standard EBITDA Add-backs:

+ Interest Expense: \$420,000

+ Income Tax Expense: \$610,000

+ Depreciation & Amortization: \$980,000

= Reported EBITDA: \$3,850,000

SELLER'S CLAIMED ADD-BACKS:

+ Owner comp above market (\$750K paid vs \$300K mkt): \$450,000

+ One-time legal settlement (2023): \$380,000

+ Personal auto/travel (substantiated): \$120,000

+ COVID PPP loan forgiveness income (reversed): (\$210,000)

+ Non-recurring IT migration: \$290,000

+ Rent above-market to owner LLC (\$95K × 12 mo): \$180,000

+ Charitable contributions (owner personal): \$48,000

Total Seller's Add-Backs: \$1,258,000

SELLER'S CLAIMED ADJUSTED EBITDA: \$5,108,000

BUYER'S CHALLENGES:

- Legal settlement: pattern of litigation (-\$380K): (\$380,000)
(company had settlements in 2021, 2022, 2023)

- IT migration: Phase 2 still needed (-\$290K): (\$290,000)

- Rent normalization: lease is 3 years, not 1 year;
only \$80K above market, not \$180K: (\$100,000)

Total Buyer Challenges: (\$770,000)

NEGOTIATED ADJUSTED EBITDA: \$3,850,000 + \$488,000 = \$4,338,000

(Seller's \$1,258K add-backs less \$770K buyer challenges)

DIFFERENCE FROM SELLER'S CLAIM: (\$770,000)**AT 10× MULTIPLE: Value reduction = (\$7,700,000)**0
1

CASE STUDY 1

Heritage Family Restaurants LLC*Family Business QofE — Personal Expenses, Related-Party Rent, and Owner Perks*

Background

Heritage Family Restaurants operates 8 casual dining locations, all owned and managed by the founder for 22 years. The business has been run as a personal fiefdom — with significant personal expenses flowing through the P&L; a building owned by the founder's holding company and leased to Heritage at above-market rates, and family members on the payroll in roles that would not be retained post-acquisition. The asking price is 7.5× EBITDA of \$2.1M (enterprise value: \$15.75M).

◆ HERITAGE — COMPLETE ADD-BACK BUILD

HERITAGE FAMILY — FULL QofE ADD-BACK ANALYSIS

Reported EBITDA (before add-backs): \$2,100,000

OWNER COMPENSATION:

Founder salary: \$620,000

Market-rate GM (replacement salary): (\$180,000)

Add-back: \$440,000

FAMILY MEMBER SALARIES:

Spouse (bookkeeper): \$95K; market rate \$48K: \$47,000

Son (asst. manager): \$88K; he will not stay: \$88,000

Add-back: \$135,000

RELATED-PARTY RENT:

Paid to founder holding company: \$48,000/month

Market rate (3 comparable leases): \$38,500/month

Above-market: \$9,500/month

Annual add-back: \$114,000

PERSONAL EXPENSES IN P&L;:

Florida condo (coded as 'corporate retreat'): \$36,000

Country club dues (2 memberships): \$24,000

Personal auto (3 vehicles): \$61,000

Non-business travel (receipts reviewed): \$38,000

Add-back: \$159,000

BUYER CHALLENGES / DEDUCTIONS:

New GM hiring costs (search + relocation): (\$45,000)

Market-rate son replacement (no successor): (\$55,000)

(Buyer needs assistant managers at 8 locations)

NET ADD-BACKS: \$440K + \$135K + \$114K + \$159K - \$100K = \$748,000

ADJUSTED EBITDA: \$2,100,000 + \$748,000 = \$2,848,000

ADJUSTED EV (7.5x): \$21,360,000

vs. UNADJUSTED EV: \$15,750,000

ADD-BACK VALUE TO SELLER: \$5,610,000

■ THE FAMILY BUSINESS ADD-BACK IMPERATIVE

Family-owned businesses consistently under-report true EBITDA because personal expenses obscure the underlying earnings power. A thorough QofE in a family business transaction routinely uncovers 20-40% more EBITDA than reported. The seller's M&A; advisor should prepare the add-back schedule before going to market — buyers who discover these add-backs themselves are less willing to credit them fully.

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CASE STUDY 2

TerraLink Construction Services

Run-Rate Cost Increases Hidden in the QofE

Background

TerraLink Construction signed a new union labor agreement in September of the LTM period, effective January 1 of the following year — 3 months after the LTM measurement period end. The new agreement increased labor costs by 14%. The seller's EBITDA bridge did not include this run-rate cost increase as a negative adjustment. The QofE team identified it.

◆ TERRALINK RUN-RATE ADJUSTMENT

TERRALINK — RUN-RATE COST ADJUSTMENT

LTM Labor Costs (October-September): \$12,400,000

Labor as % of revenue (38%): 38%

New union agreement increase: 14%

Forward run-rate labor cost increase: $\$12.4M \times 14\% = \$1,736,000$

This \$1.736M cost was NOT in LTM EBITDA

Forward EBITDA will be \$1.736M lower than LTM

SELLER'S CLAIMED EBITDA (LTM): \$4,200,000

Run-rate deduction (labor increase): (\$1,736,000)

BUYER'S FORWARD EBITDA: \$2,464,000

At 8x multiple, value impact: (\$13,888,000)

NEGOTIATION: Buyer requests \$1.5M price reduction

Seller argues wage increase already in new backlog pricing

Resolution: \$750K price reduction + \$500K escrow

Released if Year 1 EBITDA exceeds \$3.5M target

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3

CASE STUDY 3

Apex Digital Agency

*SBC Add-Back Dispute — Buyer vs. Seller on Stock Compensation***Background**

Apex Digital Agency has been growing rapidly and retaining key talent through equity grants. In the LTM period, stock-based compensation (SBC) expense totaled \$1.8M. The seller's investment banker added this back to EBITDA in full, arguing it is non-cash. The buyer's CFO pushed back: replacing the seller's equity program with buyer's RSUs would cost the buyer \$1.4M annually in new grants. The debate illustrates why SBC is the most contested add-back in tech and agency M&A.;

◆ SBC ADD-BACK NEGOTIATION

APEX DIGITAL — SBC ADD-BACK DISPUTE

SELLER'S POSITION:

SBC (non-cash expense): ADD-BACK \$1,800,000

Claimed adjusted EBITDA: \$6,200,000

At 11× SaaS multiple, EV: \$68,200,000

BUYER'S POSITION:

SBC is non-cash, BUT buyer must replace it

Buyer's RSU program for Apex employees: \$1,400,000

(estimated based on retention analysis)

Allowable SBC add-back: \$1,800K - \$1,400K = \$400,000

Buyer's adjusted EBITDA: \$4,800,000

EV gap: $(\$6,200K - \$4,800K) \times 11\times = \$15,400,000$

NEGOTIATED RESOLUTION:

Full SBC add-back accepted: \$1,800,000

BUT: \$1.4M/year RSU commitment added as

post-close working capital requirement

for 3 years, reducing earnout calculation base

Effective compromise: ~\$900K net add-back