What is Quality of Earnings and Who Benefits?

By: Michael R. Koeppel – CPA, ABV, CFF, CTP, CITP & CGMA

GENERAL BACKGROUND

A Quality of Earnings ("QOE") report assists in establishing the value of a business by analyzing and reporting on detailed aspects that may not be readily identifiable to a seller, buyer or investor in reviewing the standard financial statements. When a company is going through a merger or acquisition or an individual is considering investing in a company, for example, the more informed a buyer or seller is during the process the better. A close examination of a business's records can instill confidence in the quality of the target company's financial information as well as its historical earnings performance. A quality of earnings report also helps to establish the value of a business by analyzing and reporting on detailed aspects that may not be readily identifiable to a seller, buyer or investor.

The quality of earnings report highlights the key aspects of your business, including the normalized level of EBITDA and the addbacks to bridge from reported EBITDA to adjusted EBITD, along with fluctuations in annual and monthly financial information. Revenue and gross margin by product, customer or distribution segments is also included. Equally germane is the determination of the necessary cash flow required to maintain this normalized EBITDA. This includes, but is not limited to, capacity, overall market considerations, and necessary expenditures on infrastructure, facilities, human resources, and other hard costs.

To be confident that the parties are making the right decision, buyers and sellers often consider an independent review to perform a quality of earnings analysis. Parties need to verify the earnings and its' basic strength. There are times when the same might be said of a financial statement. As part of your due diligence process, it is invaluable to have an independent buy-side report that drills down into the account balances, cash flows, and operations of the business.

For the most part, we are not talking fraud here. Instead, the "devil in the details" might be something as simple as a one-time revenue source, a smaller-than-usual expenditure, a change in production or an overly aggressive accounting policy that acts to inflate or deflate a business' reported performance and perceived value.

The reason? It could be anything, from accurately reporting a current-but-unsustainable activity to reducing income taxes or even maximizing executive compensation that is tied to the company's performance. Or the motive may simply be to make the business look its best in advance of a possible sale.

So, if you are a seller, buyer or investor, how do you sort this all out? Enter the quality of earnings report.

QOE VS. FINANCIAL AUDIT OR REVIEW

The goal of an audit or review is to provide a level of assurance that the business' financial statements conform to generally accepted accounting principles, or GAAP. These statements are also inherently backward-looking.

A quality of earnings report examines the sustainable and forward-looking performance of the business at an incredibly detailed level. The report is not a valuation, but it does play a significant role in negotiating and structuring the deal. And hopefully in reducing risk and the possibility of buyer's or seller's remorse by looking at past historical rather than pro forma forecasts.

A quality of earnings report is NOT the same as a financial statement audit. Here are key reasons why:

Financial Statement Audit

- Emphasis is traditionally on a company's balance sheet
- Confirms whether a company's historical financial statements align with GAAP
- Provides strongest form of assurance as basis for QoE analysis
- Measures information as of fiscal year-end

Quality of Earnings Report

- Focuses on a company's current and future earnings power
- More concerned with non-GAAP financial measurements, like EBITDA and EBIT, and their sustainability
- Analyzes audited financial statements, but can also involve reviewed, compiled or internally prepared financials
- Measures information as of most recent 12 months

Clients frequently ask why there is a need to perform a quality of earnings study when the subject company is already audited. There are several differences between an audit and a quality of earnings study. Such differences include the following: In a QOE, the focus is on the economic earnings vs. the balance sheet serving as the focus in an audit; a QOE is a consulting engagement, not an attest service, providing flexibility in the approach and scope; and the individual company materiality is much lower in a quality of earnings study than an audit.

TYPES OF QOE – SELLER / BUYER

- A sell-side report can help them to understand the business from the perspective of a potential buyer or investor. It can also enable you to **take any remedial actions that may be necessary in advance of a sale** — accelerating the due diligence process and potentially increasing the selling price.

In our practice, we see the lack of a sell-side QOE as the #1 challenge for a seller. A QOE prepared by an independent professional provides the seller with the "unvarnished truth" of the company's earning s and its potential **BEFORE** going to market. Too often a few cosmetic changes to the company can add materially to the price of the company.

- A buyer or investor, a buy-side QOE report provides a more detailed and representative picture of just how well the business is really doing and whether it is worth the price under consideration. For example, it evaluates such things as the recurring nature and quality of its operations and cash flows, as well as the underlying assets and liabilities of the business.

ANALYSES IN A QUALITY OF EARNINGS REPORT

The types of detailed analyses in a quality of earnings report vary depending on the business and industry. But a general outline follows:

- Unusual trends and variances in balance sheets, cash flow statements and income statements
- Unusual trends in comparison to economy and / or competitors
- Significant and/or unusual accounting policies
- Revenue recognition policies
- Changes in accounting methods, key financial team members, accounting firm, principles, policies, procedures or practices
- Nature and extent of period-end closing adjustments and reconciling items between general ledger balances and internally prepared financial statements
- Unusual or nonrecurring items of income or expense
- Compensation and equity structure
- Transactions with related parties
- Internal Controls as noted by auditors
- Proof of cash: analysis of cash receipts and expenditures compared to reported EBITDA (earnings before interest, tax, depreciation, amortization)
- Customer sales, concentrations and backlog analysis
- Analysis of key reserves and allowances
- Reviews of account reconciliations, aging, and composition

WHAT GIVES EARNINGS "QUALITY?"

In order for an earnings measure to be considered of high quality, it must reflect free cash flow (more on this measurement below) and it must be sustainable. Earnings that are "tied up" in accounts receivable, for example, do not have much value because, despite being recognized, they have not yet been realized. In the same vein, earnings that are not sustainable because of

understated expenses due to an unfilled executive position, as an example, would overstate sustainable earnings.

EBITDA VS. OTHER EARNINGS METRICS

Many buyers default to earnings before interest, taxes, depreciation and amortization (EBITDA) as a proxy for free cash flows. Certainly, EBITDA is easy to calculate and easy to understand. However, unless the target company does not pay any taxes, has no working capital needs and does not require any investment in long-term assets, EBITDA may not be the best tool available. **Due to its simplicity, EBITDA is utilized too often to reflect the true economic value of a company.**

A more appropriate measurement of a company is the Free Cash Flow ("FCF"). There are different calculations methods of calculating free cash flows (FCF), but this is a common one:

$$\mathbf{FCF = EBITDA \pm \Delta NWC - C - t}$$

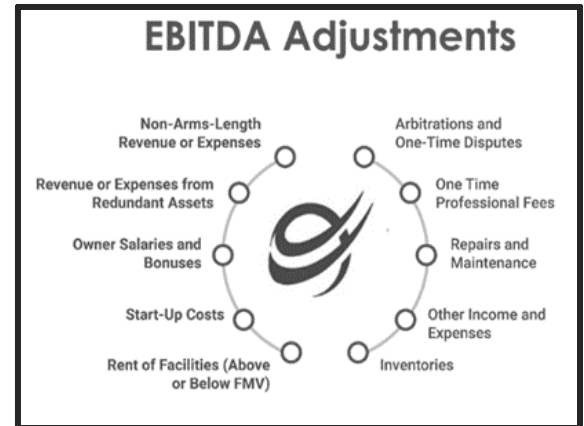
- EBITDA is reported EBITDA, net of all due diligence adjustments
- NWC is reported net working capital, exclusive of cash and funded debt, net of all due diligence adjustments
- C is normal replacement capital expenditures, net of the proceeds from the sale of fixed assets
- t is the cash taxes paid

ISOLATING THE EARNINGS

While a due diligence study should never be confused with an audit, due diligence does have the following procedures in common with an audit that help to isolate earnings. When attempting to isolate the earnings of the trailing twelve months ("TTM"), the professional should be performing a proof of cash. The QOE is based upon the premise that "Cash is King". Earnings in US GAAP does not equal cash!!

Next, revenue recognition should be evaluated to ensure it is consistent with the company's policy, as well as with US GAAP. Any variations from either could have a material effect on earnings calculations. Finally, the beginning and ending balance sheets of the TTM should be scrutinized to determine if revenues and expenses are in the proper periods, liabilities and reserves are appropriately recorded, etc.

ADJUSTMENTS



- Seller's adjustments to EBITDA usually include the obvious non-recurring expenses and perhaps excess compensation. The study for a buyer should include validation of these claims including obtaining original documentation. Estimates should not be accepted and the rationale for each adjustment should be challenged.
- Due Diligence / Team Performing QOE Adjustments - These adjustments are those identified by the due diligence team and might include overlooked one-time expenses, accounting errors, effects of unrecorded or under recorded liabilities or even a reversal of the seller's adjustments that fail to hold up to scrutiny. The number of these adjustments should give the buyer not only a better understanding of the economic earnings but provide some insights into the quality of the company's information and the strength of the finance team.
- Pro forma adjustments are frequently overlooked and misunderstood by sellers. These adjustments usually are utilized to "normalize" the TTM's earnings. Such adjustments might be made to annualize a midterm rent increase or account for a new union contract. The pro forma adjustments address the sustainability of the business for the buyer.

ASSETS AND LIABILITIES

- Assets, albeit, the QOE, by its very name is a concentration of the earning's potential and trends. One cannot perform a valid QOE without addressing the asset compensation of the company. The entire gamut of assets from Accounts Receivable, Inventory (turns, composition, etc.), Intellectual Property, Facilities, and human capital are all detailed and assessed.
- Debt / Obligations: Although these liabilities and obligations do not provide any value to the company, they have a profound effect on the future cash flows. Included in this category one needs to access the environmental, legal exposures. pending regulatory, underfunded pension plans and deferred compensation plans.

CONCENTRATIONS AND OPERATIONAL RISKS

- Customers: When dealing with Small, Medium Size Enterprises ("SMEs") - the parties need to consider the degree of customer concentration as a key indicator pertaining to the QOE. The mere fact that the company has a high customer concentration generates a risk and this risk needs to be accounted for when opining on the QOE.

- Capacities Human Resources: This is one of the more subjective analyses in analyzing the QOE. Does the company have the team to take the company to the "Next Level"? And if not, what is involved in obtaining the necessary human resources.
- Supply Concentration: One of the many issues that the COVID pandemic has demonstrated is the volatility of our supply chains. In the performance of the QOE, it should be noted whether the company is exposed to single sourcing associated with mission critical materials. Another set of concentration concerns quality of the eearning; they should not lose sight of the relative risk of those earnings. Many studies will cover such issues as customer concentrations, but the buyer may want to consider other concentrations as well (i.e., industry, product/service, distribution channel, etc.). The buyers should evaluate these concentrations on a gross profit or contribution margin level. In addition, other risks that buyers may wish to consider include cost structure, commodity dependence, price strategy and elasticity, key person issues/insurance and dependency on intellectual property.

OTHER CONSIDERATIONS

Other diligence procedures that might provide insight on the quality of earnings that you should discuss with your due diligence advisor include the following:

- Run rate study: If the company is in a high growth mode or in sharp decline, the run rate may be more relevant than the most recent trailing 12 months. This is also true with assessing the net working capital to be delivered at closing.

- Related party analysis: If the company has numerous related party transactions, the buyer may want to be satisfied that the transactions are at arm's length or that any change in control will not affect critical relationships with customers or suppliers.

- Commercial & competitive analyses: If the investment thesis is highly dependent upon management's projections, it may be necessary to analyze the competitive environment, the go-to-market strategy and the existing customers' perception of the company and its products.

- Access the macroeconomic environment: Obviously, the company is not conducting business in a vacuum. Accordingly, one needs to understand the macroeconomic environment.

- Industry Trends: Independent of the company and the macroeconomic environment, one needs to look at the industry as a whole.

HOW LONG DOES QOE TAKE?

On average, Lakelet Advisory Group is able to provide our client with a DRAFT report within three (3) weeks and a following final report within three (3) business days of receiving the draft back from the client. Timing is contingent upon the nature of the supporting document requested and the adjustments necessary.

AVERAGE COSTS

Depending on the deal and the audience of potential investors or buyers, Quality of Earnings studies cost between $25,000 and $80,000 on average. Typically, the costs are on the lower end of this spectrum. The overall costs are directly correlated to the financial documents available, and the historical accounting attestation performed. For example, audit, review, or compilation of existing financials vs.creating new financials. In addition, the number of facilities, international operations, ability to rely on the fact that the entity is a “going-concern”, and the impact that COVID has had on the industry / company are all factors that can affect cost.

WHY LAKELET ADVISORY GROUP?

Lakelet Advisory Group’s QOE process involves more than addressing the accounting associated with the company. The firm performs a deep dive into the business, transactions, related parties, market, industry, SWOT anaysis, trends over the years as well as trends in comparison to the company’s peers.

As a prior co-founder to a private equity firm, we understand what is required to properly access a company and its associated risks. Another critical attribute the firm brings is its experience in financial forensics – we know how to “dig” into the details to provide our clients with the necessary support to generate a more informed decision.

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