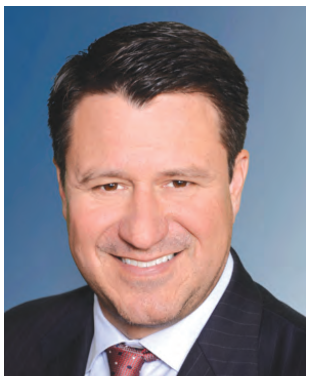
Quality of Earnings Report – Key Considerations for Entrepreneurs and Their Advisors

Entrepreneurs face complex issues and difficult decisions when contemplating growth or exit strategies for their business. Successful transactions require careful and thoughtful analysis to maximize value to a buyer or seller of a business. Seeking an advisor to assist with financial due diligence is a key factor that will help to promote deal success.



Thielman

What is financial due diligence or a Quality of Earnings Report? Although the scope of work may vary from one M&A transaction to the next, financial due diligence is often described as providing a buyer (or seller) with an assessment of the unique risks and opportunities of a target company. Often the central focus with regard to financial due diligence is validating or confirming a target company's key financial metrics such as sales, gross margins, EBITDA (before and after adjustments – more to follow on this concept), operating cash flows and working capital requirements.

Common financial accounting and business issues include the following:

1. Has the seller understated income historically for income tax purposes?
- a. Common example is under-reporting inventory
- b. Making adjustments for this can sometimes be more of an "art" than a "science"

2. Working capital adjustments gone wrong
- a. Are the accounting policies and methods consistently applied?
- b. What is included and not included in working capital?

3. Earn-outs ("contingent consideration")
- a. Should the earn-out be based on revenue or earnings?
- b. How are earn-outs accounted for under the latest GAAP rules?

4. Personal/Owner expenses
- a. Common examples are airplanes, condos, country club dues, travel
- b. Where are the expenses recorded in the books and records?

5. Poor internal accounting and lack of internal controls
- a. Has the target company had annual audits and reviews?
- b. Diligence is often focused on interim financial statements, how do the monthly financials differ from the annual financials? (The results of this diligence can affect representations and warranties, in addition to purchase price)

6. Non-recurring revenues/expenses
- a. Are they really one-off?
- b. How should they be quantified?

7. Out of period income or expense
- a. Has the target company released accruals and reserves on the balance sheet to inflate income?
- b. Do current year financials include charges that should have been recognized in prior periods? (for example switching from cash to accrual or setting up reserves for the first time)

8. Key executives/employees leaving the business
- a. How much does the business depend on the skills, relationships, and overall leadership of the selling shareholder or key executive? (Consider having seller retain an ownership post-close)
- b. Who owns the key customer relationships?

9. Concentration risk (customers/vendors)
- a. What are the chances a key customer or vendor could be lost? (Most buyers will contact key customers during due diligence)

10. Unrecorded liabilities
- a. How will they be identified?
- b. What are the EBITDA implications?

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The M&A practice at HCVT has deep bench strength with over 50 professionals with financial or tax M&A experience. Last year, the M&A group worked on over 80 buy-side or sell-side transactions across a broad variety of industries. HCVT is a team of over 550 members, including over 100 team members in our Orange County office. We provide tax, audit, business management, and mergers & acquisition services to private companies, public companies and high net worth individuals and family offices.

Mike Thielman

Mike Thielman is an audit partner and oversees the firm's audit department in Orange County. Mike co-founded the firm's M&A group and leads the financial due diligence team. Visit HCVT's website at *www.hcvt.com*. Contact Mike directly at miket@hcvt.com or 714.361.7666.