Quality of Earnings Analysis

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Quality of earnings ("QofE"), or financial accounting due diligence by an independent accounting firm, takes a deep dive into a company's financial and operating information emphasizing earnings before interest, taxes, depreciation, and amortization, or EBITDA. This metric is widely considered a more relevant indicator for determining a business's enterprise value than other metrics such as net income. Although technically not a financial measurement defined by U.S. GAAP, EBITDA is believed to be a good indicator of a company's ability to generate cash flow and removes the effects of various capital structures and other business conditions that may change post-transaction. Generally, sellers engage a specialist to perform this analysis before a buyer begins their due diligence process. Conversely, the buyer in a transaction will typically engage a specialist to perform buy-side QofE due diligence to analyze the reported numbers. At HCVT, the professionals in the firm's Mergers & Acquisitions services group perform QofE's for both buyers and sellers, typically not on the same contemplated transaction, to help the deal participants gain an understanding of the unique opportunities and risks associated with a potential transaction.

Key Benefits of a Quality of Earnings Report

- **Identify or validate adjustments to EBITDA.**For the purpose of a transaction, earnings are typically normalized for non-recurring or out-of-period revenues and expenses. The QofE process will help identify or validate add-backs/adjustments to reflect normalized earnings and help a deal participant analyze enterprise value before and after a contemplated transaction closes.
- **Address accounting issues.**Over the years, oftentimes, business owners focus primarily on running and growing their business. Keeping pace with changing and complex accounting standards is a challenge for most businesses. Now that it is the time to buy or sell, accurate financial reporting in accordance with generally accepted accounting principles in the United States ("US GAAP") is critical to determining the value of a business. During the QofE due diligence process, the target company's financial statements will be analyzed for compliance with US GAAP and adjusted accordingly.

- **It helps to promote an efficient transaction.** When an interested buyer signs a letter of intent ("LOI"), there is a limited amount of time for the buyer to complete their diligence and decide whether to move forward with a potential transaction. Having a sell-side quality of earnings report can help anticipate many of the tough questions a buyer would ask. Having the information ready will allow the buyer to progress through their accounting due diligence more efficiently. Because of the advanced preparation, the information will be ready and will alleviate pressure on the target company's management team once the sale process commences.
- **Control the process**. Due diligence will give a buyer or seller a view of the company's adjusted EBITDA and insight into how a deal participant will analyze earnings and key components of the financials. If working for a seller, initiating this diligence will allow the seller to position the company through the sale process, not leaving the analysis of the financial information to the mercy of the buyer. Buyers will typically highlight adjustments that are favorable to them. By taking the first step with a sell-side QofE, a seller can help ensure that adjustments favorable to them are taken into consideration and avoid leaving "*chips on the table*."
- **Establish a working capital target.** A working capital target is established before closing a transaction, defining the amount of working capital (current assets less current liabilities) that the seller needs to deliver to the buyer upon closing. This target is typically derived based on the recent historical working capital required to operate the business. It is essential to normalize monthly working capital for non-recurring expenses, uncollectible accounts receivable, and non-sellable inventory, among other potential adjustments. This analysis may help a deal participant avoid committing to an unreasonable working capital target resulting in unfair adjustment to the purchase price.
- **Credibility and support.** A QofE report from an experienced independent accounting firm will lend further credibility to a target company's financial statements, especially if such financial statements have not been audited or reviewed. Additionally, the target company's internal accounting and finance team may not have the bandwidth or experience to respond to due diligence inquiries and requests from a potential buyer. A sell-side QofE team can provide due diligence support to a seller when responding to buyers. Furthermore, while audited or reviewed financial statements by an independent accountant give the historical financials more credibility, a QofE analysis complements these annual financial statements with the ability to adapt the reported period to a more recent time frame and present the trailing twelve-month period most relevant to a transaction. Additionally, the QofE provides more in-depth insight and analysis into the financial statements with the flexibility to focus on key areas and normalize for transactions that will be impacted post-transaction. In certain instances, banks will accept QofEs for financing purposes instead of compiled, reviewed, or audited financials.

Articles

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