What Is a Q of E (Quality of Earnings)? Why Do I Need It to Sell My Business?

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Quality of Earnings Analysis

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November 7, 2019

Selling your business is one of the most important events of your life. You have worked hard to grow your business and are now ready to sell. You have retained an investment banker and/or an attorney, and they are advising that you obtain a sell-side quality of earnings ("QofE") report. This is an important step in the process that will help to maximize the value of your business while mitigating surprises that could arise in the sale process.

You may ask, "Why should I invest in a quality of earnings due diligence when a buyer will perform their own analysis?" Several key reasons include:

- Determine the add-backs to earnings so the transaction price will be higher
- Find and fix accounting issues in advance before buyers do
- When talking with investment bankers, you will get educated advice on the value of your business
- It can be useful in negotiating a fair fee arrangement with investment bankers
- Have an educated advocate to help you negotiate with the buyer's diligence team

<u>What is a sell-side quality of earnings (accounting due diligence)?</u>

Quality of earnings or accounting due diligence by an independent accounting firm takes a deep dive into the company's financial information with an emphasis on earnings before interest, taxes, depreciation, and amortization, or EBITDA. This metric is generally perceived to be a better indicator of the value of a business than net income. EBITDA demonstrates the ability of a company to generate cash flow and removes the effects of various capital structures and other business conditions that may change post-transaction. Generally, the seller engages a specialist to perform this analysis before a buyer begins their due diligence process. The scope of work and cost can vary, typically from $35,000 for financial analysis only to up to $150,000 depending on the complexity and quality of the books and records.

Conversely, the buyer in a transaction will typically engage a specialist to perform buy-side QofE due diligence to analyze the reported numbers. The end goal is the same: to provide information to both the seller and buyer to make informed decisions. Specific to the seller, a QofE provides management insight into their financials in advance of marketing the company, and provide accurate financial data to the buyer.

Benefits of sell-side quality of earnings

1. **Identify adjustments to EBITDA.** For the purpose of a transaction, earnings are typically normalized for non-recurring or out-of-period revenues and expenses. The sell-side QofE process will help you identify these add-backs/adjustments to reflect normalized earnings and help you maximize the value of your business in a transaction.
2. **Address accounting issues.** Over the years, your primary focus has likely been running and growing the business. Keeping pace with changing and complex accounting standards is a challenge for most businesses. Now that it is the time to sell, accurate financial reporting in accordance with generally accepted accounting principles in the United States ("US GAAP") is critical to determining the value of your business. During the QofE due diligence process, transactions will be reviewed for compliance with US GAAP and adjusted accordingly.
3. **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 on whether to move forward with a potential transaction. Having a sell-side quality of earnings report can help to 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 your management team once the sale process commences.
4. **Control the process**. Due diligence will give you a view of the company's adjusted EBITDA and insight into how buyers will analyze earnings and key components of the financials. Initiating this diligence will allow you the opportunity 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, you can help ensure that adjustments favorable to you are taken into consideration and avoid leaving "*chips on the table*."
5. **Establish your working capital target.** A working capital target is established before the close of 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. You know your business better than anyone else does and you are in the best position to propose a reasonable working capital target. It is essential to

normalize monthly working capital for such things as non-recurring expenses, uncollectible accounts receivable, and non-sellable inventory, among other potential adjustments. This analysis may prevent you from committing to an unreasonable working capital target and a potential reduction in the purchase price.

6. **Credibility and support.** A QofE report from a qualified independent accountant will lend further credibility to your financial statements. Additionally, your internal accounting and finance team may not have the bandwidth or experience to respond to due diligence inquiries and requests from a potential buyer. Your accounting advisor will advocate on your behalf and support the sell-side quality of earnings analysis while potential buyers review the QofE work for their own due diligence. 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.

Next steps

If you are considering selling your business, a sell-side QofE is a valuable tool to understand your business' earnings and address any potential issues or unfavorable findings upfront and to help maximize the value of the business. To learn more about how our team can help, please contact Raman Sain.

About Raman Sain

Raman has over 20 years of experience in public accounting, seven of which were with a Big Four firm. Raman provides audit services to private companies in all phases of the business cycle. Raman is also a member of the firm's Mergers & Acquisitions practice and provides assurance and transaction advisory services to private equity, strategic buyers, and entrepreneurs. Raman's M&A diligence projects include quality of earnings analysis, working capital analysis, post-closing adjustments, among others. His industry experience is diverse and includes technology, healthcare, management services organizations, manufacturing, retail, distribution, and entertainment.

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About HCVT

At HCVT, we have a team of professionals that specialize in M & A transactions, including acquisitions, dispositions, recapitalizations, mergers, reorganizations, formations, and other significant transactions. The team works on both buy-side and sell-side transactions. We assist clients with the quality of earnings analysis, financial due diligence, tax due diligence, and tax structuring. In 2018, the team worked on over 100 transactions with a combined transaction value of over $5 billion. We focus on middle-market transactions, and the average deal size was $98 million. Our transactions were varied and included:

- 27% buy-side consultations
- 70% sell-side consultations
- 3% restructure and recapitalizations consultations

A look at the industry sectors:

- 64% from manufacturing and distribution, with 17% in the food and beverage industry
- 10% from wellness and beauty
- 9% from technology
- 10% from healthcare
- And the balance from services, real estate, and the entertainment industry sectors.

To learn more about HCVT, see www.hcvt.com