Quality of Earnings Reports

Kevin Swanson

For business owners not active in merger and acquisitions many aspects of a company sale process may seem foreign. One of those, which is relatively new, is the necessity for a Quality of Earnings (“QOE”) report from a well regarded accounting firm. While this practice was uncommon twenty years ago, it has become an essential feature of today’s market, particularly when private equity firms participate.

Audits are by definition backward-looking. An audit provides reasonable assurance that a company’s historical financial statements contain no material misstatements and match the “actual” earnings for any fiscal year. It also verifies that those statements conform to common accounting procedures, in the United States U.S. GAAP (“Generally Accepted Accounting Principles”). Essentially, it confirms that the accounting methods result in financial statements that can be compared year to year and with those of other similar companies.

A QOE report, on the other hand, is a more analytical form of financial due diligence. A QOE can be commissioned by either the seller, in which case it’s called a “sell-side QOE,” or the buyer, a “buy-side QOE.” The contents of the report are the same no matter who requests it; however, if the seller requests it before engaging a buyer, the company can address deficiencies uncovered and reduce the risk of a failed transaction. QOE reports differ depending on a company’s size and industry, as well as the sponsor’s specific objectives. When initiated by a potential buyer, they not only fact check a seller’s presentation of his business but also provide a valuable risk assessment of future prospects.

The primary objective of a QOE report is to confirm the accuracy of historical earnings, as well as their sustainability. The QOE report helps a potential buyer learn about the quality and source of a business’s earnings and understand its key operating metrics. The first objective is to determine if the earnings are accurate. For example, some companies use accounting methods that do not conform to GAAP. A QOE analysis will make appropriate adjustments. The

second objective is to determine the source of a business's profits to ensure that they are not overly concentrated by product (service) or customer, which may pose risks for future profitability.

While QOE reports' contents vary based on the target's business and industry as well as market conditions, there is usually a set of standard elements, including:

- ***Income statement analysis***: An in-depth analysis of a company's revenue, expenses, and net income, including revenue recognition policies, timing of expenses, and the impact of non-recurring items such as gains or losses on the sale of assets, restructuring charges, and one-time tax benefits.
- ***Balance sheet analysis***: An examination of a company's assets, liabilities, and equity, including working capital and other balance sheet items to identify any potential risks, such as obsolete inventory, bad debts or long-term liabilities.
- ***Cash flow analysis***: An assessment of a company's cash flow from operations, investing, and financing activities.
- ***Management analysis***: An evaluation of a company's management team and its track record, including the company's corporate governance practices, management's ability to execute on its strategy, and any potential conflicts of interest.
- ***Industry analysis***: An assessment of the company's position within its industry, its competitive landscape, and any potential threats or opportunities.

A QOE report is important for several reasons. First, it helps investors identify any potential risks in a company's financial statements. By conducting a thorough analysis of a company's earnings quality, a QOE can identify any areas where the company may be overstating or understating its earnings. Second, a QOE report can help investors make more informed investment decisions. By providing a comprehensive analysis of a company's financial statements, a QOE report can help investors understand the company's financial health, its growth prospects, and any potential risks or opportunities. Third, a QOE report can be useful for management in identifying areas where the company can improve its financial performance. By highlighting any areas where the company may be

falling short, a QoE report can help management to develop strategies for improving the company's earnings quality and profitability.

Summary

Sellers should be aware that QOE reports are now common in the M&A business and they will almost certainly undergo such analysis as part of buyer due diligence. Indeed, the QOE has become a critical milestone for the completion of a company sale, frequently anteceding preparation of legal documents and financing discussions. Obviously, if a substantial issue is exposed by the QOE, the transaction as agreed may require restructuring or termination. It is well worth serious consideration for the seller to commission a QOE in advance of proceeding with a sale process. It may obviate mistakes or a significant waste of time and should also allow for price maximization.