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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Quality of Earnings Analysis

What Buyers and Sellers Need to Know About Quality of Earnings Reports

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QUALITY OF EARNINGS SERVICES

Mercer Capital assists clients by developing and performing customized due diligence procedures for potential transactions. Our focused approach to quality of earnings analysis generates *Insights That Matter* to potential buyers and sellers.

ANALYSES PERFORMED

Profitability Analysis – Investigating historical reported financial performance to identify the target's sustainable, and transferable, earning power. We measure pro forma run rate EBITDA (or other relevant measures) for acquisition targets.

Revenue Analysis – Investigating revenue data at the product, segment, and customer levels to reveal underlying trends in growth and customer retention. Procedures include: (1) identifying critical customer concentrations; (2) analyzing gross margin by product, segment, and customer; and (3) customer churn and retention analysis.

Working Capital Analysis – Investigating the components of net working capital required to operating the business. Procedures includes: (1) examining collections history, bad debts, and turnover; (2) analyzing inventory components and turnover; (3) reviewing prepaid expenses and operating expense accruals; and (4) assessing impact of seasonality on required working capital levels.

Our QofE engagements are led by senior professionals with deep transactional experience. We leverage that experience to customize procedures to generate *Insights That Matter* for the specific transaction under consideration.

SENIOR PROFESSIONALS

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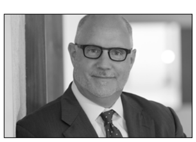
Nick leads Mercer Capital's Transaction Advisory Group and has extensive experience in working with both buyers and sellers in merger and acquisition advisory engagements and assists clients through all phases of the selling or buying process.



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Tim is the firm's Managing Director of Corporate Valuation services and has extensive experience in working with both sellers and buyers in M&A advisory engagements. Tim assists clients through all phases of the sales process, from conducting strategic alternatives analysis to determine if selling is indeed the best option, to structuring, negotiating, and closing transactions.

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Bryce, Senior Vice President, has been involved with hundreds of valuation and transaction-related engagements during his 25+ year career. These engagements have been conducted for the purposes of mergers and acquisitions, buyouts, and corporate planning purposes.

Mercer Capital's staff consists of CPAs, CFFs (Certified in Financial Forensics), CFAs, industry experts, big four alums, and other valuation and finance experts. Each quality of earnings engagement is staffed appropriately to ensure that our analysis generates *Insights That Matter* to potential buyers and sellers.

Quality of Earnings

For buyers and sellers, the stakes in a transaction are high. You only get one chance to do it right. Commissioning a quality of earnings report is an essential step in getting the transaction right.

In this whitepaper, we illustrate how buyers and sellers benefit from a quality of earnings report that extracts a company's sustainable earning power from the thicket of historical GAAP earnings. We review the most common earnings adjustments applied in QofE analyses and review the role of working capital and capital expenditures as the links between EBITDA and cash flow available to buyers.

Leverage the experience of our QofE team to generate ***Insights That Matter*** in support of your next transaction.

SECTION 1 - INTRODUCTION

Corporate earnings are an important guidepost to transaction prices negotiated by buyers and sellers. However, reported earnings – even when audited and presented in accordance with generally accepted accounting principles ("GAAP") – have limitations. GAAP earnings are backward-looking: they report how a business has performed in the past under specific rules. GAAP earnings certainly have their uses, but buyers and sellers care about the view through the windshield, not the rearview mirror.

Credible perspectives on the future must be grounded in a reliable base of historical information. However, not every dollar of GAAP earnings is equally relevant to establishing that base. A quality of earnings ("QofE") report helps buyers and sellers discern that base of ongoing earning power relevant to establishing the transaction price. As shown in Exhibit 1, a QofE report is neither an audit, nor a projection of future results for the subject company but instead serves as a pivot between the two.

Exhibit 1 :: Audit, QofE Report, and Projections

Audit	QofE Report	Projections
Present historical results according to generally accepted accounting principles (GAAP)	"Translate" GAAP earnings into reliable base for projections / valuation	Expected future financial performance built off of reliable base earnings, reflecting forecasts for economy, industry, market share, etc.

The objective of a quality of earnings report is to "translate" historical financial information into a relevant picture of earnings and cash flow that is useful in developing a credible view through the windshield.

What needs to be translated from historical performance to create a relevant picture of earnings and cash flow? As summarized in Exhibit 2, there are five broad categories of adjustments used in QoE analyses to translate historical GAAP earnings to pro forma run rate earnings.

In Section 2 of this whitepaper, we illustrate each of these adjustment categories. Section 3 addresses the relationship between EBITDA and cash flow, illustrating working capital and capital expenditure analyses that are a critical element of QofE reports.

Exhibit 2 :: QofE Adjustment Categories

1. **Discretionary expenses**
2. **Unusual and nonrecurring items of revenue and expense**
3. **Timing / accounting policy adjustments**
4. **Major customer wins and losses**
5. **M&A run rate adjustments**

SECTION 2 – QofE EARNINGS ADJUSTMENTS

In this section, we illustrate how earnings adjustments in QofE analyses translate historical GAAP earnings to a measure of pro forma run rate earnings that is relevant to buyers and sellers.

1. Discretionary Expenses

Private business owners occasionally commingle business and personal expenses. For example, some family businesses have employees-in-name-only that could be terminated with no effect on operations. Other businesses incur expenses that have more to do with owner lifestyle than business operations (automobiles, aircraft, vacation properties, event tickets, etc.). Such discretionary expenses depress historical earnings of the business and should be identified and documented in a quality of earnings report.

For example, Exhibit 3 summarizes reported and adjusted earnings for a family business. Three second generation family members, while titular sales managers of the business with handsome compensation packages, do not actually work in the company and would not be retained by any buyer following a transaction. Eliminating compensation, benefits, and associated payroll taxes for these individuals from reported historical earnings yields a more accurate measure of the true earning power of the business.

Exhibit 3 :: Adjusting for Discretionary Expenses

	As Reported	Discretionary Expenses	Adjusted for Discretionary Expenses
Net revenue	$249,253	$0	$249,253
Cost of goods sold	129,972	0	129,972
Gross profit	$119,281	$0	$119,281
Selling expenses	34,222	(1,500)	32,722
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	0	62,582
Operating expenses	99,538	(1,500)	98,038
Operating income / EBIT	$19,744	$1,500	$21,244
Depreciation	5,132	0	5,132
Amortization	1,094	0	1,094
EBITDA	**$25,970**	**$1,500**	**$27,470**
EBITDA margin	*10.4%*	*nm*	*11.0%*

2. Unusual and Nonrecurring Items of Revenue and Expense

As the maxim goes, "time and chance happens to them all." No business is immune to exogenous forces that can distort the company's reported financial performance. Business interruptions, revenue windfalls, casualty losses and the like influence historical earnings but do not affect the company's core ongoing earning power. Unusual and nonrecurring items can be either favorable or unfavorable from the perspective of historical results. A thorough QofE analysis should seek to identify such adjustments regardless of whether they increase or decrease adjusted EBITDA.

A word of caution is in order here. Identifying a business event as "unusual" or "nonrecurring" is inherently subjective. A regular or predictable pattern of unusual or nonrecurring events in the same direction can undermine the credibility of a QofE analysis. The QofE report should carefully describe the nature of the events identified as unusual or nonrecurring and offer a compelling rationale as to why the associated items of revenue and expense are not representative of the ongoing earnings of the subject company.

Continuing our previous example, the subject company wrote off $10 million of stale inventory to cost of goods sold during the fourth quarter. The written-off inventory was acquired as part of a failed product diversification bid that has since been abandoned. As shown in Exhibit 4, removing the inventory write off as a nonrecurring event increases gross profit and EBITDA for the company.

Exhibit 4 :: Adjusting for Unusual or Nonrecurring Events

	Adjusted for Discretionary Expenses	**Unusual or Nonrecurring Items**	**Adjusted for Unusual or Nonrecurring**
Net revenue	$249,253	$0	$249,253
Cost of goods sold	129,972	(10,000)	119,972
Gross profit	$119,281	$10,000	$129,281
Selling expenses	32,722	0	32,722
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	0	62,582
Operating expenses	98,038	0	98,038
Operating income / EBIT	$21,244	$10,000	$31,244
Depreciation	5,132	0	5,132
Amortization	1,094	0	1,094
EBITDA	**$27,470**	**$10,000**	**$37,470**
EBITDA margin	*11.0%*	*nm*	*15.0%*

3. Timing / Accounting Policy Adjustments

There is more than one way to comply with generally accepted accounting principles. Companies make a host of accounting elections (inventory accounting methods, capitalization thresholds, etc.) that do not represent deviations from GAAP, but may nonetheless warrant adjustment to enhance comparability with the accounting policies of potential acquirers.

Furthermore, despite the best intentions of GAAP, sometimes revenue and associated expenses are recognized in accounting periods that do not conform to the economic substance of a transaction. For example, if a company incurs operating expenses in one period which are reimbursed by customers in a subsequent period, it may be appropriate to adjust recognition of the events across time to represent more faithfully the economic substance of significant transactions. Such timing adjustments will, over time, net to zero.

Exhibit 5 illustrates the impact of an accounting policy adjustment. The subject company uses the LIFO (last-in first-out) method of accounting for inventory, while FIFO (first-in first-out) is the standard method in the company's industry. During the period under question, use of the LIFO method understated cost of goods sold (through liquidation of "old" LIFO layers) relative to the FIFO method favored by industry peers.

This example underscores the need for QofE analyses to consider interactions between the income statement and the balance sheet. In this case, use of the LIFO method has understated cost of goods sold on the income statement and the QofE analysis should evaluate whether a corresponding adjustment to the balance sheet is warranted.

Exhibit 5 :: Adjusting for Timing/Accounting Policy Adjustments

	Adjusted for Unusual or Nonrecurring	Accounting Policy / Timing	Adjusted for Acctg Policy / Timing
Net revenue	$249,253	$0	$249,253
Cost of goods sold	119,972	1,236	121,208
Gross profit	$129,281	($1,236)	$128,045
Selling expenses	32,722	0	32,722
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	0	62,582
Operating expenses	98,038	0	98,038
Operating income / EBIT	$31,244	($1,236)	$30,008
Depreciation	5,132	0	5,132
Amortization	1,094	0	1,094
EBITDA	**$37,470**	**($1,236)**	**$36,234**
EBITDA margin	*15.0%*	*nm*	*14.5%*

4. Major Customer Wins and Losses

While nearly every business experiences some degree of "churn" in its customer base, for businesses with significant customer concentrations, adding or losing a major customer during the year may merit adjustment in a QofE analysis. To help unearth and support such adjustments, a QofE report should include a robust analysis of historical customer churn. The results of detailed customer analysis can be summarized in the form of customer count and revenue rollforwards, as illustrated in Exhibit 6.

Exhibit 6 :: Customer and Revenue Rollfowards

	Customer Count	Revenue	Customer Average
Prior Year Total	673	$225,634	$335
less: Lost customers	(72)	(7,436)	103
plus: Retained customers (increase)	*488*	15,992	33
less: Retained customers (decrease)	*113*	(3,167)	(28)
plus: New customers	180	18,230	101
Current Year Total	781	$249,253	$319
Lost customers / beginning total	-10.7%	-3.3%	
Revenue growth (increasing retained)		9.4%	
Revenue growth (decreasing retained)		-6.6%	
Y/Y change (excluding new customers)	-10.7%	2.4%	14.7%
Net Y/Y change	16.0%	10.5%	-4.8%

The year-over-year revenue growth of 10.5% that can be read off the face of the income statement masks the underlying narrative that is of most interest to potential acquirers.

- Nearly 11% of customers from the prior year did not return in the current year. These lost customers were – on average – smaller than average ($103k average annual revenue vs. overall average of $335k).
- Of the customer accounts that were retained from the prior year, approximately 81% of them purchased more in the current year (an aggregate increase of 9.4%). The balance of the retained customer accounts generated less revenue in the current year (a 6.6% decrease).
- On a net basis, excluding the impact of new customers, total revenue increased 2.4% year-over-year, with the average revenue per customer increasing by 14.7%.
- The company closed on an acquisition that extended its geographic footprint and added new customers at the end of the third quarter. That acquisition accounted for a significant portion of the total number of new customers gained during the year. Since sales for the current year reflect only fourth quarter sales from the acquired customers, the average revenue per new customer ($101k) is lower than the overall average ($319k).

The company does not have any significant customer concentrations, with no single customer accounting for more than 3% of annual revenue. Aside from the impact of the acquisition, the observed customer churn was judged to be typical, so no discrete adjustment was warranted in the QofE analysis.

5. M&A Run Rate Adjustments

When companies make acquisitions, the GAAP financial results for the year of acquisition will include results for the acquired entity only from the closing date of the acquisition. Similarly, the results of divested operations are included in the financial results for the year through the effective date of the divestiture. As a result, the reported financials for the year of acquisition (or divestiture) will not reflect the true "run rate" of the business as of the analysis date.

Exhibit 7 illustrates the adjustment for the company's acquisition that closed at the end of the third quarter. To establish an annualized run rate, the income statement for the acquired company during the period leading up to the acquisition date is added.

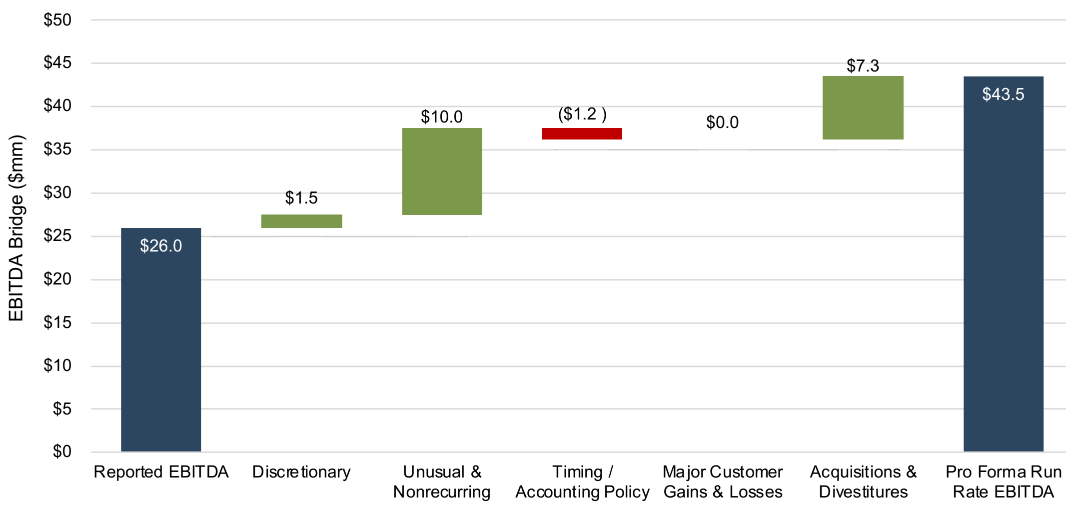
Exhibit 7 :: Adjusting for Mid-Year Acquisitions/Divestitures

	Adjusted for Acctg Policy / Timing	Pre-Closing Earnings of Acquiree	Pro Forma Run Rate Earnings
Net revenue	$249,253	$39,724	$288,977
Cost of goods sold	121,208	16,679	137,887
Gross profit	$128,045	$23,045	$151,090
Selling expenses	32,722	7,428	40,150
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	8,964	71,546
Operating expenses	98,038	16,392	114,430
Operating income / EBIT	$30,008	$6,653	$36,661
Depreciation	5,132	622	5,754
Amortization	1,094	0	1,094
EBITDA	**$36,234**	**$7,275**	**$43,509**
EBITDA margin	*14.5%*	*18.3%*	*15.1%*

Net Effect of QofE Adjustments

Having identified relevant (and material) adjustments of each type, it is instructive to step back and assess the overall direction and magnitude of the adjustments made. A "bridge" chart like that shown in Exhibit 8 summarizes the adjustments made in deriving pro forma run rate EBITDA.

Exhibit 8 :: Net Effect of QofE Adjustments



From reported EBITDA of $26.0 million, the QofE adjustments for discretionary expenses, unusual & nonrecurring events, and timing / accounting policy adjustments resulted in a net upward adjustment of $10.2 million to $36.2 million. Including full-year earnings for the company acquired at the end of the third quarter brings pro forma run rate EBITDA to $43.5 million.

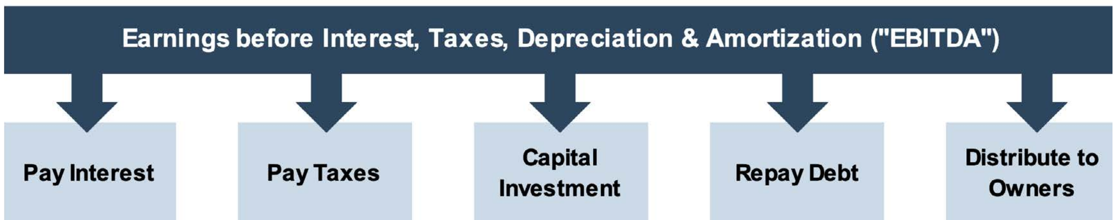
While in compliance with GAAP, the reported EBITDA of $26.0 million was not an appropriate base from which to derive valuation indications (using guideline or single-period capitalization methods) or build an earnings forecast. For sellers, QofE analysis is an essential step in achieving transaction outcomes that reflect the true earnings potential of the business they have built. Likewise, a proper QofE analysis helps buyers maintain discipline by identifying the truly durable components of earning power for the target company.

SECTION 3 - EBITDA AND CASH FLOW

The principal earnings measure analyzed in QofE reports is EBITDA. Why do buyers and sellers focus on EBITDA?

First, EBITDA is the broadest measure of earnings and cash flow for the firm. As depicted in Exhibit 9, EBITDA is a proxy for cash flow available for a variety of purposes.

Exhibit 9 :: Potential Uses of EBITDA



Second, referencing EBITDA promotes comparability across firms. Working up from the bottom of the income statement, EBITDA provides the most consistent measure of relative operating performance across companies by "normalizing" for how different companies are organized, financed, and assembled.

- **Income taxes.** Many private companies are organized as tax pass-through entities and therefore report no income tax expense on the income statement. Since EBITDA is calculated without regard to income taxes, C corporations and S corporations are on equal footing.
- **Interest expense**. The decision to finance operations with debt rather than equity does not directly affect the operating performance of the business. Since EBITDA is calculated without regard to interest expense, the operating performance of highly leveraged companies can be readily compared to that of companies with no debt.
- **Depreciation.** Depreciation is a non-cash charge that depends on various accounting estimates and fundamental business decisions, such as whether to own or lease productive assets. Nonetheless, while it is true that depreciation does not represent a cash flow in the current period, it does arise from a real cash outflow in a prior period, and one that will need to be repeated as the asset wears out.
- **Amortization.** Acquisitive companies recognize acquired intangible assets on their balance sheets that are subsequently written off through amortization charges on the income statement. Companies that grow organically do not incur amortization charges. EBITDA is unaffected by amortization charges, thereby putting companies that grow organically and those growing by acquisition on an equal footing. Unlike depreciable fixed assets, amortizable intangible asset generally do not need to be replaced through subsequent cash outflows.

Not all EBITDA dollars are equally valuable, however. That is why some prominent investors like Warren Buffett are dismissive of the measure. Transactions are ultimately built on cash flow, not EBITDA. Therefore, a useful QofE report will not stop at EBITDA, but will also analyze the capital investments that stand between EBITDA and cash flow.

Of the five potential uses of EBITDA noted on Exhibit 9, four are discretionary, meaning that the buyer of a business will choose how to allocate EBITDA to those purposes:

- Interest payments depend on how a buyer elects to finance the business. If the buyer elects to finance the purchase with all equity, there will be no interest expense.
- While you can't really opt out of paying taxes, tax elections made by buyers will influence the form and magnitude of those payments.
- Debt payments depend on past and future financing decisions which are ultimately at the discretion of the buyer.
- The amount and timing of owner distributions are also at the buyer's discretion.

Since these four uses are a function of choices made by the buyer, they do not affect what a given dollar of EBITDA is worth. Capital investment, on the other hand, does influence the value of EBITDA since capital-hungry businesses with significant capital investment obligations to sustain operations generate less cash flow per dollar of EBITDA than their capital-light peers.

Capital investment consists of two components: capital expenditures and incremental working capital. A comprehensive QofE report should analyze each.

Capital Expenditures

Capital expenditures are essential to supporting a company's productive capacity. Broadly speaking, capital expenditures are required either to maintain existing capacity (i.e., maintenance expenditures) or add new capacity (growth expenditures). For capital-intensive businesses, a comprehensive quality of earnings report should distinguish between the two categories. Often, depreciation expense can serve as a proxy for maintenance expenditures when a more precise breakdown is not possible.

Exhibit 10 (on the next page) illustrates potential analyses around capital expenditures.

- Since capital expenditures are often lumpy, it can prove helpful to consider cumulative measure over longer periods of time. For the subject company in this example, five year aggregate capital expenditures represented 2.9% of cumulative revenue.
- For the same period, depreciation charges were equal to approximately 74% of capital expenditures, suggesting material growth expenditures.
- The efficiency of capital expenditures made can be measured by comparing the net balance of fixed assets to revenue over time. Over the period analyzed, this ratio declined from 9.5% to 7.8%, indicating improving capital efficiency.

Exhibit 10 :: Fixed Asset Rollfoward

	2018	2019	2020	2021	2022	Cumulative
Beginning balance - gross	$101,706	$121,654	$153,653	$171,019	$236,959	$101,706
plus: Capital expenditures	20,860	32,077	15,566	56,121	45,929	170,553
plus/less: Other, net	(912)	(78)	1,800	9,819	(22,279)	(11,650)
Ending balance - gross	$121,654	$153,653	$171,019	$236,959	$260,609	$260,609
Beginning balance - A/D	$27,923	$47,557	$71,043	$92,944	$117,915	$27,923
plus: Depreciation	19,573	23,197	24,616	25,732	32,889	126,007
plus/less: Other, net	61	289	(2,715)	(761)	(14,782)	(17,908)
Ending balance - A/D	$47,557	$71,043	$92,944	$117,915	$136,022	$136,022
Beginning balance - net	$73,783	$74,097	$82,610	$78,075	$119,044	$73,783
plus: Capital expenditures	20,860	32,077	15,566	56,121	45,929	170,553
less: Depreciation	(19,573)	(23,197)	(24,616)	(25,732)	(32,889)	(126,007)
plus/less: Other, net	(973)	(367)	4,515	10,580	(7,497)	6,258
Ending balance - net	$74,097	$82,610	$78,075	$119,044	$124,587	$124,587
Revenue	$778,833	$913,734	$1,091,721	$1,410,989	$1,595,222	$5,790,499
Capex / Revenue	2.7%	3.5%	1.4%	4.0%	2.9%	2.9%
Depreciation / Revenue	2.5%	2.5%	2.3%	1.8%	2.1%	2.2%
Net book value / Revenue	9.5%	9.0%	7.2%	8.4%	7.8%	
Depreciation / Beg bal (gross)	19.2%	19.1%	16.0%	15.0%	13.9%	
Accum depr as % of gross	39%	46%	54%	50%	52%	

Working Capital – Components and Cyclicality

The second component of capital investment is the annual change in working capital. Since working capital investment is sensitive to cyclical and seasonal factors, it is often appropriate to analyze working capital balances on a monthly basis. For illustrative purposes, we present a quarterly analysis for our sample company in Exhibit 11.

Exhibit 11 :: Working Capital Analysis

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Accounts receivable, net	10,221	10,477	12,796	13,010	17,114	12,968	14,727	14,672	12,413
Inventory	21,892	28,738	34,635	41,558	49,823	64,537	76,565	68,663	58,033
Prepaid expenses & other	2,763	3,824	3,724	3,694	4,623	6,185	6,370	5,244	5,206
Accounts payable	(19,316)	(18,757)	(22,763)	(25,950)	(29,894)	(26,158)	(31,889)	(19,190)	(22,003)
Accrued expenses & other	(13,917)	(11,349)	(13,564)	(15,134)	(20,673)	(19,032)	(20,300)	(16,719)	(33,031)
Taxes payable	(2,862)	(3,090)	(2,489)	(1,073)	(2,268)	(2,736)	(2,662)	(1,185)	(2,389)
Accrued payroll	(4,033)	(1,572)	(3,120)	(3,830)	(4,819)	(1,163)	(668)	(506)	(757)
Net working capital	**($5,250)**	**$8,271**	**$9,219**	**$12,275**	**$13,905**	**$34,601**	**$42,141**	**$50,979**	**$17,473**
NWC / net sales (annualized)	-2.2%	5.3%	4.1%	5.4%	5.0%	18.9%	16.1%	18.8%	6.2%
Days sales outstanding	16	25	21	21	23	25	20	20	16
Days inventory on hand	85	165	137	157	156	268	222	191	122
Days payables outstanding	75	88	79	85	89	95	81	52	63
Cash conversion cycle	27	102	79	94	89	198	161	159	75

The company's investment in working capital grew sharply over the two years analyzed, ballooning (as an annualized percentage of sales) from -2.2% at December 31, 2020 to 18.8% at September 30, 2022. The increase was primarily attributable to bloated inventory levels, which moderated during the fourth quarter of 2022, albeit at the expense of lower gross margin (37%, compared to 58% in 4Q21).

In addition to assessing the incremental working capital requirements over time, the working capital analysis in a QofE report is typically referenced when buyers and sellers are negotiating required working capital balances to be delivered at the closing of a transaction. These negotiations can lead to meaningful changes in the net proceeds received by sellers in transactions.

SECTION 4 - CONCLUSION

Corporate transactions are "measure twice, cut once" projects. An independent quality of earnings analysis plays an important role in the transaction process for both parties.

- For buyers, a thorough quality of earnings analysis is an essential component of the due diligence process. A quality of earnings report helps the buyer maintain pricing discipline by isolating the underlying ongoing earning power from the "noise" that often accompanies historical reported earnings.
- For sellers, a quality of earnings analysis can help position the company to increase the likelihood of achieving a premium price. Commissioning a quality of earnings analysis in anticipation of a sales process helps sellers present a compelling narrative regarding the true underlying earning power of the business for competing buyers.

Quality of earnings analysis is a multi-disciplinary task, requiring expertise in financial reporting and forensics combined with the judgment and expertise possessed by professionals with decades of experience in valuation and investment banking.

Additional Resources

5 Reasons Buyers Need a Quality of Earnings Report

Travis W. Harms, CFA, CPA/ABV

After sitting on the sidelines for much of 2022 and 2023, the prospect of Fed rate cuts may lure buyers back onto the field in 2024.

And when deal activity heats back up, due diligence will be as critical to buyers as ever. For many buyers, a quality of earnings ("QofE") report is a cornerstone of their broader diligence efforts.

For businesses, an acquisition that goes sour can negatively affect family wealth for decades to come. Obtaining a thorough QofE report as part of deal diligence can help business directors avoid such a misstep. In this article, we review five reasons business directors need a QofE report before approving an acquisition.

1. Avoid overpaying for earnings that aren't sustainable.

Audited financial statements provide assurance that the past performance of the target company is faithfully represented. However, successful acquirers are focused on the future, not the past. A thorough QofE report helps buyers extract what truly sustainable performance is from the welter of the target's historical earnings. Paying for historical earnings that don't materialize in the future is a recipe for sinking returns on invested capital. QofE reports analyze historical earnings for adjustments that convert historical earnings to the pro forma run rate earnings that make an acquisition worthwhile.

2. Identify opportunities for cost savings in the target's expense base.

The detailed analysis of cost of sales and operating expenses in a QofE report can uncover opportunities for acquirers to boost margins at the target through cost-saving initiatives. By observing trends in headcount by function, occupancy, and other components of operating expense, buyers can identify redundancies and develop strategies for enhancing post-acquisition cash flow from the target.

3. Find revenue synergies with your existing business.

A thorough QofE report is not just about expenses. Observing revenue trends by product and business segment, coupled with analysis of customer churn data, can help buyers better understand how the target "fits" with the existing business of the buyer, which can open up strategies for fueling revenue growth in excess of what either company could accomplish on a standalone basis. Armed with a better understanding of opportunities for revenue synergies, buyers can move to the closing table more confident of the upside to be unlocked through the transaction.

4. Clarify working capital needs of the target.

Incremental working capital investment is the silent killer of transaction return on investment. A thorough QofE report will move beyond the income statement to evaluate seasonal trends in the core components of net working capital. Doing so helps buyers plan adequately for the ongoing working capital requirements they will need to fund out of post-acquisition earnings. Working capital analysis in the QofE report also helps buyers negotiate appropriate working capital targets in the final purchase agreement.

5. Assess capital expenditure needs at the target.

Not every dollar of EBITDA is equal. EBITDA multiples are a function of risk, growth, and capital intensity. Buyers cannot afford to overlook capital intensity when evaluating targets. A thorough QofE report examines historical trends in capital expenditures and fixed asset turnover to help buyers better discern the prospective capital expenditure needs of the target and how those needs influence the transaction price and prospective returns.

Conclusion

For businesses contemplating an acquisition, the stakes are high. You can't eliminate risk from an M&A transaction but obtaining a thorough QofE report on the target can help directors avoid mistakes and increase the odds of a successful deal. If you are considering an acquisition, give one of our senior professionals a call to discuss how our QofE team can generate *Insights That Matter* for your diligence team.

5 Reasons Sellers Need a Quality of Earnings Report

Timothy R. Lee, ASA

M&A deal flow was sidelined for much of 2022 and 2023, but the economy's soft landing, stabilizing interest rates, and pent-up M&A demand are expected to compel buyers and sellers to renew their efforts in 2024 and beyond.

As deal activity recovers, sellers need to be prepared to present their value proposition in a compelling manner. For many sellers, an independent Quality of Earnings ("QofE") analysis and report are vital to advancing and defending their asset's value in the marketplace. And it can be critical to the ensuing due diligence processes buyers apply to targets.

The scope of a QofE engagement can be tailored to the needs of the seller. Functionally, a QofE provider examines and assesses the relevant historical and prospective performance of a business. The process can encompass both the financial and operational attributes of the business.

In this article, we review five reasons sellers benefit from a QofE report when responding to an acquisition offer or preparing to take their businesses to market.

1. Maximize value by revealing adjusted and future sustainable profitability.

Sellers should leave no stone unturned when it comes to identifying the maximum achievable cash flow and profitability of their businesses. Every dollar affirmed brings value to sellers at the market multiple. Few investments yield as handsomely and as quickly as a thorough QofE report. A lack of preparation or confused responses to a buyer's due diligence will assuredly compromise the outcome of a transaction. The QofE process includes examining the relevant historical period (say two or three years) to adjust for discretionary and non-recurring income and expense events, as well as depicting the future (pro forma) financial potential from the perspective of likely buyers. The QofE process addresses the questions of why, when, and how future cash flow can benefit sellers and buyers. Sellers need this vital information for clear decision-making, fostering transparency, and instilling trust and credibility with their prospective buyers.

2. Promote command and control of transaction negotiations and deal terms.

Sellers who understand their objective historical performance and future prospects are better prepared to communicate and achieve their expectations during the transaction process. A robust QofE analysis can filter out bottom dwelling opportunists while establishing the readiness of the seller to engage in efficient, meaningful negotiations on pricing and terms with qualified buyers. After core pricing is determined, other features of the transaction such as working capital, frameworks for roll-over ownership, thresholds for contingent consideration, and other important deal parameters are established. These seemingly lower priority details can have a meaningful effect on closing cash and escrow requirements. The QofE process assists sellers and their advisors in building the high road and keeping the deal within its guardrails.

3. Cover the bases for board members, owners, and the advisory team and optimize their ability to contribute to the best outcome.

The financial and fiduciary risk of being underinformed in the transaction process is difficult to overcome and can have real consequences. Businesses can be lovingly nurtured with operating excellence, sometimes over generations of ownership, only to suffer from a lack of preparation, underperformance from stakeholders who lack transactional expertise, and underrepresentation when it most matters. The QofE process is like training camp for athletes — it measures in realistic terms what the numbers and the key metrics are and helps sellers amplify strengths and mitigate weaknesses. Without proper preparation, sellers can falter when countering an offer, placing the optimal outcome at risk. In short, a QofE report helps position the seller's board members, managers, and external advisors to achieve the best outcome for shareholders.

4. Financial statements and tax returns are insufficient for sophisticated buyers.

Time and timing matter. A QofE report improves the efficiency of the transaction process for buyers and sellers. It provides a transparent platform for defining and addressing significant reporting and compliance issues. There is no better way to build a data set for all advisors and prospective buyers than the process of a properly administered QofE engagement. This can be particularly important for sellers whose level of financial reporting has been lacking, changing, outmoded due to growth, or contains intricacies that are easily misunderstood.

For sellers content to work their own deals with their neighbors and friendly rivals, a QofE engagement can provide some of the disciplines and organization that are typically delivered by a side-side representative. While we hesitate to promote a DIY process in this increasingly complicated world, a QofE process can touch on many of the points that are required to negotiate a deal. Sellers who are busy running their businesses rarely have the turnkey skills to conduct an optimum exit process. A QofE engagement can be a powerful supporting tool.

5. In one form or another, buyers are going to conduct a QofE process – what about sellers?

Buyers are remarkably efficient at finding cracks in the financial facades of targets. Most QofE work is performed as part of the buy-side due diligence process and is often used by buyers to adjust their offering price (post-LOI) and design their terms. It is also used to facilitate their financing and satisfy the scrutiny of underlying financial and strategic investors. In the increasing arms race of the transaction environment, sellers need to equip themselves with a counteroffensive tool to stake their claim and defend their ground. If a buyer's LOI is "non-binding" and subject to change upon the completion of due diligence, sellers need to equip themselves with information to advance and hold their position.

Conclusion

The stakes are high in the transaction arena. Whether embarking on a sale process or responding to an unsolicited inquiry, sellers have precious few opportunities to set the tone. A QofE process equips sellers with the confidence of understanding their own position while engaging the buy-side with awareness and transparency that promotes a more efficient negotiating process and the best opportunity for a favorable outcome. If you are considering a sale, give one of our senior professionals a call to discuss how our QofE team can help maximize your results.

What to Look For in a Quality of Earnings Provider

Nicholas J. Heinz, ASA and Travis W. Harms, CFA, CPA/ABV

The cost of corporate M&A failures is high for both buyers and sellers.

- For buyers, overpaying for a target can hamper returns and crowd out other more attractive investment opportunities for years to come.
- Sellers only get one chance to sell their businesses. Failing to maximize proceeds represents a missed opportunity they can never get back.

These high stakes mean that thorough and high-quality due diligence is critical. A Quality of Earnings (or QofE) analysis is an essential component of transaction diligence for both buyers and sellers. Optimizing your transaction diligence requires assembling the right team.

In this article, we discuss four things buyers and sellers should look for when evaluating potential QofE providers.

1 . Transaction Experience

Don't view your QofE analysis as a mere "check box" on your diligence list. A QofE report should provide genuine insight about the target before you reach the closing table. While a QofE analysis can, in some respects, feel like an audit, it is not one. Instead, it is a component of transaction diligence, so you should inquire about a potential provider's transaction experience.

- Has the QofE provider represented buyers or sellers in transactions?
- Has the QofE provider advised buyers on M&A strategy?
- Has the QofE provider rendered fairness or solvency opinions?

2. Valuation Perspective

A quality of earnings analysis is not a valuation. However, every valuation includes an assessment of earnings quality. A QofE provider that brings a valuation perspective to the engagement is more likely to identify insights that matter to the proposed transaction price (i.e., valuation). Because of the close connection between QofE analysis and valuation, you should inquire as to a potential provider's valuation perspective.

- Does the QofE provider have an active valuation practice?
- Do any of the QofE provider's team members hold recognized valuation credentials?
- Do the members of the QofE provider's team undertake continuing professional education in valuation topics?

3. Technical Expertise

A quality of earnings analysis requires attention to detail, a thorough understanding of generally accepted accounting principles, and familiarity with the practical elements of accounting practice. Certified public accountants with audit experience are likely to possess each of these attributes.

- Does the QofE provider's team include one or more experienced CPAs?
- Does the QofE provider's team include members with audit or industry experience?

4. A Deep Bench

Transactions don't wait. When it is time to move on a deal, you can't waste time waiting for your QofE provider to catch up. When evaluating QofE service providers, you should inquire about the depth of resources they can bring to your assignment.

- Does the QofE provider have multiple engagement leaders capable of overseeing your engagement?
- Does the QofE provider have a pool of qualified staff capable of executing on the engagement on your timetable?

Conclusion

Successful buyers and sellers take Quality of Earnings analyses seriously. This requires taking care to select a QofE provider that can be a valuable member of your transaction diligence team. The best QofE providers generate relevant insights before you close your transaction – those insights are most likely to come from a team with a broad and deep technical skill set, transactional experience, and a valuation perspective.

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