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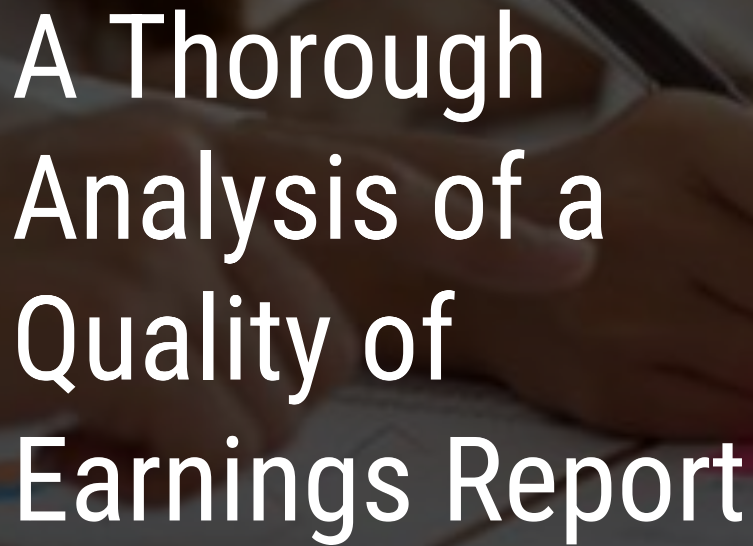


A Thorough Analysis of a Quality of Earnings Report

December 2023

What is a Quality of Earnings report?

Defining the quality of earnings (QoE) involves considering whether earnings are cash or noncash, recurring or nonrecurring, and based on precise measurement or subject to change through estimates. Assessing earnings quality aids financial statement users in forming judgments about the certainty ofcurrent income and future prospects.

The fundamental idea behind a Quality of Earnings (QoE) is to exclude non-recurring, non-operational revenue and expense items, along with extraordinary events that fall outside the realm of normal operations.

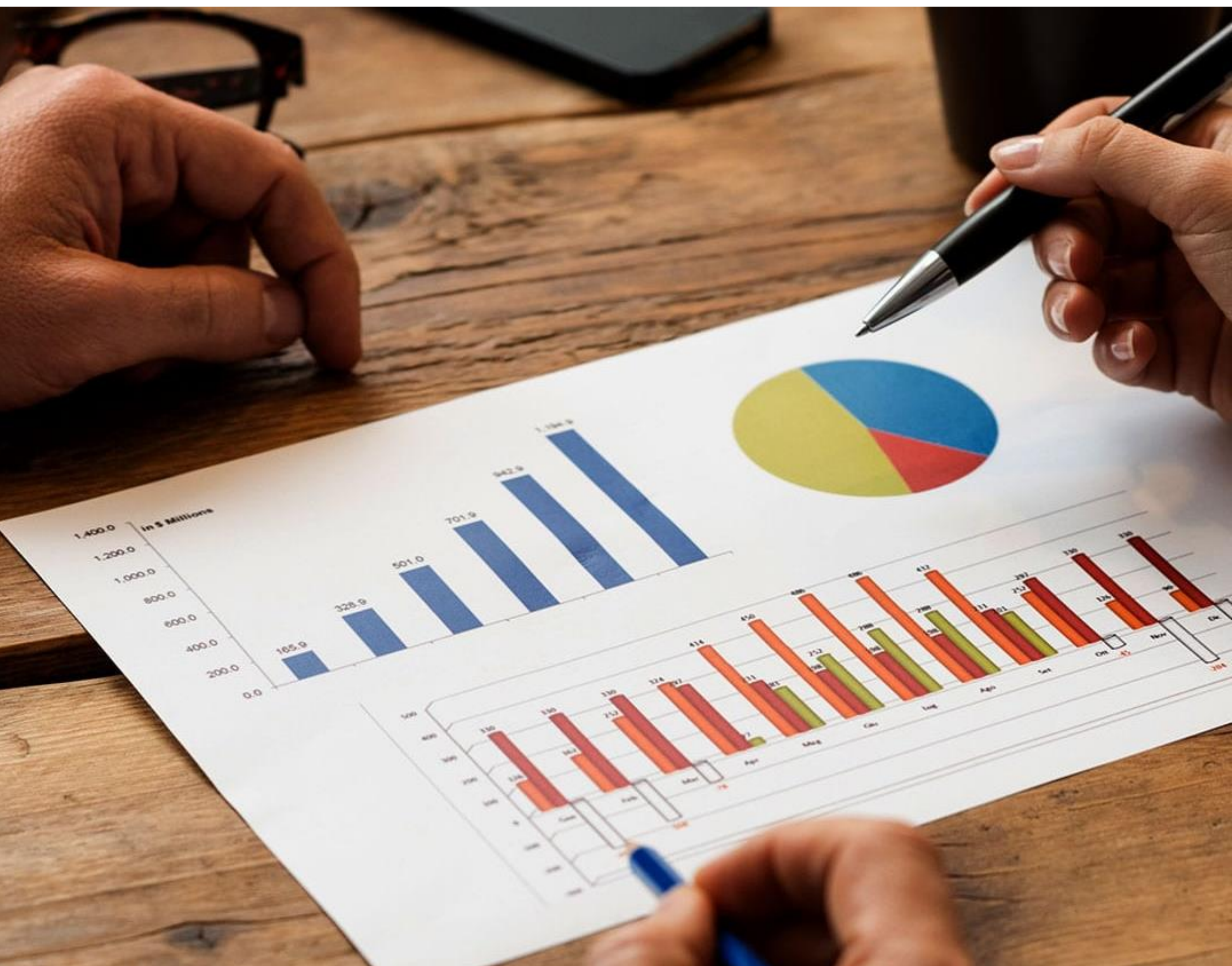
A concise and unambiguous Quality of Earnings (QoE) report facilitates:

- A more efficient transaction process
- Enhanced transparency and insights
- A well-defined understanding of operations

Why QoE report is important?

A Quality of Earnings (QoE) report is a standard aspect of the due diligence process for private acquisitions. Net income alone may not provide a wholly accurate representation of a business's financial performance. For instance, if a company showcases substantial net income figures but exhibits negative operating cash flow, its financial stability might be less robust than it appears. The QoE report evaluates how a company generates its revenues—considering factors like cash or non-cash, recurring or nonrecurring income.

Income statements often lack crucial details, underscoring the significance of comprehending a company's cash sources. Simply put, if a company boasts a positive net income but demonstrates poor-quality earnings, acquiring it could entail more investment risk than suggested by its financial statements. This evaluation significantly influences the decision-making process for potential acquirers in private acquisitions.



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What are High Quality and Lower-Quality Earnings?

The concept of quality of earnings serves as a risk assessment metric. When a company's revenue is influenced by factors beyond fundamental sales and cost reduction, the quality of earnings tends to be perceived as lower.

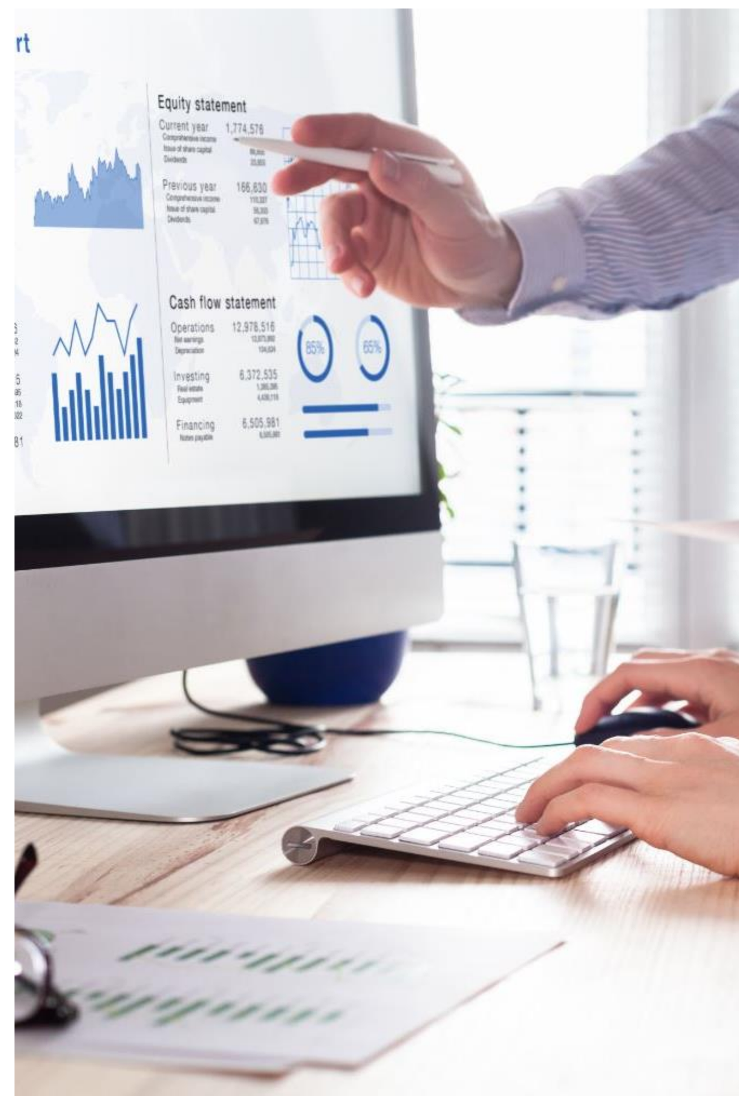
In essence, high-quality earnings exhibit stability across multiple reporting periods and allow the company to generate substantial free cash flow. On the contrary, revenue that is less predictable, sustainable, or certain typically characterizes lower-quality earnings. It's essential to recognize that each business is unique, and there is no clear-cut distinction between high-quality earnings and others. The industry in which a business operates can also impact the perceived risk associated with recurring or 'sticky' revenues.

Moreover, lower-quality earnings don't necessarily indicate problems or suggest that the overall business is of lower quality. Uncertainty may stem from one-time cash influxes that, despite being nonrecurring, positively reflect the company's financial strength.

Common Reasons for Lower-Quality Earnings:

In assessments outlined in earnings reports, various accounting issues, events, or financial conditions may be identified that are not directly linked to the company's revenue. These include macroeconomic factors such as broader economic inflation. Indicators of lower-quality earnings may include:

- Adjustments to net income
- Aggressive or optimistic accounting and financial forecasting
- Flat cash flow despite increased income
- Deferred debt repayments
- Earnings relatively low compared to the cost of capital
- High levels of accounts receivable or unrealized revenue
- Low cash reserves
- One-time revenue unlikely to recur
- Issues with GAAP reporting
- Related party transactions
- Stock buybacks
- Deferred capital investments
- Inconsistent US GAAP application
- Supporting schedules and system reports that do not reconcile with the general ledger."



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It's crucial to recognize that "lower" quality earnings don't necessarily indicate poor financial reporting or the misapplication of accounting policies. Often, lower quality earnings pertain to transactions inherently more subjective or with a higher degree of risk or uncertainty. Accounting standards are intentionally flexible to accommodate various industries, geographies, marketplaces, and circumstances. Some degree of judgment or estimation is typically required in applying accounting principles, depending on the measurability, predictability, and commonality of a transaction or situation.

For instance, a bank may not precisely predict the collection portion of its outstanding loans, but historical data, industry insights, and understanding of the customer base and market trends can aid in estimating the loan-loss reserve. Management can interpret assumptions conservatively or aggressively, considering the unknown nature of the measured item. However, since the estimate's accuracy remains uncertain for some time, it cannot be definitively termed "right" or "wrong." Therefore, clear and comprehensive disclosure becomes imperative.

Defining the Scope of a Quality of Earnings Analysis

A QoE analysis serves as a comprehensive evaluation aimed at understanding and assessing various facets of a company's financial landscape, operational efficiency, and adherence to key policies and accounting practices. The scope of this analysis typically encompasses the one or two most recent fiscal years and the last 12-month interim period, commonly referred to as LTM or TTM.

Time Frame:

The analysis is concentrated on the income statement, with a focus on the one or two most recent fiscal years and the last 12-month interim period. This duration provides a holistic view of the company's financial performance.

Comprehensive Insight:

- While the income statement takes center stage, a QoE analysis extends its purview to other financial statements, offering insights into various operational aspects.
- Examination of the condition and valuation of diverse assets on the balance sheet, key customer and product evaluations, working capital needs, and other pertinent factors crucial to the Buyer's decision-making process.

Ratio Analysis:

- The analysis incorporates ratio analysis, a vital tool for identifying any potential red flags within the company's operations.
- By delving into key financial ratios, the QoE analysis provides a deeper understanding of the company's financial health and operational efficiency.
- In essence, the scope of a Quality of Earnings analysis is comprehensive, encompassing various financial dimensions and operational intricacies to provide a thorough assessment for potential buyers.

How is a Quality of Earnings Analysis Conducted?

Quality of Earnings

Evaluating financial performance

Normalising earnings

In the course of a quality of earnings analysis, the advisory team systematically collects and scrutinizes detailed account-level data from a company's Profit and Loss Statement (P&L) and Balance Sheet. The objective is to delve into the fundamental components of the company's earnings, pinpoint potential issues, and highlight areas of concern. This involves:

- Assessing the quality, sustainability, and accuracy of the company's financial performance, illuminating its historical financial patterns and the robustness of its earnings.
- Normalizing earnings, contemplating how the company would have operated under "normal" or "new" conditions. The ultimate aim is to eliminate the impact of extraordinary and non-operational events.

What Aspects Does a Quality of Earnings Analysis Cover?

A quality of earnings analysis delves into three crucial areas, forming the foundation of the resulting quality of earnings report: adjusted EBITDA, proof of cash, and working capital.

Adjusted EBITDA:

EBITDA (earnings before interest, tax, depreciation, and amortization) serves as a focus on the core operational and accounting-standard-compliant earnings. Often utilized as a proxy for 'operating' cash flow in middle-market M&A, EBITDA is instrumental in setting enterprise value for transactions in this segment. By excluding non-operating items, EBITDA offers a clearer snapshot of a company's operating performance and profitability. Adjusted EBITDA, a crucial metric in due diligence, undergoes validation through a comprehensive examination of the Profit and Loss (P&L) and Balance Sheet accounts.

The quality of earnings analysis ensures compliance with accounting standards by adjusting EBITDA according to the terms outlined in the Letter of Intent (LOI). However, it emphasizes that complete accounting compliance should not solely rely on the LOI.

These meticulous evaluations within the adjusted EBITDA framework contribute significantly to the overall quality of earnings analysis.

Proof of Cash:

This phase involves a thorough comparison of the cash inflows and outflows recorded in bank statements with the revenue and expenses reported in the company's financial statements. Adjustments are made for accrual accounting considerations.

By validating these aspects, potential buyers gain confidence that the reported earnings align with actual cash transactions.

The proof of cash extends beyond mere validation; it provides valuable insights into the company's cash cycles and its overall financial standing.

Working Capital:

The quality of earnings analysis delves into the company's working capital dynamics, shedding light on cash cycles and the cash required for operational needs.

Examination of the management of current assets and liabilities assesses the company's ability to efficiently navigate cash flow, pinpointing any areas of concern.

In transactions, negative net working capital can trigger liquidity and financial management apprehensions. In middle-market deals, buyers often structure transactions as 'cash-free and debt-free,' signaling their commitment to providing additional working capital post-closing to address any negative net working capital situations.

These comprehensive evaluations of cash-related aspects enhance the overall precision and reliability of the quality of earnings analysis.

Understanding Different Types of QoE Reports

Buy-Side QoE:

This is the conventional form of Quality of Earnings analysis and is conducted as part of due diligence on behalf of a Buyer interested in acquiring a target company from a Seller.

- Key Focus: The primary objective is to provide the Buyer with a thorough assessment of the target company's financial performance, historical trends, and potential risks or opportunities.
- Scope: The analysis delves into various financial aspects, including income statements, balance sheets, working capital considerations, and key operational factors.

Sell-Side QoE:

This type of analysis is initiated by the Seller in preparation for a potential sale of the company.

- Key Focus: The focus is on presenting the company in the best possible financial light to potential Buyers.
- Scope: Similar to buy-side diligence, it involves comprehensive procedures and analyses, but with potential variations influenced by the Seller's perspective and desired interpretation of adjustments and historical trends.
- Timing: Sell-side QoE typically precedes buy-side diligence and aims to proactively address any concerns that may arise during the sale process.

In summary, while buy-side QoE is a standard part of acquisitions, sell-side QoE is less frequent and is driven by the Seller's proactive preparation for the sale, emphasizing a strategic presentation of the company's financial value.

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