CAPITAL RESTORATION

Transforming Enterprises

Quality of Earnings Report:

Is it adding value to your deal flow

All too often we hear of transactions that did not work out as planned.

The ability to identify critical trends and understand what is behind the numbers can have a real impact on the transaction value and its ultimate success.

In one such case, a long time low earnings enterprise was having impaired earnings and a QOE report / assessment was requested. In the end, the report found a company with a solid workforce, solid manufacturing facilities, consistent application of GAAP, profits across most of the product lines, with a bumbling CEO with a pet project. Because this QOE report went beyond the numbers the company went on to generate 10X historical earnings and a profitable exit.

The primary objective of a quality of earnings report is to assess the sustainability and accuracy of historical earnings as well as the achievability of future projections. Many reports just provide detailed analysis of the company's revenue and expenses. While these are critical elements a QOE report they alone will not provide a clear picture of the enterprises ability to continually generate those earnings. A QOE report that broadens the scope to include a review of the company's integrity, management assessment, and an operational overview may lend critical information on the enterprises ability to generate future earnings.

A QOE report is not an audit. An audit's purpose is to provide assurance that management has presented a true and fair view of a company's financial performance and position, through testing and analytical procedures with an emphasis on the balance sheet. A QOE report's purpose is to identify issues likely to be of interest to a buyer or seller regarding the economic earning power of a going concern.

Capital Restoration LLC is a boutique strategic management consulting firm with a financial focus providing due diligence services to investors and lenders as well as working with companies in transition to improve financial and operational performance.

The QOE report may cover a wide range of areas including; management, operational, marketing and financial matters. Financial due diligence (often referred to as "accounting" due diligence) is focused on providing potential investors with an understanding of a company's:

- sustainable economic earnings,
- historical sales and operating expense trends,
- historical working capital needs, and
- key assumptions used in management's forecast.

Although audits may provide a starting point for a potential investor's evaluation of a company, they generally do not comment on the focus areas noted above.

What follows are some of the basic factors one might find in a QOE report. The following items are not all-encompassing, but discuss a few accounts / issues starting with historical financials.

Financial Data

Receivables

- Is the increase in AR an increase in sales or slow collections?
- Was the sales cut off done correctly?
- What is the AR turn trend – can be helpful in identifying issues within the organization or customer base.
- Is the company buying future sales impairing future earnings?

Inventories

In today's world most companies have a perpetual inventory system, but what cost method was used and is the underlying data materially correct. While this is a balance sheet item its fluctuation impacts gross profit

- Is the inventory salable?
- Is the costing build up correct?
- What is the individual inventory turns of substantive items? Obsolesce?

- Has previously reserved or written off goods been added back to the ending inventory increasing period profits in the most recent periods?
- Are adequate supplies and sources available to meet future demand?
- Will future earnings be impaired by move slow moving goods?

Fixed Assets

- Can the current equipment meet sales growth?
- Is the current equipment efficient and competitive?
- Has the company been aggressive in capitalizing?
    - *In one case the company was capitalizing custom software for customers that would not result in ongoing revenue nullifying the EBITDA projections.*
- Has the inventory increased in recent periods decreasing cost of sales or is it a real inventory increase?
- Does the cash flow forecast reflect capital needs?

Current Liabilities

- Are there over accruals to smooth out earnings?
- Are all accruals properly recorded?
- Are systems in place for proper recording of liabilities when incurred?

Revenue

- Are sales really revenue under GAAP?
- How does the company account for discounts and rebates?
- Has the company bought revenue via deep discounts?
- What is the customer concentration?
- What are margins by customer – is margin concentrated in a small group of customers
- What are the margin on specific products and its impact on profitability?
- Are there non-recurring revenue?

Pension Plan Expenses

- Are pension costs properly recorded

Nonrecurring Operating Items

- Do the current period financial results include nonrecurring items?
- Are the seller add backs real?
- Are their costs missing that will be incurred by a buyer?
- Are staffing and other resources appropriate to meet sales growth plans?

Tax Planning

- Does the company have an aggressive tax strategy that could result in future costs?

Forecast / business planning

Does the company use activity based planning breaking down sales by customer / product / aliening costs to revenue drivers / analyzes changes in working capital components / plans for fixed asset acquisitions that keeps the company competitive and a cost leader within its industry.

In many ways this is one of the most critical documents to be reviewed or created. It is the company's ability to generate future cash and earnings that will support the purchase price or debt service.

Non-Financial Items:

- Does management have the expertise and experience to meet the growth plans?
- What additions / changes to the management team are essential to meeting growth plans?
- Are the current facilities, equipment and systems providing essential efficiencies and were appropriate a low cost producer?
- Does the report include interviews with rank and file employees who are essential to the success of the enterprise?

- Can the current systems and procedures support the company into the future?
- What is the management style – free flowing information, a top down dictator, lazy fair, consultative, consensus driven or other ?
- Has the management team bought into the business plan?
- Does the CFO have a voice or are they a bean counter?

Conclusion:

Central to a QOE report is EBITDA followed by adjusted EBITDA. Adjusted EBITDA is the key number in a transaction as it is the number to which a multiplier is attached. GAAP reporting does not address adjusted EBITDA.

A well-researched and developed QOE report goes beyond an accounting review of the financial statements. It looks at whether an enterprise and proposed transaction have the necessary financial, human, capital, and other resources to execute the strategic plan.

The firm engaged to produce your QOE report should include seasoned operating professionals with strong forensic skills. Most CPAs / financial professionals do not have the combined operating and forensic skills necessary to execute a quality QOR report necessary to enhance the decision process and pricing.

With multiples of 4 to 8+ X for a privately held enterprise the ability of the QOR report to enhance pricing will pay big dividends.

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Armand is the founder and managing director of Capital Restoration LLC. He provides transaction advisory services, consulting to companies in transition, debt restructuring, M & A consulting and interim "C" suite services for companies in transition. He has won national awards for his forensic, pro bono and restructuring work.