What To Expect from a DD or QOE Report

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The Quality of Earnings Report, or QOE, is an integral part of a responsibly conducted merger or acquisition deal. During the financial due diligence part of the transaction agreement, a QOE report will be drawn up for both the buyer and the seller detailing the quality of earnings for the company to be acquired. The report details the sources of income for the company, any outlying or unusual amounts of revenue as well as nonrecurring revenue sources, any accounting method changes that may have impacted income or revenue recognition for the year, and how net income compares to the cash flow statement.

Why is the QOE important?

The QOE is part of a responsibly conducted merger or acquisition deal. Both buyer and seller need a more accurate and detailed picture of the worth of the company to be acquired for valuation purposes or, in extreme cases, to know whether to continue with the deal in the first place.

One might wonder why a quality of earnings report is necessary when an audit of the company to be acquired is already part of the process. There are a few reasons for this. First, the QOE focuses on the income statement and cash flow statement as metrics of the actual earnings of the company, whereas the audit focuses on balance sheet items as well. Imagine the audit committee taking the owner's equity section of the balance sheet and taking a magnifying glass to those few line items. That's not part of their job to do – it's the QOE team's job to do that specialized work. Second, and leading from this point, the QOE work is classified as consulting, not attestation, so the report can be as broad or as detailed as circumstances require, depending on the complexity of the organization's finances.

Good quality of earnings means that a company follows accounting principles generally accepted in the United States, and that actual cash flow is going to track closely to income reported, rather than income being artificially inflated to satisfy investors, or artificially deflated to minimize taxable income. It also means that the company has fairly steady revenue streams, rather than income for a particular year being artificially inflated by outside factors. It could be unusually low expenses due to outside circumstances, or it could be a one-off deal that the company participated in that particular year. QOE sets those items aside to look at a company's core economic health. A QOE analysis can be detailed but we can perform a *QOE light* which can flag major or key items to be watched and adjusted for in the merger transaction.

Who reads them?

Different QOE reports can be prepared for buyer and seller, focusing on specific things that each party will be interested in. The buyer's QOE can detail the earnings of the company and recommendations for pricing the transaction. The seller's QOE report can detail any discrepancies that the seller will be able to rectify to expedite the transaction. While the bulk of the material for each side will be the same, it can be presented in a way that is most relevant to both buyer and seller, since the entire purpose of a QOE report is to make a transaction as clean and smooth as possible. At the beginning of the engagement, procedures typically performed by the QOE team are agreed upon with the client and users of the report. Our procedures can cover an analysis of target company revenues, expenses, receivables, payables, debt, investments, inventory, cash flows, working capital, depreciable assets, equity roll-forward, etc. We will look at typical management adjustments to earnings and also interview with personnel involved in financial and related operations. We will present to you our finding in a summary.

What should you expect to see when you read a QOE report?

A QOE report will be divided into the following main sections.

- Executive Summary

The Executive Summary portion of the QOE report will have a summary of the business, a summary of the proposed transaction underway, and a summary of the consultation team's findings and any recommendations to action they may have. The business summary will include such information as the age of the company, its history, organizational structure, financial holdings and shareholders, and tax status. The transaction summary will include all necessary information about the transaction, such as the name of the buyer, which parts of the target and any subsidiaries are being acquired, the proposed purchase price, and its relationship to the earnings and value of the acquisition target. The summary typically includes adjusted results of operations, reconciliation to free cash flows, and changes in adjusted net working capital. The summary can also include other significant financial statement item analyses like sales by customer, purchases by vendor, and other operating trends.

Depending on the target company's individual situation, the QOE consulting team may choose to use EBITDA as a measure of earnings or may choose another metric such as free cash flow to more accurately represent the actual cash available to investors and debt holders. An example of a situation where free cash flow might be a better metric to use would be if the acquisition target was expected to owe significant taxes or make significant interest payments.

The QOE will also include an assessment of the risk involved in the income streams of the acquisition target. A relevant example in the current economy would be an acquisition target in an industry that follows the economy in a recession and might be on the verge of a downward trend that would not be reflected in past years' earnings.

- Revenue Analysis

The QOE team will study the different income sources on the income statement, remove any anomalous amounts, and analyze the recurring sources of revenue. Such analysis will compare year over year revenue and TTM revenue for two years. We can also look at normalized revenue as determined by management which may take into consideration any aberrations and sustainability of the revenue stream.

- Quality of Earnings Analysis

This analysis typically shows the EBITDA reconciliation where EBITDA is reconciled down from reported EBITDA to management, our due diligence and proforma adjusted EBITDA. We typically explain the key items in the reconciliation.

- Income Statement and Balance sheet Analysis

This analysis will include a comparison of two years of income statement and balance items with a trend explanation of major line items.

- Net working capital

We will analyze how the target company's net working capital has changed for the past two years. This will reconcile from reported net working capital to adjusted working capital incorporating diligence and proforma adjustments. Proforma adjustments can include potential changes to debt and other liabilities.

- Balance Sheet

While QOE is primarily an income statement investigation, the consulting team will need to go to the balance sheet to investigate number of shares outstanding, earnings per share, and whether the company was engaged in any buyback activities to artificially boost earnings per share. Finding that the company took on additional debt in order to buy back stock and inflate earnings per share should raise questions about the true profitability of the company and is a red flag.

- Other Considerations in a QOE

The QOE will also look at factors off the financial statements that could affect the risk, future profitability, and overall health of the acquisition target. These could include inquiry and adjustments for a large number of related-party transactions, any pending legal suits or disputes, off-book assets or liabilities, or underfunded pension plans. Since they do not show up in an audit of the financial statements, they can be easy places for a company to hide risky activities or financial skeletons in the closet. These items are of the highest importance and can make or break a transaction.

A thorough, well-conducted quality of earnings investigation is of the highest importance for both buyer and seller in a merger or acquisition deal. It allows both parties to have the highest degree of assurance that the acquisition target is in the state of financial health that it is alleged to be. This allows both parties to negotiate the most accurate sale price of the transaction, leading to a healthier transaction on both sides.

Kislay Shah CPA is ready to help you and your business with your accounting and consulting needs. You can reach Shah at *kislay@shahcpaus.com* or call at 646-328-1326.