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WHAT IS A QUALITY OF EARNINGS REPORT AND WHY MIGHT I NEED IT?

BY JEFF KAMIN, CPA

Financial data can be interpreted in several different ways depending on how it is looked at.

The information extracted from a set of data and the importance placed on it is derived from circumstance and purpose. When a potential buyer of a business seeks to validate the initial impressions they developed during the pre-due diligence phase of an M&A transaction, their primary purpose is to determine the quality of the earnings presented to them in the financials and other management reports. At first glance, trying to ascertain the quality of a company's earnings seems like a potentially nebulous affair. The purpose of a quality of earnings (QofE) study is to hone in on the relevant considerations of quality that will allow a potential investor to feel comfortable with their assessment of the business.

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The first step is to specify that a quality of earnings study is not – namely an audit. While the purpose of an audit is to test the representations of management in material respects for a whole year, a quality of earnings study focuses much more on the sustainability of earnings for a more recent period, typically the trailing twelve months. The specific earnings metric commonly examined is EBITDA – Earnings Before Interest, Taxes, Depreciation, and Amortization – which is an indicator of the efficiency and profitability of a business's operations. The key difference between EBITDA and net income is that EBITDA excludes the effects of a company's capital structure, the non-cash effects of depreciation and amortization, and the amount of tax the entity pays. This makes EBITDA a more accurate measure of a company's true earnings power. However, EBITDA alone can be misleading for any number of reasons.

For example, excess owner's compensation or personal expenses being run through a business in a closely held company distort the true earnings from operations. There can also be one-time expenses, such as the payout of a litigation settlement that can significantly drive down EBITDA for a particular period but have no relevance for future periods. Therefore, the authors of Quality of Earnings reports need to analyze the balance sheet and income statement of a business to build a more complete picture of the quality of earnings.

The following are some of the areas we look at when performing a Quality of Earnings study:

REVENUE AND COSTS

- **Sales Fluctuation Analysis** – Is the business given to cyclical revenue that impacts it's cash flow strategy or does it have a relatively even inflow of revenue year over year and month over month?
- **Customer Concentration** – How much does the company rely on a small number of large customers to drive revenue? Furthermore, what is the company's strategy for replacing a terminated customer relationship?
- **Churn Rate** – How often is the company losing customers and is the reason industry-driven or more specific to the operational management of the company itself?
- **One-Time vs. Recurring Revenue** – How sustainable is the revenue the company generates? Is revenue over a specific period being driven by one-time vs. monthly or annually repeating engagements?
- **Comparable Company Analysis** – How do the margins of the business compare to similar companies for which public financial data is available?
- **Material and Labor Cost Trends** – How do supply chain constraints or labor market shortages impact the company's ability to maintain its margins?
- **Normalization of Trailing Twelve-Month Earnings** – Are there expense or income items that need to be allocated more evenly across a trailing twelve-month period to bring them more in line with a typical fiscal year?

Of course, a healthy income statement can only tell so much. Great revenue by itself is a bit hollow if earnings aren't efficiently being converted into cash. Furthermore, we also want to know if that cash is being put to good use. In addition to examining Accounts Receivable (A/R) turnover ratios and the conversion of A/R into cash, it's important to look at trends in accounts payable, as well as working capital and capital expenditure for fixed assets. In an M&A transaction, it is usually net working capital that is part of a transaction (current assets, excluding cash less current liabilities, excluding debt) since cash and debt are quite often excluded from purchases (the so-called cash-free, debt-free transaction).

Additionally, directly tied to the concept of quality is the amount of available free cash flow. This is defined as EBITDA plus or minus the change in net working capital minus capital expenditure replacement cost minus taxes paid. This is called the Free Cash Flow and is, in effect, the amount of cash available to the owners of the business.

The above components of a QofE are not a comprehensive list of the items to consider and they vary on a case-by-case basis. Regardless of the company specifics, the quality of earnings study is an essential component of the due diligence process in helping to determine whether a company's ability to sustain earnings and convert those earnings into cash for ownership aligns with representations made in the pre-diligence process of an M&A transaction.

Contact our experts if you have any questions on Quality of Earnings Reports, Due Dilligence, or M&A Transactions.

About the Author

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Jeff Kamin is a Senior M&A and Capital Markets Manager at KROST. He has been with the firm since June 2014 and has been in public accounting for nearly 15 years. Jeff focuses on financial reporting and consulting engagements and handles clients primarily in the areas of family office, professional services, financial services, manufacturing, and restaurants. » Full Bio

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