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Effectively Using a Quality of Earnings Study

What is a QOE, when is it necessary, and how it should be deployed?

by Michael Dannenberg

Over the last decade, the use of formal quality of earnings studies ("QOE") has become a standard part of the buy side due diligence process, allowing acquirers to outsource a significant portion of the financial due diligence to a third party, thereby providing significant manpower in a short period of time and a stamp of approval from an established firm.

In response to this trend, the middle market has seen a corresponding increase in seller commissioned studies, with many advisors encouraging business owners to incorporate them as part of the pre-marketing process. While we generally believe that an appropriately scoped QOE is helpful to the seller (The Case for a Seller Conducted Quality of Earnings Study, Spring 2013), there is confusion in the market about what a QOE is, when it is necessary, and how it can be effectively deployed in a sales process.

WHAT IS A QUALITY OF EARNINGS STUDY?

A QOE is quite simply a due diligence report performed by a third party, generally an accounting firm, analyzing the historical profitability of the business with the intent of assessing the normalized and sustainable future profitability of the business. Rather than an audit, which authenticates the accuracy of recorded transactions, a QOE is a restatement of the company's performance, adjusting for trends, one-time events, and extraordinary revenues or expenses. Perhaps the biggest misconception is that these studies are standardized, when in fact, there is a wide variation in the scope, quality and cost to have these performed.

Commissioning a QOE is not a "box-checking" activity. In fact, a sell-side quality of earnings report should not be thought of as a replacement for sound financial preparation, but rather as a tool to be carefully considered as part of a holistic approach to preparing a business for market.

RIGOROUS PREPARATION IS A REQUIREMENT FOR A COMPETITIVE PROCESS

As a firm, our view has always been that rigorous analytical preparation is the cornerstone for creating a competitive market and for minimizing the risks that the chosen deal will fall apart during diligence. During a competitive process, the goal is to allow multiple potential buyers to learn as much about a company in a short period of time, so that they can submit competing bids based on complete knowledge about the economic opportunity and the specific risks inherent in the business. Preparation

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is critical because, although these bids (which may come in the form of an indication of interest, a term sheet, or a letter of intent) are designed to clearly detail the economics of a proposed transaction, terms at this stage are never binding. This leaves room for a buyer to walk away based on discoveries during diligence. Furthermore, upon agreeing to pursue a specific proposal, exclusivity is almost always

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granted to the buyer, causing negotiating leverage to swing away from the seller in favor of the buyer.

At this point in the process, a seller must have complete confidence that the information that has been and will be shared with the buyer is complete, accurate, readily accessible, and will not be contradicted when the buyer eventually commissions its own QOE. Final diligence should be an effort to confirm, not discover. The discovery of new information at this time can impact the economics of the deal negatively and give the buyer an excuse to reexamine its position.

CONFIDENCE IN SUSTAINING A DUE DILIGENCE PROCESS

In our engagements, we spend a significant amount of time analyzing financial, operational, and customer data so that it can be presented to a buyer in an easily digestible format with a clear reconciliation to the source documentation. Before taking a company to market, we seek to have answers to all of the questions that buyers will need to formulate their investment theses including sustainability of earnings, nature of customer and supplier relationships, segment, product, and geographic profitability, anticipated future capital expenditures, working capital requirements, and adjustments for pro-forma or non-recurring items.

Although we do not prepare an official QOE report, our due diligence process is extensive and designed to develop confidence internally that the company is prepared to provide the materials and explain each area of inquiry that will eventually be probed.

With certain clients who have robust financial capabilities, regular audits or reviews, monthly management reporting, sophisticated IT and financial systems, and strong financial management teams capable of providing data and responding to requests, the need for outside help might not be as critical. However, more often than not, closely-held businesses, especially those with an entrepreneurial culture, do not have this infrastructure, thereby placing enormous strain on the organization and risk to the deal. Over the years, we have seen several types of situations where the expertise of a third-party accounting firm has (or would have added) substantial benefit. Some of these characteristics include:

- Limited internal financial horsepower
- Limited reporting capabilities
- Lack of sufficient financial controls
- Financials that are not GAAP compliant (especially with regards to accruals)
- Multiple subsidiaries that are not consolidated

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- Complex issues with foreign currency translations.

WHAT SHOULD BE DONE?

A QOE should be thought of as a tool to solve specific problems in presenting and validating key pieces of financial information. Prior to taking any business to market, a good advisor should be able to methodically walk through a very detailed list of questions that will need to be answered and describe the supporting data that will be required both for marketing the business and surviving due diligence. Specific areas of weakness should be identified and, to the extent that internal capabilities are insufficient to provide accurate and timely responses, carefully scoped third party assistance should be utilized.

Maximizing value through a competitive process requires an extremely invasive diligence process at a speed that few closely-held businesses are prepared to handle on their own. The probability of success almost always favors those businesses that have the infrastructure and are organized to respond quickly to each area of inquiry. A carefully scoped QOE to address specific weaknesses can fill holes and drive value.

A seller-commissioned QOE is an additional tool that can be used to shorten the analysis time for buyers and reduce the potential for discovery derailing a deal that both parties expect to complete. The most effective use of a QOE is to develop scope that fills the holes of the entirety of the financial preparation. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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