



Quality of Earnings

It's not how much money a company is making that counts; it's how it makes its money.

by William S. Hanneman

Savvy investors that wish to understand how a company really makes its money must dig beneath the reported figures to assess the “quality” of earnings. A quality of earnings assessment measures the elements of the company’s operating performance in terms of sustainability and, thereby, provides a strong basis for projecting future operating performance.

NOT A “ONE SIZE FITS ALL”

While it may seem cost-effective to simply review the audited financial statements that have been prepared in accordance with Generally Accepted Accounting Principles (“GAAP”), it should be understood that GAAP is not a “one size fits all” system. Although the set of accounting standards comprising U.S. GAAP is generally considered to be high quality, these accounting conventions permit considerable discretion by financial managers to make judgments and estimates. As a result, a company can report a range of earnings results, all of which are “GAAP compliant.” A “clean” audit opinion indicates only that the financial statements are prepared in accordance with GAAP, a conclusion that is quite different from a conclusion of earnings quality. Quality will vary even when well-intentioned managers are faithfully following GAAP.

For this reason, investors seeking to fully understand firm performance and value will perform a quality of earnings review to identify the extent to which reported figures differ from the underlying economics of a business.

The highest quality earnings are sustainable, controllable and are ultimately bankable, meaning that the result can reliably be paid out in cash to capital providers. What ultimately matters is how and when the company will generate cash in the future, which is not something that the cash flow statements provided with the published figures can answer.

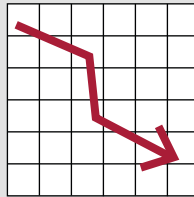
UNDERLYING BUSINESS ECONOMICS

The underlying economics of a business can differ from reported figures due to business practices, uncontrollable factors, as well as from management manipulation.

Business Practices Equipment Costs Deferred



Uncontrollable Factors Dollar Down



Management Manipulation Numbers Skewed

$$2+2=5$$

Changes In Economic Condition Markets Down

RECESSION

Business Practices

Even in its aim to fairly present financial results, GAAP allows for considerable discretion by financial managers to make judgments and estimates. Business practices that are entirely in compliance with GAAP may negatively affect future cash flows. For example, revenue can be moved forward through the use of aggressive discounting. Income can be enhanced by opting to capitalize rather than expense research and development expenditures. And operating expenses can be trimmed by scrimping on maintenance or insurance coverages. None of these business

practices are violations of GAAP, yet each will impact the ability to replicate past performance in the future.

Uncontrollable Factors

There are a variety of factors that management cannot control that can affect the quality of earnings. Exchange rates are one obvious example. If a company must convert its European profits back into the U.S. dollar, a dollar that is falling against the euro will boost the company’s earnings. However, management has nothing to do with those extra earnings or with repeating them in the future. On the other hand, if the dollar moves upwards, earnings growth could come in lower.

Other uncontrollable factors can also influence earnings. Inflation, for instance, can provide a brief profits boost when products in inventory are sold at prices boosted by inflation. Volatile commodity input prices (e.g. fuel, metals, chemicals, etc.) can either help or hinder earnings over a discrete period of time.

Management Manipulation

Manipulation of financial results can be quite alluring even for companies that do not publish public financial results. Various types of contracts (particularly credit agreements, bonus plans and tax regulations) provide managers with such incentives. Company acquirers should also recognize that prospective sellers might also have an incentive to manage earnings and to delay important investment decisions.

Changes In Economic Condition

Because of volatile business conditions, the sizing of capacity, cost structures, and customer bases has been under constant flux. Any one period of accounting transactions, as measured by GAAP, may not capture the changes as they affect the following periods. This is of particular importance in periods of economic volatility, industry restructuring, and underlying demand variations.

Perhaps the most prevalent type of earnings manipulation tends to be understatement of costs and expenses. This can be accomplished in a variety of ways, including reducing the allowance for doubtful accounts, capitalizing rather than expensing costs, and

omitting asset write-offs. These, and a myriad of other accruals (e.g., pension assumptions, overhead allocation, and the timing of tax payments), require managers to make forecasts, estimates, and judgments and thereby create opportunity for earnings management.

SUSTAINABILITY OF PERFORMANCE

Forecasting profitability has become a particular challenge in a volatile economy. Austerity measures taken in the last half of 2008, and through 2009, have brought cost structures

down to very low levels and have constrained new investment. In some instances, these are levels that will prove to be unsustainable in the face of economic expansion. Persistent cost cutting, along with the deferral of investments, could represent a double hit for unwary buyers. Acquirers run the risk of basing their evaluations on cost structures that are unlikely to support expected business growth. For these reasons, it is particularly important in the current environment for acquisition due-dil-

igence to evaluate the quality of earnings and determine whether the published figures accurately reflect the company's current operating performance and the degree to which current performance can be sustained.

A thorough due diligence process and an assessment of the quality of earnings can reveal these otherwise hidden risk factors that assist the business analyst to improve the estimate of future financial performance and thereby better evaluate the value of a target company. ♦



Zachary Scott

INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

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, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com