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The Case for a Seller Conducted Quality of Earnings Study

Conducting a seller QOE in advance enhances the seller's certainty in a deal.

by Frank S. Buhler

In an increasing proportion of private business transactions, buyers commission a Quality of Earnings review ("QOE") after signing a letter of intent ("LOI"). A QOE review, typically prepared by an accounting firm, is designed to thoroughly analyze the target's profit and loss in conjunction with

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operating metrics and the balance sheet to confirm that the financial performance and position accurately reflects the underlying economics of the business, both historically and on a proforma basis.

Although codified in the LOI, differences may continue to exist between buyers and sellers with regard to precision of the purchase price. Sellers view the transaction value as chiseled in stone, while buyers often consider the value as the product of an equation with numerous unconfirmed variables (e.g., profitability, asset composition, and amounts), some of which remain to be defined or clarified during the due diligence process. A significant component of the diligence process is the financial review and a QOE is more often than not the cornerstone of that effort.

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In order to improve certainty, both of the value and the commitments made in the LOI, in certain cases we advocate that sellers commission their own QOE study in advance of commencing the sale process. Commissioning a QOE in advance of discussions with buyers prepares the seller to quickly address the questions that inevitably arise, giving the buyer greater confidence in the metrics of the business, and thereby greatly reducing the probability of changes to the price and terms.

WHAT IS A QOE STUDY?

The typical QOE looks back at historical reporting to compare it to the underlying economics of the business, and looks forward in an attempt to anticipate future financial performance. Specifically, a QOE will cover:

- Revenue recognition policies and procedures (including the accounting for rebates, allowances, credits, and collections);
- Adequacy of accruals, including contingent liabilities;
- Identification of non-recurring revenues and expenses;

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- Trends in working capital;
- Adequacy of capital reinvestment to sustain performance and support operational plans;
- Stratification of revenue and gross margin by customer and product;
- The impact of operating leverage (fixed vs. variable costs at various levels of capacity utilization);
- Changes in personnel levels and compensation as it affects the cost structure of the business;

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- Valuation of the tax shield that will result from various transaction structures; and
- The effects of anticipated business combination synergies.

There is rarely any upside for the seller in a buyer commissioned QOE review, and there can be considerable downside if surprises are uncovered. Coupled with the intense requirements of a transaction process, sellers often underestimate the amount of work required to respond to a QOE investigation. Further, once a bright light is cast on the target, buyers can use the QOE as a negotiating tool in order to justify changes to the terms and economics of the transaction. Although supposedly "independent", sellers should recognize that professionals being paid by a buyer have a bias toward identifying reasons to justify a reduction in the purchase price both to mitigate the cost of the QOE and to build the basis for future assignments.

Having witnessed this drama play out over and over, we are of the opinion that sellers without robust, consistent, and detailed

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financial and operating reporting consider commissioning its own QOE. It is, we believe, money well spent. First, it provides the seller with better visibility of potential issues or areas that can be mitigated prior to proceeding with the sale process. Second, the independently prepared report provides a well-documented basis to defend economic performance. Third and lastly, the seller QOE establishes credibility for the seller's disclosures, which helps to build trust between the buyer and seller, thereby creating goodwill that might be need to be "spent" during the transaction process.

While buyers will always complete their own diligence prior to closing, providing to buyers a seller commissioned QOE prior to granting exclusivity improves the chances that the deal closes at the price and under the terms negotiated in the LOI. ❖

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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, please go to ZacharyScott.com.

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