Go BEYOND Checking the box

By Susan Koss

A quality of earnings report is an important tool for parties involved in the purchase or sale of a business. The primary purpose of a quality of earnings report is to assess the accuracy of the company's historical earnings and the sustainability of earnings into the future. A potential buyer may already understand the reasons why they want to purchase a company, but the buyer really needs to understand the reasons why it may not want to buy a company. A quality of earnings analysis should not be a "check the box" type of analysis since such checklists do not always identify critical problems. Instead, the analysis should be prepared in an effort to look beneath the numbers shown on the books and records. Red flags identified need to be investigated during the analysis in an effort to "peel back the layers of the onion" to get the true understanding of the quality of the earnings of a company.

Some of the components of the analysis may include:

- Assessment of revenue and gross margins by categories and customers
- Trend analysis of historical revenue and operating expenses
- Review of revenue recognition policies and procedures
- Analysis of inventory, receivables and other balance sheet items and working capital
- Identification of one-time or non-recurring expenses
- Validation of revenue and expense projections
- Analysis of management and due diligence adjustments

Generally speaking, it is the purchaser who engages an outside party to prepare a quality of earnings report during the process of a purchase transaction. However, it can be tremendously beneficial for the seller to obtain one prior to selling their business. A seller can gain advantages by understanding the results of the quality of earnings analysis by being prepared to address questions or issues from the buyer. A seller can also benefit for the following reasons:

- Educating the seller on the true sustainable future earnings of the business
- Providing the seller the opportunity to address issues, or concerns, detected during the quality of earnings analysis
- Preventing unwelcome issues from surfacing when the buyer completes its due diligence review
- Identifying issues and risk parameters that could potentially influence the selling price of the business

Uncovering surprises once the due diligence phase begins can significantly weaken the seller's negotiation position. Conversely, not uncovering surprises, that should have been discovered, can provide additional risk to the buyer post-acquisition. Regardless of the party that requests it, a quality of earnings report should not be performed following only a traditional checklist approach. It should be prepared with a unique approach to best understand the risks involved with the company earnings and industry.