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Quality of Earnings Reports in M&A Transactions

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Performing thorough due diligence is a must in M&A transactions. The acquirer will often want a Quality of Earnings (Q of E) report prepared by an independent party as part of the process unless the acquisition is inconsequential in magnitude. Q of E reports are different than an audit, although the audited financial statements of the acquisition target are often a good starting point.

The difference is a Q of E study focuses on the economic earnings power of the business. After all, businesses are typically acquired for their sustainable earnings stream and the potential growth of these earnings. The Q of E study's goal is to provide assurance that the earnings are sustainable and will translate into cash flows.

Q of E studies are often focused on sustainable earnings before interest, taxes, depreciation and amortization (EBITDA) or free cash flow (FCF). The selection of which metric to focus on depends on the facts and circumstances of each transaction. FCF includes performing an analysis of the incremental working capital needs of the target along with the need for capital expenditures (cap-ex) and taxes that need to be paid. It is beneficial if capital expenditures can be analyzed in categories.

CATEGORIES FOR ANALYSIS OF CAPITAL EXPENDITURES

- Replacement cap-ex includes expenditures made to replace current equipment. Therefore, it simply maintains current capacity levels.
- Compliance cap-ex includes expenditures made to comply with laws and regulations (i.e., Clean Air Act, etc.)
- Growth cap-ex includes expenditures made to increase the capacity of the operations and facilitate the growth of the company.

It should be noted that a study using EBITDA as the metric typically will also include an analysis of working capital and cap-ex.

Some other factors to consider are normalization adjustments. These adjustments remove the effects of one-time income boosts, non-recurring expenses and the effect of utilizing the LIFO method of accounting for inventory, to name a few. Officers/owners compensation is also analyzed and adjusted to market rates if necessary. Related- party transactions should also be reviewed as part of this process. If they are not done at arm's-length rates, an adjustment needs to be made. Pro-forma adjustments can also be part of the process to annualize less than full-year numbers. A proper analysis of these areas will provide a clearer picture of organic growth and allow for a better quality run-rate analysis.

Some other factors to consider include customer and vendor concentrations, as well as other operational risks. A liability analysis should also be performed. Some key things to look at are deferred compensation, defined benefit pension plans and the status of any litigation.

In summary, a thorough due diligence process is a critical part of mergers and acquisitions. Please contact us if you have any questions on due diligence and visit the Schneider Downs Business Advisory Services webpage for more information regarding our service offerings.

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