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Critical Procedures Within a Quality of Earnings Engagement

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The goal of a quality of earnings engagement is to present a clear picture to the buyer of a target company's financial condition. The business analyst will focus not only on the balance sheet and income statements as presented by the company, but also the underlying quality of those statements. A quality of earnings analysis may be conducted by taking a qualitative approach to evaluating the amounts presented. There are two approaches that can be used to enhance this evaluation.

INCOME STATEMENT FLUCTUATION ANALYSIS

The performance of fluctuation analysis on the income statement of the company is the analysis that most effectively identifies deviations from standard operating conditions. Within this analysis, the income statement categories are "spread" to identify trends over a period of time. Most often, this analysis is performed on a month-to-month basis. The reasoning behind choosing this subset of time is that some trends occur on a seasonal basis and would not be identified over a longer time period. The trends are then evaluated against underlying assumptions for each financial statement category to determine if an adjustment is needed to bring the results in line with the normalized operations of the company. Common trend categories include sales by product or service line, the timing of revenue recognition and revenue in association with customer contracts.

DETAILED REVIEW OF BALANCE SHEET ACCOUNTS

In addition to identifying potential earnings due to one-time adjustments and non-recurring other income by examining the operating results of the company, the balance sheet accounts will also need to be analyzed when looking to normalize earnings. For example, net income can be overstated if there are accounts receivable that should have been written-off against income. By doing an analysis of the aging of accounts receivable, uncollectible accounts can be identified. Conversely, an understatement of income can occur if an asset is not correctly recorded on the balance sheet when an item is prepaid, since the associated expense would not fall into the correct period. This is important, because a cut-off point is established for the underlying transaction of the engagement. By confirming whether assets and liabilities are properly recorded at that point in time, the company can understand cash flows.

By performing these procedures during the course of a financial due diligence engagement, one can present the true financial condition of the company being evaluated. The results revealed allow buyers to appropriately evaluate the transaction and maximize the value of their purchase.

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