



Quality of Earnings:

The value of sell side quality of earnings analysis

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- More than 5,000 employees
- Offices coast to coast
- Transaction support team helps negotiate better terms and improve value



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Speaker Introductions

- **Joseph Baez, CPA**

Joe is a principal with CLA delivering transaction services with 16 years of experience and more than 250 transactions under his belt. He has extensive experience performing buy side and sell side quality of earnings reports and gained a comprehensive understanding of the concerns confronting owners and managers of lower to middle market companies.

- **Jeffrey Servais, CPA**

Jeff is a principal with CLA focused on providing accounting and transaction structuring advice for leveraged recapitalizations, purchase accounting and assessing quality of earnings, and GAAP accounting. His experience includes more than 16 years of experience, more than 250 successful transactions and work with variety of clients from development stage to private multi-national companies.



Learning Objectives

- At the end of this session, you will be able to:
 - Describe a sell-side quality of earnings analysis and its objective
 - List the differences between an audit and a quality of earnings analysis
 - Discuss the valuation focus areas of a quality of earnings analysis
 - Outline parameters that determine the scope of a quality of earnings analysis
 - Summarize typical adjustments to EBITDA seen within a quality of earnings analysis





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Agenda

- Welcome and introductions
- What is a quality of earnings
- Rise of sell-side quality of earnings
- Objective of sell-side quality of earnings
- Determination of scope
- How buyers evaluate a business
- Timing
- Summary



What Is Sell-Side Quality of Earnings?

- An independent analysis of the seller's financial information
- Components of a typical Q of E engagement
 - Analysis of EBITDA
 - ◇ Assessment of the defensibility of the adjustments to EBITDA
 - ◇ Independent identification of EBITDA adjustments
 - Analysis of management's numbers including historical working capital and working capital pegs
 - Tax Matters
- Assist in the preparation of a financial information package
- What is the difference between an audit and a Q of E?
- Who typically provides the Q of E?



Rise of Sell-Side Quality of Earnings

Competitive and efficient market process

Increasing valuation multiples

More intense buy side process

Over 40% of investment banker deals failed

Long established European practice

Objective of Sell-Side Quality of Earnings

- Preserve value through the process
- Increase certainty of close
- Decrease time to close
- Reduce the number of “surprises” in the process
- Prepare the business owner and company for the buy-side process

What Determines Scope?

- General quality of the existing financial information
- Are the financial statements, compiled, reviewed or audited?
- Are there specific issues with the company revenue generation (e.g. percentage of completion) or sales that would benefit from additional analysis
- Large changes in working capital or other balance sheet accounts
- Seasonality and cyclicity and the potential affects on the working capital
- Rapid growth or dramatic swings in the profitability of a business
- Changes in the Company's cost structures were a pro-forma analysis would be beneficial
- Tax complexity



Understanding Adjustments to EBITDA

- Owner Compensation and Perks
- Non-Arms-Length Revenue or Expenses
- Revenue or Expenses Generated by Redundant Assets
- Rent of Facilities at Prices Above or Below Fair Market Value
- Recapitalizing vs. Expensing Items
- Non-Recurring Expenses
- Lawsuits, Arbitrations, Insurance Claim Recoveries and One-Time Disputes



Understanding Adjustments to EBITDA (continued)

- Professional Fees
- Recruiting Expenses
- Severance Expenses
- Inventory Write-downs
- Restructuring Charges
- Non-cash Stock Compensation Expense



Normal Level of Working Capital



- Pay for change not absolute amounts
- Seasonality
- Growth
- “Wide” versus “narrow” definition

Additional Thoughts...

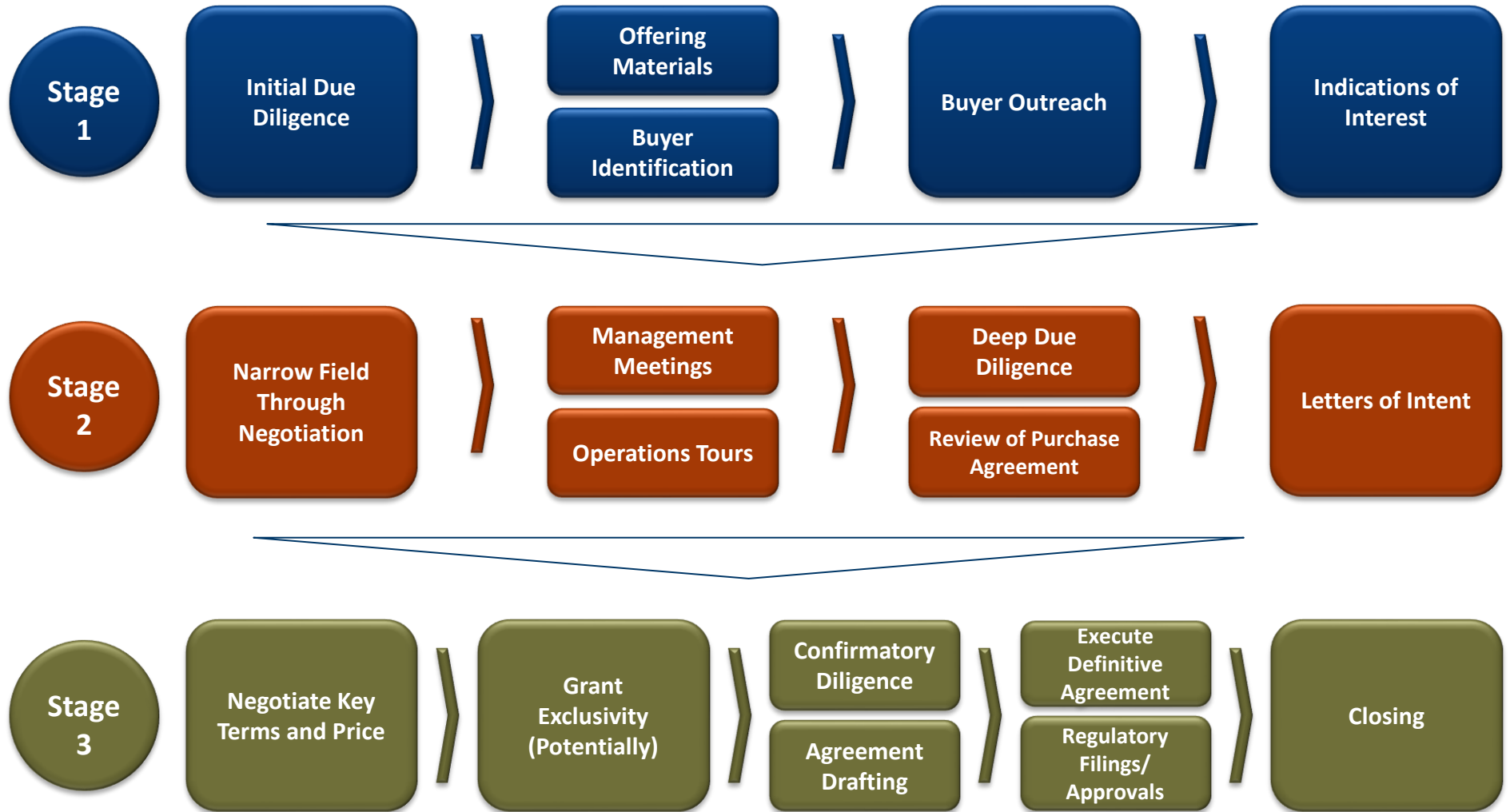
- Unrecorded Liabilities
- Capex
 - Requirements
 - Liens
- Federal Taxes
 - Personal Expenses
 - Accounting Positions
- State Taxes
 - Income Taxes
 - Sales Taxes
 - Other Taxes (Realty Transfer, Franchise)



How Will Buyers Value a Business?



Milestones of a Sell-Side Auction Process



Summary of Benefits?

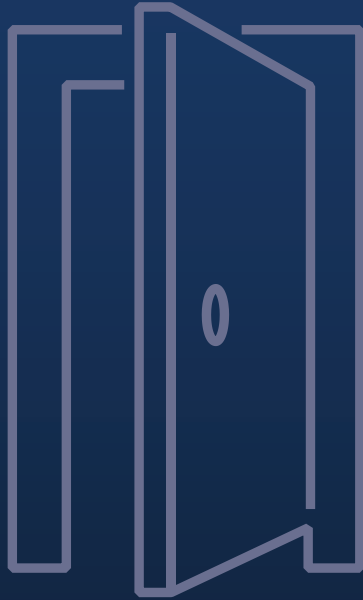
- Better seller preparation to successfully meet an extensive due diligence process
 - Validity of EBITDA and EBITDA adjustments
 - “Discovery” of significant issues upfront so that appropriate mitigation and/or corrective actions can be made
 - Sell side report helps frame and address any issues
- Sell side Q of E can preserve the seller’s valuation
- Increase the certainty of close
- Increase the speed to close
- Increase seller credibility
- What is the cost for a sell side Q of E engagement?



Questions?



Thank you!



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