HERE'S THE DEAL: M&A INSIGHTS

The Quality of Earnings Playbook

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These days, the term quality of earnings (QoE) is thrown around so much that it has become common nomenclature in reference to the wide scope of work transaction accountants are focused on during a deal process. While the QoE analysis is a focal point of the broader scope of services provided by transaction advisors, it is by no means all-encompassing. Below, we have scripted a winning playbook and strategy for buyers and sellers to use as a part of their financial due diligence efforts.

From Countdown to Kick-Off

When kicking off a financial due diligence engagement, many accountants are quick to dive deep into the numbers. However, at the onset of a process, it is important to understand the buyer's investment thesis, the seller's transaction rationale and the terms of the proposed transaction. Let's face it, if an accountant doesn't understand the underlying premise and structure of the deal, their analysis will more than likely fall short.

Spending time synthesizing the nature of a target company's operations is vital. This background helps provide much-needed perspective on the company's operating model, which in turn helps to better appreciate the financials. As a part of this effort, it's good to discuss a target company's value proposition, go-to-market strategy, key business development wins and losses, as well as strategic initiatives that have been implemented or planned. Altogether, this backdrop sets the stage for transaction advisors to be able to deliver an all-inclusive message around both key risks and value enhancers that might exist in the business, and what, if any, pro forma impact might result.

Establishing the Ground Game

Transaction advisors should get grounded in the trenches of the accounting environment sooner, rather than later. This includes understanding the roles of the major players within the accounting and finance function as well as a target company's reliance on external accountants. Gaining a sense of the control environment, accounting systems in use, differences between interim and year-end close cycles and the target company's experience with top-side or post-closing adjustments are all an important part of the process. It is a best practice to read through any accounting policies and procedures, ascertaining whether any of these policies have changed over time and assessing how such changes impact the comparability of the financials. As a part of this evaluation, it is important to pinpoint the areas of accounting that require significant time and judgement by management. A thorough comprehension of the basis of how the financial statements are presented helps tell the story of how the numbers that are being reported were derived.

If a target company's financial statements are audited by an independent accounting firm, transaction advisors will direct their attention towards reading and analyzing audit work papers and meeting with the engagement team. Remember, just because a target company's financials have been audited, doesn't mean that there isn't a need to engage transaction advisors. Most transaction advisors were auditors in a past life and are trained to analyze issues that can have significant deal implications by reviewing the audit work papers. Of course, if a target company's financials are not audited, it is even more critical to engage transaction advisors, if nothing else, for purposes of having someone with a trained eye stress test the numbers. Alternative measures, such as revenue-to-cash proof analyses, can be used to help clients gain a sense of comfort that the numbers being reported by a target company are real.

Basic Blocking and Tackling

Breaking down the income statement and balance sheet is basic blocking and tackling for a transaction advisor and a fundamental part of the due diligence process. With the income statement, it is good to start by dissecting a target company's product and / or service offerings and seeing how they feed into the various revenue streams. In doing so, a transaction advisor can address topics such as revenue recognition, concentration risk, seasonality and margin implications that may arise from mix shift. Placing emphasis on the cost structure of a target company is an important step as well. There, transaction advisors bifurcate direct vs. indirect costs and analyze the impact of contractual arrangements, vendor and / or supplier concentrations and changes in the cost structure. Broadly, a transaction advisor should take a bottoms-up approach and identify significant or unusual trends at the general ledger level and discuss those fluctuations with a target company's management team. Transaction advisors also look to analyze key performance indicators, among other operating metrics, that are pertinent to the target company and / or the industry.

If available, it is good to assess a target company's budgeting process and track their historical experience in terms of meeting or exceeding the forecast. As sellers typically present forward-looking financial information to prospective buyers, a forecast reasonableness assessment is often a great way to demonstrate just how credible management is at not only developing, but also, meeting or beating its projections.

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Whether the deal being contemplated is a stock- or asset-deal, there are certain balance sheet accounts that are expected to transfer in connection with the closing of a proposed transaction. Understanding the components of the balance sheet conveying at the time of close as well as historical trends and nuances around timing of accruals are all critical to making sure a buyer gets everything they pay for and that sellers aren't playing games with the balance sheet in anticipation of a sale. Gaining a sense of whether off-balance sheet exposures exist, and whether they should be captured on the balance sheet, is important in painting a holistic picture of what a purchaser is really buying.

Often, clients ask transaction accountants to spend more time focusing on the income statement instead of the balance sheet. While that is a noteworthy ask, the income statement and the balance sheet should be connected, meaning if the balance sheet is incorrect, the income statement is also not correct. Ample efforts should be used on both sets of financial documents.

Evening Up the Scoreboard

After thoroughly scrubbing the income statement, many times the QoE analysis becomes perfunctory. The QoE analysis usually covers three time periods, which are the last two fiscal years and the most recent trailing twelve months. The focus of a QoE, is obviously on the "E", or earnings of a target company. Often defined as earnings before interest, taxes, depreciation and amortization (EBITDA), EBITDA is a common metric used for valuation purposes as it generally serves as proxy for operating cash flow before factoring in any changes to working capital and the impact of capital expenditures (CapEx). EBITDA, in the traditional sense, is often adjusted by target management in preparation for a deal process to remove items that they view as "one-time" in nature and to factor in prospective developments that may not be fully baked into the historical periods. While it's great that target management can put a few points on the board through favorable add backs, transaction advisors should spend time gauging the validity of the adjustments made and evening up the scoreboard for their clients. Taking this one step further, the QoE zeroes-in on additional non-recurring, non-operating, non-cash, out-of-period and erroneous activity at the general ledger level to come up with a normalized view of EBITDA. Accountants are inherently trained to look at numbers with a sense of skepticism. As this professional skepticism bleeds into a QoE analysis, it generally reflects normalized EBITDA from the most conservative, or worst-case, scenario. But it is also important for buyers to know the head-room, or best-case scenario, to bid up in a competitive auction process. This is where focusing on the impact of pro forma implications becomes an essential part of the analysis.

That said, it is important to remember that EBITDA is not always the best metric for valuing a company. For example, free cash flow (FCF) is a better metric to use for assessing businesses that are CapEx intensive. An advisor should be focused on custom tailoring the scope of services to fit individual needs.

The thing to keep in mind, which is often misconstrued, is that a QoE is not an audit. It is an analysis used to help level set the baseline earnings, which often feeds into the deal model. Remember, if revenue and earnings aren't right in the current year, forward-looking projections that build upon that baseline number won't be correct either.

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It's a Game of Field Position

While net working capital (NWC) is frequently neglected on the front-end of a deal, it is one of the most contentious points in a transaction. The income statement is to the QoE analysis, what the balance sheet is to the NWC analysis. After trending NWC historically and adjusting for anomalies that may exist, you arrive at a NWC target that represents the level of NWC that needs to be delivered to a buyer at the time of close. Intuitively, buyers want the NWC target to be as high as possible at the time of close to avoid inheriting a shortfall or the need for a post-closing cash infusion. Conversely, sellers want the NWC target to be as low as possible, so they are committed to delivering as little as needed to continue operating the business. As a result, both sides are constantly posturing for field position when it comes to setting the NWC target. Working through this conundrum on the front end of a deal process will save a lot of heartburn and headache on the back-end. There are many mechanisms that can be used to set the NWC target and successfully come out on the right side of this equation.

Playing Defense Down the Stretch

Most transactions are structured on a cash-free, tax-free and debt-free basis. But the concept of debt-free is misleading. While debt, in the traditional sense, is typically very easy to identify on the balance sheet, there are many items that are inherent in a target's business operation that could be debt-like in nature and should remain with the seller, or be settled by the seller, at the time of close. The list is endless, but some examples include: capital leases, accrued interest and transaction expenses, among other things. Getting a complete picture of what all is potentially debt-like in nature is a good defensive strategy that opens the door for buyers to negotiate some of these items as potential purchase price reductions, depending on the specific situation.

Closing Out with a Win

Collectively, the above-mentioned analyses should provide clients with the necessary toolkit to make an informed decision about the transaction they are evaluating. While many clients expect financial due diligence reports to merely support the numbers that were presented, at times, transaction advisors meticulously end up with results that are different than expected. The financial due diligence findings can certainly validate the deal thesis, but alternatively, it can provide clients with the evidence needed to renegotiate deals or walk away altogether. Regardless of the outcome from our analysis, clients should take comfort in knowing they will be able to close out the deal process with a win.

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