

# QUALITY OF EARNINGS STUDIES

Quality of Earnings studies provide a basis to evaluate the risks and opportunities faced by both potential buyers and sellers. Our specialists perform detailed reviews of a variety of factors affecting sustainable EBITDA and cash flow in order to identify and assess issues which may impact pricing, structure, and risk of a prospective transaction.

The expertise of our accounting, finance, and transaction advisory professionals ensures that our Quality of Earnings reports go beyond the traditional assessment of historical performance and achievability of projections.

## What are Quality of Earnings Studies?

Quality of Earnings studies can include:

- Normalized historical and forecasted EBITDA
- Description of the differences between EBITDA and cash flow
- Detailed customer and product analysis
- Analysis of nonrecurring revenue and expenses
- Working capital analysis
- Detailed review of related party transactions
- Analysis of key reserves and allowances
- Review of any contingent or off-balance sheet liabilities or assets
- Special circumstances related to the individual company or transaction

## Who Needs Quality of Earnings Reports?

**Buyers** who are:

- Looking to gain a deeper understanding of the financial situation of target acquisitions
- Looking to acquire closely held businesses
- Acquiring businesses for a new product or service line not previously offered
- Seeking a bank loan to finance transactions; banks require due diligence reports for their loan files

**Sellers** who are:

- Seeking to facilitate and streamline transactions
- Looking to understand and explain any areas that may be of concern to buyers in a future transaction

## How to Focus on “Quality” in Quality of Earnings Reports

### Quality Issue #1: What Drives EBITDA?

Examine the key value drivers of sales growth and profit margins to determine what really drives and impedes EBITDA. Understanding these and any other value drivers requires an in-depth analysis of their contributing elements. This can be illustrated using a generic products company.

### Quality Issue #2: Test the Business Plan Assumptions

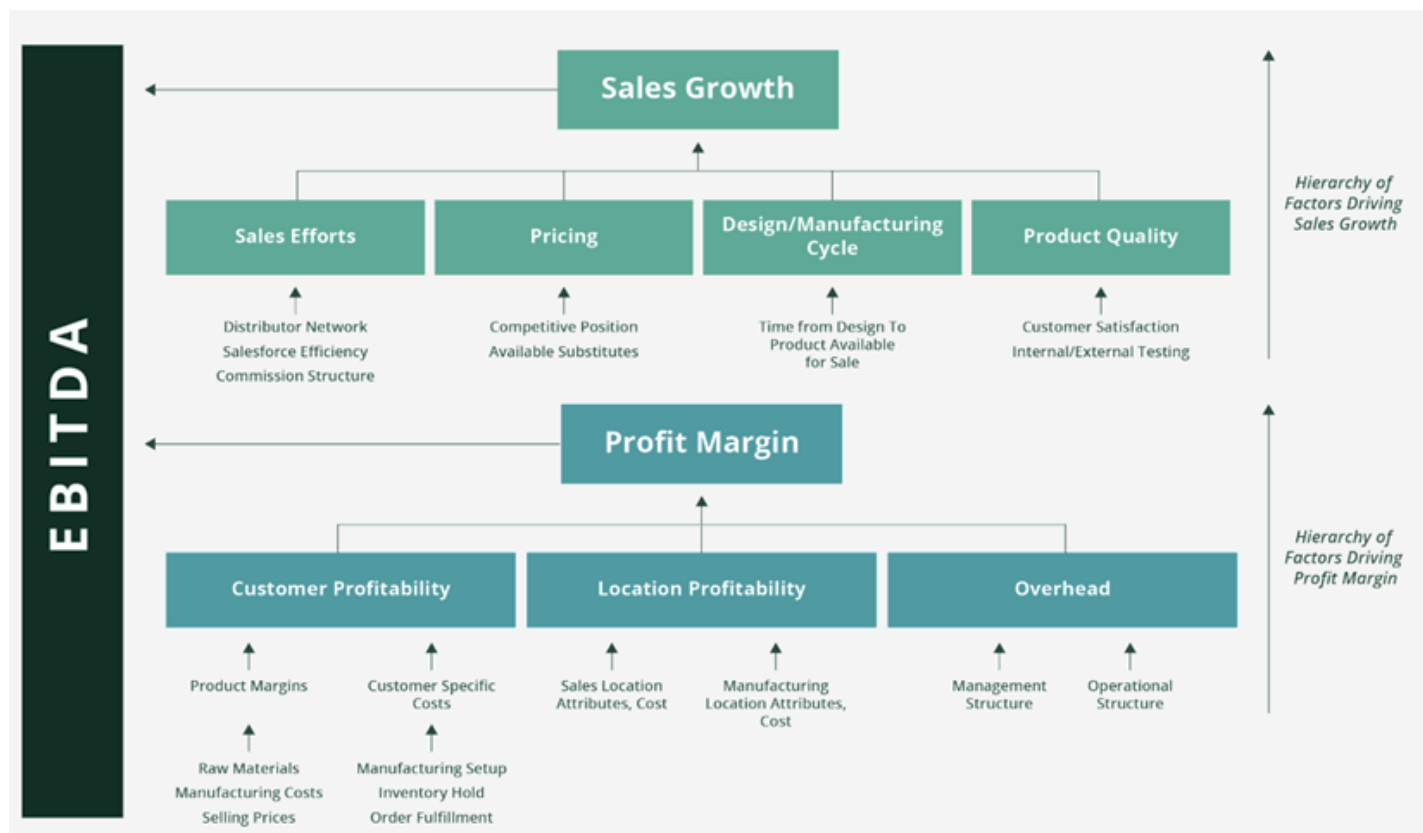
Test the earnings sensitivity to changes in operating and financial parameters. Testing needs to reflect:

- Key metrics that drive growth and profitability
- Cyclicity of sale and inventory buildup
- Customer and/or vendor concentration
- Working capital needs
- Capital requirements
- Tax assumptions
- Returns to shareholders

### Quality Issue #3: Balance Sheet Review for Potential Effects on Profits

Review the balance sheet for anything relevant in understanding the company's past and future performance. Such as:

- Atypical working capital
- Inventory turn and obsolescence
- Receivables issues
- Vendor payables and accruals



## Quality Issue #4: Funding Capacity, Leverage, and Financial Structure

Review the business' funding capital structure, return on debt and equity, and income taxes. The following areas must be examined:

- Cash reserves and borrowing facilities
- Borrowing costs
- Debt service and covenants
- Cyclical funding needs
- Financial leverage risk
- Taxation
- Returns to shareholders

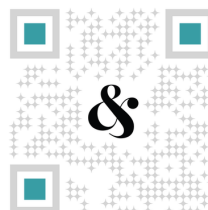
## EXPERTISE IN ACTION

Founded in 1932, Marshall & Stevens provides valuation consulting, transaction advisory, and litigation support services. The firm's specialists are relied upon by businesses, investors, and advisors for analyses utilized in complex transaction and legal matters.

From the boardroom to the courtroom, Marshall & Stevens delivers clarity, independence, and results.

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### QUALITY OF EARNINGS WEBPAGE:



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