

ACCOUNTING/DUE DILIGENCE

Qualifying the numbers

An audit report provides a useful and objective snapshot of a target company's financial health, but equally useful is a 'quality of earnings' exercise, which can produce information far more intriguing, according to McGladrey partners Joseph Mazza and Robert Moore

Consider two manufacturing companies that are virtually identical in all matters except for one thing. Company A pays its chief executive a modest \$250,000 in annual salary and bonus – standard for its industry and size. Company B, however, pays its chief above-market rates, compensating its star executive \$2.5 million in total per year.

Now unless you knew the executives were pulling in different salaries, the two companies' earnings would look one in the same. In audited financial statements, their bottom lines are identical. But when you begin to look at the *quality* of earnings, nuances begin to appear, such as the fact that one chief executive was able to book the same net earnings as an industry rival while charging the

company 10 times more in pay. Those types of numbers can be significant to private equity firms when conducting due diligence on target companies with seemingly similar financial metrics.

Robert Moore, an Illinois-based partner at professional services firm McGladrey who specialises in M&A transactions, says a "quality of earnings" analysis is a way for GPs to dig past the cold hard numbers contained in audited financial statements, which must follow strict standards set out in any given financial reporting framework (such as US Generally Accepted Accounting Principles). That's not to say an audited financial statement is too rigid, in fact its objective methodology is its greatest strength, adds Joseph Mazza, an audit partner and managing partner of McGladrey's Los Angeles office.

With an audited financial statement in hand a dealmaker has a high level of assurance that a company has presented its full set of financial statements (balance sheet, income, cash flow, etc.) along with all the required footnotes describing the firm's accounting policies and other matters, he says. "It's a complete picture that reflects the actual operating results of the company, subject to management estimates, judgments and other factors, in arriving at net income," says Mazza. For private equity firms, that audited financial statement is therefore a key element in their ability to apply a multiple to a company's earnings as part of their

valuation process.

"At the same time however firms need to know that those earnings are appropriate," adds Moore. "That is why due diligence on the quality of earnings is so important." Moore and Mazza often use the term "normalising" a company's earnings to describe how this kind of analysis can pinpoint fluke years, or one-off events, that can distort what a business sells, earns and spends in an average (or "normal") year.

Mazza describes the exercise as involving "adjusting net income or EBITDA for revenue or expenses that are judged to be nonrecurring". This, Mazza explains, is "in order to develop an adjusted or pro forma EBITDA, reflecting a normalised picture of EBITDA". And with that, the two partners stress, GPs can derive a value more reflective of a business' actual health and operations (assessed over a multiyear period), as opposed to a one-year snapshot of its core financial numbers.

To fully appreciate the value in a quality of earnings analysis, consider a widget company that landed a massive contract with a global retailer like Wal-Mart. In the first year of the arrangement, Wal-Mart purchases, say, 20,000 widgets to display on its shelves and stock in its warehouses. Each year thereafter Wal-Mart reviews how many widgets it sold and replenishes its supply of widgets accordingly, maybe selling two to three thousand widgets per



Moore: providing the story behind a company's earnings

year. A private equity analyst reading the company's financial statement the year 20,000 widgets were sold may be excited by the sales figure unaware that in subsequent years that pace of sales was expected to drop. "You wouldn't expect audited financial statements to provide that kind of disclosure around particular relationships with buyers if the company has more than just one major customer," says Mazza. Without due diligence around the quality of earnings, GPs would be left in the dark on these hidden details.

The McGladrey partners explain

“ Without due diligence around the quality of earnings, GPs would be left in the dark on certain hidden details ”

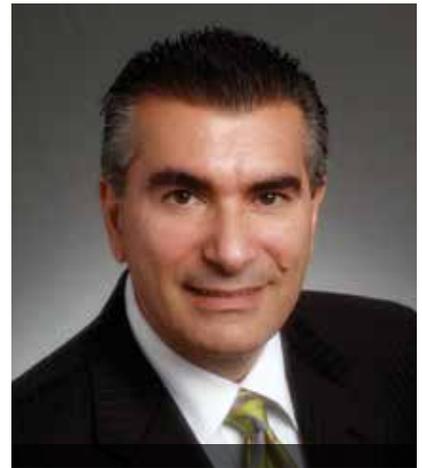
that a typical quality of earnings report starts with a look at a financial statement, but immediately begins adjusting the numbers to tell a different story on the company. As described above, expenses are normalised. These include fluctuations on bad debt expenses; eliminating one-time costs such as severance, moving costs, and transaction fees; adding back noncash compensation like stock options to senior management; and possibly normalising significant changes in reserve estimates, if needed, among other adjustments.

From there accounting adjustments

are made. This includes investigating for any changes in accounting policy made between one financial statement to the next; eliminating certain items like impairment charges; and if a last-in, first-out inventory valuation method was used, most often convert to first-in, first-out. The last major step is to then make pro forma adjustments to the numbers. Here is where the partners would, among other adjustments, 'normalise' or eliminate foreign currency fluctuations; factor in public reporting costs (if a public to private transaction); and assume certain costs for a controller or chief financial officer if the target company had not yet hired one. In all, the adjustments provide GPs an earnings report more representative of the company's future revenues and costs of doing business.

Conducting due diligence on a company also requires speed. While an audit can be completed in a month or two, a quality of earnings report is more of a continual work in progress. "After the first few days we can often provide clients a preliminary idea of earnings quality, and then a draft report a week or two later," says Moore. "The client can then read that to identify which areas of a company they'd like to see additional analysis on." As due diligence is completed, and more documents come through, clients are kept up to speed with updated findings and analysis until a completed report can be delivered. The whole process can typically run from three to four weeks, but ultimately depends on a company's size, complexity and industry.

That level of flexibility is clutch in producing a valuable quality of earnings report, says Mazza. "Clients can be provided anything from a simple executive summary on a company, to a



Mazza: dig past the audit numbers

full investigation into its operations." He adds sellers too may want to conduct a quality of earnings exercise as a way of making the company more attractive to buyers, or be better prepared for questions they may have.

For buyers and sellers, an audit complemented with a quality of earnings analysis may provide the most complete analysis and picture of earnings and EBITDA. Or in other words, provide dealmakers an information advantage in selecting the most promising companies in which to invest their capital. ■

Joe Mazza leads McGladrey's assurance practice in the western United States from Los Angeles. He has over 20 years of diversified public and private accounting experience, serving both public and privately held middle-market companies.

Robert Moore is a partner with the national transaction advisory services practice. His experience with financial transactions includes debt financing, private placements, asset securitizations, portfolio acquisitions, loan workouts, and company acquisitions and divestitures.