Financial Executives Alliance
A First Republic Affinity Group

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SECURING VALUE

# Pitfalls, Risks, and Deal Breakers Surfaced (or Should Have Been) by a Quality of Earnings

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***Managing Director & President***
**Avant Advisory Group**

# Preview of Key Takeaways

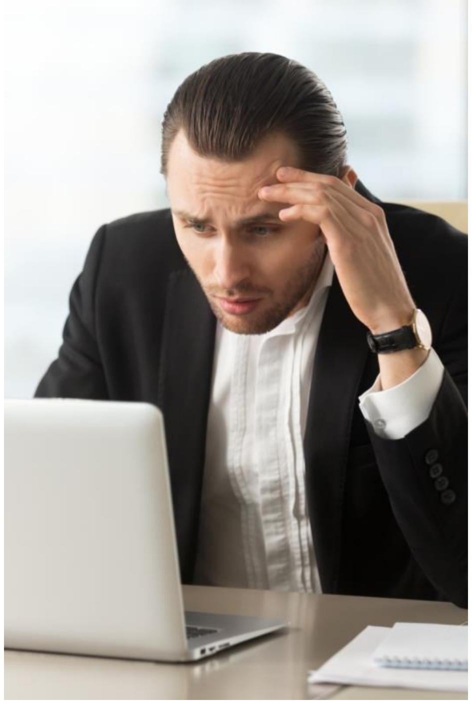
## Quality of Earnings

- Critical differences between Quality of Earning ("Q of E") and a CPA audit.
- Primary objectives & requirements of a Q of E.
- Key Q of E items that affect the deal and its valuation.
- Just a Few Takeaways – Forewarned is Forearmed!
- Red flags of a Q of E that a buyer should never ignore – Real case examples!
- Sometimes the best deal is the one you don't do.

# Quality of Earnings

## Critical Differences between Q of E and CPA Audit

- The audit is **historically** focused, i.e., on **past (dated)** financial information and is **heavily balance sheet-driven**. The Q of E diligence is **current & future** operating and (**quasi**) cash flow-oriented.
- An audit and a financial diligence / Q of E may **overlap but are not equivalent**. The purpose of the audit is to opine on the fairness of the overall financial statements (as a whole) based on materiality.
- CPA financial statement audit should never replace a financial Q of E due diligence; **different focus and objectives.**
- Q of E **directly** impacts valuation; financial audit does not.
- In fact, we specifically adjust EBITDA for items that the audit firm passes as immaterial – **That impacts valuation!**



# Quality of Earnings

## Q of E – EBITDA Focused

Q of E emphasis is on **recurring** EBITDA (**not free cash flow**), but full Q of E should adjust for that too.

The Q of E seeks to determine **operating profitability** before capital and tax structures.

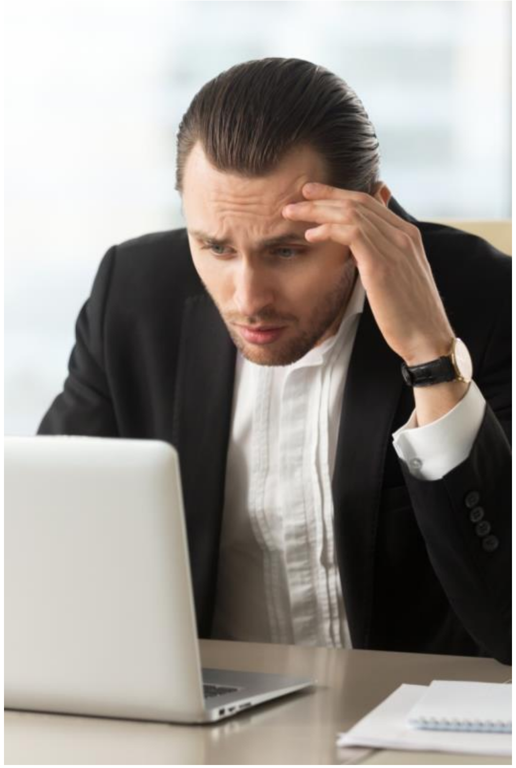
- EBITDA **neutralizes** capital/financing and tax structure, while financial audit encompasses that.
- The Q of E **emphasizes operating profitability** that includes only **core revenues/expenses intrinsic to the business.**
- Core revenues & expenses form the basis for the business: substance, nucleus, heart of existence.

**Adjusted** EBITDA measures operating performance by only including **recurring core** items **removing extraneous income & expenses that are rare, unusual, nonoperational, and will not recur.**

# Quality of Earnings

## Focus on EBITDA & Impact on Valuation

- CPA audit alone is insufficient
- But focusing on EBITDA alone also leaves underestimated risks that impact valuation; **EBITDA has its limitations too**.
- **Not true cash flow**
    - **Proxy for operating cash flow** (excludes investing and financing).
    - **Ignores CAPEX, working capital requirements, existing debt and debt-like items, & taxes.**
    - Lack of GAAP definition increases manipulation risk.



# Quality of Earnings

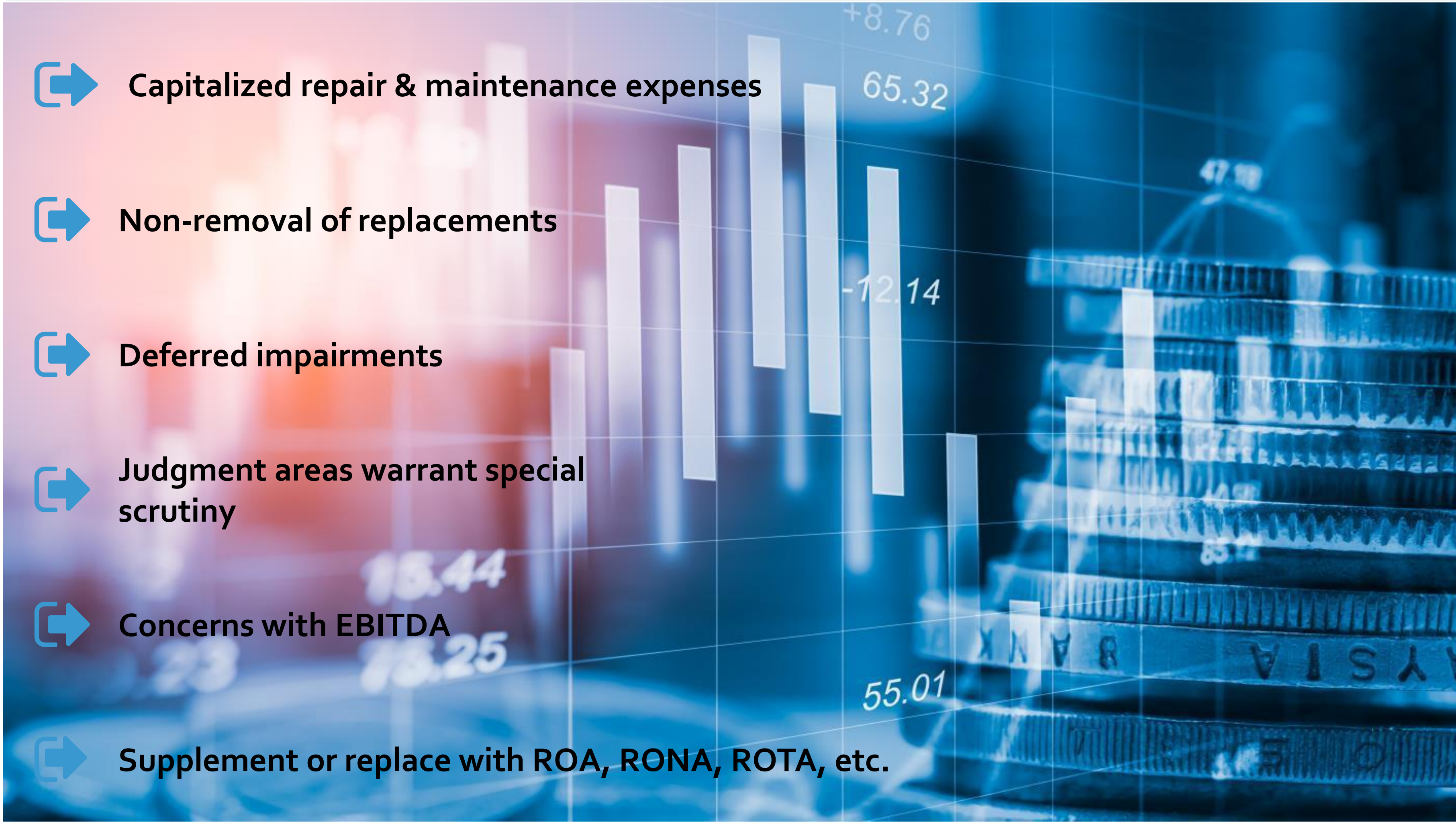
## Primary Objectives & Requirements of the Q of E

**Firstly, ensure EBITDA based on GAAP**

- **Quality of assets** focus, e.g., valuations and reserves
  – **Inventory & receivables most problematic**
  – Affect both sales and gross profit
  – Changes in reserves/assumptions, if any
- **Ensure liabilities scrutinized** - affect working capital (& debt-like items) and expenses/EBITDA.
- Also consider **other GAAP & recurring cash flow impacts**:
  – Foreign exchange effects
  – Stock/option/compensation
  – Management fees

# GAAP Concerns First – Potential Financial Statement Misstatement

## Examples of Asset & (Potential) EBITDA Overstatements




- Capitalized repair & maintenance expenses
- Non-removal of replacements
- Deferred impairments
- Judgment areas warrant special scrutiny
- Concerns with EBITDA
- Supplement or replace with ROA, RONA, ROTA, etc.

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# GAAP Concerns First – Potential Financial Statement Manipulation

## Examples of Inventory & EBITDA Overstatement

### Most Common Misstatements

- Capitalized SG&A expenses
- Capitalized variances in WIP, top-side
- Applied overhead is larger than actual
- Capitalized “idle capacity,” i.e., excess overhead
- Obsolescence not recognized/understated
- Inventory turnover by SKU not provided

# GAAP Concerns First – Potential Financial Statement Manipulation

## Examples of Revenue / Receivables & EBITDA Overstatement

### Most Common Misstatements

- Fictitious
- Timing
- Improper cut-off
- Bill and hold
- Intercompany & related party
- Channel stuffing
- Unissued credits
- Conditional and consignment

# Quality of Earnings

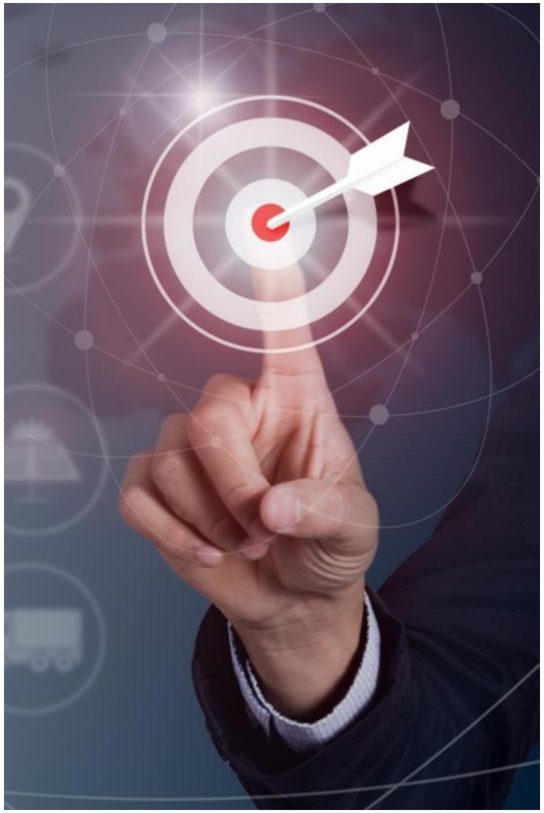
## Primary Objectives & Requirements of a Q of E

Secondly, determine **normalized/pro forma recurring EBITDA**

- Assess and **validate** EBITDA adjustments
- Determining true "one-off" **highly judgmental**

Evaluate management/seller proposed adjustments

- Scrutinize **underlying documentation** (following theoretical justification)
- Objectively evaluate in **context of the business**
- Ensure truly nonrecurring/noncore



Next, **determine diligence adjustments**, e.g., items not identified by seller/management (**or disagreements**)

- Deferral of discretionary expenses, e.g., R&M, R&D, IT, marketing
- Determine standalone normalizing/pro forma before synergies
- Corporate allocations/carve-out issues, etc.

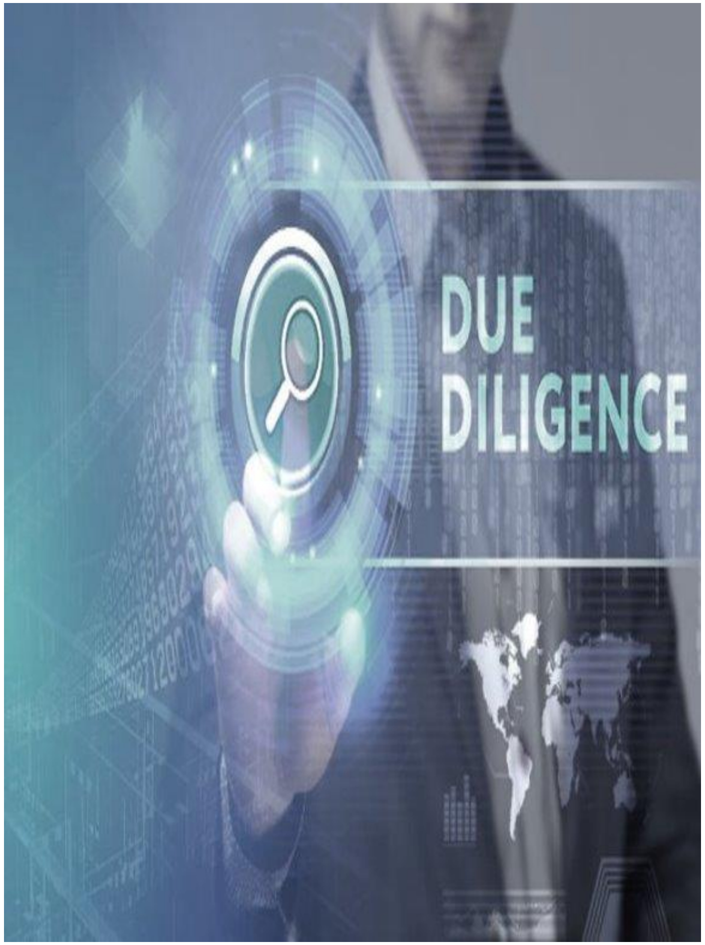
Also, assess nonfinancial items

- Quality of management
- "Stickiness" of customers

# Quality of Earnings

## Q of E Items that Affect the Deal and its Valuation

- **Accounting** issues affecting quality of reported earnings
- Revenue recognition practices (e.g., **ASC 606 unearned revenues**)
- GAAP adjustments & technical reporting, e.g., **unrecorded liabilities, commitments, debt like**
- Financial & operational **abnormalities** that **skew recurring earnings**
- Potential **staffing** adjustments
- Key **assumptions & operational drivers** that affect pro forma projections
- Working capital **includible in enterprise value**
- Significant **capital expenditures affecting free cash flows**
- Seller & buyer due diligence



# Just a Few Takeaways –Forewarned is Forearmed!

- **Do not ignore Red Flags**
- **Trust your "gut"** because downside is too great
- Revenue/receivables should be first concern
- Inventory overstatements should be second concern
- Consider proven financial ratios, e.g., **M**-Score, **Z**-Score, F-Score and CCC
- **Scrutinize related party transactions carefully**
- Non-consolidated affiliates are particularly suspect

# Just a Few Takeaways – Forewarned is Forearmed!

- Evaluate related party transaction trends in relation to total sales and total assets
- **Corporate structure is overly complicated?**
- **Granularity & disaggregation of data are key**
- **The "devil is in the details"**
- **Do not inordinately rely on financial audits**
- Diligence staff may be inexperienced – **Be extra careful!**
- Staff may not be forensic-oriented
- Be aware of no external CPA involvement

# Quality of Earnings

## Q of E Red Flags a Buyer Should Never Ignore – Real Life Examples!

# Lessons from True Stories

## Misleading Financials: Loss of Value – Millions!

### True Stories/Actual Experience

| | | | |
|---|---|---|---|
| **\$40M**<br>Investment **Gone**<br>Consumer products (private; **California**) | **\$600M**<br>**Bankrupt**<br>Plastics manufacturer (public; **Pennsylvania**) | **\$300M**<br>**Distressed**<br>Consumer products (international private; **Utah**) | **\$60M**<br>**Distressed**<br>Industrial products manufacturer (private; **South Carolina**) |
| **\$100M**<br>**Bankrupt**<br>Restaurant chain (private; **Oklahoma**) | **\$100M**<br>**Defunct**<br>Principals **Imprisoned** Design/office services; furniture distribution (private; **New York**) | **\$50M**<br>**Distressed**<br>Software/e-commerce (private; **Colorado**) | **\$100M**<br>**Bankrupt**<br>Electronics manufacturer (private/public; **California/China**) |
| **\$150M**<br>**Bankrupt**<br>Construction (private; **Florida**) | **\$150M**<br>**Bankrupt**<br>Medical devices; consumer products (private; **Toronto**) | **\$150M**<br>**Distressed**<br>Food service; consumer products (private; **Hawaii**) | **\$300M**<br>**Uncertain**<br>E-retailing; consumer products (private; **California/China**) |

# Lessons from True Stories

## Overvaluations Occur & Worse!

- Poor financial diligence and/or
- Weak quality of earnings findings ignored
- External audits detected only 3% of frauds
  - Have preventive effect
  - But ranked poorly in limiting fraud losses
  - Usefulness for uncovering fraud is limited

**What, How, and Why**

# About Us

**Avant Advisory Group** is a premier, operationally focused-financial advisory and management consulting firm. With a focus on middle-market companies, we combine our financial and operating skills with senior level management experience to help clients identify value opportunities and implement improvements in cash flow, EBITDA, and profitability to secure and increase value for our clients.

# About Us

## James F. Davidson

**CM&AA, CM&AP, CPA, CFF, CFE, CGMA, CIRA, CTP, CBA**

- M&A Diligence – Q of E, Operations, Tax
- Forensic Accounting
- Fraud Investigations
- CFO & C-Suite Services
- Financial Restructuring
- Operational Turnarounds

**Jim Davidson** has more than 30 years of experience in M&A due diligence – Q of E, operations, IT, and tax; forensic accounting; fraud investigations; CFO & C-Suite services; financial restructuring & operational turnarounds.

He has led hundreds of sell-side & buy-side due diligence assignments, assessing Q of E, carve-out reporting, and post-acquisition integration for both high growth and financially distressed companies. Jim has served in executive positions at both public and private companies ranging to multibillion-dollar firms. After 10 years with Big Four firm PricewaterhouseCoopers, including in the Transaction Advisory Practice, Jim spent another 20 years on several boards of directors and in various financial and executive positions, including as president & CEO, CRO, COO, CFO, chief accounting officer & corporate controller of a $3-billion-revenue SEC registrant. In that capacity, he led multiple acquisitions, including post-transaction integrations.

# Thank You!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**FEA Networking Group**

Thursday, April 20th
10:00 AM PT / 1:00 PM ET

Webinar

**Avant Advisory Group**

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# Appendix
# Supplemental Data

# Red Flags & Warning Signs (Don't ignore them!)

## Questionable Accounting Involvement

1. Management, particularly **CEO, overriding** controls
2. Tight **management control** or involvement of principals
3. Heavy accounting staff **turnover**
4. Different audit firms for related companies
5. **CFO not** involved or distances from reported numbers
6. Accounting personnel work in "silos" and **absolve themselves of** responsibility beyond narrow sphere

# Red Flags & Warning Signs (Don't ignore them!)

## Ineffective Corporate Governance


- Minimal board oversight; or
- **Excessive board involvement or micromanagement**
- No **outside/independent** directors (separation of duties)
- Undocumented or poorly drafted policies and procedures
- Frequent/unusual related party transactions and/or complex **legal structure**

# Red Flags & Warning Signs (Don't ignore them!)

## Performance Too Good to Be True

**Rapid** growth beyond reasonable expectations

Company **not** materially impacted by external forces

- Recession
- Supply limitations
- Infrastructure constraints

Company **outperforms** competitors, industry, etc.
without clearly delineated reason

# Red Flags & Warning Signs (Don't ignore them!)

## Incomplete Reporting

- **Top-side** entries not pushed down to individual companies
- Erratic, **incomplete, late,** financial information (classic)
- **Weak, tenuous,** inconsistent explanations
- **Unreconciled** accounts, especially cash/bank
- **Numerous**/excessive adjustments
- Excessive number of manual checks
- Continuous adjustments to inventory
- No audit or **downgraded** CPA involvement
- **Acquisitions** preventing comparable period analysis
- Financial information **not** reproduced from information systems

# Red Flags and Risk Factors

## Incomplete Reporting

- Disparate information systems
- Change in fiscal year ends
- Accruals not recorded timely
- Unreconciled subsidiary to general ledger accounts, particularly bank accounts

# Red Flags & Warning Signs (Don't ignore them!)

## "Twitchy" Non-executives and Gossip

- Comments that do not add up or make sense
- **Worries and concerns**
- Staff **whispers** and **rumors** that "not all is right"
- Information **not** readily available
- Confidentially shared information by lower level or operationally oriented employees

# Red Flags & Warning Signs (Don’t ignore them!)

## Site Inspection Inconsistent with Performance

1. Minimal level of **activity**
2. **Key personnel** not present
3. Amount, **volume,** types of inventory
4. Information **not** readily available
5. Operational indicators **inconsistent** with reported sales or financial information

# Red Flags and Risk Factors

## Site Inspection Inconsistent with Performance


1. Level of activity, inventory, and other objective indicators of performance not coinciding with sales or scale of purported operations
2. Key employees not present and critical information not readily accessible
3. "Twitchy" non-executives and office gossip
4. Employee concerns about something not adding up or information not making sense

# Red Flags and Risk Factors

## Excessive Domination and Control By Principals or Key Management

1. Unreasonably restrictive control on financial or business information by CEO
2. Financial data "filtered" through CEO prior to release
3. Senior executives "walled off" or unwilling/afraid to speak freely in presence of CEO
4. CEO sharing of EBITDA adjustments with CFO to get him on "same page"

# Red Flags & Warning Signs (Don't ignore them!)

## Be Wary of Emotion, Time, and Costs Invested

- More costly later?
- Case Study

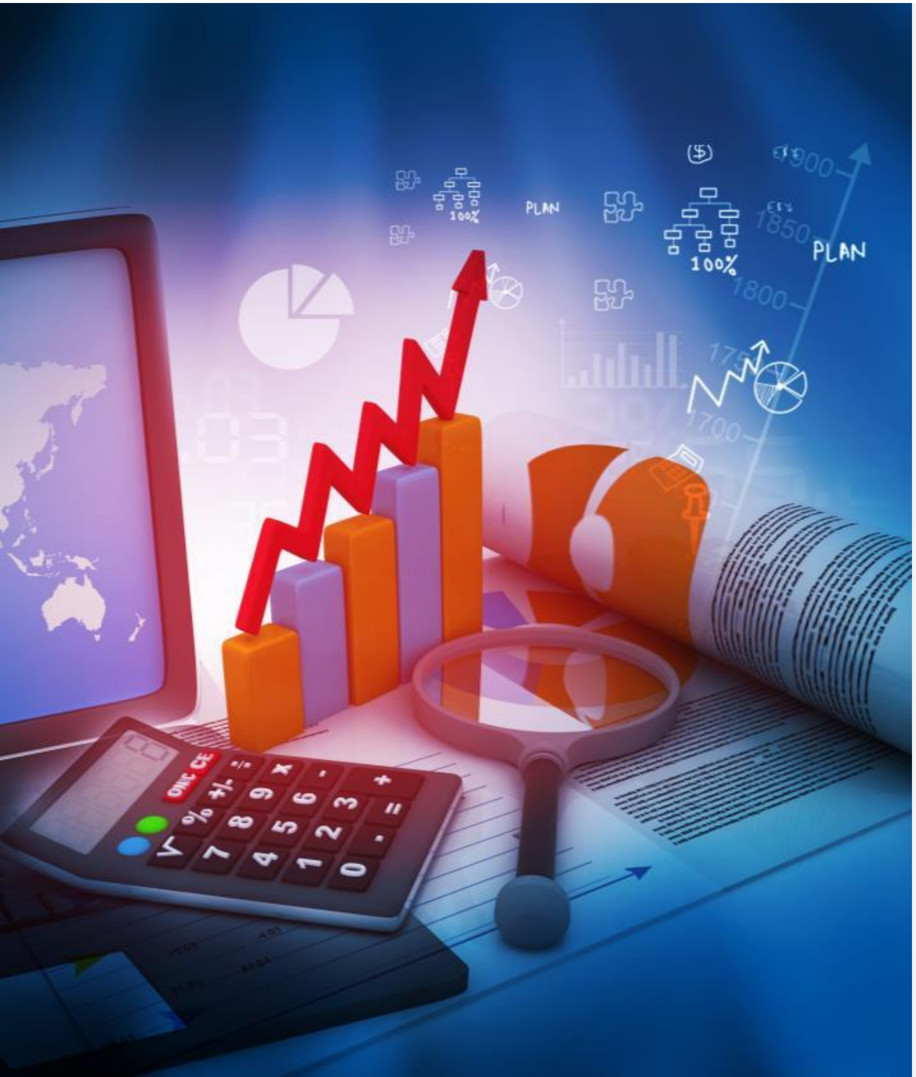
*"Death by a Thousand Cuts"*

*Lack of transparency/consistency with cash flows*

*Inability to reconcile reported revenues to cash*

*No clarity on cash flows by company*

# Telling Financial & Ratio Analyses




- Banish **M** Score
  - Powerful predictor of financial **manipulation**
  - Better predictor of **manipulation** than misappropriation
  - Five and eight factor formulas
- Altman **Z** Score
  - 80–90% accurate predictor of **bankruptcy**
  - Two of five ratios standalone indicator of **fraud**
  - Distress and **fraud** oftentimes related
- **F**-Score
  - Predicts material **misstatements**
  - 28 ratios; 2/3 related to revenues and **soft** assets
  - Higher percentage off balance sheet financing (e.g., leases)

# ALTMAN "Z" SCORE

Predicts likelihood of bankruptcy within two years

Applicable across industries and company sizes and types; Public | Private | Manufacturing | Service

**ALTMAN "Z" SCORE**

Test highly accurate

May be monitored each year for corrective action

# Thank you!

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2023

# FEA Networking Group

## Pitfalls, Risks, and Deal Breakers Surfaced (or Should Have Been) by a Quality of Earnings

Avant Advisory Group is a Biblically-based firm serving God and our clients with the highest honor and integrity.

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