Prepare a Quality of Earnings Report

Business Owner Action Item: Prepare a quality of earnings report.

A quality of earnings report is an analysis of the Company's financial and operating information emphasizing earnings before interest, taxes, depreciation, and amortization (EBITDA).

EBITDA is (i) considered a more relevant indicator for determining a business's enterprise value, (ii) considered a good indicator of a company's ability to generate cash flow, and (iii) removes the effects of business conditions that may change post-transaction.

The quality of earnings report highlights the key aspects of the Company, including:

- Normalized level of EBITDA;
- Fluctuations in annual and monthly financial information;
- Revenue and gross margin by product, customer, and distribution segments;
- Operating expenses and employee analysis;
- Key balance sheet highlights; and
- Normalized levels of working capital needed to operate the Company.

The Buyer will usually engage an independent accounting firm to prepare a quality of earnings report during its due diligence. By preparing a quality of earnings report during the pre-sale process, a business owner is proving that he is serious about his intent to sell and that the Company is sale-ready.

Why is This Important?

- A quality of earnings report provides insight into how the Buyer will analyze the Company's financial statements.
- A quality of earnings report identifies key performance indicators and value drivers of the Company.
- The process to prepare a quality of earnings report prepares the business owner for difficult questions that the Buyer will eventually ask.

In My Experience: The quality of earnings report usually identifies operating inefficiencies that negatively affect the Company's valuation. If the inefficiencies are identified in the pre-sale process, then the Company can mitigate any impact to the valuation.