SAPLING
Financial Consultants

QUALITY OF EARNINGS

THE VALUE OF QUALITY OF EARNINGS AND WHAT MAKES FOR HIGH QUALITY EARNINGS

Quality of Earnings: The Value of QoE and What Makes for High Quality Earnings

Quality of Earnings ("QoE") analysis is an essential tool in understanding a business' true historical and future earnings. The use of QoE reports differs based on the purpose and requestor (buyer/seller) of the analysis, however, the intention is always to eliminate bias and to give an accurate view for both parties.

A seller might undertake a QoE report to better understand true earnings, allowing them to negotiate a higher and better sale price. Often, there are numerous non-recurring expenses which the seller is motivated to addback to improve earnings or sale price. QoE reports can also help a seller identify discrepancies early on to explain them better to a potential buyer and mitigate the probability of a lost deal.

For a buyer, QoE reports help provide third-party objectivity to data, giving the buyer assurance that the seller is not fabricating revenues/costs. Additionally, it validates several key operating metrics within the business in silos, which helps a buyer understand different sources of earnings risk independently. It also, provides a buyer with a deeper understanding of the business model, including trends in seasonality, consistency of operating expenses as well as product, geographic and customer concentration. Finally, a QoE report gives a buyer conviction to expedite the purchase process by reducing internal due diligence requirements.

WHAT CONSTITUTES HIGH QUALITY (VALUABLE) EARNINGS?

Earnings are considered high-quality if they are repeatable, comparable, and transparent. QoE reports themselves aim to present comparable earnings, such that identical cash flows between two companies would be worth the same value. However, this is not always the case.

Subjectivity and basis of accrual introduce inconsistent standards, which must be analyzed. The "Continuum of Earnings Quality" [1], shown in exhibit A, highlights this well, where increased discretion in earnings decreases the value of those earnings, as does a cash-basis for accounting.

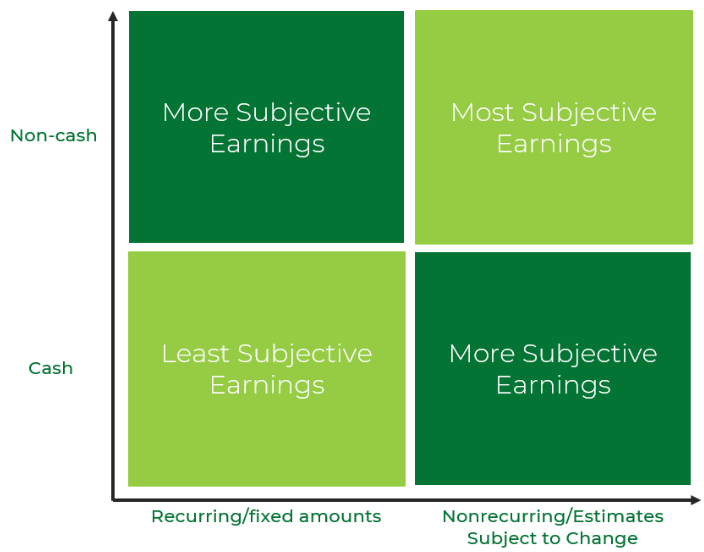


Exhibit A. A continuum of earnings quality: the degree of objectivity and quality of earnings is proportional to the portion of earnings that represent cashflow and the certainty and/or frequency of the earnings

[1] Brady , Jim. "Quality of Earnings: Focus on Integrity and Quality." Deloitte, 2010, https://www2.deloitte.com/

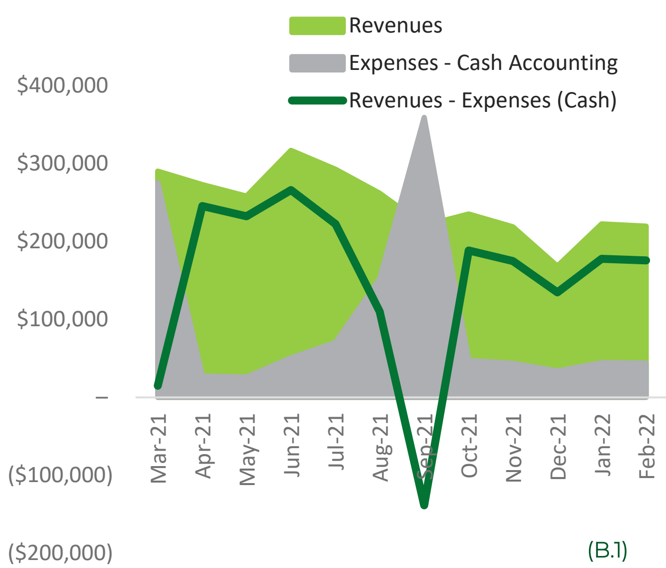
1. ACCRUAL AND ACCOUNTING STANDARDS

Small organizations often follow the cash basis of accounting . While cash basis accounting eases accounting requirements for management, the accrual basis for accounting provides higher quality of earnings as managers aren't as easily able to manipulate costs over time. Additionally, the level of discretion involved in measuring specific accruals varies across companies and is important in evaluating earnings quality. For example, managers may have the ability to manipulate earnings through deferred revenue or accounts receivable where recognition is based on several key performance obligations, which can vary.

A common example of cash basis accounting organizations overstating expenses is through bulk purchases. Professional clinics, such as medical or dental clinics, which are increasingly the target of acquisitions and in need of QoE reports, tend to purchase inventory in bulk to take advantage of discounts. Under a cash-based accounting system, where inventory isn't tracked, earnings in later periods will be much higher than their true values, reducing earnings comparability, as shown in Exhibit B.

Additionally, fluctuations in annual cash flows can lead to significant discrepancies if not considered in EBITDA calculations. Not only do significant expenses that should be spread out over the asset's useful life obscure earnings, but certain revenues can also have a similar effect. For example, loan forgiveness and large one-time revenues can artificially inflate earnings and should be normalized. This is especially important during the COVID-19 pandemic where many US companies received PPP loans, which must be adjusted for to accurately determine sustainable EBITDA.

Despite all of this, the accrual basis for accounting can be manipulated in similar ways as with the cash basis. A manager may use aggregate accruals to artificially inflate or deflate earnings by recognizing revenue or expenses that have not yet been earned or incurred, manipulating the timing of when revenue or expenses are recognized, reversing accruals that were previously recognized, or adjusting accruals to estimate future cash flows. Thus, the highest quality earnings report displays consistent expenses and revenues that are recognized in a timely manner, aligning as closely as possible to their actual occurrence.



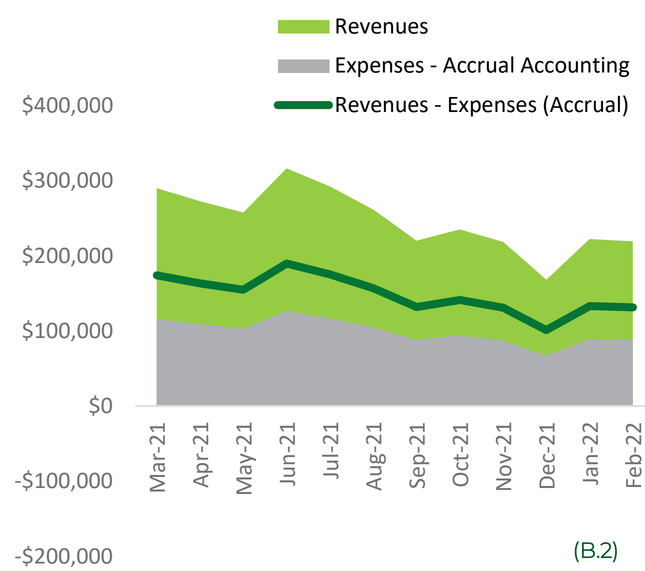


Exhibit B. The Impact of bulk inventory purchases on earnings when using cash accounting (B.1), compared to accrual accounting and an inventory management system (B.2)

2. DEGREE OF ESTIMATION OR SUBJECTIVITY IN DETERMINING EARNINGS

Two key principles can be used to confirm quality of earnings: conservatism and validation.

Conservatism: accounting conservatism is viewed by many as an important determinant of earnings quality. This is due in part to the perception that earnings are less likely to be proven overstated if they are measured using conservative accounting principles . While accounting figures are often not open to interpretation, incorporating conservativism into figures which necessitate discretion can increase the quality of earnings. A common example of lack of conservatism is a company that expenses development costs within their first year and hence overstate their earnings in later years.

Validation: Often key assumptions that have major impacts on the final earnings value can be validated, either through confirming assumptions or historical validation. The first check of a calculated value is generally to compare it to historical data; usually from the year before. The most common example of this is checking allowance for doubtful account against the bad-debt expense for prior periods. Assumptions can be further confirmed through discussion with parties involved in a transaction.

3. PRESENCE OF PRO-FORMA MEASURES OF EARNINGS

The inclusion of applicable pro-forma measures of earnings not only demonstrates completeness of earnings analysis, but also presents important trends in costs and revenues over time. Certain industries will use specific pro-forma measures to describe their cost-structure.

For example, telecommunication companies carry a lot of depreciable assets and thus report on net operating profit to better show their financial picture. The inclusion of such measures serves to increase transparency and comparability of earnings and hence its value. However, without complete transparency of these measures, they lack comparability and therefore value.

Another example of a company specific pro-forma is We Work, whose stock currently sits 83.0% below their IPO price. The company famously reported a "Community Adjusted EBITDA" figure which included normal GAAP EBITDA, but also "building and community level operating expenses," a category that included rent and tenancy expenses, utilities, internet, the salaries of building staff and the cost of business amenities, and also constituted their largest category of expenses.

This type of "creative accounting" that attempts to increase attractiveness of a company is not new. A review by financial data platform FactSet found that since 2016, 75% of companies in the Dow Jones Industrial Average have reported non-GAAP earnings per share that exceed their GAAP earnings, on average [2]. Therefore, the inclusion of clear, comparable pro-forma earnings measures is vital for achieving high-quality earnings reporting.

[2] Griswold, Alison. "Get Ready for Some Creative Accounting in WeWork's IPO Filing." Quartz, Quartz, 13 Aug. 2019, https://qz.com/1685919/wework-ipo-community-adjusted-ebitda-and-other-metrics-to-watch-for

4. TRANSPARENCY OF FINANCIAL DISCLOSURES

While accurately capturing financial metrics is an important factor in earnings, a key concept of earnings quality is comprehensiveness and comparability of disclosures.

Empirical evidence shows that the inclusion of more transparent non-GAAP earnings disclosure is associated with more transitory non-GAAP exclusions and a lower likelihood that managers will aggressively exclude expenses in calculating non-GAAP earnings to meet or exceed expectations [3].

Additionally, using industry standard accounting policies, such as implementing FIFO when peers also use FIFO, increases informativeness of a QoE report, but also has been shown to reduce perceptions of misstating metrics.

5. QUALITY OF MANAGEMENTS DISCUSSION AND ANALYSIS

While management may do everything in its power to present a fair picture of their company, certain limitations may prevent full and entire disclosure. In such cases, full disclosure serves to increase transparency between the two parties.

In a way, managements discussion and analysis (MD&A) is the primary vehicle for management to inform investors about the quality of the company's earnings.

There are several inherent estimates and areas of discretion involved in the application of accounting principles, which should be flagged through complete and transparent disclosures.

It is helpful and provides substantial value to provide the reader with enough information to facilitate an understanding of the various components of earnings, risks and uncertainties that led to the underlying accounting decisions.

6. DATA LIMITATIONS

One common limiting factor when performing QoE is the data provided by the target firm. Generally, earnings are based on a trailing twelve-month (TTM) EBITDA. While in theory, TTM EBITDA will represent a normal operating year, there are very often one-time expenses or increases in revenue.

Although these items should be adjusted, oftentimes they are categorized within a larger account or are combined with other transactions, especially within smaller organizations where there are fewer financial controls. Therefore, recognizing these items as an adjustment becomes highly challenging.

Scenarios where data becomes a limiting factor are exceedingly common for a quality of earnings practitioner. Quality of earnings reports should attempt to make every effort to present the data in a clearly and concisely, but where this is not possible, the report should clearly define what processes were undertaken in arriving at the final result.

> While this paper seeks to aid in understanding what causes one company's earnings to be more valuable than another, it is not a comprehensive list. Many industries have unique measures and thus it is not advisable to rely on a single indicator to assess overall earnings quality; rather it is appropriate to consider all indicators on aggregate.

[3] Nissim, Doron. "Earnings Quality." SSRN, 1 Mar. 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3794378

Ethan Black
Analyst
Sapling Financial Consultants Inc.
ethan.black@saplingfinancial.com

290 Caldari Road, Vaughan
ON L4K 4J4 Canada
info@saplingfinancial.com