Business Buyer Advocate®

Quality of Earnings Ripoffs & Risks

Costly Reports & Providers

Tell me about it.

You're kidding?

I do not prepare QofE reports. I help clients source and review them.

Ted J. Leverette, The Original Business Buyer Advocate ®

PartnerOnCall.com

Ted Leverette's entire street-smart way to buy a business involves:

Answering your "Why?"

And then deciding upon your acquisition criteria.

And then successfully handling these phases:

- search
- due diligence
- financing
- valuation
- negotiations
- post-completion transition of ownership and management

Use this report and its accompanying video to independently manage your financial strategy.
It provides guidance for DIY, so you can eliminate/defer the need for QofE advisory services. Actionable checklist:

1. **Learn**
   - Read this report thoroughly.
   - Watch my entire how-to video.

2. **Self-Manage Finances**
   - Self-assess your financial situation, and the apparent financial condition of your target company.
   - Postpone hiring QofE advisory services unless critical.

3. **Conduct Initial QofE Analysis**
   - Handle the initial quality of earnings analysis yourself.

4. **Discuss your findings with stakeholders and potential lenders.**
   - Try to conduct further research to satisfy their requirements; ask them for specifics.
   - If they demand an independent quality of earnings evaluation and report, ask them for recommendations of service providers.

5. **Evaluate and hire QofE Providers**
   - Use Ted Leverette's report to assess and specify scope of work of potential QofE service providers.
   - Don't fully pay for the report unless or until it complies with the scope of content that you and your potential lender/investor requires.

6. **Communicate with Lenders and Stakeholders**
   - Discuss the report's findings with lenders and stakeholders.
   - Clarify/verify the QofE report requirements and due diligence needed for loan/investment approval.

   Remember: Employ this report as a **benchmark** to evaluate prospective QofE providers.

Contents

Introduction

Welcome to our deep dive into Quality of Earnings.

We're going to navigate some ripoffs and risks in business acquisitions.

I'm Ted Leverette, the Original Business Buyer Advocate ®.

For more than 30-years I've been training and guiding people, worldwide, who buy small and midsize businesses.

I've privately coached more than 1,000 clients. And, I've trained 298 independent advisors, so they can better-serve people buying and selling businesses.

I'm not a broker; never have been. I don't sell businesses. I don't represent sellers.

Today, we're tackling the critical topic of Quality of Earnings (QofE) in M&A, specifically for small and midsize businesses. I'll guide you through the must-dos and the must-nots, highlighting the rampant issue of missing crucial information.

Drawing from decades of experience and recent insights from AI-driven analysis, this report aims to provide actionable strategies so you can find and buy the right businesses the right ways.

My insights might be startling or even unsettling for some people, as I peel back the layers to expose hidden truths often overlooked in the acquisition process.

- Before you risk wasting your time, money, and business opportunities on quality of earnings reports, especially on deals that are destined to fall through (no matter what the report says), watch my webinar and read this how-to report; it supports my video.

- You can find it on my YouTube channel.

- Watch the entire video; some of the commentary does not appear in this report.

Heads Up! 5 Tips

Alarmingly, many acquirers are falling into the trap of selecting inadequate service providers or paying a premium for QofE reports.

1. Here's what you need to do above all: Broaden your understanding of QofE—place equal, if not more, emphasis on future potential than past performance.

2. Be discerning when shopping for QofE reports. Insist on written assurances that the analysis will go beyond meeting lender criteria so the QofE report spotlights potential pitfalls and *actually* enhances your dealmaking skills.

3. Lenders want to know whether your merger or acquisition will handle debt service. Lenders focus on loans. You must live with the results.

4. It's your challenge to evaluate whether you want to live the business ownership experiences to earn the profits, which are the basis for obtaining acquisition financing.

5. There's a big difference between earning profit (the financials). And living it (which is where the non-financial factors impact your lifestyle and peace-of-mind).

6. And for you cynics: Most buyers lack the expertise to fully identify risks, jeopardizing the security of their investment.

Keep reading.

Some of the best tips are toward the end of this report.

For the Providers of QofE Reports

Rest assured, I'm not in your lane.

My role is to empower clients to effectively scrutinize these reports.

That's the expertise I'm eager to share with you today. And later.

The Essential Questions

Why commission a QofE report in the first place?

- **When** should you do it?
- **Who** should you trust to deliver it?
- **What** costs are involved?
- **What** risks are you facing?

All that, and more, coming up**.**

Big Dose of Marketplace Reality

Many lenders require buyers to obtain and submit a QofE report, as a condition of the lender processing an application for acquisition financing.

I'm sorry to say it, but: Lenders make mistakes. Well, let's say, when *lenders* make mistakes, *you* get to pay for it. I'm referring to lenders who rely on inaccurate or incomplete QofE reports, and then approve your loan, oh yeah, *with* your personal guarantee.

Let's hope the lender requiring a QofE report causes you to obtain it from a competent evaluator.

Of course, ill-informed buyers are complicit when they, too, fail to comprehend the shortfalls of most QofE reports.

But that won't matter much if the business you buy can't pay for itself.

And then your bank expects to be paid . . . no matter what.

With the right knowledge and approach, you can ensure a successful transaction that benefits everyone involved. And that's what you want, isn't it?

What Is Quality of Earnings?

Let's be realistic. I like the definition from Morgan & Westfield. They specialize in business sales, mergers, acquisitions, and valuations for privately owned businesses.

Here's their easily understood definition:

"A third-party analysis of the selling company's financial records prepared by an independent professional. The report verifies stated EBITDA, examines projected financial performance, and assesses to what extent revenue and earnings are sustainable. Other areas that are examined include quality of the assets, net working capital, accounting policies, debt and debt-like items, proof of cash and revenue, financial controls and reporting, quality of the supply chain, and adequacy of the management team.

"A third-party is retained to prepare the QofE report. The team is independent and has no stake in the game, so they are generally unbiased and not influenced by any pressure to do a deal."

So, here's another tip:

Don't risk errors and omissions. You and/or your service provider should evaluate every topic I cover. Think of it as your checklist. Make some notes. Verify that your service provider will or will not address every topic I cover. Plus, get whatever else you need to know for your circumstances.

Don't hire people without knowing the output you will receive. I'll say it again:

- Don't risk errors and omissions.

Fees, Competency, Shortchanging Among Report Providers

Cost of reports and completion times vary widely.

So does the competency of providers.

The range of pricing for various levels of QofE reports mostly range from $5,000 to more than $30,000. Don't assume you get what you pay for by ordering from the most expensive service providers.

Here's what a partner in a small investment company with several active small business holdings said about fees: *"The price point of a standard QofE report is so disproportionate to the typical deal size."*

I replied: *"Thank you for 'disproportionate.' I've been losing sleep trying to find the right word, among these possibilities: (Now remember, we're talking about the pricing of these reports.) Peculiar, excessive, unreasonable, extraordinary, irregular, too much, ripoff, criminal, LOL."*

Be wary when service providers say you only pay them one time, and if that deal does not complete, they won't charge you again no matter how many times you come back to them ordering a QofE report for your next potential deal. (BTW, this same tip pertains to lawyers and others who say they won't charge more, regardless of how many deals you want them to handle for you.)

And don't fall for marketing pitches like: *"I'm #1."*

Or, *"We're the best."*

You want the person who is best for you and your situation. The keyword there is "person." Do not let any firm's reputation blind you to the capability of whoever you're going to interacting with.

I'm going to reveal how some QofE service providers shortchange their clients and why some lenders fund transactions that would be questionable if the buyers, sellers, and lenders had a more complete picture of the potential merger or acquisition.

So, what kinds of professional service providers prepare M&A reports covering quality of earnings?

Keep in mind that your best choice relates to the kind and size of transaction and your locality.

So, who are they?

1. Accounting Firms
2. Consulting Firms
3. Subject Matter Experts
4. Financial Advisory Services
5. Investment Banks
6. Financial Analysts
7. Specialized Financial Due Diligence Firms
8. Quality of Earnings Consultants
9. Incompetent or Troublesome Sources

Schedule a private Zoom with me. I can help you locate and evaluate service providers, and then help you interpret their reports, and then help you decide about the rest of due diligence and dealmaking.

If you get this wrong, not much else may go right for you, because of how the reports influence you. And how the reports influence potential lenders and investors . . . and the other side of your dealmaking table.

Who Wants/Needs QofE?

Stakeholders: Investors, lenders, potential acquirers.

And savvy owners, sellers, brokers.

They want QofE evaluations to facilitate M&A transactions.

It's not an audit.

It is not comprehensive due diligence.

If you're considering applying for SBA loans, there's one important factor to keep in mind. They typically require a personal guarantee and, maybe, a QofE report . . . from a provider acceptable to the lender.

Issues Inadequately Addressed

Unfortunately, the problems I will first state are the problems you probably won't know about: Such as overpaying for reports. Or buying reports that do not cover as many topics, especially essential topics, that are included in the reports from alternative service providers.

And then we have the typical issues that we hope are adequately evaluated: Accounting anomalies, cash flow concerns, accruals and adjustments, deviations from industry norms.

Too many users of QofE reports don't realize the financial statements, to a large degree, are directly influenced by **non**-financial factors; the kinds of forces that create the financial results, and inform the forecasts.

Closely followup with report writers who say something like this in their reports: *"It cannot be determined if . . . whatever"* (which means they did not cover it)

And, this kind of disclaimer:

"We do not represent that our report is sufficient for the customer's needs."

Find out why, and what you can do about it.

Common Errors & Omissions

Beware of the potential mismatch between what lenders will evaluate and the content of QofE reports.

Some loan brokers and lenders, upfront, give to applicants for financing the list of topics the applicant must address.

I’ve compared those lists with the typical content of QofE reports. It’s not a pretty picture.

Let’s consider issues not addressed or not adequately addressed in lots of QofE reports. There are 15 of them.

1. Overlooking non-financial factors, such as economic and other trends, management, operations, competition, AND relationships (e.g., customers, employees, landlords, banks, suppliers, etcetera.).

2. QofE analysis should reveal hidden liabilities and contingent obligations that were not adequately disclosed in the financial statements. These liabilities, such as pending litigation, warranty claims, or environmental liabilities, can have a significant impact on the company's financial position and future cash flows.

3. Inventory reporting, such as valuation, tracking amounts, usefulness, turnover. This topic, inventory, can be a major cause of arguments and time delays when accountants and lawyers and appraisers do their thing.

4. Failure to identify inappropriate accounting policies and practices, such as compliance with accounting standards and accuracy in reporting. And, keep in mind how comparability of the numbers within the target company, AND against similar companies.

5. Accruals and Adjustments: Watch out for discrepancies with accrual and cash accounting. Large and unexplained accruals or changes in accruals may indicate earnings manipulation.

6. Omitting comparative analysis: Deviations from industry norms or peer performance that could signal underlying issues.

7. Improper revenue recognition, such as too early, too late, not related to the subject company, not at all (skimming).

8. Overlooking non-recurring revenues.

9. Neglecting macroeconomic factors, such as external economic conditions like interest rates, inflation, and availability of capital.

10. Incomplete financial analysis, such as the changes in revenue streams, expenses, and cash flow.

11. Neglecting expense analysis, such as the relationship between variable and fixed expenses. Also, detect non-recurring, extraordinary, consistency, and appropriateness. What about failure to

accrue for future expenses, or excessive discretionary spending? Don't forget: Expenses not related to the subject company, which happens when another entity is paying the subject company's expenses.

12. Inadequate cash flow analysis, which can mask liquidity problems.

13. Failure to consider industry-specific factors, such as regulatory, technological, or competitive.

14. What about management integrity and governance issues? QofE reports may raise concerns about management integrity and governance practices, such as conflicts of interest, related-party transactions, or inadequate internal controls. These issues can erode investor confidence and affect the company's reputation and valuation.

15. Owner distributions. Are they reasonable and legitimate?

Those errors can enable an inaccurate assessment of a company's quality of earnings. This is not good for buyers, lenders, and others.

Differences between Diligence and QofE

Doer (in other words: Who is doing the work?), the focus (who is focusing?), scope (what's the scope?), details, comprehensiveness, whether there is non-financial, and how deep, interviews (are we talking to other people or merely taking the seller's word for it?), legal, market research, other risks, opportunities.

There are many things that overlap. You must get those right. You must know how to allocate the QofE and the other due diligence jobs.

QofE **reports**, btw, are *supposed* to facilitate due diligence.

QofE **analysis**, as done by some of the less helpful service providers, merely helps people identify discrepancies or risks in the target company's HISTORICAL financial statements.

If QofE analysis does not adequately handle non-financials, get it done during the rest of due diligence.

CYA Recommendations

CYA means cover your ass.

It also means . . . cover your **ass**ets.

Learn more about best practices, about risks, mitigation, timing, providers, and broken deal fees and arrangements with your advisory team.

Don’t believe you’re getting a good deal from advisors who say “pay me once, for one potential transaction, and then if it falls through, you don’t have to pay me again no matter how many potential deals in which you want to involve me.

Shop around. When it comes to finding the right provider of QofE reports.

3 tips:

- See samples of their workmanship.
- And verify their credentials.
- And whether your lender will accept their report.

Begin with your target pretax net cash flow requirements. Annual and monthly.

And then screen businesses for sale on their non-financials. The non-financials answer the who, what, when, why, how.

Chat Box Q&A

Watch my webinar video for these topics:

- What is skimming of profit?
- Omitting comparative analysis
- What kinds of companies don't need QofE?
- Who should evaluate QofE?
- What about wasting dead deal fees?
- What about 11th hour pullouts by lenders (sometimes at escrow)?
- What steps can we take pre- and after-LOI before hiring QofE consultant?
- DIY ways for QofE and due diligence?
- Providers using this webinar to improve their offerings and performances.

Schedule a Private Zoom with Me

I can help you locate and evaluate service providers, and then help you interpret QofE reports, and then help you decide about handling the rest of due diligence and dealmaking.

If you get this wrong, not much else may go right for you, because of how the QofE and due diligence reports influence you, potential lenders and investors, and the other side of your dealmaking table.

You can reach out to me by email through my website, partneroncall.com.

BTW, I can also guide you through the tactics and strategies explained in my books:

How to Prepare Yourself and Find the Right Business to Buy

How to Buy the Right Business the Right Way

You can get them on Amazon.

Fair warning:

Mistakes made on the playing field may not be reversible. (As they say, we can't unscramble eggs.)

I hope this presentation has brought to light the challenges and opportunities that come with QofE.

So . . . I'm Ted Leverette, the Original Business Buyer Advocate.

Thanks for reading this report, and watching my video . . . be careful out there!

Struggling to find and buy the right small or midsize business?

Competition is a natural part of the business acquisition process, but it doesn't have to deter you. Here's how you can stand out:

Personalize Your Approach
Tailor your communication to each business owner. Show genuine interest in their business and its legacy, which can set you apart from competitors who may take a more generic approach.

Build Strong Relationships
Focus on building rapport and trust with business owners. People sell to those they like and trust, so prioritize relationship-building over transactional interactions.

Highlight Your Unique Value Proposition
Clearly articulate what makes you the best choice for taking over their business. Emphasize your strengths, vision for the business, and how you plan to preserve and build upon their hard work.

Be Prepared and Professional
Have your financials in order, and be ready to move quickly if an opportunity arises. Professionalism can make a significant impression.

Stay Informed and Knowledgeable
Demonstrate your industry knowledge and business acumen. Sellers are more likely to engage with buyers who understand their business and its market.

Offer Flexibility
Be open to seller terms and conditions. Flexibility can be a deciding factor for sellers choosing between multiple buyers.

Communicate Your Passion
Let your enthusiasm for their business shine through. Passion can be infectious and may influence a seller's decision.

Remember, while competition is inevitable, your unique approach and dedication can make all the difference. Keep refining your strategy, and you'll find a seller who appreciates the value you bring. Stay motivated and focused on your goal!

Watch this 2-minute video:
"What the Savviest Searchers Do to Find and Buy the Right Businesses the Right Way"

Learn more by Zooming with **Ted J. Leverette,** The Original *Business Buyer Advocate* ®