CBV Institute

CBV INSTITUTE

SPONSORED RESEARCH PAPER

BEST PRACTICES FOR QUALITY OF EARNINGS REPORTS

Melanie E. Russell, FCPA, FCA, CBV, CIM, CFE, CFF, ABV, FDRP-Val

CBV INSTITUTE
SPONSORED RESEARCH

About Chartered Business Valuators Institute (CBV Institute)

CBV Institute leads the Chartered Business Valuator (CBV) profession – Canada's only designation dedicated to business valuation since 1971. With CBVs and Students across Canada and around the world, we uphold the highest standards of business valuation practice through education, accreditation and governance of the CBV, for the benefit of the public interest. The integrity of the CBV accreditation is grounded in the rigorous CBV Program of Studies and upheld by the Membership Qualification Examination and Code of Ethics.

CBV Institute - Sponsored Research Initiative

CBV Institute's Sponsored Research Initiative was started in 2004 to foster original research on emerging topics of interest to CBVs. Since its inception, the initiative has annually sponsored CBVs, academics, and students to further innovative research in the business valuation field. The views expressed are those of the authors and are not necessarily those of CBV Institute.

1. INTRODUCTION

When I started preparing Quality of Earnings ("QOE") reports for clients some time ago, I began a search for guidelines, practice standards and/or reporting standards – anything that would assist me with such engagements. As a CBV, CPA and CA, I am used to having some sort of "box" or set of parameters for preparing analyses and reports that end up in the hands of users, whomever those users may be. However, after a lengthy search and many discussions, I concluded that there are no all-encompassing QOE practice standards or reporting standards.

The first two places I looked for guidance were the CBV Institute (practice standards, practice bulletins, etc.) and CPA Canada reference materials, but found nothing of direct relevance, or that provided fulsome guidance[1]. Although I could not locate any standards or guidance in Canada that explicitly apply to QOE reports, I identified a few indirectly relevant standards. For example, the American Institute of Certified Public Accountants ("AICPA") issued, effective January 1, 1992, "Statement on Standards for Consulting Services" ("SSCS1"). SSCS1 provides very general standards on issues such as professional competence, due professional care, planning and supervision, obtaining sufficient relevant data, independence, conflicts of interest, and obtaining an understanding of the engagement terms with the client, which appear to be similar to the 20's (i.e., Scope of Work Standards) in the Practice Standards of the CBV Institute as well as Codes of Conduct and Rules of Professional Conduct of the Institute and the provincial CPA bodies. In SSCS1, consulting services are defined as "[p]rofessional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process…[and] may include…[t]ransaction services, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party…[such as] insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger…"[2]. Consulting services are differentiated from attestation functions as the "practitioner develops the findings, conclusions, and recommendations presented…[and] generally, the work is performed only for the use and benefit of the client." However, many QOE reports are prepared for clients but provided to third parties, generally with the execution of a non-reliance letter being a requirement.

It should also be noted that there are courses that cover QOE reports, either as a component of a financial diligence course or separately. For example, CPA Ontario (and the other provincial CPA bodies) offer a course on due diligence, which I have taught. The course material contains one module covering QOE reports. I also noted a short course offered by an organization in compliance with the U.S. National Association of State Boards of Accountancy dedicated to QOE reports, and a fulsome search may locate other courses. And, of course, numerous courses and reference materials are available regarding the concepts of earnings quality and cash flow vs. earnings in general.

I also researched publicly available information on QOE reports. I located brief, and not overly helpful, material (short articles, videos, etc.) on the websites of QOE providers. As their objective was to market QOE reports to users as part of their menu of transaction advisory offerings rather than educate preparers, there was little helpful guidance for preparers. Specifically, I found no information regarding the level/extent of analysis conducted by the QOE provider or about the coverage in their QOE reports. Ultimately, I was unable to find any publicly available QOE standards or guidance, whether practice, work, reporting or ethical, reports that would apply to all QOE providers. However, of note is that I identified somewhat consistent practices within the larger public accounting firms. Based on interviews with preparers from larger public accounting firms, it appears that such firms have developed internal practices, guidelines, checklists, processes, etc. relating to QOE reports and engagements.

I then defaulted to the next best option – consult with the users (who can be defined as those who initiate the report or those who utilize the report) as to their desired scope of work. I found that while some users had clear visions of what they wanted to be covered in a QOE report or could come to a clear vision with the assistance of the QOE preparer, not all users were aware of what they wanted or needed beyond a "QOE report". Among the former type of users, users may have a different set of expectations, list of procedures or scope of review to be covered in a QOE report. In some cases, users had full understanding and discernment as to what they wanted to be covered and the users played a significant role in selecting coverage and scope of the QOE engagement; in other cases, there was a lack of understanding of the QOE report beyond something that was required simply to "tick the box" and obtain investment or financing committee approval.

This paper is meant to be a starting point for a discussion on the nature of QOE reports and best practices, with the hope it will provide useful guidance to CBV practitioners and assist in the consideration of whether there is a need to develop further guidance in the expanding area of QOE reports and engagements in Canada. Based on my experience and discussions with the study participants, the demand for QOE reports is increasing. QOE reports are prepared by various professionals and not just CBVs. Developing standards and/or guidance and, thereby, solidifying and expanding the professionalism of QOE report preparation, may be an untapped opportunity for the CBV profession to expand its service offerings and increase the profession's standing in the fields of QOE report preparation and transaction advisory services.

Before I continue with my findings to date, I wanted to acknowledge and thank all of those who assisted me with the research, sharing their insight and experience. I would not have been able to prepare this paper without the input of so many wise and thoughtful individuals who volunteered to share their time on this project. I consulted with both preparers, some of whom were CBVs but many of whom were not, as well as users. Each of them (with a couple of exceptions) completed a survey (see Appendix A for the contents of the questionnaire) and met with me for a discussion on the issue. I also consulted with the following: (a) lawyers to find out whether there were any reported lawsuits involving QOE reports (no reported Canadian decisions were identified by these lawyers), and (b) insurers to learn whether there were any claims made under representations and warranties insurance relating to QOE reports[3]. (What better way to develop a set of best practices than to find examples of QOE failures?) Their names are listed at the end of this paper. Once again, thank you to all of those who assisted.

Embedded throughout this paper are comments received from the research study participants, both from the completed questionnaire and my discussions with them. A summary of the responses received from the participants is included at the end of the paper. It goes without saying that while there were several contributors and they were widely divergent in terms of their experience with QOE reports and engagements, the sample covered herein may not have addressed all issues or comments had a wider number of respondents been involved.

2. WHAT IS A QOE REPORT?

Let's start this paper by discussing what a QOE report is, and maybe a bit about what it is not. They are generally undertaken in contemplation of a potential financing or investing (buy or sell) transaction. It is important to note that there is not one definition that applies to a QOE report, and such reports vary significantly in their form and content. In my experience, the term is used to cover engagements that may include a variety of procedures with slightly different objectives, but they are all generally aimed at providing the client and/or user some level of comfort in assessing potential future cash flows based on (a) an assessment of normalized historical earnings/cash flow proxy, and (b) other procedures and analysis that may be covered in a QOE report.

Unlike financial statement audits and reviews, which are highly consistent in terms of scope and reporting regardless of the subject company, the coverage in a QOE engagement and the contents of a QOE report may vary from engagement to engagement. For example, all financial statement audits and reviews prepared under relevant assurance standards report on the subject company's financial statements which reflect pre-established income and cash flow measures such as income before taxes and net income (per the income statement/statement of operations), and cash flows from operations, investing and financing (per the statement of cash flow). In contrast, QOE reports generally use different terminology for the "E" in "QOE". This generally occurs because the user of the QOE report is focused on other measures of cash flow. For example, a purchaser of a company may be more interested in earnings before interest, taxes, depreciation and amortization ("EBITDA") because that is the basis upon which the purchase price has been determined.

Quality of earnings refers to the degree to which a company's reported earnings reliably represent its underlying sustainable economic performance (ergo the term "economic earnings"). Earnings that fluctuate due to cyclical trends, non-recurring transactions, off-market transactions or other atypical sources are not considered sustainable or reflective of future expected operating results. The objective is to identify sustainable earnings that are indicative of a company's true profitability. If a company reports high net income but negative operating or discretionary cash flow, it may not be as financially sound as it appears per its financial statements. Quite simply, if a company reports positive net income but inconsistent earnings, then investing in the company may be riskier than the company's financial statements indicate. Income, regardless of the selected proxy such as EBITDA or some other measure, is only considered to be of high quality if it is sustainable and reflects discretionary cash flow.

As valuators (and many of us are also accountants or auditors/assurance providers by training), we understand that historical net income is not necessarily, and usually is not at all, a reliable indication of the historical, never mind the expected future, financial performance of a business.

Required characteristics/features in order for earnings to be considered to be high quality can be categorized as follows:

a) Predictable and expected to recur, which will exclude non-recurring or unusual items, be from regular/core operations, and be closely aligned with cash flow (i.e., cash conversion ratio is high and generally, fewer accruals);

b) Comparable to other entities, which requires consistency in terms of selected accounting policies and verifiable/supportable estimates and assumptions;

c) Transparent and understandable, which requires full/comprehensive and clear disclosure.

If the audited financials are the "window" into the business, a QOE report is like opening the door and getting a guided tour. A QOE report generally assesses how a company accumulates its revenues and incurs its expenses – such as cash or non-cash, recurring or non-recurring. Many key details are not outlined in a company's income statements – therefore, a breakdown of cash sources is very important. The QOE report generally evaluates various factors that influence earnings quality. It assesses the consistency of earnings growth, the nature of revenue sources, the completeness/ adequacy of accruals and accounting practices, the presence of non-recurring items and the impact of management's financial decisions. By analyzing these elements, potential investors and creditors gain insights into a company's financial stability, the reliability of its reported earnings and potential future operating results.

The QOE report often goes beyond the scope of an audit, review or compilation of historical results in certain areas by rigorously analyzing a company's past, present and future earning power[4]. The objective is to correctly interpret a company's earnings and assist in developing projections of maintainable/sustainable earnings/ cash flow (or assessing existing projections). Audits are backward-looking as they focus on whether a company's past financial statements comply with generally accepted accounting principles (GAAP), whether ASPE, IFRS or another accounting basis. An audit is not intended to look at business trends and outlook nor does it address the company's history of earnings or its potential as does a QOE report. However, investors and lenders are concerned about future cash flow (whether measured by EBITDA, EBIT or some other cash flow proxy) since that is what repays borrowed funds or pays a return on invested capital. A QOE report, on the other hand, focuses on the company's financial track record, current financial position and ongoing earning power, and provides broader insight into key aspects of the company's operations to help identify how the business might perform on a go-forward basis. A QOE engagement considers how purchases and expenses are recorded and whether and to what extent those transactions are necessary to business operations.

A QOE report draws on key portions of the analyses used by valuators in their engagements, and may involve a significant expansion of that analysis. It may include an analysis of an entity's historical earnings/cash flow to assess the reliability of reported results, accounting policies used, identification of cash flow drivers and related risks, and the likely continuity or predictability of results. It may be comparable to an in-depth analysis of one of the four key components of a valuation - maintainable/projected future cash flows. While valuations (regardless of the level of valuation report) and pricing analyses generally include normalization of historical earnings and financial positions to assist with developing operating and cash flow forecasts or projections, QOE engagements generally involve a more detailed review of normalizations, including source documentation and accounting records.

However, it is important to note that while a QOE engagement is more detailed and meticulous in areas specifically relating to the company's earnings/cash flow than an audit, review or compilation report, it is focused on certain issues and areas, which often differ depending upon the nature of the engagement, the budget, the users, etc. In other words, it should consider the areas of transaction risk in the situation, and focus procedures and scope of work accordingly.

As mentioned previously, while some CBVs prepare QOE reports, many QOE preparers are not CBVs. Understanding the quality of a company's earnings is paramount for making sound investment and lending decisions. QOE reports play a vital role in assessing the reliability, sustainability and transparency of a company's reported earnings, and assist in providing guidance regarding potential future operating results. By examining various financial indicators and evaluating accounting practices, QOE reports provide investors and lenders with a deeper understanding of a company's historical and expected future financial performance and help uncover potential risks. Incorporating QOE analysis into investment and lending decision-making processes enhances the ability to make informed choices and mitigate risks, ultimately leading to more successful investment and financing outcomes.

3. POTENTIAL PURPOSES OF QOE REPORTS

A QOE report can be used in a variety of situations including being part of preparing a company for potential sale by a vendor (i.e., “sell-side”); as part of the post-letter of intent/expression of interest (“LOI” or “EOI”) diligence process for M&A transactions on the buy-side (including for the purchaser and potentially the insurer if representations and warranties insurance is being utilized in the transaction[5]) and deal negotiations; as part of the financing requirements by a lender (e.g., one of the steps required for credit committee approval); as part of an entity’s strategic initiatives (including transition on an M&A transaction or corporate reorganization); or as part of governance requirements (e.g., if the Board is evaluating a potential divestiture). It can also be a useful tool to assist in the transition/integration stage of a closed deal, given that it may identify issues and risks relating to the target or the nature of the transaction.

On the buy-side or financing side, it is beneficial if a QOE report outlines and analyzes the benefits and risks of the investment or financing. A QOE report may be utilized by the potential investor or lender to validate key pieces of financial information, to critically assess the target’s performance against the measure on which an offer was based and to identify items of interest or financial issues that require further due diligence, specific carve-outs and restructuring of the proposed transaction or financing, or may need to be included as representations and warranties in a purchase and sale agreement or covered by representations and warranties insurance.

As one research study participant noted, the fact that companies have downgraded the level of assurance provided on their historical financial statements over the past number of years to reviews, compilations or internally generated statements, a QOE report can help to “fill the gap” by increasing reliability of certain components in the non-audited financial statements rather than a vendor having to obtain an audit on all past years’ statements.

QOE reports are typically used to confirm the following:

a) EBITDA (or whatever cash flow proxy is being utilized to price the business or determine the amount of financing to offer to a borrower) and normalization adjustments proposed by the vendor are accurate and traceable to source financial information; and

b) the reported earnings are representative of the target’s sustainable/maintainable, ”true” or economic earnings.

On the sell-side, QOE reports allow sellers to get an objective look at their business to better prepare for a potential sale, save time in the sale process and have a more successful outcome. The report can highlight inconsistencies in financial data and areas of concern to address before selling. It also should help to identify key areas to “fix” to get the most favourable deal. Essentially, it gives existing owners time to correct issues and puts them in a good position to explain their financial performance to, and address diligence issues with, potential buyers. The QOE report should offer the opportunity for the vendor to identify and fix otherwise unforeseen but important issues that could be potential deal-killers or issues that may drag down a purchase price or negatively affect the structuring of a proposed offer.

In summary, the benefits of QOE reports include the following:

a) Identifying risks: QOE reports provide insights into the risks associated with a company’s earnings capacity. They highlight factors that could impact earnings sustainability such as volatile revenue sources, excessive reliance on non-recurring items or aggressive accounting practices. This information assists potential investors and lenders in making informed decisions and managing risk effectively.

b) Unveiling financial inconsistencies: QOE reports help uncover any potential financial or accounting inconsistencies. By examining various financial indicators, they enable potential investors and lenders to detect red flags and assess the reliability of a company's reported earnings relative to factors such as its discretionary cash flows or a purchaser's accounting policies.

c) Enhancing decision-making: By analyzing the quality of earnings, investors and creditors can gain a deeper understanding of a company's financial performance. QOE reports offer valuable information that complements traditional financial statements, enabling potential investors and lenders to make more informed investment decisions.

d) Assessing long-term sustainability: Companies with consistent and sustainable/predictable earnings are more likely to maintain their financial health and withstand economic downturns. QOE reports assist potential investors and lenders in evaluating a company's long-term sustainability and potential for future growth.

4. CONTENT AND COVERAGE/SCOPE OF QOE REPORTS

Although the objective of this paper was not to make conclusions about whether standards or guidelines relating to QOE should be established and the content thereof, one of my key findings is that there is not, and there should not be, a "one-size-fits-all" work program or scope of review and procedures, or report disclosures and sections in QOE reports. This was reinforced by each of the research study participants. Regarding the most common procedures, some participants indicated that while all of the procedures I listed in the questionnaire (see Appendix A) may be relevant, the appropriate procedures will depend upon the particular circumstances. In question #9, I asked participants to select which of the following procedures they expected to be undertaken in a QOE engagement:

a) Bridge/reconciliations from accounting-based net income to EBITDA or cash flow

b) Assessment of recurring and non-recurring income and expenses

c) Assessment of accounting policies used by the target entity and changes over time

d) Assessment of working capital

e) Analysis of the target and areas of financial risk (e.g., history, clients, suppliers, products/services, key staff/contractors, key contracts, related parties, SWOT analysis, etc.

f) Analysis of historical operating results – trends, ratios, etc.

g) Analysis of historical financial position and condition and value of relevant assets and liabilities

h) Analysis of revenue by type, currency, customer, etc.

i) Analysis of receivables by customer, currency, # of days outstanding, etc.

j) Analysis of normalized operating results/EBITDA/cash flows

k) Analysis of capital expenditures

l) Analysis of normalized financial position

m) Analysis of related party transactions and accounts

In addition, research study participants provided other potential procedures that they have seen used in QOE reports:

- Assessment of net debt and any debt-like items in the working capital;
- Testing around revenue cut-offs and analysis of undisclosed liabilities;
- Trend analysis of financial performance to detect any outliers in the periods being used to drive a transaction price (i.e., sales acceleration or expense deferral to drive up EBITDA);
- Preparation of sensitivity analysis;
- Industry-specific measures and benchmarking;
- Presentation of internal key performance indicators;
- Assessment of the reasonableness of projections;
- Reconciliation of bank statements to General Ledgers.

As discussed in this section, should any standards or guidance be developed in the future, they should reflect that QOE reports need to be tailored to the particular situation based on the needs of the users and taking into consideration factors including, but not limited to, proposed timing, size and nature of the transaction; particular issues relating to the target company; nature of the industry and economic conditions; availability of relevant information and documentation; and the budget for QOE preparation fees. Any standards or guidance will need to be sufficiently flexible and relevant to allow preparers to exercise their professional judgment in determining the appropriate procedures, scope of review and contents of a QOE report. It is important to give preparers the ability to develop custom QOE reports to meet the needs of users in a variety of situations.

With that said, this section covers possible areas, procedures, etc. that may be covered in a QOE report. The overall intent of the QOE report is to compile a single document that objectively presents the quality of a company's historical earnings/cash flow and certain assets (and possibly liabilities in some cases), as well as the sustainability of future earnings/cash flow. However, the specific coverage of procedures and content of the report vary among QOE reports, and sometimes significantly.

A) QOE REPORT SECTIONS - POTENTIAL

While the report's contents should vary based on the type of business being analyzed, market conditions, the purpose and users of the report, the nature of the proposed transaction, cost considerations, etc., in my experience, there is usually a set of standard sections in most QOE reports such as:

- Introduction and Company Overview: provides essential background information such as the company's industry, business model, products and services, customer base and market position. It sets the context for understanding the company's earnings and the factors that impact the quality thereof.
- Methodology/Procedures Performed and Scope of Review: outline of the approach, methods and data sources used (i.e., scope and procedures) in the QOE analysis including the period covered, financial statements and other financial and non-financial information reviewed, and any specific areas of focus or limitations.
- Income statement and EBITDA (or other cash flow proxy utilized) analysis: analysis of key financial metrics and ratios that are relevant to assessing earnings quality; may include benchmarking.

- Revenue and Customer/Client Analysis: an examination of the company's revenue sources (types of products and services), revenue recognition policies and the quality of its revenue by, for example, categories, key customers, currency, geographical location, terms of any contracts, etc.; assesses whether revenues reflect actual sales and services were rendered, and consistency, reliability and sustainability of the company's revenue streams and identify any potential risks or red flags. Objectives include assessing the following:

  a) The stability of sales to customers over the period reviewed;

  b) The level of concentration with individual customers or groups of customers;

  c) The relative trend toward a more diverse or more concentrated customer base during the period reviewed;

  d) Seasonality issues.

    - Expense Analysis: evaluation of the company's expense structure, cost management practices, operating efficiency and the reasonableness of expense allocations.
    - Cash Flow Analysis: assessment of the relationship between reported earnings and actual cash flows, highlighting any discrepancies or factors that may impact earnings quality.
    - Analysis of capital expenditures, specifically delineating between maintenance and growth capital expenditures, which likely includes benchmarking against industry statistics.
    - Normalized EBITDA (or other cash flow proxy utilized) - identification and analysis of non-recurring or one-time items that may have influenced the reported earnings. It discusses the nature, magnitude and impact of these items on the company's earnings quality and provides insights into the sustainability of earnings without such items.

In preparing the normalized EBITDA (or other cash flow proxy), the QOE preparer will consider adjustments familiar to professional valuators such as:

- Non-recurring/"one-off" revenues or expenses;
- Unusual transactions;
- Changes made to accounting policies, procedures and practices over time;
- Inadequate and/or inappropriate accounting estimates;
- Accounting policies that do not comply with GAAP relevant in the circumstances;
- Transactions with related parties;
- The impact of the proposed transaction (e.g., elimination of certain staff, premises or lines of businesses on closing or other anticipated "right-sizing"; termination of agreements; not acquiring certain assets; not assuming certain liabilities).
- Accounting Policies and Practices, and Internal Controls: evaluation of the company's key accounting policies, practices and judgments for appropriateness, consistency and transparency of accounting policies selected such as revenue recognition, expense recognition, and asset (e.g., accounts receivable, inventory, capital asset, impairment) and liability fair valuation; highlights potential risks or concerns related to accounting practices and internal controls including aggressive or overly conservative practices affecting the sustainability of reported earnings.

- Working capital analysis: assists in determining the amount of working capital needed to (a) generate the profits produced by the business historically and to the closing of a proposed transaction (i.e., ensure enough working capital is left in the business at any point in time, or injected on closing if working capital is insufficient, so that operations are not disrupted as a result of a change in control due to a transaction), and (b) meet the company's current obligations promptly. Major components of working capital are analyzed to determine if they are complete and fairly valued (e.g., collections of accounts receivable, inventory turnover, deferred revenue), and EBITDA/cash flow normalization adjustments are reviewed to consider if there is a corresponding working capital adjustment required. Another common adjustment is required when the proposed transaction will occur on a cash-free, debt-free basis (i.e., the vendor will keep the cash and will be responsible for repaying the debt); therefore, cash and debt items are generally normalized in the working capital analysis.
- Risks, Limitations and Key Assumptions: acknowledges any inherent uncertainties, restrictions and limitations of data, assumptions made, or constraints that may impact the accuracy or reliability of the report's findings and conclusions.
- Conclusion and Recommendations: summarizes the main findings of the QOE analysis and may (or may not) present recommendations based on the assessment of earnings quality and suggestions for improvement, areas of concern that require further investigation (e.g., "red flags"), or actions to mitigate identified risks.
- Appendices/Schedules and Supporting Data: for example, historical financial statement summaries, detailed financial analysis, tables, charts, etc.

The QOE report may also contain an executive summary including a concise overview of the report's key findings, conclusions, and recommendations, and a summary of the primary items influencing a company's earnings quality with a focus on any significant issues or risks identified during the analysis.

In addition to the above, other areas may need to be covered in a QOE report depending on circumstantial, business-specific or industry-specific considerations. For example, a proof of cash can assist with tracking a company's cash receipts and disbursements against its recognition of revenues and expenses. The amount of cash deposited in the bank in a period rarely aligns perfectly with the amount of revenue recognized by the company due to, for example, changes in receivable and other working capital balances; timing of payments such as HST, employee withholdings and corporate tax instalments; recording of accrued liabilities; receipt of customer deposits; and prepaid expenses. The same is true of cash disbursements and expenses. A proof of cash gives comfort that the transactions being reflected in a company's bank accounts are being included in its accounting records, and vice versa. This procedure may be relevant in situations when a company's financial statements are not audited or reviewed by an external/public accountant. Several user-participants indicated that some of the procedures they want to see in a QOE report relate to verifying cash receipts – e.g., a cash flow bridge or a reconciliation of the bank statements to accounting documents such as General Ledgers.

Other possible procedures to be covered relate to budgets, forecasts or projections, including underlying assumptions, review of backlog, etc. This was an interesting area – some user- participants thought it would be useful to include verification procedures in a QOE report, and review projections, budgets, etc., whereas most participants were used to seeing the focus of a QOE report be on historical operating results for a specified period.

B) QOE REPORT SECTIONS – PER PARTICIPANTS

Regarding the most common report sections, participants were eager to remind me that while all sections I listed in the questionnaire (see Appendix A) may be relevant, the appropriate report format will depend upon the particular circumstances. In question #10, I asked participants to select which of the following sections/disclosures they expected to see in QOE reports:

a) Statement of mandate/purpose and intended user
b) Identity of engaging client
c) A statement of independence/objectivity OR if the preparer is not independent, details of the nature of the relationship between the engaging client and the preparer
d) Definitions of key terms used
e) Scope of review/documents used
f) Listing of procedures performed
g) Identification of any scope limitations
h) Analysis of the target and areas of financial risk (e.g., history, clients, suppliers, products/services, key staff/contractors, key contracts, related parties, SWOT analysis, etc.
i) Key accounting policies used and impact of changes over time
j) Historical operating results – trends, ratios, etc.
k) Historical financial position and condition and value of relevant assets and liabilities
l) Breakdown of revenue by type, currency, customer, etc.
m) Breakdown of accounts receivable by customer, currency, number of days outstanding, etc.
n) Normalized operating results/EBITDA/cash flows
o) Reconciliation of accounting income to cash flow (“cash flow bridge”)
p) Historical and future capital expenditures
q) Normalized financial position
r) Historical and future working capital analysis
s) Industry factors affecting the target
t) Economic conditions affecting the target
u) Findings/conclusions
v) Key assumptions

Other desirable sections identified by participants included the following:

- A robust executive summary that lists pertinent “red flags” upfront;
- Presentation of alternative findings/analyses when key components are open to interpretation (i.e., sensitivity analysis);
- “Red flags” outlining the issues identified and categorized by level of risk;
- Industry-specific measures/benchmarking;
- Presentation of internal key performance indicators.

Some participants indicated that users prefer shorter reports, other forms of reporting (such as PowerPoints, oral reports, etc.), expanded use of analytics, and focus on exceptions/notable findings.

5. PERIOD COVERED IN QOE REPORTS

Consistent with my previous comments that the content of QOE reports varies based on the relevant situation, so too does the appropriate period covered by a QOE report vary. Generally, users like to have more than one year covered, but the appropriate period is a matter that should be determined by the QOE preparer in conjunction with the client. Relevant considerations in this decision may include cost, timing of the transaction at issue, fluctuations in the target's historical operating results, etc. Based on my experience and the input from those surveyed for this study, a common period covered is the last two years plus year-to-date and/or trailing 12 months ("TTM"). With that said, I have also been involved in situations where due to changes in the business, a shorter period is deemed appropriate. Some respondents advised me that they had prepared QOE reports covering longer periods than two years plus TTM. While more insights should be gleaned into a company's business and earnings capacity, and whether or not current performance is an anomaly or reflects a prolonged trend, when a longer period is analyzed, there are cost and timing considerations to undertaking an extended period of review.

Analysis over multiple years and periods within each year (e.g., months or quarters) also sheds light on the relative seasonality of revenue volume and/or profitability within a single business cycle and over time.

6. BEST PRACTICES FOR QOE REPORTS

Based on my research to date, I have outlined below some potential best practices for preparers of QOE reports. The objective of any standards developed for QOE reports is to help ensure the reports are reliable, relevant and useful for investors and decision-makers, and to provide a framework for preparers of QOE reports to help them achieve these objectives.

Scope of Review and Procedures Performed:

i. Obtain a clear understanding of the mandate, the proposed transaction, the users and their objectives: documentation of this understanding, whether by engagement letter (standard practice) or otherwise, is critical.

ii. Understand the business and industry: Gain a thorough understanding of the company's industry, business model and key revenue drivers to assist the preparer in assessing the appropriateness of the company's earnings and identify potential risks specific to its operations. (As mentioned later, this was seen as a specific criticism of some QOE reports by some of the research study participants.)

iii. Conduct a comprehensive analysis consistent with the mandate: a holistic approach to analyzing the company's financial and non-financial information is critical including looking beyond the surface and the historical figures, and consider the underlying factors that may impact earnings quality. Both quantitative data and qualitative analysis and contextual understanding are critical.

iv. Consider whether to undertake common procedures, such as those below, and whether the engagement and situation requires other tailored procedures:

   a) Scrutinize revenue recognition: the company's revenue recognition policies and practices should be analyzed to ensure they align with the relevant accounting standards, and any potential aggressive or unusual revenue recognition practices that may inflate reported earnings are identified. (This was a concern for several user-participants.)

   b) Assess the completeness and quality of accruals, adjusting entries and estimates: the reasonableness and consistency of the company's adjusting entries such as accounts receivable, inventory, accounts payable, income and commodity taxes, payroll, customer discounts, warranties, government grants and subsidies, etc. should be assessed.

   c) Evaluate non-recurring and unusual items, and items that are inconsistent with the proposed transaction: these items can distort the true underlying profitability of the company.

   d) Look for related party transactions and balances, and compare those to market/arms' length indicators.

   e) Consider cash flow analysis: the company's cash flow statement and the consistency between cash flows from operating activities and the reported net income should be analyzed; discrepancies may indicate potential issues with earnings quality.

   f) Scrutinize accounting policies: the company's accounting policies and practices should be consistent, transparent and in accordance with relevant accounting standards, especially those of the potential purchaser in a M&A transaction.

   g) Monitor key metrics: key financial metrics such as gross margin, operating margin, return on equity and free cash flow should be analyzed over time to assess the company's financial performance and earnings quality.

   h) Compare to peers and industry benchmarks: the company's earnings quality should be benchmarked against its industry standards (where available) to identify any significant deviations that may require further investigation.

v. Do not ignore the future outlook: normalization adjustments are intended to assist with considering the future outlook and sustainability of earnings – i.e., the company's prospects, industry trends and potential risks that may impact future earnings quality.

vi. Materiality/significance: QOE reports should focus on significant items that could influence the economic decisions of users/decision-makers. Whether to involve users of QOE reports to assist in the establishment of any materiality/significance thresholds should be considered by the QOE preparer.

General Reporting:

i. Transparency and disclosure: clear and comprehensive disclosure of the documents, methods, analyses, assumptions and judgments used should be made along with limitations, risks and uncertainties associated with the findings and conclusions.

ii. Independence and objectivity: QOE reports should be prepared by independent and objective professionals who do not have conflicts of interest when appropriate; if independence is not required, specific disclosure should be made.

iii. Consistency and comparability: consistent methodologies and approaches should be used to facilitate meaningful trend analysis and assessment of changes in earnings quality.

iv. Clarity and understandability: QOE reports should be written clearly and concisely using language that is easily understandable to users without specialized accounting knowledge; key terms should be defined.

In addition, research study respondents provided other useful comments regarding best practices, including:

a) In M&A transactions involving reasonably sophisticated parties (dedicated corporate development team or private equity support) and multiple due diligence streams (financial, operational, tax, insurance, IT, management consulting), QOE reports should have a narrow scope centred on vetting the financial statements and bringing material issues to the client's attention. This likely differs from situations involving less sophisticated parties or where only the QOE is the primary source of diligence.

b) Preparers (and possibly in conjunction with users) should consider whether the QOE analysis should be "top-down" or "bottom-up" – i.e., whether the report starts with normalized EBITDA and works backward to confirm the normalization adjustments, or starts with the General Ledger level data and builds up to normalized EBITDA independent of whatever adjustments the seller is proposing. One research survey participant indicated that they found the latter approach to be superior in terms of being able to rely on the quality of the underlying information. The "bottom-up" approach may provide more granularity to the analysis which can be useful in conducting broader financial due diligence, setting key performance indicators ("KPIs"), and establishing performance dashboard reporting post-acquisition, particularly for a private equity buyer.

c) The content of a QOE report should be situation-specific. The QOE report should also be concise and focus on outlining notable findings. Exceptions should be assessed in terms of risk levels, and the extent of report disclosure determined against a risk model. In some cases, users may only be interested in the verification of certain key figures on the financial statements, analytical procedures, benchmarking or checking bank statements. In other cases, users may require the QOE engagement scope to be much broader.

7. RISKS/ISSUES AFFECTING THE USEFULNESS AND RELIABILITY OF QOE REPORTS

In question #12 (see Appendix A), I asked participants to select which of the following were the common key risks or issues affecting the usefulness and reliability of QOE reports:

a) Not communicating with the user in advance to set out required procedures and timeframe

b) Reliability of the documentation provided

c) Not completing sufficient procedures to verify the reliability of the documentation provided

d) Misunderstanding of "recurring" vs "non-recurring" in the particular circumstance

e) Over-reliance on the quantitative data

f) Lack of understanding of the business, industry or economy relevant to the target

g) Selection of "materiality"/significance thresholds

h) Considering the impact of the proposed transaction on the historical operating results of the target

i) Restricted budgets

j) Restricted timeframes

Each of the above was selected by at least one of the participants; however, some user-participants emphasized the lack of understanding of the target (item f)), over-reliance on the quantitative data (item e)) and misunderstanding of recurring vs. non-recurring (item d)). I note that the latter two may result because of the first. Preparer-participants referenced restricted budgets and timeframes (items i) and j)) and reliability of documentation (item b)) as particular concerns. More than one preparer-participant indicated that the scope of work is often significantly affected by the fee budget, which is determined by the client.

In addition, participants identified other risks including:

- Independence of the preparer;
- Biased selection of the period to be covered (e.g., ignoring years with poor results or over-emphasizing strong years);
- Normalization adjustments made that are not logical, realistic, fully analyzed or supportable[6]; and
- Not considering macroeconomic influences on the entity's historical earnings and future earnings ability.

8. INDEPENDENCE AND THE NEED FOR STANDARDS

In this section, I summarize the key input from the research study participants on the issue of independence and the need for standards, which were not covered previously in this paper.

Issue 1
Whether a QOE preparer should be independent

Based on my discussions with participants, it seems that independence is not an issue that has been given much thought in relation to QOE reports and engagements. While most of the respondents indicated that preparers should be independent, some were not comfortable mandating independence, and definitely not in every situation. This uncertainty may arise from the concern that M&A advisors who also prepare sell-side QOE reports would be restricted from offering such services. One preparer-participant from a larger firm indicated that there are advantages to the auditor/external accountant of the client preparing QOE reports for the client given their pre-existing knowledge of the business.

Whether independence is mandatory in any particular situation, or whether QOE reports should be considered to be advisory/non-independent reports some or all of the time, will likely be a question of fact based on the users and the intended use of the QOE report. For example, whether there is a concern about the auditor/external accountant presenting a more favourable position for the client due to the recurring nature of the engagement is an issue for consideration. Provided all parties are informed about issues relating to independence, having a two-pronged approach to QOE report preparation (i.e., the ability to reflect in a QOE report that the preparer is either independent or is not) may address this particular concern.

Issue 2
Whether standards should be developed and, if so, by whom

Most of the research study participants, especially user-participants, commented that there is little consistency in QOE reports and engagements in the market, and pricing in the industry is also inconsistent (presumably because the work undertaken differs by engagement and possibly by provider). On the other hand, preparer-participants from larger firms indicated that they have seen consistency in QOE engagements among their firms and the larger firms. The reason(s) for the discrepancy in views based on the participants in this research study may be due, at least in part, to the experience levels of certain QOE users.

While many respondents, especially the user-preparers, indicated that they believe a set of standards should be developed, some were unsure. Some thought that only guidance was needed, and not standards. Others thought that minimum standards would assist preparers in having discussions with users about the coverage required in QOE reports, in addition to protecting the preparers from clients misunderstanding the deliverable and type/level of assurance provided. Those who were unsure indicated the concern that establishing standards might be too restrictive or result in “boilerplate” report formats, whereas the value of QOE reports is in their flexibility of scope and coverage. Ergo, should any practice standards be developed for QOE reports, they should be “big picture” in nature and not outline specific required procedures or disclosures (beyond general ones). Further, a practice guideline, courses or some other format could be used to provide more detailed guidance regarding possible QOE procedures/scope, reporting, risks, etc.

A few respondents did indicate that while QOE reports used in M&A transactions or governance situations are generally more divergent in terms of scope of work, there may be more consistency in terms of QOE reports that are prepared for financing purposes.

While some respondents thought that the development of any standards should be led by the CBV Institute, others thought this may be more appropriately the purview of the accounting/assurance standard setters. Based on my experience and findings via this research study, the focus of QOE reports is to assist the potential investor or creditor in their assessment of the target's future cash flow generating ability and the potential issues and risks affecting their desired return on that investment/financing. QOE engagements require a broad skillset which may include accounting, valuations, transactions, diligence, and possibly even operational. CBVs are trained to focus on future cash flows, values, financing and transactions; therefore, QOE reports are a natural fit with their skill set. If some professional body, the CBV Institute or another entity, develops guidance on QOE reports and engagements, it will also be imperative to develop courses and/or other training for QOE preparers.

Some respondents indicated that they had seen relative consistency among QOE reports among various firms, in particular, among larger firms. However, others indicated that there was too much variance in QOE reports among firms and service providers, with one respondent suggesting that there should be an international standard governing QOE reports globally because of such divergence in practice.

9. OTHER BEST PRACTICE POINTS RAISED BY PARTICIPANTS

During my interviews, participants raised other points of note concerning good practices relating to QOE reports and engagements, as summarized below:

a) Professional valuators are well-poised in terms of training to undertake and complete QOE engagements.

b) Some participants indicated that their QOE engagements are collaborative and heavy on the involvement of clients, and principals and management of the target company. This may include involving the client in the development and approval of the procedures to be performed and the scope of review, regular communication with the client regarding findings, communicating with the target company's principals and management concerning the adjustments, requiring the client to approve the identified adjustments, requiring a third-party user of the QOE report to sign a non-reliance letter, etc.

c) Some participants advised that their firms had established an entire set of proprietary guidance, forms, processes, report outline, independence requirements, etc. for QOE reports (as part of its advisory practice), some of which are drawn from CBV Institute Practice Standards. As a result, they had not considered whether there was a need for any governing body to establish standards or guidance.

d) Several user-participants stated that it would be desirable to have a set of standards so that they knew what to expect when engaging a QOE report to be prepared. They also indicate a preference for having clarification regarding different "types" of reports, or what was termed a "full QOE" vs. "QOE lite".

e) One user-participant indicated the preference for more analysis and explanations regarding the normalization adjustments made (i.e., "no-brainers", "gray areas", etc.). This could logically be expanded to include sensitivity analysis on "gray areas" of adjustments.

10. SUMMARY

This paper does not make recommendations as to the next steps, if any, in the area of QOE reports for the CBV Institute or for any other professional body. However, it is my view that guidance is required in this area to help improve the professionalism of QOE reports, ensure uniformity/consistency among all providers, and encourage a high quality and consistent product for users. Doing so may result in an increase in demand and wider use of QOE reports for various purposes.

Developing guidance will not only assist QOE report preparers but also provide users with a framework to assist in understanding the deliverable. One can liken this to the CBV Institute's Practice Standard for Valuation engagements (Standards 110/120/130) and the assurance standards of CPA Canada ("CPAC") or the International Auditing and Assurance Standards Board ("IAASB"). Specifically, when users request an audit or review engagement to support, say, its financing requirements, they expect to get a consistent product, regardless of the identity of the public accountant selected to do the work. This also is consistent with valuation reports prepared by CBVs – users can expect to see certain sections and scope of review in an estimate level valuation regardless of the identity of the valuer.

Given that QOE preparers and users need to have flexibility in terms of the scope of work and procedures to be undertaken, any standards that are established should not be prescriptive but should be principles-based, which would require a high degree of professional judgment. Whether there should be different levels of QOE reports is a point that requires consideration as well (e.g., specific procedures/compliance vs. judgmental development of scope of work based on client needs and situational assessment).

Regardless of which professional body develops standards or guidance for QOE engagements and reports, the CBV Institute should consider developing or co-developing training courses on QOE reports and diligence-related matters given that CBVs are preparing QOE reports currently and this appears to be a growth service area for the valuation profession.

User involvement in setting the scope of review and understanding the limitations of QOE reports will likely be critical in most engagements. This study found that flexibility and user involvement are extremely important. Accordingly, while this study suggests certain standard guidelines or practices, I also encourage preparers to involve users in the scope and selection of procedures. Accordingly, obtaining a signed engagement letter and outlining the proposed scope of work and/or procedures is important in QOE engagements.

Whether independence is required to complete a QOE engagement should also be considered. Based on my experience and the results of the research study, the importance of independence is a key issue. While most engagements likely require independence, there may be a place for a non-independent set of QOE standards or guidance. However, transparency for the user in terms of disclosure of whether the preparer is independent, and factors affecting independence, was considered by some participants to be important.

ACKNOWLEDGEMENTS

I want to thank the CBV Institute's Research Task Force for selecting my proposal "Best Practices for QOE Reports" for the 2022 Ian R. Campbell Research Award. Selfishly, this has been a very satisfying expedition into what I have found to be the somewhat lightly charted territory of guidance relating to QOE reports.

The author is also immensely grateful for the assistance of the following individuals:

Brian Atkins, CPA, CBV

Alexandre Baril, CPA, CBV, CF

Nick Bellows, CPA, CA, CFA

Shyam Bid, CPA, CA, CFA, CF

Craig Dootson

Sean Flinn, MBA

Dino Fracassi, CFA

Kristin Godwin

Mark Groulx, MBA

Steve T. Harrar, CFF, EEE/CBV, CPA

Guy Jarvis

Dr. Howard Johnson, DBA, FCPA, FCA, FCMA, FCBV, CPA, CFA, ASA, CF, C.Dir

Umair Khan, MBA

Chris Lewthwaite, CFA

Jen Lucas, CBV, ASA

Gord McFarlane, FCA, FCPA, CBV

Michele Middlemore, CPA, CA, CFA, CBV

Kristen Miners, CPA, CBV

David Naiman, CPA, CA, MBA

Brett Norris, CPA, CA, CFA

Sayyida Nusrath, FCCA, CPA

Maha Rahman, CFA

Mark Reineking, CPA, CA, CFA, CBV

Luciano Renda, CPA, CFA, CBV

Ajay Shivdasani, MBA

Josh Spagnoletti, CBV

Laura Stoddard. LL.B

Dan Teguh, CPA, CA

Riya Tanna, CPA, CA

Perry Watt

Alex Wong, CPA, CA, CBV

Michael Wolfer, AICB

Sean Pisarski, CFA

APPENDIX A – QUESTIONNAIRE TO RESEARCH STUDY PARTICIPANTS

On behalf of the author of the study "Best Practices for QOE Reports", Melanie Russell, and the CBV Institute, I want to thank you in advance for your assistance and input into this study. I have outlined below some preliminary questions for which I would greatly appreciate your input. I have tried to limit these questions to recognize that your time is likely limited. However, I encourage you, if you are so willing, to expand on the responses and provide other information that you think would be relevant to the study. My experience has been that the area of QOE is an expanding market, for CBVs and other professionals, and I believe that there is a need for more formal guidance and standards to assist preparers, protect users and enhance the reliability and usefulness of QOE reports. With your assistance, this study intends to start the process to increase the professionalism of QOE reports.

1. Are you a preparer or user of QOE reports? (select one)
   a) Preparer
   b) User
   c) Both
   d) Neither

2. Approximately how many quality of earnings ("QOE") reports have you reviewed (as a user) or been involved in preparing (as a preparer)? (select one)
   a) 1-5
   b) 6-10
   c) 11-20
   d) 21-100
   e) 101+

3. In your experience for what purposes have QOE reports been used? (select all that are relevant)
   a) To support financing (i.e., requested by creditors)
   b) As part of diligence on a sale transaction
   c) As part of diligence on a purchase transaction
   d) Corporate governance
   e) Other – please identify

4. Are you aware of any standards or guidance for the preparation of QOE reports? (select one)
   a) Yes
   b) No
   c) Not sure

5. If you answered yes to #4 above, please specify these standards or guidance.

6. In your view, should a set of standards be developed by a governing body such as the CBV Institute or another body? (select one)
   a) Yes
   b) No
   c) Not sure

7. If you answered yes to #6 above, do you have any suggestion as to who the appropriate governing body for such reports should be? If so, please specify below.

8. Do you believe that a QOE report should be independent of the target company? (select one)
   a) Yes
   b) No
   c) unsure

9. What type of procedures do you expect to see in QOE reports? (select all that are relevant)
    a) Bridge from accounting-based net income to EBITDA or cash flow
    b) Assessment of recurring and non-recurring income and expenses
    c) Assessment of accounting policies used by the target entity and changes over time
    d) Assessment of working capital
    e) Analysis of the target and areas of financial risk (e.g., history, clients, suppliers, products/services, key staff/contractors, key contracts, related parties, SWOT analysis, etc.
    f) Analysis of historical operating results – trends, ratios, etc.
    g) Analysis of historical financial position and condition and value of relevant assets and liabilities
    h) Analysis of revenue by type, currency, customer, etc.
    i) Analysis of receivables by customer, currency, # of days outstanding, etc.
    j) Analysis of normalized operating results/EBITDA/cash flows
    k) Analysis of capital expenditures
    l) Analysis of normalized financial position
    m) Analysis of related party transactions and accounts
    n) Others – please specify

10. What type of disclosures/report sections do you expect to see in a QOE report? (select all that are relevant)
    a) Statement of mandate/purpose and intended user
    b) Identity of engaging client
    c) A statement of independence/objectivity OR if the preparer is not independent, details of the nature of the relationship between the engaging client and the preparer
    d) Definitions of key terms used
    e) Scope of review/documents used
    f) Listing of procedures performed
    g) Identification of any scope limitations
    h) Analysis of the target and areas of financial risk (e.g., history, clients, suppliers, products/services, key staff/contractors, key contracts, related parties, SWOT analysis, etc.
    i) Key accounting policies used and impact of changes over time
    j) Historical operating results – trends, ratios, etc.
    k) Historical financial position and condition and value of relevant assets and liabilities
    l) Breakdown of revenue by type, currency, customer, etc.
    m) Breakdown of accounts receivable by customer, currency, number of days outstanding, etc.
    n) Normalized operating results/EBITDA/cash flows
    o) Reconciliation of accounting income to cash flow (“cash flow bridge”)
    p) Historical and future capital expenditures

q) Normalized financial position
r) Historical and future working capital analysis
s) Industry factors affecting the target
t) Economic conditions affecting the target
u) Findings/conclusions
v) Key assumptions
w) Others – please specify

11. How frequently do you see QOE reports include analysis of/diligence on forecasts/budgets/projections?
    a) Never
    b) On occasion
    c) Frequently
    d) All of the time

12. What do you believe are key risks or issues affecting the usefulness and reliability of QOE reports? (select all that are relevant)
    a) Not communicating with the user in advance to set out required procedures and timeframe
    b) Reliability of the documentation provided
    c) Not completing sufficient procedures to verify the reliability of the documentation provided
    d) Misunderstanding of "recurring" vs "non-recurring" in the particular circumstance
    e) Over-reliance on the quantitative data
    f) Lack of understanding of the business, industry or economy relevant to the target
    g) Selection of "materiality"/significance thresholds
    h) Considering the impact of the proposed transaction on the historical operating results of the target
    i) Restricted budgets
    j) Restricted timeframes
    k) Other – please specify

13. For preparers, does the volume of QOE reports affect the quantum of liability insurance you believe to be relevant?
    a) Yes
    b) No
    c) Not sure

14. Any other comments?

TOTAL PARTICIPANTS: 31

(28 who provided a survey; 3 which remain outstanding)

1. Are you a preparer or user of QOE reports?
   a) Preparer
   b) User
   c) Both
   d) Neither

2. Approximately how many quality of earnings ("QOE") reports have you reviewed (as a user) or been involved in preparing (as a preparer)
   a) 1-5
   b) 6-10
   c) 11-20
   d) 21-100
   e) 101+
   Not Answered

3. In your experience for what purposes have QOE reports been used?
   a) To support financing (i.e., requested by creditors)
   b) As part of diligence on a sale transaction
   c) As part of diligence on a purchase transaction
   d) Corporate governance
   e) Other – please identify

COMMENTS
Supplier Check, Investments, USA and Valuations.
Using a QofE to evaluate integration / cost savings when consolidated into a larger organization acquiring the business.
As underwriting materials for R&W insurers.

4. Are you aware of any standards or guidance for preparation of QOE reports?
   a) Yes
   b) No
   c) Not sure

COMMENTS

Deloitte Standards.

5. If you answered yes to #4 above, please specify these standards or guidance.

   Not applicable

   No Answer

COMMENTS

Seen certain standards referenced in US reports, specifically the Standards for Consulting Services of the American Institute of Certified Public Accountants, however have not typically seen standards referenced in Canadian prepared QOEs.

6. In your view, should a set of standards be developed by a governing body such as the CBV Institute or other body?
   a) Yes
   b) No
   c) Not sure

COMMENTS

This is a tricky question, as some guidance would be useful, however each QofE has custom requirements that wouldn't difficult to standardize.

Relevant if the CBV is opining in an independent capacity, but probably seen as a negative in instances where the CBV is acting as an advisor.

Would be nice to align with regulations of Banking adherence, standardization could be integrated with technology in the future to provide quicker financing turn-around times.

QoE can have a wide range of uses and is typically specified by the users up front to the preparer. Ultimately users can determine if they are getting what they need from the report. Having said that if it is being used directly for bank debt financing maybe there are standardized procedures and reporting that should be completed.

There may be an opportunity to introduce standards to some degree although this may be difficult given that the scope and extent of QOE procedures can vary for many reasons across mandates. Keep in mind that a QOE mandate is not an attest service. It's a consulting mandate that provides for a lot of flexibility in the approach and scope. This holds true in both Canada and the US (most of my mandates are for US clients).

7. If you answered yes to #6 above, do you have any suggestion as to who the appropriate governing body for such reports should be? If so, please specify below.

COMMENTS

CBV or CPA

Accounting Profession

Needs to be a standard amongst the various national bodies that exist globally. Need to define components of a report...no different than IFRS definition of financial statements. There is too much variance in reports between firms / service providers.

CBV Institute

OSFI

The appropriate governing body in Canada would be the CBV Institute. QoE's tend to be very transactional in nature and can have an increased scope beyond what a typical public practice accountants would have expertise in. It could also be the most beneficial to have a joint standard between the CBV Institute and CPA Canada.

I'm not sure standards are appropriate as I think the scope of work and specific procedures should be customized on a case by case basis. I think a set of guidelines would be appropriate as that would allow for more professional judgement while at the same time encouraging consistency among service providers. Separate guidelines for different use cases would be helpful (i.e., M&A vs. financing). I think the CICA would be the appropriate governing body.

8. Do you believe that a QOE report should be independent of the target company?

a) Yes

b) No

c) unsure

d) Depends

COMMENTS

Depends on the wants of the client, but even an independently prepared QoE would likely be viewed with skepticism by many users.

Not necessarily, a vendor due diligence is a mandate where you are preparing a QOE report on behalf of a Company (Target) who is undergoing a sale process. I've been called upon to perform a VDD mandate on behalf of an audit client who is looking to sell. In fact, in my experience, most purchasers appreciate the added value that we can bring in this situation (leveraging audit experience) as they will ultimately perform their own confirmatory due diligence on the buy-side. I do think it's important to maintain independence in a scenario where you are on both the buy and sell-side.

I think that independence would be important in some cases but, for the most part, if the service provider is governed by a professional code of conduct, they would be able to be engaged by the target and also provide a fair report taking into consideration the user thereof.

9. What type of procedures do you expect to see in QOE reports?
   a) Bridge from accounting-based net income to EBITDA or cash flow
   b) Assessment of recurring and non-recurring income and expenses
   c) Assessment of accounting policies used by the target entity and changes over time
   d) Assessment of working capital
   e) Analysis of the target and areas of financial risk (e.g., history, clients, suppliers, products/services, key staff/contractors, key contracts, related parties, SWOT analysis, etc.
   f) Analysis of historical operating results – trends, ratios, etc.
   g) Analysis of historical financial position and condition and value of relevant assets and liabilities
   h) Analysis of revenue by type, currency, customer, etc.
   i) Analysis of receivables by customer, currency, # of days outstanding, etc.
   j) Analysis of normalized operating results/EBITDA/cash flows
   k) Analysis of capital expenditures
   l) Analysis of normalized financial position
   m) Analysis of related party transactions and accounts
   n) Others – please specify (Details below)

COMMENTS

This is very dependent on the target – a lot of these items may/may not be necessary based on the type of business/deal.

Assessment of the reasonableness of projections.

There are also always industry-specific issuer (e.g., yields in the cannabis sector) which are often relevant as they are a key driver of financial results. The KPIs the company internally tracks are generally important.

Integration of forecast for term of transaction (buy side).

Substantive procedures, typically if Company is not audited (i.e., proof of cash, payroll reconciliation).

Proof of Cash and revenue run off reporting.

Should be in the QOE report (a,b,c,j and l).

This work should be done, however, may not necessarily be included in the report due to fee constraints (d,e,f,g,h,I,k and m).

Note that all of the above may not be relevant in all cases. Other items that may be relevant in certain circumstances include:

- Competitive environment
- Industry and regulatory dynamics
- Quality of internal financial information/management information systems
- Internal control weaknesses
- Quality of financial forecasts/credibility of underlying assumptions
- General operations/workflow
- HR policies/procedures including Health & Safety
- Tax compliance

10. What type of disclosures/report sections do you expect to see in a QOE report?
    a) Statement of mandate/purpose and intended user
    b) Identity of engaging client
    c) A statement of independence/objectivity OR if the preparer is not independent, details of the nature of the relationship between the engaging client and the preparer
    d) Definitions of key terms used
    e) Scope of review/documents used
    f) Listing of procedures performed
    g) Identification of any scope limitations
    h) Analysis of the target and areas of financial risk (e.g., history, clients, suppliers, products/services, key staff/contractors, key contracts, related parties, SWOT analysis, etc.
    i) Key accounting policies used and impact of changes over time
    j) Historical operating results – trends, ratios, etc.
    k) Historical financial position and condition and value of relevant assets and liabilities
    l) Breakdown of revenue by type, currency, customer, etc.
    m) Breakdown of accounts receivable by customer, currency, number of days outstanding, etc.
    n) Normalized operating results/EBITDA/cash flows
    o) Reconciliation of accounting income to cash flow ("cash flow bridge")
    p) Historical and future capital expenditures
    q) Normalized financial position
    r) Historical and future working capital analysis
    s) Industry factors affecting the target
    t) Economic conditions affecting the target
    u) Findings/conclusions
    v) Key assumptions
    w) Others – please specify

COMMENTS

Depends but Most of the above are relevant. People wants less lengthy reports these days and use analytics way more and other forms of reporting.
A robust executive summary that lists pertinent red flags upfront.
Assessment of net debt and any 'debt like' items in the working capital.
Assessment of normal working capital.
Discussion/testing around revenue cut-offs and analysis of undisclosed liabilities.
Trend analysis of financial performance to detect any outliers in the periods being used to drive a transaction price (i.e. sales acceleration or expense deferral to drive up priced EBITDA).

Presentation of alternative possible conclusions when key components are open to interpretation (i.e.: sensitivity analysis).
Should be in the QOE report (a,b,d,e,f,g,n,q,r,u and v).
This work should be done, however, will only be included on an exception basis if there are notable findings. Also depends on the scope of work, if it is a long form report all of these will be included, however a “red flags” report will only report on exception basis (c,h,i,j,k,l,m,o,p,s and t).

11. How frequently do you see QOE reports include analysis of/diligence on forecasts/budgets/projections?

a) Never

b) On occasion (Details below)

c) Frequently

d) All of the time

e) Not Answered

COMMENTS

All of the time – for the limited amount I’ve seen.
Typically, out of scope unless deal is valued based on forecast or if specifically requested by client.

12. What do you believe are key risks or issues affecting the usefulness and reliability of QOE reports?

a) Not communicating with the user in advance to set out required procedures and timeframe

b) Reliability of the documentation provided

c) Not completing sufficient procedures to verify the reliability of the documentation provided

d) Misunderstanding of “recurring” vs “non-recurring” in the particular circumstance

e) Over-reliance on the quantitative data

f) Lack of understanding of the business, industry or economy relevant to the target

g) Selection of “materiality”/significance thresholds

h) Considering the impact of the proposed transaction on the historical operating results of the target

i) Restricted budgets

j) Restricted timeframes

k) Other – please specify (Details below)

COMMENTS

Independence and impartiality.
Not taking into account current macro influences.
Limitations on scope and lack of detail reduces reliability of the QOE.
Point (a) is usually a non-issue as this is outlined in the engagement letter.
The quality of financial reporting, information and management responses can certainly limit the scope of a QOE report.
Typically, when we have engaged a firm to complete a QoE they have done a great job with the key drawback being they do not understand the industry the same as we do internally. It may not ultimately matter depending on the use of the report but just a point of interest.
Point (j) may limit the scope of a QOE report.
I often find that there is little communication between the service provider, the client and/or the stakeholders during the performance of the work to discuss preliminary findings and refine the scope as the work progresses. The majority of the queries are undertaken via email and standard questionnaires as opposed to interviews/dialogue whereby a more in depth understanding of the business and the risk factors most important to the stakeholders could be developed.

13. For preparers, does the volume of QOE reports affect the quantum of liability insurance you believe to be relevant?

    a) Yes

    b) No

    c) Not sure

    d) Not answered

14 Any other comments?

COMMENTS

Happy to help think through issues you are trying to solve for.
The answers above assume the buyer is doing the primary diligence and the QoE is fairly narrow in scope. Additional elements of the report/scope would be required if the buyer is expecting the QoE to speak to the reasonableness of the investment thesis rather than simply packaging historic financials and obtaining explanations for deviations from norms/extraordinary events. My limited experience with QoEs is from situations with reasonably sophisticated parties (dedicated corporate development team and/or private equity support) and multiple due diligence streams (financial, operational, tax, insurance, IT, management consulting). In these instances my view is that the QoE should have a narrow scope centered on vetting the financials and bringing material issues to the client’s attention. This likely differs significantly from situations with less-sophisticated parties or where only one QoE is prepared.

A big difference in QofE reports that I have noticed has been whether the analysis is "top down" or "bottom up". This relates to whether the report starts with normalized EBITDA and works backwards to confirm the addbacks or if it starts with the GL level data and builds up to normalized EBITDA from that level independent of whatever adjustments the seller is proposing. In my opinion and experience I have found the latter approach to be far superior in terms of being able to rely on the quality of the report. In addition, this approach also provides a great deal more granularity to the analysis which I have found to be useful in conducting broader financial due diligence and also for setting KPI's and establishing performance dashboard reporting post-acquisition particularly for a private equity buyer.

In my world we use Q of E on larger deals, our regular tuck ins we do our own financial diligence. I see the firms treating this an service delivered by advisory services groups but mostly auditors doing the work not CBV's.

I don't think enough time is spent planning and customizing the work plan - understanding the business/industry, users of the report and what is going to be important to them. Too often, there is a lot of time and expense put toward procedures and analysis that is not useful/relevant and/or will not have a material impact in the circumstances while other material risks are missed entirely. Time and budget constraints often result in inexperienced personnel executing the work with minimal oversight/review.

REFERENCES

1. It should be noted that CPA Canada has issued CSRS 4400, Agreed-Upon Procedures Engagements, the most recent version of which is effective for engagements entered into on or after January 1, 2022. Also, IAASB has issued ISRS 4400, Agreed-Upon Procedures Engagements, the most recent version of which is also effective for engagements entered into on or after January 1, 2022. These engagements have been available to public accountants for many years (previously called "Specified Auditing Procedures" in Canada). While such engagements are not directly relevant to most QOE engagements, some general guidance of relevance may be contained in these standards.
2. One of the research study participants advised me that he had seen a reference to these standards in a U.S.-prepared QOE report.
3. Although I was advised, based on discussions held to date, that there have been claims made under representations and warranties insurance that may have utilized information/disclosure in a QOE report, I was also advised that the QOE reports themselves have not been disputed by the insurers.
4. With that said, I found significant variance among the study participants as to the inclusion of a review of projections in QOE reports/engagements (see the summary of survey results later in this paper).
5. It should be noted that insurers do not generally require a separate QOE report in determining whether to approve a "reps and warranties" insurance policy. However, they will request copies of relevant diligence material in the deal, including the QOE report(s) when prepared. Items covered in the QOE report may be scoped out of the representations and warranties policy coverage, with a resulting reduction in the cost of the insurance.
6. One user-participant stated that her lending committee often does not accept certain proposed normalization adjustments that are made by the QOE preparer.