

CBV INSIGHTS

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MAXIMIZING BUSINESS VALUE

HOW QUALITY OF EARNINGS
REPORTS REDUCE FRICTION AND
IMPROVE DEAL OUTCOMES



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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.

CBV Insights

CBV Insights is a thought leadership periodical published by CBV Institute with the aim of sharing the expertise of Chartered Business Valuators with our network and the broader public. While the insights shared by contributing authors in *CBV Insights* are designed to inform and inspire, they do not necessarily carry the endorsement of CBV Institute.



Whether you're buying, selling, or financing a business, one thing is clear: you need to fully understand the financial story behind the numbers. That's where a Quality of Earnings (QoE) report becomes indispensable. For business owners, CEOs, CFOs, board members, investment committees, equity investors, and lenders, a well-executed QoE report can serve as a vital tool in assessing the true financial health of a company before a transaction or investment.

WHAT IS A QoE REPORT?

In private company transactions, the price is often negotiated based on a multiple of EBITDA – earnings before interest, taxes, depreciation and amortization – and so the critical question becomes: “What is EBITDA for this business?”

A QoE report is a comprehensive analysis of the sustainability and reliability of a company's earnings and cash flow. It helps assess whether reported earnings accurately reflect the company's underlying economic performance.

For prospective buyers, QoE reports are used to validate reported earnings and cash flow, ensure historical EBITDA has been appropriately normalized to reflect potential future earnings, confirm valuation assumptions, and identify potential risks prior to a transaction.

Sell-side or vendor QoE reports are also used proactively by astute sellers to reduce deal friction, build buyer confidence, justify the asking price, and accelerate negotiations.

No two QoE reports are identical. As Melanie Russell, CBV, notes, “the flexibility and customizability of the content and coverage of QoE reports is a significant advantage for users. During the preparation of a QoE report, a preparer will consider such factors as predictability of cash flows, comparability to other entities, and degree of transparency of disclosure.” Some common components of QoE analyses that reflect these principles are:

- **EBITDA Normalization:** Adjusting for discretionary, non-operational, non-recurring and extraordinary revenues and expenses, as well as inconsistent or non-cash accounting policies, to make earnings more comparable across periods and with industry peers (e.g., legal settlements, one-time gains or losses, above-market salaries, passion projects, non-compliant accounting practices).
- **Revenue Quality Assessment:** Evaluating long-term revenue viability at the product, segment and customer levels, and identifying trends that may lead to growth or retraction (e.g., customer concentration risks, revenue recognition policies, contract stability).
- **Cash Flow Examination:** Analyzing cash conversion efficiency and working capital trends to assess the consistency of cash flows and identify potential volatility (e.g., receivables collection timing, inventory turnover, seasonality and adequacy of working capital, prepaid and operating expense accruals).



“A well-executed QoE report isn’t just about validating numbers—it’s about uncovering value. If you can identify gaps or inefficiencies that the other side hasn’t priced in, that’s where real value arbitrage happens.”

– Mackenzie Regent, CBV

WHY QoE REPORTS MATTER IN TRANSACTIONS

Buyers, sellers, lenders and investors all have different reasons to get a QoE report. Here are some of the considerations for the situations where they can make the greatest impact.

1. FOR BUYERS: UNCOVERING RISKS AND OPPORTUNITIES

A QoE report helps buyers verify that a target company’s earnings are sustainable and aligned with their investment thesis. It identifies potential issues such as aggressive revenue recognition, customer concentration risks, or underreported liabilities that could affect future profitability. In essence, it provides a financial “stress test” before a deal is closed, ensuring that buyers don’t overpay or inherit unexpected financial issues. A strong QoE report does more than just validate the purchase price equation, it provides insights to the buyer to assist in their value creation strategies post-close. Going beyond a compliance exercise, top advisors look to create value arbitrage for their clients.

2. FOR SELLERS: MAXIMIZING BUSINESS VALUE

For business owners preparing to sell, a QoE report can be an invaluable tool in strengthening their position. By proactively addressing financial inconsistencies or areas of concern before going to market, sellers can present their business in the best possible light. This transparency increases buyer confidence and can lead to a smoother negotiation process, potentially resulting in a higher valuation. Since buyers are focused on de-risking their investment, the completion of a vendor due diligence report signals that the company is “transaction ready,” helping facilitate a smoother and more efficient sale process.

3. FOR LENDERS AND INVESTORS: ENHANCING CONFIDENCE

Banks and private equity firms often require a QoE report as part of their due diligence process when evaluating financing or investment opportunities. A QoE report provides comfort that the company’s financials are reliable, reducing the risk of loan defaults or underperforming investments. When prepared by an independent expert, a QoE report further reinforces confidence and safeguards the integrity of the deal process.

4. FOR BOARDS AND INTERNAL DECISION-MAKERS: SUPPORTING STRATEGIC INITIATIVES

A QoE report is not just for transactions. It can also be used as a governance tool for boards assessing strategic options such as divestitures, restructurings, or capital allocation decisions. Understanding the true financial standing of a company enables more informed decision-making at the highest levels.



WHY FOCUS ON TRAILING TWELVE MONTH (TTM) EBITDA?

QoE reports commonly cover the following periods: (a) the last two years of historical operating results,¹ and (b) Trailing Twelve Month (TTM) EBITDA. Here are some of the considerations that go into analysing these periods for valuation insights.

WHAT DOES THE FUTURE HOLD?

Generally, TTM EBITDA is the primary basis for valuing private acquisitions, largely because of the assumption that the most recent 12-month results are the most relevant and predictive of post-closing performance. However, TTM may have limitations as the appropriate earnings period to form the valuation. For example, if a structural change to the business is on the horizon, or if it is a high-growth scenario, historical cash flows may not be indicative of the future. “A strong QoE advisor needs to ascertain if the general assumption to use TTM as the foundation actually holds,” says Mackenzie Regent, CBV. “This is where the CBV perspective is critical, as it helps ascertain the proper valuation methodology.”

IS RECENT PERFORMANCE REPEATABLE?

Buyers are ultimately purchasing future cash flows. TTM EBITDA incorporates the most recent results but also captures a full year of earnings, helping to smooth out seasonal or short-term fluctuations. It’s often considered the best of both worlds. However, “just because it is the most recent, does not mean it is the most recurring,” cautions Mackenzie. By analysing the previous two years of historical operating results, the advisor can uncover additional insights into what “normal” may actually look like for the business.



WHAT NEEDS TO BE ADJUSTED?

Translating what’s recorded in the books into a meaningful TTM EBITDA can present challenges. According to Mackenzie, it is common for private middle-market businesses to record a years’ worth of adjusting journal entries in the last month of the fiscal year. For example, a full years’ worth of inventory or WIP adjustments, payroll accruals, etc., may be posted in the last fiscal month, leaving the other eleven months unadjusted. This skews interim financials and can distort TTM EBITDA calculations. To address this, advisors smooth year-end entries across the appropriate periods and accrue relevant adjustments into the stub period to produce a more accurate and normalized TTM EBITDA figure.

For buyers, sellers, investors, and lenders, understanding TTM EBITDA is key to making **informed financial decisions** and ensuring that valuation expectations align with reality. However, as Mackenzie points out, “while history is interesting and can inform that baseline, it’s not always relevant – so you always have to ask whether the past truly equals the future.”



“A QoE report is like lifting the hood on a business before you go on a long drive – it will assist you in understanding the true engine of the target company’s earnings and help you identify key risks associated with the potential transaction, and a good QoE analysis will be another critical piece of the puzzle that can assist in deciding to transact or not, or at a minimum assist in negotiations with respect to the terms for the deal and the ultimate purchase price.”

– Ian Lobo, CBV

WHAT IS DIFFERENT ABOUT A QoE REPORT FROM A CBV LENS?

There is no such thing as a one-size-fits-all QoE report. It is highly customizable. The depth and reliability of the report are a direct reflection of the preparer’s expertise and professional judgment. Ultimately, the quality of a QoE report depends on the qualifications and experience of its author.

This is where the expertise of Chartered Business Valuators (CBVs) makes a difference.

While QoE reports can be prepared by various financial professionals, CBVs bring a distinct advantage due to their expertise in valuation, forensics, financial analysis and forecasting, disputes quantification, and transaction advisory. A CBV’s multi-disciplinary and integrated approach ensures that financial diligence goes beyond surface-level analysis, providing valuable insights into a company’s financial health and future prospects. In addition, a CBV’s independent expertise enhances the credibility of a QoE report.

Above all, CBVs provide more than just technical expertise. They speak the language of business owners, shifting the emphasis away from accounting norms and toward deal relevance and business realities.



FIELD NOTES FROM THE FRONT LINES

Chartered Business Valuator Alexandre Baril shares how a few well-placed questions — and professional acumen — led to high-impact QoE findings that shaped critical decisions:

SHELF LIFE SECRETS

During a QoE for a retail food chain, Alex visited a few stores and casually asked employees how they liked working there. One responded, “I like it, except for one thing, the owners ask us to change the expiry dates on the breads.” A small inquiry beyond the spreadsheets identified a serious financial and reputational risk consideration.

SURVEY SAYS... SOMETHING'S OFF

In another engagement, Alex used customer surveys to validate revenue trends. The seller's narrative painted a rosy picture, but the feedback from customers told a different story. Discrepancies like that can significantly affect forward-looking assumptions.

DOUBLE TROUBLE WITH REVENUE

When doing a proof of cash exercise, Alex found that revenue was being counted twice for every contract. The deeper dive exposed inflated earnings that could have misled a buyer.

The right QoE provider can not only uncover these red flags, they can also assess the impact (e.g., overstated revenue or understated waste), make appropriate normalizing adjustments, and recommend further operational or legal due diligence where necessary. In addition, today's leading diligence practices leverage AI and advanced data analytics to review 100% of a company's transactions, notes Alex.



“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.”

– Melanie E. Russell, CBV



HOW DO ROBUST QoE REPORTS IMPROVE DEAL OUTCOMES?

According to Alexandre Baril, CBV, what separates a very good QoE report from a merely good one is its depth and breadth – covering not just financials, but also industry benchmarks. Comprehensive due diligence may also speak to HR, IT, ESG, and legal findings, along with both positive and negative risks. It may also include scenario analysis and account for current macro trends such as interest rates, tariffs, and foreign exchange movements. But what truly distinguishes an excellent report, he says, is its ability to tie all those insights together **to help the purchaser negotiate a better deal and a successful integration.**

Mackenzie Regent, CBV, emphasizes that “A strong QoE report doesn’t just inform the deal, it helps ensure the deal you negotiated is the one that gets signed and closed.” By aligning financial definitions and working capital targets in the Share Purchase Agreement (SPA) with the realities uncovered during diligence, a QoE report can **help prevent surprises at closing.** It’s a powerful tool for protecting value and delivering better outcomes for clients.



CONCLUSION

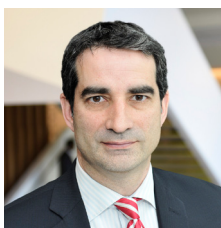
Understanding the quality of a company's earnings is paramount for making sound investment and lending decisions. QoE reports assess the reliability, sustainability and transparency of reported earnings, offering insight into future performance and potential risks. By examining financial indicators and accounting practices, QoE analysis helps investors and lenders make informed decisions, reducing risk and leading to more successful investment and financing outcomes.

For business leaders navigating a transaction, engaging a qualified professional – such as a CBV – can make the difference between a well-structured deal and a costly oversight. Given the complexities and financial implications involved, a QoE report is not just a best practice, it's a necessity.

¹ While QOE reports typically cover two years of historical earnings and the TTM period, the appropriate period can vary based on cost, timing, and the specific needs of the analysis. In some cases, a shorter period may be sufficient, while in others, a longer timeframe can provide deeper insights into a company's financial trends. However, extending the coverage period does not always add value, it depends on whether current performance represents a temporary anomaly or a sustained trend.



THANK YOU TO OUR CONTRIBUTING EXPERTS



Alexandre Baril

CPA, CA, CBV, CFF

Partner, M&A Transaction Services & Corporate Development Services, Deloitte



Ian Lobo

CPA, CA, CBV, CFF

Principal, Valuations, SB Partners



Mackenzie Regent

CPA, CA, CBV

Co-founder and Managing Partner, Kalos LLP



Melanie E. Russell

B. Comm., FCPA, FCA, CBV, CIM, CFE, CFF, ABV, FDRP-Val

President & Senior Managing Director, Kalex Partners Inc



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