

Drilling down into the quality of earnings and why it matters



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AS CORPORATE collapses continue to catch stakeholders off guard, analysts face growing pressure to dig deeper than traditional audits allow. The limitations of standard financial reporting – especially in identifying “going-concern” risks – have exposed systemic blind spots in evaluating a company’s true financial stability.

For those involved in mergers and acquisitions (M&As), private equity (PE) or strategic planning, Quality of Earnings (QofE) analysis has become an indispensable tool. It helps surface red flags, validate financial performance and provide a more reliable foundation for investment decisions. Here is my take on why this topic is important, as well as a rundown of the components of QofE analysis.

Why quality of earnings analysis is critical

Research from the Audit Reform Lab at the University of Sheffield found that auditors failed to identify material uncertainties related to going-concern risks in three-quarters of significant corporate failures in the UK from 2010 to 2022. The Big Four auditing firms – Ernst & Young (EY), PricewaterhouseCoopers (PwC), Deloitte & Touche, and KPMG — provided going-concern warnings in less than 40 per cent of situations; smaller firms had an even more disappointing warning rate of 17 per cent.

Several high-profile cases have highlighted audit failures which reveal significant deficiencies in the auditing industry. For example, KPMG came under scrutiny for its audits of Carillion, a UK construction and facilities management company that collapsed in 2018. The Financial Reporting Council (FRC) imposed a £21 million (\$\$36.4 million) fine on KPMG for its role in the audit failures, citing serious shortcomings in the firm’s work.

EY also faced investigations related to its audits of Wirecard, a German payment processing company embroiled in a massive fraud scandal. PwC has also encountered several major controversies, including a six-month ban in China for audit failures linked to the collapse of Evergrande.

While an audit report confirms that historical financial statements adhere to generally accepted accounting principles (GAAP), it does not always accurately reflect a business’s true earnings capacity. The QofE process goes beyond GAAP by adjusting for non-recurring items, normalising revenue streams, and establishing a reliable baseline for projections and valuations.

While the scope of a QofE report is not strictly defined, and determining the quality of earnings can be challenging, there are three key factors that should be addressed in any QofE analysis. They are:

- Financial performance analysis
- Proof of cash (PoC)
- Net working capital (NWC)

Financial performance analysis

The revenue mix in the QofE report can sometimes highlight customer concentration as a significant risk factor. A high reliance on only a few customers exposes the busi-

ness to revenue volatility if those customers decrease their demand or terminate contracts. This concentration can lead to scenarios where the financial health of the business is heavily tied to the performance and longevity of a limited number of clients.

Furthermore, the geographical distribution of the customer base introduces different levels of risk. For example, global customers are influenced by a range of factors, including local supply and demand dynamics, economic conditions, political stability, regulatory changes and exchange rate fluctuations. These external forces can greatly impact customers’ purchasing behaviour, which in turn affects the company’s revenue stability.

Proof of cash

The PoC test is a critical factor in QofE analysis, offering a detailed reconciliation of cash inflows and outflows to ensure the integrity of reported financial performance. This test links the company’s reported cash transactions to its bank statements, thereby validating that the financial data aligns with actual cash movements. It helps detect discrepancies that could indicate errors, fraudulent activity or mismanagement.

The PoC test ensures the accuracy of key financial metrics like revenue, expenses and Ebitda (earnings before interest, taxes, depreciation and amortisation), which are central to a transaction’s valuation. By reconciling transactions, the test verifies that:

- Revenue is not overstated (such as uncollected sales not [being] reflected in cash inflows).
- Expenses are complete, accurate and have proper cash documentation.



Quality of earnings analysis is an indispensable tool to help surface red flags, validate financial performance and provide a more reliable foundation for investment decisions. PHOTO: PIXABAY

- There are no unrecorded liabilities or unusual cash activities like large transfers to related parties.

The PoC test relies on three primary data sources:

- Bank statements: Detailed records of all cash inflows and outflows over a specific period, typically covering several months or years.
- General ledger entries: The company’s official record of transactions, used to match reported figures with actual cash movements.
- Source documents: Supporting documentation for major transactions including invoices, receipts, contracts and payment confirmations.

Net working capital

NWC is an important aspect of QofE analysis because it indicates a business’ liquidity and operational efficiency. In a QofE assessment, NWC is evaluated to ensure that the company maintains sustainable working capital levels that enable it to support ongoing operations and meet its short-term obligations without relying on external financing. NWC is calculated as the difference between current assets (such as receivables and inventory) and current liabilities (such as payables and accrued expenses).

NWC is important for QofE for many reasons, including:

- Sustainability of operations: By

analysing trends in NWC, analysts can assess whether a company’s operational cash flow is stable and sufficient to support normal business activities after a transaction. ■ Adjustment of purchase price: NWC is crucial for establishing what constitutes a “normal” level of working capital for the business. Deviations from this standard may lead to adjustments in the purchase price during M&A transactions, ensuring that neither party assumes undue risk.

A thorough review of NWC can reveal several risks, including:

- Volatility in working capital fluctuations may indicate operational inefficiencies, seasonal patterns or poor cash flow management.
- Revenue recognition risks: Unusually high accounts receivable might suggest overly aggressive revenue recognition practices.
- Liability mismatches: Large, unrecorded or unusual current liabilities can indicate hidden risks or mismanagement.
- Inventory concerns: Excessive or obsolete inventory may artificially inflate current assets.
- Operational insights: Analysing NWC often uncovers underlying issues such as customer concentration risks, supplier payment delays, or inventory turnover trends. These factors can significantly affect a company’s valuation and operational viability.

While evaluating NWC is crucial, it is equally important to estimate the cash requirements needed to support working capital for the first 30 to 90 days after the transaction.

This step is often overlooked in M&A, particularly in PE deals. Properly addressing this ensures that the business can maintain uninterrupted operations during the ownership transition.

Here are some best practices for using NWC in QofE Audits:

- Detailed forecasting: Use historical NWC trends and scenario analyses to model cash flow requirements for 30, 60 and 90 days post-transaction.

- Buffer for uncertainty: Account for contingencies, such as unexpected delays in collections or increased working capital needs due to integration complexities.

- Coordinate with lenders: Establish financing options before closing the transaction to address potential short-term funding gaps.

Incorporating a cash requirement analysis for the transition period in the QofE process enables PE investors to reduce post-transaction risks, maintain operational stability and avoid the stress of needing emergency funding. This facilitates a smoother and more successful integration.

For analysts tasked with assessing risk, value and operational resilience, a robust QofE review offers critical insights that conventional audits often miss.

From uncovering customer concentration risks and irregular cash flows to ensuring working capital adequacy during post-transaction periods, QofE provides the analytical rigour necessary for sound decision-making.

By approaching financials with this sharper lens, analysts can not only anticipate problems, but also identify opportunities that align with long-term value creation.

The writer has 17 years of experience in private markets, specialising in debt and equity