



HANCOCK ADVISORS
INVESTMENT BANKING & TRANSACTION ADVISORY

UNDERSTANDING FINANCIAL STATEMENT AUDITS VS. QUALITY OF EARNINGS REPORTS

A GUIDE FOR BUSINESS OWNERS

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Business owners considering the sale or purchase of a business within the next five years should understand how to assess the financial health and operational efficiency of the target companies.

Two essential tools business owners consider in this process are Financial Statement Audits and Quality of Earnings (QoE) Reports. These services may appear similar, but they serve distinct purposes and are conducted differently. This whitepaper will clarify these differences and explain their significance in the context of business transactions.

WHAT IS A QUALITY OF EARNINGS (QoE) REPORT?

A QoE Report is a thorough examination of a company's financial performance and associated risks, crucial during the due diligence phase of a transaction. The key elements of a QoE Report include:

Comprehensive Analysis: Provides an in-depth review of the company's financial statements to ensure they accurately represent the company's true financial condition.

Third-Party Assessment: Conducted by an independent third party, typically a CPA firm, to ensure an objective and unbiased evaluation.

Earnings Assessment: Focuses on assessing the quality and sustainability of the company's earnings, identifying whether they are consistent and repeatable.

Sustainability of Earnings: Evaluates whether the business earnings can be sustained over time, offering insight into the long-term viability of the company's income and margins.

Disaggregated Analysis: Identifies products or services where the company is operating efficiently and areas needing improvement.

Net Income Metrics: Uses various metrics to break down the company's net income, providing a clearer picture of financial health.



KEY DATA ANALYZED IN A QoE REPORT

ADJUSTED EBITDA:

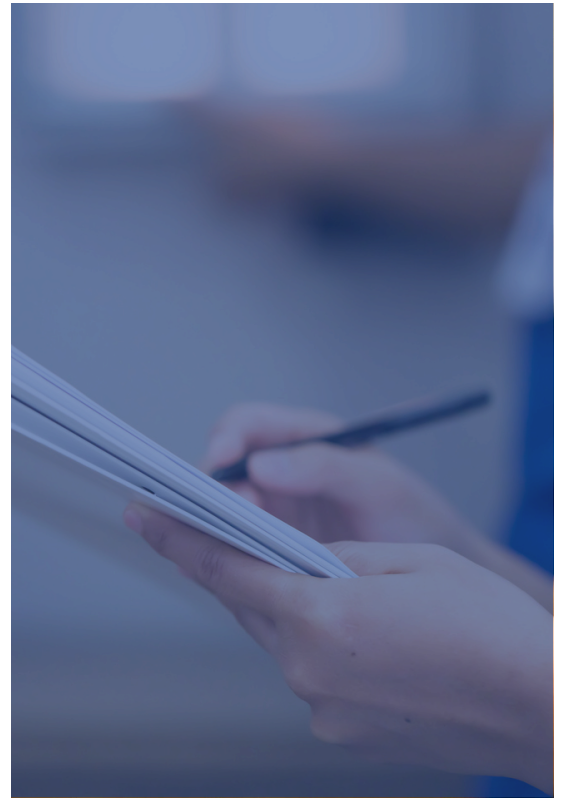
Adjusts earnings before interest, tax, depreciation, and amortization to focus on core operational earnings. It excludes one-time, non-recurring, and non-operational items.

PROOF OF CASH

Verifies that the cash reported in the financial statements matches the actual cash in the company's bank accounts, ensuring no discrepancies and validates revenues and expenses to cash flows.

WORKING CAPITAL

Assesses the company's working capital, which is crucial for understanding liquidity and operational efficiency by evaluating current assets and liabilities.



INFORMATION INCLUDED IN QoE REPORTS

Executive Summary: Overview of the business's current client profile, products and services, processes, locations, employees, mission statement, and other key matters.

Accuracy of Financials: Verification of the accuracy of financial statements.

Revenue of Company: Analysis of the company's revenue streams and associated trends, including a detailed breakdown of revenue sources and key customer relationships.

Income Statement Analysis: Examination of the income statement to assess profitability, including a detailed understanding of top vendors and special terms.

Debt Analysis: Review of the company's debt structure.

Working Capital Analysis: Detailed evaluation of working capital.

Summary of EBITDA: Comprehensive summary of EBITDA and adjustments for capital expenditures, non-recurring transactions, and transactions outside the ordinary course of business.

Tax Filing Positions: Examination of tax filing positions and reporting.





WHAT IS A FINANCIAL STATEMENT AUDIT?

According to the American Institute of Certified Public Accountants (AICPA), an audit is defined as “the highest level of assurance service that a CPA performs and is intended to provide a user comfort on the accuracy of financial statements. The CPA performs procedures in order to obtain “reasonable assurance” (defined as a high but not absolute level of assurance) about whether the financial statements are free from material misstatement.” This is achieved through inquiries of management, a detailed understanding of business processes and controls, analytical procedures, and testing of a selection of individual transactions.

WHAT IS INCLUDED IN A FINANCIAL STATEMENT AUDIT?

Financial Reporting Processes: Evaluation of the processes and controls around financial reporting and accuracy of reporting under accounting principles generally accepted in the United States of America (US GAAP) or other applicable reporting framework.

Compliance with Laws and Regulations: Ensuring adherence to relevant laws and regulations.

Risk Assessment: Identification and assessment of the risks of material misstatement in the financial statements and designing an audit approach to appropriately address those identified risks.

Substantive Testing: Testing material financial areas or transactions, either analytically or via a sampling approach, to obtain evidence that transactions recorded are complete, accurate, and in the correct period.

WHEN TO HAVE A FINANCIAL STATEMENT AUDIT?

Financial Statement Audits are generally conducted to give a financial statement user reasonable assurance that management’s financial statements are not materially misstated and are disclosed in accordance with their applicable accounting framework. Audited financial statements for nonpublic companies are typically requested by lenders providing high levels of financing or credit to a company. Audited financial statements can also be requested by investors of the company or included as a requirement in a company’s operating agreement.



KEY DIFFERENCES

QUALITY OF EARNINGS REPORT

PURPOSE: QoE Reports are transaction-specific, focusing on validating the financial health and earnings quality of a company for potential buyers or sellers.

SCOPE: QoE Reports focus on financial performance and risk over a historical period (typically three years and a trailing twelve-month period).

FREQUENCY: QoE Reports are conducted once during a transaction and may be subject to monthly updates.

PERFORMED BY: Conducted by an external third-party firm, providing an objective view.

FINANCIAL STATEMENT AUDIT

PURPOSE: Financial Statement Audits are typically annual and focus on risk-based testing to validate the completeness and accuracy of financial data and compliance with the applicable accounting framework.

SCOPE: Financial Statement Audits use analytics and sampling to validate financial data over a period that is typically one fiscal year.

FREQUENCY: Financial Statement Audits are performed annually.

PERFORMED BY: Conducted by an external third-party firm, providing an objective view.

CONCLUSION

Both Financial Statement Audits and Quality of Earnings Reports are critical tools for business owners. Financial Statement Audits ensure that a company's books and records are complete and accurate, transactions are reported in the proper period, and financial statements comply with necessary regulations, providing a solid foundation for business operations. Quality of Earnings Reports, on the other hand, offer an in-depth analysis of a company's financial health, providing essential insights into the sustainability and quality of earnings. Understanding these differences will help you leverage each tool effectively, ensuring a smooth and successful business transaction.

If you have questions about evaluating the financial health and operational efficiency of a business, contact [Rachel Connor](#), Hancock Advisor's Advisory Consultant and Audit Partner, or [visit our website](#).

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