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QUALITY OF EARNINGS REPORT IN ESOP TRANSACTIONS AFTER GREATBANC SETTLEMENT

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In June 2014, the Department of Labor ("DOL") and GreatBanc Trust Company ("GreatBanc") entered into a Settlement Agreement (referred to herein as "Settlement") regarding how GreatBanc will perform its due diligence in future employee stock ownership plan ("ESOP") transactions involving non-public companies. While the settlement only pertains to GreatBanc, the DOL may use the Settlement as a playbook for evaluating future ESOP transactions.

> "Others in the industry would do well to take notice of the protections put in place by this agreement."

- **Phyllis Borzi**, Assistant Secretary of Labor, Employee Benefits Security Administration, June 30, 2014, EBSA News Release, U.S. Department of Labor

Many of the concepts are an integral part of a *best practices* due diligence process. This article will discuss the policies and procedures included in Attachment A to the Settlement, "Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions" and will address the DOL's concerns in the reliance on historical and prospective financial statements.

INTERPRETATION

The DOL appears to express concern that a Trustee relies on unaudited financial statements. However, given the size of a business that typically implements the ESOP ownership structure, it is our experience that many transactions involve unaudited financial statements. Thus, it is left to GreatBanc's discretion to determine whether unaudited financial statements may be relied upon and the appropriate due diligence procedures to be performed in relation to them.

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> "If the ESOP Sponsor provides to the Trustee or its valuation advisor unaudited or qualified financial statements prepared by a CPA for any of the preceding five fiscal years (including interim financial statements that update or supplement the last available audited statements), the Trustee will determine whether it is prudent to rely on the unaudited or qualified financial statements notwithstanding the risk posed by using unaudited or qualified financial statements."

> "If the Trustee proceeds with the transaction notwithstanding the lack of audited unqualified financial statements prepared by a CPA (including interim financial statements that update or supplement the last available audited statements), the Trustee will document the basis for the Trustee's reasonable belief that it is prudent to rely on the financial statements, and *explain in writing how it accounted for any risk posed by using qualified or unaudited statements*. If the Trustee does not believe that it can reasonably conclude that it would be prudent to rely on the financial statements used in the valuation report, the Trustee will not proceed with the transaction. While the Trustee need not audit the financial statement itself, *it must carefully consider the reliability of those statements in the manner set forth herein*."

In addition, the DOL notes its concerns regarding the reliability of financial statement projections by requiring GreatBanc to perform the following:

> "Critically assess the reasonableness of any projections (particularly management projections), and if the valuation report does not document in writing the reasonableness of such projections to the Trustee's satisfaction, the Trustee will prepare supplemental documentation explaining why and to what extent the projections are or are not reasonable. Document in writing its basis for concluding that the information supplied to the valuation advisor, whether directly from the ESOP sponsor or otherwise, was current, complete, and accurate."

The Settlement requires GreatBanc to determine the reasonableness of the financial statement projections in comparison to historical and industry averages, including the consideration of at least the following metrics:

a. Return on assets
b. Return on equity
c. EBIT (earnings before interest and income taxes) margins
d. EBITDA (earnings before interest, income taxes, depreciation and amortization) margins
e. Ratio of capital expenditures to sales
f. Revenue growth rate
g. Ratio of free cash flows (of the enterprise) to sales

The Settlement allows GreatBanc to use discretion to include additional metrics or not address those metrics in the preceding list as long as they document the rationale for including or excluding the metrics.

The DOL did not prescribe *how* GreatBanc will meet the above requirements for projections or unaudited financial statements. An area in ESOP transactions that has historically been lacking has been the independent evaluation of the underlying data composing management's financial statements and the linkage of the historical financial statements to the projections provided to valuation professionals.

In typical Mergers and Acquisitions ("M&A") transactions, it is customary for the buyer to perform this type of analysis as part of its financial due diligence by retaining a qualified firm to perform a Quality of Earnings ("QoE") analysis. The DOL appears to rely in part on its understanding of best practices in the M&A market when indicating QoE analysis as a viable option in the Settlement.

WHAT IS QOE?

A QoE analysis is a deep dive into the financial statements to understand where value is generated by the business. In order to identify the value, the first step is to understand how a company records its transactions and reports its results. However, the QoE is not an audit but rather a detailed financial analysis and the two are not mutually exclusive but very complementary. An audit is balance sheet focused, whereas the QoE is concentrated on the income statement with the emphasis on determining a company's true ongoing earnings and cash flow potential, often measured as EBITDA. Both focus on the importance of getting the accounting correct but the QoE's ultimate goal is to allow a buyer to gain a detailed understanding of the underlying earnings power of the company. An audit is historical by definition, while the QoE starts with historical results but "normalizes" reported EBITDA for items that are non-recurring or non-operating in nature in order to provide a pro-forma presentation of EBITDA and what it will look like on a *go-forward* basis. At this stage, a company's pro-forma EBITDA can then be compared on a consistent basis to the projections of future EBITDA generated by the company. Since investment bankers, private equity professionals, and M&A practitioners consider EBITDA to be a reasonable proxy for operating cash flow, the "Adjusted EBITDA" or normalized amount is the central figure in the M&A community. Below are key differences between an audit and QoE analysis:

AREA	AUDIT	QUALITY OF EARNINGS
Presentation	Reflect actual historical results of the company in accordance with generally accepted accounting principles ("GAAP"). Amounts are subject to management estimates and judgments about materiality and other facts in determining net income. In order to achieve an unqualified opinion, the entity must present a full set of financial statements (balance sheet, income statement, statement of cash flow, and statement of shareholders' equity) along with required footnotes describing the accounting policies and other matters.	Involves adjusting EBITDA for revenue or expenses that are determined to be non-recurring in order to develop an adjusted or pro forma EBITDA reflecting a "normalized" level of EBITDA. The QoE report is a tailored consulting product and does not have a *standards* body dictating minimum requirements. Industry standard methodologies exist and the income statement, balance sheet and shareholder's equity section are all analyzed for their impact on EBITDA and working capital.
Compliance	An audit is an attestation function. Performed in accordance with generally accepted auditing standards ("GAAS") and provides the user reasonable assurance that the reported net income is in accordance with GAAP and is not materially misstated.	QoE does not involve compliance with GAAS and the resulting pro forma EBITDA is not a measurement prescribed in GAAP. QoE work is performed under the American Institute of Certified Public Accountants ("AICPA") consulting standards.
Disclosures	▶ Balance sheet ▶ Income statement ▶ Statement of cash flows ▶ Statement of shareholders' equity ▶ Financial statement footnotes	▶ Discussion of key deal issues ▶ Quality of earnings with explanations and exhibits supporting adjustments ▶ Cash free/debt free working capital adjusted for due diligence items ▶ Income statement and balance sheet schedules, trends, and key performance indicators ▶ Detail of revenue recognition and customer/product revenue and margin analysis ▶ Analysis of cost of sales, operating expenses and compensation ▶ Proof of cash (depending on deal size and whether previously audited)
Scope	▶ Testing ▶ Obtaining third party evidence ▶ Observation ▶ Statistical sampling	Level of testing and third-party confirmations not performed in QoE analysis. The scope will vary as agreed upon with the client. Analytical in nature using source documents with certain analysis involving transaction evidence.
Timing & Delivery	Requires significant up-front planning, mailing of confirmations in advance of work, materiality and scope selections and other preliminary work and analysis.	Requires the target company to prepare and provide document requests, although with fewer audit type supporting schedules necessary. Due to the speed of transactions and nature of the M&A process, a QoE analysis often begins as documents are being assembled.

The QoE analysis may identify issues such as:

- Insufficient supporting documentation for management's adjustments to EBITDA
- Changes with key customers, such as churn or pricing, not previously observable
- Issues related to inventory valuation
- Significant changes in reserves between periods or a lack thereof
- Where amounts are recorded in the financial statement from operating to non-operating ("geography issues")
- Inaccurate capitalization policies for fixed assets on the balance sheet
- Inconsistent application or changes in accounting policies or procedures between periods

After the QoE process is completed, users of the financial statements have greater visibility into the quality of the historical financial statements and a clearer picture with regards to the run rate of EBITDA on a *go-forward* basis.

WHO SHOULD PERFORM IT?

Traditionally, the QoE report is commissioned by the buyer, which, in the case of an ESOP transaction, is the Trustee. This is referred to as a buy-side report. However, it is not uncommon for the seller in a M&A transaction, or sponsor of an ESOP transaction, to commission a sell-side QoE report.

Buyers want to gain greater reliance on the financial statements but also want to discover business or financial reporting issues that may affect valuation as well as any possibly deal killers that cannot be solved. If expectations have been based upon incorrect financial statements that are later proven to be inaccurate, frustration and distrust can result which may lead to a material revision or termination of the transaction.

Neither buyers nor sellers like surprises. Therefore, sellers have begun to commission QoE reports on themselves, not only to preemptively prepare for the due diligence process but also to provide credibility and transparency to their financial statements, especially when audited financial statements are not available. The sell-side QoE analysis identifies potential deal issues early in the process so they can be addressed and resolved prior to the buyer's due diligence. The buyer will likely still commission its own independent QoE analysis. However, this second independent analysis is normally confirmatory in nature and does not, and should not, result in significant changes in normalized EBITDA.

WILL QUALITY OF EARNINGS ADDRESS THE DOL'S CONCERN IN ESOP TRANSACTIONS?

The overriding edict in the Settlement is "documentation." DOL representatives have stated to various ESOP advisors (including a seminar organized by BDO in August 2014) that if there is no documentation on how a fiduciary issue was addressed, then the DOL will assume the fiduciary issue was not addressed. As a result, there is a renewed emphasis on documentation and a QoE report can go a long way in satisfying this requirement. Having a QoE report prepared may allow all parties involved in an ESOP transaction to avoid future issues with the DOL, ESOP Trustees, ESOP participants, and the seller and can therefore be viewed as risk protection. However, the benefit of having a QoE report goes beyond documentation.

Perhaps the largest benefit from a well-structured QoE engagement is assessing the quality of the financial statement projections. The financial statement projections are prepared by management, who may be a shareholder or who may be employed directly under the shareholder, which could impair independence. Management typically understands that the projections will impact the ESOP transaction value; many managers have never prepared financial statement projections that extend beyond the next year's budget. Forecasts and projections are not the same and the authors have observed CFOs and their staff also struggle with the fact that they do not always have the expertise to develop projections with the level of detail required for an ESOP transaction nor have a means to independently evaluate the financial projections they prepare.

A QoE report is an analysis of the historical components of pro-forma EBITDA and analyzing the historical trends of the financial statements can provide management with the basis for assessing their financial statement projections. Any QoE engagement in an ESOP transaction should include the analysis of the financial statement projections to assure the underlying assumptions of the projections are supportable based upon the historical financial performance.

Financial projections that are supported by a QoE report should provide ESOP Trustees and their financial advisors with greater comfort in the projections. In informal discussions with ESOP financial advisors, we noted that they adjust other factors in their valuation models, such as market multiples and discount rates, in part based upon their comfort with, and their assessment of, the credibility of the financial projections. In the absence of such independent support for projections, ESOP Trustees and their financial advisors may rely on more conservative valuation assumptions in light of the DOL actions, including the GreatBanc Settlement and several court cases.

Another benefit for the seller and ESOP company sponsor is when the QoE report is provided to lenders. Lenders must have confidence that a company's earnings and cash flows are sufficient to service its debt. QoE reports are routinely distributed to lenders in non-ESOP M&A transactions via equity sponsors or strategic acquirers who commission the reports regularly. The reports provide greater comfort to the lender in setting the amount of exposure they are willing to base on the company's cash flows. The reports help the company in negotiating the interest rate and the amount of the loan from the lenders. The report can also assist in negotiating covenants and in determining the need for or when shareholder guarantees can be released.

WHAT DOES AN ESOP TRANSACTION QOE INCLUDE?

According to the Settlement, it is at GreatBanc's discretion on how to document the reasonableness of the historical and projected financial statements. The Settlement does not require a QoE report. However, a reasonable question for ESOP Trustees to consider is "If a QoE is used in the normal course of a non-ESOP M&A transaction, why should we not seek one in an ESOP transaction?" After all, through the process requirements set forth in the Settlement, the DOL has provided a playbook for ESOP transactions which is effectively patterned off of the M&A market.

The QoE report is not a "one-size-fits-all" deliverable. The scope of services is tailored to meet the specific needs of the seller/sponsor and/or ESOP Trustee. The scope, and resulting deliverable, is typically dependent upon the size of the deal and whether the financial statements have been audited. In the simplest form, a QoE report typically takes one of two forms, although the scope of the underlying work is identical:

- **Short-Form Report -** Executive summary, key deal issues, quality of earnings, quality of working capital and projections.
- **Full Report -** Executive summary, key deal issues, quality of earnings, quality of working capital, projections, income statement and balance sheet schedules and trends, analysis of cost of sales, operating expenses, compensation and customer/product analysis.

A QoE study can also be performed in stages with a preliminary "red flags" first phase that will provide visibility into whether additional QoE procedures are required. For instance, many ESOP transactions involve unaudited financial statements. In this case, the Trustee could request a proof of cash exercise that reconciles a company's general ledger to its underlying bank statements. The proof of cash often identifies accounting errors, misstatements and where amounts are recorded in the financial statements . When this exercise is coupled with a "red flags" or issues-based report, the Trustee can gain significant insight into the quality of the historical financial statements and can then determine whether a subsequent "deeper dive" into the quality of earnings is needed. As a next step, the Trustee could potentially request a Short Form report. But at minimum, a "red flags" version of a QoE report will provide significant insight into the quality of the historical financial statements and a perspective into management prepared projections using these records.

As noted above, we have discussed the Settlement with numerous ESOP Trustees, valuation firms, investment bankers, and attorneys. A common concern is whether the added costs of a QoE analysis will discourage companies from doing ESOP transactions or make them overly expensive. The benefits of a QoE analysis can outweigh the cost and in most cases are comparable to the ongoing audit that may be required on a post closing basis.

CONCLUSION

There is no majority consensus on how ESOP Trustees should treat the GreatBanc Settlement. Although the Settlement only pertains to GreatBanc, it appears that the Settlement may be the DOL's playbook for evaluating future ESOP transactions. We believe the DOL expects the ESOP community to exercise similar due diligence processes that any non-ESOP buyer would follow in a traditional M&A transaction. The QoE is not a guarantee that fiduciary due diligence has been satisfied; it is only one part of this process. ESOP transactions including a QoE will have performed one step of the due diligence process. The QoE may be the ESOP Trustee's most prudent way to satisfy the DOL's documentation threshold for assessing the reasonableness of the historical and projected financial statements.