Lessons & Warnings from the Wreckage:

What a Flawed Quality of Earnings ("Q of E") Can Teach Lenders & Investors

James F Davidson

CPA, CFF, CFE, CGMA, FCPA, CD, CBA, CIRA, CTP, CM&AA, CM&AP

President & Founder

James A Hughes

CPA, CFE

Senior Consultant

www.AvantAdvisory.com

Preview of Key Takeaways

- What a properly performed **Q of E encompasses**
- The vital **importance** of a **Q of E** and what it **achieves**
- How a Q of E differs from a CPA-performed audit
- Why a Q of E can be **more valuable** than a CPA audit for lenders & investors
- Where **lender** and **buyer / investor needs & objectives differ**
- How a **defective** Q of E created the illusion of value

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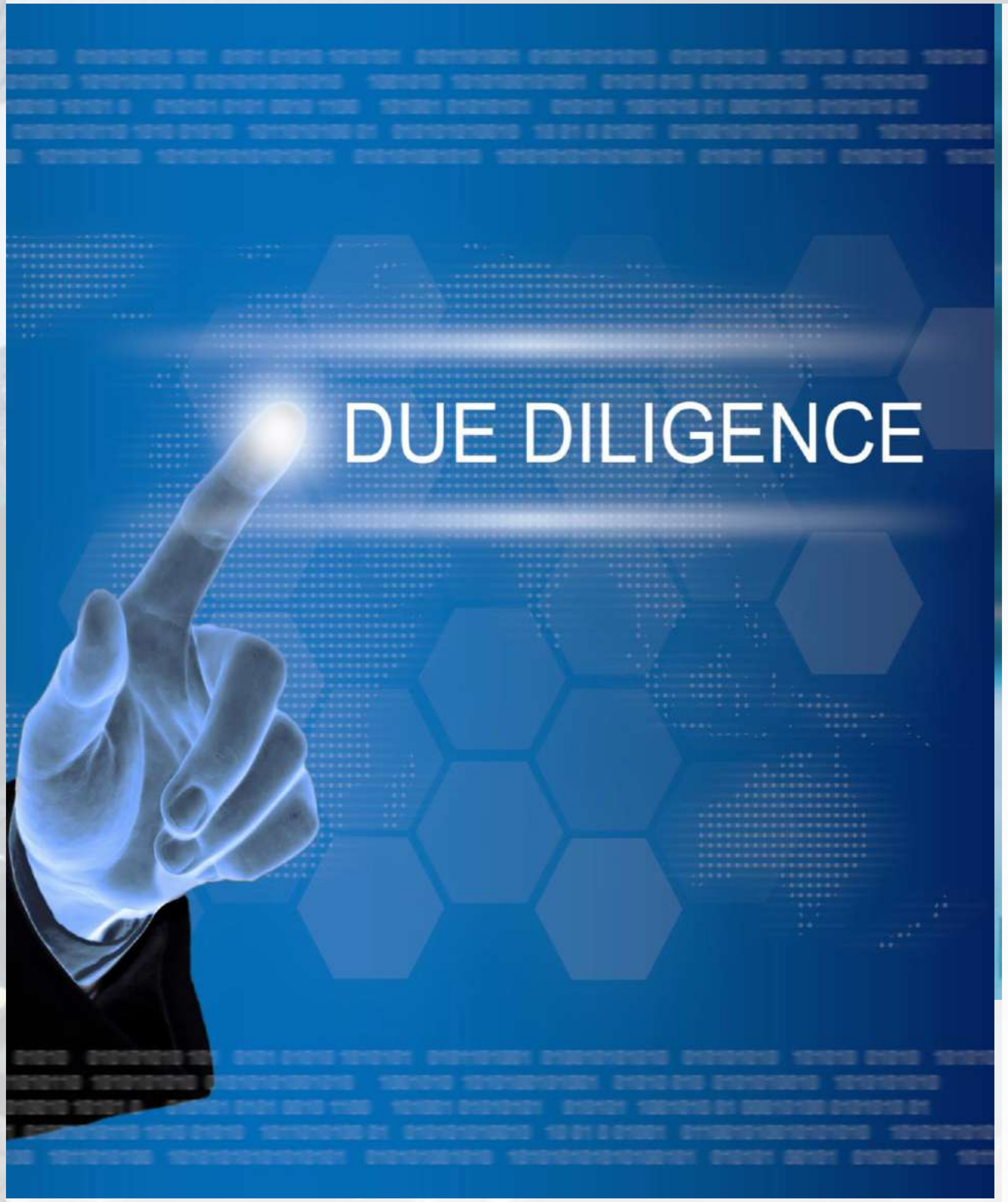
What Does a Quality of Earnings Encompass?

- **GAAP adjusted EBITDA** that reconciles the Q of E with CPA reviewed/audited financials
- **Normalized / pro forma adjusted EBITDA**
  - Removes one-off, non-recurring items
  - Eliminates extraneous, non-core operational items
- **Working capital** determination**, an integral part of purchase price**
- Identification of **debt-like items** to
  - Reduce purchase price if assumed
  - Or seller's proceeds payoff
  - **Either seller pays off debt or buyer assumes and reduces seller's net proceeds**
- Determine **maintenance & growth CAPEX** that will require cash or impact free cash flow
- Reconcile projected financials with pro forma adjusted EBITDA

Importance of Q of E Diligence



- A CPA-performed audit cannot replace a financial due diligence / Q of E because the **focus and objectives are different.**

- The **audit is historically focused**, i.e., on past financial information and is **balance sheet-driven**. The **Q of E is primarily current & future focused & cash flow-oriented.**

- An audit and a financial diligence / Q of E are **not** interchangeable, **nor** equivalent. The purpose of the audit is to opine on the **fairness** of the **financial statements** taken **as a whole or overall**, which is based on the concept of **materiality**.

Importance of Q of E / Financial Diligence

The Q of E should **not ignore immaterial** items as will a financial audit. Instead, we analyze items that the **audit firm passes as immaterial, and we specifically include them in our EBITDA adjustments.**

The Q of E's emphasis is on **recurring EBITDA (rather than free cash flow)**, but we try to adjust for that too when we perform a full Q of E.

- ❖ The Q of E seeks to determine **operating profitability & cash flows which is why EBITDA definitionally excludes interest & income taxes, disregarding** capital/financing & tax structures.
- ❖ A **Q of E-determined EBITDA neutralizes capital/financing/debt, tax structure & income taxes,** while those are encompassed in a financial audit.
- ❖ The **Q of E determines recurring operating profitability that includes income & expenses intrinsic to the business, i.e., core income & expenses only.**
- ❖ **Key question: Are expenses core or not? Core income & expenses drive the recurring business model, i.e., guts, substance, nucleus, heart of the business.**

Adjusted/normalized EBITDA measures the true recurring operating performance of the business by including the core expenses, but removing extraneous income & expenses that are rare, unusual and will not recur.

Diligence - Concerns & Objectives

Buyer/Investor

- ❖ Quality of reported financial information
- ❖ Identification of unusual & nonrecurring items
- ❖ Identification of debt-like items
- ❖ Operational risks & contingencies
- ❖ Operational & financial drivers
- ❖ Quality of operations – Risks & opportunities
- ❖ Management assessment
- ❖ Business integration challenges
- ❖ Information technology – Planning & risks
- ❖ Purchase price adjustments/valuation

Lender Concerns

- ❖ Cash flows & working capital
- ❖ Vetting financial projections
- ❖ Borrowing base requirements
  - Inventory age & obsolescence
  - Dilution, concentration & collections
- ❖ Loan covenant compliance
- ❖ Default risk
- ❖ Financial reporting & information systems
- ❖ Financial trends
- ❖ Management integrity & capabilities
- ❖ Accounting policies & procedures-GAAP
- ❖ Company - & industry-specific anomalies

Quality of Earnings

- ❖ GAAP compliance including:
  - Revenue recognition
  - Asset overstatement
  - Unrecorded liabilities
- ❖ Normalizing / Pro forma adjustments:
  - Financial & operational abnormalities that skew **recurring** earnings
  - Potential staffing adjustments
  - Discretionary items
- ❖ Working capital requirements
- ❖ Identification of **debt-like items**
- ❖ Maintenance & growth **CAPEX affecting free cash flows**
- ❖ Pro forma add-backs vetted in projections

Primary Concerns – Lenders v. Investors

Concern	Private Equity / Investors	Lenders
Primary Goal	Maximizing **return on investment (ROI)** through combination of **EBITDA / valuation growth & future sales transaction**.	Ensuring debt **repayment** & **minimizing downside risk**.
Focus Area	**Sustainable, go-forward normalized EBITDA & future projections**.	**Cash flow & debt service coverage**.
Adjustments	Focus on **pro forma adjustments** that reflect **normalized, recurring core earnings** (e.g., post-acquisition cost savings, market-rate salaries & facility costs) and **impact valuation & future performance**.	Primarily concern with historical & recurring adjustments that **impact current & future cash flows & debt covenants**.
Risks	Primary risks involve **overpaying** for the acquisition, **unsustainable growth**, **hidden financial & operational issues** that could hinder anticipated value creation.	Key risks revolve around **liquidity**, the **adequacy of collateral** & potential **default on loan terms.**
Working Capital	Ensure **sufficient working capital** & the **true cash requirement** to **confirm operational stability post-transaction** .	Satisfied with the **soundness of current assets & liabilities**, to ensure there is **sufficient liquidity to cover short-term obligations.**
Accounting	Identifying **aggressive or unusual accounting practices** that could **inflate EBITDA & valuation**.	Assure **compliance with GAAP** & **reliable financial reporting** for **collateral** & **loan agreements**.
Customer & Revenue Base	Assess customer **concentration risk**, **churn rates & pricing dynamics** for **revenue & EBITDA stability** & **growth potential**.	**Consistency & predictability of core revenue streams** to **ensure** steady **cash flows for debt servicing.**

Background

Transaction

- $100M equity purchase, 7.5X multiple
- Seller note -$5M; equity rollover -$5M
- Reps & warranties insurance - $10M
- $55M major bank financing

Buyers

- Independent sponsor
- Two multi-billion, sophisticated private equity firms

Post-Transaction Concerns

- Significantly underperforming EBITDA
- Multiple issues to investigate
- Client selected Avant due to capabilities in
  - M&A, particularly Q of Es
  - Distressed/turnarounds
  - Fraud investigations & forensic accounting
  - C-suite - CRO, CEO & CFO services
  - Litigation support – consulting & testifying experts

Why Engaged?

Mergers & Acquisitions
Financial / Q of E & Operational Diligence

Forensic, Fraud, Investigative & Dispute Resolution

C-Suite Interim Management & CFO Services

Operational Turnarounds & Financial Restructuring

Working Capital Analysis; Post-Acquisition Disputes – Expert Witness

Engagement Objectives

Engaged under **legal privilege**, to review, analyze, and opine on multiple issues primarily focused on:

- Appropriate **technical accounting** & impact of each issue on 2015 financial statements
- **Effects on 2015 audited financials** & TTM 2016 EBITDA
- Adjustment to **net working capital**, if any, at Transaction Date
- Potentially inaccurate or inadequate Seller disclosures
- Potential **seller fraud**

Scope

Interviewed

- Multiple accounting, financial & operational personnel
- Members of board of directors & management
- Outside experts
  - Company's auditors
  - Legal counsel
  - Big 4 CPA Firm – Q of E
  - Investment banker

Read thousands of pages

- **CPA audited financial statements**
- **Big 4 firm Quality of Earnings diligence report**
- SPA & related acquisition documents
- Seller emails year preceding the sale

Performed

- **Financial / forensic analyses**
- **Technical accounting** application
- Industry research

Overriding Finding – Overstated Transaction Value

Impact of Multiple Issues?

- 2015 **audited** financial statements **materially misstated**
- Normalized / pro forma TTM May 2016 **EBITDA grossly overstated**
- **Working capital target significantly understated**
- Missed **debt-like items inflated purchase price by $10M**
- **Deferred CAPEX** (plus, **deferred R&M**) - **required millions more cash post-transaction catch-up**
- Multiple inaccurate, inadequate, and **undisclosed** items in the SPA
- **Highly leveraged** financing **significantly over-leveraged** given the **real numbers**

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Avant Corrected EBITDA – Big 4 Firm Q of E

Normalized 2015 EBITDA		
Big 4 Firm adjusted EBITDA		**$ 13,355**
CPA audit adjustments		
Difference in net income	(2,276)	
Difference in depreciation	954	
Difference in interest expense	155	
Difference in gain/loss	(161)	
Other audit adjustments		(1,328)
Big 4 firm EBITDA after correction for CPA audit adjustments		**12,027**
Avant adjustments		
Adjustments related to audit/diligence		
Customer G accounts receivable allowance	630	
Correction to Big 4 firm taxes in definitional EBITDA	**(369)**	
Avant GAAP adjustments		
Capitalized repair and maintenance expenses	**(1,683)**	
Customer A contract expense	(921)	
Expensing of prepaid items	(226)	
Capitalized rebranding expenses	(89)	(2,657)

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Avant Corrected EBITDA – Big 4 Firm Q of E

Avant GAAP adjusted EBITDA		**9,369**
Proforma/other adjustments		
Customer M relationship issues & liquidated damages	(1,950)	
Deferred truck maintenance & repairs	**(545)**	
Customer G terminated contract (nonrecurring revenues)	**(302)**	
Recurring operational dysfunction	**(233)**	
Workers' Compensation Claims attributable to 2015 **(out-of-period)**	(161)	
Nonrecurring rebranding expenses	89	(3,101)
Avant adjusted EBITDA		**$ 6,269**
Variance from Big 4 firm adjusted EBITDA		**(7,086)**

Severely Defective Q of E

ISSUE	GAAP	NWC	Normalized EBITDA	Debt Like Item
1. Non-GAAP Capitalization of Equipment Maintenance & Repairs	**X**		**X**	
2. Non-CAAP Accounting Treatment for Long-Term Obligations	**X**	**X**	**X**	**X**
3. Treatment of Prepaid Items		X	X	
4. Customer M Relationship and Operations Issues		X	X	
5. Customer G Terminated Contract			X	
6. Non-Ordinary Course Delaware Operations/ Financial Shortfall			X	
7. Deferred Truck Expense			X	X
8. State A Re branding				X
9. Customer M Code Violations	X	X	X	
10. **Trade Payables Delay**				**X**
11. Unpaid Title and Survey Costs		X		X

Audited Financials Materially Misstated

Pro Forma adjusted 2015 audited financial statements after Avant proposed adjustments under generally accepted accounting principles (“GAAP”) for a single item alone (contract indebtedness)

Pro Forma Effect of CNG (in $000s) As of the year ending December 31, 2015	CPA Audit	Avant Adjusted
Total current assets	$ 8,240	$ 9,041
Property and equipment, net	26,831	25,834
Total assets	41,063	45,551
Total current liabilities	8,576	10,178
Long term Liabilities	30,715	36,01
Total liabilities	**39,291**	**46,239**
Members' equity	**1,772**	**(688)**
Total liabilitles & equity	41,063	45,551
Revenues	36,834	36,033
Gross profit	32,966	32,352
Income from operations	2,444	1,830
Net income	**$ 1,144**	**$ 256**
Impact on EBITDA		(614)
Working Capital	(336)	(1,137)
Debt/Equity	22.2	(67.2)

Note: Analysis **ignores effects of fuel purchase commitments** on members’ equity and debt **that would further negatively impact debt to equity ratios and debt covenants.**

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Key Observations

- **Extremely poor quality of earnings** as suggested by **number & size of Avant adjustments**
- Several questionable items, e.g., **deficient audit; aggressive accounting, including increasing capitalization levels preceding acquisition,** physical inventory not observed, changed pricing methodology, **understated E&O reserves, etc.**
- Materially misstated historical financial statements attributable to:
  - **Inappropriate capitalization** of expense items
  - Incomplete booking of deferred expenses, **omission of contract indebtedness, inadequate disclosure of a $10M contract – debt-like item**
  - **Overstated assets & understated liabilities**
- **Multiple red flags (fraud indicia)** in overstating EBITDA and other financial data
- **Too complex for prosecutors to pursue criminally, especially given sophisticated investors**

Avant Q of E EBITDA Table - 5 Years Later

		TTM		Audited	
		2021	2020	2020	2019
Total Revenues		$ 53,910	$ 53,053	$ 50,847	$ 53,259
Pro Forma Revenues, including discontinued operations		55,570	53,264	51,433	53,259
Discontinued operations		(3,361)	(13,693)	(9,030)	(16,103)
Pro Forma Revenues		**$ 52,210**	**$ 39,571**	**$ 42,403**	**$ 37,156**
Expenses		71,240	77,059	68,918	77,775
Net Loss		**(17,330)**	**(24,007)**	**(18,071)**	**(24,515)**
Discontinued operations		362	(1,026)	427	(1,221)
Interest		**13,781**	10,354	11,849	10,281
Depreciation & Amortization		9,376	11,540	11,164	11,442
Other (income) loss		265	(62)	(6,431)	(64)
Reported EBITDA, excluding discontinued operations		**$ 6,455**	($ 3,200)	($ 1,062)	($ 4,078)
Management Adjustments					
Corporate	A	**5,462**	4,318	3,944	5,117
Nonrecurring / noncore expenses	B	**954**	**1,657**	2,589	599
Acquisition related	C	**66**	**2,273**	741	2,465
Bad debts – out of period	D		1,176	1,062	1,765
Truck spill	E	**250**			
Management / board fees	F	**222**	**355**	243	365
Total Management Adjustments		6,954	9,779	8,579	10,310

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Avant Q of E EBITDA Table - 5 Years Later

		TTM		Audited	
		2021	2020	2020	2019
Management Adjusted EBITDA		$ 13,409	$ 6,579	$ 7,517	$ 6,232
Avant GAAP Adjustments					
AR write-off	G	(15)			
Capitalized repairs $ maintenance	H		(4)	(10)	(4)
Debt issuance cost	I				
Total GAAP Adjustments		(15)	(4)	(10)	(4)
Avant Diligence Adjustments					
Out of period bad debts	K		**(708)**		**(1,062)**
IBNR	L		**(214)**	**214**	**(214)**
Corporate paid operational expenses	M	(250)	(596)	(682)	(513)
Diligence Adjustments		**(250)**	**(1,518)**	**(468)**	**(1,790)**
Avant Adjusted EBITDA		$ 13,145	$ 5,056	$ 7,039	$ 4,438
Normalizing / Pro forma					
Annualized price increases	N	596			
Annualized new contracts	O	222			
Customer S COVID	P	138	74	197	
Customer A COVID	Q	47	16	141	
Normalizing / Pro Forma Adjustments		**1,003**	**90**	**338**	
Avant Normalized / Pro Forma EBITDA		$ 14,148	$ 5,146	$ 7,377	$ 4,438

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TAKEAWAYS - LESSONS LEARNED

- Careful of **emotional investment bias, i.e., urgency to deploy capital.**
- Big 4 / large CPA firms use of **lower-level, inexperienced staff – too many mistakes.**
- **Trust the professionals but verify and don't be afraid to question!**
- **Question if too good to be true.**
- Consider **failure of professionals to collaborate**, i.e., working in silos.
- **Don't count on justice and full recovery** regardless of strength of the case.
- **Investors** are **directly** negatively **impacted** by a poorly performed Q of E. **Lenders** can be **indirectly** impacted with **increased default risk** & subsequent **write-downs / increased loan provisions.**

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About Us

Avant Advisory Group is a national operationally focused-financial advisory and management consulting firm. Focusing on middle-market companies, we combine our financial and operating skills with senior-level management experience to help clients identify value opportunities and implement improvements in cash flow and profitability.

Also, our forensic accounting and investigation expertise identifies potential financial misstatement and performs financial Quality of Earnings (Q of E) due diligence. Many clients find our financial guidance and operational expertise particularly valuable during periods of transition such as required in performing CFO Services and interim C-Suite Management.

SELECTED INDUSTRIES WE WORK IN

We support private equity firms, family offices, lenders & middle-market companies across multiple industries that include:

Industrial Manufacturing & Assembly

Consumer Products & Services

Technology, Media & Telecommunications

Food Processing/Packaging/ Restaurants/Retail

Real Estate, Construction & Infrastructure

Professional & Business Services

Transportation & Logistics

Healthcare Services, Products & Medical Devices

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Supplemental Data

Red Flags & Warning Signs (Don’t ignore them!)

Questionable Accounting Involvement

1. Management, particularly **CEO, overriding** controls
2. Tight **management control** or involvement of principals
3. Heavy accounting staff **turnover**
4. Different audit firms for related companies
5. **CFO not** involved or distances from reported numbers
6. Accounting personnel work in “silos” and **absolve themselves of** responsibility beyond narrow sphere

Red Flags & Warning Signs (Don't ignore them!)

Ineffective Corporate Governance

- Minimal board oversight; or
- **Excessive board involvement or micromanagement**
- No **outside/independent** directors (separation of duties)
- Undocumented or poorly drafted policies and procedures
- Frequent/unusual related party transactions and/or complex **legal structure**

Red Flags & Warning Signs (Don't ignore them!)

Performance Too Good to Be True

Rapid growth beyond reasonable expectations

Company **not** materially impacted by external forces

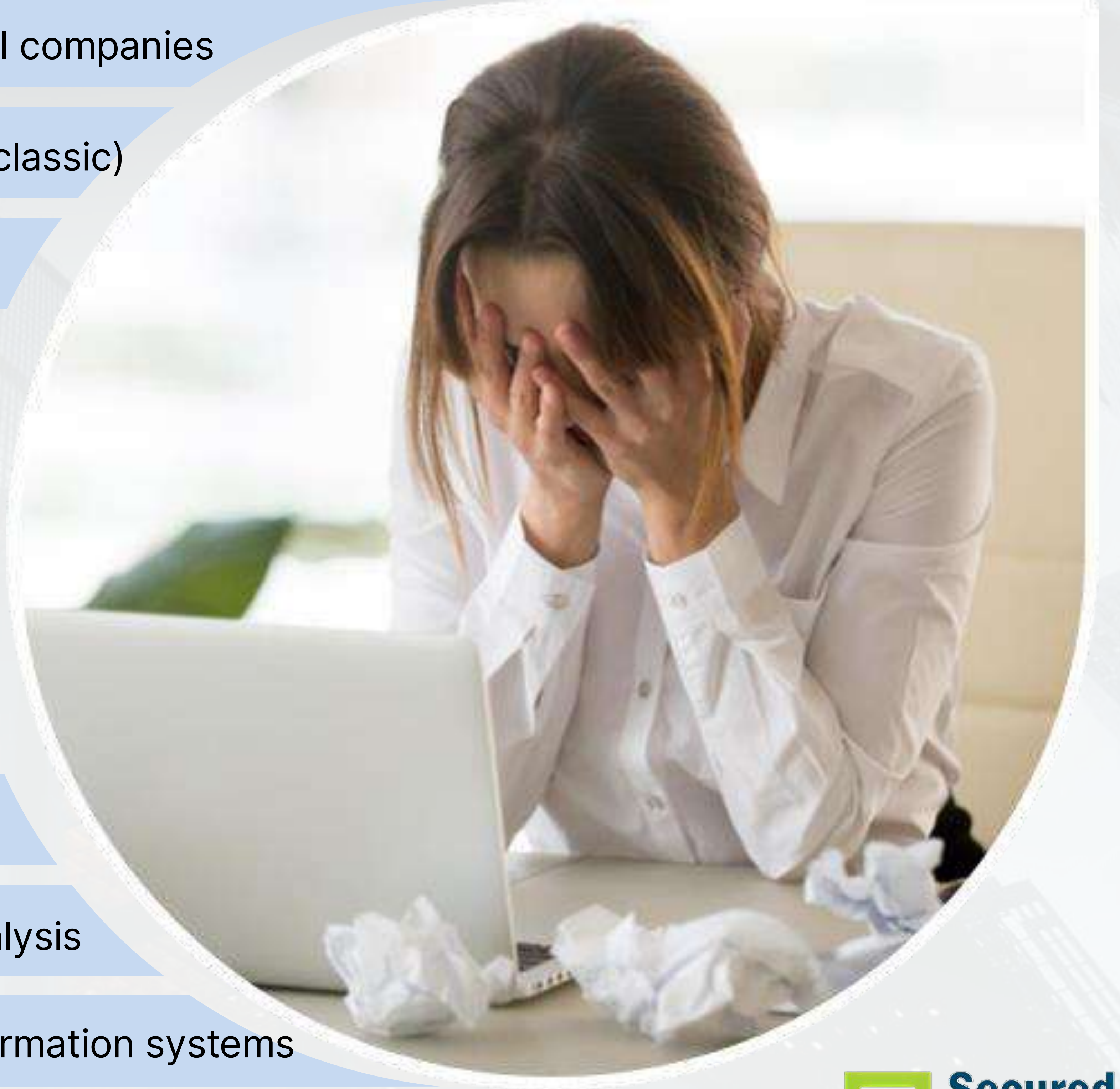
- Recession
- Supply limitations
- Infrastructure constraints

Company **outperforms** competitors, industry, etc. without clearly delineated reason

Red Flags & Warning Signs (Don’t ignore them!)

Other Fraud Indicia or Quality of Earnings Concerns

- **Top-side** entries not pushed down to individual companies
- Erratic, **incomplete, late,** financial information (classic)
- **Weak, tenuous,** inconsistent explanations
- **Unreconciled** accounts, especially cash/bank
- **Numerous**/excessive adjustments
- **Excessive** number of manual checks
- Continuous adjustments to inventory
- No audit or **downgraded** CPA involvement
- **Acquisitions** preventing comparable period analysis
- Financial information **not** reproduced from information systems



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Red Flags and Risk Factors

Incomplete Reporting

- Disparate information systems
- Change in fiscal year ends
- Accruals not recorded timely
- Unreconciled subsidiary to general ledger accounts, particularly bank accounts

Red Flags & Warning Signs (Don’t ignore them!)

“Twitchy” Non-executives and Gossip

- Comments that do not add up or make sense
- **Worries and concerns**
- Staff **whispers** and **rumors** that “not all is right”
- Information **not** readily available
- Confidentially shared information by lower level or operationally oriented employees

Red Flags & Warning Signs (Don’t ignore them!)

Site Inspection Inconsistent with Performance

1. Minimal level of **activity**
2. **Key personnel** not present
3. Amount, **volume,** types of inventory
4. Information **not** readily available
5. Operational indicators **inconsistent** with reported sales or financial information

Red Flags and Risk Factors

Site Inspection Inconsistent with Performance

1. Level of activity, inventory, and other objective indicators of performance not coinciding with sales or scale of purported operations
2. Key employees not present and critical information not readily accessible
3. "Twitchy" non-executives and office gossip
4. Employee concerns about something not adding up or information not making sense

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Red Flags and Risk Factors

Excessive Domination and Control By Principals or Key Management

1. Unreasonably restrictive control on financial or business information by CEO, overriding CFO
2. Financial data “filtered” through CEO prior to release
3. Senior executives “walled off” or unwilling/afraid to speak freely in presence of CEO
4. CEO sharing of EBITDA adjustments with CFO to get him on “same page”

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Red Flags & Warning Signs (Don't ignore them!)

Be Wary of Emotion, Time, and Costs Invested

- More costly later?
- Case Study

"Death by a Thousand Cuts"

Lack of transparency/consistency with cash flows

Inability to reconcile reported revenues to cash

No clarity on cash flows by company

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Key Topics

Focus – Poor Diligence and/or Portfolio Monitoring

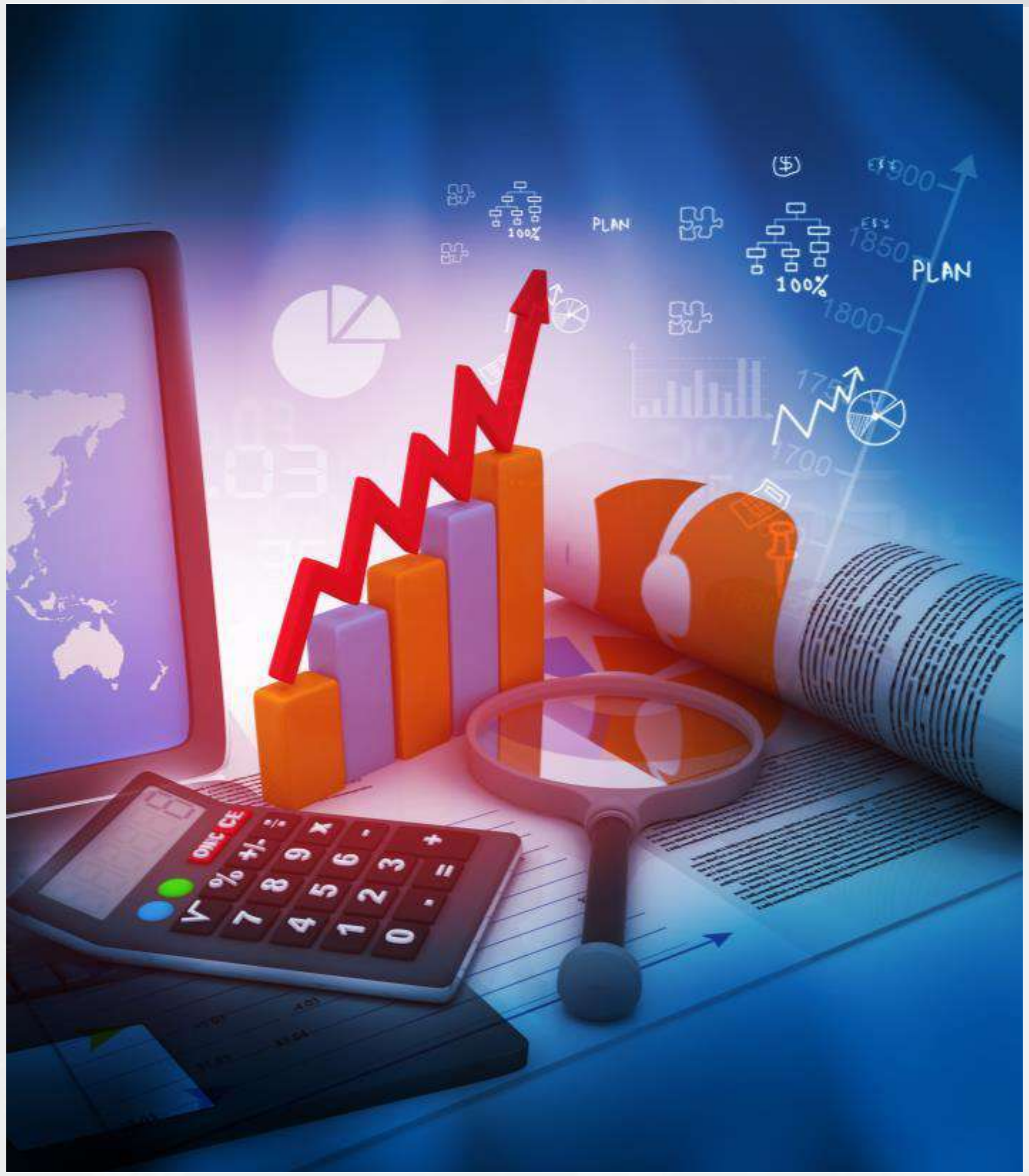
Fraud Schemes

Asset Misappropriation

Corruption

Financial Statement Manipulation

Telling Financial & Ratio Analyses



- Banish **M** Score
  - Powerful predictor of financial **manipulation**
  - Better predictor of **manipulation** than misappropriation
  - Five and eight factor formulas
- Altman **Z** Score
  - **80–90% accurate predictor of bankruptcy**
  - **Two of five ratios standalone indicator of fraud**
  - **Distress and fraud oftentimes related**
- **F**-Score
  - Predicts material **misstatements**
  - 28 ratios; 2/3 related to revenues and **soft** assets
  - Higher percentage off balance sheet financing (e.g., leases)

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ALTMAN "Z" SCORE

ALTMAN "Z" SCORE

- Predicts likelihood of bankruptcy within two years
- Test highly accurate
- May be monitored each year for corrective action
- Applicable across industries & company sizes & types; Public | Private | Manufacturing | Service