

# **Lessons & Warnings from the Wreckage: What a Flawed Quality of Earnings ("Q of E") Can Teach Lenders & Investors**

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# Preview of Key Takeaways

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- ➡ 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

# What Does a Quality of Earnings Encompass?

02

- ➡ 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



- ❖ 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**.



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.

## 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

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

## 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?

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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



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**

## 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

## 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

# Avant Corrected EBITDA – Big 4 Firm Q of E

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## Normalized 2015 EBITDA

|                                                                     |                |                  |
|---------------------------------------------------------------------|----------------|------------------|
| <b>Big 4 Firm adjusted EBITDA</b>                                   |                | <b>\$ 13,355</b> |
| <b>CPA audit adjustments</b>                                        |                |                  |
| 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)          |
| <b>Big 4 firm EBITDA after correction for CPA audit adjustments</b> |                | <b>12,027</b>    |
| <b>Avant adjustments</b>                                            |                |                  |
| <b>Adjustments related to audit/diligence</b>                       |                |                  |
| Customer G accounts receivable allowance                            | 630            |                  |
| <b>Correction to Big 4 firm taxes in definitional EBITDA</b>        | <b>(369)</b>   |                  |
| <b>Avant GAAP adjustments</b>                                       |                |                  |
| <b>Capitalized repair and maintenance expenses</b>                  | <b>(1,683)</b> |                  |
| Customer A contract expense                                         | (921)          |                  |
| Expensing of prepaid items                                          | (226)          |                  |
| Capitalized rebranding expenses                                     | (89)           | (2,657)          |

# Avant Corrected EBITDA – Big 4 Firm Q of E

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

# Severely Defective Q of E

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| 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

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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                                                                | <b>41,063</b>   | <b>45,551</b>  |
| Total current liabilities                                                   | 8,576           | 10,178         |
| Long term Liabilities                                                       | 30,715          | 36,01          |
| <b>Total liabilities</b>                                                    | <b>39,291</b>   | <b>46,239</b>  |
| <b>Members' equity</b>                                                      | <b>1,772</b>    | <b>(688)</b>   |
| Total liabilities & equity                                                  | 41,063          | 45,551         |
| Revenues                                                                    | 36,834          | 36,033         |
| Gross profit                                                                | 32,966          | 32,352         |
| Income from operations                                                      | 2,444           | 1,830          |
| <b>Net income</b>                                                           | <b>\$ 1,144</b> | <b>\$ 256</b>  |
| <b>Impact on EBITDA</b>                                                     |                 | <b>(614)</b>   |
| <b>Working Capital</b>                                                      | <b>(336)</b>    | <b>(1,137)</b> |
| <b>Debt/Equity</b>                                                          | <b>22.2</b>     | <b>(67.2)</b>  |

**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.

- ➡ 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

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

# Avant Q of E EBITDA Table - 5 Years Later

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

- ➡ 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**.



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

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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



SECURING VALUE

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# Questions?

[www.AvantAdvisory.com](http://www.AvantAdvisory.com)

**Los Angeles**

**Newport Beach**

**Sacramento**

**Miami**

**New York City**

# Supplemental Data

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

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## 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

## 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!) 26

## Performance Too Good to Be True

**Rapid** growth beyond reasonable expectations



Company **not** materially impacted by external forces

Recession

Supply limitations

Infrastructure constraints

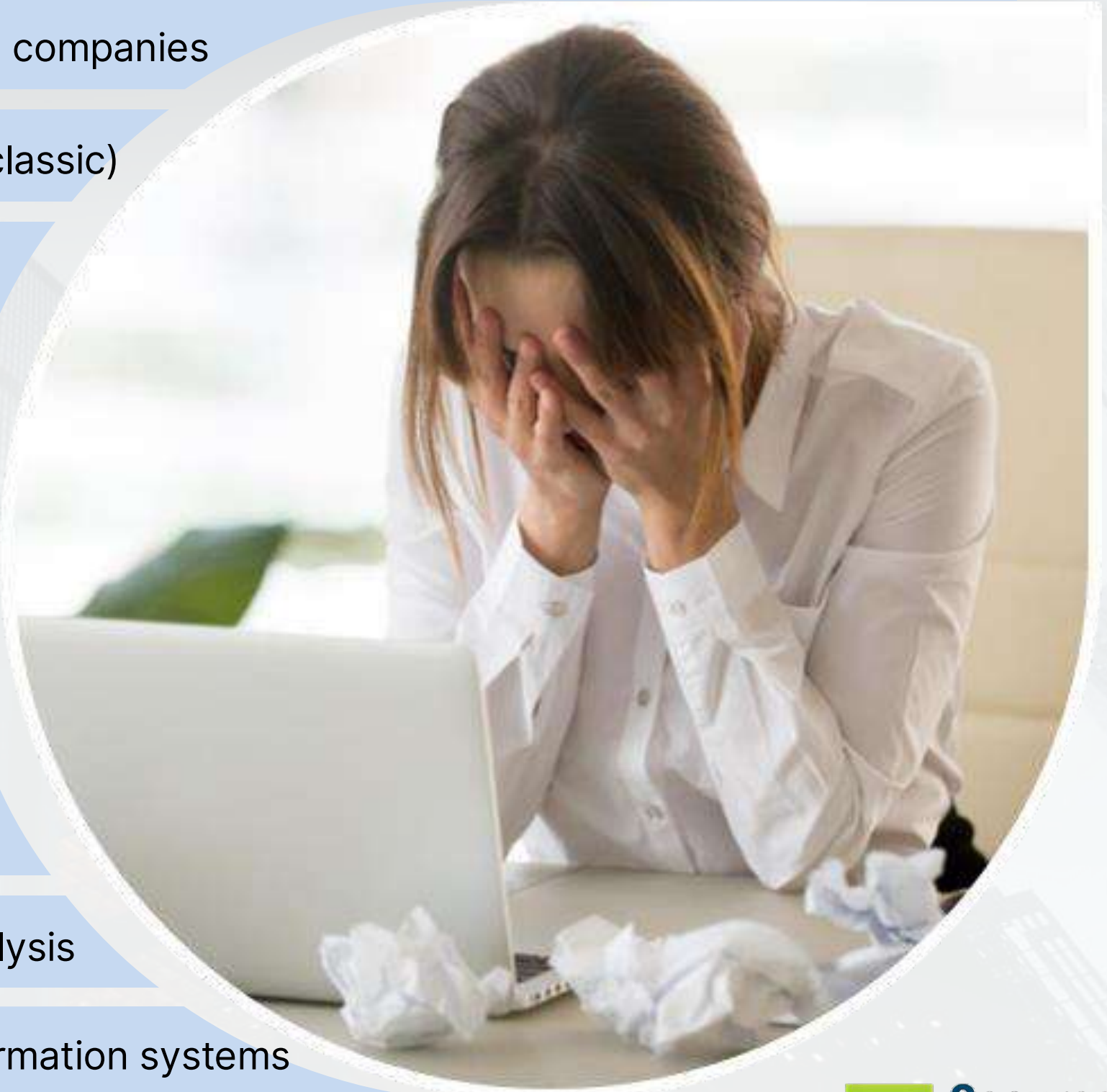


Company **outperforms** competitors, industry, etc.  
without clearly delineated reason



## 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



## 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!) 29

## "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!) 30

## 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

## 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

## 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”



# Red Flags & Warning Signs (Don't ignore them!) 33

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*



## Focus – Poor Diligence and/or Portfolio Monitoring Fraud Schemes



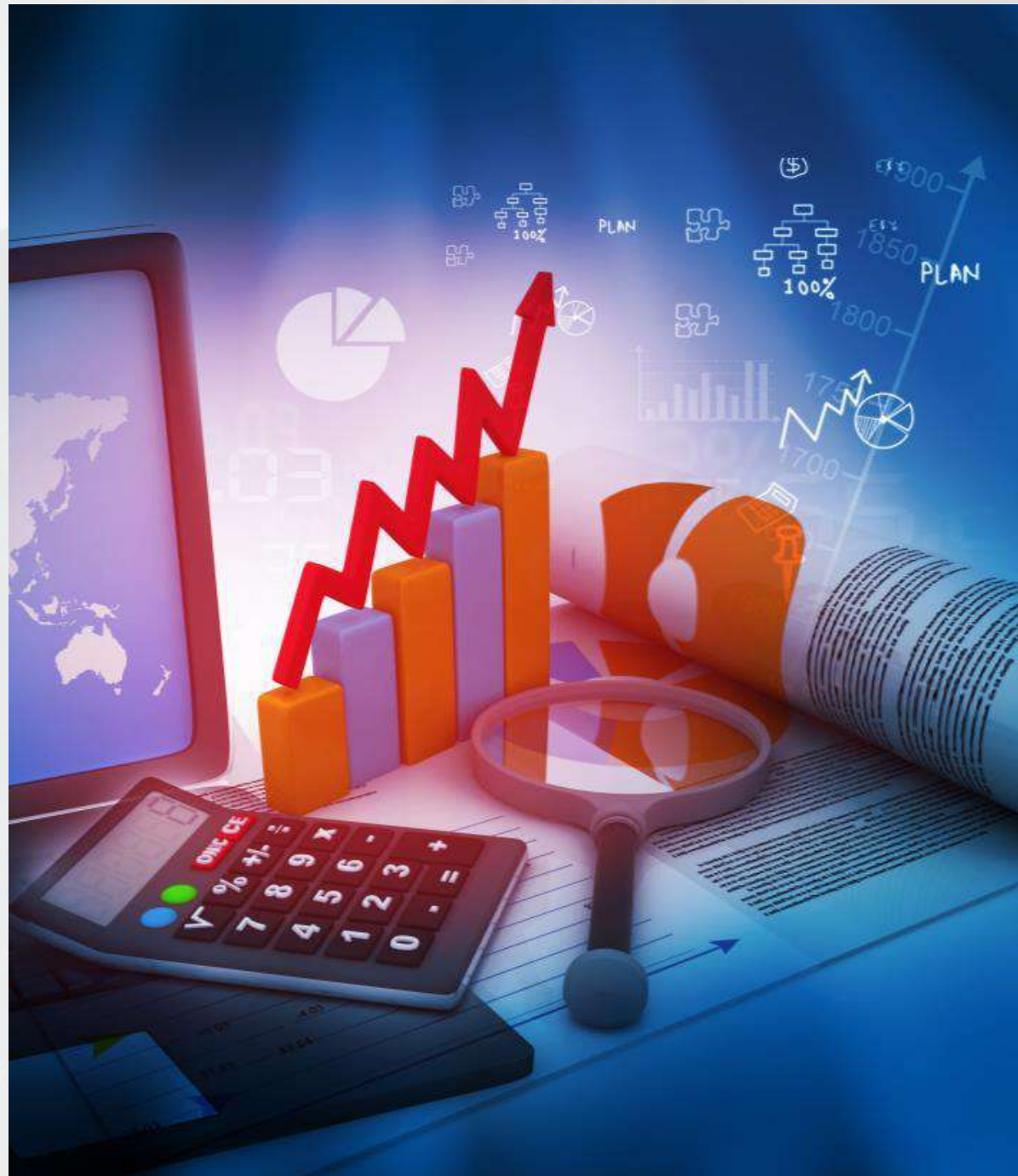
Asset  
Misappropriation



Corruption



Financial Statement  
Manipulation



- 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)

# ALTMAN “Z” SCORE

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