Quality of Earnigs (QoE)

Quality of Earnings, also known as quality of earnings, is a term coined to indicate quality, reliable income from management that can be counted on, including in terms of maintaining a certain future profitability of a company.

Net income is not necessarily a 100% accurate indication of a company's financial performance. If a company reports high net income figures but negative operating cash flow, for example, it may not be as financially sound as it seems and, therefore, acquiring the company may be a riskier investment than the company's financial statements indicate. There are many key details that are not outlined in a company's income statement, so a cash source analysis is very important; hence the importance of a quality of earnings (QoE) report that can help the investor understand and model the company's performance by distinguishing between normalized income and those factors that have affected the company's cash flow, positively or negatively, that are not repeatable or sustainable over time.

A QoE report, therefore, differs from an audit in that, while an audit allows companies to review their annual performance retrospectively by providing business owners with a level of assurance that the company's financial statements are consistent with generally accepted accounting principles, the QoE explains in detail the year-to-year variability in financial performance and considers potential changes in profitability that could result from a transaction and accordingly adjusts for one-time items that may have impacted historical performance but do not adequately reflect the expected cash flows of the business on a run-rate basis.

An earnings quality report, therefore, is able to address these inherent disconnects between the historical performance presented in audited financial statements and the annual cash flows that an investor should reasonably expect to generate under its ownership in the future by focusing on both determining a normalized level of EBITDA for the business, rather than a net income amount based on adopted accounting principles, and a normalized net financial position.

Based on the above, it is intuitable that in a due diligence process today, a quality of earnings (QoE) report is now a critical, useful and routine step.

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