Illinois ESOP Chapter 2017 Spring Conference

Financial Due Diligence/Quality of Earnings: Assessing The Credibility of Financial Statements and Projections

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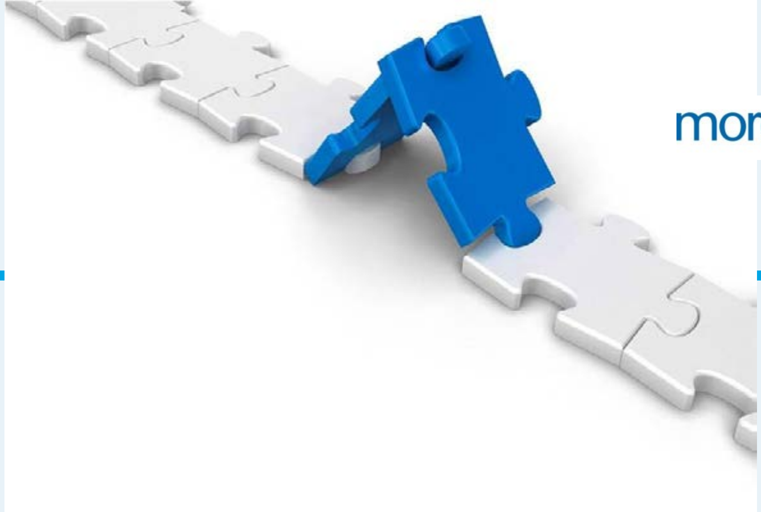
Presenters



more Insight.

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The evolving need to undertake Financial Due Diligence

- In assessing new ESOPs there is a trend toward greater involvement and oversight by regulators, Trustees, attorneys, Board members and lenders

- For companies without audited financial statements, some in the profession have suggested involvement by an independent firm to analyze financials and projections, highlight strengths, identify risks and assess the quality of earnings

- These types of engagements may also be appropriate to conduct periodically after establishment of an ESOP to better inform Board members and other interested parties

Can a Trustee rely on unaudited financials when doing a transaction?

- DOL requirements: The GreatBanc Settlement is worded in a way that almost creates a presumption that it is unreasonable to rely on unaudited financial statements.
- The Trustee must SEEK audited financial statements for the five previous fiscal years
- The Trustee may determine that reliance is reasonable but must carefully document this reasoning
- Some level of diligence/procedures should be undertaken for the "Gap Period":
  - Represents the time between the date of the last audit and the ESOP transaction date

What can Trustees do?

- Involve its financial advisor, and possibly internal resources, to scrutinize unaudited financial statements and projections to better understand risks and the viability of a transaction
- Engage a third-party vendor to perform a Quality of Earnings Analysis when deemed appropriate
- Conduct pre-engagement due diligence to assess financials to determine if a client/transaction will be accepted
- Reject the transaction

Primary purposes of a Quality of Earnings analysis

- Document that certain procedures were undertaken to gain insights regarding the company being analyzed
- Tailor procedures to higher risk areas (e.g., projections, customer concentration, integrity of accounting controls, unrecorded liabilities, volatility of raw material costs, margins)
- Mitigate investment risk for a better understanding of the company, its operations and outlook

•Can QOE reports be shared with various interested parties?

What should the scope be for a QOE analysis?

- Based on a cost/benefit/risk analysis
- There is a wide spectrum of procedures that can be undertaken (see next page)
- Cost and risk considerations are often the driving factors in determining how much, if any, diligence work is required
- Potential users of a QOE report: lenders, Boards, other?

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Illustrative topics to assess in a Quality of Earnings analysis

Revenue recognition
Revenue per employee
Order backlog
Gross margins
Expense recognition issues
Selling and administrative expenses
One-time items (e.g., goodwill impairment charges, litigation settlements, and asset write-downs)
Tax-rate percentage and strategy
Operating earnings (excludes one-time items)
Earnings quality/variability (financial strength; predictability)
Return on assets over time
Cash flow from operations
Share buyback/issuance
Employee stock options
Executive compensation, performance incentives, SARs, phantom stock, seller notes, warrants, etc.
Omission or understatement of liabilities
Changes in debt levels
Current and leverage ratios

Change in inventory and AR versus revenue
Provision for doubtful receivables
Growth rate in net working capital
Inventory valuation methodology
Capital expenditures and sufficiency
R&D spending
Return on total capital
Acquisitions
Pension and benefit expenses
Gains/losses from asset sales
Past and projected restructuring charges
Unrealized hedging gains/losses
Impact of seasonality and cyclicality
Breakeven analysis. Fixed v variable cost structure
Quality of information systems
Conformance with historical loan covenants

Financial projections-Reasonableness of underlying assumptions:
-growth rates, margins, capex, working capital, loan repayment

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Risks that a Quality of Earnings Analysis can uncover

- Improper accounting policies:
  - Aggressive or improper revenue recognition
  - Inadequate reserve policies (e.g., under accrual for bad debts and inventory obsolescence)
  - Inadequate procedures to reconcile inventory counts to records
  - Inadequate internal controls (e.g., expense approvals, cash management)

- Related party transactions:
  - Inflated lease or rental arrangements
  - Loans and advances to owners and family members

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Risks that a Quality of Earnings analysis can uncover (continued)

- Identification of unrecorded liabilities (typically part of a Trustee's standard due diligence):
  - Environmental
  - Pension
  - Pending litigation
  - Taxes
  - Vacation and other employee benefits
- Operating risks (e.g., management/customer/product concentration, deferred maintenance, competitive landscape)
- Reasonableness of projections and underlying assumptions

Other possible insights from a Quality of Earnings analysis

- Adjustments to projections:
  - Include cost of audits, Trustee and other professional services
  - Exclude discontinued operations or products
  - Exclude lost customer revenue and earnings if material and not replaced
  - Normalize owner compensation, occupancy, entertainment, etc.

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Three Illustrative outcomes from a QOE Process-Example 1

- **Minimal Impact**:
  - Modest weaknesses in internal controls related to segregation of accounting approvals and data processing systems noted. Remediated with limited investment.
  - Some accruals understated (e.g., reserves for bad debts and obsolesence). Adjustments not material.
  - Projections seemed modestly aggressive. Sensitivity analysis indicates less than 5% impact on value with more conservative assumptions
- **Conclusion**: Deal can move forward with no changes required (subject to an Adequate Consideration Opinion and a Fairness Opinion)

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Three Illustrative outcomes from a QOE Process-Example 2

- **Some Material Findings**:
  - Deferred maintenance issues identified requiring more significant capital expenditures than budgeted
  - Projections not reasonable based on historical trends and current market conditions

- **Conclusion**: Deal terms/pricing must be renegotiated for the transaction to move forward

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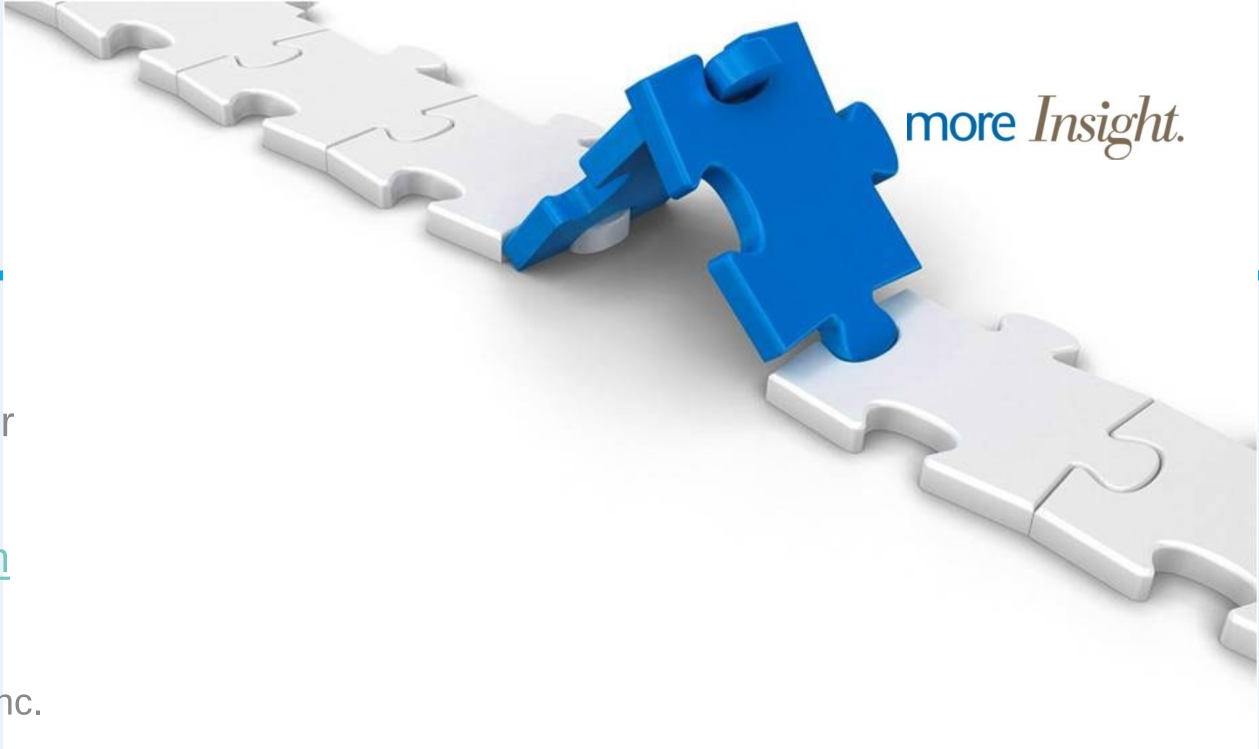
Three Illustrative outcomes from a QOE Process-Example 3

- **Significant Findings**:
  - Undisclosed litigation exposure related to several lawsuits with limited insurance coverage
  - Review of tax returns highlighted several major, questionable transactions (e.g., inventory, transfer pricing)
  - Related party transactions suggest questionable judgement by senior management and possibly some fraudulent transactions
  - Projections appear very aggressive, especially given the cyclicality of this business and concentration of 50% of revenue with two customers
- **Conclusion**: Terminate discussions with the company

Wrap up

- Expect regulators (e.g. the DOL) when reviewing ESOP files to expect:
  - More extensive analysis of unaudited companies
  - For approved transactions: Trustees to address in their documentation the resolution of weaknesses and risks identified

Questions?



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