TECHNICAL PRIMER

Quality of Earnings & Due Diligence

How buyers test whether a company's earnings are real and will repeat, and what happens to the price when they are not.

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HOW TO USE THIS PRIMER

Read Primer 1 first; this primer assumes you know the three statements, EBITDA and SDE. Each section covers one test a buyer runs. Work every example by hand, then try the same test on your team's company using whatever public information you can find, labeling each number as a reported fact or an estimate. You are not expected to master every detail: the goal is a basic understanding of each concept, and the extra depth is here for when you want it.

A buyer pays a multiple of earnings, so every dollar of earnings that turns out not to be real costs the buyer several dollars of price. Due diligence is how a buyer checks everything before closing; the quality of earnings review is the part that checks the number the price is built on.

The data shows why this matters. Calder Growth Partners' analysis of Stanford's 2026 search fund study found that searchers sign about **2.5 letters of intent for every deal that closes**, and about **79% of failed LOIs cited diligence findings**. Most deals that die, die when the numbers are checked.

1. Due Diligence

1.1 What it is

> **Due diligence** is the investigation a buyer carries out after signing a letter of intent and before signing the purchase agreement, to confirm that the business is what the seller says it is.

It runs during the LOI's exclusivity period, usually 60–90 days, and the buyer pays for it whether or not the deal closes. That is why buyers try to find deal-killers early and cheaply, before paying for a full quality of earnings report and legal work.

1.2 The workstreams

Workstream	Question it answers	Typical evidence
Financial	Are the earnings real?	Tax returns, bank statements, monthly financials, the QoE report
Commercial	Will customers stay and keep buying?	Revenue by customer, contracts, customer calls, market research
Operational	Can the business run without the seller?	Process documents, key-employee interviews, systems, equipment condition
Legal	Are there hidden liabilities?	Lawsuits, permits, leases, contracts that need consent to transfer
Human resources	Will key people stay, and are they paid and classified correctly?	Payroll records, employment agreements, contractor vs. employee classification
Tax	Are back taxes owed?	Federal, state, sales and payroll tax filings

1.3 The request list

Diligence begins with a request list sent to the seller. A typical first request for a small business:

Financial
Three years of business tax returns
Three years of annual and current-year monthly financial statements
Twelve to 36 months of bank statements
Accounts receivable and payable aging reports
A list of every add-back the seller claims, with support

Commercial, operational and legal
Revenue by customer for three years
Copies of major customer and supplier contracts
Employee list with roles, tenure and pay
Leases, permits and licenses
Any current or past litigation

INTERVIEW QUESTIONS

What would you look at first in diligence on a small business, and why?

Revenue by customer and the bank statements. Customer concentration can make a deal unfinanceable on its own, and matching bank deposits to reported revenue quickly shows whether the numbers are real. Both are cheap to check before spending on a full QoE.

2. The Quality of Earnings Report

2.1 What it is, and what it is not

A quality of earnings (QoE) report is an analysis, usually by an outside accounting firm, that starts from the seller's claimed earnings and tests each adjustment to answer one question: what will this business earn, year after year, under a new owner?

	Audit	Quality of earnings
Question	Do the financial statements follow accounting rules?	Are the earnings real, and will they repeat?
Who it serves	Shareholders, lenders, regulators	The buyer and the buyer's lender
Output	An opinion on the statements	Adjusted EBITDA, normalized working capital, a list of risks
Looks forward?	No	Yes: it removes anything that will not continue

For SBA 7(a) acquisition loans, a third-party QoE is required when the business price is $3 million or more (SBA SOP 50 10 8.1). Below that, many buyers and lenders still commission a lighter version.

2.2 The four main tests

Test	What it checks	Common finding
Add-back review	Is each claimed one-time or personal expense really non-recurring?	"One-time" repairs that happen every year
Owner pay normalization	What would it cost to replace the owner with a hired manager?	An owner paid $50,000 doing a $110,000 job
Revenue recognition	Is revenue recorded in the year the work was delivered?	Prepayments booked as revenue before the work
Proof of cash	Does reported revenue match money actually deposited?	Revenue higher than deposits with no explanation

INTERVIEW QUESTIONS

What is the difference between an audit and a quality of earnings report?

An audit checks that historical statements follow accounting rules. A QoE starts from the seller's adjusted earnings and asks whether they are real and repeatable for a new owner, so it removes add-backs that do not hold up and normalizes items such as owner pay.

3. Testing Add-backs and Owner Pay

3.1 The add-back test

An add-back is an expense the seller says should be ignored because it is one-time, personal or discretionary. A valid add-back must be **non-recurring** (it will not happen again), **non-operating** (the business does not need it) or **personal** (the owner's own cost run through the company), and it must be documented.

Claimed add-back	Test	Usually
Lawsuit settlement	Was it a single event? Is anything similar pending?	Valid if truly isolated
Owner's personal car lease	Is the car used only personally?	Valid with records
"One-time" equipment repairs	Do repairs appear every year?	Invalid if recurring
Family member on payroll who does no work	Payroll and duties records	Valid; but if they do real work, a replacement cost applies
Marketing the seller "paused"	Will revenue hold without it?	Usually invalid: cutting it inflates earnings now and hurts revenue later

3.2 Owner pay normalization

FORMULA

Owner pay adjustment = Owner's actual pay − Market cost of a replacement

Positive: earnings rise (the owner was overpaid). Negative: earnings fall (the owner was underpaid, often because they took profits as distributions instead of salary).

WORKED EXAMPLE

The owner pays themselves $50,000. A hired general manager for this business would cost $110,000 including benefits. Adjustment = $50,000 − $110,000 = **−$60,000**. The business earns $60,000 less than it appears to under a new owner who must pay a manager or pay themselves a market wage.

Illustrative.

3.3 The QoE bridge

A QoE report presents its findings as a bridge from the seller's number to the supportable number.

WORKED EXAMPLE

Line	Amount	Finding
Seller's adjusted EBITDA	$750,000	From the broker's marketing materials
(−) Recurring repairs claimed as one-time	($40,000)	Similar amounts in each of the last three years
(−) Owner pay normalization	($60,000)	Owner paid $50K; market cost $110K
(−) Revenue recognized early	($25,000)	Annual contracts billed in December, booked in full before the work
(+) Personal expenses not yet added back	$25,000	Owner's vehicle and phone, documented
QoE adjusted EBITDA	**$650,000**	

Effect on price. The LOI offered 4.0x the seller's $750,000, or $3,000,000. At the same 4.0x, $650,000 supports $2,600,000: **$400,000 less**. A $100,000 earnings finding became a $400,000 price finding.

Illustrative.

INTERVIEW QUESTIONS

A seller adds back $30,000 of "one-time" consulting fees. How do you test it?

Look at the general ledger for three years to see whether similar fees recur, read the invoices to see what the work was, and ask whether the business needs that work done again. If it recurs or is needed to run the business, it is not an add-back.

Why can a QoE finding of $100,000 reduce the price by much more than $100,000?

Because the price is a multiple of earnings. At 4.0x, every $1 of earnings removed takes $4 off the price.

4. Proof of Cash and Revenue Quality

4.1 Proof of cash

Proof of cash matches the revenue on the income statement to the money actually deposited in the bank, after adjusting for timing differences.

FORMULA

Expected collections = Revenue − Increase in accounts receivable

Compare expected collections to customer deposits on the bank statements. Small differences should be explainable (sales tax, refunds, timing). A large unexplained gap is one of the most serious red flags in diligence.

WORKED EXAMPLE

Line	Case A	Case B
Reported revenue	$4,000,000	$4,000,000
(−) Increase in accounts receivable	($50,000)	($50,000)
Expected collections	**$3,950,000**	**$3,950,000**
Customer deposits per bank statements	$3,950,000	$3,700,000
Unexplained difference	**$0**	**$250,000**

Case A ties out. In Case B, $250,000 of reported revenue has no cash behind it. Either the receivables are overstated or the revenue is not real; until the seller explains it, the buyer cannot rely on the earnings.

Illustrative.

4.2 Customer concentration

WORKED EXAMPLE

One customer provides 22% of revenue: $880,000 of $4,000,000. Suppose the business keeps a 40% gross margin on that work and cannot cut fixed costs quickly.

Lost gross profit if the customer leaves = $880,000 × 40% = **$352,000**. Adjusted EBITDA falls from $650,000 to about $298,000, less than half. The debt sized on $650,000 could no longer be paid.

Diligence responses: call the customer (with the seller's permission), read the contract's term and termination clauses, and if risk remains, move part of the price into an earnout tied to that customer staying.

Illustrative.

4.3 Real cases where the earnings were not real

HP and Autonomy (2011–2012). Hewlett-Packard bought the British software company Autonomy in 2011 for about $11.1 billion. In November 2012 it wrote down $8.8 billion of the investment and attributed more than $5 billion of that to what it called serious accounting improprieties and misrepresentations at Autonomy before the deal. The case led to years of litigation.

Caterpillar and Siwei (2012–2013). Caterpillar acquired ERA Mining Machinery, the parent of Chinese mining-equipment maker Siwei, in 2012. In January 2013 it announced a goodwill impairment of about $580 million after discovering deliberate accounting misconduct, including inventory discrepancies, at the subsidiary.

Luckin Coffee (2020). In April 2020, Luckin Coffee disclosed that an internal investigation found its chief operating officer and others had fabricated about RMB 2.2 billion of 2019 sales. Fabricated revenue is exactly what a proof of cash is designed to catch.

These were large, public, audited companies. Small private businesses have no audit at all, which is why QoE work matters even more in ETA.

INTERVIEW QUESTIONS

What is a proof of cash and why does it matter?

It reconciles reported revenue to actual bank deposits after timing adjustments. Revenue can be manipulated in the books; cash in a bank account is much harder to fake, so a proof of cash is one of the strongest checks that earnings are real.

What level of customer concentration worries you?

A common rule of thumb is any single customer above roughly 10–15% of revenue. The real test is what happens to earnings and debt coverage if that customer leaves.

5. Working Capital and Closing the Gap

5.1 Normalized working capital and the peg

Net working capital (NWC) = accounts receivable + inventory − accounts payable, usually excluding cash and debt. **The peg** is the normal level the seller must deliver at closing, usually the trailing 12-month average. The QoE report calculates it.

WORKED EXAMPLE

Scenario	Peg	Actual at closing	Price adjustment
Seller collected receivables and delayed bills	$400,000	$350,000	Price falls $50,000
Seller left extra inventory	$400,000	$430,000	Price rises $30,000

Illustrative.

5.2 What happens after a red flag

Every significant finding leads to one of four outcomes:

Outcome	When it fits	Example
Lower the price	The earnings are lower than claimed, and the gap is measurable	$650K × 4.0x = $2.6M instead of $3.0M
Change the structure	The risk is uncertain rather than certain	Move $300K into an earnout tied to the top customer renewing
Get a specific promise backed by escrow	A known, limited liability	The seller indemnifies a pending tax audit; $100K held in escrow
Walk away	The seller cannot explain the numbers, or the risk cannot be priced	Case B in the proof of cash example

Lowering the price after a diligence finding is legitimate. Trying to lower it without a finding ("re-trading") damages trust and often kills the deal.

INTERVIEW QUESTIONS

Diligence finds earnings are $100,000 lower than the seller claimed. What are your options?

Reprice at the same multiple; keep the price but move part into a seller note or earnout so the seller shares the risk; or walk away if the finding suggests the numbers cannot be trusted. Which one depends on whether the gap is certain, uncertain or a sign of dishonesty.

Why does the working capital peg exist?

Without it, a seller could collect receivables and delay payables before closing, keep the extra cash, and leave the buyer to refill working capital with their own money.

KEY TAKEAWAYS

1. Most deals that fail after an LOI fail in diligence; diligence is paid for whether or not the deal closes.
2. A QoE asks whether earnings are real and repeatable, which is a different question from an audit.
3. Every add-back must be non-recurring, non-operating or personal, and documented.
4. Proof of cash and customer concentration are the fastest ways to find a broken deal.
5. Every dollar of earnings removed is multiplied into the price.
6. A finding leads to a lower price, a different structure, a backed promise or a walk-away.

Sources

1. Calder Growth Partners, “Acquisition Search Is Getting Harder: Takeaways from Stanford’s 2026 Search Fund Study”
2. Beancount, “SBA SOP 50 10 8.1: Change of Ownership, Equity, DSCR and QoE Guide,” September 23, 2026
3. Hewlett-Packard Company, fiscal 2012 fourth-quarter results and statement on Autonomy, November 20, 2012
4. Caterpillar Inc., announcement of goodwill impairment related to ERA Mining Machinery (Siwei), January 18, 2013
5. Luckin Coffee Inc., announcement of internal investigation, April 2, 2020
6. Standard diligence and accounting concepts (quality of earnings, proof of cash, working capital, customer concentration) are general material not tied to a single source.

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