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Quality of Earnings Report: What a QoE Covers and Omits

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What a quality of earnings report is

A quality of earnings (QoE) report is a transaction-specific analysis of whether a company's reported earnings are a fair base for pricing a deal. In practice it rebuilds earnings before interest, taxes, depreciation and amortization (EBITDA) into an adjusted figure (the quality of earnings glossary entry gives the short definition), tests each adjustment against evidence, and sets up the working-capital mechanics that the purchase agreement will use.

Two features distinguish it from the financial statements it starts from. First, it is commissioned for a deal and scoped by an engagement letter, so two QoE reports on the same company can cover different ground. Second, it is not an audit. One accounting firm that sells the service states plainly that "a quality of earnings analysis is not an audit and, therefore, no opinion is given" (Warren Averett, 2023).

The CPA Journal's February 2026 article on selling accounting practices to private equity describes the sequence from the seller's side: the buyer engages an outside accounting firm to "conduct a quality of earnings (QOE) evaluation," and "diligence and QOE are ongoing while the parties negotiate the transaction documents" (Krosner, The CPA Journal, 2026). That article concerns accounting firms as targets, but the mechanics it describes, EBITDA multiples, normalised compensation and a net working capital adjustment, are the same ones deal teams meet in other sectors.

This article describes what a QoE typically examines, how to test the adjustments in it, and what it cannot tell you. It is a description of practice, not accounting or legal advice.

Sell-side versus buy-side

Who commissions the report shapes how far a buyer can lean on it.

	Sell-side QoE	Buy-side QoE
Commissioned by	Seller, usually before or at launch of a sale process	Buyer or its financing sources, after an indication of interest or letter of intent
Purpose	Surface and defend adjustments before buyers find them; shorten diligence	Test the seller's adjusted EBITDA and working capital independently
Who may rely on it	Set by the engagement letter; buyers often receive it under a non-reliance or limited-reliance letter	The commissioning buyer, and lenders if the letter allows
Main risk for the reader	Adjustments framed by the party that benefits from them	Scope narrowed to fit budget or timetable

The table reflects common arrangements, not a rule; reliance terms in particular vary by provider and should be read in the actual letter. Warren Averett notes that a QoE is "required by most buyers either for their own analysis or as required by their investors and finance partners" (Warren Averett, 2023), which is a provider's view of its market rather than a measured share.

Timing matters as well. Because the QoE runs while documents are negotiated (Krosner, 2026), its findings typically feed directly into price, the working-capital target, and the representations, escrows and indemnities that the parties are drafting at the same time.

What it typically examines

Warren Averett names "adjusted EBITDA, proof of cash and working capital" as the three key areas, and includes "the amount of debt and debt-like items" in its balance-sheet work (Warren Averett, 2023). No accounting standard defines QoE scope, but one regulator now does for its own loans. For SBA 7(a) Initial Acquisitions and Business Expansions with a purchase price "equal to or greater than $3 million," SBA SOP 50 10 8.1 (effective October 1, 2026) requires the lender to obtain a QoE that reconciles accountant-prepared statements, tax returns, internal statements and IRS transcript data, includes a "Cash Proof" on a trailing 12-month basis and the last two fiscal years, documents "all add-backs and adjustments," and assesses customer concentration; the report "must not be prepared by or for the seller" (SOP 50 10 8.1, Appendix 15). Taking these as a working map, a buyer should expect the scope to address the following, and should check the engagement letter for anything missing.

Adjusted EBITDA. The report starts from reported EBITDA and lists every proposed adjustment: non-recurring items, owner-related costs, out-of-period entries and pro forma items. The CPA Journal identifies owner "compensation and benefits in excess of market" as a standard example and notes that the resulting "adjusted/normalized/increased EBITDA amount" drives price because buyers often pay "a multiple of EBITDA" (Krosner, 2026). The glossary entry on adjusted EBITDA covers the term itself.

Proof of cash. A reconciliation of reported revenue and expenses to bank activity. It is the most direct test of whether booked revenue turned into cash, and matters most where the company's statements have not been audited.

Revenue quality. Customer concentration, contract terms, recurring versus project revenue, pricing changes and any revenue recognised ahead of delivery.

Net working capital. The CPA Journal describes the usual mechanism: the purchase agreement requires the seller to deliver "a specified (target) amount" of net working capital at closing, with closing working capital "calculated using the same accounting principles and assumptions that were used to determine that target" (Krosner, 2026). The QoE supplies the monthly history from which that target is negotiated.

Debt and debt-like items. Deferred revenue, unpaid bonuses, customer deposits, deferred capital spending, accrued taxes and similar items that a buyer may seek to deduct from enterprise value.

Fictional example: an EBITDA bridge with reviewer calls

Fictional company and figures, for illustration only. "Harbor Ridge Mechanical, Inc." reports fiscal 2025 EBITDA of $3,120,000. The seller's adviser presents adjusted EBITDA of $4,260,000. A buy-side reviewer works through each line.

#	Adjustment	Seller ($000)	Reviewer ($000)	Reviewer call	Reason
	Reported EBITDA	3,120	3,120		Ties to trial balance
1	Owner pay above market (owner $650k vs $250k replacement general manager)	+400	+400	Accepted	Supported by a signed post-close employment term sheet at $250k
2	Legal settlement	+180	+68	Challenged	Settlements of $60k and $95k in the two prior years; reviewer treats the three-year average ($112k) as a normal cost
3	Office relocation	+75	+75	Accepted	Invoices and lease; no relocation in prior five years
4	Relatives on payroll with no role	+90	+90	Accepted	Payroll records; roles confirmed absent in interviews
5	New contract, annualised	+350	0	Rejected	Pro forma revenue not yet earned; belongs in the forecast, not trailing EBITDA
6	Owner personal vehicle and travel	+45	+30	Challenged	$15k of travel was customer-facing
7	Gain on equipment sale	0	−70	Added by reviewer	One-off gain left in EBITDA while one-off costs were removed
8	Below-market rent to owner's building	0	−60	Added by reviewer	Post-close lease at market rent will cost $60k more
	Adjusted EBITDA	**4,260**	**3,653**		Gap: $607k

At a purchase multiple of 6.0x, chosen only to make the arithmetic visible and not as a market figure, the $607,000 gap is worth $3,642,000 of price. Four of the eight lines moved, and two of the moves were adjustments the seller never proposed. Both patterns are the subject of the next section.

The add-back test

No rule governs adjustments in a private transaction; the parties negotiate them. The most useful written test comes from a different setting: the Securities and Exchange Commission (SEC) staff's guidance on non-GAAP financial measures in public-company filings. It does not bind a private deal, but its reasoning travels well.

The staff states that "presenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business is one example of a measure that could be misleading," and that it "would view an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring" (SEC Division of Corporation Finance, Non-GAAP C&DI 100.01). That is the logic behind line 2 above: a legal settlement every year is a cost of doing business, however irregular the amounts.

Three further staff positions translate directly into diligence questions (SEC Non-GAAP C&DIs 100.02-100.04):

- **Consistency across periods (100.02).** An adjustment made in the current period but not for similar items in prior periods can mislead unless the change is disclosed and explained. Ask for the same adjustment schedule for every year presented.
- **Charges without gains (100.03).** A measure "adjusted only for non-recurring charges when there were non-recurring gains" in the same period can mislead. That is line 7 above.
- **Changing the accounting (100.04).** Adjustments that change recognition and measurement principles, such as switching from accrual to cash accounting, are treated as individually tailored. In a QoE, watch for adjustments that pull deferred revenue forward or reverse accruals.

A compact test for any add-back, built from those positions:

1. Has a cost of this kind occurred in any prior period presented, even irregularly?
2. Will the business need to spend this money, or its replacement, after closing?
3. Is there a document (invoice, agreement, payroll record) for the amount, or only a schedule?
4. Are offsetting one-off gains and below-market costs adjusted with the same rigour?
5. Is the adjustment the same in every period, using the same accounting policy?

An adjustment that fails question 1 or 2 is a forecast, not a normalisation, and belongs in the model's assumptions rather than in trailing EBITDA.

What it is not: audit and assurance

An audit has a defined objective. Under the Public Company Accounting Oversight Board's (PCAOB) general standard, the auditor must "obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud" and "issue an auditor's report that expresses an opinion" on them (PCAOB AS 1000). That standard applies to audits of public companies; private-company audits follow American Institute of CPAs (AICPA) standards with a comparable opinion structure.

A QoE does not do this. It analyses the numbers for a transaction and, as one provider puts it, gives no opinion (Warren Averett, 2023). An audited company can still have a poor quality of earnings, because an audit asks whether statements follow the accounting framework, not whether this year's EBITDA is a sustainable base for a price.

Some diligence work is performed as an agreed-upon procedures (AUP) engagement. In an AUP engagement, "a practitioner performs specific procedures on financial or nonfinancial subject matter" and "reports the findings without providing an opinion or a conclusion" (Reinstein, Miller and Fleming, Journal of Accountancy, 2020). The current AICPA standard, SSAE No. 19, "takes effect for agreed-upon procedures reports dated on or after July 15, 2021" and allows "procedures to be developed over the course of the engagement" (Journal of Accountancy, 2019).

Whether a particular QoE is issued as an AUP report, as a consulting deliverable, or under no attestation standard at all depends on the provider. The engagement letter says which. That matters because it determines what the report claims, who may rely on it, and what recourse exists if it is wrong.

Earnings quality in the research literature

"Earnings quality" is also an academic field, and it is broader than deal diligence. Dechow, Ge and Schrand's review, "Understanding earnings quality: A review of the proxies, their determinants and their consequences," in the *Journal of Accounting and Economics* (2010), surveys measures including "persistence, accruals, smoothness, timeliness, loss avoidance, investor responsiveness" and restatements. Its abstract concludes: "We reach no single conclusion on what earnings quality is because 'quality' is contingent on the decision context" (Dechow, Ge and Schrand, 2010). For a deal team, the decision context is the purchase price, so a QoE should be read as a set of specific tests with stated scope, not a grade.

When small deals skip it, and what replaces it

Smaller transactions sometimes close without a full third-party QoE, usually on cost or timetable grounds. No public source verified for this article measures how often that happens, so treat any statistic you meet on the point with caution.

If a full QoE is not commissioned, three questions decide what replaces it:

- **What does the lender require?** Senior lenders and government-guaranteed loan programmes set their own diligence conditions. Under SBA SOP 50 10 8.1, a 7(a) acquisition below $3 million needs a business valuation but no QoE, and Owner Buyouts are exempt at any size; the lender may still ask for one. Ask the lender in writing before deciding scope.
- **What can be tested in-house?** A proof of cash on twelve months of bank statements, a payroll-to-headcount tie-out and a customer revenue roll-forward are within reach of a careful buyer with the data room.
- **What protection replaces the work?** Counsel can tighten financial-statement representations, the working-capital definition and escrow terms. That shifts risk; it does not measure it.

Pre-QoE self-check with public records

Before the data room opens, public records can corroborate or contradict the headline claims a QoE will later test. They will not produce EBITDA, but they can catch a seller story that does not fit the observable business.

- **Headcount.** Retirement-plan filings report participant counts that can be set against the payroll the seller describes. The method and its limits are in the guide to Form 5500 headcount estimates.
- **Revenue scale.** Public contracts, licences and permits, and job postings give partial evidence of scale and trend.
- **Conflicts between sources.** When two sources disagree, record both with dates rather than averaging them; the conflicting sources ledger sets out a field-level method.

Fictional worksheet

Fictional records, for illustration only.

Claim in CIM	Public evidence	Date	Agrees?	Question for the QoE
62 employees	Form 5500: 41 active participants	Plan year 2024	Partly	Eligibility rules, part-time staff, or contractors?
Revenue grew 18% in 2025	Two new municipal service contracts posted	2025	Consistent	Confirm contract revenue recognised and collected (proof of cash)
No customer above 10%	Public award to one customer equal to an estimated 15% of stated revenue	2025	Conflict	Request customer revenue by year
Owner part-time since 2023	Owner named as licence qualifier on 2026 renewal	2026	Conflict	Who replaces the qualifier after closing, and at what cost?

Each "conflict" row becomes a request in the QoE scope, which is the cheapest moment to ask it.

Checklist: questions to ask about a sell-side QoE

1. Who engaged the provider, and what does the reliance letter allow you to do with the report?
2. Is it issued under an attestation standard (for example as an AUP report) or as a consulting deliverable?
3. Which periods are covered, and is the trailing-twelve-month period tied to monthly closes?
4. Was a proof of cash performed, for which months, and against which bank accounts?
5. Is every adjustment supported by a document, and are the same adjustments applied in every period?
6. Were one-off gains and below-market costs adjusted as well as one-off charges?
7. Which adjustments are pro forma (not yet earned) and which are historical normalisations?
8. How was the working-capital target computed, and under which accounting policies?
9. Which debt-like items were identified, and which were considered and excluded?
10. What did the provider ask for and not receive?

Research platforms such as Docket work earlier in the funnel, on identifying and screening targets before a QoE is commissioned.

Source links

Links cited in this article, in order of first appearance. Full addresses are provided for readers using extracted text.

1. https://warrenaverett.com/insights/quality-of-earnings-analysis
2. https://www.cpajournal.com/2026/02/25/the-benefits-and-risks-of-selling-an-accounting-practice-to-private-equity
3. https://legacy.sba.gov/sites/default/files/2026-10/SOP%2050%2010%208.1%20Technical%20Policy%20Updates%20effective%20%2010.1.2026.docx
4. https://www.sec.gov/corpfin/non-gaap-financial-measures
5. https://pcaobus.org/oversight/standards/auditing-standards/details/as-1000--general-responsibilities-of-the-auditor-in-conducting-an-audit
6. https://www.journalofaccountancy.com/issues/2020/sep/ssae-no-19-flexibility-for-agreed-upon-procedures
7. https://www.journalofaccountancy.com/news/2019/dec/aicpa-asb-standard-agreed-upon-procedures-201922560

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