

M&A; EXECUTION PROGRAM

PART 03 OF 12 · PART 1: DEAL FOUNDATIONS & STRATEGY

PART 3

QUALITY OF EARNINGS: REVENUE & GROSS MARGIN

How to dissect reported revenue, challenge the top line, identify non-recurring and channel-stuffed revenue, stress-test gross margins, and build a defensible pro-forma EBITDA bridge.

IN THIS PART

- ASC 606 revenue recognition principles
- Proof of Cash vs. accrual reconciliation
- Customer concentration and churn analysis
- Gross margin normalization
- Contract backlog and pipeline quality
- The QofE report structure and process

THREE CASE STUDIES

Each session includes one fully worked case study with detailed calculations, negotiating dynamics, and CFO-level decision frameworks.

■ SESSION 3: REVENUE QUALITY ANALYSIS

What Quality of Earnings Actually Means

The Quality of Earnings (QofE) report is the cornerstone of financial due diligence. It is not a simple audit — it is a forensic deconstruction of reported financial performance designed to answer one question: **What is the true, recurring, sustainable earning power of this business?** The QofE is typically prepared by an independent accounting firm hired by the buyer (a buy-side QofE) or sometimes pre-emptively by the seller before going to market (a sell-side QofE, which provides credibility but invites skepticism).

The QofE process unfolds across two primary dimensions: the income statement (revenue quality and expense normalization) and the balance sheet (working capital quality and debt-like items). This session focuses on revenue quality and gross margin analysis. Session 4 covers expense normalization and add-backs.

Revenue Recognition: The ASC 606 Framework

Under ASC 606, revenue is recognized when (or as) a company satisfies performance obligations by transferring control of a good or service to a customer. The five-step model is: (1) identify the contract, (2) identify performance obligations, (3) determine the transaction price, (4) allocate the price to obligations, (5) recognize revenue as obligations are satisfied. In due diligence, the QofE team verifies that the target is applying this framework correctly and consistently.

Revenue Type	ASC 606 Treatment	Key QofE Risk
Perpetual software license	Recognized at point in time when license delivered	License bundled with services — must allocate price; risk of over-acceleration
SaaS / subscription	Recognized ratably over subscription period	Deferred revenue understated; billed-not-earned revenue inflating reported numbers
Professional services (time & materials)	Recognized as services rendered	Revenue recognized before billable milestones met; unbilled AR quality
Long-term construction contracts	Percentage of completion (input or output method)	Over-recognition of % complete; cost overruns masked in revenue calculation
Product distribution	At point of delivery / transfer of control	Channel stuffing — loading distributor inventory at quarter-end; returns reserve adequacy
Managed services (monthly recurring)	Ratably over service period	Contract modification — price changes mid-period; proper treatment of modifications

Proof of Cash: The Most Powerful QofE Tool

The Proof of Cash is a reconciliation that starts with the company's beginning cash balance, adds all bank deposits during the period, subtracts all disbursements, and arrives at the ending cash balance — then reconciles those cash flows back to the income statement and balance sheet. Any discrepancy between bank deposits and reported revenue is a red flag that demands explanation. The proof of cash cannot be manipulated through accruals — cash is cash.

◆ PROOF OF CASH RECONCILIATION

PROOF OF CASH — RECONCILIATION FRAMEWORK

CASH RECEIPTS ANALYSIS (12 months)

Beginning Accounts Receivable: \$4,200,000

+ Revenue reported (accrual basis): \$24,600,000

- Ending Accounts Receivable: (\$5,100,000)

= **Expected Cash Collected: \$23,700,000**

Actual Bank Deposits (from bank statements): \$23,450,000

UNEXPLAINED VARIANCE: \$250,000

INVESTIGATION FLAGS:

1. AR increase of \$900K — is new AR collectible?
2. \$250K variance — possible credit memos not properly recorded, or revenue pulled forward without cash basis

Resolution: Request all credit memos, customer statements, and collections data. Verify AR aging by customer invoice.

Customer Concentration Analysis

Customer concentration is one of the most significant valuation risk factors in middle-market M&A.; A business where a single customer represents 30%+ of revenue is fundamentally different from a business with a diversified base — in terms of business risk, negotiating leverage, contract renewal dynamics, and acquirer appetite. The QofE must quantify this risk precisely and translate it into a valuation discount.

◆ MERIDIAN — FULL QofE REVENUE ADJUSTMENT

MERIDIAN — QofE REVENUE ADJUSTMENT FRAMEWORK

STEP 1: REPORTED FINANCIALS

LTM Revenue: \$34,000,000

LTM Gross Profit (margin 28%): \$9,520,000

LTM EBITDA: \$3,800,000

Asking price (9× EBITDA): \$34,200,000

STEP 2: CUSTOMER A CONTRACT ANALYSIS

Revenue at risk (40% × \$34M): \$13,600,000

Gross margin on Customer A (22%, lower): \$2,992,000

EBITDA contribution of Customer A: \$1,360,000

(GM - dedicated sales & logistics: \$1.63M)

STEP 3: SCENARIO ANALYSIS

Scenario 1: Customer A renews (100% probability for illustrative):

EBITDA unchanged at \$3.8M; EV = \$34.2M

Scenario 2: Customer A lost (renewal fails):**Revenue: \$34M - \$13.6M = \$20,400,000****EBITDA: \$3.8M - \$1.36M = \$2,440,000****Justified EV (9×): \$21,960,000****Value destruction: \$12,240,000**

STEP 4: PROBABILITY-WEIGHTED PRO-FORMA EBITDA

P(renewal) = 40% (based on RFP competitive dynamics)

P(lost) = 60%

Probability-weighted EBITDA:

40% × \$3.8M + 60% × \$2.44M = \$2,984,000

Risk-adjusted EV (9×): \$26,856,000

BUYER'S REVISED BID: \$24,000,000

(includes additional conservatism discount)

SELLER'S ACCEPT: \$24M + \$4M earnout tied to renewal

If Customer A renews for 2 years: additional \$4M paid

FINAL EFFECTIVE VALUE: \$24M-\$28M based on outcome

■ THE QOFE LESSON ON CUSTOMER CONCENTRATION

The QofE is not about finding reasons to kill the deal. It is about pricing the risk correctly. The Meridian transaction was at risk of failing when the buyer initially wanted to walk. The CFO structured an earnout that gave the seller full value if the customer renewed — and protected the buyer if it did not. The QofE analysis made the earnout structure possible by quantifying exactly what the risk was worth.

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CASE STUDY 2

NexGen Software Solutions*ASC 606 Restatement — \$3.2M of Revenue Recognized Too Early***Background**

NexGen Software sells perpetual licenses bundled with 12 months of implementation services. The company had been recognizing 100% of the contract value at license delivery, before any implementation services were rendered. The QofE team identified this as a material departure from ASC 606 and reconstructed the financials using the proper allocation methodology.

◆ NEXGEN ASC 606 RESTATEMENT MATH

NEXGEN — ASC 606 RESTATEMENT

Average contract value: \$180,000

License component (SSP-allocated): \$135,000 (75%)

Implementation services (SSP-allocated): \$45,000 (25%)

COMPANY'S REPORTED METHOD (incorrect):

Revenue recognized at contract signing: \$180,000 (100%)

Month 0: \$180,000 recognized

Months 1-12: \$0 additional recognized

CORRECTED ASC 606 METHOD:

License revenue: \$135,000 recognized at delivery (Month 0)

Services: \$45,000 recognized ratably over 12 months (\$3,750/mo)

CUMULATIVE RESTATEMENT IMPACT (LTM, 85 contracts):

Services revenue deferred (avg 6 months into period):

$85 \text{ contracts} \times \$45,000 \times 6/12 = \$1,912,500$

Prior period contracts partially recognized in LTM:

Additional deferral: \$1,287,500

TOTAL REVENUE OVERSTATEMENT: \$3,200,000

EBITDA OVERSTATEMENT (high-margin services): \$2,880,000

(at 90% contribution margin on services)

CORRECTED EBITDA: \$8.4M reported - \$2.88M = \$5,520,000

CORRECTED EV AT 11x: \$60,720,000

ORIGINAL EV AT 11x (on \$8.4M): \$92,400,000

VALUE DESTRUCTION FROM ASC 606 ERROR: \$31,680,000

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CASE STUDY 3

Coastal Foods Inc.

Channel Stuffing Detection — Quarter-End Revenue Reversal

Background

Coastal Foods Inc. distributes specialty food products through a network of regional distributors. The QofE team noticed a suspicious pattern: revenues were consistently highest in the last two weeks of each quarter, followed by elevated return rates in the first two weeks of the following quarter. This is the classic signature of channel stuffing.

◆ CHANNEL STUFFING — DETECTION AND QUANTIFICATION

COASTAL FOODS — CHANNEL STUFFING DETECTION

REVENUE PATTERN ANALYSIS (by two-week period):

Q1 Weeks 1-4: \$3,200,000 avg per 2-week period

Q1 Weeks 5-6: \$7,100,000 (week 5-6 combined — end of Q1)

Q2 Week 1: \$1,800,000 (returns and credits)

Pattern repeats every quarter

QUANTIFICATION OF STUFFING:

Quarter-end spike above run rate: $\$7.1\text{M} - \$6.4\text{M} = \$700\text{K}/\text{qtr}$

Annualized stuffed revenue: $4 \times \$700\text{K} = \$2,800,000$

Return rate on stuffed product (Q+1 credits): ~82%

Net retained revenue from stuffing: $18\% \times \$2.8\text{M} = \$504,000$

Over-stated LTM revenue: $\$2.8\text{M} - \$0.5\text{M} = \$2,296,000$

EBITDA ADJUSTMENT:

Lost margin on returned product (25% gross margin):

$\$2.296\text{M} \times 25\% = \$574,000$

Plus: restocking/return processing costs: \$180,000

TOTAL EBITDA OVERSTATEMENT: \$754,000

BUYER ACTION: Adjusted EBITDA down by \$754K;

required seller to implement distributor sell-through

reporting as a condition to closing