MEET THE QOE

A Field Guide to Quality of Earnings for SBA 7(a) Lenders

If your loan is $3 million or more, you now need an earnings number that can hold up to scrutiny. This guide explains what a Quality of Earnings report actually checks, who it protects, and how to spot a report that is really just the seller's own numbers with a new cover page.

A QOE, PLAINLY

A Quality of Earnings report rebuilds a company's earnings and cash flow from scratch, using an independent reviewer. It does not simply repeat what the seller says. It does not check whether the accounting follows the rules, since that is what an audit does. And it does not say what the business is worth, since that is what a valuation does. It answers one question: how much of the reported profit will still be there next year to help pay back the loan?

WHAT IT IS

- It rebuilds the numbers from the general ledger instead of reusing the seller's own figures.
- It traces every adjustment back to the document that supports it.
- It looks at revenue, margin, and expenses month by month.
- It proves that the reported earnings actually turned into cash.
- It reviews working capital, cash flow, and any debt-like items.
- It creates a written record that the lender can defend in the credit file.

WHAT IT IS NOT

- It is not an audit, so it gives no opinion and no assurance.
- It is not a business valuation, and it cannot replace the required appraisal.
- It does not guarantee the numbers are correct or that the business will perform.
- It is not a tax return review, although tax risk can be checked at the same time.

An audit asks whether the statements are fairly stated under GAAP. **A QoE asks how much of this money will still be here next year to pay us back.**

WHEN THE RULES REQUIRE ONE

Appendix 15 of SOP 50 10 8.1 does not ask for a QoE on every deal. It draws one specific line, and only loans on one side of that line need the report.

1. **The $3 million threshold**
   If the purchase price is $3 million or more for a Business Expansion or Initial Acquisition loan, the lender needs a QoE in addition to the required valuation. This $3 million figure is measured before any buyer equity, seller debt, or other financing is added in.

2. **Who does not need one**
   Owner Buyouts, ESOPs, and Cooperative transactions do not need a QoE. In these deals the existing owner stays involved and already knows how the business runs, so the management and operations do not really change hands.

3. **Who it has to be ordered by**
   The lender must order this report, and it must be written for the lender. Even a very thorough QoE does not satisfy Appendix 15 if the borrower or the seller ordered it instead.

A TYPICAL SCOPE

Quality of Earnings
This section rebuilds reported profit step by step and checks every adjustment the seller made along the way.

Cash Flow & Proof of Cash
This section matches revenue and expenses to the money that actually moved through the bank, then shows how much cash is left to pay down debt.

Revenue & Gross Margin
This section breaks revenue down by month, customer, and product, so you can see how much depends on volume, price, or just a few big customers.

Balance Sheet & Liabilities
This section checks whether reserves are big enough, identifies debt and debt-like items, and flags related-party balances or hidden commitments.

Net Working Capital
This section tracks working capital over twelve to twenty-four months and sets the target level the business needs, including its seasonal peak.

Tax Diligence & Structuring
This section checks state tax exposure and entity structure, and it lays out how to fix any problems it finds.

The scope can flex depending on the deal. Carve-outs, roll-ups, and multi-entity borrowers each need a different level of focus. **One thing never flexes: every adjustment must have independent support behind it.**

WHAT THE FINANCIALS DON'T SHOW

These findings come up again and again, and they can change how big a loan should be. Each one shows the gap between what is presented and what is actually true.

1. **Add-backs that aren't really add-backs**
   Paying the owner more than a replacement manager would cost is a fair adjustment to add back. But "one-time" costs that show up in all three years, or savings that were promised but never happened, are not fair add-backs.

2. **Revenue that won't repeat**
   Sometimes revenue looks steady only because of accounting timing or one large contract that will not come back. A pandemic-era sales spike can also get carried into next year's numbers as if it were normal.

3. **Concentration and pricing risk**
   One customer might make up 40% of gross profit. A supplier rebate might have quietly driven last year's margin. Or the market may have already reset pricing lower than what shows up in the numbers.

4. **Working capital reality**
   The business may have a seasonal cash need, or it may be stretching out payments to vendors to hide a cash problem. Old receivables or unsold inventory can also sit inside the borrowing base without anyone noticing.

5. **Liabilities nobody booked**
   Unused vacation pay, unpaid payroll or sales tax, balances owed to related parties, and maintenance that was postponed instead of paid for can all be liabilities that were never recorded.

Your whole credit decision rests on one number. Advance rates, leverage, DSCR, and hold size all depend on EBITDA. **If that number is wrong, every one of them is wrong too.**

THE CASH PROOF

A cash proof asks a simple question: did the earnings a company reported actually show up as real cash? SOP 50 10 8.1 requires this to be checked over a trailing twelve months and the last two fiscal years.

FIVE STEPS TO A HIGH-QUALITY PROOF OF CASH

Collect the complete bank records
We gather records for every operating, payroll, savings, and merchant account going back two fiscal years, plus the current year to date. The accounts nobody wants to hand over are usually where undisclosed activity is hiding.

Reconcile the bank activity to the P&L
We match total deposits and withdrawals to the reported revenue and expenses for each month, adjusting for receivables, payables, accruals, and deferred revenue.

Split out non-operating cash
We identify owner distributions, fixed asset purchases, and debt draws or repayments, then pull them out of the operating picture so they do not distort it.

Build a monthly cash flow model
We roll the reconciled activity into a month-by-month model that shows how much cash the operations actually generated.

Bridge EBITDA to real cash
We connect the reported profit to the cash it actually produced. If a gap remains that working capital or non-operating items cannot explain, that gap becomes the finding.

A tax return is useful, but it is not the source of truth about earnings. It is built to minimize tax, not to measure profit. It often runs on a cash basis, and it does not say which deductions are real business costs versus owner perks. A QoE checks its work against the tax return, but it never relies on the tax return alone.

TWO REPORTS, DIFFERENT JOBS

Both reports belong in an acquisition credit file, but neither one does the other's job. And only one of them follows a rulebook.

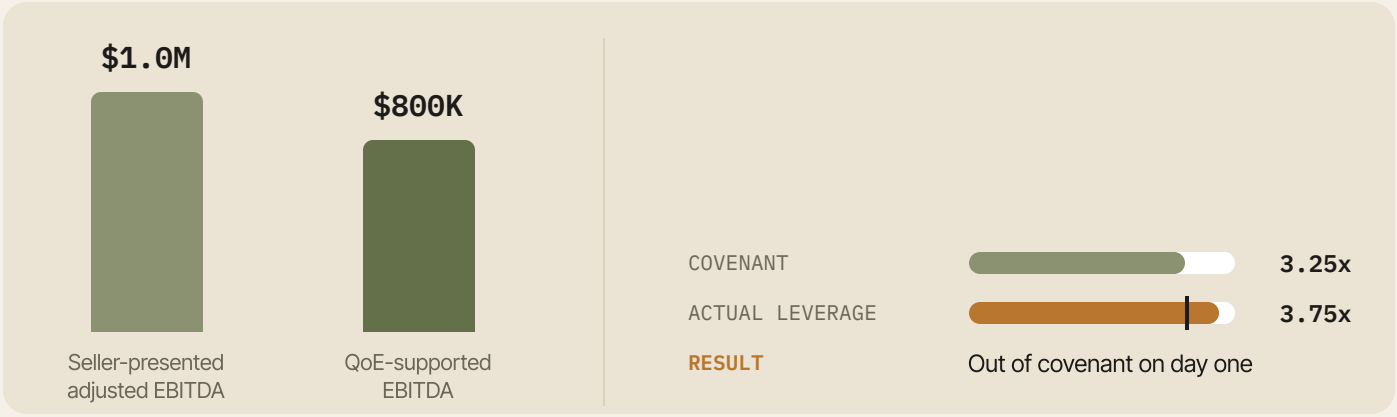
GOVERNED **Business Valuation**	vs	UNGOVERNED **Quality of Earnings**
THE QUESTION		
What is this business worth?		Is that earnings number real, recurring, and supportable?
WHO CAN PERFORM IT		
Only an accredited Qualified Source can do this work, such as someone holding an ASA, ABV, CVA, CBA, or BCA credential. A CPA license by itself is not enough.		Anyone can perform a QoE. There is no required accreditation, no license, and no peer review of the work.
WHAT'S REQUIRED		
The valuation must consider the income, market, and asset approaches, and reconcile them in a way that is consistent with IRS Revenue Ruling 59-60.		Nothing is required. There are no set procedures, time periods, or report contents. The scope is simply whatever the engagement letter says it is.
THE CATCH		
The lender must engage this report. It is never engaged by the buyer or the seller.		With no set scope, the vendor you choose becomes the only quality control in the process.

Saying "we have a QoE" tells you a report is in the file. It does not tell you what was actually reviewed. **The appraisal tells you what multiple to pay, and the QoE tells you what number to multiply it by.**

WHY THE NUMBER MATTERS

A 20% error in EBITDA is not a 20% problem. It compounds through leverage, advance rate, and debt service coverage all at once. Here is an illustrative example using one borrower.

ILLUSTRATIVE



A loan sized at 3.0x the presented $1.0M EBITDA closes at $3.0M. But when measured against the QoE-supported $800K, **that same $3.0M loan actually carries 3.75x leverage against a 3.25x covenant.**

RUN THE TWO TOGETHER

It helps to sequence the work properly. Get the QoE, or at least a preliminary earnings estimate, before the business valuation is finalized, and give the appraiser the supported number to work with. A multiple applied to diligenced earnings is easy to defend. A multiple applied to the seller's own schedule just inherits the seller's optimism. An acquisition credit file really rests on three legs, not two. The valuation supports the price, the QoE supports the earnings, and the cash flow analysis supports repayment. If you drop one leg, the file leans entirely on the other two.

VETTING A PROVIDER

Nothing about a QoE is required by rule, so the answers you get before you engage a provider tell you more than the report title ever will.

1. **Who personally does the work?**
   Find out who is actually on the calls. It might be the name on the cover of the report, or it might be someone junior you have never spoken to.

2. **How many lower-middle-market QoEs has this team closed?**
   Good pattern recognition comes from repetition, not from reading about it. Spotting a rebate that shifted margin, or revenue booked a month early, comes after seeing it many times.

3. **What share of the firm's time is transaction advisory?**
   A QoE squeezed in during tax season gets tax-season attention, and deal timelines do not wait for the slow season to end.

4. **Can they walk you through one add-back, end to end?**
   Ask them to trace one add-back all the way from the ledger entry, to the source document, to the final number that lands in the report.

5. **Do they have a relationship with the sponsor, seller, or broker?**
   A firm that also serves the other side of the table has a recurring relationship to protect. Your credit decision, by contrast, is a one-time event.

RED FLAGS IN A DELIVERED REPORT

- The EBITDA bridge does not tie back to the trial balance.
- Adjustments have no stated source, and "per management" is treated as if it were proof.
- There is no proof of cash, or only a partial one.
- The report never once says "we could not verify."

SIGNS OF REAL DILIGENCE

- A senior person leads the work, and it is the same person on your call.
- Every adjustment is independently validated and traced back to its support.
- Findings are written in credit language, showing the real impact on leverage and coverage.
- The team will present to your credit committee and stand behind its work.

WHO ORDERED IT CHANGES WHAT IT IS

The procedures can look the same, but the client is different. Under Appendix 15, only one version of this report actually counts.

BUY-SIDE **Buyer-Ordered**	vs	SOP-COMPLIANT **Lender-Ordered**
WHO'S THE CLIENT		
The buyer is the client, and the buyer is named in the engagement letter.		The lender is the client, and the lender is named in the engagement letter.
BUILT TO ANSWER		
What should I pay, and on what terms?		Will these earnings be there to service the debt?
UNDER APPENDIX 15		
This does not satisfy the requirement. A file without a conforming QoE is missing what it needs at guaranty purchase.		This is required at $3 million or more on Initial Acquisitions and Business Expansions, and its earnings figure must drive the DSC determination.

Private equity sponsors order the report the other way, because they are putting up first-loss capital and can rely on reps, covenants, and a MAC clause instead. An SBA 7(a) lender has none of that to fall back on, **so Appendix 15 fixes the one variable it can control: who the client is.**

THREE TAKEAWAYS

1. A clean audit is not a QoE, and neither is the SBA valuation. All three answer different questions.
2. Ask who actually does the work, and ask them to walk you through one add-back from start to finish.
3. Price the report against the risk it removes, not against another firm's quote.

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CHOOSE THE RIGHT LEVEL OF INSIGHT

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MUST BUY

SBA-COMPLIANT VALUATION

$3K

What is the business worth?

`3 business days*`

BEST FOR

This is required on every SBA transaction to support the purchase price.

- **Financial Foundation** — We organize and normalize the financials so they are ready for valuation.
- **Valuation Analysis** — We apply multiple valuation methods with adjustments specific to the company.
- **Market Benchmarking** — We benchmark against private transaction multiples by sector, size, and region.
- **Value Drivers** — We identify and quantify the factors that raise or lower the value.

REQUIRED AT $3M+

SBA-COMPLIANT QOE

$10K

How reliable are the earnings and cash flow?

`Under 2.5 weeks*`

BEST FOR

This is required under SOP 50 10 8.1 whenever the purchase price is $3 million or more.

- **Financial Reconciliation** — We tie out the books, tax returns, and IRS transcripts.
- **SBA Cash Proof** — We verify bank deposits against the books and tax returns.
- **Independent QoE** — Chief identifies and supports every earnings adjustment.
- **Revenue Quality** — We assess customer concentration, mix, and continuity.

GO FURTHER

QOE + DETAILED FDD

$15K

What are the broader transaction risks?

`Scoped at engagement`

BEST FOR

This suits buyers and lenders who want more than the SBA minimum.

- **Working Capital** — We analyze historical trends and normalize them, with support for setting the peg.
- **Balance Sheet** — We review receivables, payables, inventory, and deferred revenue as needed.
- **Net Debt** — We identify debt, debt-like, and cash-like items that affect the purchase price.
- **Enhanced Analysis** — We build deeper revenue, margin, and KPI schedules.

The lender must use QoE-supported earnings in the Debt Service Coverage determination and keep the report in the credit file **(SOP 50 10 8.1).** *Turnaround assumes a complete data request and a finished Q&A.