

Quality of Earnings & Business Valuation

COMPLIANCE CHECKLIST

Quality of Earnings (QoE) & Business Valuation (BV) Alignment

Pre-Closing Compliance & SBA Guaranty Protection for Change-of-Ownership Loans

RSI & ASSOCIATES | Valuations • Exit Planning • Feasibility Studies

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SECTION 1: Statutory Scope & Engagement Authority

Verify compliance before loan authorization and issuance of the SBA Loan Number.

- ☐ **\$3,000,000 Threshold Test:** Business purchase price is $\geq$ \$3.0M (strictly excluding the appraised value of owner-occupied commercial real estate).
- ☐ **Transaction Scope Verified:** Initial acquisition or business expansion requiring independent verification (Exempt: Partner Buyouts $\geq$ 24-month tenure; ESOP/Co-op transactions).
- ☐ **Direct Lender Engagement:** Engagement letter executed *by the lender, for the lender's benefit*. (Sell-side, broker-commissioned, or borrower-provided reports are strictly disallowed under Appendix 15).
- ☐ **Timing Rule:** Independent professional engaged prior to or concurrent with SBA Loan Number issuance.

SECTION 2: QoE Mandatory Diligence Pillars

Core audit-grade verification required to establish a compliant, defensible earnings baseline.

- ☐ **Four-Source Financial Reconciliation:** Line-by-line reconciliation completed across:
 - ☐ Federal Tax Returns (Form 1120/1120-S/1065)
 - ☐ IRS Form 4506-C Official Tax Transcripts
 - ☐ CPA Financial Statements (Reviewed/Compiled)
 - ☐ Internal General Ledger (GL) & Operating Software
- ☐ **Bidirectional Cash Proof (100% Full-Period Coverage):**
 - ☐ Reconstructed cash receipts and disbursements for TTM and two prior fiscal years.
 - ☐ Reconciled 100% of operating, payroll, and merchant accounts (*No random sampling*).
 - ☐ Screened for unrecorded expenses, phantom revenue, and disguised owner capital injections.
- ☐ **Adjustment & Add-Back Substantiation:**
 - ☐ Personal, non-operating, and non-recurring expenses verified to invoices/receipts.
 - ☐ Disallowed speculative add-backs (synergies, future cost cuts, unproven efficiency gains).
 - ☐ Normalized market-rate replacement compensation for exiting principals.
 - ☐ Normalized arm's-length facility rent (if leased from a related entity).

- [] **Revenue Quality & Continuity Analysis:**
 - [] Customer concentration quantified (flagging accounts > 10%–15% of gross revenue).
 - [] Commercial contract terms, expiration schedules, and customer churn trends verified.
- [] **Non-Negotiable Principal Interview:** Direct interview conducted with company principals to evaluate operational dependencies, transferability, unrecorded liabilities, key-man golf/ handshake accounts, and deferred capital expenditures (CapEx).

SECTION 3: Business Valuation (BV) & Underwriting Interlock

Ensuring the valuation reflects tested earnings and eliminates post-close debt-service gaps.

- [] **Input Integrity Check:** Certified Appraiser utilized the **QoE Adjusted EBITDA** as the baseline financial input (replacing broker pitch-book or seller-asserted schedules).
- [] **Dual-Risk Protection Segregation:**
 - [] **QoE Function:** Cash Flow Protection → Dictates Repayment Ability & Sets DSCR.
 - [] **BV Function:** Collateral Protection → Justifies Purchase Price, Intangibles, & Goodwill.
- [] **DSCR Recalculation:** Underwritten Debt Service Coverage Ratio recalculates to the statutory minimum (1.25x for Initial Acquisitions, 1.15x for Expansions) using QoE verified earnings, *without reliance on post-closing projections*.
- [] **Dynamic Restructuring (if QoE reflects earnings drop):**
 - [] Purchase price renegotiated to align with the revised Fair Market Value.
 - [] Seller note sized and structured on full standby to cure DSCR deficiencies.
- [] **Equity Injection Integrity:** Buyer equity injection verified at $\geq 10\%$ of total project costs, free of debt and unencumbered by Day-1 enterprise overpayment.
- [] **Non-Negotiable Principal Interview:** Direct interview conducted with company principals to evaluate operational dependencies, transferability, unrecorded liabilities, key-man golf/ handshake accounts, and deferred capital expenditures (CapEx).

GUARANTY RISK WARNING: Red Flags for Repair or Denial

- During National Guaranty Purchase Center (NGPC) liquidation reviews, the SBA enforces repairs or full denials if diligence deficiencies contributed to borrower insolvency:
- Desktop-Only Scopes (Unverified Revenue Continuity): Failing to interview principals leaves credit files with zero documentation to defend how the lender tested customer retention, key-man dependencies, or contract continuity under Appendix 15 when a post-close revenue collapse occurs.
- Random Sampling Cash Tests: Substituting statistical sampling for the required bidirectional reconstruction across the full TTM and two prior fiscal years violates the SBA's explicit full-period tie-out mandate.
- Unverified Synergies: Underwriting to projected "post-closing synergies" or hypothetical cost cuts to meet debt service, explicitly prohibited by SOP 50 10 for change-of-ownership coverage.
- Broken DSCR from Unsupported Add-Backs: Relying on unverified seller add-backs that mask a Day-1 operational deficit (sub-1.0x DSCR), invalidating the statutory reasonable-assurance-of-repayment standard.