BEHIND THE NUMBERS
Quality of Earnings Analysis
October 16, 2023

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Deckers Outdoor Corporation (DECK)
Earnings Quality Review

Summary

We are initiating earnings quality coverage of DECK with a 4- (Acceptable) rating

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Overall, we see DECK as a quality company with a good financial footing and reasonable accounting quality. It makes no non-GAAP adjustments beyond reporting currency-adjusted figures which is unusual to find these days. It also gives excellent detail regarding its large reserves.

A non-earnings quality flag is the fact that one brand, *Hoka*, is growing rapidly while essentially all of its other brands are experiencing declining sales. This was still sufficient to generate 10% sales growth in the June quarter. The exposure to *Hoka* is well-known and we have learned over the years not to attempt to predict the beginning or end of fashion trends. We also observe that after adjusting for cash, investors are paying a fairly reasonable 20 times earnings for a company with a decent growth profile.

Nevertheless, the nature of DECK's business gives rise to substantial variable consideration reserves that can dramatically impact the company's sales and margins. More concerning is that in the last couple of quarters, accruals for these reserves have moved decidedly in the company's favor, providing an artificial tailwind to earnings. The bulk of recent earning beats can be traced to reductions in these accrual rates. It is therefore imperative for investors to understand these reserves and track their movements every quarter to have a clear picture of revenue and earnings growth trends.

- Net revenue is almost 9% lower than gross revenue after giving effect for substantial variable consideration accruals. In fiscal 2023, DECK reported EPS of $19.37 but that is after $9.25 per share in various variable consideration accruals. Even minor changes in the accrual rates will have a huge impact on reported sales and profits. ***(See detail below)***

- While movements in these reserves were moving against the company in the last couple of fiscal years, the last two quarters have seen the reserves shift in the company's favor. We estimate that reductions in the rate of accruals for sales returns added about 13 cps to the June quarter and 62 cps to the March quarter. These amounts were key to the 18 cps beat in June and the 77 cps beat in March. ***(See detail below)***

- Bad debt expense moved to a credit from an expense a year ago which added 10 cps to quarterly earnings in the June quarter. This followed a 5 cps benefit in the March quarter. ***(See detail below)***

Variable Consideration Has a Huge Impact on Sales and Margins

DECK maintains multiple reserve accounts related to variable consideration estimates and deferred revenue. These include:

- **Sales discounts** for fast payment and **volume discounts.** Accruals are netted against gross sales and are only reported annually.

- **Chargebacks** to cover mark-downs on pricing so distributors are not hurt on their existing inventories. This also netted against sales, but DECK says it may also impact SG&A. These are also only reported annually.

- **Sales returns** – DECK has a very liberal sales return policy of 30-90 days for both distributors and end-consumers. There are two accounts associated with sales returns:

  - Asset account – Sales Returns. This reflects the value of the inventory expected to be returned and is credited to cost of goods sold and is recorded in other current assets on the balance sheet.

  - Liability account – Sales Returns. This is for defective shoes or returns where cash is refunded. It is charged against sales and recorded in the other current liability account on the balance sheet.

- **Loyalty Programs** – Customers earn rewards for buying shoes such as discounts on future purchases. This is recorded in Deferred Revenue until used, expiration, or breakage (DECK estimates that some of it will never be redeemed.) These discounts are netted against sales when used. Amounts deferred and redemptions/expirations are reported quarterly.

- **Deferred Revenue** – Customer prepayments made before the shoes are delivered are deferred until delivery. That is very standard, it just relates to the timing of sales.

As noted above, most of the variable consideration accounts are not disclosed quarterly but we do have good visibility into the annual impact of all of these estimates. The following table shows a calculation of a gross sales figure after factoring in variable consideration reserves:

DECK Sales Items	**FY 2023**	**FY 2022**	**FY 2021**
Reported Sales	$3,627	$3,150	$2,546
Sales Discounts	$20	$21	$16
Chargebacks	$27	$32	$23
Sales Return Liability	$230	$179	$154
Loyalties Redeemed	$49	$57	$44
Gross Sales	$3,953	$3,439	$2,783
Adjustments % Sales	8.25%	8.39%	8.54%

We can also examine the impact of accruals related to the sales return asset on cost of sales:

DECK COGS Adj.	**FY 2023**	**FY 2022**	**FY 2021**
Reported COGS	$1,802	$1,543	$1,172
Sales Return Asset	$67	$44	$40
Adjusted COGS	$1,735	$1,499	$1,132
Reported Sales	$3,627	$3,150	$2,546
Adjusted Sales	$3,953	$3,439	$2,783
Reported Gross Margin	50.32%	51.03%	53.98%
Adjusted Gross Margin	56.12%	56.40%	59.34%

The sheer size of the accruals means that any changes will materially impact earnings.

The accruals are falling as a percentage of total sales and at 8.25% of gross sales. At such a large part of sales, movements in these accounts are very meaningful to EPS. In fiscal 2023, DECK reported EPS of $19.37. Because the costs would stay flat without the various accruals booked against sales, having vs. not having the accruals cost DECK $9.25 per share.

A decline in accruals relative to sales was a tailwind in FY 2023

We see in the first table that accruals for discounts, chargebacks, sales return liabilities, and loyalty programs as a percentage of sales fell by 14 bps. We estimate that this added 15 cps to fiscal 2023 EPS. DECK handily beat forecasts by more than that in the period. However, as we will see in our look at the quarterly data in the next section, the boost from lower accruals has become an important component of the earnings beats in the last two quarters.

On a positive note for quality, with the exception of chargebacks, accruals were larger than the usages of the reserve in FY 2023.

The following table shows the amounts accrued for each account and the actual amounts utilized during the year. (Keep in mind that accruals related to the sales return asset impact the cost of sales, not sales.)

DECK Accruals	Returns Asset	Returns Liab	Loyalty	Sales Discount	Chargebacks
Accrual for 23	$67.2	$229.9	$51.4	$19.7	$27.5
Used in year	$63.1	$224.4	$49.1	$16.9	$29.8
Net change	$4.2	$5.5	$2.3	$2.8	-$2.4

We would expect this to be the case for a growing company since the larger sales base in the current period would be generating more accruals than the smaller sales base in the previous period would be generating actual returns, chargebacks, and discounts.

From a Quarterly Perspective, Accruals Are Starting to Look Aggressive

When viewed annually, DECK looks like it has been very conservative in accruing for its variable consideration. However, this view breaks down when we look from a quarterly perspective. As noted above, we do not have quarterly details on discounts and chargebacks, but the company

does disclose quarterly data on the sales return asset and liability as well as the loyalty program. Those show that DECK's accruals are lagging behind actual experience and materially boosting earnings in the process.

Sales asset and liability

The following table shows amounts accrued for the sales assets and liability accounts compared to the actual returns experienced for the last eight quarters:

Sales Return Asset	6/30/2023	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Net Additions to Sales Return Asset	$8,387	$12,169	$28,636	$12,600	$13,844	$13,952	$17,742	$6,058
Actual Returns	$12,867	$21,853	$16,824	$11,698	$12,680	$15,994	$12,426	$7,598
Surplus Accrual/(Shortfall)	-$4,480	-$9,684	$11,812	$902	$1,164	-$2,042	$5,316	-$1,540
EPS Impact of Sales Asset Accruals vs Experience	***-$0.13***	***-$0.28***	***$0.34***	***$0.03***	***$0.03***	***-$0.06***	***$0.15***	***-$0.04***
Sales Return Liability	6/30/2023	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Net Additions to Sales Return Liability	$40,609	$46,950	$98,578	$43,838	$40,498	$56,569	$75,422	$25,835
Actual Returns	$49,373	$77,714	$64,198	$41,480	$41,017	$64,721	$53,319	$30,649
Surplus Accrual/(Shortfall)	-$8,764	-$30,764	$34,380	$2,358	-$519	-$8,152	$22,103	-$4,814
EPS Impact of Sales Liability Accruals vs Experience	***$0.26***	***$0.90***	***-$0.98***	***-$0.07***	***$0.01***	***$0.23***	***-$0.61***	***$0.13***
Net EPS Impact	**$0.13**	**$0.62**	**-$0.64**	**-$0.04**	**$0.05**	**$0.17**	**-$0.47**	**$0.09**

Remember that an increase in the return asset account is a reduction in the cost of sales. For example, in the 6/23 quarter, DECK reduced cost of sales by $8.4 million to reflect undamaged inventory that could be returned and sold later. However, there was actually $12.8 million of inventory returned during the quarter so earnings were penalized by the accounting estimate by approximately 13 cps. On the sales return liability side, the increase in the return liability reduced sales by $40.6 million to reflect revenues that will be reversed when returns are made for either contractual returns or defective goods. However, the actual amount of sales reversed by goods being returned in the quarter was $49.4 million so earnings were helped by 26 cps. The net impact on the quarter was 13 cps.

Deferred Revenues May Be Pointing to a Slowdown

DECK gives excellent quarterly data detailing the progress of the deferred revenue account. Deferred revenue is created when the company receives cash payments from wholesalers but

it has yet to meet contractual terms that allow it to recognize it as a sale. The following table shows the deferred revenue data for the last eight quarters:

	6/30/2023	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	09/30/2021
Beginning Deferred Revenue	$13,448	$11,448	$18,718	$23,885	$15,804	$13,591	$21,334	$18,309
Additions of Customer Cash Payments	$20,589	$12,015	$10,279	$10,993	$20,510	$15,263	$4,500	$13,960
Revenue Recognized	-$13,401	-$10,015	-$17,549	-$16,160	-$12,429	-$13,050	-$12,243	-$10,935
Ending Deferred Revenue	$20,636	$13,448	$11,448	$18,718	$23,885	$15,804	$13,591	$21,334
Deferred Revenue Days of Sales	2.8	1.5	0.8	2.0	3.5	1.9	1.1	2.7

There is a definite seasonal trend in deferred revenue, with balances climbing to a peak in the June quarter and bottoming in December, so year-over-year trends are important. We see that there has been a general trend in the last few quarters of the year-over-year growth in revenue recognized outrunning the growth in cash deferred. One should always be concerned that lagging deferred revenue indicates more aggressive revenue recognition, but in this case, the trend seems to be due more to a slowdown in new cash being deferred. Essentially all but the *Hoka* brand is experiencing declining sales, so perhaps the drop in early ah payments from these brands is causing the problem. This is a trend for analysts to watch in upcoming quarters for continuing signs of weakness.

Bad Debt Credit Added 9 cps to the Quarter

The following table shows DECK's bad debt expense/(credit) for the last twelve quarters:

	6/30/2023	3/31/2023	12/31/2022	9/30/2022
Provision for Bad Debts	-$2,974	-$1,709	-$752	$4,232
Provision for Doubtful Accounts % of Sales	-0.44%	-0.22%	-0.06%	0.48%
	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Provision for Bad Debts	$212	-$88	-$244	$2,444
Provision for Doubtful Accounts % of Sales	0.03%	-0.01%	-0.02%	0.34%
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Provision for Bad Debts	-$2,454	-$3,339	-$771	$4,499
Provision for Doubtful Accounts % of Sales	-0.49%	-0.59%	-0.07%	0.72%

DECK's accounts receivables are highest in September ahead of the holiday sales season which explains the large provision expense in that quarter. However, in 2023, the company has written back much of the reserve into profits as the receivables appear to be performing better than expected. We can see something similar happened in the 2020-2021 time frame which likely reflected large reserves established around Covid. Still, the benefit of writing back reserves so

far in 2023 is significantly greater than the same period in 2022, particularly in the last two quarters. We estimate that the June quarter received a 10 cps benefit while the March quarter benefitted by 5 cps.

To get an idea of what may be in store in future quarters, let's examine the allowance for bad debt as a percentage of gross receivables which is shown below for the last twelve quarters.

	6/30/2023	3/31/2023	12/31/2022	9/30/2022
Allowance for Bad Debt	$25,380	$32,504	$49,295	$37,234
Gross Receivables	$296,583	$334,015	$375,636	$471,908
Allowance %	8.6%	9.7%	13.1%	7.9%

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Allowance for Bad Debt	$33,996	$30,591	$40,965	$28,962
Gross Receivables	$355,992.0	$333,279.0	$375,506.0	$399,323.0
Allowance %	9.5%	9.2%	10.9%	7.3%

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Allowance for Bad Debt	$20,478	$26,516	$37,777	$35,325
Gross Receivables	$239,285.0	$242,234.0	$350,690.0	$361,591.0
Allowance %	8.6%	10.9%	10.8%	9.8%

We see that the company's allowance percentage tends to be higher in the December quarter and trend down. But despite the decline in the receivables balance, the credit drove the allowance as a percentage of gross receivables to 8.6% which is down almost a full point from the year-ago level.

As we pointed out above, the company's provision expense is highest in the upcoming September quarter. On the surface, the high provision expense in the 9/22 quarter would seem to be setting the company up for an easy comparison it the current quarter. However, given the level of the allowance percentage coupled with potentially tightening credit conditions, the company may be facing higher expense in this area in the next couple of quarters.

Other Points to Note

- Advertising is a big figure also, but it only grew by 6% in fiscal 2023 against sales growth of 15%. There was some discussion that it reduced advertising in one division and diverted some spending to *Hoka*. In 1Q24, advertising jumped $9.4 billion vs. the growth for all of fiscal 2023 of $15.2 million. This may have already corrected.

- The company repurchases common stock which adds to EPS growth but DECK generates more than enough cash flow to pay for this. (Note that in 2022, DECK had a surge in inventory that hurt cash flow from operations by $228 million.)

DECK Cash flow	FY 2023	FY 2022	FY 2021
Cash from Ops	$537	$172	$596
Sales Return Asset	$81	$51	$32
Free Cash Flow	$456	$121	$564
Share Repos	$297	$357	$99

- While DECK has a credit line, it is not tapped so there is no financed debt, and the cash on hand at over $1 billion on June 30 is almost $40/share. We would subtract that $40/share in computing P/E ratios and Price-to-EBITDA. That would make the forward P/E 20.7x instead of 22.4x and Price-to-TTM EBITDA 17.3x vs 18.8x.

- The various working capital items had some surge after Covid but have returned to normal levels in terms of days outstanding. The company's growth often makes working capital a consumer of cash overall. The following table shows inventory, payable, and receivable days of sales for the last three years:

DECK Wrk Cap	Inventories				Payables				Receivables			
	Mar	Dec	Sep	Jun	Mar	Dec	Sep	Jun	Mar	Dec	Sep	Jun
f- 2024				204.6				64.3				36.5
f- 2023	121.3	105.1	187.6	239.0	44.9	62.0	48.0	65.5	34.3	22.3	45.7	47.7
f- 2022	120.9	89.4	165.0	170.6	58.2	80.5	71.9	78.3	37.0	25.9	47.2	39.5
f- 2021	95.4	60.6	146.3	281.5	74.9	91.3	59.5	53.0	34.6	26.7	48.1	43.5

There are definitely some seasonal swings. Notice that payables were coming down even though inventories were still rising.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.