BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

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The Coca-Cola Company (KO)
Earnings Quality Update

We are maintaining our earnings quality rating of KO at 3- (Minor Concern).

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

Summary

KO's 2Q23 adjusted EPS of $0.78 beat forecasts by 6 cents. It further boosted the forecast for organic revenue growth from 7-8% to 8-9%, but moved the FX headwind up 100bp so it nets out to the same forecast. It did raise adjusted EPS growth from 7%-9% to 9%-11% with again only a 100bp rise in FX headwind.

There are still some positives and negatives with recent earnings, netting these together – we think KO did realize an earnings beat.

- KO enjoyed a tax rate that came in below guidance of 19.5% which added 1 cent to EPS.

- Depreciation declined again adding about 0.7 cents. Total capital spending is rising again, and this expense may rise soon.

- Stock compensation dropped $40 million adding another 0.8 cents.

- Latin American pricing still looks out of line, rising 17% against an FX hit of only 4%. The other large overseas markets are not showing this type of excess pricing as EMEA was up 14% but gave back 9% in FX and Asia was up 5% and gave all 5% back in FX. Historically, Latin America FX is often equal to or greater than the pricing gains. It's not a 13% net positive. If this was 5%-7% lower, it would have cost KO 1.1-1.5 cents in EPS. KO is still saying that customers are price conscience and are trading down in some areas. That should make it tough to continue monster price hikes. KO noted that it will anniversary 2022"s large price hikes. Plus, it noted that 2023 pricing gains are much more subdued like pricing gains were before Covid and inflation. Thus, pricing gains could be lower going forward.

- Equity income has a large exposure to bottling operations. Those are being helped by higher pricing too, but we know many of the costs related to bottling and distribution are declining. On adjusted EPS, equity income rose by $113 million or 2.1 cents. Bottlers have seen their price hike equal the FX hit for both 1Q and 2Q. This is another area where we doubt the growth will hold. KO said on the call that this exceeded guidance and it does not expect this to hold up as 2023 continues.

- Also on pricing, KO is reporting that marketing expenses are rising in EMEA, North America, and Latin America. That would be a return to more normalized operations for KO – some modest pricing gains offset by growing marketing and FX.

- Bad debt reserves remain lower on higher receivable totals. This was a bigger issue for 1Q23 than 2Q23. This may still have added to EPS.

- Inventory remains inflated as we have discussed. We think KO delayed replacing inventory trying to wait out inflation and finally had to give in. The problem now is it acquired inventory at higher costs that will need to be expensed as pricing power returns to normal. We think this will keep pressure on gross margins. It is worth noting that selling some bottlers (lower margin) helped the small boost in margin in 2Q23. That may not recur.

	2Q23	2Q22	2Q21	2Q20	2Q19
Inventory	$4,646	$3,621	$3,281	$3,501	$3,453
Adj COGS	$4,859	$4,634	$3,904	$3,038	$3,927
DSI	87.0	71.1	76.5	104.9	80.0
Gross Margin	59.4%	59.0%	61.4%	57.7%	60.7%
Pricing	10%	12%	11%	-4%	2%
FX	-4%	-6%	5%	-3%	-6%

International Business Machines Corporation (IBM)
Earnings Quality Review

We are maintaining our earnings quality rating of IBM at 2- (Weak)

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

Summary

IBM's 2Q23 beat forecasts by 18 cents. This is on top of a 12-cent beat in 1Q23. After 1Q, IBM cut revenue guidance. After the 2Q beat, it still has not raised forecasts.

Much of the 2Q looks like it benefited from gross margin expansion due to raising prices and the change in depreciation policy to extend equipment lives. We still think investors should also be asking if higher wages are the justification for price hikes – why aren't costs like R&D or SG&A rising? Having those costs come in flat with price hikes looks like a big source of 2Q's EPS gain. If they should have risen 3% vs. 6%-10% wage growth, then coming in flat produced over 16 cents of EPS. Lower depreciation produced 3 cents more than guidance. We still found 4 cents of EPS from IBM's common levers of cutting advertising and warranty accruals against higher stock compensation.

- Advertising dropped again from $395 million to $372 million – adding 2.1 cents to EPS. Adjusted retirement costs fell $6 million y/y adding 0.5 cents.

- Extended Warranty accruals dropped from $66 million to $11 million – adding 5.0 cents to EPS.

- Standard Warranty accruals dropped from $25 million to $18 million. However, in 1Q23, IBM reversed $17 million of prior accruals back into earnings and the total reserve was raised another $3 million in 2Q – giving a net $4 million tailwind of 0.4 cents.

- Against that 8.0 cents of tailwind, IBM had a headwind of 3.1 cents from higher stock compensation and 0.7 cents from higher bad debt reserves.

- The tax rate came in at 16.4% vs. guidance of mid-high teens. Every 1% change is worth 2.6 cents in quarterly EPS.

- As we have commented on extensively, IBM has used up the big-bath charge from the Kyndryl spin-off that booked several quarters of the recurring workforce rebalancing charges. IBM now warns that this headwind is coming as the charge was $117 million in 2Q23 vs. $28 million last year for an 8.1-cent headwind.

- Other income had a few components that should be looked at. The figures adjusted for Kyndryl and retirement items show a y/y decline of $418 million in income to $262 million.

    - 2Q22 had a $232 million gain on the sale of the health care unit that should be viewed as one-time.

    - The y/y change in interest income with higher interest rates was $173 million. That's real money but it's tough to attribute that to IBM's business skills.

    - Losses on Derivatives declined y/y by $210 million as well for a positive. But, the gains on FX contracts fell by $328 million.

    - When we look at this, other income rose from $184 million to $261 million y/y or $77 million. And, that is coming entirely from higher interest rates. That netted out to 7 cents of EPS for 2Q23.

- Higher gross margin was a big source of EPS growth. This helped in 1Q too. Adjusted gross profit was $8.65 billion (55.9%) vs. $8.47 billion (54.5%) for 2Q23. That level of increase was worth 16.4 cents. Within that figure, we can break down some key points to focus on:

    - IBM stretched out the depreciation lives of equipment coming into 2023. That was expected to add 6 cents per quarter to EPS or about $65 million. The bulk of this is in the Infrastructure segment. Depreciation actually declined by $100 million y/y. **That would be an 9.1-cent positive impact for EPS. That is 3.1 cents better than the forecast**. Also, the Infrastructure segment reported gross margin rose by 200bp on lower sales. IBM touted the 200bp improvement on the call noting that

they are cutting costs so that even a 30% drop in Z-system sales didn't hurt margins:

Infrastructure	2Q23	2Q22
Sales	$3,618	$4,235
Gross Margin	55.8%	53.8%
Gross Profit	$2,019	$2,278
less Dep. Chg	$100	
Adj Gross Profit	$1,919	$2,278
Adj Margin	53.0%	53.8%

- The problem with IBM's analysis of the situation is without the lower depreciation figure, margins actually declined by 80bp and the bulk of that was simply an accounting estimate change – not changes in operations. Also, after 1Q, IBM attributed some of the 120bp increase in infrastructure gross margin to lower infrastructure support business which is lower margin. In 2Q, support revenues were down 8%, which should have helped again.

- The financing gross margin was 49.2% vs. 35.3% y/y in 2Q23 and revenues increased to $185 million from $146 million. That produced $39.5 million more in gross profit y/y or 3.6 cents. Looking at the 1Q23 10-Q, IBM noted that gross profit for financing was under pressure from higher interest rates – that likely didn't change for 2Q23, but was not called out in the 2Q 10-Q. However, 2Q the higher revenue was pointed out due the prior increase in Z-system sales giving them higher asset totals. Also, the improvement in 1Q profit margins came from reversing past accruals for losses and settlements on non-accrual assets. The discussion for 2Q results focused on why income from financing dropped on higher revenues. The main drivers were higher FX losses and an increase in unallocated loss reserves. Given that pretax income y/y by the same amount gross profit is supposed to have grown – we'll leave out the bump in gross margin from financing.

  If we adjust the reported gross margin for the infrastructure's deprecation and pull out the financing unit where final profitability declined, gross margin rose by only 80bp, not 150bp.

- IBM is touting that it raised prices. It says rising costs for labor justify the increase in pricing. However, it is also warning that further price hikes are unlikely to be as high and competition may hold them lower. From the 2Q23 earnings call:

  > *"Was there a price increase (in Transaction Procession – part of Software)? Given the labor inflation of 2022 and some ongoing in '23, given the strong dollar, effectively, there was pricing increase, because of those factors, and that got taken well by the market, because of the value they see on that.*
  >
  > ***Would I expect to see similar pricing on TP and then I'll come to other parts of both consulting and software? I doubt, David, that it will be on the same range…"***
  > ***"I think on the rest of software, except TP, I would expect that as labor inflation is there, those elements do come in effectively on pricing, renewal rates and so on. But I'd also say it's a competitive market, and you have to remain competitively priced to where the others are."***
  >
  > *"Now consulting has also got both labor and inflation built in.* ***And when we are seeing 6%, 8%, 10% increases in labor cost, it is, I think, appropriate to be able to pass some of that on, albeit with a lag.*** *And you heard Jim talk in his prepared remarks about that, that is some of what is coming through in consulting. If there remains underlying labor inflation, I fully expect to be able to pass that on, again, with a bit of a lag…"*

- The first issue is software is the larger unit with higher margins: Software - where IBM expects it to be tough to pass through more price hikes – is a 79.3% gross margin business on $6.6 billion in quarterly sales producing $5.2 billion in gross profit (over 60% of the total company). Consulting is a $5.0 billion quarterly business but only at a 25.9% margin or $1.3 billion (only 15%) of total gross profit. Already y/y for 2Q, software's margin was virtually flat at 79.3% vs 79.2%, with pricing up. Consulting was up 170bp in 2Q vs. only 90bp in 1Q which IBM attributed to higher pricing exceeding wage growth.

- The second issue is "why aren't other costs rising?" Don't those involve labor and higher wages? IBM is talking about dealing with 6%-10% wage inflation. When we pull out items like stock compensation, advertising, the higher workforce rebalancing charges (which we already talked about above) – we should be arriving at a more wage-heavy figure for expenses. We concede travel, some level of depreciation is still part of this. But, shouldn't these costs be increasing even 3%-4%? Yet, both are basically flat:

Costs	2Q23	2Q22
R&D	$1,687	$1,673
Stock Comp	$73	$58
Adj R&D	$1,614	$1,615
SG&A	$4,655	$4,576
Advertising	$372	$395
Wrk Force chg	$117	$28
Stock Comp	$168	$153
Bad Debt	$14	$6
Adj SG&A	$3,984	$3,994

What if both costs should have been up only 3% amid higher wages? R&D would have been $50 million higher and hurt EPS by 4.5 cents. SG&A would have been $130 million higher which would cost EPS 12.0 cents. Instead, IBM took price hikes and didn't report inflation from overhead costs – we would expect these two trends to match more closely going forward even the company is indicating that pricing will be tougher to take again.

Kimberly-Clark Corporation (KMB)
Earnings Quality Review

We are maintaining our earnings quality rating of 4+ (Acceptable)

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

Summary

KMB posted second-quarter non-GAAP EPS of $1.65 which was 17 cps ahead of estimates. We saw about 10 cps in unusual benefits (discussed below) in the quarter, but the beat remained well intact after considering that.

The company raised guidance for full-year organic sales growth to 3-5% from the previous 2-4% while EPS is expected to grow 10-14% compared to the previous outlook of 6-10%. This additional growth is expected to be driven largely by a larger improvement in operating margin from +130 bps to +150 bps as input costs are now expected to rise by $100 million compared to the previously expected $150 million. Regardless of the beat and improved outlook, the market punished the stock which appeared to be the result of concerns regarding market share losses and pricing pressure in Consumer Tissue. However, we believe these concerns are overdone and given the potential for margin expansion and relatively cheap valuation, we are leaving KMB on our On-Deck Value list.

Observations on the quarter:

- The tax rate came in at 20.5%. KMB had forecast a full-year rate of 23-25% before the quarter. The lower rate would have added about 7 cps versus analyst models that were expecting the 24% midpoint. Note that tax rate guidance for the full year remained the same.

- Lower share compensation added about 1.2 cps.

- The company surprised with a $658 million pretax impairment charge to write down the value of its Softex investment in Indonesia. In the 10-K filed for 2022, the company stated that it was more likely than not that the fair value of the Softex intangibles exceeded their carrying value and there was no mention of the margin of safety. However, management cited changed buying patterns post-Covid and increased competition in the Indonesian market as reasons for downward revisions in its outlook. Nevertheless, management indicated that it remained excited about the long-term prospects for the operation.

- Depreciation and amortization added about a penny per share to EPS which we assume is related to the Softex impairment.

- Adjusted gross margin was 34%, an improvement from 33.2% in the March quarter and 30.2% in the year-ago quarter. Gross margin in fiscal 2022 was 30.8% and management implied on the call that gross margin would expand by 250 bps in 2023 which means 33.3%. With trailing 12-month margin already at 32.6%, no sequential improvement in gross margin would be needed in the next two quarters to make this goal. A return to the pre-Covid margin of 35% in 2024 also seems possible.

- With regards to pricing pressure concerns, KMB was among the first in the industry to raise prices. It is already seeing price increases lapping and volumes growth improved (may not add due to rounding):

TOTAL	6/30/2023	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Volume	-3.0%	-5.0%	-7.0%	-5.0%	-1.0%	2.0%
Price	8.0%	10.0%	10.0%	9.0%	9.0%	6.0%
Mix/Other	1.0%	1.0%	1.0%	1.0%	1.0%	2.0%
Organic	5.0%	5.0%	5.0%	5.0%	9.0%	10.0%
Acquisition	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-4.0%	-4.0%	-5.0%	-4.0%	-2.0%	-2.0%
Total	1.0%	2.0%	0.0%	1.0%	7.0%	7.0%

Some competitors were later to follow with price increases. According to management, the competition has leaned more heavily on promotional activity which has led to some market share losses for KMB. While the company has not permanentlay conceded the market share, it does not want to compete on the basis of promotional spending but rather advertising to emphasize value and build a more loyal customer base. Advertising increased by 100 bps in the quarter and the company looks to build on that investment.

Continued improvement in volumes as the impact of price increases fully lap in the second half will be a sign the strategy is working.

Philip Morris (PM) Earnings Quality Update

We are maintaining our earnings quality rating of PM at 4- (Acceptable).

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

Summary

PM's adjusted EPS of $1.60 beat forecasts by 12 cents but 7-9 cps was from a lower-than-forecast tax rate. Still, there was a meaningful beat without the low tax rate. The company did boost 2023 guidance slightly despite raising its prediction of FX headwind from 30 cents to 33 cents. EPS is now expected to be $6.13-$6.22 up from $6.10-$6.22. Cigarette volume decay is expected to be negative 1.5%-2.5% vs. negative 2.5%-3.5% and it raised the low-end for organic growth from 7% to 7.5%. Interesting to note that PM held operating margin guidance of down 50-150bp the same, but noted it expects to come in at the high-end of that forecast.

- PM guided to a 20.5%-21.5% effective income tax rate and came in at 17.3% again, just like 1Q23. That was 7-9 cents of the beat. With the full-year forecast of 20.5%-21.5%, we would expect this tailwind to become a headwind soon.

- Equity Investment income looked high last quarter at $51 million. Historically it is lower in 2Q and 3Q, but came in at a loss of $21 million. That was a 1.4-cent headwind to EPS. We still wonder if dividends remain low with the Russian issues and if that is inflating this source of earnings. Dividends are only reported in the 10-K. Also, much of this souce of income is coming from Russia and in both 1Q and 2Q, PM raised its forecast for FX losses and called out Russia as a key reason. We wonder if there may be a greater impairment possibility in the future. There was a 1-cent charge against earnings in 2Q23 for fair value adjustment on equity security investments.

- PM took a $680 million impairement on its Wellness and Heathcare unit. This was due to unsuccessful tests for inhalable aspirin and slower development of the business. This was 44 cents that was added back to adjusted EPS.

- PM is still forecasting higher tobacco, energy, and manufacturing costs which also have an FX headwind component to it. That is why management sees 2023 operating margin likely to be hurt by 150bp. When we see the continual changes in guidance to FX impacting EPS, revenue growth, and margins – we always come back to the idea that a great deal of FX can be hedged, but not the full impacts. And for a company that relies heavily on US dollars to service debt and pay its dividend – we still like the Swedish Match and Heated Tobacco roll-out in the US.

- After 1Q and early 2Q, PM noted manufacturing constraints were impacting sales. It was moving some markets from IQOS to ILUMA and wanted to keep inventory for IQOS lower, but could not fully supply ILUMA. Thus, it was losing some sales. On the 2Q call, PM reported that the supply constraints have been resolved and the ILUMA roll-out can accelerate. That is likely why PM boosted the low end of sales guidance.

- PM reported it is still on pace to roll out its heated tobacco in the US in 2Q24, which we still regard as a very positive development for PM's future growth and something that will help deliver dollars and tone down some of the FX issues.

Texas Instruments (TXN) Earnings Quality Update

We are maintaining our earnings quality coverage of TXN at 4+ (Acceptable).

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

Summary

TXN's EPS of $1.87 beat forecasts by 11 cents. TXN also made no adjustments to EPS continuing its record of very high earnings quality. We will note that TXN picked up 11 cents from other income which is largely interest income. As with IBM, this is real earnings, but not really operational income. It was up 6 cents in 1Q, so some level of growth here was expected. There was also a 2.4-cent headwind from higher stock compensation in the 2Q which offset 2.8 cents from lower share count.

TXN hit the high end of revenue guidance for 2Q23 also, but did not report improvement in end markets and guided to 3Q sales in the $4.4-$4.7 billion range vs. $4.5 billion in 2Q, and $5.2 billion in 3Q22.

The biggest issue still appears to be weak Chinese sales – but this was not mentioned on the 2Q earnings call. We know Chinese sales were down 28% y/y in 1Q and TXN noted that it was not seeing improvement in China during the 1Q earnings call.
The earnings beat looks solid as TXN continued to invest in the business for R&D, overhead, and capital spending. We have long pointed out that the company runs as a fixed-cost entity with a long-term focus on growing its base – but it views revenues as the wild card to move earnings.

- Depreciation and capital spending continue to rise per TXN guidance as it builds more plants and turns them on. The rising depreciation is a drag on EPS when revenues are not growing:

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Depreciation	$285	$265	$249	$249	$227	$200	$200
Capital Spend	$1,446	$982	$967	$790	$597	$443	$1,282
Revenues	$4,531	$4,379	$4,670	$5,241	$5,212	$4,905	$4,832

TXN did point to history that its depreciation policy is very conservative and it often has equipment that lasts longer than the depreciation range used to expense it. Thus, the rising investment level sets it up for higher margins as depreciation ends before the equipment is retired.

- The same is seen in R&D and SG&A. Plus stock compensation has been a headwind this year too.

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
R&D	$477	$455	$434	$431	$414	$391	$389
SG&A	$461	$474	$429	$431	$422	$422	$404
Stock Comp	$111	$104	$62	$68	$85	$74	$50
Revenue	$4,531	$4,379	$4,670	$5,241	$5,212	$4,905	$4,832
R&D % Sales	10.5%	10.4%	9.3%	8.2%	7.9%	8.0%	8.1%
SG&A % Sales	10.2%	10.8%	9.2%	8.2%	8.1%	8.6%	8.4%
Stk Comp % Sales	2.4%	2.4%	1.3%	1.3%	1.6%	1.5%	1.0%

- Inventory remains the bulk of investor concern. Analysts continue to ask if TXN will slow production until sales catch up with supplies. TXN repeated its long-stated policy that it looks at multi-year cycles and it has been rewarded by avoiding out-of-stock situations which enables it to also keep customers when competition may be more aggressive. With its new plant ramping up, it believes the best way to drive margins is to run fixed costs over more units of inventory.

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSIs	209	195	160	136	126	128	118
Fin Gds DSI	69	63	50	41	36	40	37

- The bigger question is can TXN afford to build inventory and boost capital spending with higher R&D and SG&A? We would say it can. Plus it has $9.6 billion of cash and investments vs. $11.2 billion debt with only $300 million due in the next 12 months. However, the repurchases to drive EPS growth are disappearing at this point:

	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Net Income	$1,722	$1,708	$1,662	$2,205	$2,291	$2,201	$2,138
CFO pre Inv.	$1,840	$1,691	$2,394	$2,971	$1,907	$2,294	$2,399
Inventory	-$441	-$531	-$353	-$205	-$139	-$150	-$42
Capital Spend	-$1,446	-$982	-$967	-$790	-$597	-$443	-$1,282
Dividend	-$1,125	-$1,125	-$1,123	-$1,051	-$1,060	-$1,063	-$1,062
Repurchases	-$74	-$103	-$848	-$996	-$1,182	-$589	-$142

  - The table adds the inventory change to Cash from Operations.
  - The lower sales and higher R&D and SG&A are reducing Net Income
  - Capital Spending is expected to be about $5 billion and the dividend is $4.5 billion per year.
  - Cash from operations may run about $7.5-$8.0 billion until the revenue trends swing back to more favorable situations.
  - Even in 2Q23, past share repurchases drove diluted shares from 930 million to 916 million y/y. That was worth 2.8 cents in EPS growth, but TXN will lap that source of growth soon.
  - There could be cash flow coming from the CHIPS act too in very late 2023 and into 2024. TXN had accrued $619 million in this area through 1Q23, Looking at Other Long Term Assets, this accrual could have risen another $320 million in 2Q23. This could become another source of more than $1 billion in future cash flow.

- If TXN views its investment and cost structure as fixed and revenue is the wild card, there is considerable upside leverage here. Revenues are running about $700 million below

last year's level and every $100 million that returns is worth about $65 million in cash flow and 6-7 cents of EPS. What will help revenues turn during 2023 especially after TXN guided to modest sequential growth?

- TXN noted that its transition to more direct shipment and less use of distributors meant some distributor inventory had to be sold off before customers ordered more. It sounded like much of that is completed.

- Management also said that as lead times declined from orders and delivery, customers have been able to reduce inventories on hand. That has been a common theme since the end of 2022 – supply chains have opened up. With the bulk of orders now able to be shipped immediately now, it does not sound like this transition has much further to go.

- China's lockdowns and issues lasted into 2Q. TXN spoke more about this in 1Q as a headwind and didn't address it on this week on 2Q's call. That may also be a situation that could have bottomed out.

- Easier comps will start to hit as it has been several quarters now of negative growth in many areas of demand with the exception of automotive.

- Also, the new plants that are starting up are designed to lower TXN's total cost of production, so in addition to having sales recover, there could be some gross margin tailwind that helps cash flow.

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

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