BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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International Flavors & Fragrances, Inc. (IFF) Earnings Quality Review

We are initiating earnings quality coverage of IFF at 3- (Minor Concern).

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

Summary

IFF has had some sizeable acquisitions and divestitures in recent years. It only missed 1Q23's EPS forecast by 2 cents. More distressing has been that guidance has been reduced after 3Q22 and after 1Q23.

Guidance	Sales	EBITDA	Sales growth	EBITDA growth
1Q23	$12.3b	$2.34b	5%	0%
4Q23	$12.5b	$2.34b	6%	0%
3Q23	$12.4-$12.5b	$2.5-$2.6b	9-10%	4%
2Q23	$12.6-$13.0b	$2.5-$2.6b	9-12%	4-8%

- Sales and EBITDA growth assume currency-neutral comparable sales

The stock price has been cut in half. We see some problems with IFF's accounting quality. The largest problem relates to inventory which may resolve itself within two years – but we are very skeptical the improvement can occur as quickly as management seems to be promising.

IFF has the following goals for 2024-26:

- 4%-6% currency-neutral sales growth Sales > $13b
- 8%-10% EBITDA growth add 250bp to margin = 22.5%
- Leverage < 3.0x – adjusted EBITDA and repurchase shares after met
- CapX 5% of sales

If IFF is successful with these goals:

- Debt would decline from $10.715 billion to $8.775 billion or down $1.94 billion.
- Adjusted EBITDA would be $2.925 billion vs. 2023's forecasted $2.34 billion.
- The value of the company would 10.0x EBITDA vs. today's 13.4x

We think investors should focus on the balance sheet and debt goals – that may be the toughest target to meet with the current $825 million dividend. Also, we believe that inflation has helped boost sales but with raw materials now falling in cost – IFF may see pressure on sales. The

turnaround story here may take longer than 2023 in our view and the dividend may not be sustainable given the need to retire debt.

What to Watch

- Inventory was elevated intentionally to deal with supply chain problems. However, it rose higher than planned and had a negative impact on cash flow. IFF also built inventory at the peak of inflation for raw materials and energy. It is now seeing costs decline as it works to sell off the higher-cost inventory. Using average cost accounting, it will take longer for this higher cost inventory to be reduced and IFF is dealing with customers destocking too. That is causing it to reduce production and is deleveraging fixed cost absorption for newer inventory.

- Predictions for inventory problems to end after 2Q23 look unrealistic to us and IFF has already missed forecasts that the problem would be corrected in 4Q22. We see reasons that this could last into 2024 with weak sales, margin pressure and cash released from inventory may occur more slowly.

- Price hikes have compensated for negative volume, but with raw material and energy costs down, we wonder if IFF may see price hikes reverse in late 2023 and 2024. That could keep pressure on margins against current forecasts of adding 250bp to EBITDA margins in 2024-26.

- IFF's recent EPS results came in within 1-2 cents of forecasts. Every 100bp of margin change is worth 9 cents in quarterly EPS. Every 1% change in sales forecasts is worth 6 cents in quarterly EPS. Past price hikes are anniversarying and IFF has higher cost inventory to sell. There may be more danger of EPS misses in the next few quarters given these trends intersecting.

- We would also point out that IFF is counting on working capital to decline. The inventory should come down. But, receivables are up due to higher selling prices, not DSOs. If IFF expects to keep boosting prices, receivables and inventory could consume more cash

than expected. If price hikes do not hold, IFF could see cash released from working capital, but income would be impaired from forecasts and that could still hurt cash flow.

- The forecast for IFF requires $2 billion in debt reduction if it is successful in reaching $2.9 billion in EBITDA vs. this year's $2.34 billion. Otherwise, it may need to reduce debt by more than $3 billion. The problem we see is cash flow is about $1.6 billion and capital spending is $600 million with a dividend of $825 million. There just isn't much cash to retire debt. Divestitures in 2023 should bring about $1 billion to the table, but what then?

- The acquisition accounting reduces IFF's earnings quality. Non-GAAP EPS is running about $1.00 per quarter. However, adding back the amortization of acquired intangibles is 52 cents of that adjusted EPS. Plus, IFF uses a very long amortization schedule, the amount added back could easily be more than 70-80 cents. IFF also has $13.5 billion in goodwill that is not expensed at all, that is another 33 cents of expense being ignored. All those purchases cost cash and are the reason the share count and dividend are up, plus the reason IFF has to retire debt. That looks like recurring cash expenses to us and it makes up more than half of IFF's adjusted EPS.

- Other adjustments non-GAAP EPS look reasonable. Integration programs and restructurings after large deals are expected. Those are one-time in nature and lumpy. And Kudos to IFF – the programs end quickly. We see other companies where restructuring continues for decades. The larger parts of IFF's adjustments are gains/losses on divestitures, and integration/restructuring costs.

Inventory Remains too High and Impacts Cash Flow

IFF did what several other companies did to handle the supply chain issues and inflation – they purposefully bought more inventory than necessary to continue meeting its customers' needs with as little interruption as possible. We are not going to chastise IFF for this policy. It made sense at the time:

> IFF 4Q21 conference call – *"I think net of these investments will be sort of about equal on a cash flow basis.* ***One is we're going to be adding inventories building, I should say,***

inventories of about $300 million. *As a reminder, when the deal was closed a year ago, we were at artificially low inventory levels, about 111 days.”*

IFF 1Q22 conference call – *“Unfortunately, since our February earnings call, we have seen additional increases in raw material, logistics and energy costs and are diligently working with our customers on incremental pricing actions.* ***One important note to call out is that we are seeing the strong cost increases flowing to inventory, which due to our inventory days means that the higher cost will eventually impact the P&L*** *as we progress through the balance of the year.”*

IFF 2Q22 conference call – *“In our first 6 months,* ***our free cash flow position was impacted by higher inventory values. This was a result of a combination of continued inflationary pressures and rebuilding inventories*** *to support customer service levels.”*

“I would also note that just the nature of the time ***it takes raw materials to go through inventory and show up in the P&L, any additional impact for the balance of the year is likely to be muted to 0 and really hit 2023.***”

Inventory	**4Q**	**3Q**	**2Q**	**1Q**
2023				$2,946
2022	$3,151	$3,122	$2,993	$2,795
2021	$2,516	$2,401	$2,464	$2,589
2020	$1,132	$1,151	$1,166	$1,076
DSI				
2023				129
2022	147	139	126	121
2021	113	112	103	136
2020	138	142	148	125

In 1Q21, IFF closed on the DuPont acquisition and we can see the inventory appeared low in DSIs for much of 2021. However, three things happened: 1) IFF’s inventory increase cost $600 million, not $300 million, 2) inflation started to cool on raw materials (so IFF loaded up on expensive inventory), and 3) customers and their consumers started to lower their own inventory levels:

The higher inventory and higher selling prices leading to rising receivables in dollar terms have provided big pressure to cash flow. Plus, IFF has not been boosting its Days of Payables as inventory has risen:

Receivables	4Q	3Q	2Q	1Q
2023				$1,899
2022	$1,818	$2,031	$2,180	$2,160
2021	$1,906	$1,975	$2,059	$2,023
2020	$929	$929	$962	$943
DSO				
2023				57
2022	59	61	60	60
2021	58	59	61	74
2020	67	67	73	64

Payables	4Q	3Q	2Q	1Q
2023				$1,197
2022	$1,418	$1,527	$1,576	$1,629
2021	$1,532	$1,332	$1,389	$1,337
2020	$556	$505	$551	$456
DPO				
2023				52
2022	66	68	66	71
2021	69	62	58	70
2020	68	63	70	53

Here are the reported cash from operations and the net change in working capital items for the last five quarters and last three years:

	1Q23	4Q22	3Q22	2Q22	1Q22		2022	2021	2020
Cash Ops	$127	$208	$289	-$96	-$4		$297	$1,437	$714
Wk Cap Chg	-$127	$40	-$5	-$518	-$489		-$1,052	-$146	$74

Inventory Issues Could Last into 2024

IFF uses average cost in valuing its inventory. This has the impact of more slowly raising and lowering the Cost of Goods Sold figure in response to rising and falling prices than if IFF used FIFO or LIFO. Even though IFF was raising selling prices, it noted on the 2Q22 call above that the real inflationary impact was going to hit in 2023 as a result of how inflation would move through COGS. This is becoming evident now:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Sales	$3,027	$2,844	$3,063	$3,307	$3,226	$3,031	$3,071	$3,089	$2,465
Adj COGS	$2,063	$1,975	$2,062	$2,171	$2,081	$2,050	$1,981	$2,179	$1,711
Gross Marg.	31.8%	30.6%	32.7%	34.4%	35.5%	32.4%	35.5%	29.5%	30.6%

Margins have been under pressure for several quarters in a row. We believe this should continue as IFF wants to work down inventories now. At the same time, its volume growth is negative as customers are destocking too. This started as a minor mention in 2Q22 and has become a common theme now for IFF earnings:

- 2Q22 call- *“you may have some temporary transition quarter or two as customers sort of destock inventories, but in general, you don't see massive swings in terms of volume.”*

- 3Q22 call – *“To provide some more color, nearly two-thirds of our volume decline in the quarter came in Protein Solutions, which is part of the Nourish business, where we have seen customer destocking to address higher inventory levels in response to sluggish end consumer demand.”*

  “The other thing is with regards to what is the driver, primarily as mentioned, it is destocking for our business is what we're seeing Gunther. And that is -- the main driver is our customers are looking at year-end their inventory levels and wanting to obviously manage their working capital appropriately. So, that's really the driver.”

  Later on the call – IFF said it expected this to end in 4Q22

- 4Q22 call – *“In the fourth quarter, we also saw a more pronounced slowdown in terms of volumes than we initially expected, down high-single-digits for the quarter, due mainly to*

consumer demand slowdowns and significant customer destocking actions. We estimate that about 75% of the drop in volume in Q4 is related to destocking, with the balance coming from softer consumer demand."

- 1Q23 call – *"So let me unpack a little bit about some of the key assumptions as we get into the back half of the year and even into the second quarter. First, destocking, we are assuming that ends pretty much in Q2. So if you think about destocking, Heidi, we saw this really come to fruition in Q4, the volumes were down high single digits of Q4 of '22. We continue to see destocking in Q1 and some destocking is continuing in Q2."*

If we look at the last five quarters for sales growth – we know that IFF's sales were carried by price hikes in the last year of > $1 billion which is about 9%. More of that was coming for 2023. Here's what we know about sales growth adjusted for acquisition/divestiture and FX. Plus we have an estimate from IFF on volume:

Sales	Comp	FX	Vol.
1Q23	1%	-4%	-MSD
4Q22	4%	-7%	-HSD
3Q22	10%	-7%	neg
2Q22	11%	-4%	pos
1Q22	13%	-4%	5%

The negative and positive volume figures for 3Q22 and 2Q22 were both small figures labelled "marginally" and "modestly."

Going forward, we question how long the price hikes can hold. IFF notes that about 60% of its costs are raw materials, energy, and logistic operations. IFF reported on the last earnings call that it is seeing deflation in all three items. If they lose some pricing – sales growth could turn negative quickly.

Margin pressure should continue to come from selling higher-cost inventory. Plus, IFF is already reporting that its production levels are down as it tries to work down inventory. That is causing new inventory to absorb more of the fixed costs per unit than in the past. That should keep some pressure on margins into 2024 also.

One area that may offset some of this is we know shipping costs are down and so are fuel costs, so this could be a tailwind for margins. IFF reports shipping costs billed to clients in both sales and COGS. These numbers are not broken out – but here's a really simple example of what is happening. Let's assume $1 billion in sales, $700 million in COGS and $100 million in shipping costs as a base case and then put in inflation and deflation:

	Base	**Inflation**	**Deflation**
Sales	$1,000	$1,000	$1,000
Shipping	$100	$150	$50
Total Sales	$1,100	$1,150	$1,050
COGS	$700	$700	$700
Shipping	$100	$150	$50
Total COGS	$800	$850	$750
Gross Margin	27.3%	26.1%	28.6%

Our conclusion is the inventory situation will correct itself – but it may take into 2024 not the 2H23. As the price increases anniversary, we believe sales growth will slow further because even if volume decay slows, pricing has been a major part of sales growth. We still expect the higher cost inventory to be a drag on margins as well. Less pricing growth should only hurt margins more. Plus, IFF already had to get waivers on its debt covenants because lower earnings were also hurting cash flow. We would look for the turnaround in 2024. We would also look at the goals of EBITDA margins reaching 22.5% in 2025 at this point.

From a sensitivity standpoint, 100bp of margin change in any given quarter is about 9 cents in EPS. A 1% change in sales in any given quarter is about 6 cents in EPS. Of late, misses and beats have been by -2 cents, 1 cent, and 3 cents. So if IFF has more margin pressure from inventory or sales pressure from negative volume and/or price hikes lapping – it wouldn't take much to push IFF to a miss. As this corrects, there should be some better operating leverage at work on the upside.

Debt Reduction GoalsNeed More than Divestitures

The debt-to-EBITDA ratio is currently at 4.6x. IFF has negotiated covenant waivers for the near future so we do not expect that to be a problem. In the intro, we noted that assuming IFF achieves its operating goals by 2025, it would still need to retire $2 billion of the debt.

IFF has already sold its Savory Solutions unit in 2Q23 for $900mm of gross proceeds. It expects that to be $750 million after tax payments. It has a deal to sell its Flavor Specialty Ingredients for $220mm. Netting just under $1 billion would get IFF halfway to the $2 billion target. It will still need free cash flow to cover some of the remaining debt paydown. That's a problem in our view:

- IFF's 81-cent quarterly dividend consumes $825 million per year of free cash flow.
- IFF's goal is to spend 5% of sales on Capital Investments. On $12.3 billion in sales for 2023 – that's $615 million. 1Q23 spending was $175 million.
- The company is guiding to $55 million in lost EBITDA from the Savory Solutions divestiture, which could roughly offset the interest savings from retiring debt.
- Guidance is for adjusted earnings to produce $1.2 billion in income. That already includes amortization being added back and all restructuring. It also gives IFF credit for some cost savings. Depreciation should be another $450 million – That would give free cash flow of about $1 billion before the dividend.
- We would be skeptical of adding back the restructuring too as the $70-$100 million expected will likely consume cash. That could push cash from operations under $1.6 billion before the capital spending for more than $600 million.
- Working capital should add to free cash flow in 2023, with declining inventory, payables may not need to decline further.
- It still does not look to us like IFF can make meaningful progress on additional debt reduction without selling something else or reducing the dividend.

- Weaker sales growth due to unsustainable price hikes as raw material costs decline could prove another headwind in 2024 and 2025 if that reduces earnings further via lower sales.

We found it odd that IFF talked about repurchasing shares on the 4Q22 call – after it achieves its 3.0x debt/EBITDA ratio. First of all, needing only a $2 billion paydown requires EBITDA to rise from $2.3 billion to $2.9 billion. That alone could take until 2025 or later. Second, free cash flow after the dividend appears to be in the $100-$200 million range before working capital changes. Divestitures may cover the first billion in debt reduction, but the next billion could take much longer.

Acquisition Policies Are as much as 80% of non-GAAP EPS

The spread between GAAP and adjusted earnings is enormous for IFF:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
GAAP EPS	-$0.04	-$0.10	-$8.60	$0.43	$0.96	$0.35	$0.76
Adj EPS	$0.87	$0.83	$1.36	$1.54	$1.69	$1.10	$1.47
Spread	-$0.91	-$1.07	-$9.96	-$1.11	-$0.73	-$0.75	-$0.71

The biggest part of this is adding back the amortization of intangibles. IFF is carrying $9.0 billion of acquired intangibles at this point. It is also amortizing these assets over periods that often exceed 20 years. Of the Dupont intangibles, 73% is being amortized over 11-27 years. The Health Write deal in 2022 has a 19-year amortization period.

We have our regular complaints about this type of amortization add-back. IFF spent cash/stock/debt to make the deals. Those are requiring cash payments now – look at the dividend and the debt service. If they had built these assets in-house, they would have spent cash too but would have expensed much of it as it was incurred. Adding this back is a huge part of IFF's adjusted EPS:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Adj. EPS	$0.87	$0.83	$1.36	$1.54	$1.69	$1.10	$1.47
Amortiz	$0.52	$0.53	$0.54	$0.55	$0.56	$0.55	$0.59

The stock is $79 with adjusted EPS of $4.68 for 2023 – that's a P/E of 17. However, over $2 of the $4.68 is adding back this amortization. The P/E jumps to 30 if this is not added back. Also, what if amortization was happening twice as fast – in most quarters, that would become 70%-100%+ of adjusted EPS. That looks like low-quality earnings to us.

This does not even include the bigger issue which is $13.5 billion in goodwill that is not being expensed at all. This is larger than the amortizing intangibles over a long period. If IFF was amortizing this asset over even 40 years – it would cost it another 33 cents in quarterly EPS.
In the 3Q22, IFF took a $2.25 billion impairment against goodwill for its Health & Biosciences unit. It blamed this on inflation, higher interest rates, reduced macro-outlook, and FX headwinds. Those types of headwinds may still be impacting results in 3Q23 when IFF does the next test. It may be difficult to justify the long lives IFF is using for these assets.

Medtronic plc (MDT)
Earnings Quality Update

We are upgrading our earnings quality rating of MDT to 3+ (Minor Concern)

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

Summary

MDT's 4Q23 non-GAAP EPS of $1.57 topped the consensus estimate by 2 cps. MDT's organic revenue growth of 5.6% was ahead of its internal expectations but despite this and the EPS beat, the market punished the stock over disappointing guidance for FY 2024 ended in April. The company is forecasting 4-5% organic revenue growth for 2024 and non-GAAP EPS of $5.00-$5.10, well below 2023's $5.29. The Street was expecting $5.19.

Management comments seemed to indicate it is being conservative with its outlook. The company faces both positive and negative factors in the next year. MDT faces tougher comps in the first half of the year, but the second half will benefit from new product releases. Increased investment in R&D is expected to be offset by cost reductions.

We are upgrading our earnings quality rating on MDT given the improvement in inventory and receivables, and accrued expenses.

- **Inventory improved but margins remain under pressure.** Inventory declined sequentially in the 5/23 quarter for the first time in two years which resulted in a slight YOY decline in DSI, also the first in two years. ***(See below for detail)***

- **However, gross margin will remain under pressure**. MDT uses FIFO inventory and it takes almost half a year for inventory to work its way through to the income statement. Management highlighted during the call that the higher costs capitalized in its inventory will continue to negatively impact gross margin well into FY24. While comps get easier in the current 7/23 quarter, the higher costs that are already baked into inventory should limit any sequential improvement for 2-3 quarters. This should make any meaningful

YOY improvement in gross margin unlikely until the very end of the fiscal year. ***(See below for detail)***

- **Receivables growth has moderated**. Our last review flagged the company for two quarters of significant DSO increases coupled with the company noting that it was experiencing slower collections. YOY DSO jumped to 63.9 versus 62.4 last year but was down sequentially from 69.3 in the previous quarter. In addition, a return of sales growth to the mid-single digits also reduces our concern.

- **The allowance for bad debts fell sharply in the 4/23 quarter**. There was no mention of the decline in the 10-K or the conference call. However, we can tell from the 10-K disclosure that provision expense was $73 million in FY23 versus $58 million in FY22. It was a sharp increase in write-offs from $69 million in FY22 to $127 million in FY23 that led to the decline in the allowance. Given the normal level of provision expense, we are not overly concerned that the company is materially underreserved moving forward.

- **The decline in accrued expenses also moderated**. We noted in our last review that accrued expenses showed a sharp sequential decline which we could not explain. While the balance fell by $49 million in the 4/23 quarter, this could be explained by the exit of the contribution of the Renal Care business. Our concern level is therefore reduced although the accrued expenses balance should be closely monitored in upcoming quarters.

- **The company disclosed in the 10-K that on June 1, 2023, an Israeli court determined that the company owes taxes on a transfer of intellectual property which it currently estimates could approximate $200 million.**

Inventory Is Improving but Margins Are Still Pressured

MDT's inventory levels have been rising for several quarters driven by raw materials and labor inflation, supply chain constraints, and higher freight. The 5/23 quarter marked the first decline in inventory levels in several quarters which we view as a positive sign. The following table shows inventory DSIs for the last 12 quarters:

	4/28/2023	1/27/2023	10/28/2022	7/29/2022
Total Inventory	$5,293	$5,375	$5,055	$4,809
Non-GAAP COGS	$2,918	$2,631	$2,453	$2,467
DSI	165.1	185.9	187.5	177.4

	4/29/2022	1/28/2022	10/29/2021	7/30/2021
Total Inventory	$4,616	$4,514	$4,349	$4,288
Non-GAAP COGS	$2,543	$2,415	$2,446	$2,549
DSI	165.2	170.1	161.8	153.1

	4/30/2021	1/29/2021	10/30/2020	7/31/2020
Total Inventory	$4,313	$4,508	$4,484	$4,551
Non-GAAP COGS	$2,601	$2,569	$2,660	$2,466
DSI	150.9	159.7	153.4	180.9

Points to note:

- Inventory declined sequentially in the 5/23 quarter for the first time in two years which resulted in a slight YOY decline in DSI which is also the first in two years.

- The higher costs have taken their toll on gross margin as seen in the following table:

	4/28/2023	1/27/2023	10/28/2022	7/29/2022
Adjusted Gross Profit Margin	65.8%	66.0%	67.7%	66.5%

	4/29/2022	1/28/2022	10/29/2021	7/30/2021
Adjusted Gross Profit Margin	68.6%	68.9%	68.8%	68.8%

	4/30/2021	1/29/2021	10/30/2020	7/31/2020
Adjusted Gross Profit Margin	68.2%	67.0%	65.2%	62.1%

- MDT uses FIFO inventory and it takes almost half a year for inventory to work its way through to the income statement. Management highlighted during the call that the higher costs capitalized in its inventory will continue to negatively impact gross margin well into FY24. While comps get easier in the current 7/23 quarter, the higher costs that are already baked into inventory should limit any sequential improvement for 2-3 quarters.

This should make any meaningful YOY improvement in gross margin unlikely until the very end of the fiscal year.

Allowance for Bad Debt Plummeted Due to Write-Offs

There was an unusual decline in the allowance for doubtful accounts in the 4/23 quarter as shown in the following table:

	4/28/2023	1/27/2023	10/28/2022	7/29/2022
Gross Receivables	$6,174	$6,094	$5,829	$5,527
Allowance for Doubtful Accounts	$176	$207	$203	$219
Allowance % of Gross Receivables	2.9%	3.4%	3.5%	4.0%

	4/29/2022	1/28/2022	10/29/2021	7/30/2021
Gross Receivables	$5,781	$5,699	$5,748	$5,688
Allowance for Doubtful Accounts	$230	$253	$255	$257
Allowance % of Gross Receivables	4.0%	4.4%	4.4%	4.5%

	4/30/2021	1/29/2021	10/30/2020	7/31/2020
Gross Receivables	$5,703	$5,492	$5,660	$5,152
Allowance for Doubtful Accounts	$241	$277	$312	$276
Allowance % of Gross Receivables	4.2%	5.0%	5.5%	5.4%

	4/24/2020	1/24/2020	10/25/2019	7/26/2019
Gross Receivables	$4,853	$6,453	$6,316	$6,090
Allowance for Doubtful Accounts	$208	$205	$198	$196
Allowance % of Gross Receivables	4.3%	3.2%	3.1%	3.2%

Points to note:

- Before the pandemic, the allowance as a percentage of gross receivables ran in the 3%-3.5% range. This understandably jumped in 2021 and began to gradually pull back to normal throughout 2022.

- However, despite a $111 million sequential increase in receivables in the 4/23 quarter, the allowance dropped by $31 million. There was no mention of the decline in the 10-K or the conference call. However, we can tell from the 10-K disclosure that provision expense was $73 million in FY23 versus $58 million in FY22 and it was a sharp increase in write-offs from $69 million in FY22 to $127 million in FY23 that led to the decline in the allowance. Given the normal level of provision expense, we are not overly concerned that the company is materially underreserved moving forward.

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.

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