BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Paychex, Inc. (PAYX)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of PAYX at 5+ (Strong).

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

Summary

PAYX's business model appears to have three sources of growth: small to mid-sized businesses restarting growth after COVID and bringing back employees; cross-selling customers on new services such a retirement, insurance, regulation training; and government's never ending ability to change various laws and regulations as well as create new ones that make it onerous for employers to maintain current knowledge of the maelstrom.

The company beat forecasts each of the last four quarters by 4-cents, 7-cents, 8-cents, and 1-cent. The beats were solid in all but fiscal 4Q20 (the 1-cent beat and the first period of COVID) when PAYX realized more gains on securities than normal which added almost 2-cents. Non-GAAP earnings are actually slightly lower by 1-2 cents than GAAP. PAYX does not have a myriad of adjustments and does not add back amortization of acquired intangibles. Rapid amortization rates boost earnings quality and a high ROI limits impairments.

Looking at several issues such as capitalizing customer acquisition costs (mostly sales commissions), potential risks to rising interest rates on the bond portfolio, and insurance reserves – we believe the risks are very low – 1 or 2 cents vs. EPS of essentially $3.00.

What is strong?

- GAAP and non-GAAP earnings are essentially the same. Paychex has some excess tax benefits from stock compensation that generally lowers non-GAAP EPS from GAAP figures and the difference is normally about 1-cent. The only other adjustment in the last eight quarters was some cost savings actions during COVID to consolidate office space and a small reduction in headcount. The costs of 6-cents were added back.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
GAAP EPS	$0.97	$0.75	$0.59	$0.61	$0.98	$0.72	$0.73	$0.64
Excess Tax benefits	$0.00	-$0.02	-$0.02	$0.00	-$0.01	-$0.01	-$0.02	-$0.01
Cost Saving Program			$0.06					
Non-GAAP EPS	$0.96	$0.73	$0.63	$0.61	$0.97	$0.70	$0.71	$0.63

We looked back at the period of 2016-2020. The only time the difference between GAAP and non-GAAP EPS was more than 4-5 cents was in 2018 when the tax laws changed and PAYX adjusted the valuation of deferred tax liabilities. This very narrow spread related to one item that actually had PAYX reporting non-GAAP EPS lower than GAAP which is a good sign of quality in our view.

- ROI before COVID was 55%. It is still basically 50% during COVID. That ROI does not add back amortization of intangibles or depreciation. The operating income figure is actually very close to free cash flow, which does add back the depreciation and amortization and would reconcile working capital needs and capitalized costs and subtract capital spending. Thus, the ROI is very strong in our view and supports the value of intangible assets such as $1.8 billion in goodwill and $300 million of intangibles. The ROI is helped with the $3.0 billion equity balance growing slowly because PAYX pays a large percentage of net income out as dividends and share repurchases:

	2021 ytd	2020	2019	2018	2017
Net Income	$834.5	$1,098.1	$1,034.4	$933.7	$817.3
Dividends	$670.5	$889.4	$826.8	$739.7	$662.3
Share Repos	$76.0	$171.9	$56.9	$143.1	$166.2
Equity Balance	$2,976.4	$2,781.4	$2,619.5	$2,024.5	$1,955.3

- Revenue recognition is conservative in our view. For example, insurance commissions earned are not reported as revenue until the premium is billed and collected. Revenues are reported net of the pass-through components such as wages, FICA, income taxes, IRA contributions etc. Thus, if a client's total payroll is $200,000 and Paychex earns $1,000 – revenue at Paychex is $1,000 not $201,000 with a cost of goods sold of $200,000. Also, PAYX bills for its fees with the payroll processing and pulls its fees from the bank account at the same time as the payroll transfers are made. So the lag between revenue being recognized and cash being received is often less than 5 days. Only in the case when PAYX retains risk such as worker's compensation does it report gross amounts in revenue. Set-up fees paid by clients are deferred and recognized over 3-4 years.

- Acquired assets and internally developed assets have similar lives. One of our most common complaints with companies making acquisitions is when internally developed assets are expensed as incurred or over 3-5 years while acquired assets are amortized over 20 years. That allows acquisitions to inflate profitability. PAYX buys assets and the largest component of intangible assets that are amortized are customer lists. It is amortizing those with an accelerated method over a weighted average life of 10-years. PAYX also incurs costs to acquire customers when it grows organically. It capitalizes some of those costs and amortizes them on an accelerated method over 8-years. It is also important to note that PAYX does not add back the amortization of either in non-GAAP EPS making that higher quality too. It is also important to note that if PAYX changed the acquired amortization life by 1-year, it would only impact EPS by 0.7 cents per year.

What to Watch

- There are some moving parts that can conceivably generate a few cents in EPS for PAYX that we identified. We found little evidence of any problems here with items like deferring customer set-up costs and recognizing them as revenue over 3-4 years. Bad debt reserves jumped as COVID restarted employee hiring and was actually a headwind to EPS of more than 1-cent last quarter when PAYX beat by 4-cents. For discussion, 1-cent in EPS at PAYX is $4.8 million in pretax earnings. Fiscal 4Q20 (last May) did see a large amount of realized gains on securities that added 2-cents and could be a slight headwind for 4Q21 earnings in a few weeks.

- Interest on client funds does not look like a sizeable risk. PAYX notes that a 25bp move in rates has a $3.0-3.5 million impact on net earnings or less than 1-cent per year. We see a very low duration with 40% of assets maturing in less than 30-days and the rest 2.5-3.75 years. The credit quality is also high.

- Capitalized costs to obtain new business look reasonable. The cash spent for commissions is nearly equal to the amortization of capitalized expense. The difference is often only 1-2 cents +/- in quarterly EPS. When it's negative, it indicates the company is actually growing. PAYX does not add back the amortization from non-GAAP EPS which also boosts earnings quality in our view.

- Insurance reserves for workman's compensation and some limited vision and dental policies pose a risk but appear manageable. Thus far, adjustments have been immaterial for reserves based on historical experience and independent actuaries. The reserves are only 7% of book value.

Supporting Details

EPS Beats Look Solid. Areas Where PAYX Could Pick Up 1-2 Cents in EPS from Unsustainable Sources Look Tame

There are some moving parts that can conceivably generate a few cents in EPS for PAYX that we identified. We found little evidence of any problems here other than one area to watch. For discussion, 1-cent in EPS at PAYX is $4.8 million in pretax earnings.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Deferred Rev	$38.4	$40.6	$39.6	$39.2	$38.8	$42.2	$41.3	$40.3
Bad Debt Reserve	**$20.3**	$13.8	$11.5	$12.5	$12.1	$10.8	$10.6	$7.5
Prepaid Exp.	$244.9	**$241.3**	**$252.9**	$244.8	$250.0	$240.9	$242.3	$233.9
Realized Gains	$0.3	$0.4	$0.3	**$8.9**	$0.6	$0.9	$0.9	$0.1

- Deferred Revenue arises when clients pay set-up fees to PAYX. These fees are minor and longer-term sources are deferred and amortized into income over only 3-4 years. The level of deferred revenue has held around $40 million per quarter for some time. We see little issue with this and compared to quarterly revenue of about $1 billion, small changes in this area look immaterial to us.

- Bad debt reserves did jump last quarter and actually hurt EPS by about 1.4-cents and PAYX still beat forecasts by 4-cents. We think this was the result of COVID ending. One of the bigger sources of Receivables at PAYX are Purchased Receivables. PAYX has arrangements with temporary staffing companies where it helps their cash flow by buying their receivables and earning fees. The receivables turn every 35-45 days. At the end of 3Q21 (February), total receivables were $695 million with the purchased receivables at $616 million. During COVID, these purchased receivables fell to the low $300 million range in 4Q20 and 1Q21 (May 2020 and August 2020). The recent surge is what led to bad debt reserves being raised. We think this represents a snap-back to employers looking to add staff and we will watch to see if this receivable figure goes much higher or if it falls to normal levels and the bad debt reserve could actually help EPS by 1-cent.

- Prepaid expenses had a noticeable drop in 2Q21 after a rise in 1Q21 that was largely a wash. This is where some of the deferred costs to acquire customers are located and we did not see a change in that area during this time (we'll discuss below). There was no explanation for this, and it was likely some COVID-related timing and it was in 1Q21 when PAYX did some minor cost savings plans on employees and real estate. So it was a tailwind 4Q20, headwind 1Q21, tailwind 2Q21 each time for 1.5-2.0 cents in EPS and it's back to normal levels now.

- Realized gains net of losses on securities have been modest in all recent quarters except 4Q20. That added about 1.7 cents to EPS in a period PAYX beat by 1-cent and it gives PAYX a small headwind for 4Q21 results.

Interest on Funds Seem at Low Risk from Rising Interest Rates

One of the income sources for PAYX comes from collecting taxes and insurance premiums before they are due. It invests the cash and earns interest for PAYX until the cash needs to be remitted, often once a month or quarterly. It also invests its own cash in similar investments – basically AA or better muni bonds and some very minor other ventures.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Funds Held	$4,211	$3,393	$3,314	$3,431	$4,356	$3,735	$3,769	$3,804
Interest Earned	$15.1	$14.8	$14.9	$25.3	$21.2	$19.9	$20.5	$22.2
Other,Exp	-$7.0	-$4.7	**-$7.9**	**-$8.0**	-$5.9	-$4.7	-$4.8	-$4.0

- Other, expense is a combination of interest expense, income on corporate investments, and a small miscellaneous other item. In 4Q20 (May 2020), the company had more money borrowed and that boosted interest expense. In 1Q21 (August 2020), the income on corporate investors declined with the market. In both cases this cost PAYX 0.6-0.8 cents in EPS.

- There is some potential headwinds to earnings if interest rates rise. A change in interest rates of 25bp is about $3.0-$3.5 million in earnings according to management or 0.8-1.0 cents in EPS per year. It can also move the value of the portfolio by about $25 million. There are several risk abatement items at work here:

  - Credit quality is very high AA or better ratings

  - The duration is low – with 40% of investments with duration of less than 30-days. VRDN (Variable Rate Demand Notes) are another 5% of the portfolio which Paychex can demand repayment at any time so the duration there is short if interest rates increase. The remaining portfolio has a duration of 2.50-3.75 years.

  - Offsetting loss potential – PAYX had $63 million of unrealized gains as of April 2021.

- COVID lowering rates hurt the interest income at PAYX. With so much of the portfolio with very low duration, PAYX may actually benefit from some higher rates. Just looking at pre-COVID to COVID periods, PAYX was losing about $5 million per quarter in interest income or 1-cent in EPS

- Overall, we do not see material risk to earnings +/- from the investment portfolio.

Capitalized Costs to Obtain Business Do Not Look Aggressive

Capitalized costs to obtain contracts and fulfill future obligations on contracts also do not look too nefarious. PAYX pays commissions, bonuses, and ancillary costs when it signs up new customers. It capitalizes these costs and amortizes the account over an accelerated eight years, which matches the attrition rate and historical customer retention. At the end of 3Q21, the amounts capitalized were $476.1 million to obtain contracts and $68.6 million for future obligations. These intangible assets are 18% of shareholders.

There are three reasons why we think this situation is not a serious or material issue

- PAYX is not adding back this amortization to GAAP or non-GAAP results. Thus earnings reflect this actual cash cost.

- The amortization is reducing the book value too.

- The difference between what is being capitalized (new cash costs) against what is being amortized (non-cash expense) is actually very small and when the level of new capitalized costs is larger, it indicates the company is growing.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Cost to Obtain new K	$49.9	$40.4	$37.2	$49.0	$49.4	$37.4	$35.9	$48.3
Amortz Obtain costs	$41.9	$41.7	$41.4	$41.0	$40.7	$40.5	$40.2	$39.6
Difference	-$8.0	$1.3	$4.2	-$8.0	-$8.7	$3.1	$4.3	-$8.7
Cost to Fulfill K's	$7.2	$6.0	$6.1	$6.2	$6.7	$6.0	$6.0	$5.9
Amortz Fulfill K's	$6.0	$6.1	$5.9	$5.9	$6.0	$5.9	$5.8	$5.8
Difference	-$1.2	$0.1	-$0.2	-$0.3	-$0.7	-$0.1	-$0.2	-$0.1
EPS Impact	-1.9c	0.3c	0.8c	-1.7c	-2.0c	0.6c	0.9c	-1.8c

This is typically a 2-cent headwind to GAAP and non-GAAP earnings or at best a 1-cent tailwind. The cash spending is close to equal to the amortization so PAYX is being conservative by not adding back the amortization for non-GAAP earnings. Yet at the same time, it's simply not a material part of earnings looking at the difference between cash spending and non-cash amortization.

Insurance Reserves Have Some Risk but Look Manageable

Part of PAYX's business involves workman's compensation insurance and to some clients dental and vision insurance. In these cases, PAYX retains some risk and is not simply acting as an agent earning a commission from a third-party insurance company.

PAYX has good annual disclosure on this business and the maximum payouts of individual claims. The company notes it uses its own historical experience and independent actuarial analysis to determine the size of the liabilities that it carries for this business. PAYX adjusts these forecasts often and the changes have been immaterial for years. There is always a risk that the reserves for this business prove too low. We believe this risk is worth following, but it appears unlikely to be a game-changing issue:

- Total reserves in this area are $210 million. Book value is $3 billion. Free cash flow after dividends and share repurchases has been about $250 million per year from 2018-2020. Even if their estimates are off by 100% in one-year, the company could absorb the hit.

- Thus far, experience has shown that adjustments have been immaterial.

- This type of insurance renews frequently. Pricing can be adjusted if necessary. This is not 20-years of flat premium term insurance. If claims are rising higher than expected, the pricing can be adjusted likely in less than 12 months.

Boston Scientific Corporation (BSX)
EQ Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are downgrading our earnings quality rating on BSX to 3- (Minor Concern)

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

Summary

BSX reported non-GAAP EPS of $0.37 which was 6 cps ahead of the consensus estimate. However, we noted multiple one-time benefits to results.

What was weak?

- The effective tax rate fell to 5.9% from 9.9% in the year-ago quarter. The company had forecast a full-year tax rate of 11% for 2021. We estimate the lower-than-expected rate added 1.5-2.0 cps to earnings versus the average analyst's model.

- A beneficial swing in adjusted other income/(expense) added about a penny per share to earnings in the period.

- R&D expense fell to 10% of sales from 11.8% in the year-ago first quarter. This comes after management stated in the 4Q call that "you're likely to potentially see a little bit of an uptick in the spend as a percentage of sales in the first half of '21". We estimate that if R&D had remained at the year-ago level as a percentage of sales, it would have cost almost 3 cps in earnings.

- Gross margin was below the company's expectations partly due to ongoing inventory charges related to COVID. Future quarters should be monitored for artificial benefits from selling these written down inventories at a lower cost basis.

- Rebuilding inventories is also expected to be a drain on cash flow during the remainder of 2021.

What to watch

- Like all the large medical device companies, BSX has amassed sizeable goodwill and intangible balances. The goodwill is not amortized and the company adds back the amortization of the intangibles to its non-GAAP results. This effectively ignores the cost of the acquisition while a company that developed the same technology in-house would have to expense the associated costs. ***We recommend readers see the industry review below which compares how this issue impacts BSX versus its peers.***

- BSX maintains a receivables factoring program with $347 million of receivables moved off the balance sheet versus $1.6 billion left on. The factored balance has remained relatively flat the last several quarters with no recent signs of artificial boosts to cash flow or masking of a receivables buildup. This should be monitored quarterly for changes in the trend.

Medtronic plc (MDT)
EQ Update- 4/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are raising our earnings quality rating on MDT to a 4+ (Acceptable)

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

Summary

MDT reported non-GAAP EPS of $1.50, beating the consensus estimate by 8 cps. Despite some one-time benefits, the earnings beat remained intact.

What was weak?

- MDT's non-GAAP tax rate fell to 9.5% versus 12.6% a year ago. Management attributed this to a change jurisdictional mix and one-time benefits. Kudos to the company for prominently calling out the 6 cps non-operational benefit during the call.

- Lower bad debt provision as a percentage of revenue compared to the year-ago quarter added about a penny per share to growth. Comparisons will be favorable for the next couple of quarters. We will assess the allowance percentage when the K comes out.

What to watch

- Like all the large medical device companies, MDT's past acquisitions have led to huge goodwill and intangible balances. Goodwill is not amortized, and the company adds back amortization of intangibles to its non-GAAP results. We believe this can be misleading when interpreting results as the company benefits from the acquired intellectual property with no cost while a company that developed the technology in-house would have to expense the associated costs. ***We recommend readers see the below industry discussion which compares how this impacts MDT versus its peers.***

- On the positive side, MDT has one of the lowest debt loads in the industry with net debt of just over 1x pre-pandemic EBITDA.

Medical Device Industry Overview

A Quick Look at Non-GAAP Adjustments of (BSX, MDT, SYK, and ZBH)

We currently cover four of the large medical device companies that compete in the high-end, technology-intensive areas such as defibrillators, heart valves, pacemakers, and joint replacements. These are:

- Boston Scientific Corporation- currently rated 3- (Minor Concern)
- Medtronic plc (MDT)- currently rated 4+ (Acceptable)
- Stryker Corporation (SYK)- currently rated 3- (Minor Concern)
- Zimmer Biomet Holdings (ZBH)- currently rated 3+ (Minor Concern)

While our ratings reflect various company-specific earnings quality factors, none of these companies receive our highest ratings for earnings quality, largely because they have all grown in the past through acquiring other companies in the space. This has led to sizeable intangible asset balances on the balance sheet. The goodwill is not amortized at all, and all add back the amortization of the definite-lived intangible assets to their non-GAAP results. We believe this erodes the overall quality of reported earnings for these companies.

The conventional response to our point is that amortization is a non-cash expense and therefore should not be counted in earnings-based valuations and return calculations. However, we believe that this misses the key point that the company's growth rate benefitted from the technology obtained from the companies it acquired. It otherwise would have needed to spend the cash on developing the technologies in-house. For some of these companies, these acquisitions have already resulted in sizeable debt balances. The following table shows net debt/EBITDA for all four using a pre-pandemic EBITDA figure:

Ticker	Net Debt/EBITDA
ZBH	2.7
SYK	2.6
BSX	2.5
MDT	1.2

ZBH, SYK, and BSX all are knocking on the door of a 3+ net debt/EBITDA which can limit their ability to make huge acquisitions in the future. All these companies are going to see near-term growth rates benefit as the pandemic subsides and there is a return to normal elective surgical procedures. However, growth after conditions return to the pre-pandemic norm faces the old headwind of lower reimbursement rates, pricing pressures, and intense competition.

Below, we will compare the degree to which these above factors impact each of these companies.

Intangibles Amortization Add Backs

The most valuable asset of any medical device company is the intellectual property it develops through its R&D efforts or collects via acquisition. A company that spent hundreds of millions of dollars developing a new device and asked Wall Street to add back all the associated R&D expenses when calculating earnings or returns would be laughed at. However, if a company builds its intellectual property stable by acquiring other companies in the industry, it will inevitably build up sizeable goodwill and intangibles balances. Under GAAP, the company will not have to amortize the portion of the purchase price allocated to goodwill, so no cost will ever be recognized. The portion of the acquisition prices allocated to intangible assets may be amortized, but current practice is for the company to add back the amortization to its non-GAAP results which are used by analysts to value the stock and calculate returns. If those assets are deemed to be impaired in the future, the company will have to write them off. But again, industry practice is to add any impairment charges back to non-GAAP results. We argue that this practice has the same effect as perpetually adding back all R&D costs for a company that develops its intellectual property in-house.

The following table shows goodwill and intangibles as a percentage of total assets for each of the four companies for the trailing 12 months over the last three years as well as the amortization added back to non-GAAP earnings as a percentage of pre-tax non-GAAP income before taxes:

Table 1

	Goodwill % of Assets			Intangibles % of Assets			Add Back %*	3-yr. % Write-Off**
ZBH	38.4%	35.1%	39.4%	28.3%	27.7%	31.0%	42.8%	9.4%
MDT	45.1%	43.9%	44.6%	19.1%	21.0%	22.9%	26.1%	0.1%
BSX	35.2%	33.5%	34.4%	19.4%	24.6%	27.1%	47.5%	4.8%
SYK	38.3%	30.7%	33.6%	16.1%	14.0%	16.3%	16.4%	0.0%

*Add Back % is the pretax intangible amortization added back to non-GAAP results as a percentage of non-GAAP pre-tax earnings.

**3-yr. % Write-Off is total goodwill and intangible asset write-offs taken in the most recent 12 quarters as a percentage of the intangible asset and goodwill balances from three years ago.

We also believe is it informative to look at what results would be if the amortization is not added back and goodwill was amortized over 40 years (as it was in the past). The following table shows our reconciliation to non-GAAP pretax return on capital (operating income/debt+equity) to an adjusted return on capital which takes out intangible amortization and amortizes goodwill over 40 years. Note that we use operating income for the period ended 2019 to adjust for distortions from the pandemic.

Table 2

Ticker	Non-GAAP Op Inc	Debt+Equity	Non-GAAP ROI	Goodwill/40	Int. Amort.	Adj Op Inc	Adj. ROI	Difference
BSX	$2,800	$24,815	11.3%	$272	$773	$1,755	7.1%	4.2%
ZBH	$2,189	$20,284	10.8%	$231	$605	$1,352	6.7%	4.1%
MDT	$9,171	$78,986	11.6%	$1,049	$1,782	$6,340	8.0%	3.6%
SYK	$3,908	$26,576	14.7%	$320	$535	$3,053	11.5%	3.2%

Our quick observations on each company are below:

Zimmer Biomet Holdings (ZBH)

ZBH has the highest percentage of goodwill and intangibles as a percentage of total assets in the group. It also has the highest proportion of that booked as amortizable intangibles rather than goodwill which is not amortized. While this may be a positive for the quality of GAAP results, it is irrelevant for non-GAAP results which have the amortization added back.

In addition, ZBH has sustained multiple material write-offs of goodwill/intangibles balances over the preceding three years which amounts to almost 10% of the balances as of three years ago.

Medtronic plc (MDT)

MDT has the second-highest percentage of goodwill and intangibles to total assets. In the case of MDT, its add back of amortization is the lowest as a percentage of non-GAAP pretax earnings. However, this is partly a result of a greater proportion of its acquisition purchase prices being allocated to goodwill which is not amortized at all. When subtracting both amortization of intangibles and an estimate of amortization for goodwill, we can see in table 2 that MDT's adjusted ROI falls by a similar amount to its peers.

On a positive note, the company has not experienced any major write-offs in the last three years.

Boston Scientific Corporation (BSX)

BSX's goodwill and intangibles percentage of assets is the third highest in the group. However, it has also incurred write-offs in the last three years totaling almost 5% of the balances three years ago. Likewise, its adjusted ROI in table 2 falls by the largest amount (11.3% to 7.1%) which is partly due the company's faster pace of amortizing its intangibles.

Stryker Corporation (SYK)

SYK has the lowest goodwill and intangibles percentage of total assets. Its amortization add-back percentage is also the lowest but like MDT, this is partly due to a larger percentage of acquisition purchase prices being allocated to goodwill which is not amortized. When accounting for an estimate for goodwill amortization, SYKs adjusted ROI falls by an amount similar to its peers.

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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