BEHIND THE NUMBERS
Quality of Earnings Analysis

April 30, 2021

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Microsoft Corp. (MSFT)
Earnings Quality Update- 3/21 Qtr. Preview

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

We maintain 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

MSFT's non-GAAP EPS of $1.95 topped the consensus estimate by 17 cps with revenue exceeding the Street's target by more than $850 million. We identified about 8 cps of unusual items benefitting the non-GAAP EPS number but results still decidedly topped estimates without them. Results from all three segments were ahead of company guidance but the market was apparently expecting more as the stock reacted negatively. Other items of note in the quarter:

- Recognized gains from equity investments added over 4.5 cps to earnings growth in the quarter.
- The non-GAAP effective tax rate was 14% which was below the company's forecast of 15%. This added about 2.5 cps to earnings in the period.
- Intelligent Cloud unearned revenue days of sales fell once again to 78 from 87 in the previous quarter and 96 in the year-ago quarter. Management continues to cite a move towards larger, longer-term hybrid cloud contracts with more of the contract billed as used. This results in less revenue deferred upfront. The remaining performance

obligation, which is the total amount of revenue remaining under contract less revenue deferred continued its strong trend of growth, rising 30% YOY in the quarter. About 73% of the RPO is made up of revenue that has not been billed yet versus 67% a year ago. While the amounts under contract is definitely less certain to be realized than amounts that have been billed and deferred, this does substantiate management's claims that less revenue is being billed upfront and that future billings look strong.

- Note that the change in the company's depreciation schedule for server and network equipment that took effect in the 9/20 quarter continued to add about 7 cps to earnings growth. This benefit has one more quarter to go before it laps. Management has discussed and disclosed the benefit well so expectations should reflect the impact of the benefit disappearing.

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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