BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

December 6, 2018 | www.btnresearch.com

Resmed (RMD) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We are maintaining our EQ Review rating at 3- (Minor Concern).

RMD reported adjusted EPS of $0.81, beating consensus estimates by a penny.

- Warranty expense and the ending warranty reserve balance have been flat while sales have been increasing, leading to a decline in the warranty balance as a percentage of sales falling about 50 bps compared to the 9/17 quarter. While the decline has not been overly aggressive, it is worth noting that it would take about 2 cps in charges to lift the reserve percentage back to the level it was a year ago.

- Accrued expenses declined both sequentially and year-over-year. About half of the decline appears to be related to foreign currency hedging balances. While we don't know the source of the remainder of the decline, this could be an indication that the quarter benefitted from the timing of expense accruals and should be monitored going forward.

- We noted in earlier reviews that RMD sets up third-party financing arrangements for customers to finance the purchase of its products. Outstanding balances remain about 5% of sales so we are still not seeing evidence that revenue growth is dependent on overly-aggressive credit extension. We will continue to monitor this trend going forward.

- The 10-Q cited no material changes with the outstanding tax matters with the Australian Tax Authority.

Product Warranty Balance Has Been Flat as Sales Increase

RMD accrues estimates of eventual warranty costs which are recorded in accrued expenses. The following table shows the progression of the warranty reserve for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Warranty Balance	$19.227	$19.949	$20.863	$19.956
Quarterly Accrual	$3.948	$4.298	$4.666	$4.573
Quarterly Costs	-$3.589	-$4.271	-$5.642	-$3.816
FX Adjustment	-$0.261	-$0.749	$0.062	$0.150
Ending Warranty Balance	$19.325	$19.227	$19.949	$20.863
% of Sales	3.3%	3.1%	3.4%	3.5%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Warranty Balance	$19.558	$20.187	$16.914	$17.578
Quarterly Accrual	$3.802	$4.568	$6.386	$3.608
Quarterly Costs	-$3.677	-$5.404	-$3.960	-$3.270
FX Adjustment	$0.273	$0.207	$0.847	-$0.855
Ending Warranty Balance	$19.956	$19.558	$20.187	$16.914
% of Sales	3.8%	3.5%	3.9%	3.2%

We can see that warranty balance has declined slightly year-over-year for the last three quarters and fell 50 bps as a percentage of revenue in the 9/18 quarter. The "quarterly accrual" line in the table is the actual expense charged against the income statement every period. While there was a material year-over-year drop in the 3/18 period, the expense amount has been relatively flat in the last couple of quarters. We also observe that on a trailing 4-quarter basis, the expense accrual has been very close to the actual costs incurred. We would be more concerned if we saw several quarterly drops or even a writeback of the reserve back into earnings. Regardless, the warranty balance is relatively low relative to sales and should warranty experience require the company to boost the reserve back to the 3.9% range would cost the company about 2 cps in charges.

Accrued Expenses Declined

RMD's accrued expense balance in the 9/18 quarter declined both sequentially and year-over-year as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$588.3	$623.6	$591.6	$601.3
Accrued Expenses	$169.5	$185.8	$190.7	$189.4
Accrued Expenses days of sales	26.3	27.2	29.4	28.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$523.7	$556.7	$514.2	$530.4
Accrued Expenses	$179.2	$186.3	$169.9	$216.2
Accrued Expenses days of sales	31.2	30.5	30.1	37.2

We also note that accrued expenses on a days of sales basis is the lowest it has been in three years. RMD does not break out the detail of accrued expenses in its 10-Qs, but did offer an itemized disclosure of the account in its 6/18 10-K:

Product Warranties	$19.227
Consulting and Professional Fees	$10.341
Value Added Taxes and Other Taxes Due	$20.130
Employee Related Costs	$109.280
Marketing and Promotional Programs	$3.466
Business Acquisitions Contingent Consideration	$1.505
Hedging Instruments	$2.373
Liabilities on Receivables Sold With Recourse	$2.277
Accrued Interest	$0.120
Logistics and Occupancy Expenses	$6.356
Other	$10.730
	$185.805

We know that product warranties in the 9/18 quarter were roughly flat with a year ago, while heading instruments actually fell by about $5 million from the 9/17 quarter. However, this leaves about $5 million of the year-over-year decline unaccounted for. From the above account detail that it is impossible to tell the exact source of the decline. Nevertheless, such a sharp decline in accruals can be an indication that the quarter benefitted unsustainably from the timing of expense recognition which could reverse in upcoming quarters.

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 recent 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 Concerns"	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 may 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 the next quarter. 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

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

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

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

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