BEHIND THE NUMBERS
Quality of Earnings Analysis

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Consumer Discretionary Revenue Recognition

Five consumer discretionary names with anomalies in their latest revenue numbers

Companies included

Carter's Inc. (CRI)	*p. 2*
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For this report, we examined the latest quarter's revenue-related disclosures for over 50 consumer discretionary names with market caps of over $4 billion and focused on five with unusual benefits that investors should be aware of. Our concerns included items such as:

- Falling allowances for bad debts, chargebacks, and/or discounts
- Unsustainable cuts or credits to provision expense
- Declines in reserves for warranties
- Unsustainable benefits from factoring receivables

Carter's Inc. (CRI)

Lower provision expense accounted for almost half the earnings beat.

Carter's (CRI) designs and markets branded children's apparel. The company has its own chains of retail stores and sells direct-to-consumer, but it also generates revenue through wholesale channels. Retail sales do not generate receivables, but its wholesale operations do.

The company gives excellent disclosure regarding its receivables and allowances and breaks out the receivables allowance between the credit loss portion and the allowance for chargebacks. Chargebacks relate to customers' ability to receive refunds if the pricing of items changes after purchase as well as short shipments and, handling charges, returns, and freight. The following table shows the calculation of trade receivable DSOs, and both types of allowances as a percentage of gross receivables:

	12/23	9/23	6/23	3/23	12/22	9/22	6/22	3/22
Trade Receivables	$172,106	$239,493	$128,421	$222,069	$195,078	$260,635	$182,523	$266,970
Sales	$857,864	$791,651	$600,199	$695,880	$912,130	$818,623	$700,696	$781,284
DSO	19.5	27.7	20.2	29.4	19.9	29.6	24.0	31.0
Allowance for Chargebacks	$8,400	$9,000	$8,200	$10,500	$9,300	$9,200	$8,400	$11,700
Chargeback Allowance %	4.5%	3.5%	5.8%	4.4%	4.4%	3.3%	4.3%	4.1%
Allowance for Credit Losses	$4,800	$6,700	$3,800	$7,400	$7,200	$6,300	$5,800	$5,800
Credit Loss Allowance	2.6%	2.6%	2.7%	3.1%	3.4%	2.3%	2.9%	2.0%

Points to note:

- There is significant seasonality with sales peaking in the December quarter and receivables peaking in September. Thus a year-over-year comparison of DSOs and allowance percentages is appropriate.

- While DSOs and chargeback allowances have remained fairly steady, there was a noticeable YOY decline in credit loss allowances which prompted us to look at the company's disclosure of provision expenses which is shown below:

	12/23	9/23	6/23	3/23	12/22	9/22	6/22	3/22
Sales	$857,864	$791,651	$600,199	$695,880	$912,130	$818,623	$700,696	$781,284
Provision Expense	-$1,931	$2,893	-$726	$235	$1,062	$533	-$7	-$1,513
% of Sales	-0.23%	0.37%	-0.12%	0.03%	0.12%	0.07%	0.00%	-0.19%

- With sales declining, we would also expect a decline in provision expense. However, CRI enjoyed a ***credit*** of $1.9 million in 4Q23 versus a $1.1 million bad debt expense in the year-ago quarter.

- If provision expense had remained consistent as a percentage of sales, it would have shaved 6 cps off EPS in the period. CRI reported EPS of $2.76 in 4Q23 which beat the consensus by 15 cps. While the benefit from the provision expense swing did not explain the whole beat, it was still very meaningful.

- We note that there appears to be a timing factor here as provision expense was unusually high in the September quarter. Nevertheless, investors should be aware of the benefit to December's growth.

- CRI will enjoy another easy comp on provision expense in March as it incurred only $235,000 in bad debt expense in last year's first quarter. However, June will compare to a $726,000 credit which could be a 5+ cps headwind to growth.

Dorman Products, Inc. (DORM)-

Rising rates are cutting into its aggressive factoring- but comps are now boosting earnings

DRM is the leading supplier of automotive aftermarket parts for the professional installer and consumer markets. Its professional installer customers and distributors/retailers must keep deep inventories of hundreds of thousands of different parts to ensure quick deliverability to their customers. This explains the unusually high payables at automotive retailers like AutoZone (AZO) and O'Reilly Automotive (ORLY). As a result, DRM must finance its customers by extending payment terms past what one would typically see at other industrial product companies. DRM has had to lean heavily on receivables factoring programs under which it sells receivables to third-party financing institutions. It gets to collect its cash now and pay the financing company back when its customers pay it. The company describes this in its 10-K as follows:

> ***"Over the past several years, we have continued to extend payment terms to certain customers as a result of customer requests and market demands****. These extended terms have resulted in increased accounts receivable levels and significant uses of cash. Where available and when we deem appropriate, we participate in accounts receivable sales programs with several customers that allow us to sell our accounts receivable to financial institutions to offset the negative cash flow impact of these payment term extensions. However, any sales of accounts receivable through these programs ultimately result in us receiving a lesser amount of cash upfront than if we collected those accounts receivable ourselves in due course, resulting in accounts receivable factoring costs."*

These factoring arrangements qualify as sales, so the receivables generated are removed from the company's balance sheet. The following table shows the components of receivables DSOs broken down by balance sheet receivables and receivables that have been factored but remain outstanding.

	12/23	9/23	6/23	3/23	12/22	9/22	6/22	3/22
Sales	$494,296	$488,186	$480,568	$466,738	$501,281	$413,470	$417,419	$401,579
Balance Sheet Receivables	$526,867	$484,447	$452,603	$429,308	$427,385	$433,229	$417,354	$456,070
DSO	97.3	90.6	85.9	83.9	77.8	95.6	91.2	103.6
Factored Receivables	$526,400	$866,500	$806,300	$745,900	$722,300	$783,500	$784,800	$844,800
Factored DSOs	97.2	162.0	153.1	145.8	131.5	172.9	171.6	192.0

Total Receivables	$1,053,267	$1,350,947	$1,258,903	$1,175,208	$1,149,685	$1,216,729	$1,202,154	$1,300,870
Total DSOs	194.4	252.5	239.0	229.8	209.3	268.5	262.8	295.6

DSOs are trending down after reaching a peak of almost 320 during Covid. However, the concern here is that the company is having to back off on its factoring activity, likely due to the rising cost. The following table shows the amounts of receivables sold along with the factoring costs for the last three years:

	2023	2022	2021
Sales of Accounts Receivable	$949,517	$1,048,671	$935,770
Factoring Costs	$50,231	$37,188	$11,704

According to the cash flow statement, accounts receivables were a $104 million drain on cash flow compared to a $48 million source last year which is driven by the decline in factoring activity. This could be a meaningful drag on cash flow growth in 2024 if the company continues to unwind its pace of factoring. Meanwhile, the increase in the cost of factoring cost the company more than 32 cps in 2023.

It is also very informative to examine factoring costs on a quarterly basis as well:

	12/23	9/23	6/23	3/23	12/22	9/22	6/22	3/22
Sales of Accounts Receivable	$236,327	$233,513	$241,937	$237,700	$270,620	$239,926	$262,897	$275,200
Factoring Costs	$12,557	$12,255	$11,895	$13,500	$14,199	$9,828	$8,268	$4,900

Note that factoring costs rose by $2-$4 million YOY in the June and September quarters but December saw the first decline since rates started to rise. The fall in factoring costs added 4 cps to the fourth quarter in which results beat expectations by 16 cps.

PVH Corp (PVH)-

Built up reserves, now taking them down

PVH markets apparel under several well-known brands including *TOMMY HILFIGER* and *Calvin Klein*. It sells both through wholesale channels as well as Pits own retail locations. Its receivables are generated mostly through the wholesale sales.

During the pandemic, PVH built up its allowance for doubtful accounts and it has been taking it down ever since as shown in the following table:

Fiscal year ended January	2023	2022	2021	2020	2019	2018
Receivables	$923,700	$745,200	$641,500	$741,400	$777,800	$658,500
Allowance for Bad Debts	$42,600	$61,900	$69,600	$21,100	$21,600	$21,100
Allowance % of Receivables	4.41%	7.67%	9.79%	2.77%	2.70%	3.10%

The allowance as a percentage of gross receivables rose from its pre-Covid range of 2.5%-3.0% to almost 10% at the height of the pandemic. The table below shows that this trend has continued into the most recent quarter:

	10/23	7/23	4/23	1/23	10/22	7/22	4/22	1/22
Receivables	$1,045,400	$889,200	$911,400	$923,700	$979,500	$804,600	$831,100	$745,200
Allowance for Bad Debts	$43,900	$42,000	$44,700	$42,600	$50,900	$49,100	$57,200	$61,900
Allowance % of Receivables	4.03%	4.51%	4.68%	4.41%	4.94%	5.75%	6.44%	7.67%

PVH does not disclose provision expense and write-offs on a quarterly basis, so we can’t tell what the exact impact the decline in the allowance percentage in the 12/23 quarter had on profit compared to the year-ago quarter. However, we can observe that if the allowance percentage had remained the same as the year-ago quarter, it would have shaved about 13 cps off of EPS in the October quarter in which PVH beat estimates by 16 cps.

Let’s look at the annual figures for the last seven fiscal years for more insight into how this could impact earnings going forward.

Fiscal year ended January:	2023	2022	2021	2020	2019	2018	2017
Beginning Allowance	$61,900	$69,600	$21,100	$21,600	$21,100	$15,000	$18,100
Charged to Expenses	$2,900	$0	$58,000	$5,700	$14,200	$7,500	$6,100
Written Off	$22,200	$7,700	$9,500	$6,200	$13,700	$1,400	$9,200
Ending Balance	$42,600	$61,900	$69,600	$21,100	$21,600	$21,100	$15,000

We can clearly see where PVH shored up the reserve in 2021 with the $58 million charge. However, provision expense went to zero in 2022, and in 2023, it was well below the historical norm seen in 2017-2019 where it ranged from $6-$14 million per year.

Our conclusion is that the current allowance percentage of 4% is still above the 3% pre-Covid range, so there is no immediate pressure to raise the reserve. However, the days of getting a tailwind from incurring much lower-than-normal provision expense appear numbered. Provision expense returning to just the $8 million range would be a 6-cps drain on EPS.

Allowance for Chargebacks and Markdowns

In addition to the allowance for bad debts, accounts receivable are also reported net of an allowance for contractual rights to chargebacks and markdowns which are reimbursed to the customer. PVH does not disclosure these quarterly, but we can collect the following information from the10-Ks:

Fiscal year ended January:	2023	2022	2021	2020	2019	2018	2017
Allow for Chargebacks/Markdowns	$133,700	$165,100	$220,200	$226,800	$271,000	$289,500	$291,900
Charged to Expenses	$243,300	$266,900	$264,900	$529,300	$403,800	$498,200	$551,000
Deductions	$256,100	$298,300	$320,000	$535,900	$448,000	$516,700	$553,400
Ending Allowance	$120,900	$133,700	$165,100	$220,200	$226,800	$271,000	$289,500
Days of Sales	4.82	5.26	8.33	8.00	8.45	10.94	12.70

PVH’s allowance for markdowns has fallen well below the pre-Covid norm. However, the difference between this and the credit losses is that the amount charged to expenses has tracked relatively closely to the deductions. This may simply be a reflection of lower markdown activity. It is an area to keep an eye on when the 10-K comes out at 4Q results in a few weeks.

Skechers USA, Inc. (SKX)

Lower provision expense more than accounted for the earnings beat- but allowances remain high

SKX reports its accounts receivable net of allowances for doubtful accounts and chargebacks. This allowance is reported every quarter in the accounts receivable title of the balance sheet. The company also sets up an allowance for sales returns at the time of sale which is recorded in the accrued expense footnote in the 10-K annually. Provision expense for doubtful accounts and chargebacks is recorded quarterly in the cash flow statement.

SKX's earnings in the December quarter received a significant tailwind from lower provision expense as shown in the following table:

	12/23	9/23	6/23	3/23	12/22	9/22	6/22	3/22
Sales	$1,960,940	$2,024,958	$2,012,516	$2,001,928	$1,878,785	$1,878,367	$1,867,804	$1,819,594
Provision Expense	$9,257	$4,113	$25,377	$9,792	$15,594	$12,670	-$4,482	$14,024
% of Sales	0.47%	0.20%	1.26%	0.49%	0.83%	0.67%	-0.24%	0.77%

Note that provision expense is related to both bad debts, chargebacks, and returns. The company's provision expense is quite lumpy, making it an area that can significantly impact reported earnings in any given quarter. In the last two quarters, the provision expense has been considerably lower which we estimate added 3.5 cps and 4.8 cps to earnings, respectively. Note that the 12/23 quarter's 3.5 cps boost was material compared to the 2 cps beat and the 8 cps in YOY EPS growth in the period ($0.56 vs $0.48).

We realize there has been a shift in sales towards the direct-to-consumer (DTC) channel which would seem to have no risk for bad debt or chargebacks compared to sales made through the wholesale channel. However, we would still expect DTC sales to be subject to returns, possibly more so than wholesale sales. Regardless, we see in the table below that provision expense also declined as a percentage of wholesale revenue:

	12/23	9/23	6/23	3/23	12/22	9/22	6/22	3/22
Wholesale Sales	$962,600	$1,174,600	$1,073,000	$1,294,600	$1,049,200	$1,191,600	$1,140,300	$1,251,300
Provision Expense	$9,257	$4,113	$25,377	$9,792	$15,594	$12,670	-$4,482	$14,024

% of Wholesale Sales	0.96%	0.35%	2.37%	0.76%	1.49%	1.06%	-0.39%	1.12%

Interestingly, SKX's allowances don't look alarmingly low when viewed in a longer-term historical context. The following table shows the allowance for doubtful accounts and chargebacks as a percentage of gross receivables and the liability for sales returns on a days-of-sales basis for the last seven years:

	2023	2022	2021	2020	2019	2018
Receivables	$860,300	$848,287	$732,793	$619,800	$645,303	$501,913
Allowance for Chargebacks	$33,303	$36,417	$40,134	$26,674	$17,413	$18,773
Allowance for Doubtful Accounts	$24,564	$23,055	$22,550	$21,888	$6,693	$6,843
Allowance % of Gross Receivables	6.3%	6.6%	7.9%	7.3%	3.6%	4.9%
Liability for Sales Returns and Allowances	$80,968	$60,482	$68,944	$77,219	$69,048	$48,466
Days of Sales	3.6	2.9	3.9	6.0	4.8	3.8

While the liability for sales returns looks somewhat low compared to pre-Covid levels, the allowance for doubtful accounts and chargebacks is in its pre-Covid range. Therefore, we do not believe that SKX is facing the long-term headwind of rebuilding the allowance that some companies with historically low reserve percentages do. Still, investors should be aware of the degree to which the last two quarters depended on lower provision expense. Referring back to the provision expense table above, that benefit will likely decline in the March quarter due to a more difficult comparison before the company enjoys a very easy comp in June.

Helen of Troy Ltd (HELE)

Credit allowances are up- but other allowances are down by much more

HELE's allowance or credit losses is relatively small relative to its receivables balance, but as shown in the following table, HELE let its allowance for bad debts fall even lower following the pandemic:

Fiscal year ended February:	2023	2022	2021	2020	2019	2018
Receivables (Factored and Trade)	$377,604	$457,623	$382,449	$348,023	$280,280	$275,565
Allowance for Bad Debts	$1,678	$843	$998	$1,461	$2,032	$2,912
Allowance % of Receivables	0.44%	0.18%	0.26%	0.42%	0.72%	1.05%

However, the company has been rebuilding its allowance for bad debts over the last few quarters:

	11/23	8/23	5/23	2/23	11/22	8/22	5/22	2/22
Receivables	$463,323	$387,498	$349,699	$377,604	$505,555	$507,261	$475,904	$457,623
Allowance for Bad Debts	$6,879	$5,144	$4,959	$1,678	$2,024	$1,718	$1,103	$843
Allowance % of Receivables	1.46%	1.31%	1.40%	0.44%	0.40%	0.34%	0.23%	0.18%

This has led to an increase in provision for bad debts expense as a percentage of sales:

	11/23	8/23	5/23	2/23	11/22	8/22	5/22	2/22
Sales	$549,614	$491,563	$474,672	$484,583	$558,606	$521,400	$508,078	$582,020
Provision Expense	$1,750	$282	$3,389	$425	$410	$643	$320	$20
% of Sales	0.32%	0.06%	0.71%	0.09%	0.07%	0.12%	0.06%	0.00%

We estimate that the increase in provision expense as a percentage of revenue was a 4.5-cps headwind to EPS growth in the 11/23 quarter. HOWEVER:

HELE also provides both product returns as well as trade discounts and other customer programs at the time of sale. These are recorded as reductions of revenue with the allowance reported in the accrued expenses footnote. The following table shows the accrual for sales returns on a days of sales basis for the last eight quarters:

	11/23	8/23	5/23	2/23	11/22	8/22	5/22	2/22
Accrued Sales Returns	$25,584	$23,240	$29,880	$28,498	$33,067	$29,639	$29,729	$33,384
Sales	$549,614	$491,563	$474,672	$484,583	$558,606	$521,400	$508,078	$582,020
Days of Sales	4.25	4.31	5.74	5.37	5.40	5.19	5.34	5.23

Sales have been declining, but the rate of decline dropped off in the last quarter. Understandably, the accrual fell given the lower sales. However, the accrual has fallen faster than sales as evidenced by the decline in days of sales. We don't know how much the quarter was impacted as we don't know the associated provision expense. However, we expect to see the reserve trend upward as sales recover.

	11/23	8/23	5/23	2/23	11/22	8/22	5/22	2/22
Accrued Sales Discounts and Allowances	$60,267	$48,908	$52,473	$63,881	$79,564	$72,380	$71,248	$69,120
Sales	$549,614	$491,563	$474,672	$484,583	$558,606	$521,400	$508,078	$582,020
Days of Sales	10.0	9.1	10.1	12.0	13.0	12.7	12.8	10.8

Likewise, we see a similar trend of the accruals dropping more than revenue causing a 3-day YOY drop on a days of sales basis. We expect to see both reserve accounts trend upward as sales recover and a one-day of sale increase in the reserves equals 20 cps in expenses. This would not hit earnings all in one quarter, but this could be a minor, unexpected headwind to growth in the year ahead.

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