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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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September 13, 2018 | www.btnresearch.com

# Stryker Corporation (SYK) EQ Review

| Current EQ Rating* | Previous EQ Rating |
|---|---|
| 4- | NA |

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

**We initiate coverage of Stryker Corporation (SYK) with a 4- (Acceptable)**

We have no significant concerns with the quality of SYK's earnings but note the following:

- The company adopted ASC 606 for revenue recognition at the beginning of 2018. This resulted in expenses previously recorded in SG&A now being recorded as a reduction of sales. Since historical periods are not restated, this impacts the comparability of reported results, but the company has done a thorough job disclosing the impact in its filings. Investors should note that while the impact on operating profit itself is negligible, it did have the impact of increasing reported operating profit margin by 20 basis points.

- Under ASC 606, the company now reports contract liabilities in its revenue recognition footnotes. We noted that contract liabilities as of 1/1/2018 were reported to be $381 million in the 6/18 10-Q but were reported to be $251 million for the same period in the 3/18 10-Q. We have contacted the company to understand the difference.

- SYK faces an ongoing overhang related to its 2012 product recall of its hip stem systems.

## ASC 606 Impact

SYK adopted ASC 606 for revenue recognition beginning in 2018. While the overall impact on net income was negligible, the company now recognizes costs previous included in SG&A as a reduction of sales. SYK did not restate historical periods for the change, so this has led to an artificial decrease in sales in the last two quarter versus year-ago periods and a similar artificial decrease to SG&A. The company has done a very thorough job disclosing the effects, even including a separate section in the 10-Q detailing the impact. The company also noted in the MD&A that reported operating margin received a 20 bps boost from the adoption of ASC 606 which investors should take careful note of.

One area we do have a question about is the company's new disclosure of its contract liabilities which essentially represent amounts that have been billed but not yet recognized. Most companies are now beginning to disclose these amounts in revenue recognition footnotes for the first time. In BDX's case, the 6/18 10-Q states that contract liabilities were $337 million as of 6/18 and $381 million as of 1/1/2018. Without a year-ago number to compare to, it is difficult to draw too much of a conclusion from this but on the surface, a sequential decline is a concern. However, the company's 3/18 10-Q does not give a balance for contract liabilities as of the end of the 3/18 quarter and states that the balance as 1/1/2018 was $251 million, substantially different from the amount shown for the same date in the 6/18 10-Q. We have contacted the company to understand this issue and note that this will be an important data point to track going forward.

Another question we have is the explanation in the company's discussion of operating cash flow:

> "Cash provided by operating activities was $946 and $801 in the six months 2018 and 2017. **The increase was primarily driven by higher cash receipts related to contracts with customers for unsatisfied performance obligations (partially attributable to ASC 606),** higher net earnings and cash receipts from an interest rate hedge settlement partially offset by payments related to the Tax Cuts and Jobs Act of 2017 and working capital as the net of accounts receivable, inventory and accounts payable used cash of $114 in 2018 compared to $107 in 2017."

We note that this explanation is substantially different from the discussion in the conference call:

> "Turning to cash flow, our year-to-date cash from operations was approximately $946 million. This reflects increased earnings which are somewhat offset by increases in working capital including higher tax payments as a result of tax reform and specifically required payments related to the toll tax on previously untaxed foreign profits."

We are unclear of how ASC 606 would impact the amounts of cash received from contracts and will continue to follow up with the company to understand the issue.

## Litigation Contingency

As noted in other reviews of medical products companies, litigation contingencies are present for almost all in the industry and a review of the likelihood of outcome is beyond the scope of this review. Nevertheless, it is worth pointing out that BDX experienced a product recall in 2012 of its *Rejuvenate* and *ABG II* Modular-Neck hip stem system. The company announced a settlement agreement to compensate patients who had revision surgeries and it continues to support patients who did not qualify for the settlement program. It also faces ongoing unsettled lawsuits related to the matter. The company's estimate for the probable loss incurred to solve the issue is between $2.073 billion and $2.313 billion and the company's reserve is currently below the low-end of the range which resulted in essentially no expenses being recognized in the most recent quarter. However, this matter has the potential to produce a negative surprise until fully resolved.

# 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

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