ALLISON KOESTER TALKING POINTS

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INTRODUCTION

- Good morning. My name is Allison Koester, and I am a tenured associate professor of accounting at Georgetown University's McDonough School of Business. *Please note that my views expressed today are mine and do not necessarily reflect the views of my employer.*
- I earned a PhD in Business Administration with a focus on accounting in 2011.
- Prior to academia, I worked at KPMG (one of the Big 4 accounting firms) in Virginia and Washington, DC. I was a practicing CPA, licensed in the Commonwealth of Virginia.
- I have taught corporate financial reporting to more than 2,000 graduate students at Georgetown to date
- My research focuses on corporate financial reporting and taxation. I have been invited to present my research at nearly 50 academic institutions and conferences (including opportunities at the SEC and PCAOB). My research has been published in leading accounting academic journals and featured in non-academic outlets like the *Wall Street Journal, Tax Notes,* and *Inside Investor Relations*.

OVERVIEW

I've been invited here today by Coalition members to discuss five things:

1. Provide a brief overview of US generally accepted accounting principles (US GAAP),
2. Discuss a unique aspect of the 4th tier domestic cigarette industry related to the financial implications of the 1998 Master Settlement Agreement (MSA),
3. Why we should think about Coalition members' financial performance post-MSA,
4. Provide a comparison of Coalition member firms' post-MSA financial performance (focusing on three metrics) during the import surge period (which is defined as the first three quarters of 2019), relative to the pre-import surge period (which is defined as the first three quarters of 2018), and
5. How these analyses provide insight into whether Coalition members could be viewed as materially injured (or experiencing a threat of material injury) during the import surge period.

Note that while I use the term "Coalition members" or "Coalition member firms" throughout my discussion, my understanding is that Coalition members represent the vast majority of the 4th tier domestic cigarette industry.

GAAP

- Coalition members prepare audited financial statements in accordance with US GAAP
- The basis of US GAAP is accrual accounting (as opposed to cash accounting or tax accounting)
- Accrual accounting depicts the effects of economic events irrespective of cash flows. This is because cash flow timing can occur in different periods from economic activity.
- Simple illustration: John Doe works for me on December 31st, but I don't pay him until January 1st. I prepare GAAP-based financial statements, so I recognize labor expense in December even though my cash outflow doesn't occur until the next month. John Doe prepares his own GAAP-based financial statements, so he recognizes labor income in December even though his cash inflow doesn't occur until the next month.
- Accrual accounting is useful because it tells you about economic activity (i.e., John Doe worked) regardless of when cash flows occur, and because it helps you predict future cash flows (i.e., my recognition of labor expense but no cash outflow in December indicates that a labor-related cash outflow is going to happen in the future)

MSA

- A unique aspect of the 4th tier cigarette industry relates to the financial implications of the 1998 MSA
- Coalition members are considered non-participating manufacturers (or NPMs), so they are required by law to make annual (and often quarterly) cash payments to escrow accounts as a function of cigarette sales within a state
- Escrow account funds are expected to be used to satisfy future tobacco-related judgements and/or settlements in these MSA Settling States
- Technically, unutilized escrow funds are to be returned to NPMs (for unrestricted use) 25 years after the applicable date the funds were placed into the escrow
- Given no payment has reached the 25-year mark, there isn't empirical evidence as what percentage of funds, if any, will ever be returned to NPMs

MSA Financial Reporting

- While Coalition members prepare audited GAAP-compliant financial statements, they treat MSA-related obligations differently for financial reporting purposes. One member recognizes a MSA-related charge on its income statement (as an expense included in cost of goods sold), while the other member does not.
- Regardless of financial reporting treatment, MSA-related obligations are a required condition for operating in the domestic tobacco producer market. These required payments materially dampen economic performance and restrict cash resources available for use in operating, investing, and financing activities.
- Let's first think about internal decision-makers – management. Management uses post-MSA numbers when constructing operating budgets, when determining whether sufficient cash is available for new machinery and production equipment upgrades, and determining whether capital can be disbursed to equity holders. Dr. Phillips and Mr. Smith provided specific examples of this in their prepared remarks today.
- There is also evidence that external decision-makers (like existing and potential capital providers) consider member firms' financial performance post-MSA. One member firm notes that its current lender considers "net income after MSA payments" when determining the amount of available credit extended. One member firm also notes that during IPO discussions, potential equity investors from representative institutional investment firms viewed the recurring MSA payment as an expense regardless of financial reporting treatment, and valued the firm as a multiple of adjusted EBITDA net of MSA-related charges.
- As operating performance net of MSA-related charges appears to be what is relevant for both internal and external decision-makers, my analyses focus on post-MSA financial metrics.

Financial Analysis

- For brevity, my discussion today will focus on three key financial metrics computed using aggregated CAKC member financial data. I compare metrics during the import surge period (first three quarters of 2019) relative to during the pre-import surge period (first three quarters of 2018).
- These three financial metrics are:
  1. **Net revenues per carton sold,**
  2. **Adjusted net profit per carton sold** (net revenues less net expenses including the MSA), and
  3. **Adjusted net profit margin** (net revenues less net expenses including the MSA as a percentage of net revenues). An intuitive way to think about this metric: for every dollar of net sales earned, what percentage is left over after all expenses and MSA charges are considered?
- In comparing the surge period (relative to the pre-surge period), analyses show that during the surge period Coalition member firms:
  1. **Earn MATERIALLY LESS net revenues per carton sold** – This is consistent with members being required to offer more lucrative wholesaler and retailer rebates, in an attempt to maintain market share during the import surge
  2. **Earn MATERIALLY LOWER adjusted net profit per carton sold** – This is due to less revenue per carton, as analyses indicate that members' net expenses including the MSA per carton remained relatively flat during the two periods
  3. **Realize MATERIALLY LOWER adjusted net profit margin** – for every dollar of net sales earned, member firms had much less left over after all expenses and MSA charges are considered
- **Collectively, a decline in these three metrics can be viewed as consistent with Coalition members being materially injured (or experiencing a threat of material injury) during the import surge period.**

Looking forward

I don't proport to have a crystal ball, but if one attempts to extrapolate forward....

- *If these low-priced products continue to be imported, Coalition members are likely to continue to experience negative financial implications*
- *A further increase in import volume, or further decrease in imported product prices, is expected to exacerbate the speed and intensity of these negative financial implications for the domestic industry*