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Companies Invent Their Own Performance Benchmarks

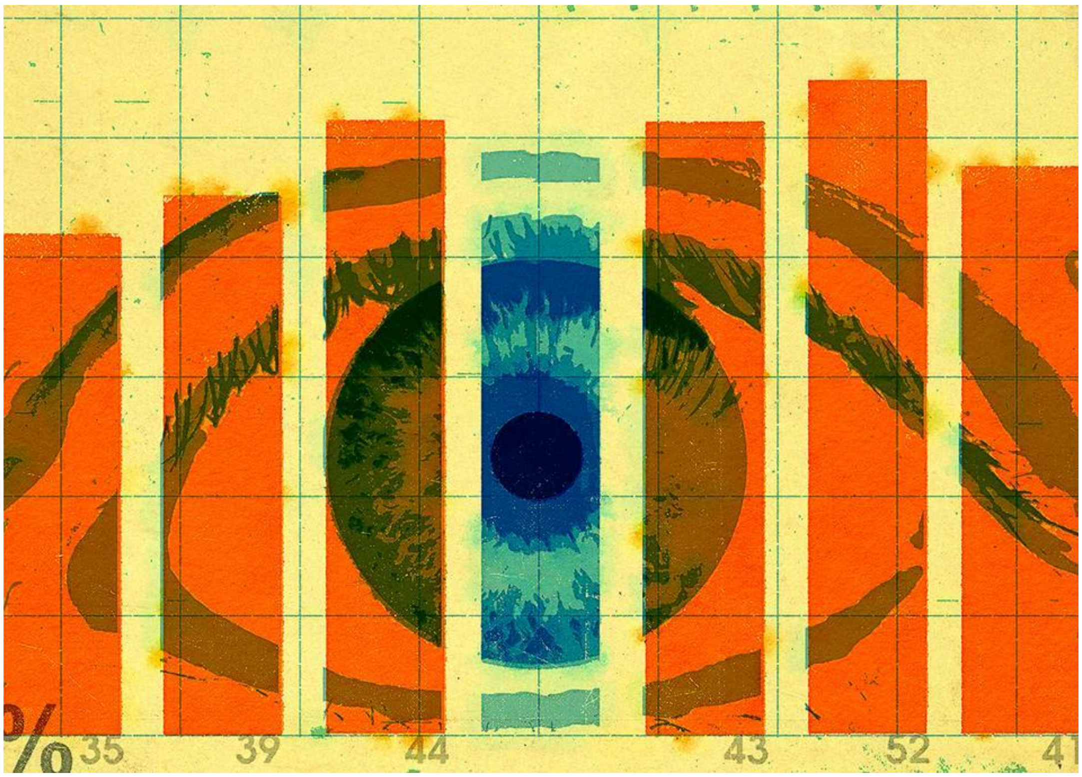

Illustration: Richard Mia

By Tatyana Shumsky

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Adobe Systems Inc., which built its reputation on getting people to buy its photo and video-editing software, says it will no longer tell the public how many customers it has.

About two-thirds of Adobe's revenue comes from online subscriptions, instead of packaged discs. Still, the company eliminated quarterly subscriber numbers in favor of reporting "annualized recurring revenue," a performance indicator that combines subscription fees with corporate contracts.

"What I don't want, frankly, is to mislead investors with this huge subscriber number," said Adobe finance chief Mark Garrett.

Adobe is just the latest company to change the way it defines success. As they are forced to adjust to new delivery methods or changing consumer tastes, corporate finance chiefs are reconsidering what benchmarks they should share with investors.

“You ultimately have to be proactive in having the right data to be able to show the ongoing health of an enterprise,” said Ryan Senter, a managing director at management consulting firm Protiviti Inc.

Such moves can be risky. Investors tend to be skeptical of changes in a company’s financial reporting, and uncertainty can hurt stock prices.

“It’s usually a bad sign when companies pull back from transparency,” said Jim McDonald, chief investment strategist at Northern Trust Corp. , which manages $875 billion in assets.

In Adobe’s case, reaction has been mixed. Subscriber growth in recent quarters has fallen at the lower end of the range of analysts’ expectations. Even so, what likely matters most to investors is that the business is growing overall.

“Ultimately, you want more revenues and more earnings, and whether it’s achieved through units or revenue growth per unit is not really that important,” said Deutsche Bank equity analyst Nandan Amladi, who follows Adobe.

A change in the way a company discloses financial information can also alarm regulators, even if it doesn’t involve figures defined by conventional accounting standards. The Securities and Exchange Commission has expressed concern about the spread of such customized benchmarks.

“People choose metrics that make them look better, but if you report it one period and don’t report it the next, that’s going to raise questions,” said Angela Newell, national assurance partner with auditing firm BDO USA.

Even so, investors often want more insight into a business than required accounting can provide. That can leave them reliant on metrics that can change at the company’s discretion.

For years, analysts say, Valeant Pharmaceuticals International Inc. used customized accounting measures such as “cash earnings per share” to paint a more appealing picture of its business. Like many companies, Valeant steered investors away from putting too much stock in standard accounting figures.

“Management doesn’t create [custom accounting] metrics to look worse, they create them to look better; that’s the case with Valeant and with many others,” said ***Dimitry Khmelnitsky***, analyst with ***Veritas Investment Research*** in Toronto.

Valeant declined to comment.

“The SEC is critical of metrics that you’ve made up, especially if they’re not relevant to your results,” said BDO’s Ms. Newell.

As Houghton Mifflin Harcourt Co. morphed from a traditional textbook publisher to selling a combination of print and electronic teaching materials, it also changed the way it accounts for those sales.

Even though it collects cash upfront for books and online guides that will be distributed over time, the company isn’t allowed to record those revenues until the final product is delivered to the customer. But, to show investors that sales were improving, even if the improvement wasn’t fully reflected in the company’s disclosures, Houghton in 2014 began reporting the sums it actually collected during a given period as “billings.”

“Without this tool, we couldn’t have the ability to communicate the performance of both what we have and what we expect for the year,” said finance chief Joseph Abbott.

Still, finance chiefs must be vigilant to avoid reporting customized accounting benchmarks that have become irrelevant. Sticking with an outdated indicator can warp investors’ view of a company’s performance.

McDonald’s Corp. last year began reporting same-store sales on a quarterly basis, rather than monthly. The quarterly data smoothed out big swings in the monthly numbers, making it easier for investors to see trends, said UBS equity analyst Keith Siegner.

The shift allows “us to focus our attention and resources on longer-term drivers of financial performance,” McDonald’s said in a statement, adding that it also brought the company into line with most competitors.

“Investors want clarity, consistency and relevancy in terms of metrics, and I think that’s what CFOs are generally striving for,” said David Garfield, managing director with consulting firm AlixPartners LLP. “If a change in strategy warrants a change in metrics, you can’t always know how that strategy is going to evolve,” he said.

Corrections & Amplifications:

Angela Newell is national assurance partner with auditing firm BDO USA. An earlier version of this article incorrectly identified the firm on one reference as DBO. (March 29, 2016)

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