

## NON-GAAP DEFERRED REVENUE: HOW COMMON IS IT?

### Non-GAAP Deferred Revenue: How Common is it?

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Investors were puzzled in Q1-F18 when BlackBerry reported a GAAP increase in Enterprise Software and Services revenue (its key segment for future growth) of 12% YoY, but a drop of 4.7% YoY on a non-GAAP basis. For a company whose future is staked on a successful software transition, BlackBerry's metrics for revenues are critical to tracking progress on this strategy.

At the heart of BlackBerry's divergence between GAAP and non-GAAP revenues is the treatment of deferred revenue balances picked up by acquiring other companies. In BlackBerry's case, these amounts largely stem from the company's acquisition of Good Technology on October 30, 2015.

Prior to being acquired, Good would have recorded a deferred revenue liability for licenses where it had received cash but future work, such as software updates or bug fixes, remained outstanding. Over time, Good's accounting would have brought the deferred revenue balances into GAAP revenues, typically on a ratable basis, matching the life of the license.

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Upon acquisition, all Good's assets and liabilities were marked to their fair value, including deferred revenue. Instead of recording deferred revenues at a revenue-like figure (i.e. cash received less revenue recognition so far), BlackBerry's acquisition accounting required a revaluation of the account at an estimated cost to service the obligation plus a normal profit, with GAAP revenue recognition becoming more like a cost-plus margin than a topline revenue figure.

BlackBerry's non-GAAP revenues adjust these balances back to a figure that is more like Good's prior accounting, causing BlackBerry's GAAP and non-GAAP revenues to diverge — there are several more wrinkles that our June 2017 Accounting Alert considered in detail (see *Behind BlackBerry's GAAP and Non-GAAP Revenue Divergence*, [available here](#)), however, our Vigil this month asks a few follow up questions:

- How common is BlackBerry's practice of non-GAAP Deferred Revenue Adjustments?
- How material are these adjustments across the industry?

Our review of six Tech companies finds that the practice of deferred revenue adjustments is not uncommon and can be material to non-GAAP revenue calculations.

## HOW GAAP REVENUE CAN DISAPPEAR POST-ACQUISITION

Software-as-a-service (SaaS), Platform-as-a-service (PaaS) and other subscription based business models common to the technology and telecom space often involve the upfront collection of cash for services delivered in a future period. This arrangement results in the creation of a liability on the balance sheet – deferred revenue. As the company provides services to the customer, revenue is recognized on the income statement while the deferred revenue balance is progressively drawn down.

When a company is acquired, however, deferred revenue accounts are revalued, with the liability of the target entity recognized at its fair value as of the acquisition date, based on an estimate of the expenses expected to be incurred when the obligation settles, plus some reasonable margin.

Often, the incremental cost to render services outstanding for software companies is close to nil, which results in a significant write-down of the deferred revenue balance on acquisition. Writing down the deferred revenue effectively results in the disappearance of prior GAAP revenue that would have been recognized in the pre-acquisition entity. In Figure 1, we provide a hypothetical acquisition as an example:

Figure 1  
**Illustration of a Fair Value Adjustment to Deferred Revenue for an Acquisition**

Amounts are illustrative and in millions of dollars

	Yr 1	Yr 2	Growth %
<b>GAAP Revenue</b>	100	160	60%
<b>Non-GAAP Deferred Revenue Adj.</b>	40	-	
<b>Non-GAAP Revenue</b>	140	160	14%

Source: Veritas calculations

Our illustration assumes that, had the target's deferred revenues not been revalued at the time of acquisition, the run rate of revenue recognition on this book would have been \$140 million in Year 1 and the same \$160 million in Year 2. Our illustration shows how a non-GAAP adjustment returns the accounting to its prior basis and \$140 million run rate, while GAAP accounting recognizes the lower (written down) revenue rate of \$100 million in Year 1, resulting in apparent growth of 60% in Year 2. The consequence of non-GAAP revenue adjustments is a divergence in growth rates versus the revenue growth reported under GAAP.

In our view, non-GAAP deferred revenue adjustments are defensible in most instances. Adjusting the non-GAAP results for the acquisition-related fair value adjustment to deferred revenue should, all else equal, provide greater comparability with other GAAP-recorded revenue and EBITDA growth, both for future GAAP metrics and for those of peers.

For example, if we assume that acquired customers continue to renew their subscriptions in future periods, using GAAP revenues would show artificially low results in the period immediately after the acquisition, and then exhibit higher growth in subsequent periods when the subscriptions are eventually renewed (as illustrated by GAAP revenue growth of 60% YoY in Figure 1). Had the GAAP revenue recognition continued uninterrupted by the change of ownership, it would have posted the same, higher revenues as the adjusted non-GAAP figures, resulting in a lower non-GAAP growth rate in subsequent periods (the 14% growth rate in Figure 1). Assuming no-acquisition effects at peers, the adjusted non-GAAP metrics are more comparable to those of peer accounting, where GAAP recognition has continued uninterrupted.

## NON-GAAP DEFERRED REVENUE ADJUSTMENTS: NOT UNCOMMON AND MATERIAL

Given that many of the businesses acquired in the tech and telecom industries operate on a subscription model, we are not surprised to find that a large number of acquiring companies apply a deferred revenue adjustment in their non-GAAP results. In Figure 2, we show a sample of companies which have acquired other tech firms over the past 3 years. Of the 6 acquiring companies, 4 reported their non-GAAP results with deferred revenue adjustments which ranged anywhere from 0.1% to 10.1% of their unadjusted GAAP metrics:

Figure 2  
**Tech Companies Reporting Non-GAAP Adjustments for Post-Acquisition Deferred Revenues**

Amounts in thousands of U.S. dollars, except as noted

Buyer	Target	Acquired Deferred Revenue Fair Value Adjustment? (Y/N)	Non-GAAP Deferred Revenue Adjustment? (Y/N)	Non-GAAP Metric	Non-GAAP Metric BEFORE adjustment	Adjustment Amount	Adj. as % of unadjusted total
SS&C Technologies	Advent Software	Y	Y	Adj. Revenue	280,894	30,532	10.10%
Roper Technologies	Delttek, Construct Connect et al.	Y	Y	Adj. Revenue	1,011	7	1%
Logmein	Citrix	Y	Y	Adj. Revenue	187,458	13,645	7.30%
Oracle	DataLogix	Y	Y	Adj. Revenue	27,250	21	0.10%
OpenText	Enterprise Content Division	Y	N	N/A	N/A	N/A	N/A
VMware	Airwatch	Y	N	N/A	N/A	N/A	N/A

Source: Company reports, and Veritas estimates

For both OpenText and VMware, it does not appear that explicit non-GAAP adjustments for acquired deferred revenue have been made. We note that OpenText acquired the Enterprise Content division of Dell in January 2017 for \$1.6 billion, recording an adjustment to the fair value of acquired deferred revenue of \$52 million that resulted in a net deferred revenue balance of \$164 million after closing. In the EMM space, VMware acquired Airwatch in February 2014 for \$1.5 billion, allocating \$45 million to the fair value of assumed deferred revenue. No further disclosures were provided regarding the extent of fair value adjustments, if any. However, not including adjustments for acquired deferred revenues can also have distorting effects.

Based on our survey of the accounting, it is clear that investors need to follow deferred revenue closely, especially when acquisitions are mixed in.

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## V-LIST - MODEL PORTFOLIO

Portfolio Yield: 2.9%

COMPANY	TICKER	DATE ADDED	PRICE (C\$) 28-July-2017	INTRINSIC VALUE ESTIMATE	CURRENT YIELD	QUALITY RATING (OUT OF 25)
Allied Properties REIT	AP-U	24-May-17	\$38.45	\$45.00	4.0%	20.0
Canadian Utilities Ltd.	CU	28-Jun-16	\$40.13	\$46.25	3.6%	17.0
Capital Power Corp.	CPX	9-Apr-15	\$24.78	\$29.50	6.7%	12.5
Cenovus Energy Inc.	CVE	7-Mar-16	\$10.57	\$21.00	1.9%	15.0
CGI Group Inc.	GIB/A	22-Nov-16	\$65.84	\$71.00	0.0%	19.0
Enbridge Inc.	ENB	5-Jul-17	\$51.13	\$66.00	4.8%	17.0
Granite REIT	GRT-U	5-May-17	\$50.07	\$54.00	5.2%	13.0
Husky Energy Inc.	HSE	11-Jan-17	\$14.58	\$21.50	0.0%	13.0
Loblaw Companies Ltd.	L	9-Apr-15	\$68.06	\$85.00	1.6%	16.0
Manulife Financial Corp.	MFC	27-May-13	\$25.44	\$27.00	3.2%	19.0
Maple Leaf Foods Inc.	MFI	29-Oct-04	\$34.33	\$35.50	1.3%	17.5
Metro Inc.	MRU	25-Nov-14	\$42.09	\$51.00	1.5%	19.0
Northland Power Inc.	NPI	13-Mar-13	\$23.33	\$27.00	5.1%	16.5
Quebecor Inc.	QBR/B	9-May-14	\$43.97	\$45.00	0.5%	16.5
Shaw Communications Inc.	SJR/B	26-Aug-16	\$27.59	\$31.50	4.3%	15.0
Telus Corp.	T	24-May-17	\$45.19	\$50.00	4.4%	18.0
The Jean Coutu Group Inc.	PJC/A	24-Jun-15	\$20.68	\$24.00	2.5%	16.0
TransCanada Corp.	TRP	16-Dec-15	\$63.50	\$67.50	3.9%	16.5
Waste Connections Inc.	WCN	1-Jun-16	USD \$64.42	USD \$72.50	0.7%	17.0

**Recent Additions:** Enbridge Inc. (ENB)

**Recent Deletions:** Crescent Point Energy Corp. (CPG), and Restaurant Brands International (QSR)

### V-List Track Record November 1, 2004 to June 30, 2017

Rating	Number of Calls	Average Performance vs. S&P/TSX CAGR
V List Buys	174	421 bps higher

Returns calculated using model portfolios that include all Veritas calls in each category (Buys/Sells). Veritas Buy and Sell returns reflect equal-weighted portfolios that are rebalanced each month and on dates where recommendations change.

CAGR = Compound Annual Growth Rate Returns for each rating and the benchmark include dividends.



## ACCOUNTING WATCHLIST

### HIGHLIGHTING ACCOUNTING AND BUSINESS CONCERNS:

Company	Analyst	Date Added	Organic Growth	Earnings Quality	Cash Flow Sustainability	Liquidity / Leverage / Off-B/S Concerns	Non-GAAP Metrics Cloud Financial Performance	Mgmt. Comp. Structure & Corp. Governance	Disclosure	Tax
<b>Aimia Inc.</b> TSX-AIM	Wong	3-Sept-14		✓	✓	✓	✓		✓	
<b>Amaya Inc.</b> TSX-AYA	Khmelnitsky	18-Oct-16		✓		✓	✓	✓	✓	
<b>Badger Daylighting Ltd.</b> TSX-BAD	La Bell	15-May-17		✓	✓		✓	✓	✓	
<b>Callidus Capital Corp.</b> TSX-CBL	Georgopoulos	16-Apr-15		✓					✓	
<b>Cameco Corp.</b> TSX-CCO NYSE-CCJ	Khmelnitsky	30-Apr-14		✓	✓	✓				✓
<b>Constellation Software Inc.</b> TSX-CSU	Leung	26-Jan-16					✓		✓	
<b>Element Fleet Management</b> TSX-EFN	D'Souza	17-Jun-17	✓	✓			✓	✓	✓	
<b>Home Capital Group Inc.</b> TSX-HCG	Rizvanovic	17-Apr-17						✓	✓	
<b>MacDonald Dettwiler &amp; Associates Ltd.</b> TSX-MDA	Khmelnitsky	3-Nov-11		✓			✓		✓	
<b>Silver Wheaton Corp.</b> TSX-SLW NYSE-SLW	Khmelnitsky	13-Oct-15		✓	✓					✓
<b>Valeant Pharmaceuticals Intl, Inc.</b> TSX-VRX NYSE-VRX	Khmelnitsky	5-Jan-12	✓	✓	✓	✓	✓	✓	✓	✓

Recent Additions: None

Recent Deletions: None



## RECENT PUBLICATIONS

### EQUITIES

COMPANY	PUBLICATION TITLE (CLICK ON TITLE)	V-LIST & WATCHLIST	DATE PUBLISHED	RATING
AIR CANADA AND AIMIA INC.	Flash: Gaining Altitude on Aeroplan		Jul.6.2017	SELL/SELL
BLACKBERRY LTD.	Accounting Alert Flash: Behind Black-Berry's GAAP & Non-GAAP Revenue Divergence		Jun.29.2017	BUY
CANADIAN FINANCIALS	Cdn. Financials: On-the-Ground with GTA Housing - Going to Extra Innings?		June.22.2017	
CENOVUS ENERGY INC.	Flash: CEO Departure Doesn't Retire Assets		Jun.22.2017	BUY
COGECO CABLE INC.	Flash: Making a Caisse for More U.S. Cable		Jul.11.2017	BUY
EMPIRE COMPANY LTD.	Project Sunrise Looks to Tame SG&A		Jul.5.2017	BUY
HOME CAPITAL GROUP INC.	Flash: Diminishing Earnings Power		Jul.26.2017	SELL
HYDRO ONE LTD.	Flash: Avista Accretion Guidance is Modest		Jul.20.2017	BUY
NORTHLAND POWER INC.	Flash: Strategic Review Uncertainty & Ontario Assets Weigh on NPI		Jul.7.2017	BUY
TRICON CAPITAL GROUP INC.	Cherry Trees		Jul.18.2017	BUY

### ACCOUNTING ALERTS

COMPANY	PUBLICATION TITLE (CLICK ON TITLE)	V-LIST & WATCHLIST	DATE PUBLISHED	RATING
AMAYA INC.	Accounting Alert Flash: Need-To-Know Q1-17		May.15.2017	SELL
CANADIAN REITS	Canadian REITs - REALPAC's Remodeled AFFO		Jun.27.2017	
OPEN TEXT CORP.	Open Text: A Look into OTEX's Simplified Tax Structure		Jun.8.2017	





## RECENT PUBLICATIONS

### QUARTERLY SNAPSHOTS

COMPANY	QUARTER	V-LIST & WATCHLIST	DATE PUBLISHED	RATING
BANK OF NOVA SCOTIA	Q2-F17		May.31.2017	SELL
CANADA GOOSE HOLDINGS INC.	Q4-F17		Jun.6.2017	SELL
CANADIAN IMPERIAL BANK OF COMMERCE	Q2-F17		May.26.2017	BUY
CANADIAN WESTERN BANK	Q2-F17		Jun.2.2017	SELL
CAPITAL POWER CORP.	Q2-F17		Jul.28.2017	BUY
CONSTELLATION SOFTWARE INC.	Q2-F17		Jul.28.2017	SELL
COGECO CABLE INC.	Q3-F17		Jul.17.2017	BUY
DOLLARAMA INC.	Q1-F18		Jun.8.2017	BUY
ENCANA CORP.	Q2-F17		Jul.25.2017	SELL
HUDSON'S BAY COMPANY	Q1-F17		Jun.12.2017	SELL
HUSKY ENERGY INC.	Q2-F17		Jul.25.2017	BUY
IMAX CORP.	Q2-F17		Jul.27.2017	SELL
LOBLAW COMPANIES LTD.	Q2-F17		Jul.28.2017	BUY
NATIONAL BANK OF CANADA	Q2-F17		Jun.1.2017	SELL
NEWMONT MINING CORP.	Q2-F17		Jul.27.2017	BUY
PRAIRIESKY ROYALTY LTD.	Q2-F17		Jul.26.2017	BUY
ROGERS COMMUNICATIONS INC.	Q2-F17		Jul.21.2017	BUY
ROYAL BANK OF MONTREAL	Q2-F17		May.26.2017	BUY
SHAW COMMUNICATIONS INC.	Q3-F17		Jun.29.2017	BUY
SUNCOR ENERGY INC.	Q2-F17		Jul.28.2017	SELL
TORONTO DOMINION BANK	Q2-F17		May.26.2017	BUY
THE JEAN COUTU GROUP INC.	Q1-F18		Jul.12.2017	BUY
VERMILION ENERGY INC.	Q2-F17		Jul.27.2017	BUY
WASTE CONNECTIONS INC.	Q2-F17		Jul.27.2017	BUY



Included in Veritas' V-List or Watchlist



**IN THE NEWS**

ARTICLE TITLE	SOURCE	DATE PUBLISHED
<b>HOW A SHORT-SELLER MAY HAVE CAUSED AN ACCIDENTAL SELL-OFF FOR TWO CANADIAN COMPANIES</b>	Financial Post	June 26, 2017
<b>WHY DO CANADIAN STOCKS KEEP BLOWING UP?</b>	Barron's	June 24, 2017
<b>THREE KEYS FOR DOLLARAMA'S SUCCESS: PRICING POWER</b>	Business News Network	June 2, 2017
<b>CHINA'S COMAC EYES INVESTMENT IN BOMBARDIER</b>	Globe and Mail	May 18, 2017
<b>BOMBARDIER-BOEING SPAT 'CREATES UNCERTAINTY FOR PROSPECTIVE U.S. BUYERS': VERITAS</b>	Business News Network	May 18, 2017
<b>VERITAS ON MOODY'S DOWNGRADE OF CANADIAN BANKS</b>	CBC	May 18, 2017
<b>HOME CAPITAL'S COLLATERAL WITH HOOPP MUCH HIGHER THAN EXPECTED</b>	Business News Network	May 12, 2017
<b>WHY CIBC'S FUND ARM HAS JUST TRIPLED ITS STAKE IN HOME CAPITAL</b>	Globe and Mail	May 10, 2017
<b>CAISSE TO WITHHOLD VOTE FOR BEAUDOIN AS BOMBARDIER CHAIRMAN</b>	Globe and Mail	May 8, 2017
<b>HOME CAPITAL SUSPENDS DIVIDEND, TAPS CREDIT LINE, BOLSTERS BOARD</b>	Reuters	May 8, 2017
<b>HOME CAPITAL REBOUNDS AS IT FIRMS UP LINE OF CREDIT, LOOKS AT POSSIBLE SALE</b>	Globe and Mail	Apr. 27, 2017




**VERITAS TRACK RECORD**

MARCH 25, 1999 TO JUNE 30, 2017

Rating	Number of Calls	Portfolio Performance vs. S&P/TSX	
Buy	309	472 bps Higher	"Buy" portfolio outperformed by 4.72% CAGR
Sell	369	629 bps Lower	"Sell" portfolio underperformed by 6.29% CAGR

Returns calculated using model portfolios that include all Veritas calls in each category (Buys/Sells). Veritas Buy and Sell returns reflect equal-weighted portfolios that are rebalanced each month and on dates where recommendations change.

CAGR = Compound Annual Growth Rate Returns for each rating and the benchmark include dividends.

Source: Bloomberg data, Veritas Investment Research.

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