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# EDITED TRANSCRIPT

EA - Electronic Arts Inc to Discuss Changes in External Financial Reporting Conference Call

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## OVERVIEW:

Based on SEC's new interpretations on use of non-GAAP financial measures on 05/17/16, EA reported that it has decided to modify the way in which it reports financial results by no longer externally reporting many non-GAAP financial measures, including net revenue, GM and EPS.



## CORPORATE PARTICIPANTS

**Chris Evenden** *Electronic Arts Inc. - VP of IR*

**Blake Jorgensen** *Electronic Arts Inc. - CFO*

**Ken Barker** *Electronic Arts Inc. - Chief Accounting Officer*

## CONFERENCE CALL PARTICIPANTS

**Chris Merwin** *Barclays Capital - Analyst*

**Colin Sebastian** *Robert W. Baird & Company, Inc. - Analyst*

**Justin Post** *BofA Merrill Lynch - Analyst*

**Mike Hickey** *The Benchmark Company - Analyst*

## PRESENTATION

### Operator

Good afternoon. My name is Doris and I will be your conference operator today. At this time, I'd like to welcome everyone to the call to discuss changes in external financial reporting conference call.

(Operator Instructions)

Thank you. I will turn the call over to Chris Evenden, VP of Investor Relations. Sir, please go ahead.

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### Chris Evenden - *Electronic Arts Inc. - VP of IR*

Thank you Doris. Welcome. With me on the call today are Blake Jorgensen, our CFO; and Ken Barker, our Chief Accounting Officer.

We are holding this call to help you understand the changes we will making in our external financial reporting in response to the SEC's recent interpretations changes in our external financial reporting in response to the SEC staff's recent interpretations on the GAAP financial measures. We will not be making any statements about our business or financial performance on this call.

After the call, we will place our prepared remarks and audio replay of this call, the transcript, an FAQ and a spreadsheet that illustrates the GAAP and non-GAAP adjustments for Q4 FY16. These materials and our comments may include forward-looking statements regarding future events with respect to the Company, including the ways in which the Company may modify its external financial reporting and the ways in which our Board and Management will assess the Company's performance.

Actual events may differ materially from our expectations. Important factors that could cause actual events to differ materially from those in the forward-looking statements include additional guidance or rules from the Securities & Exchange Commission, refinement of our analysis with respect to the subject matter of the forward-looking statements and any of the risks discussed in our most recent Form 10-K.

Electronic Arts makes these statements as of today, July 19, 2016, and disclaims any duty to update them. And now, I'll turn the call over to Blake.

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### Blake Jorgensen - *Electronic Arts Inc. - CFO*

Thanks, Chris. The SEC issued new interpretations on the use of non-GAAP financial measures on May 17, 2016. With these new interpretations, they no longer permit the use of historical non-GAAP revenue measures.



After reviewing these interpretations, we have decided to modify the way in which we report financial results by no longer externally reporting many non-GAAP financial measures including net revenue, gross margin and EPS. We will continue to provide and report financial measures on a GAAP basis. In addition, we will separately provide guidance and report the financial data that we historically used to calculate our non-GAAP financial measures, so that you may calculate comparable measures yourself if you wish to do so.

These interpretations apply to all US public companies that report non-GAAP measures, particularly those that make an adjustment for revenue recognition such as many of our video game peers. Because the new interpretations are effective immediately, we will use the earnings call for our fiscal first quarter, which is scheduled for August 2, as a transition to our new external reporting structure. That call will be the last one in which we report our financial results on a non-GAAP basis.

On that call, we will use the results for our first fiscal quarter to describe the ways in which EA's external reporting is changing and explain how to bridge from our GAAP results to non-GAAP results should you choose to perform similar calculations in the future. Also on that call, and in future earnings calls, we will only provide guidance on GAAP financial measures and the financial data that we have historically used to compute non-GAAP guidance.

It is important to note that this is only a change in external financial reporting on a prospective basis. We are not restating any of our prior financial results.

It has no effect on our business, nor how we manage our business, nor the way our Board of Directors evaluates management and Company performance. It has no impact on the key valuation measure for our business cash flow. But it will change how we present our business results externally.

We remain fully committed to maintaining the highest level of transparency into our business operations and results. Let me provide some background on the issue.

We have been externally reporting both GAAP and non-GAAP financial measures using a consistent methodology since FY08 along with the required reconciliation between the two measures. Our Management and Board have utilized these non-GAAP financial measures internally to assess the Company's operating results as well as to forecast and analyze future periods. Our management team is compensated in part based on non-GAAP financial measures. In addition, these non-GAAP measures align more accurately with cash flow.

Our non-GAAP measures included an adjustment for revenue recognition due to the delayed revenue recognition of software with online capabilities. As you know, many of the games that we sell can be played online and often include the right to receive unspecified future updates. Because we do not separately sell these services, we do not have vendor-specific objective evidence of their fair value. Therefore, GAAP rules require us to recognize the revenue ratably over the period we expect people to play the games. Today, for most of our online-enabled games, this period is between 6 months and 9 months.

However we do not defer any of our costs. We expense our costs when they actually occur. As a result, given the seasonality of our business and the period of time in which we recognize revenue, our profitability under GAAP is subject to significant variability depending upon when our products are sold.

For example, two of our largest franchises, Madden and FIFA, are released towards the end of our second quarter which ends in September. This means the September quarter includes the majority of the costs associated with releasing these games but very little of the revenue, often resulting in a significant GAAP loss in that quarter.

In order to better match the revenue with our costs, we have historically provided the non-GAAP measures that adjust our GAAP revenue for the impact of this revenue deferral. This adjustment was made for only online-enabled games; it was not adjusted for other revenue recognition issues such as subscriptions or extended payment terms. However, the new SEC interpretations no longer permit us to externally report non-GAAP financial measures, that adjust for revenue recognition, to be recognized upon the delivery of the game.

Rather than develop new non-GAAP measures, that are not used internally and risk confusion with comparing historical data, we will report many financial measures on a GAAP-only basis including net revenue. Therefore, going forward, you will need to add our GAAP revenue to change in deferred revenue in order to calculate a revenue number that can be compared to our historically reported non-GAAP revenue.

We will also report the financial data that is used to adjust it for our internal Management and Board reporting. With this data and our long-term tax rate of 21% that Management and the Board of Directors use to evaluate our financial performance, you will be able to calculate all of the financial measures comparable to our historical non-GAAP financial measures. We intend to provide this information for all of the various cuts of revenue we currently provide whether it is based on geography, platform or composition.

We will take the same approach to guidance, providing GAAP guidance across a number of measures, together with the GAAP adjustments we make for our internal reporting. We will be providing a new financial model to our Investor Relations website to help you with these calculations.

Today we've posted a model that illustrates how we applied the adjustments for the last quarter of FY16. We understand that this change will require some extra steps for each of you to compare our results to prior periods. We'll review the transition and translation between GAAP and non-GAAP again on August 2, when we report our non-GAAP numbers for the final time.

Thanks for your time and patience on this issue, one that is impacting everyone in our industry. Now Ken Barker and I will be happy to take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions)

We do have a question from the line of Chris Merwin.

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### Chris Merwin - *Barclays Capital - Analyst*

Great, thanks for taking my question. I just had a couple. If you wouldn't mind talking about the genesis of this, in terms of why the SEC decided to go after deferred revenue. I think within internet we see big differences in earnings between GAAP and non-GAAP based on stock-based comp. And yet, that wasn't what the SEC tried to exclude from non-GAAP EPS. In terms of your conversations with them, any clarity you could provide on why they decided to do this.

And then, a second question on free cash flow, obviously, to the extent that it is more challenging to look at non-GAAP metrics and the free cash flow is certainly something that adjusts for changes in deferred and stock-based comp. So if you wouldn't mind talking about how you think about free cash flow in managing the business and also how free cash flow conversion has been improving over the years and some of the drivers for why that is the case.

Thanks.

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### Blake Jorgensen - *Electronic Arts Inc. - CFO*

Yes, let me start and if Ken wants to add anything, he can do so.

We cannot attest to exactly what is driving the SEC. We know that there are some abuses out there of non-GAAP, and those could be across lots of different accounts. And so we don't try to interpret what the SEC has done.



We're trying to do exactly what we have been asked to do by the SEC and we feel like we're doing that in a very proactive way. So I can't really answer that and I don't really know what more to say on the SEC's approach other than to try to make sure that there is transparency and clarity and consistency across reporting, which we believe we've consistently done, as I mentioned, since 2008 and clearly before that time.

In terms of free cash flow, we'll continue to report our operating cash flow. We'll continue to report our CapEx during the quarter. We'll have very clear reporting on exactly what adjustments have been made to get from our earnings number to our operating cash flow number. I think that is consistent with what we've done in the past and I don't think you'll have any trouble understanding and assessing our operating cash flow nor our free cash flow, for that matter.

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**Chris Merwin** - *Barclays Capital - Analyst*

Thank you.

And just a quick follow-up in terms of free cash flow conversion in terms of why that has been improving historically. Is that just a function of a shift to digital revenue, or what are some of the drivers there?

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

I can't really talk about the business other than what we have said historically to you. I think you know historically, obviously, there have been performance improvements.

I can't talk about what is going forward. We'll talk about that August 2, but we're really just trying to give people a sense of exactly how we're changing our reporting and not any new insights on the business.

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**Chris Merwin** - *Barclays Capital - Analyst*

Okay. Fair enough. Thank you.

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**Operator**

(Operator Instructions)

We have a question from the line of Colin Sebastian.

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**Colin Sebastian** - *Robert W. Baird & Company, Inc. - Analyst*

Thanks, and hi to Blake and Ken.

Quick question here or follow-up, reading from the SEC, the CNDIs, it sounded like they were specifically targeting non-GAAP revenues. But are you also indicating that there is an inevitability around the SEC restricting the use of non-GAAP operating earnings and net income, as well?

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

Yes, our understanding is, is that if you eliminate non-GAAP revenue effectively you're eliminating the non-GAAP P&L that we've had historically. You've got to start at the top and working down through that P&L, it will be difficult to have a non-GAAP EPS or non-GAAP gross margin.



I think, as I said though in my prepared remarks, we're going to do everything possible to provide you with the historical information that helps you go from GAAP to non-GAAP if you choose to do that. We are focused on providing GAAP measures only, so we'll give you the GAAP revenue and we'll give you the GAAP net-deferral numbers that will allow you to create a P&L which best matches your interest and focus on where you think the business, or what's driving the business and the profitability of the business.

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**Colin Sebastian** - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And then, there is another round of changes, I believe, affecting cloud computing or SaaS companies from FASB next year on revenue recognition. Will there be any further impact on your reporting from that round of changes?

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

Yes, I'll let Ken address the future, but we're not impacted by the cloud issues from next year. We're really impacted by the SEC's rules on revenue accounting for two years out, and I'll let Ken just briefly address that.

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**Ken Barker** - *Electronic Arts Inc. - Chief Accounting Officer*

Right.

There is a new standard that is coming out that will affect all US GAAP companies with regard to revenue recognition, not just in the video game space, but everyone. And, as we've disclosed in our filings, that could very likely have a big impact to us. The biggest issue deals with this issue of vendor-specific objective evidence of fair value.

That concept goes away under the new standard and, therefore, the new rules basically say that when you sell these bundles of things, these various types of things in one fixed price you allocate it based on your best estimate of the fair value, not this desell concept. So we're going through the process now to estimate or to determine what the various offerings are across our various business models and offerings, and make that best estimate, and then be able to apply it in our first quarter FY19, so right at two years from now.

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

I think, Colin, as you are well aware, at the end of the day, none of these measures either the current measures or the measures Ken just described for two years out, will impact what we see as our fundamental focus, and that is cash flow. And our hope is to be able to continue to provide full transparency on what's driving cash flow for our business, because we know that is what investors are very interested in and none of these changes should impact the ability for you to understand that, hopefully.

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**Colin Sebastian** - *Robert W. Baird & Company, Inc. - Analyst*

Understood. Thanks.

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**Operator**

Our next question is from the line of Justin Post.

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**Justin Post** - *BofA Merrill Lynch - Analyst*

Hi, I just have a quick one. I think you said you would be guiding to deferred revenue stock-based comp and maybe amortization. Is that fair on a quarterly and full-year basis, Blake?

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

Yes, that's fair.

You know, it's different than where we've gone historically, but we understand you need to try to be able to compare it to your historical models and build your future models. And so we'll give you the components of revenue, both GAAP revenue and then the net deferral, which is also a GAAP number. We'll also give you, as we have historically, all of the details in the balance sheet and the income statement, particularly things like stock-based comp or any issues around amortization that may have occurred.

So think of the materials that we've provided every quarter which provide you the guide from GAAP to non-GAAP. We'll continue to give you all of those details, so that you should be able to create a model that's consistent with how you've dealt with us in the past.

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**Justin Post** - *BofA Merrill Lynch - Analyst*

Okay.

And I don't want anything new, but I think you have guided for free cash flow for the year and it actually was larger per share than earnings. Why historically, or in guidance that you have already provided, does EA generate better cash than non-GAAP earnings? Can you think of anything on the working capital side, or what is driving that?

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

I think we have talked about historically is the shift towards digital which requires far less working capital. I can't really give you anything relative to our business or financial performance for the quarter or our forecast, but I think you can really understand that the delta historically has been driven primarily by the shift towards more and more digital business.

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**Justin Post** - *BofA Merrill Lynch - Analyst*

Is there anything unusual about the tax rate for cash taxes historically?

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**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

No.

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**Justin Post** - *BofA Merrill Lynch - Analyst*

Thank you.

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**Operator**

(Operator Instructions)



We do have a question from the line of Mike Hickey.

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**Mike Hickey** - *The Benchmark Company* - Analyst

Hey, thanks for doing this call. I appreciate it.

Just to clarify, Blake, obviously you're giving us the map to get to where we were before for comparability, which is obviously makes a lot of sense. If we made the historical adjustments, which doesn't seem too hard to get to what we had as non-GAAP historically, are you able then to discuss those measures on the call with us or are you regulated now to speak only to GAAP?

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**Blake Jorgensen** - *Electronic Arts Inc.* - CFO

That's a great question, Mike. I think, as we said in the prepared remarks, our goal is to maintain the same level of transparency that we tried to maintain over the last 3 or 4 years and we'll continue to do that. We'll give you the best insights as to what is driving the business and we'll try to help you understand that both within the context of GAAP reporting, as well as any other metrics that we can provide.

I would hope that your world is not all that different than it has been historically. You may have to do a little more math than you have in the past, but at the end of the day, our goal is to make sure you fundamentally understand what's driving the performance of our business and that we're very transparent about that.

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**Mike Hickey** - *The Benchmark Company* - Analyst

Fair enough. Thank you.

The N&L guidance piece, Blake, are we still going to get some visibility on what was non-GAAP over the sales segments themselves, or is it just total revenue?

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**Blake Jorgensen** - *Electronic Arts Inc.* - CFO

No, we're going to try to be able to provide you with the same level consistent with the past both on geography, on business model, or composition, on digital components. It might sound a little different, but at the end of the day we're going to try to give you the same level of details so you can understand the transitions or the trends that are going on in the business.

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**Mike Hickey** - *The Benchmark Company* - Analyst

Thanks, guys. Good luck.

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**Blake Jorgensen** - *Electronic Arts Inc.* - CFO

Thanks.

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**Operator**

We have no other questions in the queue

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## JULY 19, 2016 / 9:00PM, EA - Electronic Arts Inc to Discuss Changes in External Financial Reporting Conference Call

**Blake Jorgensen** - *Electronic Arts Inc. - CFO*

Great. I appreciate everyone's time today. And once again, we appreciate you helping us through this process as we make some changes. We hope that it is not overly difficult, but we look forward to talking to everyone on August 2, when we report our earnings. Thanks.

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**Operator**

Ladies and gentlemen, this does conclude today's conference call. You may now disconnect.

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