**ZIPPY ZYNGA (AND HOW THE SEC MISSES THE BIG PICTURE)**

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Zynga, Inc. has become the latest darling of the IPO world, hoping to debut with a zesty price for its common stock. Some analysts think Zynga could be a great investment, including [Anders Bylund](http://www.fool.com/investing/general/2011/07/05/will-zynga-sink-or-sing.aspx?source=isesitlnk0000001&mrr=0.50). It is also receiving some favorable press, such as in “Virtual Farms, Rich Harvest” by [Nick Wingfield and Lynn Cowan](http://online.wsj.com/article/SB10001424052702304584004576419813801652724.html). Given the buzz, we looked at the firm’s S-1 and S-1/A, and we didn’t find the usual zits in terms of accounting malpractice and disclosure, and so, for the most part, we find it an interesting investment.

The SEC recently intervened and required two amendments to this filing. One amendment was due to the puffiness in the CEO’s letter to the shareholders—there’s a big issue! In our view virtually all letters to the shareholders are dripping with self-glory and self-congratulation, so we don’t understand why they singled out Zynga. The second amendment was due to the focus on “bookings,” a non-GAAP measure. But, in doing so, the SEC omitted a more important issue, which we discuss later.

Zynga does have some risks and the managers describe some of these risks in the S-1 and the two amended registration statements. The risks that we think investors should most consider are three. First, the relationship with Facebook, where Zynga’s games are played, is not one of equals, and Facebook has instituted some policies that have eaten into Zynga’s profits. Facebook could do this again and again in the future. Second, industry barriers to entry are rather weak, so other companies could challenge them in the future, especially if these competitors are willing to concede greater allowances to Facebook. Third, most of the revenues come from a small percentage of players and a small percentage of games. If these few people decide not to pay or to play games by other corporations, then Zynga could be hurting.

As to the financial statements themselves, we were pleased to see healthy profits, plentiful cash flows, and vigorous growth. Traditional financial ratios are generally good to strong. A refreshing change after the stench of [GroupOn](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/191)!

Nonetheless, we are bothered by two items in Zynga’s financial report. The firm writes much about its adjusted EBITDA, a number computed by subtracting from earnings not only interest, taxes, depreciation, and amortization, but also legal losses, stock-based compensation, and the change in deferred revenue. Almost always, corporations that extol the merits of EBITDA do so because their earnings stream is poor and their cash flows are negative. Zynga is an exception. As EBITDA is a worthless metric designed only for purposes of bolstering stock prices by firms devoid of income, we think Zynga may be harmed by its association with those of ill repute. Further, it is absurd to think that interest, taxes, depreciation, amortization, legal losses, stock-based compensation, and the change in deferred revenue have no cash flow implications. The metric is unnecessary and managers should just excise this useless section from its S-1/A.

The SEC is flexing its muscles about these extra-curricular measures. In Groupon’s case, it pooh-poohed [consolidated segment operating income](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/248) and required some excising. In Zynga’s case, the SEC wanted a de-emphasis on bookings and more focus on GAAP revenues. Ok, but adjusted EBITDA is equally as worthless as consolidated segment operating income.

Why is the SEC using precious resources to monitor these non-GAAP numbers? The Congress created the SEC in 1934 to ensure the disclosure of important information and to prevent the disclosure of fraudulent data. Non-GAAP measures are not fraudulent numbers—they are irrelevant and stupid numbers. As long as the registrant clearly marks the quantitative measures as not being GAAP, we have no problem in allowing any fool that wants to employ the numbers to have the freedom to do so, though we shall try to educate users that these measures are indeed irrelevant and unaudited and so unreliable.

The SEC misses a bigger point. We have concerns with the revenue recognition of this business entity. In its first footnote, Zynga states: “We derive revenue from the sale of virtual goods associated with our online games and the sale of advertising within our games… We operate our games as live services that allow players to play for free. Within these games, players can purchase virtual currency to obtain virtual goods to enhance their game-playing experience.” The quarterly numbers indicate that advertising is a relatively small part of the revenue stream, so one’s focus needs to be on the virtual currency purchased with real dollars.

Then the S-1 makes this curious statement:

“The proceeds from the sale of virtual goods are initially recorded in deferred revenue. We categorize our virtual goods as either consumable or durable. Consumable virtual goods represent goods that can be consumed by a specific player action. For the sale of consumable virtual goods, we recognize revenue as the goods are consumed, which approximates one month. Durable virtual goods represent virtual goods that are accessible to the player over an extended period of time. We recognize revenue from the sale of durable virtual goods ratably over the estimated average playing period of paying players for the applicable game, which represents our best estimate of the estimated average life of durable virtual goods.”

The statement is slightly changed in the S-1/A filed on August 11, but still curious:

“We recognize revenue from the sale of durable virtual goods ratably over the estimated average playing period of paying players for the applicable game, which represents our best estimate of the average life of our durable virtual goods. If we do not have the ability to differentiate revenue attributable to durable virtual goods from consumable virtual goods for a specific game, we recognize revenue from the sale of durable and consumable virtual goods for that game ratably over the estimated average period that paying players typically play our games. We determine our estimated average playing period of paying players for each significant game beginning with the time a player first purchases a virtual good. For the three months ended March 31, 2011, the estimated average playing period of paying players for our games ranged from ten to 25 months.”

What is fascinating about these statements is that Zynga is actually trying to map the virtual world of fantasy and dreams to the real world of cold cash and hard knocks. While there is a certain plausibility in trying to determine when customers make use of their enhanced game-playing skills, it is fundamentally a silly idea. How long a durable virtual good performs is a caprice of the programmers and the players. As such, any correlation between the fantasy world of Zynga game-players and revenue performance is spurious.

What this means is that Zynga is understating its revenues and its income. Not many firms have been criticized for understating revenues and profits, but those who have include large oil companies and gigantic firms like Microsoft or Wal-Mart. In those cases, managers understated revenues and earnings for political reasons; they wanted to reduce the regulatory cry for reining in the firms because they were huge and made “unconscionable” amounts of money.

In the case of Zynga, we believe that managers are scared of the risks we first pointed out. They are afraid of further pinching by Facebook, entrance by several competitors, and unfavorable actions by customers, any of which would lead to decreased earnings. So, with fantastic current revenues, managers are trying to spread some of them into the future. Investors should be wary of such gifts because, in the end, they make predictions of future performance much more difficult.

In other words, if the big bang of cash flows will be ongoing, investment bankers and analysts can discount this virtual perpetuity at some appropriate amount and obtain a huge present value for Zynga. But, if the impressive cash flows will only last a couple of years, then the value is much smaller.

The SEC seems ok with this method of revenue recognition, but we don’t understand why. Of course, it makes sense to search for those firms who are overstating revenues and earnings, for that is a greater problem to the investment community. Nonetheless, understating revenues also causes problems and we recommend that the SEC pay more attention to GAAP revenues and less attention to useless and irrelevant bookings and other non-GAAP measures.

One further note before anybody runs out to buy this stock. We agree with Robert Cyran, Christopher Swann, and Lisa Lee that there are “[Too Many Classes of Zynga Stock](http://www.nytimes.com/2011/07/07/business/too-many-classes-of-zynga-stock-reuters-breakingviews.html)”. The problem is that the common shares will not constitute control of the firm because the existing owners have created elitist classes of stock that will have super voting powers. This creation of three classes of stock will leave the present ownership in control of the firm and avoid any accountability to the ordinary shareholders. We urge financial analysts and investors to subtract out a substantial minority discount when valuing this stock.

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