**TRUST NO ONE, PARTICULARLY NOT GROUPON’S ACCOUNTANTS**

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***Grumpy Old Accountants***

“Trust no one,” was the advice given by Deep Throat to Fox Mulder in the X-Files television series. The advice seems particularly appropriate to Groupon’s accountants. Recently, much has been made of Groupon’s use of ACSOI (adjusted consolidated segment operating income) for pro-forma reporting purposes, and its [recent abandonment](http://www.bloomberg.com/news/2011-07-29/groupon-s-digestive-problems-at-sec-may-delay-ipo-former-official-says.html) of the metric in the face of SEC scrutiny. But there are greater mysteries within Groupon’s alien reports.

We previously discussed the shortcomings in the reported balance sheet, income statement, and cash flow statement, as well as complaining about ACSOI (see [Groupon: Comedy or Drama?](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/191)). We added that investors who utilized this metric were foolish but we had no wish to prevent them from experiencing the consequences of their folly (see [Should the SEC Protect Groupon Investors from CSOI?](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/248)). We expand these essays to discuss some problems in the accounting methods employed by Groupon.

No one can dispute the lack of liquidity and high leverage that drive the Altman Z into negative territory, but isn’t that why this young Company needs capital? And who can really blame the Company for trying to paint the best possible picture for itself with its ACSOI metric as it tries to sell stock, particular with its net losses and weak cash flows? What really troubles us though, is the deafening silence in the accounting, auditing, and investment communities about the Company’s questionable basic accounting practices and lack of internal reporting controls.

**Let’s start with revenue.** According to its amended S-1 financial statement notes, Groupon:

*Records the gross amount it receives from Groupons, excluding taxes where applicable, as the Company is the* ***primary obligor in the transaction****, and records an allowance for estimated customer refunds on total revenue primarily based on historical experience…the Company also records costs related to the associated obligation to redeem the award credits granted as issuance as an offset to revenue. (emphasis added)*

This means that if the Company sells a coupon for $40 promising $80 in services, it records the entire $40 as revenue, despite its having to remit 50% or more of the coupon proceeds to the merchant that actually provides the goods or services. Has Groupon really earned $40 (gross revenue recognition) or $20 (net recording, Groupon’s actual marketing commission).

What’s the big deal you ask? Only that the Company has overstated its actual revenue by 154.82% in 2010 and 178.81% in 2009. Real revenue is really what the Company reports as gross profit.

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|  | ***Year Ended December 31,*** | | |
|  | **2008** | **2009** | **2010** |
| Revenue (as reported) | $94 | $30,471 | $713,365 |
| Cost of revenue (as reported) | 89 | 19,542 | 433,411 |
| Gross profit (as reported) Real Groupon revenue | 5 | 10,929 | 279,954 |
| Revenue overstatement % | 1,780% | 178% | 154% |

The highlighted wording in the above Groupon accounting policy is key to the Company’s argument for reporting the entire (or gross) amount of a Groupon sale as revenue, and comes almost verbatim from Emerging Issues Task Force (EITF) 99-19 which lists ***primary obligor*** as only one *indicator* (not a criteria) for *possible* gross revenue reporting. And how does a coupon broker like Groupon become the primary transaction obligor? To force this accounting, the Company cleverly created the Groupon Promise, which promises customers a refund of the amount paid for the Groupon if the merchant is unable or fails to deliver the goods or services in a satisfactory manner. ***However, the Company clearly acknowledges that the merchants are responsible for fulfilling the obligation to deliver the goods and services that are sold when a Groupon is redeemed.***

So, despite what the Company says, it is NOT the primary obligor as it contends, since it is NOT the “party responsible to the customer for providing the product or service that is the subject of the arrangement” ([EITF 99-19](http://www.fasb.org/pdf/abs99-19.pdf))…the merchants are. Therefore, Groupon is not the primary obligor, but rather **a guarantor** of sorts! Oh, by the way, Groupon selectively ignored other gross revenue indicators outlined in the EITF. For example, the Company:

* Has no inventory, and consequently no inventory risk.
* Cannot set product or service price.
* Cannot change the product, nor does it perform part of the service.
* Has no discretion in supplier selection.
* Is not involved in product or service specifications.
* Has no credit risk.

If you remain unconvinced, check out SEC [Staff Accounting Bulletin 101](http://www.sec.gov/interps/account/sab101.htm) on *Revenue Recognition*, Question 10 specifically. This example mirrors Groupon’s fact pattern except that in the example, the internet company actually sells products (not coupons), and offers no “satisfaction guarantee.” Even in this case the SEC concludes that revenue should be reported NET not GROSS, since the internet company:

* Did not take title to the products,
* Did not have the risk and rewards of ownership, and
* Acted as an agent or broker.

Clearly, Groupon should report its revenue NET, not gross. And the Company’s CFO should have known better given his tenure with Amazon as a finance VP in Asia (and as an accountant with Arthur Andersen). Amazon’s revenue recognition policy clearly states:

*If we are not primarily obligated, and do not have latitude in establishing prices, amounts earned are determined using a fixed percentage, a fixed payment schedule, or a combination of the two,* ***we generally record the net amounts as commissions earned***.

So why does Groupon insist on the presentation of gross revenues? The analyst community is fixated on the “topline,” particularly for start-up enterprises, where revenue growth can signal future prospects even in the absence of real cash flows. This fixation also translates directly into inflated valuations which will benefit senior management when the Company goes public. For example, did you know that the CFO who “blessed” this revenue recognition policy received almost $9.5 million in stock-based compensation in 2010 (26.2% of the Company’s total stock-based compensation for the year)? Was this a reward for “creative accounting?” Surely, he is not incentivized to promote higher valuations! And the inflated revenue amounts also mask the huge increases in stock-based compensation for management as whole. If revenue were recorded net, stock-based compensation would be 12.93% of revenue for 2010, up over 14 times from the previous year. We can’t imagine why management would want to downplay this figure. And given the huge growth in stock-based compensation in 2010, we now better appreciate why the Company was so adamant about deducting these charges in its ACSOI metric.

But the income statement games don’t end there! We asked ourselves why Groupon made such a big deal about *acquisition related expenses* in its ACSOI measure. Well, as it turns out, these are not your classic accountant, attorney, consultant, or investment banker fees that we are used to seeing in this P&L line item. Instead, this $204.2 million amount on page F-15 of the S-1/A ($203.2 million on page F-5) represents the *correction of an estimation error* made by Groupon in calculating earn-out payments related to its CityDeal acquisition. Clearly, management’s estimation prowess, particularly for acquisitions, must be called into question.

And given the earn-out payment bust coupled with the gross revenue issue, shouldn’t we now be concerned about the valuations assigned to the 17 acquisitions done this past year? First of all, were the deals based on gross revenues? And is management qualified to do the estimates? Remember, the Company has actually admitted to an inexperienced finance and accounting staff in its S-1/A (see page 26). Clearly, investors should be concerned about the goodwill and intangible assets reported by Groupon, particularly the $172.8 associated with the CityDeal (45.3% of the Company’s total assets at the end of 2010). Impairment write-downs are likely in the near future particularly given the reported operating losses of the international (CityDeal) segment.

What else could be wrong you ask? After downplaying the ACSOI, Groupon has begun touting its 2010 free cash flow of $72.2 million (operating cash flow of $86.9 million less property and equipment purchases of $14.7 million). Unfortunately, operating and free cash flows are driven solely by the fact that Groupon is dragging its feet in remitting coupon sale payments to its merchants. Had merchants been paid in a timely fashion, the Company’s free cash flows would likely have been closer to zero and possibly even negative. Seriously, in a competitive market space, how long does Groupon believe that it can get away with a 60 day payment delay (or longer) to merchants? Merchants simply cannot stay in business by providing services (even discounted ones), two months ahead of payment. Simply put, Groupon’s free cash flows aren’t real. They come from an unusual (and likely temporary) vendor financing model, and are not sustainable.

As an aside, we are amazed that no one has picked up on all the financial reporting red flags emitted by Groupon. There is the Enron-like marketing pitch employed by Groupon:

*We aggressively invest in growth…we are always reinventing ourselves…we are unusual and we like it that way…we don’t measure ourselves in conventional ways (S-1, pages 31 and 32)*.

At least they didn’t say they were the smartest guys in the room.

Finally, there is the issue of adequate internal controls. It is absolutely ludicrous to think that Groupon is anywhere close to having an effective set of internal controls over financial reporting having done 17 acquisitions in a little over a year. When a company expands to 45 countries, grows merchants from 212 to 78,466, and expands its employee base from 37 to 9,625 in only two years, there is little doubt that internal controls are not working somewhere. Any M&A expert will agree. And don’t forget that Groupon admitted to having an inexperienced accounting and reporting staff. Note that Ernst & Young supplied an audit opinion about the financial statements but not about the entity’s internal control system. E&Y instead points out, *“We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting.”* So we ask how have these weak or nonexistent controls affected the numbers Groupon reports? Can we trust these numbers?  
  
So what needs to be done? After reading our rant, hopefully the SEC will ask Groupon to restate its financial statements for the past three years to adjust its reported revenues, and enhance disclosure about acquisition related expenses, and operating cash flows and to have an audit of its internal control system.

That’s it until we get the next Groupon amended S-1.

Additional insights regarding Groupon that affect financial reporting can be found at:

Groupon's Main Problem Is That It Hasn't Yet Discovered A Viable Business Model - <http://www.businessinsider.com/groupons-main-problem-is-that-it-hasnt-yet-discovered-a-viable-business-model-2011-8>

Groupon’s Other Funny Numbers - <http://blog.agrawals.org/2011/08/08/groupons-other-funny-numbers/>

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*