**ZYNGA’S PROFITS GET ZYNGIER**

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Zynga, Inc. filed another amendment to its registration statement. The [fourth-amended S-1](http://www.sec.gov/Archives/edgar/data/1439404/000119312511270669/d198836ds1a.htm) for Zynga involves a change in the revenue recognition, which fortuitously turns a semi-annual loss into a semi-annual profit. Ain’t accounting great!

For some reason, critics don’t like the changes. Dean Takahashi (“[Zynga’s Accounting Change Sets Off Alarms](http://venturebeat.com/2011/10/14/zynga-accounting-change/)”) favorably quotes Sam Hamadeh, “It’s a red flag when a company wants to suddenly start recognizing revenues faster.” Chris O’Brien (“[Updates to Zynga IPO Filing Provides Grist for Critics and Fans](http://www.siliconbeat.com/2011/10/13/update-to-zynga-ipo-filing-provides-grist-for-critics-and-fans/)”) critiques the reduction in the life of the virtual fixed assets in Zynga’s games, such as Farmville, but praises the managers for their greater transparency.

We think it all very funny. After all, only California can produce managers who think that virtual long-term assets have any meaning in the real world. The whole discussion is bogus as well as amusing.

As we have said before, (“[Zippy Zynga](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/235)”), Zynga’s revenue recognition policy is strange. Zynga has stated: “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.

The original S-1 included this 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 entertaining:

“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.”

More information has come out in the October 13, 2011 S-1, but essentially Zynga has just reduced the life of the so-called durable virtual goods. Big deal. After all, there ain’t no such thing as a “durable virtual good.”

The exercise is not only arbitrary, but also capricious and outlandish. As we said last time, any correlation between the fantasy world of Zynga game-players and revenue performance is spurious.

In August we pointed out that Zynga was understating its revenues and its income. We believed that Zynga’s managers were scared of the risks they faced: further pinching by Facebook, entrance by several competitors, and unfavorable actions by customers, any of which would lead to decreased earnings. What we didn’t realize was how fast these risks were going to materialize.

Zynga’s latest numbers were not so attractive, so the managers modified the life of the durable virtual goods, thereby taking a more aggressive accounting posture so they can have positive earnings. They will do it again if necessary. And who can say they are wrong? After all, the life of a durable virtual good is unauditable.

Any financial analyst worth his or her salt will forget accrual accounting as it is really cruel in this case. Follow the cash flows and forget the games played by Zynga’s managers.

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