**FACEBOOK GETS AN “A” IN FINANCIAL REPORTING
*Anthony H. Catanach Jr. and J. Edward Ketz***

***Grumpy Old Accountants, February 2012***

Facebook’s financial disclosures as reported in its recent S-1 filing should be anointed the “gold standard” for internet companies planning initial public offerings (IPOs). Had Groupon been able to see Facebook’s registration statement before its public offering, there is no telling what IPO price they might have realized…probably a more realistic one! And kudos to the San Francisco office of Ernst & Young (E&Y) who apparently really know their stuff when it comes to advising clients on internet company accounting and reporting. Too bad, Groupon picked E&Y Chicago.

So, what motivates two Grumpy Old Accountants who are notoriously stingy for giving out A’s to their students to award Facebook this grade? Simple: ***financial reporting transparency***. No games, no hype, no spin; just quality, detailed, investor-relevant disclosures not commonly found in most internet company IPO filings. Facebook even went the extra mile to report in detail the not so flattering stuff…what an interesting concept: *honest reporting*. Enough with the generalities, let’s get to the specifics, beginning with the good stuff.

Are you sitting down for this? Facebook does NOT use the term EBITDA (earnings before interest, taxes, depreciation, and amortization) or adjusted EBITDA *anywhere* in its securities filing. This suggests that the Company has absolutely no problem reporting its performance using income amounts computed using generally accepted accounting principles (GAAP). When was the last time we saw an internet company NOT make excuses about how GAAP failed to reflect reality for their operations?

If that doesn’t trip your trigger, how about this? Facebook actually recognizes revenue in a simple, straightforward manner. There are no multiple deliverable issues as in the case of LinkedIn, or the “gross vs. net” questions that plagued Groupon (see [Trust No One, Particularly Not Groupon’s Accountants](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/281)). Advertising revenue is recorded when vendor ads appear to users, or in the case of “click-based” ads, in the period a user clicks on an ad. For its payment processing services, Facebook records its negotiated fee when users make purchases from Platform developers.

And then there is the fact that Company has “real” and growing operating cash flows from its operating activities that actually exceed reported net earnings during each of the past two years. If that doesn’t bring a smile to your face, then how about the fact that Facebook’s free cash flow (FCF) definition deducts not only property and equipment purchases from operating cash flow, but also property and equipment acquired under capital leases. Yes, this is a small thing, but it suggests that the Company values good numbers, not “make believe” metrics like Groupon’s consolidated segment operating income metric (see [Groupon: Comedy or Drama](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/191)). How refreshing! Additionally, it is now crystal clear why Groupon’s investment bankers held institutional investors hostage by making them buy Groupon in order to get a piece of Facebook. The contrast between both companies is staggering.

What also got our attention is that Facebook actually appears to be making money even when using GAAP numbers. And the Company’s conservatism ratio (which compares net income before tax with estimated taxable income) yields not a hint of aggressive revenue recognition in either 2010 or 2011 with ratios of 1.05 and .95 respectively. The table below shows healthy three-year performance for both return on equity (ROE) and profit margin.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2009** | **2010** | **2011** |
| Return on Equity | 38.07% | 40.00% | 28.32% |
| Profit Margin | 29.47% | 30.70% | 26.95% |
| Asset Turnover | 0.96 | 0.96 | 0.80 |
| Leverage | 1.34 | 1.35 | 1.32 |

While the asset turnover and leverage look weak, it’s hard to complain about the financial health of a company with almost 59 percent of its assets in cash and marketable securities, and that finances its “reported” assets with 79.5 percent in stockholders’ equity. We wonder what the DuPont Model ratios would look like if the Company was allowed to report the global communication intangible assets it has created.

Still convinced we are giving away grades? How about this? Facebook’s financial statements and notes are not tainted by many of the accounting and reporting issues found in most IPOs. For example, the Company reports no “special items,” or off-balance sheet transactions, nor is its balance sheet burdened by uncertainties associated with receivable collections, intangible impairments, deferred tax asset valuations, or warranty accruals.

Now, Facebook’s “A” in financial reporting does not necessarily mean that everything is perfect. In fact, there are several questions that potential investors may want to monitor going forward, but again, the Company’s disclosures more than adequately address these issues. As with most IPOs, Facebook intends to use a significant amount of its IPO proceeds to enrich its founders and original investors. And not surprisingly, the Company’s founder and chief executive officer will retain control over the majority of voting stock, and thus decision-making. What is somewhat surprising is that Facebook decided to avail itself of the “controlled company” exemption to the NASDAQ’s corporate governance regulations. Specifically, on page 31 of its S1, the Company indicates:

*Because we qualify as a “controlled company” under the corporate governance rules for publicly-listed companies, we are not required to have a majority of our board of directors be independent nor are we required to have a compensation committee or an independent nominating function…our board of directors has determined not to have an independent nominating function and has chosen to have the full board of directors be directly responsible for nominating members of our board, and in the future we could elect not to have a majority of our board of directors be independent or not to have a compensation committee.*

We wonder why this exemption was necessary for Facebook.

The level of stock-based compensation in 2011 also caught our eye, given that it rose almost eleven-fold from 2010 despite income before tax only increasing 68 percent during the same period. Now, to Facebook’s credit, it does clearly highlight share-based compensation expense on the face of its income statement (see F-4). But any time the percentage of stock-based compensation (relative to pre stock-based compensation income) exceeds 10 percent, one must question whether management’s compensation is excessive or not.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2009** | **2010** | **2011** |
| Income Before Tax | 254 | 1008 | 1695 |
| Add: Stock Compensation Expense | 27 | 20 | 217 |
| Income Before Tax and Stock Compensation | 281 | 1028 | 1912 |
|  |  |  |  |
| % of Stock-Based Compensation | 9.61% | 1.95% | 11.35% |
|  |  |  |  |

Finally, there are the usual IPO concerns about possible financial report manipulation associated with performance pressures (i.e., growth), management control issues (i.e., CEO founder and related party transactions), and industry and market structures (i.e., competition in a new industry). In fact, the [Beneish earnings manipulation model](http://www.investopedia.com/terms/b/beneishmodel.asp#axzz1lRW1nMQb) shows only a small probability of manipulation (3.16%) driven primarily by Facebook’s rapid sales growth over the past three years. Nevertheless, the Company’s financial statements do an excellent job calling attention to most all of these risks.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **2008** | **2009** | **2010** |  | Weighted Predictor Ratios | **2010** |
|  |  |  |  |  |  |  |
| Accounts Receivable | N/A | 373 | 547 |  | Days Receivables Index | 0.7177 |
| Current Assets | N/A | 2,246 | 4,604 |  | Gross Margin Index | 0.5156 |
| Prop. Plant & Eq-Net | N/A | 574 | 1,475 |  | Asset Quality Index | 0.2828 |
| Total Assets | N/A | 2,990 | 6,331 |  | Sales Growth Index | 1.6769 |
| Current Liabilities | N/A | 389 | 899 |  | Depreciation Index | 0.1246 |
| Long-term Debt | N/A | 367 | 398 |  | Sell. & Admin. Exp. Index | -0.2231 |
| Sales | 777 | 1,974 | 3,711 |  | Leverage Index | -0.2650 |
| Cost of Goods Sold | 223 | 493 | 860 |  | Total Accruals/Total Assets | 0.1530 |
| Selling & Admin. Exp. | 292 | 449 | 1,095 |  | Constant | -4.8400 |
| Operating income | 262 | 1,032 | 1,756 |  | Value of y | -1.8574 |
| Cash Flow from Oper. | 155 | 698 | 1,549 |  |  |  |
| Depreciation | 76 | 130 | 303 |  | ***Probability of Manipulation*** | ***3.16%*** |
|  |  |  |  |  |  |  |

So, the good news about Facebook’s “A” for investors is that they can focus their attention almost exclusively on what the Company’s growth prospects are. They don’t have to worry about the reliability of reported financial statement amounts. Facebook is clearly well managed, it has a believable business model that is creating real cash flow, and the numbers make sense. The only question remaining is what cash flows this global social communication juggernaut will create in the future, and how these should be valued.

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