**GROUPON’S FIRST 10-K: LOOKING UNDER THE HOOD**

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***Grumpy Old Accountants, April 2012***

Now that we’ve recovered from the [April Fool’s Day surprises](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/593) offered up by Groupon in the form of accounting revisions and material weaknesses, we just had to dig a bit further into the Company’s numbers, and we were not disappointed! Management continues to amaze us with their aggressive and non-transparent financial reporting, as does E&Y with their continued “lapdog” auditor role.

Last time we looked at the structural issues and found a rusting body. Today we look under the hood and find the engine leaking oil and the spark plugs missing. We aren’t interested in purchasing this used car!

Let’s begin with the limited good news. Given the Company’s recent recapitalization ($744 million net), it is not surprising that Groupon no longer reports a high bankruptcy probability according to either the [traditional Altman Z model or the modified Altman Z model](http://pages.stern.nyu.edu/~ealtman/Corp-Distress.pdf) for manufacturing and nonmanufacturing companies, respectively. In fact, both models reported a decline in bankruptcy probability from 100 percent in 2010 to virtually zero in 2011.

Similarly, the Beneish earnings manipulation model yields a decline in the likelihood of earnings manipulation from 100 percent in 2010 to 23.68 percent in 2011. As with the Altman models, this “supposed” improvement is driven by the asset growth resulting from the Company’s recent IPO. It still is too high for investors and creditors to feel good.

So what bad stuff did we find? Oh, there are the usual suspects: goodwill valuations and operating cash flows. But there are some new potential minefields: income tax accounting and accounting for equity method investments. And then there are the new asset and liability valuation concerns prompted by the recently reported material weaknesses in internal controls over financial reporting. So let’s jump in.

As you may recall, we first sounded the alarm over the Company’s reported goodwill in June of last year in “[Groupon: Comedy or Drama](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/191),” expressing concern over the large intangible asset amounts being added to the balance sheet. Well, it appears that our concerns were justified after all, and that an impairment charge is imminent (it should be noted we don’t use E&Y’s impairment valuation model); indeed, Groupon probably should report the goodwill impairment now.

How do we know that a goodwill write-off is on the horizon? Simple…the international operations to which Groupon has assigned over 75 percent of total goodwill ($126.2 of $166.9 million) is operating at a loss according to Note 14 of the Company’s financial statements. To make matters worse, goodwill comprises over 18 percent of the international segment’s total assets ($126.2 of $698.4 million). So which international assets are not performing? Goodwill, of course!

And in case you missed it, in 2011 Groupon made new acquisitions in India, Malaysia, South Africa, Indonesia and the Middle East, which added $36.5 million in goodwill to the struggling international segment. Goodwill in these transactions represented over 76.5 percent of the acquisitions’ price according to Note 3 in the financial statements. Given that kind of premium, how do you think these investments will play out?

Moving on, we first voiced our concern about the quality of Groupon’s operating cash flows (OCF) in August of last year in “[Trust No One, Particularly Not Groupon’s Accountants](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/281).” At that time, we argued:

*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…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*.

We then followed this up with a challenge to Groupon’s CFO to provide more cash flow disclosure in “[Groupon CFO’s Spin Raises More Red Flags](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/530)” in February of this year. We pointed out that the Company’s “magic cash machine” was atypical of most growth companies in which operating cash flows tend to lag revenues, and even Groupon’s CFO agreed by stating “it is pretty unusual to have a business that loses money from a GAAP income perspective, but actually generates free-cash flow.”

So, what’s the problem now? Well, Groupon has no current assets that justify vendor payables being treated as traditional accounts payable. Specifically, except for $12.6 million of prepaid expenses, the balance of current assets are cash, yes, even the accounts receivables. According to Note 2 of the financial statements:

*Accounts receivable primarily represent the net cash due from the Company's credit card and other payment processors for cleared transactions*.

In most companies, accounts payable represent amounts due to vendors for inventory or services that they have sold or supplied. In Groupon’s case, however, the vendor payables do not relate to any product or service ***actually supplied*** to the Company by merchants; hence they do not create a cost to Groupon whatsoever. Instead, they represent advanced cash collections made by Groupon on behalf of merchants for whom Groupons have been sold. Clearly, these are some type of payable, but the question is whether they are *operating or financing cash flows*.

Being grumpy AND old, we were taught that OCF generally is the amount of cash a company generates from the revenues it brings in, excluding costs associated with long-term investment on capital items or investment in securities. In short, operating cash revenues less operating cash expenses! Merchant payables create no future revenue or expenses for Groupon; so, including merchant cash flows collected as operating cash flows is simply ludicrous! Instead it is like a note payable, a financing cash flow. By the way, the Company acknowledges reliance on merchant payables as a necessary funding (aka financing) source in its risk disclosures on page 20 of its 10K:

*If we offer our merchant partners more favorable or accelerated payment terms or our revenue does not continue to grow in the future, our operating cash flow and results of operations could be adversely impacted and we may have to seek* ***alternative financing*** *to fund our working capital needs. (****emphasis added****).*

Therefore, we propose using “adjusted” cash flow metrics (Groupon should love this) to analyze the Company’s real operating cash flows and free cash flow (FCF), that excludes the effect of merchant payables, which are clearly financing cash flows.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2009** | **2010** | **2011** |
| Reported OCF | 7,510 | 86,885 | 290,447 |
| Merchant Payable Adjustment | (4,305) | (149,044) | (380,108) |
| ***Adjusted OCF*** | ***3,205*** | ***(62,159)*** | ***(89,661)*** |
| Purchases of Property & Equipment | (290) | (14,681) | (43,811) |
| ***Adjusted FCF*** | ***2,915*** | ***(76,840)*** | ***(133,472)*** |

So, when merchant payables are correctly excluded from operating cash flows, Groupon’s reported cash flow picture dims significantly. The Company’s operations are really burning up cash, not creating it!

Next, we turn our attention to the Company’s income tax accounting. We find it very curious that Groupon pumped up its valuation reserve for deferred tax assets by $72.3 million (actual expense was $92 million according to Schedule II-Valuation and Qualifying Accounts) in 2011 with little or no discussion as to why in either the MD&A or the financial statement notes. We know why! This is the first of two earnings charges the Company will be forced to take since it is losing money, with no foreseeable prospects of generating taxable income against which deferred tax assets can be used. To discuss the current year income tax charge, the Company would have had to admit how bleak its future prospects are! Ceteris paribus, next year’s income tax asset valuation adjustment will be $112.9 million, i.e., 2011’s net deferred tax assets.

What does Groupon do if its own operations are losing money? Invest actively in other losing ventures, of course. In 2011, the Company’s two new equity method investments, Restaurantdiary.com and GaoPeng.com, added $26.7 million in losses. These are worth mentioning because if Groupon held true to form with its international acquisitions, it also paid an excess premium (goodwill) for these two, which GAAP allows to be “buried” in the $50.6 million investment reported on the balance sheet. Given the operating losses of these two investments, can an investment impairment charge be far behind?

Let’ now turn to leases and purchase obligations. As so many companies do, Groupon hides behind feckless GAAP standards that allow the debts to be off-balance sheet. We shall adjust the balance sheet and the income statement to report these liabilities properly. (See [CVS CareMark](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/550) for an example of how to do this.) These adjustments add $135 million to the liabilities of the firm. It reduces income by $4 million and retained earnings by almost $35 million (the additional amounts are due to prior year effects).

If we put together the capitalization of the lease obligations and the purchase obligations and the goodwill impairment that we think Groupon should acknowledge, we can recast the balance sheet as follows (again, Groupon managers should love the adjustment process!):

|  |  |  |
| --- | --- | --- |
|  | **As reported** | **As adjusted** |
| Current assets | $1,323,327 | $1,323,327 |
| Property and equipment | 451,149 | 427,429 |
| Total assets | $1,774,476 | $1,750,756 |
|  |  |  |
| Current debts | $ 995,162 | $1,035,211 |
| Long-term debts | 78,194 | 175,433 |
| Shareholders’ equity | 701,120 | 540,112 |
| Total equities | $1,774,476 | $1,750,756 |

We note in passing that the debt/equity for the reported 2011 numbers is .60, but for the more realistic adjusted numbers, it is .69. Groupon has a lot of financial leverage and thus a lot of financial risk.

Finally, we wanted to leave you with one last cheerful thought…remember the material weaknesses over financial reporting? Well, how confident are you now that the Company has or ever will appropriately record liabilities for its reward programs, refunds, unredeemed Groupons, merchant liabilities and litigation contingencies, all of which require assumptions and judgment? We aren’t either.

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