**DOES FACEBOOK STILL DESERVE AN “A” FOR ITS FINANCIAL REPORTING?**

***Anthony H. Catanach Jr. and J. Edward Ketz***

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In our February essay “[Facebook Gets an ‘A’ in Financial Reporting](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/519),” the two of us discussed what we liked about the firm’s S-1 filing. We felt that Facebook demonstrated financial reporting transparency and didn’t attempt to buff up earnings with any nonsense about EBITDA or similar metrics. Revenue recognition seems simple and appropriate. Operating cash flows are reasonably reported and healthy. We did not detect any special items, off-balance sheet transactions, or puffery. Further, the Beneish model revealed a very low probability of accounting “manipulation.”

Facebook recently issued its stock, and it ain’t going well. During the first full day of trading, “[Investors Pummel Facebook](http://online.wsj.com/article/SB10001424052702303610504577417911775222058.html),” as the *Wall Street Journal* called it. The stock price dropped an amazing 11 percent that day. It lost another 9 percent on the second day.

Several readers are asking us if we want to retract our previous column. They seem to interpret the plunging stock price as evidence that something is wrong in the accounting—that the firm’s financial reporting is not what it should be or lacks transparency.

The answer is that we still hold our opinions as expressed in February. The way to understand the accounting and the current stock price movements is to be sure to distinguish financial statement analysis from valuation. While there is clearly a relationship between the two, as the efficient markets hypothesis asserts, the relationship is by no means automatic or always rational. That’s because, for whatever reason, the stock market tends to overreact to news.

The stock market tends to overreact to unexpected good news by bidding up the price of common shares too high. A good earnings report should drive up the prices to some new equilibrium, but when it goes too high, there are opportunities to cash out one’s profits. Similarly, the stock market tends to overreact to unexpected bad news by driving down the price too far. For example, a bad earnings report can lower prices too much, thereby creating buying opportunities.

One must separate accounting and reporting issues from investment decisions. One should employ financial statement analysis to assess an appropriate equilibrium price. Investment decisions then focus on whether the stock is under-priced or over-priced.

What may now be going on with Facebook is that investment bankers and Facebook managers overhyped the stock. They may have oversold its value. The market has responded by suggesting that the initial price was too high.

What is happening in the market does not change our opinion. Facebook’s accounting and financial reporting appears fundamentally sound. We remind the reader, however, that we did point out two issues raised by the registration statement, and they remain concerns.

The first is with the corporate governance structure. Facebook utilized a “controlled company” exemption so that it does not have to have a majority of independent directors. This is troubling because truly independent board directors are needed in today’s world to rein in potential managerial excesses. Without such controls, managers are not so easily monitored.

The second concern is that stock-based compensation is relatively high. When an entity has a lot of stock-based compensation, we realize that managers may have perverse incentives to use accounting shenanigans to drive up stock prices merely to enrich themselves.

In conclusion, yes, we still give Facebook an “A” at this time for its financial accounting and reporting. But we also completely understand the market’s reaction in adjusting prices given all of the IPO hype.

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