THE WALL STREET JOURNAL.
WSJ.com

TECHNOLOGY | JULY 28, 2011

Groupon's Accounting Lingo Gets Scrutiny

By SHAYNDI RAICE And NICK WINGFIELD

Groupon Inc. has attracted scrutiny from regulators over a newfangled accounting metric it is using to market itself to investors ahead of its initial public offering, said a person familiar with the situation.

The Securities and Exchange Commission has asked Groupon to answer questions about the unusual measure it invented, which paints a more robust picture of performance by excluding marketing and other expenses, this person said.

There is a growing back-and-forth between the SEC and Groupon's over their accounting for marketing costs. Heard on the Street's Rolfe Winkler explains how this issue may affect the company's IPO. (Photo: Getty Images.)

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The company's IPO, expected this fall, is one of several multibillion dollar technology offerings teed up for this year. Some of those companies, which are unprofitable, also highlight creative ways to measure their businesses.

The financial gymnastics harken back to Silicon Valley's late 1990s dot-com boom, when companies introduced terms like "eyeballs," or the number of people visiting a website, to reinforce how much traction they had with consumers, even if the start-up had no revenue.

John Coffee, a professor at the law school at Columbia University, said the SEC has become more cautious about using nontraditional metrics after the dot-com bubble and subsequent bust. "The more we get into a bubble, the more we have analysts wanting to use numbers giving a sense of momentum," said Mr. Coffee. "In social media, there are signs of a bubble and that creates some nervousness at the commission."

SEC spokesman John Nester declined to comment specifically on Groupon. He said the agency's "staff currently reviews all IPO filings, and an average range from filing to effective date might be three to six months."

Groupon, whose IPO is expected to value the company at $20 billion, has highlighted in regulatory filings something it calls "adjusted consolidated segment operating income," or adjusted CSOI. Investors and analysts said that draws attention away from marketing costs, which are causing the company to hemorrhage money.

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While it isn't unusual for companies to use nonstandard financial measurements, Ben Strubel, a portfolio manager with Strubel Investment Management, a money management firm in Lancaster, Penn., says he has "never encountered" the one Groupon is using. "In essence Groupon is asking investors to look at their profit before any expenses," says Mr. Strubel, who doesn't plan to invest in the IPO and has no intention of shorting the stock. "It's not a surprise they want investors to focus on measures that don't include expenses since their expenses have been rising."

Groupon's adjusted CSOI is one of several nonstandard growth metrics that have increasingly come to prominence along with the new set of Internet companies.

Internet games maker Zynga Inc., in its July IPO filing, used a metric called "bookings." The term reflects the total amount of revenue from Zynga's two main businesses—the sale of virtual goods and ads—if it had recognized all of the revenue immediately at the time of a sale. Facebook Inc., the fast-growing social network, occasionally discloses MAU, or monthly active users.

Facebook hasn't filed to go public, and it is unclear whether it would use the MAU figure in regulatory filings. A person familiar with the matter said the SEC hasn't questioned Zynga's filing.

Pandora Media Inc.'s first IPO filing included total listener hours and total registered users as "key indicators of the growth of our business," though the Internet music firm cautioned that the total users figure was an imperfect measure.

The SEC allowed Pandora to keep the terms in its prospectus, along with a measure called "total active users" that was added in its fourth amendment. The original prospectus was amended six times before Pandora went public last month. Such amending is common.

Groupon, a 2 ½-year-old Chicago-based company, has grown at a torrid pace with its approach of selling daily deals to consumers in partnerships with local merchants. But it has been racking up losses as it spends heavily on marketing to acquire customers.

Groupon's IPO filing says that adjusted CSOI gives investors a look at the company's performance by excluding "expenses that are noncash or otherwise not indicative of future operating expenses."

Groupon said it generated $81.6 million in adjusted CSOI in the first quarter of 2011, though if marketing costs are taken into account that figure would be a loss of $98 million.

To address concerns over adjusted CSOI, Groupon filed an amendment on July 14 to its initial SEC filing. In that amendment, Groupon clarified the metric "should not be considered as a measure of discretionary cash available to us to invest in the growth of our business or as a valuation metric."

Instead, the company said investors should look at standard financial metrics such as cash flow, net loss and others when evaluating its performance.

Groupon plans to file another amendment to address the SEC's concerns over adjusted CSOI and still aims to go public in mid-September, said people familiar with the matter.

CNBC earlier reported the SEC was reviewing Groupon's accounting metrics.

The flap over adjusted CSOI is the latest issue Groupon has run into during the regulatory period before its IPO. Eric Lefkofsky, a Groupon co-founder who is now executive chairman, was quoted by Bloomberg News as saying that "Groupon is going to be wildly profitable" just three days after the company filed for its IPO.

Speaking publicly about the financial projections of a company that has filed to go public is restricted by the SEC.

In its July 14 amended filing, Groupon said Mr. Lefkofsky "requested that the statement not be published. The reported statement does not accurately or completely reflect Mr. Lefkofsky's views and should not be considered by prospective investors in isolation or at all."

Lou Kerner, an analyst with Wedbush Securities who covers privately held Web firms, said he believes the new metrics like adjusted CSOI aren't unique to Web companies, but are part of the regular course of how businesses evaluate themselves.

"This is more art than science and it's ever evolving," he said, noting that earnings before interest, taxes, depreciation and amortization, or Ebitda, a regularly used metric of cash flow, was once unknown. "Smart investors should look at the metrics they want, not the numbers that a company shoves in your face."

—Michael Rapoport
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contributed to this article.