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"Are Initial Public Offerings a License to Steal from the Unsophisticated Investor?"—An Analysis of the Facebook IPO Debacle and the Class Action Lawsuit…

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Abstract: Wall Street recognizes one size only….extra large….when it comes to earnings, profits, growth and Initial Public Offerings. Perhaps that is what initially attracted the unsophisticated investors in unprecedented numbers to the Facebook IPO. Ironically, the unknowing investors' confidence was immediately shaken when the shares failed to meet projected price targets and, the stock actually tumbles instead of rises. The deceptive valuation and pricing practices, that are rampant in the IPO and investment analysts' arena, was successfully orchestrated during the road show that Facebook insiders participated in just prior to the May 2012 stock debut. The tale as told by the Facebook insiders just prior to the IPO stock sale at $38 per share appears to be a fairy tale and is currently the subject of an SEC investigation. Wall Street unfortunately has a very short memory. History is continually repeating itself as the lessons learned from corporate fraud and malfeasance is immediately forgotten whenever opportunity for new wealth arises. Is it greed, ignorance or inflated egos that continually drive the desire of investors to buy an IPO at any price regardless of the long-term consequences?

Key words: IPO; social media; financial statements
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1. Introduction

The company known as Facebook or "FB" to Wall Street aficionados, has attracted youthful users, financial trendsetters, creative advertisers and mainstream America because of the dream come true story behind the founder of the company. A college student, who created a multi-billion dollar company inside a dorm room at Harvard, becomes an overnight success story. Yes, it is apparent, dreams do come true and every investor wanted to grab a piece of the magical dream when the opportunity was made available on May 18, 2012 at $38 per share. But why did so many people want to buy Facebook or FB as it is now known? Were these investors aware of how the $38 IPO price was set? Would these investors have been as anxious to buy the stock if they were informed of a

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potential problem with the future estimated sales growth projections? Was the proverbial wool pulled over the eyes of the naive investor by a wolf in sheep’s clothing by the name of Mark Zuckerberg? Could the dream of becoming a millionaire by investing in FB be, in reality, does the elite of Wall Street perpetrate a fraud on the unsophisticated investors?

The lurid headlines of the past few years highlighting the avalanche of hearings, lawsuits, arrests, and trials has created an aura of suspicion focusing on the “fictitious” reporting of financial value should have served as a warning to the eager investors anxious to buy the FB IPO. Wall Street, major corporations and the media are all major players in this deceptive practice of creating value where in reality there is none.

2. Is There a Problem with Social Media IPOS?

The consequences of earnings manipulation and irresponsible financial reporting and the resulting impact on the accounting profession and the economy through IPO debacles has eroded the already problematic reputations of the public accounting elite. Firms like Ernest & Young and Deloitte have been linked unfavorably with recent questionable earnings projections of some newly minted IPO’s (McKenna, 2012). The concept of manipulated earnings is currently seen as a “fait accompli” by the sophisticated investing community but not to the unsuspecting unsophisticated investor.

The FASB has wrestled with the issue pertaining to revenue recognition of social media companies and has chosen to rely on SAB 101 as the fallback strategy (Chittum, 2012). Rather than design new revenue recognition rules aimed at the social media industry they have in essence abdicated their role and assigned the job to the “biased” management of the companies in question. The accounting profession has acknowledged the complexities involved in accurately pinpointing the exact timing of when social media earnings are earned in accordance with Generally Accepted Accounting Principles or GAAP and therefore uncertainty remains the prevailing mindset. The fact that reliable earnings recognition, a premise that is one of the most essential fundamentals of accurate financial statement reporting is of great concern to the social media reporting process further complicates the IPO valuation process.

In essence, the primary source of value for social media companies like Facebook, Zynga and Linkedin is future revenue streams (Borchardt, 2012). These companies balance sheet lack any real value other than cash and retained earnings or profits. Add to the mix ambiguous assets like goodwill and you have a valuation nightmare.

Ironically, the independent auditors are not asked to issue an opinion on the IPO stock valuation, a step in the IPO process that one would think would be a requirement to assure fair reporting standards. The primary reason why the independent auditors fail to express an opinion on the fairness of the IPO’s price is because it is not based upon reported financial statement numbers, but rather projections of future earnings, which the auditing profession accurately recognizes as impossible to render an opinion upon. So what do investors of IPO stock really look for when deciding whether the IPO price is fair? It appears they rely on the “horse and pony show” created by public relations experts rather than the information presented in the voluminous registration statements.

A further indication of the problematic IPO situation is the fact that foreign companies are now attempting to have as many of their IPO’s issued in the United States because of the perceived lack of regulation by the governing bodies (Davidoff, 2012). The international investment community is increasingly aware that the American IPO market is where you file if you want to avoid regulation (Davidoff, 2012).

The attraction to a US IPO debut, in part, is related to the opportunity to issue dual-class voting stock, which the SEC allows and many international markets do not. Additionally, international companies do not need to comply with US based GAAP rules, viewed to be more restrictive than the international reporting standards (Davidoff, 2012). The overwhelming amount of failed international IPO's in recent years is serving to undermine the credibility in the international investment community leading many astute investors to conclude the American IPO system is as flawed as their foreign counterparts.

This premise is clearly evidenced by the erosion of confidence in Chinese emerging growth companies introduced on the US based IPO market after their admissions of *accounting problems* in their reports (Moscovitz, 2012). Unfortunately, over 93% of the value of these same companies, have fallen since their IPO debut (Moscovitz, 2012).

3. The Problem with the IPO Pricing Model

There are three major problems associated with fairly pricing an IPO for price (Moscovitz, 2012):

(1) Revenue recognition issues and forecasted earnings

(2) Lack of an Internal Control Effectiveness opinion

(3) Lack of Independence of the Auditor

Perhaps the reason potential investors fail to analyze the prospectuses of IPO's prior to acquiring their stock is because the process is akin to a required school's summer reading list with War and Peace and The Odyssey as the only selections. The process is both time consuming and boring. Instead the investors chose to rely on the hype for their sources of reliable information, much to their chagrin of late.

The FB prospectus is replete with all sorts of numbers, which tell a completely different story from the headlines in the financial papers. FB had earnings per share or EPS of 47 cents (vs. 28 cents in 2010) and a book value of $2.00 per share (Fidelity, 2012). Whether these numbers support a $38.00 IPO price is questionable at best. In addition to the disappointing numbers the quality of the balance sheet assets are disturbing as well. FB's primary asset is CASH, they have very little other assets, which leads one to conclude the FB financial structure has a weak foundation. There is very little debt, but without assets that have the potential to create future value for the stockholders, what in essence are stockholders buying?

Issue 1: Future revenue recognition as a primary valuation guide

Future revenue streams coupled with prior reported earnings appears to be the pricing model in place for the social media IPO stock valuation process (Pepitone, 2012). That idea would be only slightly acceptable if it were not for the fact that the future s impossible to predict. That fact is clearly illustrated by the fact that a major revenue provider, General Motors, cancelled their multi-million dollar advertising contract just prior to the FB IPO debut (Armstrong, 2012). This reminds us of the old cautionary tale of "don't count your chickens before they hatch."

Apparently, the social media IPO pricing model has chosen to ignore that time honored adage. Additionally, some FB insiders were concerned that the projected revenue stream could fall short of expectations, thus damaging the FB IPO pricing strategy (McKenna, 2012).

Whether FB's $38 initial public offering price was fair remains to be seen, but the process in which it was established is rife with problems (Chambers, 2012). If the value of the IPO stock's debut price is based upon questionable historic earnings in light of the revenue recognition issues and, future revenues, which are impossible to verify, the pricing model of social media IPO stock issues are doomed for failure (Leone, 2009).

Issue 2: Effectiveness of internal control not addressed

The prospectus should be the primary source of reliable financial information pertaining to an IPO. As these companies were private prior to their IPO debut, the prospectus is the first time the company was mandated to comply with the Securities and Exchange Commissions or SEC requirements pertaining to publically traded securities (Armstrong, 2012). The SEC requires that all public companies issue an annual report that includes all the financial statements, the GAAP methods applied in the notes, an opinion on the effectiveness of the internal controls (both management and auditor) and most importantly, an opinion from an independent auditor on the fairness of the financial statements included in the report. Ironically, the requirements for the IPO do not include all the requirements of an already public company (McKenna, 2012).

For example, the prospectus does not include an opinion on the effectiveness of the internal control, in other words known weaknesses in IPO’s internal control systems are not reported (McKenna, 2012). Companies would not be required to disclose said weaknesses until their first quarterly filing with the SEC filing the IPO’s debut. This is extremely disconcerting given the problems associated with Enron and their ineffective internal control issues which ultimately culminated in the 2002 Sarbanes-Oxley legislation (Leone, 2009).

Newly minted IPO companies being exempt from this requirement undermines the entire reporting process for the entire valuation procedure. Ineffective or weaknesses in an internal control system have been historically linked to fraud, financial statement reporting errors and undermines the credibility of the entire reporting process. Private companies, previously exempt from the internal control scrutiny process, should be required to inform the investment industry of known weaknesses prior to the issuance of the stock in order to provide the adequate disclosure mandate for all publically traded companies.

Once a private company enters the public arena, they should be required to abide by the same rules established by the SEC to ensure the investing community, are, fully informed. If auditors of publically traded companies are required to issue an opinion on the effectiveness of the internal control system of the company in question, that same requirement should be in place for the IPO valuation process (Leone, 2009).

Issue 3: Lack of independence of the auditor

Independence of the auditor is another issue undermining the credibility of the IPO prospectus reporting process. Prior to the introduction of the shares, public accounting firms are not held to the same rules as the public auditor pertaining to independence. The privately held company can have the same accounting firm provide both management advisory services and auditing, a once sanctioned practice has now become akin to a criminal offense as a result of the Enron-Arthur Andersen debacle of the 2000’s (McKenna, 2011). Publically traded companies are no longer allowed to have the same accounting firm provide both management advisory and auditing services as they have been deemed to be in conflict of one another and in essence erodes the independence factor so tantamount to the value of the auditors opinion. If this requirement is in place for publically traded companies, the same requirement should be established for the pre-IPO process. If an accounting firm has in essence guided the private company toward their goal of public, they should be prevented from issuing the financial statement opinion for the same reason: lack of independence (McKenna, 2012).

Apparently, this issue, has been a focal point of discussion, pertaining to the IPO valuation problems of Zynga, Groupon and most recently Facebook and the role Ernest & Young played in the pre and post IPO process (McKenna, 2012). The lack of independence of the provider of financial reporting is at issue at all times as the responsibility for the financial statements rests with a biased party, the management team. The independent auditor’s opinion is required to mitigate the known biases of the reports. If IPO’s are permitted to circumvent the reporting process rules mandated to correct weaknesses in the auditing process, the prospectus cannot be viewed as a legitimate financial report.

4. The Truth after the IPO Debut

Interestingly, many companies are forced to in essence “fess up” to the truth about the financial statements only *after* their companies have gone public. Groupon’s management admitted in December 2011, that their internal controls were not effective due to materially weaknesses in their system (Moscovitz, 2012). Additionally, the company issued revised earnings for the fourth quarter of 2011 in March 2012. This revelation will not be classified as a restatement of earnings because as an IPO, Groupon had not filed financial statements with the SEC prior to the announcement, only a prospectus. The fourth quarter disclosures made by Groupon were deemed pro forma disclosures and therefore not subject to the rigors of GAAP as applied to a public entity. What is so problematic about both of these issues is that Ernst & Young, the company’s auditor, never disclosed the information to the stakeholder’s because of the inconsistency in the reporting requirements for a public company vs. an IPO. The role of the public accountant is murky at best given these conditions.

The Ernst & Young auditors may not have had a legal obligation to report the major deficiencies in Groupon’s Internal Controls, but most would argue they had a moral obligation to disclosed that information. Additionally, Groupon’s Management Discussion and Analysis Section, or MD&A, should have included a reference to the major weaknesses.

Groupon, known by their trading symbol GRPN, debuted on November 4, 2011 at $20.00 per share and closed at $26.00 at the end of the first day of trading. The stock had risen as high as $31.14 but is currently trading near its low of $8.52. The cause of the wild fluctuations are in part, due, to the disturbing revelation that Groupon had seriously underfunded their coupon reserve causing materially misstated earnings for the 4th quarter 2011. That revelation resulted in a $42.7 million loss to morph into a $506.5 million loss. Additionally, Groupon has been on a buying spree acquiring a total of 17 companies, which accounts for any sales growth not being internally generated growth, but merely growth by acquisition. Furthermore, Groupon reported EPS of ($1.40) and a matching deficit in retained earnings of ($698,704) in December 2011 compared to ($419,468) in 2010. The 73% decline in the stock valuation from the $20.00 IPO to the current $8.52 value is better understood in relation to the disappointing financial statement numbers. How the $20.00 IPO price was established is clearly problematic and this issue is made more apparent by the on-going class action suit filed pertaining to alleged violations of the Federal Securities Regulations.

Another IPO disaster, Zynga, debuted on the IPO debutants ball in 2011 at a $10.00 price and quickly fell to the $5 dollar range, where it currently trades in July 2012. As in the case of the other IPO companies, the financial statements reveal a story far different from the tale spun on the IPO stock selling tour. Zygna has a reported deficit in retained earnings of ($394.09) for 2011, an issue obviously not highlighted during the stock promotion tour.

The only IPO that appears to have been successful in the social media group is Linkedin. The stock debuted in May 2011 at $45.00 and quickly rose to $94.00 by the close of the first day of trading. Linkedin has managed to maintain that inflated value, currently trading at $104.52 in July 2012. Interestingly, an analysis of the financial statements reveal that Linkedin reported an 11 cent EPS in 2011 compared to 17 cents in 2010 and a book value of $5.96 at December 31, 2011. Whether these numbers support the current stock price remains to be seen.

5. The Case for a Class Action Lawsuit

A law called Regulation and Fair Disclosure requires that publically traded companies release information to all investors at the same time, and as such, prohibits insider trading or trading based on an insider's advantage (Pritchard, 2012). Ironically, the same rule does NOT apply to a company in the process of introducing their company for an IPO sale. Technically, the IPO Company is a privately held company prior to the sale of the securities, and as such, does not need to abide by the same law. The rule guiding IPO's is disclosure of information pertaining to the prospectus of the company. The guideline establishes that a company may not present information to potential investors that are in conflict with the information as presented in the prospectus. But, ironically, oral communication is not covered by that requirement so any IPO management team can say whatever they want orally without fear of a lawsuit (Chittum, 2012).

In the case of the most recent IPO debacle, Facebook has been the target of over 40 lawsuits stemming from the May 18, 2012 stock debut (Pepitone, 2012). The issues are complex and range from problems with a "technical error" on the Nasdaq Exchange to an assertion that a privileged group of Facebook insiders were privy to the selective disclosure of problematic financial information not made available to everyone (Pepitone, 2012). The selective disclosure assertion states that a problematic outlook was disclosed to "big banks" ahead of the IPO debut (Pepitone, 2012). The lawsuit claims that issues relating to FB's mobile revenue problems were discussed with a select group of insiders and that FB updated their prospectus concerning these issues in a less than straightforward manner for the rest of the public. In response, FB has emphatically denied any wrongdoing claiming that "there wasn't any desire to obfuscate or hide information" (Pepitone, 2012).

Additionally, a securities fraud lawsuit filed in New York alleges that even though Facebook's prospectus included 23 pages of risk factors, the complaint alleges that the company made misleading statements and omitted material facts (Greenwald, 2012). The fraud lawsuit asserts further that the Facebook IPO documents were not prepared in accordance with Federal rules and regulations governing their preparation and as such violated Federal Securities Laws (Greenwald, 2012). Furthermore, lawsuits have been threatened relating to the last minute increase in the number of shares in the offering, which in essence tripled the size of the issue at virtually the last moment. The fact that Facebook insiders failed to widely disclose their projections for greatly reduced earnings in 2012 is their biggest problem because it goes to the heart of transparency which undermines their defense in the court of public opinion (Greenwald, 2012). The shareholders of Groupon have filed a similar suit alleging Federal Securities law violations citing similar financial statement distortions.

The FB lawsuit alleges that certain documents filed with the SEC prior to the IPO offering lacked the necessary relevant information required pertaining to revenue forecasts (Gilman, 2012). The primary area of concern related to the realization that a severe and pronounced reduction in revenue growth, due to an increase of Facebook users' adoption of mobile devices to access information in place of the traditional PC process, was problematic to FB's future revenue growth.

6. Conclusion

The Initial Public Offering market is viewed by many naive investors as an opportunity for dreams to come true. The dream of buying the IPO and having the stock become the next Federal Express or Apple Computer looms large in many investors thought process. The reality of the IPO story tells a far different tale. Most of the recent social media IPO's have been viewed as a nightmare instead of a dream come true. Falling prices, restated earnings, inflated sales projections and problematic internal control systems provide the truth behind the distorted picture painted by the insiders of the IPO story line. Investors should be aware of the cautionary tale told by the Facebook, Zygna and Groupon IPO debacles and look for less risky venues to provide them with their fairy tale endings. Perhaps a trip to Las Vegas is a better route, at least the odds are only 51% for the house and no one knows the odds when betting on an IPO.

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