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TECH 8/14/2012 @ 8:11AM | 9,041 views

## Memo to SEC: End Groupon's Shady Accounting

Groupon (GRPN) has a troubled



business model that it tries to cover up from time-to-time

*groupon (Photo credit: Sean MacEntee)*

with shady accounting. While competition should force Groupon to fix its business model, the SEC should clamp down harder on Groupon for its dodgy accounting practices.

Before getting into those, Groupon's latest quarterly earnings report looks like a disappointment to investors. After all, Groupon's stock tumbled nearly 23% after it announced

earnings Monday – if the stock opens trading at \$5.85, it will mark a 78% decline from its November 2011 high of \$26.19.

Why the plunge? Its more profitable daily deals business sagged while its less profitable “Goods” line of selling discounted goods soared, reported the [\*Wall Street Journal\*](#). Groupon reported that the Goods business is on track to generate \$200 million in annual revenues while its gross billings – the amount it collects from customers – fell 4% to \$1.29 billion from 2011’s second quarter.

And while Groupon reported better than expected earnings, its reported and forecast revenues fell short. Its net income of 4 cents a share beat expectations by a penny; its revenues were up 45% to \$568 million – 1% lower than expected; and its expected third quarter revenue range between \$580 million to \$620 million was considered a disappointing 2% to 9% increase from the second quarter, according to the [\*New York Times\*](#).

But this report marks the third time in its brief history with public markets that Groupon has stepped into territory that makes analysts uncomfortable with its accounting. That’s because the Goods business does not report the

share of the merchandise payments that it receives — just the gross amount that customers pay for the merchandise, according to the *Times*.

What is going on here is a simple effort to hide the true economic picture of its Group business. After all, if you're a distributor and a customer buys a suit off your rack, you get the \$400 in cash that the customer paid you but you don't get to keep that. Instead you pass on, say, \$320 of that to the factory that made the suit. Your cut as a distributor is \$80 not \$400.

According to [Reuters](#), Goods takes on inventory risk — getting a discount for buying products in bulk and selling them to consumers at a higher price. By contrast, in its daily deals business, Groupon acts as an agent between merchants and consumers. Going back to that suit example, Goods would report revenues of \$400 on that suit; whereas Groupon's daily deals business would count only its cut — between \$80 and \$160.

Groupon's reasoning for reporting on Goods this way is decidedly unconvincing. In its conference call, Jason Child, Groupon's CFO, claimed that accounting just for Groupon's share of those sales would “give too much information to competitors about its business costs,” reports the *Times*.

But I wonder –SEC are you listening? – whether Groupon is merely trying to hide from investors just how skimpy its Goods margins are.

Fortunately, the SEC finally got Groupon to stop reporting its Adjusted Consolidated Segment Operating Income in 2011 – probably with help from [Eric Savitz](#). And in March 2012, it revised fourth-quarter results and admitted to a “material weakness” in its financial statements, according to [Reuters](#).

As for Groupon’s business strategy, I [wrote last June](#) that it leaves much to be desired. After all, some small businesses end up getting flooded with customers who redeem their Groupons – plunging service quality to its regular customers and yielding nothing in the way of repeat customers who would help those businesses smooth over periods of low demand.

And for consumers, the novelty is wearing off. According to the *Times*, “coupon buyers often fail to exercise their impulse purchases and become less inclined to purchase more.”

Furthermore, Groupon suffers from the high costs of the [disloyalty effect](#). That is, merchants are unhappy that they have lost money on Groupons so they do not renew their contracts. This puts pressure on Groupon to spend more

money to replace those unhappy customers — and its sub-stellar reputation makes the cost of adding those new customers much higher.

Not only that, but Groupon can't stop competitors. And both Amazon.com (AMZN) and Google (GOOG) started their own deals businesses and they excel at applying data analysis techniques to target offers more effectively, according to the *Times*.

If there is any way to create value for merchants in the daily deals business, these competitors are likely to find it and cost Groupon its market share. But as far as letting Groupon get away with shady accounting, it's up to the SEC to get serious about cleaning up its practices.

The SEC should be thinking, fool me once, shame on you; fool me twice, shame on me.

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