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3Qs: Figuring out Facebook's financials

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Following much anticipation, Facebook filed for an initial public offering (IPO) after U.S. markets closed on Wednesday. Reports have speculated that the social media giant's offering — pending approval from the Securities and Exchange Commission (SEC) — could top rival Google Inc.'s 2004 IPO, which holds the record for the largest U.S. Internet IPO, raising $1.9 billion at a valuation of $23 billion. Northeastern University news office asked David Sherman, professor of accounting in the College of Business Administration, to analyze Facebook's IPO prospectus and explain what it reveals.

Facebook's IPO is the first significant look for the public and investors into the social networking giant's financial statements. What has it revealed?

Above all, it confirms that Facebook is a very strong, profitable company, with revenues of $3.7 billion in 2011 — more than 450 percent of its 2009 revenues and almost double those in 2010. Net income has also grown at a similar pace, reaching $1 billion in 2011. Facebook's financial situation is in sharp contrast with that of Renren, commonly referred to as the Chinese Facebook, whose IPO in 2011 showed a small loss in a recent quarter, or Zipcar, whose recent IPO prospectus reported accumulated losses of $32 million over the past three years.

Facebook's IPO also revealed details of its cost structure and revenue stream. Facebook is one of the remarkable companies in that once its platform was built, it encountered only modest service costs associated with growth in revenues, much like Google, LinkedIn and many software businesses. While much of Facebook's revenues come from advertising, a large part of the non-advertising revenues come from computer gaming revenues from users of Zynga, another 2011 IPO that reported strong revenues and profits.

One interesting component of Facebook's IPO filing was the inclusion of a letter from founder Mark Zuckerberg, detailing his motivation for the company. Zuckerberg noted, "we don't build services to make money; we make money to build better services." The entire letter is unusual, though Facebook is proceeding in a traditional route, unlike Google, which auctioned shares for its IPO.

What questions about Facebook’s performance still remain?

The company’s valuation has not been disclosed, but is speculated to be between $80 billion and $100 billion. The strength of Facebook’s business is impressive, but the question—whether this valuation of 80 to 100 times earnings offers attractive future appreciation and the implications for future growth—is one that investors will need to grapple with.

Additionally, Facebook’s 800 million members are an incredibly valuable asset that does not appear on its balance sheet. Facebook’s financials cannot answer questions such as whether the membership could grow, or whether Facebook could increase the time spent by each user on its site and/or find new services that will support the growth in advertising and other revenues Many managers would consider it a blessing to be challenged to find ways to benefit from an 800-million member customer base, so the question is going to be which paths Facebook will choose to do just that.

Now that Facebook has filed for an IPO, what, if anything, will change?

From this point on, much more of Facebook's activities and financial performance will be a public record updated on at least a quarterly basis. For example, the key question about Facebook’s potential for future growth and many other business questions will be readily tracked by following quarterly filings with the SEC, as well as in Facebook’s increased communications with security analysts.

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