September 29, 2014

THE COST OF SLOPPY BOOKKEEPING

by Bradford L. Hall

The long-awaited – and largest global – IPO of the Chinese e-commerce company Alibaba occurred recently, raising $25 billion at a company with a valuation $170 billion. During the last quarter alone, Alibaba profits tripled to $2 billion, while sales increased by 46 percent. Some have questioned the accuracy of Alibaba's financial records because it is a foreign organization and not subject to Generally Accepted Accounting Procedures (GAAP) or under the regulatory purview of the Securities and Exchange Commission (SEC), but foreign ownership is certainly not the only reason that valuation numbers can be questionable.

Whenever the financials become suspect -- either for a multinational tech giant or an American small business -- it affects company valuation, but by how much?

In my experience, the discount for poor financials can be as steep as one full point off the multiple. In other words, if a standard price-to-earnings ratio (P/E) concludes that a company is worth six times its EBITDA (net income adding back interest, taxes, depreciation and amortization) then suspicious accounting could bring it down to five times – 170 percent less or sometimes even more with un-auditable records.

Price/Earnings = Multiple (The value one would pay for a company assuming the records are accurate.)

Price/Earnings = Multiple – 1 (The reduced value one would pay for a company with questionable financial records.)

It might not seem like much on paper, but consider a company with $1 million in EBITDA that could have been sold for $6 million with fully audited financial statements. If that same company didn't have a reputable accounting firm reviewing or auditing its financial statements, it would fetch only $4 million, for a loss of $1 million. The best way to obtain the highest value for your company is to maintain good accounting records. Sloppy accounting will eventually take a huge toll when it is time to sell. Those businesses that have never had a CPA prepare financial statements will come to the realization that it is too late to go back and have them audited or reviewed. This is a basic necessity for any business that ever plans on selling.

There are many reasons why financial accounting may be suspect, including:

FOREIGN OWNERSHIP

As is the case with Alibaba, foreign companies are not under SEC regulation and may have dramatically different accounting and auditing procedures. Not only may the regulations be different, but they also may change rapidly based on political issues and government changes. China in particular has unpredictable and rapidly changing government influence, meaning that accounting standards may not be consistent or transparent even over short periods.

Underwriters for the Alibaba IPO include Credit Suisse, Goldman Sachs, Morgan Stanley, JP Morgan, Deutsche Bank and Citigroup. However, there was speculation that the Chinese government was blocking U.S. efforts to review Alibaba. It is also incorporated in the Cayman Islands, and

as such, it is not included in indexes such as the S&P 500, taking away yet another layer of credibility.

TAX DEADLINE EXTENSION

While it may seem suspect on the surface, it is not unusual for corporations to request a tax deadline extension. Most corporations are entitled to an automatic six-month extension, and corporations often opt to take advantage of this option to ensure that their tax returns are as accurate and complete as possible.

Although this does not create any issues with the IRS or for the corporation in most situations, delayed tax returns make it difficult to determine an accurate valuation. Without the most up-to-date tax return, the valuation may be based on data that does not reflect the company's current financial position. Additionally, requests for extensions can simply look bad, as if a company can't get its numbers together within two and a half months of year end. This perception can unfairly hurt a company's valuation, even if the reasons for extending the deadline are truly legitimate.

PAST AUDIT FAILURE

In finance, you carry your past with you always. A minor error in your bookkeeping from 10 years ago might come back to haunt you today, even if you're presently on solid ground. This is an important warning for CFOs and compliance officers who've previously been cited for a mistake. How can an acquiring company trust the balance sheet of its target if its new CFO was cited by the SEC a few years earlier? It's an interesting question – and one you don't want answered the hard way. Unfortunately, in the world of IPOs and mergers and acquisitions, perception can sometimes ***cause*** reality. In a nutshell, the past of the officers/management team is critical to obtaining the most for a business.

UNVERIFIABLE REVENUE

It can be difficult to find the true source of a revenue stream, and auditors often have no way of confirming certain numbers. Some information is based on manager estimates. It is clearly in managers' best interests to improve the numbers, but even the most scrupulous of managers can be affected by inadvertent bias. With regard to valuation, if there is a problem with the reported earnings, there will inevitably be a problem with the deal. Management teams looking to get top dollar for their enterprise should be careful not to depend too highly on projections and have every penny of revenue checked and rechecked on its financial statements.

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