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Unravelling company accounts not easy as ABC [NZ] [1]

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EXCERPTS

Exactly how Fast Eddy Groves managed to hoodwink investors for so long is still being investigated. But one of the biggest questions that remains is whether his accounting methods were too clever by half.

According to a report in the Australian Financial Review, one of ABC Learning's techniques was to set up regional management companies which held "franchises" to run ABC centres. ABC took the view that the "franchises" produced an active market for childcare licences, so their value kept changing. Between 2000 and 2004 it wrote up A$5 million in licence revaluations. In 2005 it increased them by a whopping A$165
million. Even after paying tax, this improved its balance sheet, enabling it to borrow more money.

However in 2007 it decided to use a different accounting approach which allowed it to claim a A$50 million profit from revaluing a British childcare group it had just bought.
According to its annual report, the value of its New Zealand licences was A$185 million in 2007, up from A$57 million in 2006.

It has been reported that in May 2006 the Australian Securities and Investment Commission received an anonymous complaint that ABC's treatment of its licences had created a new class of asset which had no intrinsic value, to give the appearance of shareholder value. ASIC supposedly dismissed the complaint.

But former Kiwi academic Sue Newberry believes the complaint was valid and raises fresh questions about how companies calculate what are known as intangible assets.
Newberry, now an Associate Professor of accounting at the University of Sydney, notes that ABC's accounts recorded almost A$3 billion of intangible assets at one point - mostly childcare licences.

"My involvement in trying to understand ABC was brought about because childcare policy analysts could not understand how licences could have such a high value, when the cost to obtain a licence is negligible and the licences are not transferable," she says.

Three firms of auditors, including KPMG, have been reported as being comfortable with ABC's accounting treatments. But the values were based on projections of future cashflow, and have convinced Newberry that current accounting standards are misleading the public by encouraging management to be over-optimistic. In her defence she cites similar concerns by renowned Cambridge University accounting Professor Geoff Whittington.

"While such an approach might make sense for those seeking to value the company's shares based on predictions of future cashflows, it also results in losing sight of what has actually happened and reduces - if not destroys - the ability to call management to account," she says.

Newberry's own analysis of ABC's acquisitions over a seven-year period is that 95 per cent of the prices it paid for centres were for childcare licences and goodwill. "In both cases it looks very much as if the amounts attributed to these were gross over-estimations."

The upshot of the practice is that when it comes to recouping losses when a company goes belly-up, there is almost nothing to sell. In ABC's case, this has been exacerbated by the fact that it sold all its premises and leased them back, so there are no properties to sell either.

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As Newberry sees it, ABC "virtually had a vacuum cleaner hose into taxpayer fundings. Massive amounts have gone in there, and now the company has gone."

In 2006 Citigroup analysts questioned whether a supposedly arms-length deal between ABC and a privately-owned company called ABC Acquisitions was to enable a childcare licence "to be categorised as an asset in ABC's balance sheet". ABC rejected the queries, saying all assets were capitalised. It was later revealed that it had agreed to lend large amounts of money to Acquisitions, and to other companies owned by the same person which provided consultancy and development services for ABC.

It is the New Zealand subsidiaries of these companies that are now being liquidated here.

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"If you've a licence to do something, and you've got a licence forever, how could that not have a value?" he says. But he agrees that ABC was paying far too much for goodwill.
"Goodwill is real simple - it's a multiplication of the potential centre contribution on an annualised basis. They took a base number, and put a multiple on it that was just totally unrealistic. It was easy for them, because their company was trading a [price to earnings] multiple of 19. If you can buy something at a PE of 6, and put it into a company that's trading at a PE of 19, you might do that. That was part of it.

The other part is, they took operating expenses and capitalised them. 'I want you to take the centre you've got, run it for another couple of years, absorb all these costs, then I want to sell it off for a capital sum.' And so that disguised their earnings.

"Those idiots were actually paying tax on earnings they weren't making so they could pump up their stock price, so they could issue new shares, so they could increase the capital base of their company, and do it all over again. All over the place - millions of dollars."

Wright believes similar practices were occurring in New Zealand.

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