The New York Times
DealBook
Edited by Andrew Ross Sorkin

AUGUST 17, 2009, 10:00 AM

Another View: Tunneling to True Profit in China

Adam Blaker Mark Dixon, near the center in a white shirt, standing amid tourists in Tiananmen Square, Beijing

Mark Dixon, a founder of the mergers and acquisitions adviser the1.com, which is active in mainland China, unwittingly unearthed some Chinese accounting tricks while valuing a local company.

What with the world still reeling from the domino effect that Lehman Brothers' balance sheet had on financial markets, the exposure of accounting frauds like the one at the Madoff fund and the final throes of the expenses scandal in the British Parliament, a trip to China promised to be a breath of fresh air in this atmosphere of fishy finances.

Hired by a client to help with an acquisition in China, I was given the job of deciding how much the buyer should pay for the business. That meant first calculating an accurate profit for the target company, its so-called normalized profit.

In the West, the process involves making a few small adjustments caused by things like no longer having to pay salaries to sellers if they aren't going to stay at the company and other nonrecurring items. But it shouldn't mean having to recalculate the entire income statement.

Generally Accepted Accounting Principles are not generally accepted in China. This is partly because the Chinese have their own accounting rules and partly because rules are for breaking.

And it's not just that some company owners are trying to confuse the tax authorities. It's that, when they do so, they end up also confusing themselves.

The gymnastics they do with revenues and costs are so impressive that the Beijing Olympics should have added an event especially for accountants. Markets with developed gray economies, like Italy, are well known for the practice of keeping one set of accounts for the government and another for the owners so they know what's really going on. Chinese companies often dispense with the second set, hence the confusion. That's probably true of other "developing gray economies."

One can hardly call something normal when it doesn't normally happen. So my quest for normalized profit was really a search for the abnormal — indeed, it might better be called abnormal profit. In fact, it was so elusive it seemed like a search for the abominable snowman.

My Chinese interpreter couldn't handle the term normalized profit, so I dropped it in favor of true profit. But that only caused offense because it implied the figure before adjustment was a lie, which indeed it was. I then tried the expression official profit, by which I meant "what it officially should be," but that didn't work because it got lost in translation with the false profit they were officially reporting. I finally explained it as "the profit you would have received if you had reported everything completely correctly," at which point I added, "Let's for simplicity just call it Profit X!"

Now everyone understood what I wanted. But they couldn't understand why I wanted it. "We'd only pay more taxes," they explained.

The mathematical difficulties of calculating Profit X are compounded by the delicacy of the subject. It's not only a confidentiality issue — after all, I might be a government spy — but it's also simply embarrassing to admit what they've been up to.

Someone who behaves like a traditional, polite accountant will never find out the truth. One needs to use both carrot and stick. The stick is "Your business looks surprisingly unprofitable." This provokes the Chinese pride, which, once awoken, quickly displaces any embarrassment. It also triggers natural commercial instinct — they instinctively realize the intentionally low profit figure is somehow going to hurt them in the upcoming negotiation. The carrot is "Don't worry, I've seen this many times before." Said with the bedside manner of a family doctor, it allows the final key to be turned. The scene is now set for a tour of their forbidden city.

At this point, we were ready to dive into the "abnormalization" process itself. Every stone I turned over seemed to reveal not a single spider but countless additional stones, each of which needed to be investigated. While pursuing each line of questioning, I found myself having to note side questions to ask later — my memory isn't that good. At the most frustrating point I was told, "You can't expect to understand China — our accounting is different."

They weren't trying to derail me from my quest. (Indeed, companies are fairly cooperative once they have bought into the process.) It was rather a way of trying to calm me down — but it only revved me up the more.

It seemed as if the project would never end (I was already down to the last clean shirt), but eventually I had exhausted all of my questions: the Profit X figure was there in black and white.

I have invented a formula to get to the truth faster. Of course, it doesn't help you get your hands on the figures to input, but it does show which ones you'll need to get and what to do with them. Even if you never need to use it yourself, you may be interested in what it reveals:

Profit X, or normalized after-tax profit =

The amount of after-tax profit actually reported to the government

+ Revenues received off the books to avoid paying revenue tax and to reduce corporation tax

+ Revenues from invoices pushed into the next period in order to delay paying revenue tax in the current period

- Revenues from invoices delayed from the prior period into the current period for the same reason

- Revenue tax the business should have paid on the net effect of these three adjustments

- Employee salaries paid off the books

- A “gross-up” to bring this off-the-books employee cost to a level at which the employees themselves would have received the same amount after tax if they had been paid legally (otherwise, they’ll go and work off the books somewhere else!)

- The extra Social Security cost the business should have paid on these two amounts

- Real expenses the business couldn’t deduct because the supplier couldn’t provide official government receipts, or fapiao, showing the supplier had paid revenue tax

- A gross-up to bring this to a level at which the supplier would have received the same amount if it had declared the income and paid both revenue and company profit taxes

+ The amount of expenses the business declared for fapiao that had nothing to do with its operations but which somehow found its way into the accounts

- The amount of additional corporation tax on the incremental profit resulting from the net effect of the above 10 items

To be fair, some companies need all the adjustments, and others perhaps none.

Only in China does a government have the power and desire to control centrally every invoice that a business issues. For an invoice to be tax-deductible, it must be printed on a government-authorized, numbered receipt called fapiao. The government charges service businesses 5 percent of the face value. The payment it receives is thereby an automatically collected revenue tax, also called business tax, levied on the business issuing the receipt rather than on its recipient.

When profitable businesses pay one another, they are economically encouraged to follow this system because the paying entity can’t deduct the expense without receiving the fapiao. Consumers, of course, have little need to show expenses when they go shopping, so they wouldn’t naturally request fapiao, letting retailers off the hook for sales tax collection. (Sales tax, which retailers must charge and remit to the government, is 13 to 17 percent of sales.)

To deal with this motivational loophole, the government, with free-market thinking, has cleverly persuaded consumers to request receipts from businesses — all retail fapiao are printed with scratch-off lottery numbers on forms issued by the government.

The government is thereby marshaling 1.3 billion Chinese as volunteer tax police by harnessing the Chinese people's well-known love for gambling. I am counting the children among this volunteer tax police figure because they especially love to check the receipts for prizes.

Such ingenious measures don't stop some Chinese businesses from cooking the books, but they make a dent in the problem. Indeed, one can hardly imagine the state of Chinese accounting in the absence of this totalitarian control of invoicing.

Back to the M.&A. negotiation. It had been a two-day herculean task to get to the truth. On top of the mathematical work itself, I had been through a cultural minefield before we came out the other side in triumph together. The Chinese owners were as satisfied as I was to arrive at this magic number. In fact, they had never known their "true profit" until that moment.

Now, we were ready for the hard part: the price of the business. The chairman was eager to know how I would value his company. Having understood the figures, I was ready with the answer. "We can give you a 10 P/E," I said. "In other words, 10 times Profit X."

The mood over the past few days had been everything but calm, but now an eerie silence descended on the room. "That isn't even close," he replied.

Indeed, it turned out he wanted 10 times his — not my — real profit: the actual cash they got from the business tax-free, or what could politely be called the pragmatic profit.

The problem was that pragmatic profit multiplied by 10 came to almost 20 times Profit X. It wasn't even worth negotiating.

"What was the point of the last two days if you are now going to use a totally different profit number?" I demanded.

He needed no time to find his thoughts. "You missed the point. We did that calculation at your request," he said. "It's a completely irrelevant number for us. Why would we give up our company for a lower value just because you want to make it legal?"

With reports of fishy finances still blowing in from the West, it wasn't the right moment to respond with a speech about morality. At times like this, one wishes instead for an Easterly wind.

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