THE GLOBE AND MAIL

February 25, 2016

Investors be warned: Valeant's success story is over

You can tell a company is beleaguered when it announces its financial statements are wrong, and the stock goes up two days in a row.

Such is the case with Valeant Pharmaceuticals Inc., one of my favourite topics. Things have been so bad for Valeant for so long, the shares bouncing around, usually down, on every bit of news, that the company's announcement Tuesday morning was greeted by investors as not nearly as awful as it could have been. The Wall Street Journal reported late Monday that the company was preparing to restate its financials; fears of a massive correction to its numbers led the shares to fall in after-market trading.

What came Tuesday was met, apparently, with relief, as the stock began a rebound. Valeant said its "ad hoc committee" studying the relationship with its controversial former subsidiary Philidor had found "certain sales" in 2014, prior to Valeant's option to purchase the company, "that should have been recognized when product was dispensed to patients, rather than on delivery to Philidor." Valeant will now move $58-million (U.S.) of revenue from the second half of 2014 into its fiscal 2015. The company's 2014 earnings per share goes down by 10 cents (to $8.24); its 2015 EPS increases by 9 cents.

Here's how some reacted: The headline in Investor's Business Daily on the news said the restatement "clears the air." One analyst told Reuters, via e-mail, that the announcement "ended up being fairly benign." The Wall Street Journal, in a follow-up, quoted another analyst as saying the restatement was "nothing more than a timing issue."

A step back, please: Many, many accounting restatements are "timing issues." And – speaking generally, of course – what makes them not terribly benign is when revenue is recognized before accounting rules say it should be. That serves to make the current period look better than it otherwise should. It pleases investors expecting the best possible numbers, but it comes at the expense of the future periods when the revenue and profits should actually have appeared on theincome statement.
The Journal helpfully notes that the prematurely booked sales came during and immediately after a battle between Valeant and Allergan Inc., which it was trying to acquire. Allergan very publicly cast stones at Valeant's business model, questioning the quality of the company's sales growth. The Journal says "the fight left Valeant [CEO] Michael Pearson, now on medical leave, determined to prove critics wrong, people familiar with the matter have said."

Howard Schiller, Valeant's interim CEO, said in a statement Tuesday that the company "remain[s] committed to improving reporting procedures, internal controls and transparency for our investors." He added the company has "made mistakes in the past and our focus today is on executing our business plan and rebuilding trust."

It should be noted, of course, that when Valeant felt it was in a stronger position regarding its Philidor narrative last October, it insisted it had already reviewed its Philidor accounting, it was proper, and it was part of Valeant's overall program of internal controls. It should also be noted that Mr. Schiller was the company's chief financial officer at the time of the now-restated accounting decision, and the members of the ad hoc committee are all board members who have been part of Philidor deliberations. So, they're all reviewing their own work in determining what was and was not a "mistake."

Dimitry Khmelnitsky, the ***Veritas Research Corp***. analyst who made that observation about the ad hoc committee, and whose work has shaped many of my thoughts on Valeant, reacted to the restatement

Tuesday not with relief, but with a report titled “Why We Should Be Worried.” He notes that Valeant itself said this week that the proposed accounting adjustments are not final, and in ***Mr. Khmelnitsky’s*** view, “this may just be the beginning of a series of restatements.” There’s a “heightened likelihood” of a Securities and Exchange Commission investigation, he believes.

And, most broadly, he says, “This is yet another piece of information that confirms our long-standing concerns with reliability of Valeant’s disclosures, which adversely affects investors’ ability to understand and forecast [the company’s] prospects.”

With Mr. Pearson still too sick to return, the company now saying it will engage in more research and development rather than rely almost completely on its M&A-driven model, and its historical financial reporting officially in question, there’s almost nothing left of the success story that made Valeant one of Canada’s best-performing stocks. Some investors may think the bad news is just about over. I say these shares are nothing but bad news.