

Questions over accounting cloud SNC earnings

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SNC-Lavalin Inc. SNC-This a lucrative, growing relationship that will add millions to its sales and profits – and yet, not a dime of new cash will flow into the company.

Indeed, it seems impossible – until you learn more about how the Montreal-based construction giant accounts for sales to AltaLink, an Alberta electric company.

SNC-Lavalin owns 76.9 per cent of Calgary-based AltaLink and is in the process of buying the remaining chunk from Macquarie Essential Assets Partnership. In a statement, SNC chief financial officer Gilles Laramée calls AltaLink “a core investment” for his company.

It is also an important customer, as SNC sells construction services to AltaLink. Typically, under Canadian generally accepted accounting principles, companies cannot book revenue and profits from sales to their own subsidiaries. But, says **Michael Yerashotis** of **Veritas Investment Research**, there’s an exception for transactions with rate-regulated subsidiaries like AltaLink.

It’s easy to understand why the rule and the exception exist. A company that makes sales to another company it controls can monkey with prices and other elements of the transaction, potentially inflating its results. But if the subsidiary has an independent regulator overseeing its economic activities, there’s much less potential for abuse.

However, international financial reporting standards typically bar recognition of intracompany sales and profits and make no specific exemption for sales to rate-regulated subsidiaries, **Mr. Yerashotis** notes. And SNC, like all Canadian public companies, moved to those accounting rules as of Jan. 1 of this year.

Yet the company says it will continue to book revenue and profits from its sales to AltaLink even as it becomes a 100-per-cent-owned subsidiary, presumably later this year. **Mr. Yerashotis**, who examined the relationship in a recent research report, stops short of alleging that SNC is about to violate accounting standards. But he does say his firm is “unsure what the specific rationale would be” for continuing the accounting policy under the new rules.

How big a deal is this, anyway? Well, it would help if SNC disclosed the sales and profits it derives from its AltaLink relationship, but it does not. A spokeswoman for SNC declined to comment on the matter.

Important Numbers

Mr. Yerashotis, however, has done some digging of his own, going to AltaLink’s filings with Alberta’s regulators, which contain historical data and future forecasts of purchases of construction services, which have typically been provided to AltaLink by SNC.

The numbers are not insignificant now and become even more important in coming years, as AltaLink is telling Alberta regulators it intends to boost spending. In 2010, SNC reported \$6.31-billion in revenue and \$437-million in profit; **Mr. Yerashotis** estimates \$263-million in sales and \$36-million in profit came from AltaLink.

In 2011, however, those numbers are forecast to rise to \$840-million in sales and \$116-million in profit to SNC-Lavalin from AltaLink; by 2013, they rise to \$1.83-billion in revenue and \$254-million in profit.

To be clear: If the forecasts from AltaLink's regulatory filings materialize, the utility will provide a 2013 profit to SNC that's more than half the company's current bottom line.

Mr. Yerashotis notes that on SNC's fourth-quarter earnings call, management gave guidance of flat-to-declining profit in its engineering and construction (E&C) business segment for 2011. "Given AltaLink's projected increase in required services from SNC, flat-to-declining 2011 E&C income would imply a potentially significant decrease in income from third-party E&C contracts."

"Going forward," he adds, "we advise investors to view any reported operating income growth within SNC's bread-and-butter E&C business with skepticism, as a great deal of reported growth may be derived from intercompany profits with AltaLink."

Mr. Yerashotis says irrespective of SNC-Lavalin's plans to report growing revenue and profits, "it is our view that SNC's transactions with AltaLink amount to little more than moving cash from one pocket to another."

Unfortunately, there will be another movement of cash: From the pockets of unaware buyers of SNC-Lavalin's stock to the sellers who understand that some of the company's profits are illusory.

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