Great Canadian Gaming bets on rosy future with accounting

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A profit warning is never a good sign. When it's followed by the sudden departure of the company president, it's ominous. But when it's accompanied by the scent of aggressive accounting, as it is with **Great Canadian Gaming** -- well, odds are the merde is about to hit the proverbial fan.

Great Canadian, which operates casinos in three provinces and Washington state, is one of those unlikely success stories, a company that went from obscurity to $1.1-billion in market value and made everyone forget about its humble beginnings. It began life on the Vancouver Stock Exchange and was known as Jettra Resources until 1997, when the market's enthusiasm for junior resource plays was dampened by the Bre-X fraud. That's when Jettra morphed into Great Canadian and bought seven casinos in British Columbia.

Two years later, police raided the home of Glen Clark, then B.C.'s premier, looking for proof that he'd received cut-rate renovations to the place in return for a provincial casino licence. Mr. Clark was later cleared of criminal charges, but the government refused to give new licences for a while, which was great for those who already had them. Great Canadian prospered, grew and made tons of acquisitions. If you had invested $10,000 at the end of 1999, your shares would have been worth $134,100 by the start of this year. (The company graduated to the Toronto Stock Exchange in 2004.)

Those days may be gone, but the huge expectations still linger. Though the stock has fallen a bit since last month's profit warning and resignation of president Anthony Martin, Great Canadian still trades at 26 times trailing earnings. And the quality of those earnings isn't very high, according to a new report by **Veritas Investment Research**, an independent firm with accounting expertise.

Veritas analyst **Anthony Scilipoti** figures the company's profit would have been 33 per cent lower in the first nine months last year if the company had used more conservative bookkeeping practices. His conclusion: The worst is not over. "Expect more negative surprises."

The accounting issue is about timing, or more specifically Great Canadian's recording of expenses to present the numbers in the best possible light. In B.C., the provincial government helps casino operators with their expansion plans. Companies like Great Canadian spend money to add slot machines, for example, and apply for reimbursement. If the B.C. Lottery Corp. approves, the casino gets to keep an extra cut of gambling revenue until those costs are paid for.

It's a sweet deal, and the only drawback is that it can take years to get back the cash. But Great Canadian books a portion of that money in advance, using a bunch of complicated assumptions about future gambling activity and interest rates, **Mr. Scilipoti** writes. The manoeuvre allows the company to report lower expenses, giving current profit a lift.

Marketing costs also provide room for optimistic accounting, again thanks to the government's involvement. B.C. casinos pay into a marketing fund of the provincial

lottery company. **Gateway Casinos**, which runs five in the province, deducts these costs right away. Great Canadian is capitalizing them (i.e., expensing them over time). Chalk up another $1.4-million in costs that don't hurt the income statement now, but will some day.

What would motivate a company to dress up its income statement this way? The stock price, sure. In Great Canadian's case, there are lenders to keep happy as well. The company's debt has ballooned to $357-million from $28-million in less than two years. **Mr. Scilipoti** estimates the accounting gave a $6.1-million boost to EBITDA in the 12 months that ended Sept. 30, which helped the company stay on side of its debt covenants. "Had [Great Canadian] used Gateway's accounting, we estimate that it would have breached the covenant in the most recent quarter."

Great Canadian's practices don't violate Canadian accounting rules; it's just that the rules are flexible, and the company uses them to its best advantage. That's a red flag, and it's not the only one. Competition in B.C. is on the rise. The executive stock option plan is generous. The financial statements carry a list of related-party deals; directors were paid $1.8-million since the start of 2004 for providing consulting and training services to the company, all of which is reminiscent of the old VSE.

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High stakes

Great Canadian's rapid earnings growth has propelled it to $1.1-billion in market capitalization. But the profits would be less impressive if the company used the same accounting as its competitor, Gateway Casinos.

Income statement

$million except for earnings per share	**As reported**	**If it used Gateway's accounting**
Revenue	$196.8	$196.8
Operating expenses	141.1	145.4
EBITDA	55.8	51.4
Operating income	46.0	36.5
Net income	28.7	19.3
Basic earnings per share	0.38	0.26

SOURCES: THOMSON DATASTREAM, **VERITAS INVESTMENT RESEARCH** AND COMPANY