

It's Smart To Check The Fine Print On CGI

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Published: Tuesday November 5, 2002

Today, CGI Group shareholders will be treated to the company's fourth-quarter financials. Since the information technology outsourcer divulged the highlights last week, few surprises are anticipated.

That said, investors will probably scour the company's statement carefully, and if they don't like what they find, CGI's premium stock multiple might be at risk.

By now, most investors are familiar with the pitfalls of merger-and-acquisition accounting. It's easy to make a company look good when it grows by acquisition, for a while at least. But chronic deal making only increases the odds that management will blow it, especially in this industry, where competition is hyper, prices are rising and CGI is a bit player internationally.

To get over these annoying humps, CGI has to resort to a variety of techniques, which **Veritas Investment Research** summed up for clients in a recent report. They start with enticements, including equity and cash discounts, offered to companies CGI wants to do business with. Although this might be an adverse business move, it's not unusual in the IT outsourcing world.

What matters is the way these incentives are treated, and how well investors understand the treatment. CGI accounts for outsourcing contracts as purchase transactions.

Enticements become deferred credit liabilities on the balance sheet, which are then amortized into revenue.

It's enough to bore you to tears, but it's also vital, so we soldier on.

For example, when CGI took over the IT business of the Desjardins credit union, it gave Desjardins \$14-million in CGI warrants and allocated \$68-million to deferred credits. The kicker is that although the contract life is 10 years, and contract costs and assets are amortized over that period, the credits are brought into revenue over a two-year period. The company justifies this on the basis that two years is a transition period. **Patrick Stephenson** and **Anthony Scilipoti**, **Veritas**'s accountants, disapprove and advise investors to spread the revenue gains over 10 years.

The effect is not helpful to anyone selling the stock: For the first nine months of the current fiscal year, the difference in revenue would have been \$32-million. The impact on earnings per share is a drop of 18.5 per cent.

Another benefit for CGI's earnings per share is the largesse of Quebec's tax policy. In exchange for hanging its shingle at Montreal's E-Commerce Place, **Veritas** notes, the company earned a 25-per-cent tax credit on salaries paid in Quebec. The company doesn't disclose the effect of these credits quarterly, but the 2001 annual report shows a benefit of \$25-million. CGI may boast of lower costs, but since these are the result of a political decision few would want to bet on, the analysts figure earnings should be adjusted yet again.

And yet again, the adjustment is not flattering: Earnings per share for the first nine months of the year drop 11 per cent, by **Veritas**'s estimates.

Another issue is which generally accepted accounting principles to use. Most of CGI's peers are U.S.-based, which affords them less accounting leeway than Canadian GAAP. Under the latter,

integration cost and incentives, which are important numbers, are capitalized. Under U.S. GAAP, they're expensed.

You cannot compare CGI to its peers without adjusting. For 2001, when the company made a lot of acquisitions, CGI's profit under U.S. GAAP was \$16.5-million lower, or about 25 per cent, than under Canadian GAAP.

CGI's stock premium is higher than it looks.

This doesn't exactly sound like a brilliant business, but if you must own it, it's worth knowing what you're paying for.