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Warning signs found in a company's financials call for close scrutiny

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When a company pulls its earnings guidance, sending its shares down 25 per cent to a level that wipes out nearly four years' worth of gains, it's worth asking if there were warning signs.

In the case of Avigilon, which did that Monday, we can say that there were. A little less than two years ago, I highlighted a report from ***Veritas Investment Research*** that enumerated some red flags with the company's financial picture. Investors who embraced Veritas' wariness have avoided a loss of more than 50 per cent.

But not all of the research firm's warnings pan out. More than three years ago, Veritas expressed even more concern about CGI Group Inc**.** and the potential fallout from its acquisition of European company Logica.

However, CGI's management has delivered on the promise of the deal, and the stock has barely missed a beat, doubling since the ***Veritas*** report. Last month, ***Veritas*** removed CGI from its "Accounting Watchlist," a compilation of companies about which it has financial-reporting concerns.

"When you find accounting issues, it alerts you to a divergence between what the business economics are doing and what the financial statements are telling you," says ***Anthony Scilipoti***, ***Veritas'*** CEO. "If the business economics improve, it doesn't matter that the financial statements were managed. If the business operations continue to erode, taking Avigilon as a case, then you can't play with the numbers any more. It's a very nice comparison between the two [companies]."

Let the comparison begin.

Late Monday night, Avigilon reported sales that beat expectations, but it revealed a sharp decline in the gross profit margin of its security-camera products (from 58 per cent to 50.1 per cent, below the analyst consensus of 55.1 per cent.) The culprit was, as Avigilon put it, a "pricing adjustment" where it cut prices on a line of its cameras and equipment "to drive unit sales and revenues, expand addressable market and capture additional market share."

While it was a conscious decision by management, and it increased the company's cash flow from operations, it also caused Avigilon to say that its preferred metric of "adjusted" earnings per share "may be materially lower" than the guidance released March 1, and it told "undue reliance should not be placed" on that guidance of five months ago. (CIBC World Markets Inc. analysts Robin Manson-Hing and Todd Coupland titled their research report When The Bottom Falls Out, while cutting the stock rating to "sector perform" from "outperform.")

What was ***Veritas'*** concern two years ago, in July, 2014? Well, it, and other investors, were shaken by the departure of the company's chief financial officer, one of a number of changes in the company's finance department, as well as with its external auditors. ***Veritas*** looked further and became concerned about an apparent change in the company's revenue-recognition policies, and the fact the company's auditors weren't reviewing Avigilon's quarterly reports at the time.

Veritas said that the accounting policy and the company's close relationship with distributors increased the risk of "channel stuffing," or recognizing revenues on products that hadn't truly been accepted by an end user. And while it found no strong evidence of that in the company's financial ratios, it did note negative trends in inventory turnover and accounts receivable "that investors should take note of."

Says ***Mr. Scilipoti***, now: “The trend piqued our interest, and there was also a sudden change in the CFO position. Those two stood out to us as some smoke, and this is an industry where there are a lot of sales to distributors, so we were concerned. I think what we’re seeing here is the fruition of that from a business standpoint. You have to lower price, so you have lower profits, so there you go.”

Avigilon spokesman Darren Seed says the company isn’t focused on analyst reports. “Fundamentally, you can’t have the tail wag the dog. [Founder/CEO] Alexander Fernandes and the executives here are focused on the long-term success of the company – and it’s not always a straight line – and value for our shareholders.”

Mr. Seed also says the margin decrease is a temporary, strategic thing. “Avigilon is focused on growth … It’s more gross profit dollars, more revenue and unit sales, and it increases our market share. It got us into a market that we previously were not focused on – the entry-level market.”

We shall see how things turn out for Avigilon. CGI, however, has emerged from ***Veritas’*** doubts in quite nearly a best-case scenario.

Here was the situation in August, 2013, when I wrote about several ***Veritas*** reports published earlier that year: CGI, a computer-services company that often serves as its customers’ outsourced IT department, was beginning its integration of Logica.

In big deals – and Logica was bigger than CGI at the time – the accounting for mergers, known formally as “purchase price allocation,” has the potential to impact earnings for years to come. ***Veritas*** scrutinized the numbers and felt CGI’s accounting decisions had the potential to add more than a billion dollars to CGI’s reported earnings over the subsequent years without a corresponding increase to the company’s cash flow.

One technical example: In scrutinizing Logica’s contracts and making those accounting choices, CGI “effectively reverse[d] profits on contracts already recognized by Logica,” thereby meaning CGI “will recognize revenue already recognized by Logica,” ***Veritas*** analyst Michael Yerashotis said at the time.

CGI’s defence was that it was applying its own, more conservative accounting policies to Logica, spokesman Lorne Gorber said at the time. And, he said, “The one thing we absolutely agree on is the conclusion of the ***Veritas*** report: Cash is what the investor should focus on. Over time, the cash you’re reporting will dictate whether you’re a happy investor and whether the stock keeps going in the direction it has.”

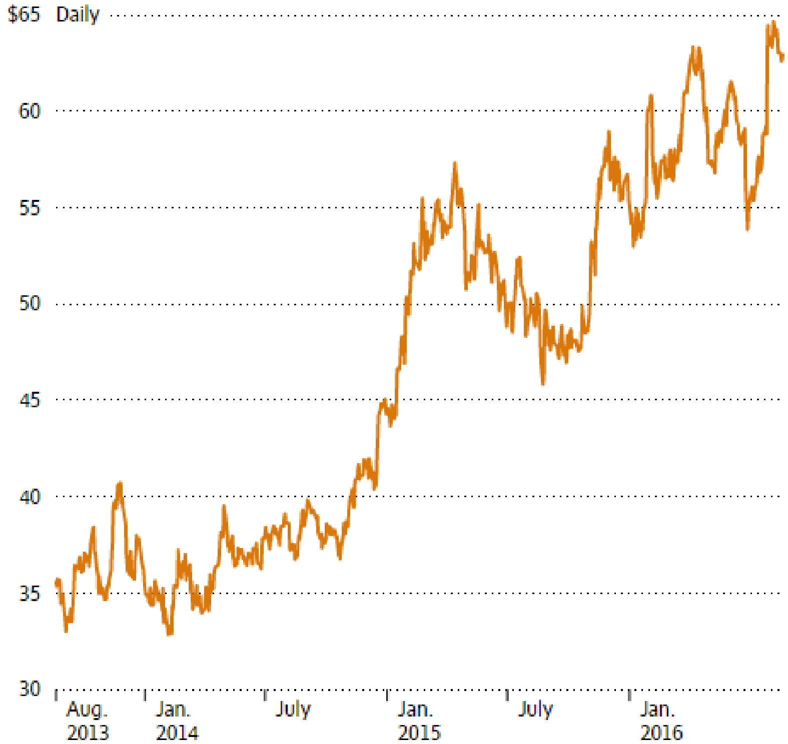
And with that as the test, CGI has passed. In a late-July report, ***Veritas*** acknowledged that CGI’s gap between cash flow from operations and its reported EBITDA (earnings before interest, taxes, depreciation and amortization) is closing, and it removed CGI from its Accounting Watchlist.

Says ***Veritas’ Mr. Scilipoti***: “Over time, we expected that difference would narrow, and unless CGI could sign new contracts at higher margins than what Logica had originally booked them at, or at margins that were commensurate with the margins CGI was now reporting, then earnings would fail to meet cash flows. What happened was they actually added contracts that were high-margin, or at the margin they were reporting, and ultimately the cash flow has come up. The impact of the purchase price has worked its way through the earnings, and management has done a good job of turning Logica around.”

CGI’s Mr. Gorber, contacted this week, says “we both converged on one common point, which is let’s wait for the cash. Now that cash flow is pretty regular and, normalized, the integration is behind us, and we’re back to positive organic growth, we’ve got what most people in ***Veritas’*** business look for, which is the alignment between the earnings you’re reporting and the cash flow you’re generating.”

He adds: “We’re happy. We don’t like to be on anyone’s watch list – we want to be on their buy list.”

CGI Group Inc. (GIB.A-TSX)



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