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CGI Group Inc. founder Serge Godin, left, and chief executive Michael Roach.
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CGI: A different view of a tech superstar

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The acquisition of the underperforming European company Logica has been a transformative event for CGI Group Inc. and its investors.

Revenue at CGI has doubled, and excitement over the successful merger has pushed shares up 50 per cent this year. Serge Godin, founder of the Montreal-based company, is now a billionaire, thanks to the stock's rise.

But what if CGI, a computer-services company that often serves as its customers' outsourced IT department, isn't doing quite as well as the company's numbers suggest?

This is the theory of the analysts at ***Veritas Investment Research***, an independent Toronto shop with a habit of taking a deep dive into companies' accounting.

Analyst ***Mike Yerashotis*** says a number of accounting decisions CGI made as it brought Logica's books onto its own have the potential to add more than a billion dollars to CGI's reported earnings over the next few years – but without a corresponding increase to the company's cash position.

To be clear, he is not suggesting the company is violating International Financial Reporting Standards, much less doing anything illegal. But he does think its accounting for the acquisition may raise expectations to unreasonably high levels among investors who don't fully understand the company's bookkeeping.

Lorne Gorber, CGI's senior vice-president of communications and investor relations, says ***Veritas's*** critique is understood – and rejected – by CGI's institutional shareholders. "Where I take the most comfort is that I know all of my big shareholders have reviewed [the ***Veritas*** reports], had the conversations, and either continued to hold [CGI stock] or continued to accumulate."

Certainly, ***Veritas's*** views are out of the Bay Street mainstream. More than half the analysts following the company rate it a "buy." Several of the analysts with "hold" ratings like the company, but feel the recent run-up in the share price limits short-term gains.

Michael Urlocker, an analyst at GMP Securities, says early fears about the Logica acquisition were a "silly market twitch" and patient investors have been rewarded. His investment thesis, simply stated, is "fixing Logica is paying off," and the next two years should demonstrate "substantial growth in earnings and shareholder value." His target price for CGI is $43, another 35-per-cent gain from current levels and a near-doubling of the company's 52-week low.

Mr. Yerashotis's view is that CGI's earnings don't tell the story. His concerns relate to what's called "purchase price allocation," the process that occurs after one company acquires another. The buyer must determine the fair market value of the assets it's acquiring in order to assign new values to them for its own balance sheet.

In its initial purchase price allocation and two subsequent adjustments, CGI made $800-million in changes to Logica's balance sheet that caught ***Mr. Yerashotis's*** eye. And nearly all of that, he believes, will flow back through CGI's earnings in the two to three years after the acquisition's closing date of August, 2012.

Here is how that can work. CGI decreased Logica's "work in progress" by $384-million. Logica described its work in progress as "amounts recoverable on contracts," or revenue that it recognized that had not yet been billed to its customers. CGI also increased Logica's deferred revenue, which is cash received but not yet recognized as revenue, by $118-million.

Those changes, ***Mr. Yerashotis*** says, "effectively reverse profits on contracts already recognized by Logica" and means CGI "will recognize revenue already recognized by Logica."

For his part, Mr. Gorber says CGI increased the deferred revenue line, reversing past Logica sales, because it reviewed Logica's contracts and found that some of the revenue would not have been recognized under CGI's more conservative accounting policies.

But this is not the whole of ***Mr. Yerashotis's*** complaint. His total estimate of CGI's earnings-boosting accounting decisions comes in at $1.06-billion. That's because he also includes £173 million ($267-million) in charges for losses on customer contracts that Logica took in its final results.

CGI management told analysts they had prompted much of the charge, saying they had reviewed the cost to complete Logica's contracts and "decided it was necessary to recognize forecasted cost overruns and penalties across a number of projects."

Mr. Yerashotis finds this odd because Logica management had already "undertaken a thorough review" of its contracts in late 2011, according to comments on their own analyst conference call at the time, and taken a £39-million charge.

By recognizing future contract losses all at once, CGI is removing those losses from future results – and thereby increasing earnings.

Mr. Yerashotis estimates the $1.06-billion in accounting-based earnings improvements will flow through CGI's income statement over 2.5 years, adding an average of $106-million each quarter to CGI's EBIT, or earnings before interest and taxes. This could make up a significant chunk of profits going forward. Analysts expect the company to post just over $1-billion in EBIT this fiscal year.

So he suggests an investor should "hang your hat on free cash flow." While CGI's EBIT in the 12 months ending in June has increased 68 per cent, its free cash flow, as he defines it, has grown an impressive but more modest 46 per cent.

By valuing CGI on its free cash flow, rather than reported earnings, he says, the stock looks much more expensive in relation to other IT services firms like Accenture, CapGemini and Atos, he says.

CGI has declined to discuss the issues with ***Mr. Yerashotis***. However, during the company's third-quarter conference call, CGI's chief financial officer David Anderson said the cumulative impact of the "adjustments to the purchase price allocation" on CGI's earnings per share in the most recent nine months "was negligible."

Mr. Gorber added to The Globe and Mail that there's "a lot of disclosure and transparency" in CGI's results. He also notes the company is entitled to make purchase price adjustments if they are warranted, and a company that didn't make such changes for fear of criticism would handicap itself against its peers and in the markets.

"The one thing we absolutely agree on is the conclusion of the ***Veritas*** report: Cash is what the investor should focus on," Mr. Gorber says. "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."