TD Goes For The Cash Return: Dealing With Canada Trust: Trumpets Its Cash Operating Return On Equity, Instead Of Lower GAAP Figure

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Toronto-Dominion Bank wants to be seen as the aggressive growth vehicle of Canada's staid financial services industry -- and has just the accounting system to reflect that self-image.

"Cash operating earnings" have proven an ideal solution to what TD executives knew would be an onerous problem following their acquisition of Canada Trust two years ago. They'd paid $7-billion for that firm, a huge price compared with previous Canadian acquisitions in the industry. It raised serious questions about their ability to make the acquisition pay. When combined with acquisitions of Newcrest and Waterhouse, they were facing an uphill battle to convince investors and analysts that the acquisition spree was a shrewd decision.

In the end, executives took an unlikely tack. Rather than set difficult goals for integration to sway analysts and investors with rosy projections of earnings growth, TD launched an attack on the very method by which financial services results had been measured for almost a century.

What ensued was a concerted effort to convert analysts and investors to "cash operating basis" accounting that would emphasize their cash flows while ignoring many of the costs arising from their spending spree.

The move to discredit and discard Generally Accepted Accounting Principles has been a total success for the company. Almost all Canadian banks have subsequently changed the way they report their earnings.

Under the new regime, comparisons between banks are rendered almost meaningless because each institution can use its own variation on the "cash earnings" theme to emphasize the most positive aspects of their performance, while minimizing their biggest challenges.

The only one of Canada's six dominant banks not reporting earnings on some form of cash operating basis is Scotiabank. And nowhere are the financial results changed so radically by cash-basis accounting as they are at TD.

Is it appropriate to manage financial reports and market expectations by doing away with traditional GAAP accounting methods in earnings releases?

"The issue isn't whether it's appropriate, the issue is that the market has accepted this logic," said one Toronto banking analyst who asked not to be named.

Dan Marinangeli, TD's chief financial officer, insists the switch to cash earnings wasn't designed to inflate results, but to bring TD's earnings more into line with those of U.S. rivals that were often not required to write down acquired intangibles against their earnings.

"It's obvious the market wants cash earnings in this case because they value our shares based on cash results," he said.

"All I read in the newspapers is that GAAP accounting is the only honest way of reporting earnings, and anybody who reports on the basis of cash earnings is a crook. Well, if that's the case, then why are investors and analysts crying out for other financial measures?"

Mr. Marinangeli said the bank discloses enough information that investors can make their own calculations if they object to the use of non-GAAP or pro-forma accounting. Most of the changes wouldn't have a significant impact on the results anyway, and since the bank pays dividends based on cash earnings, those are the most appropriate numbers to focus on, he said.

But others disagree. They say that dissecting the bank's reports is not as easy as Mr. Marinangeli suggests, and the differences between GAAP and cash results can be very significant.

There may be no better example of how the "cash earnings" phenomenon has clouded financial reporting than the quiet controversy that has surrounded TD Bank's return on equity for the past two years. Normally a simple mathematical calculation, the return on equity question is now shrouded in a philosophical debate.

In hindsight, the reasons for TD's campaign to change the way results are calculated have become crystal clear, the analyst said.

"If they came out after the Canada Trust acquisition and said they now had a 13% return on equity, their shares would tank," he said. "It's as simple as that."

Thanks in large part to "cash operating" earnings reports, the bank has no such worries.
In its fourth-quarter earnings statement to shareholders, TD reported that it had a "cash operating" return on equity of 18% last year. Nowhere does it explain how that number is calculated, but financial analysts break it down this way:

First, you take the bank's reported "cash basis net income" of $2.16-billion, a number not recognized under GAAP because it excludes $629-million in amortization of goodwill and acquired intangible assets, $138-million in restructuring costs and other "special items." You then subtract $83-million in preferred share dividends.

In total, you get cash earnings attributable to common shareholders of $2.08-billion, before special items, another number not recognized by GAAP.

To calculate the ROE, you then divide that number by the average shareholders' equity during the period. Trouble is, nowhere in the regulatory filing is that number disclosed. To find it, you must go to TD's Web site and download another file called "supplemental financial information," where you'll learn that the average equity was $11.50-billion.

You divide $2.08-billion by $11.50-billion and you get 18%.

If you want to know TD's return on equity according to the accepted accounting standards, you're on your own because GAAP ROE results are nowhere to be found in TD's report. But it's worth going the extra mile because traditional accounting tells a far different story.

Under GAAP, you must include all of the "special items" excluded under cash operating earnings. TD's GAAP-approved bottom line was $1.3-billion last year, 37% below the bank's reported number. Calculating return on equity on that basis yields a result of 11.3%, massively below the bank's cash figure and by far the lowest among Canada's six dominant banks.

The only other Canadian bank with a significant difference between its cash ROE and GAAP ROE is Royal Bank of Canada. In 2001, Royal's cash-based return was 18.6%, while regular accounting methods resulted in a return figure of 16.6%. Royal quelled any controversy by disclosing both numbers side by side, thus leaving shareholders to decide which is more significant.

TD's defenders point out that the GAAP number is hopelessly skewed by the fact that the bank has chosen to amortize its acquisitions over unusually short periods of time. That has resulted in abnormally high non-cash amortization charges, which make the GAAP numbers look worse than they otherwise would.

In this case, the cash operating results are more indicative of the bank's success, they say. But some believe TD tilted the playing field.

By choosing to amortize their acquisitions over as little as four years, executives ensured that the noncash acquisition costs would be extremely high and their GAAP results unrealistically poor. That decision made their assault on GAAP that much more convincing, and left circumspect shareholders and analysts with no choice but to accept TD's "cash earnings" revolution, critics say.

Even if you believe that cash earnings are the fairest way to evaluate TD's results, a "cash operating" return on equity doesn't make sense, because it ignores the substantial impact that amortization costs had on average shareholders' equity after the purchase of Canada Trust, while benefiting from the higher sales and earnings figures, according to National Bank Financial analyst Robert Wessel.

Essentially, TD's numbers are improved superficially by comparing a cash-based non-GAAP profit figure to a GAAP-based number that is depressed by the impact of non-cash charges, Mr. Wessel explained in a report to clients last November.

The result is that TD's reported return on equity is overstated by more and more each quarter.

"By not adding back these charges, the bank is increasing cash return on equity (ROE) by well over 100 basis points a year and the effect is cumulative," Mr. Wessel said in the report.

Mr. Wessel said that amortization costs removed from the bank's cash net income figure must be added back into its shareholders' equity before calculating cash ROE. Otherwise, comparisons to other banks are impossible.

That calculation isn't easy. First, you start with the bank's reported operating cash earnings, which were $2.075-billion in 2001.

You then take the $11.505-billion average common equity figure taken from TD's supplementary financial disclosure, downloaded from its Web site.

You must then add back all of the accumulated amortization in the year 2000, since TD completed its acquisition of Canada Trust. Those charges were $12-million in the first quarter, $225-million in the second, $228-million in the third and $257-million in the fourth quarter, for a total of $722-million on the year.

You then figure the approximate average amortization for 2001 by taking the total amortization of $629- million (found in TD's annual financial statement) and dividing by two. That equals $315-million.

Adding $11.505-billion to $722-million and $315-million, gives a total equity denominator of $12.542- billion.

Confused yet?

The final calculation is dividing TD's $2.075-billion cash operating earnings by $12.542-billion in common equity, which equals a 2001 cash return on equity of 16.5%, more than 150 basis points lower than TD's reported level of profitability.

Mr. Wessel emphasizes that what TD is doing is essentially the same as the "cash earnings" reporting used by most other Canadian banks, but in TD's case the differences between "cash" accounting and more conventional approaches are more substantial.

"I'm not suggesting at all that what they're doing is untoward ... it's industry standard," he said. "But in TD's case, their use of cash operating ROE materially overstates their profitability."

Mr. Marinangeli has heard this criticism before and concedes there may be a better way to calculate ROE than the one TD is currently using. He said the bank may start including amortization of intangibles in future ROE calculations, but only if other banks do the same.

So, should you accept the bank's version of return on equity at 18%, or GAAP-based results at 11.3%, or the adjusted cash-based calculation of 16.5% including acquisition costs? The answer to that question becomes especially important when you consider TD's premium share price and valuation.

As of last week, TD was trading at 13.1 times its estimated 2002 cash operating earnings. That valuation is a bit puzzling when you consider that the average for Canada's other five major banks is 12.02 times 2002 earnings.

Looking only at its cash earnings, that would stand to reason because TD's return on equity, by that measure, is the best among Canada's major banks. But once you add back those acquisition costs, their profitability falls to last in the group.

So deciding whether TD's stock price is reasonable or ridiculous depends entirely on who's doing the books.

DIFFERENT LINES TELL DIFFERENT STORIES:

	GAAP	Cash	Cash*
Net Income	$1.38b	$2.16b	n/a
Price to earnings ratio	21.3x	13.3x	n/a
Return on equity	11.3%	18.0%	16.5%

** Including amortization of acquired intangibles.*