Why it's Important to Understand What Adjusted Earnings Really Mean

Description

What has largely been touted as an earnings beat for one of Canada's six largest banks may not have been as good as initially reported, depending on how one-off items are viewed.

Canadian Imperial Bank of Commerce (TSX:CM)(NYSE:CM) reported its Q3 2017 earnings this morning before market open and used primarily adjusted numbers in its earnings release (these were the most-quoted numbers in most articles covering CIBC as well).

The difference between actual and adjusted earnings is staggering — see the table below:

Measure	**Q3 2017**	**Q3 2016**	**% Increase/Decrease**
Net Income	$1,097	$1,441	-23.9%
Adjusted Net Income	$1,166	$1,072	8.8%
Earnings Per Share (Diluted)	$2.60	$3.61	-28%
Adjusted EPS (Diluted)	$2.77	$2.67	3.7%
Return on Equity	16.3%		1% Difference
Adjusted ROE	17.3%		

When removing one-off items, a gain will reduce adjusted net income (subtracting a gain is not a good thing), and, vice versa, a one-off loss during a reporting period will increase adjusted net income. Most of the time, companies report both GAAP and non-GAAP earnings, adjusting the GAAP/IFRS earnings (standardized financial reporting methodologies in the U.S. and Canada) to allow investors to gauge how the company really did, adjusting for certain "one-off" items in a given period which should be excluded, assuming these will not re-occur, and the costs associated with these items are material.

What most investors don't do, however, is look deeper into what the one-off items are, and try to get an understanding if

1. These items really are one-off and will not re-occur at a later date;
2. Other miscellaneous items may show up at a later date that will impact earnings; and
3. The GAAP numbers should be used if either of the first two scenarios play out.

Looking deeper into the notes in CIBC's quarterly financial statements, we find that in Q3 2017 the company had a net one-time loss, primarily relating to the acquisition of PrivateBancorp (that's a whole other discussion) of $69 million, net of other small items, which was subtracted out, increasing earnings accordingly.

In Q3 2016, the company sold its **ACI** (Canadian Wealth Management) business and, combined with other smaller gains and losses, reported a net gain of $369 million which was backed out, thereby reducing the company's net income, making Q3 2017 appear to be better than Q3 2016 when using adjusted numbers.

Buried in the notes surrounding one-off items was also another interesting tidbit of information, in which the company acknowledged two separate CRA reassessments totaling $298 million which are being disputed, but which will potentially impact earnings in the future should these be paid out (and we all know how difficult the tax man can be).

Bottom line

CIBC is not trending in the right direction, and, in this case, due to the fact CIBC management has made it clear they will continue with U.S. acquisitions (likely overpaying for them as well), I expect these "one-off" items to continue in subsequent quarters as additional small acquisitions are made.

Combined with other potential losses from the tax implications of CRA reassessments, it appears to me that CIBC will have a difficult time working the numbers in future reporting periods to make the situation sound rosy.

The unadjusted numbers are, in my opinion, the ones that should be used.

Stay Foolish, my friends.

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