Big-Bank Earnings: What Not to Look At

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Bank of America lately has cited the non-GAAP return on tangible common equity on the first page of its earnings releases. Photo: Mark Kauzlarich/Bloomberg News

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Investors are looking for higher returns from big banks—but one measure banks are embracing can be deceiving.

Some big banks now highlight "return on tangible common equity" in earnings reports, which start landing in investors' inboxes on Friday. This performance measure typically makes banks look stronger than the more straightforward "return on equity."

In J.P. Morgan Chase's third-quarter earnings press release last year, for instance, it touted a 13% return on tangible common equity. That looked better than its 10% return on common equity, which was only in line with banks' theoretical cost of capital.

Banks say the tangible-equity return number helps investors gauge success in putting core capital to work. Investors should be wary.

Return on tangible equity is a non-GAAP measure that doesn't follow generally accepted accounting principles—something J.P. Morgan didn't make clear in its release. The Securities and Exchange Commission has been warning companies in recent months about placing too much emphasis on such ersatz measures, although it hasn't addressed banks' use of return on tangible equity during its latest push.

Tangible equity excludes intangible assets like goodwill created from acquisitions. When those assets are stripped out, earnings are measured against a smaller base, boosting the return figure.

"It's a perfect metric that ignores all the costs of acquisitions," says David Trainer, chief executive of New Constructs, an investment-research firm. J.P. Morgan has $47.3 billion in goodwill on its balance sheet; Bank of America has $69.7 billion.

At least 28 banks and other financial companies disclosed tangible-equity measures in SEC filings detailing their third-quarter results, according to consulting firm Audit Analytics.

In some cases the shift to return on tangible equity gave banks a more favorable metric to tout just when it was most useful to them. At J.P. Morgan, return on tangible equity was just another line item in its financial tables back in 2011. From then on, the bank has moved it higher in releases; it has been featured in the headline section since late 2013. The change happened as banks were struggling to post returns much above their theoretical cost of capital.

Bank of America had a return on average tangible common equity of 10.3% in the third quarter versus a return on average common equity of just 7.3%. It has included the non-GAAP number on the first page of its earnings releases since the second quarter of 2015—previously it was just a line item. BofA identifies it as non-GAAP and features it alongside the comparable GAAP number, although the non-GAAP disclosure is in footnotes deep in its releases.

Although investors have been starved for decent returns in recent years, they should pass when banks offer them junk food.