The Wrinkles Behind BCE's Fresh Face: 'Cash Baseline' Earnings: Losses Accelerating At Most Units Outside Of Bell Canada

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Profile of BCE Inc.

For professional investors, BCE Inc. is the company with two identities.

BCE's quarterly financial reports and splashy press briefings paint a picture of a company offering the safety of an old-line utility with the explosive potential of a technology growth stock.

The rarely-spoken truth behind the rosy picture is that "cash baseline" earnings defy all conventional accounting principles. By stripping out the distortions of baseline earnings, another face is revealed – one that bears the scars of BCE's acquisition-driven strategy to diversify at any cost.

One of the great puzzles of the Canadian stock market is trying to predict what BCE Inc. will do now to drag its beached convergence strategy off the rocks.

But that puzzle is nothing next to trying to sift through BCE's custom-made "cash baseline" earnings to determine just how deep the financial damage goes. As the recent 23% decline in BCE's share price can attest, the market suspects the cracks run deep.

Not only is the Bell Canada phone business the only profitable part of the conglomerate, but at most of its unprofitable "growth" units, the losses are accelerating.

Analysts and accounting experts say BCE's pro forma reporting style would be acceptable if it excluded only one-time unusual items, or if the exclusions were only non-cash charges. But BCE's "cash baseline adjustments" -- the items that BCE ignores when calculating its bottom line for public and media consumption -- seem an arbitrary mix of unusual gains, charges, non-cash accounting adjustments and cash costs.

"The biggest problem with BCE's cash baseline earnings is that they're not cash," said **Anthony Scilipoti**, a forensic accountant and vice-president of **Veritas Investment Research** in Toronto. "I find it confusing. If the cash baseline number is a pro forma or made up number, it should be labeled as such."

The differences between BCE's cultivated public image and what's going on under the surface have been extreme.

On its cash baseline basis, BCE's bottom line improved from $1.1-billion in 1999 to $1.2-billion in 2000. That steady improvement continued in 2001 to $1.3-billion.

According to Generally Accepted Accounting Principles, also known as GAAP, the performance has been far more erratic.

In 1999, net income was $5.4-billion, thanks mainly to a one-time $4.2-billion gain from the sale of a 20% ownership interest in Bell Canada to SBC Corp. and $390-million from Nortel Networks Corp.

In 2000, the bottom-line GAAP profit declined to $4.8-billion, inflated again by a $4.1-billion gain from the spinoff of Nortel. In 2001, the GAAP number tumbled to $459-million without any massive asset sales.

Analysts and company executives argue that these GAAP numbers are less useful than the "cash baseline" results because they've been skewed by unusual items, making it difficult to assess progress, or the lack thereof. But the cash baseline number is a muddle of cash, non-cash and non-operating items, which critics say gives an artificially positive view of the results.

It can be argued that a more useful measure would be the GAAP net income for each of BCE's operating units, leaving aside the unusual, non-operating items that BCE confines to its "corporate" accounting line.

Adding back in the "baseline adjustments" to its five main operating units reflects massive restructuring charges that BCE has paid to cut staff at Bell Canada, and the ongoing costs facing Teleglobe Inc. as it tries to restructure its bleeding business.

The inclusion of these expenses, some of which are paid in cash and some of which are non-cash accounting adjustments, shows BCE's 1999 net income at its operating units was $556-million, 49% below its $1.1-billion cash baseline profit. In 2000, the net figure was $600-million, 43% below the cash baseline results.

The chasm between BCE's custom-made accounting and GAAP-based calculations reached stunning proportions last year. BCE's cash baseline earnings, excluding corporate and intercompany eliminations, were $1.1-billion after preferred dividends.

This number largely ignored a series of costly failures that hit the company last year, including a huge jump in severance and restructuring costs at Bell Canada and Teleglobe, and massive losses at Bell Canada International and Excel Communications, a unit that sold long-distance phone time door to door, which was subsequently sold.

Including all of these operational "baseline adjustments" at BCE's five main units, BCE had a loss of $2.59-billion. With billions of dollars in failed investments hidden away as "baseline adjustments," many BCE shareholders were left largely unaware of the costs arising from a series of failed investments. For those who dig into the company's numbers, the poor share performance is easier to understand.

"For the Mom and Pop shareholders who own BCE and want to know why it's gone from $40 to $32, maybe it's gone that way because people are starting to realize that the only business they're really making money on is the plain old telephone system," said Robert Reid, an analyst and head of Independent Equities Research in Toronto. "All their new-economy stuff is not generating any positive earnings and some of them have been an absolute disaster, like Teleglobe and BCI."

At most of BCE's newer businesses, the losses are widening.

The latest casualty is BCE Emergis, its majority-owned electronic-business unit. Losses have ballooned from $69-million in 1999 to $209-million in 2000, and $236-million last year, as acquisition costs mounted.

BCE has consistently emphasized Emergis' growing revenue base, but even that has come under a cloud lately as investors suspect that without major contracts from its benevolent parent, Emergis would fail.

A total of $74-million, or 41% of Emergis's total revenue, came from Bell Canada and other BCE-owned companies in the fourth quarter. Excluding revenue that came from BCE, Emergis's sales actually fell from $128-million in the third quarter to $107.4-million in the fourth.

Last week, the stock plunged 44% in a day after the company announced that it would miss revenue targets this quarter. Analysts are now predicting asset sales and major layoffs -- yet another restructuring job at a troubled BCE subsidiary.

Even BCE's acquisitions of more mature businesses are struggling to pay off. Bell Globemedia, for example, was created in 2000 by combining the CTV television network with The Globe and Mail newspaper and the Sympatico-Lycos group of Internet sites. The unit saw its losses widen to $150-million last year, from $78-million in 2000.

But those troubles are nothing compared to the disaster at Bell Canada International. And yet BCE's accounting keeps the losses at BCI permanently quarantined away from the parent's manicured bottom line.

In December, BCE announced it would sell its 74% stake in BCI, which sells cellular phone service in Latin America, after pumping as much as $890-million into the business since its creation.

Since 1999, BCE's share of the losses at BCI have totalled $437-million. But those losses have never been reflected in BCE's cash baseline earnings, because the company has chosen to treat BCI as a "noncore" business. In fact, the total cost of the BCI debacle may never be fully reflected in BCE's earnings reports because once the business is closed or sold, BCE can move the losses into "discontinued operations," another category ignored in its baseline results.

Similarly, the true extent of the unfolding mess at Teleglobe, BCE's beleaguered international longdistance unit, has never been reflected in BCE's numbers.

Using the baseline approach, Teleglobe has lost $130-million in the two years since BCE acquired it for $6-billion in cash and stock.

Including amortization of the hefty premium BCE paid for the business, and the millions in restructuring and severance costs BCE has paid trying to turn the troubled business around, Teleglobe's losses are closer to $844-million.

Now BCE is laying off more staff at Teleglobe and shifting others to Bell Canada and CGI Inc., units with higher profit margins, better able to absorb Teleglobe's costs and flatter its performance.

This sort of flexibility is both the beauty and the danger of cash baseline reporting and other so-called "pro forma" accounting methods, critics say. Because such methods are not recognized accounting standards, no official guidelines or definitions exist. Companies such as BCE are free to include and exclude whatever items they choose, and they take full advantage of that flexibility.

For example, BCE's Bell ExpressVu satellite TV service has been accounted as a separate line item in quarterly reports for more than two years. The numbers showed the service was signing up customers rapidly, but losses were mounting as the company spent heavily on promotions to attract subscribers away from local cable companies.

After losing $98-million in 1999, ExpressVu bled red ink to the tune of $152-million in 2000. And through the first nine months of last year the business had lost $129-million, on pace for even wider losses than in 2000.

But in the fourth quarter, BCE stopped disclosing ExpressVu's results separately, instead folding them into Bell Canada's earnings and making it impossible to measure the unit's progress.

The only hint of the results came in the notes to the financial statements, where BCE said ExpressVu lost $100-million in the fourth quarter alone, not including taxes, interest on debt, depreciation and amortization.

"These cash baseline earnings give you a good idea of the ongoing value of the assets going forward, but when they do things like really downplaying some of the bad investments, that's a little disingenuous," Mr. Reid said. "Throwing in all of the other stuff in there -- writedowns and restructuring charges -- gives you an idea of the track record of the management of the company. And when I look at BCE, I see a lot of writeoffs."

BCE has made improvements to its earnings reports. In the fourth quarter, the company included a reconciliation to GAAP net income in its general press release, eliminating the need for investors to go to BCE's Web site and download an additional program and 20-page document, just to understand how its baseline numbers were calculated.

The company has said it plans to move back to generally accepted accounting principles this year, leaving cash baseline reporting behind for good.

Spokesman Don Doucette said the company is now a couple of years into its diversification strategy and no longer needs to rely on pro-forma measures for adequate comparisons between years.

But last month, when the firm reported fourth-quarter earnings, its guidance for upcoming quarters was based on net income "excluding non-recurring items," and all analysts now covering the stock have based their earnings forecasts on that pro-forma measure.

Last week, when the company warned that first-quarter results would fall short of expectations, the new forecasts were on the same quasi-GAAP basis, leaving many to openly wonder whether BCE is really ready to abandon its custom-made and always-flattering accounting approach.

DIFFERENT LINES TELL DIFFERENT STORIES:

BCE Earnings

	1999	2000	2001
Cash baseline earnings	$1.1B	$1.2B	$1.3B
GAAP earnings	$5.4B	$4.8B	$459M
GAAP earnings from core operations	$556M	$600M	$2.59B

BCE PROFITS -- INSIDE THE NUMBERS:

1. CASH BASELINE EARNINGS - BCE's unique profit measure, it excludes unusual charges and gains, noncash acquisition costs and losses at some subsidiaries.

2. INTEREST EXPENSE - The key cash expense that arises from rising debt levels as companies seek to expand through acquisitions and capital projects.

3. EARNINGS FROM CONTINUING OPERATIONS - Usually describes the profit or loss in a firm's core business. It can mean different things for different companies depending on what is included. With BCE, for example, it includes gains from businesses it has sold.

4. DISCONTINUED OPERATIONS - Companies can park losses in underperforming units away from its pro forma earnings by declaring them discontinued. Look in footnotes for how much of the losses or profits are cash.

5. NET EARNINGS - The bottom line profit or loss according to generally accepted accounting principles. It takes into account all revenues, costs and non-cash accounting adjustments.

6. GOODWILL - Dismissed by many investors because it represents a non-cash accounting value, goodwill measures the premium paid for acquisitions. It also gives an indication of how vulnerable the company is to writedowns if the market for certain assets slumps.

7. LONG-TERM DEBT - On the balance sheet, this shows how much bank, bond and other long-term loans the company holds. Large increases over a short period indicates rapidly increasing leverage, which will require large cash flow to finance.

8. CASH FLOWS FROM OPERATING ACTIVITIES - describes the cash generated or used in the normal course of business operations, including gains from asset sales, restructuring charges, and dividends from investments etc. this does not include cash used to invest in equipment or subsidiaries, nor cash raised through financings such as bank loans or bonds.