IBM

That Old Financial Magic

How do you grow earnings five times faster than revenues? Just watch.
FORTUNE
Monday, February 18, 2002
By Bethany McLean

"Revenues light but earnings comes in fine," wrote Bear Stearns analyst Andy Neff on Jan. 17 when IBM announced its 2001 financial results. Neff's words evoke the biggest criticism of Gerstner's regime: Given that revenues have grown less than 5% annually since 1994, Big Blue's nearly 20%-a-year earnings growth during that time is a product of financial engineering, pure and simple. The gap between revenue growth and earnings growth has become even wider in recent years; in 1999's fourth quarter IBM reported revenues of $24.2 billion and earnings of $1.12 a share. In 2001's fourth quarter, IBM reported sharply lower revenues--$22.8 billion--but sharply higher earnings: $1.33 a share.

Until recently nobody on Wall Street much cared how IBM produced its earnings--a big reason the stock has gone up more than eightfold during Gerstner's tenure. But as accounting practices have come under scrutiny, IBM has taken a hit. Since Jan. 17, the stock has slipped from nearly $120 a share to $108. The key questions: How big an issue are IBM's less than squeaky-clean earnings? And can Palmisano continue to play the game?

IBM's best-known tricks for generating earnings growth--share buybacks and a reliance on earnings that are a result of its overfunded pension plan--are fairly easy to understand. There's nothing inherently wrong with either of those--or with IBM's success at managing down its tax rate, another earnings enhancer. The issue is more the scale of such activity. For instance, from 1995 through 2001, IBM spent around $44 billion buying back shares, a move that enables a company to report higher earnings per share because there are fewer shares. That sum is only a hair less than the company's total net income of $45.5 billion during the same period. Longtime critics like Grant's Interest Rate Observer contend that there must be better uses for the cash than creating the illusion of growth, and that IBM is engaging in a "slow-mo LBO."

Year-to-Year Growth in ...

Year	Earnings per share	Revenue
1996	2.5%	5.6%
1997	11.0%	3.4%
1998	9.3%	4.0%
1999	13.2%	7.2%
2000	19.4%	1.0%
2001	-2.0%	-2.9%

At the same time, Big Blue's increasing reliance on pension-plan earnings has drawn sharp criticism from disgruntled IBMers and accounting sleuths. (Last year the SEC rejected a proposed resolution from a group of retirees and employees that would have stopped IBM from determining executive compensation based on profits that include pension-plan earnings. The group contends that executives were getting rich at their expense.) In 1997, IBM's pension plan contributed almost nothing to corporate earnings, but in 2000, according to Jack Ciesielski, who writes the Analyst's Accounting Observer, the plan contributed $1.2 billion, or 10%, of IBM's $11.5 billion in pretax profits. Some $200 million of that is due to the fact that IBM raised its expected rate of return on its plan assets from 9.5% to 10%--an odd move in a sliding market. In the first nine months of 2001, IBM's pretax profits fell 1.2%, but Ciesielski calculates that without the pension kick, profits would have fallen 3.7%. The problem is that income from the pension plan doesn't belong to shareholders, so shareholders shouldn't include it when calculating the price they're willing to pay for IBM's shares.

At least these IBM practices can be discerned by anyone who can read a balance sheet. The bigger problems for investors are those that are less visible. For instance, while IBM brags about keeping expenses in check, investors have no way of gauging the facts independently. IBM includes all sorts of things--from asset sales to income to royalties and licensing--in its expense line. And big restructuring charges--most recently a $2.2 billion charge in 1999 that was camouflaged by a $4.1 billion gain on asset sales--can inflate profits in future years. One analyst says that as a result of such charges, IBM could be benefiting by as much as $400 million a year at the operating-income line.

The most important questions, though, involve IBM's services business. Service contracts are booked over long periods--say, ten years--and lots of assumptions go into determining the amount of profit a company records each year. Companies can be as conservative or as aggressive as their accountants will allow; not surprisingly, some IBM skeptics suspect the latter. In addition, IBM has long boasted that its huge backlog of service contracts ($102 billion at the end of 2001) will provide annuity-like stability. Yet despite the backlog, service revenues fell 1% in the fourth quarter. (IBM blamed the shortfall on the economy.) There may be nothing particularly aggressive about the way IBM handles these issues. But nobody knows. Despite the size of the service business, IBM doesn't disclose enough to allow even financial sleuths to find the answers. Still, says a skeptic, "If there are worms, they will crawl out eventually."

Palmisano's challenge will be to either bring in more business--a lot more--or to convince Wall Street that IBM's strengths, such as well over $10 billion in cash flow from operations this year, are just as valuable as magical EPS growth.