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Recurring Gains?

Elizabeth MacDonald, *Forbes Magazine*, 05.14.01

It's curious how, in the face of slumping computer sales, International Business Machines isn't feeling the heat.

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Compaq and Unisys surely are. These companies have put out earnings warnings recently and their stocks are off 55% to 75% from their highs. IBM hasn't issued any profit warnings lately, and its shares trade at \$107, down just 21% from their 52-week high.

IBM does more than make boxes, of course: Services and software accounted for 52% of its \$88.4 billion in revenues last year. But what's really keeping its shares aloft is earnings. For last year the company reported \$8.1 billion, or \$4.44 a share, up 5% from the year before. For the first quarter of 2001 IBM netted \$1.75 billion, or 98 cents a share, up 15% from the first quarter of 2000, on revenues that were up only 9% to \$21 billion. But investors should be wary of this happy earnings picture, says Bradley Rexroad, an analyst at the Center for Financial Research & Analysis, a Rockville, Md. research boutique. A fair amount of the earnings gains in 2000 had nothing to do with the strength in IBM's business operations.

Rexroad backs out \$1.02 from last year's EPS to arrive at an adjusted \$3.42 figure he says is more representative of IBM's underlying earning power. IBM says Rexroad's analysis is off the mark. In a written response to questions, IBM spokeswoman Carol Makovich says the company is within the bounds of accounting rules, which is true, and that Rexroad has done "a surface analysis" without "an understanding of either our company or our industry."

This isn't the first time controversy has erupted over whether some of IBM's earnings gains are a bit artificial. We cited similar arguments in our last cover story on the company (*Forbes*, Oct. 4, 1999). But now, with weakness in capital spending haunting the economy, the matter takes on a little more urgency. Will the earnings disappointments that have butchered the stocks of Dell, Sun and Cisco afflict IBM, too? And should these kinds of accounting maneuvers cause investors to question whether a company is using them to cover up weaknesses in its core operations?

The biggest item on Rexroad's list of artificial gains is the accounting for retirement benefits. IBM has been getting a nice kick



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to reported earnings from the robust state of its pension plans. Pension-related effects boosted the aftertax bottom line by \$820 million last year, a 63% improvement in this source of profits from the year before, Rexroad says.

This shot in the arm comes in several forms. IBM has been shifting from traditional defined benefits for retirees to "cash balance" plans, which should cost less; the strength of the stock market (until 13 months ago) and the bond market has lowered the amount of additional cash IBM had to pour into the pension fund; and the company last year changed its assumption on the fund's future average returns from a somewhat optimistic 9.5% to a more Pollyannaish 10%.

The more an employer can safely assume for future earnings, of course, the less it has to set aside out of today's revenues to pay future benefits. Rexroad says that 10.1% of IBM's reported net income last year was attributable to the pension plans. But this source of earnings assistance can't be counted on every year given how unpredictable the markets are. Makovich notes that IBM's "earnings could, in fact, be hurt in future years if the expected return on plan assets decreases below the current rate expectation."

By the Numbers

IBM's earnings look healthy as can be but they're getting boosted bit by bit by nonoperating items.

Pension gains. **\$0.43**

Web-site development. **0.03**

Reduction in reserves. **0.15**

Cut in tax rate. **0.28**

Share repurchases. **0.13**

TOTAL BOOST \$1.02

Rexroad says IBM also got a 15-cent boost to 2000 EPS by dipping into cookie jars for doubtful accounts, inventories and a reserve for a restructuring related to the sale of its Micrus semiconductor business. In reply, IBM's Makovich says the decrease in its reserves for doubtful accounts was driven by its "strong fourth quarter," that IBM "scrapped over \$600 million of inventory," which thus reduced the reserves for those items and that the restructuring was "prominently disclosed" in the company's filings.

IBM has been adept at keeping its income taxes down, having pared its effective tax rate from 34.4% in 1999 to 29.8% last year. That represents a real gain for shareholders, of course, but it's not the kind of good news that can keep coming. Rexroad says that the decline in the tax rate added 28 cents a share last year. He adds another 3 cents came from an accounting rule change that forced IBM to capitalize, rather than expense Web-site development costs.



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