BEHIND THE NUMBERS
Quality of Earnings Analysis

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International Business Machines Corporation (IBM) Earnings Quality Update

We are maintaining our earnings quality rating of IBM at 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

IBM finally released a 10-K over a month after announcing earnings. Adjusted EPS of $3.87 for 4Q23 beat by 7 cents. However several items only available in the 10-K show that more than 16 cents of the earnings came from unsustainable sources. We consider the beat to be poor quality. Plus, several tailwinds look poised to reverse:

- Advertising continues to decline at IBM and continues to be a source of earnings growth – adding 5 cents to 4Q23 results and 9 cents to the full year:

IBM	4Q23	4Q22	2023	2022	2021	2020	2019
Advertising	$248	$302	$1,237	$1,330	$1,413	$1,509	$1,647

- Bad debt expense was only $3 million in 4Q23 vs. $31 million in 4Q22 adding 2.6 cents to EPS. Bad debt expense has been much lower in recent years including a credit in 2021. For the full year of 2023, IBM picked up 5 cents here.

IBM	4Q23	4Q22	2023	2022	2021	2020	2019
Bad Debt Expense	$3	$31	$10	$64	-$71	$83	$89

- How much longer can IBM draw down its Standard Warranty accrual? In 4Q23, this was a minor headwind of 0.5 cents. But look at how much the accrual has dropped. Every $10 million is 1 cent of EPS:

Standard Warranty	4Q23	4Q22	2023	2022	2021	2020	2019
New Accrual	$31	$26	$84	$84	$82	$83	$111
Used amount	-$19	-$19	-$83	-$81	-$86	-$96	-$115
change in Accrual	$0	-$1	-$14	-$2	-$1	-$16	-$1
Ending Accrual	$65	$79	$65	$79	$77	$83	$113

- Extended Warranties are also dropping. These warranties are recorded as deferred revenues and recognized over time. The amount being recognized as revenue has exceeded new deferred revenues for years. In the 4Q23, this added 1.7 cents to EPS. Notice also that the amount of deferred revenue recognized on the income statement was only down $5 million in 2023, then look at the huge change y/y for 4Q. This source of earnings may be getting smaller too.

Extended Warranty	4Q23	4Q22	2023	2022	2021	2020	2019
New Def. Rev	$15	-$3	$70	$100	$133	$166	$198
Used Def. Rev	-$36	-$19	-$158	-$163	-$198	-$224	-$253
Other	$0	-$1	$0	-$15	-$10	$6	-$2
Ending Accrual	$184	$272	$184	$272	$350	$425	$477

- The tax rate guidance was mid-teens and came in at 13.9% - we believe that is 1%-2% low. Every 1% difference helped 4Q23 results by 4.5 cents.

- IBM extended the life of servers and equipment in 2023. New assets went from 5 years to 6 years. Used equipment went to 4 years instead of 3. It guided for the lower depreciation expense to help results in 2023 by $200 million. Lower depreciation ended up being a $298 million positive. It was still $29 million lower y/y in 4Q23, or 2.7 cents of EPS. We would expect this tailwind to vanish in 2024 as IBM lapped the accounting change.

- Workforce rebalancing was a 2.2 cent headwind in 4Q23. However, this charge continues to run below historical levels. As IBM continues to make acquisitions (9 deals in 2023), we would still expect to see this increasing by more. This is especially true given that the largest acquisition occurred in 3Q23 – yet the expense dropped in 3Q and 4Q. This expense was $438 million for all of 2023. But between 2014-2020, this charge ranged from $555 million to $2.0 billion:

Workforce Rebalancing	4Q	3Q	2Q	1Q
2023	$28	$34	$117	$259
2022	$4	$13	$28	$5

- Interest income still added 7.3 cents for 4Q23 on a y/y increase of $79 million. Look at the upcoming comps though – this may become a headwind in 1Q and 2Q after adding 47.4 cents in 2023:

Interest Income	4Q	3Q	2Q	1Q
2023	$143	$156	$201	$170
2022	$64	$53	$18	$18

- IBM has complained of rising labor costs all year. We always found it odd that somehow engineers in the R&D department were not seeing much growth at all. In 4Q, R&D was up 9% y/y. Perhaps the slow growth in R&D that was helping margins and EPS is now seeing the wage pressure.

- Pension/Benefit income declined by $34 million in 4Q – for a 3.2-cent headwind. IBM noted in the 10-K that a lower discount rate will cost pension income $112 million in 2024. Using annuities in the plan could boost the rate of return which offsets some of that headwind. IBM noted that it should recognize an additional $300 million of loss amortization in 2024, but its non-GAAP earnings will add that back.

- IBM's $5.2 billion in acquisitions in 2023 were assigned to $3.9 billion in goodwill which is not being expensed and $1.9 billion to other intangible assets which IBM adds back to adjusted EPS. This infers that acquisitions are free vs. anything built in-house where the labor costs and equipment would run through the income statement. In 4Q23, IBM added back 37 cents in amortization vs. 34 cents in 4Q22. Also, if goodwill was being expensed over 40 years, IBM would have had 41 cents of cost in 4Q23 and 38 cents in 4Q22. That would cut reported EPS by 20%.

- Financing income did not have as large an impact in 4Q as in 3Q. In 3Q, revenue and gross profit both rose $39 million. In 4Q, revenue was up by $3 million, and gross profit was up by $6.9 million. That still does not seem like a sustainable situation. We would expect a smaller move in the same direction for gross profit vs. revenue.

- IBM also announced it will reconfigure its segment compositions by moving its security services out of software and into the consulting unit. Our initial thought is normally software has higher gross margins than consulting and this could make consulting suddenly appear more profitable with minimal disclosure about it. IBM will also pull stock compensation out of the operating unit results. Much like adding back intangible asset amortization inflates non-GAAP results, removing stock compensation will do the same. After a quarter or two, the market won't focus on the change but on the higher margin. We have seen companies reshuffle assets in the past – it often creates murkiness in reporting for a year. In the case of IBM, it will undoubtedly buy more companies and add those to the mix.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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