Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

BEHIND THE NUMBERS
Quality of Earnings Analysis

January 8, 2021

International Business Machines Corporation (IBM)
Earnings Quality Review- 9/21 Qtr. (part 2)

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

Summary

We could not complete our work on IBM's 3Q21 without the 10-Q, which was released today. We would recommend readers look at our first update from two weeks ago in conjunction. As a quick summary – IBM beat forecasts by 1-cent. A review of accruals and changes in ongoing costs leads us to believe IBM missed forecasts by a wide margin.

- We knew IBM guided to a 17% tax rate and it came in at 4.8%. That was 32-cents of EPS. Excluding the tax benefits from separating Kyndryl, taxes coming in lower than forecast still added 6-cents to adjusted EPS for 3Q21.

- IBM had a $21 million credit for bad debt expense in 3Q21, a y/y improvement of $17 million – this added 1.6 cents to EPS (using the forecasted 17% tax rate).

- Hedging costs fell by $68 million including a $76 million positive swing in SG&A. The $68 million added 6.2 cents to EPS.

- Advertising costs were down y/y too by $12 million, which added another 1.1 cents.

- Workforce rebalancing has been a quarterly charge for 15+ years at IBM. We have been concerned that the $2 billion charge in 4Q20 was allowing IBM to classify future charges in this area into a big-bath item which it added back to earnings. The workforce rebalancing charge had already dropped from $865 million to $241 million in the 1H21. IBM just recorded a $0 for this routine expense in 3Q21. As 4Q laps, we expect this expense to rise again to a $100-$200 million level per quarter. At $100 million, this could have added 9-cents to EPS.

- The offset we did see was IBM had to recognize $42 million in pension losses in the quarter which cost the company 4-cents.

- We noted in the past that IBM had been amortizing acquired intangibles over 5-7 years. With RedHat they boosted that life to 9-10 years for much of it and 20 years for trademarks. IBM's 10-Q shows it is using 8.9 years to amortize Turbonomic. While adjusted EPS adds back all amortization, this is another boost to GAAP EPS.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.