BEHIND
THE NUMBERS
Quality of Earnings Analysis

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

March 1, 2022

# International Business Machines Corporation (IBM)
# Earnings Quality Update- 12/21 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 coverage of IBM at 2- (Weak) and maintaining our Top Sell rating.*

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

## Summary

We have the 10-K now and can fully examine IBM's 4Q21. We urge readers to look at Part 1 of our 4Q21 update on IBM published on January 25. The company beat non-GAAP forecasts by 6 cents we found a myriad of low-quality sources of earnings in the period that more than account for the entire beat. Plus we saw that Kyndryl was a material part of its actual growth along with a very easy comp:

- IBM cut advertising for 4Q to $314 million from $357 million – that added 4 cents to EPS.

- The tax rate came in 300bp lighter than guidance – that added 12 cents to EPS.

- Workforce rebalancing has been a quarterly charge at IBM for more than 15 years. We noted that IBM in the past DID NOT add this back to adjusted EPS except for 4Q20 when it booked a charge of $2.04 billion, which was far above normal. Total workforce rebalancing in 2020 was $2.035 billion with $1.157 billion hitting in 4Q20. We believed that IBM effectively pulled some sizeable future costs into that charge and then adjusted it out. We were not only correct, IBM has now seen workforce rebalancing become a source of earnings:

| Workforce Rebalancing | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| 2021 | -$60 | $0 | $95 | $146 |
| 2020 | $1,157 | $18 | $137 | $728 |

As we said, we've seen this as routine cost for decades at IBM. After the big charges in 2020, 2021 came in much lower. For the first time, it was a $0 in 3Q21. Now, it was a credit for $60 million in 4Q21 – that added 6-cents to EPS. We believe this cost will eventually return and become a drag for earnings.

- IBM continues to report fairly tame R&D increases. We believe IBM continues to acquire much of its R&D. By assigning the bulk of acquisition cost to goodwill, IBM does not have to expense its purchased R&D. Amortization of other intangible assets does impact GAAP EPS, but IBM adds that back to adjusted EPS so it incurs no cost for its acquired R&D there either. We believe the acquisitions should be considered a necessary cash cost which makes the cash flow at IBM more problematic:

| | 2021 | 2020 | 2019 |
|---|---|---|---|
| R&D | $6,488 | $6,267 | $5,910 |
| Cash Ops | $12,796 | $18,197 | $14,270 |
| Cap Ex | $2,062 | $2,618 | $2,286 |
| Software | $706 | $612 | $621 |
| Acquisitions | $3,293 | $336 | $32,630 |
| Free Cash Flow | $6,735 | $14,631 | -$21,267 |
| Dividend | $5,869 | $5,797 | $5,707 |

IBM had some sizeable working capital releases in 2020 with Covid, but it looks like the dividend coverage isn't that great if investors treat acquisitions as a necessary growth path and source of R&D for IBM. Also, keep in mind IBM's cash flow included Kyndryl for 10 months of 2021. We know Kyndryl had negative cash flow from operations of $725 million for January through September.

- Declining bad debt allowances reversed in 4Q21 and was a $23 million cost or 2 cents of headwind for EPS. IBM had been seeing this as a credit for much of 2021 that was helping earnings by 2-3 cents per quarter.

- For the year, accruals for warranty and environmental liabilities declined by $26 million, which helped EPS by 2 cents for all of 2021.

- IBM reported an unrealized gain of $126 million for its 19.9% stake in Kyndryl. It adjusted that out for non-GAAP EPS, but it may be worth noting that the $807 million value it has for that stock is already down to just over $700 million now.

# 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.*