IBM's Accounting Tricks

Last week, The New York Times highlighted yet another one of IBM's accounting shenanigans -- one the company has used in the past, to an even greater degree. Whitney Tilson takes a closer look and says the company's stock is likely to suffer after the full extent of these tricks comes to light.

By Whitney Tilson
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Kudos to Gretchen Morgenson of *The New York Times* for flagging **IBM's** (NYSE: IBM) latest accounting shenanigan. In her column (free subscription required) last Friday, she examined IBM's sale of its optical transceiver business to **JDS Uniphase** (Nasdaq: JDSU) for $340 million on the last day of last quarter. A few weeks later, when IBM reported its fourth-quarter earnings -- which beat Wall Street estimates by a penny per share (of course), despite a big miss on the top line -- "there was no disclosure about the amount generated by the sale or the company's accounting of it." Morgenson revealed why: IBM used the net proceeds from this sale, $300 million, to lower its operating costs, rather than accounting for it as a nonrecurring one-time gain.

While $300 million might not sound like much for a company that had almost $86 billion in revenues last year, Morgenson notes that "by using that gain to offset its expenses, and taking into account the company's tax rate, the sale could have bolstered the company's earnings by as much as 12 cents a share, according to a technology analyst. Such a gain would have represented 9 percent of IBM's per-share earnings in the fourth quarter." Imagine the stock market's reaction had IBM reported earnings that missed consensus analysts' estimates by 11 cents per share!

Is such accounting proper? Not according to Lynn Turner, a former chief accountant of the Securities and Exchange Commission (SEC) who is now director of the center for quality financial reporting at Colorado State University. He told Morgenson, "Staff Accounting Bulletin 101 is very clear that gains from the sale of assets have to be in the 'other income' line. And Staff Accounting Bulletin 99 also makes it clear that when you intentionally violate accounting guidelines, any amount is material."

But IBM's CFO, John Joyce, disputed this assessment. In a report published in Tuesday's *Wall Street Journal*, he said "IBM has included gains from intellectual property in SG&A rather than as 'other income' for 10 years and continues to for the sake of consistency." Yet in a concession to critics, he said "IBM will expand the information it provides about intellectual-property income, the impact of gains and losses from its investments in other companies, the effect of amortization of goodwill from acquisitions, gains on sales of real estate and the impact of income from IBM's overfunded pension plan."

Regardless of whether IBM's accounting in this matter complies with Generally Accepted Accounting Principles, there's no question that it's aggressive, which is especially troubling in this post-Enron world. What could IBM have been thinking? Here's one guess: "We did it on a much larger scale in 1999 and no-one seemed to notice, so why not do it again?" You see, this isn't the first time IBM has engaged in this type of creative accounting. A careful analysis of IBM's 1999 10-K reveals that the company used at least $1.6 billion of the $5 billion generated by the sale of its Global Network business in a similar fashion.

IBM's accounting for its 1999 sale of its Global Network business
Deep in its 1999 10-K, IBM reported that "In December 1998, the company announced that it would sell its Global Network business to AT&T. During 1999, the company completed the sale to AT&T for $4,991 million.... The company recognized a pre-tax gain of $4,057 million ($2,495 million after tax, or $1.33 per diluted common share)."

That's a lot of money! Normally, one would expect such a sale to be treated as a nonrecurring one-time gain, but this line item is nowhere to be found in IBM's 1999 statement of earnings (from the 10-K):

For the year ended December 31:	**1999**
Total revenue	87,548
Total cost	55,619
Gross profit	31,929
Operating expenses:	
Selling, general and administrative	14,729
Research, development and engineering	5,273
Total operating expenses	20,002
Operating income	11,927
Other income, principally interest	557
Interest expense	727
Income before income taxes	11,757
Provision for income taxes	4,045
Net income	7,712
Preferred stock dividends	20
Net income applicable to common stockholders	7,692
Earnings per share of common stock:	
Assuming dilution	$4.12
Basic	$4.25

(Dollars in millions except per share amounts)

The $557 million in "other income, principally interest" is obviously too small to account for the gain on such a large sale. So where did the money go?

Further investigation in the 10-K reveals the following footnote, which shows that IBM used the gain from the sale of its Global Network business both to offset a variety of one-time charges and also boost reported pre-tax income by 16%:

Pre-Tax Income:	**1999**
Total reportable segments	10,117
Elimination of internal transactions	(145)
Sale of Global Network	4,057
1999 actions	(2,205)
Unallocated corporate expenses	(67)
Total IBM Consolidated	11,757

(Dollars in millions)

(Note that the "Total IBM Consolidated" of $11,757 in this footnote is the same as "Income before income taxes" in the earnings statement. "1999 actions" were a number of write-offs, largely stemming from big losses in the company's DRAM business.)

Using one-time gains to offset one-time charges is one of the oldest tricks in the books -- **General Electric** (NYSE: GE), for example, is masterful at this game. To some extent, it's legitimate, though companies often use it to avoid scrutiny of failed investments or underperforming divisions.

The more important issue is how IBM handled the $1.64 billion gain ($11,757 - $10,117) revealed in the footnote above. Where did this huge gain -- equal to $0.59/share after tax or 14% of IBM reported EPS -- go? The answer is revealed in yet another footnote in IBM's 10-K:

Operating Expenses

	1999	1998	1997
Selling, general, admin.	14,729	16,662	16,634
Percentage of revenue	16.8%	20.4%	21.2%

(Dollars in millions)

"Selling, general and administrative (SG&A) expense declined 11.6 percent in 1999 versus 1998 and was essentially flat in 1998 with 1997. *The decrease in 1999 reflects the net pre-tax benefit associated with the sale of the Global Network and the actions taken by the company in 1999 to improve its competitiveness and to strengthen further the company's overall business portfolio.*" [Italics added.]

In other words, IBM applied the $1.6 billion gain to reduce its SG&A expense, which explains why this line item plunged by nearly $2 billion in 1999, boosting reported earnings.

Conclusion

I first warned investors about IBM in January 2000, highlighted last May how the company's overly aggressive pension-fund accounting was inflating earnings, and only a month ago, wrote that IBM "recently reported fourth-quarter sales that were lower than those *five years ago*. With no growth whatsoever in the top line, and the bottom line only up slightly (due primarily to lower taxes and various accounting gimmicks), is IBM really worth nearly *triple* the price it was back then? I think not."

Lou Gerstner deserves credit for turning IBM around in the early and mid-1990s, but over the past few years, in my opinion, his main accomplishment has been creating the appearance of robust growth, despite the company's stagnating business, with all sorts of creative accounting tricks -- most likely legal ones, to be sure, but tricks nevertheless. I predict that these shenanigans will come to light, the stock will suffer -- and so will Gerstner's legacy.

-- Whitney Tilson

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