IBM profit warning gives the market a jolt

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The unexpected announcement by International Business Machines (IBM) that its revenues for the first quarter would be $1 billion less than expectations sent a shiver through Wall Street and global equity markets this week. The last time IBM issued a profit warning was more than a decade ago in June 1991.

In the decade since then the company “re-engineered” itself under chief executive officer Lou Gerstner and had come to be regarded as one of the soundest hi-tech industry investments, particularly in the aftermath of the collapse of the technology stock bubble.

But with the departure of Gerstner on March 1 there are concerns that some of the aggressive accounting methods developed under his leadership might have painted too rosy a picture of the company’s real position.

According to the profit warning issued on Monday, revenue for the first three months of the year will be between $18.4 and $18.6 billion compared to the $19.6 billion expected by market analysts, while earnings per share would be 66 to 70 cents, not the 85 cents which had been expected. The announcement saw an 11 percent drop in IBM shares and resulted in a fall in both the Dow and Nasdaq indexes, reflecting concerns that previous optimism that businesses would soon increase their spending on information technology might be misplaced.

IBM’s chief financial officer John Joyce warned that the business environment “remains very tough”. “We saw a continued slowdown in customer buying decisions in the first quarter,” he said.

Joyce pointed to weakness in IBM’s Technology Group that makes chips, hard drives and other computer components. Revenues in this unit would decline by around 35 percent, leading to a loss of some $200 million.

Some observers believe the profit warning could signal the emergence of long-term problems. Last January, IBM told industry analysts that some large customers of equipment had delayed new purchases of equipment but that it expected them to be made in the first quarter. The revenue write-down seems to indicate that they have not come through, indicating problems for the entire high-tech sector.

As the *Financial Times* noted: “Monday’s earnings warning reinforced the malaise that has hit a once-dynamic industry. IBM has long been considered the bell-wether of the technology sector, and any bad news ripples quickly through the industry at large. But IBM is not alone. A recent spate of warnings from big software companies has shown the lingering problems of the technology sector.

“If companies are delaying their order for big new IT systems, that hits IBM on a number of fronts, from sales of its big mainframe computers to fall-off in the systems consulting work that has been one of its most resilient businesses. IBM is also a big supplier of microchips and hard disc drives to other computer makers. This business has been falling off a cliff, with sales down 35 percent from a year before.”

In addition to concerns over the general state of the industry, questions are also being raised about IBM’s accounting methods in the light of the Enron collapse.

As the *Financial Times* commented, under Gerstner’s direction, IBM, which had been suffering from falling profits at the beginning of the 1990s, strove for “relentless fulfillment of earnings expectations” in line with the demands of Wall Street. While “no huge worries over accounting methods” had surfaced in the aftermath of the Enron debacle, there has been a “sober assessment of how exactly Mr Gerstner pulled off his turn around.”

IBM’s earnings per share have been underpinned in the recent period by extensive share buy-backs and falling tax charges. Share buy-backs mean that with less stock outstanding, earnings per share increase, even though the underlying profitability of the company has not.

Even more controversial is the issue of stock options, which have been used to “massage” earnings. The issuing of stock options enables companies to hand out large financial rewards to executives and employees without affecting the profit and loss account. According to the *Financial Times*: “If IBM were to show the cost of stock options as an expense in its profit and loss account—in common with other tech companies, it does not—its reported earnings would be 15 percent lower.” One estimate is that the impact of stock options on reported earnings today would be double what it was two years ago.

The management of pension funds is also an area where “creative accounting” has been used to lift earnings per share. “Like all companies,” the *Financial Times* continued, “IBM estimates of the costs of its pension fund—or, in its case, the profits it can report from the fund—by using subjective assumptions. But in Big Blue’s case, those assumptions are more rose-tinted than some.

“Pension fund accounting is based on two crucial estimates: the investment returns that the fund will generate over the long term; and the appropriate discount rate that should be applied to those returns to show the fund’s current value, and in turn whether it is adequately funded. During Mr Gerstner’s last two years, IBM lifted the expected return on its investments to 10 percent—high even by the optimistic standards of most big US companies. That gave a big boost to the company’s reported level of profits.”

The recent history of IBM is illustrative of a more general process. With the development of the share market bubble in the latter half of the 1990s, major corporations increasingly resorted to financial manipulation to increase reported earnings and so boost their share prices. Enron is only the most graphic expression, so far, of this tendency. It has been estimated that real profit levels have been declining since around 1997 and that reported profits since then have been overstated by as much as 20 percent.

Such methods, which in other times might well have been denounced as swindling and fraud, have not only boosted individual corporations but have also performed an important macro-economic function. With the balance of payments running at more than 4 percent of gross domestic product, the US has been sustained financially by an inflow of foreign capital to the extent of at least $1 billion per day. On present trends, some $2 billion per day will be needed by 2003.

To this point, the US has experienced little difficulty in attracting this capital and financing its deficit. But if the stock market undergoes a further decline, or if doubts are cast over the real financial status of “blue chip” companies such as IBM, capital could start moving in the other direction, precipitating a major crisis for the US economy as a whole.