

INTERNATIONAL BUSINESS MACHINES CORP

Form 10-Q

October 26, 2010

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10 - Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2010**

**1-2360**

(Commission file number)

**INTERNATIONAL BUSINESS MACHINES CORPORATION**

(Exact name of registrant as specified in its charter)

**New York**

(State of incorporation)

**13-0871985**

(IRS employer identification number)

**Armonk, New York**

(Address of principal executive offices)

**10504**

(Zip Code)

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**914-499-1900**

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐  
(Do not check if a smaller reporting company)

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The registrant has 1,242,361,137 shares of common stock outstanding at September 30, 2010.

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**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES  
CONSOLIDATED STATEMENT OF EARNINGS  
(UNAUDITED)**

(Dollars in millions except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>Revenue:</b>				
Services	\$ 14,179	\$ 13,806	\$ 41,808	\$ 40,462
Sales	9,556	9,216	27,413	26,363
Financing	536	544	1,630	1,702
<b>Total revenue</b>	<b>24,271</b>	<b>23,566</b>	<b>70,852</b>	<b>68,528</b>
<b>Cost:</b>				
Services	9,509	9,233	28,221	27,441
Sales	3,512	3,404	10,049	9,527
Financing	249	301	795	919
<b>Total cost</b>	<b>13,270</b>	<b>12,938</b>	<b>39,065</b>	<b>37,888</b>
<b>Gross profit</b>	<b>11,001</b>	<b>10,627</b>	<b>31,787</b>	<b>30,640</b>
<b>Expense and other income:</b>				
Selling, general and administrative	5,149	5,013	15,886	15,392
Research, development and engineering	1,464	1,446	4,448	4,360
Intellectual property and custom development income	(278)	(294)	(836)	(864)
Other (income) and expense	(106)	5	(746)	(326)
Interest expense	95	84	267	321
<b>Total expense and other income</b>	<b>6,324</b>	<b>6,255</b>	<b>19,019</b>	<b>18,882</b>
<b>Income before income taxes</b>	<b>4,677</b>	<b>4,373</b>	<b>12,767</b>	<b>11,757</b>
Provision for income taxes	1,088	1,159	3,192	3,145
<b>Net income</b>	<b>\$ 3,589</b>	<b>\$ 3,214</b>	<b>\$ 9,576</b>	<b>\$ 8,612</b>
<b>Earnings per share of common stock:</b>				
Assuming dilution	\$ 2.82	\$ 2.40	\$ 7.38	\$ 6.42
Basic	\$ 2.86	\$ 2.44	\$ 7.49	\$ 6.47
<b>Weighted-average number of common shares outstanding: (millions)</b>				
Assuming dilution	1,272.8	1,338.2	1,297.0	1,341.6
Basic	1,255.2	1,319.9	1,278.3	1,330.1
<b>Cash dividend per common share</b>	<b>\$ 0.65</b>	<b>\$ 0.55</b>	<b>\$ 1.85</b>	<b>\$ 1.60</b>

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(Amounts may not add due to rounding.)

(The accompanying notes are an integral part of the financial statements.)

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**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES  
CONSOLIDATED STATEMENT OF FINANCIAL POSITION**

(UNAUDITED)

**ASSETS**

(Dollars in millions)	At September 30, 2010	At December 31, 2009
<b>Assets:</b>		
Current assets:		
Cash and cash equivalents	\$ 9,859	\$ 12,183
Marketable securities	1,227	1,791
Notes and accounts receivable trade (net of allowances of \$318 in 2010 and \$217 in 2009)	9,717	10,736
Short-term financing receivables (net of allowances of \$373 in 2010 and \$438 in 2009)	13,592	14,914
Other accounts receivable (net of allowances of \$10 in 2010 and \$15 in 2009)	1,187	1,143
Inventories, at lower of average cost or market:		
Finished goods	516	533
Work in process and raw materials	2,113	1,960
Total inventories	2,629	2,494
Deferred taxes	1,596	1,730
Prepaid expenses and other current assets	4,661	3,946
Total current assets	44,469	48,935
Plant, rental machines and other property	39,936	39,596
Less: Accumulated depreciation	25,927	25,431
Plant, rental machines and other property net	14,009	14,165
Long-term financing receivables (net of allowances of \$63 in 2010 and \$97 in 2009)	9,448	10,644
Prepaid pension assets	4,379	3,001
Deferred taxes	2,953	4,195
Goodwill	22,703	20,190
Intangible assets net	3,047	2,513
Investments and sundry assets	6,166	5,379
<b>Total assets</b>	<b>\$ 107,174</b>	<b>\$ 109,022</b>

(Amounts may not add due to rounding.)

(The accompanying notes are an integral part of the financial statements.)

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**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION (CONTINUED)  
(UNAUDITED)**

**LIABILITIES AND EQUITY**

(Dollars in millions)	At September 30, 2010	At December 31, 2009
<b>Liabilities:</b>		
Current liabilities:		
Taxes	\$ 2,908	\$ 3,826
Short-term debt	5,556	4,168
Accounts payable	7,084	7,436
Compensation and benefits	4,651	4,505
Deferred income	10,499	10,845
Other accrued expenses and liabilities	4,745	5,223
Total current liabilities	35,443	36,002
Long-term debt	21,899	21,932
Retirement and nonpension postretirement benefit obligations	15,145	15,953
Deferred income	3,487	3,562
Other liabilities	8,842	8,819
<b>Total liabilities</b>	<b>84,815</b>	<b>86,267</b>
<b>Equity:</b>		
IBM stockholders' equity:		
Common stock, par value \$0.20 per share, and additional paid-in capital	44,328	41,810
Shares authorized: 4,687,500,000		
Shares issued: 2010 2,152,542,940		
2009 2,127,016,668		
Retained earnings	88,095	80,900
Treasury stock - at cost	(92,707)	(81,243)
Shares: 2010 910,181,802		
2009 821,679,245		
Accumulated other comprehensive income/(loss)	(17,479)	(18,830)
Total IBM stockholders' equity	22,238	22,637
Noncontrolling interests	121	118
<b>Total equity</b>	<b>22,359</b>	<b>22,755</b>
<b>Total liabilities and equity</b>	<b>\$ 107,174</b>	<b>\$ 109,022</b>

(Amounts may not add due to rounding.)

(The accompanying notes are an integral part of the financial statements.)





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**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30,**

**(UNAUDITED)**

(Dollars in millions)	2010	2009
<b>Cash flow from operating activities:</b>		
Net income	\$ 9,576	\$ 8,612
Adjustments to reconcile net income to cash provided from operating activities:		
Depreciation	2,737	2,806
Amortization of intangibles	859	923
Stock-based compensation	474	416
Net (gain)/loss on asset sales and other	(671)	(350)
Changes in operating assets and liabilities, net of acquisitions/divestitures	(221)	1,917
<b>Net cash provided by operating activities</b>	<b>12,754</b>	<b>14,325</b>
<b>Cash flow from investing activities:</b>		
Payments for plant, rental machines and other property, net of proceeds from dispositions	(2,448)	(2,121)
Investment in software	(433)	(476)
Acquisition of businesses, net of cash acquired	(2,993)	(125)
Divestiture of businesses, net of cash transferred	0	406
Non-operating finance receivables net	173	490
Purchases of marketable securities and other investments	(5,237)	(4,491)
Proceeds from disposition of marketable securities and other investments	6,513	2,082
<b>Net cash used in investing activities</b>	<b>(4,425)</b>	<b>(4,234)</b>
<b>Cash flow from financing activities:</b>		
Proceeds from new debt	4,665	2,414
Payments to settle debt	(5,122)	(10,760)
Short-term borrowings/(repayments) less than 90 days net	1,405	(151)
Common stock repurchases	(11,774)	(4,365)
Common stock transactions other	2,625	1,502
Cash dividends paid	(2,369)	(2,133)
<b>Net cash used in financing activities</b>	<b>(10,569)</b>	<b>(13,494)</b>
Effect of exchange rate changes on cash and cash equivalents	(83)	193
<b>Net change in cash and cash equivalents</b>	<b>(2,324)</b>	<b>(3,210)</b>
Cash and cash equivalents at January 1	12,183	12,741
<b>Cash and cash equivalents at September 30</b>	<b>\$ 9,859</b>	<b>\$ 9,532</b>

(Amounts may not add due to rounding.)

(The accompanying notes are an integral part of the financial statements.)



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**Notes to Consolidated Financial Statements:**

**1. Basis of Presentation:** The accompanying Consolidated Financial Statements and footnotes thereto of the International Business Machines Corporation (IBM or the company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial statements and footnotes are unaudited. In the opinion of the company's management, these statements include all adjustments, which are of a normal recurring nature, necessary to present a fair statement of the company's results of operations, financial position and cash flows.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the assets, liabilities, revenue, costs, expenses and accumulated other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. Actual results may be different. See the company's 2009 Annual Report on pages 52 to 54 for a discussion of the company's critical accounting estimates.

Interim results are not necessarily indicative of financial results for a full year. The information included in this Form 10-Q should be read in conjunction with the company's 2009 Annual Report.

Noncontrolling interest amounts in income of \$2.6 million and \$1.3 million, net of tax, for the three months ended September 30, 2010 and 2009, respectively, and \$5.4 million and \$4.1 million for the nine months ended September 30, 2010 and 2009, respectively, are not presented separately in the Consolidated Statement of Earnings due to immateriality, but are reflected within the other (income) and expense line item. Additionally, changes to noncontrolling interests are presented in Note 10, Equity Activity, on pages 27 and 28.

Within the financial tables presented, certain columns and rows may not add due to the use of rounded numbers for disclosure purposes. Percentages presented are calculated from the underlying whole-dollar amounts. Certain prior year amounts have been reclassified to conform to the current year presentation. This is annotated where applicable.

**2. Accounting Changes:** In July 2010, the Financial Accounting Standards Board (FASB) issued amendments to the disclosure requirements about the credit quality of financing receivables and the allowance for credit losses. The purpose of the additional disclosures is to enable users of financial statements to better understand the nature of credit risk inherent in an entity's portfolio of financing receivables and how that risk is analyzed. For end of period balances, the new disclosures are required to be made in all interim and annual periods ending on or after December 15, 2010. For activity during a reporting period, the disclosures are required to be made in all interim and annual periods after January 1, 2011. These changes will not have an impact on the consolidated financial results as this guidance only relates to additional disclosures.

In January 2010, the FASB issued additional disclosure requirements for fair value measurements. The guidance requires previous fair value hierarchy disclosures to be further disaggregated by class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. In addition, significant transfers between Levels 1 and 2 of the fair value hierarchy are required to be disclosed. These additional requirements became effective January 1, 2010 for quarterly and annual reporting. These amendments did not have an impact on the consolidated financial results as this guidance relates only to additional disclosures. See Note 4, Fair Value, on pages 11 to 13 for further information. In addition, the fair value disclosure amendments also require more detailed disclosures of the changes in Level 3

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instruments. These changes will be effective January 1, 2011 and will not have an impact on the consolidated financial results as this guidance only relates to additional disclosures.

In October 2009, the FASB issued amended revenue recognition guidance for arrangements with multiple deliverables. The new guidance requires the use of management's best estimate of selling price (BESP) for the deliverables in an arrangement when vendor specific objective evidence (VSOE), vendor objective evidence (VOE) or third party evidence (TPE) of the selling price is not available. In addition, excluding specific software revenue recognition guidance, the residual method of allocating arrangement consideration is no longer permitted, and an entity is required to allocate arrangement consideration using the relative selling price method. In accordance with the guidance, the company elected to early adopt its provisions as of January 1, 2010 on a prospective basis for all new or materially modified arrangements entered into on or after that date. The adoption of this guidance did not have a material impact on the Consolidated Financial Statements.

Also, in October 2009, the FASB issued guidance which amended the scope of existing software revenue recognition guidance. Tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are no longer within the scope of software revenue recognition guidance and are accounted for based on other applicable revenue recognition guidance. In addition, the amendments require that hardware components of a tangible product containing software components are always excluded from the software revenue recognition guidance. This guidance must be adopted in the same period that the company adopts the amended guidance for

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**Notes to Consolidated Financial Statements (continued)**

arrangements with multiple deliverables described in the preceding paragraph. Therefore, the company elected to early adopt this guidance as of January 1, 2010 on a prospective basis for all new or materially modified arrangements entered into on or after that date. The adoption of this guidance did not have a material impact on the Consolidated Financial Statements.

See Note 3, Revenue Recognition for Arrangements with Multiple Deliverables, on pages 8 to 11 for the required disclosures and other information related to the adoption of these accounting standards.

In June 2009, the FASB issued amendments to the accounting rules for variable interest entities (VIEs). The new guidance eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity and requires ongoing qualitative reassessments of whether an enterprise is the primary beneficiary. The company adopted these amendments for interim and annual reporting periods beginning on January 1, 2010. The adoption of these amendments did not have a material impact on the Consolidated Financial Statements.

**3. Revenue Recognition for Arrangements with Multiple Deliverables:** As discussed in Note 2, Accounting Changes, on page 7, effective January 1, 2010 the company adopted on a prospective basis for all new or materially modified arrangements entered into on or after that date the amended accounting guidance for multiple-deliverable revenue arrangements and the amended guidance related to the scope of existing software revenue recognition guidance. The amended guidance does not generally change the units of accounting for the company's revenue transactions. Most of the company's products and services qualify as separate units of accounting.

The company enters into revenue arrangements that may consist of multiple deliverables of its products and services based on the needs of its clients. These arrangements may include any combination of services, software, hardware and/or financing. For example, a client may purchase a server that includes operating system software. In addition, the arrangement may include post-contract support for the software and a contract for post-warranty maintenance service for the hardware. These types of arrangements can also include financing provided by the company. These arrangements consist of multiple deliverables, with the hardware and software delivered in one reporting period and the software support and hardware maintenance services delivered across multiple reporting periods. In another example, a client may outsource the running of its datacenter operations to the company on a long term, multiple year basis and periodically purchase servers and/or software products from the company to upgrade or expand its facility. The outsourcing services are provided on a continuous basis across multiple reporting periods and the hardware and software products are delivered in one reporting period. To the extent that a deliverable in a multiple-deliverable arrangement is subject to specific guidance that deliverable is accounted for in accordance with such specific guidance. Examples of such arrangements may include leased hardware which is subject to specific leasing guidance or software which is subject to specific software revenue recognition guidance on whether and/or how to separate multiple deliverable arrangements into separate units of accounting (separability) and how to allocate the arrangement consideration among those separate units of accounting (allocation). For all other deliverables in multiple-deliverable arrangements, the guidance below is applied for separability and allocation. A multiple-deliverable arrangement is separated into more than one unit of accounting if the following criteria are met:

- The delivered item(s) has value to the client on a stand-alone basis; and
- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the company.

If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element and there is a relative selling price for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative selling price. The revenue recognition policies described below are then applied to each unit of accounting, as applicable.

## Services

The company's primary services offerings include information technology (IT) datacenter and business process outsourcing, application management services, consulting and systems integration, technology infrastructure and system maintenance, Web hosting and the design and development of complex IT systems to a client's specifications (design and build). These services are provided on a time-and-material basis, as a fixed-price contract or as a fixed-price per measure of output contract and the contract terms range from less than one year to over 10 years.

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**Notes to Consolidated Financial Statements (continued)**

Revenue from IT datacenter and business process outsourcing contracts is recognized in the period the services are provided using either an objective measure of output or on a straight-line basis over the term of the contract. Under the output method, the amount of revenue recognized is based on the services delivered in the period.

Revenue from application management services, technology infrastructure and system maintenance and Web hosting contracts is primarily recognized on a straight-line basis over the terms of the contracts. Revenue from time-and-material contracts is recognized as labor hours are delivered and direct expenses are incurred. Revenue related to extended warranty and product maintenance contracts is recognized on a straight-line basis over the delivery period.

Revenue from fixed-price design and build contracts is recognized under the percentage-of-completion (POC) method. Under the POC method, revenue is recognized based on the labor costs incurred to date as a percentage of the total estimated labor costs to fulfill the contract. If circumstances arise that change the original estimates of revenues, costs, or extent of progress toward completion, revisions to the estimates are made. These revisions may result in increases or decreases in estimated revenues or costs, and such revisions are reflected in income in the period in which the circumstances that gave rise to the revision become known by management.

**Hardware**

The company's hardware offerings include the sale or lease of system servers, storage solutions, retail store systems and the sale of semiconductor design and manufacturing services. The company provides warranties for its hardware products that range up to three years, with the majority being either one year or three years. The company also offers installation services for its more complex products.

Revenue from hardware sales and sales-type leases is recognized when risk of loss has transferred to the client and there are no unfulfilled company obligations that affect the client's final acceptance of the arrangement. Any cost of standard warranties and remaining obligations that are inconsequential or perfunctory are accrued when the corresponding revenue is recognized. Revenue from extended warranty contracts, for which the company is obligated to perform, is recorded as deferred income and subsequently recognized on a straight-line basis over the delivery period. Revenue from rentals and operating leases is recognized on a straight-line basis over the term of the rental or lease.

**Software**

Revenue from perpetual (one-time charge) license software is recognized at the inception of the license term if all revenue recognition criteria have been met. Revenue from term (recurring license charge) license software is recognized on a subscription basis over the period that the client is entitled to use the license. Revenue from subscription and support, which includes unspecified upgrades on a when-and-if-available basis is recognized on a straight-line basis over the period such items are delivered. In multiple-deliverable revenue arrangements that include software that is more than incidental to the products or services as a whole (software multiple-deliverable arrangements), software and software-related elements are accounted for in accordance with software revenue recognition guidance. Software-related elements include

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software products and services for which a software deliverable is essential to its functionality. Tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are no longer within the scope of software revenue recognition guidance and are accounted for based on other applicable revenue recognition guidance.

A software multiple-deliverable arrangement is separated into more than one unit of accounting if all of the following criteria are met:

- The functionality of the delivered element(s) is not dependent on the undelivered element(s);
- There is VSOE of fair value of the undelivered element(s). VSOE of fair value is based on the price charged when the deliverable is sold separately by the company on a regular basis and not as part of the multiple-deliverable arrangement; and
- Delivery of the delivered element(s) represents the culmination of the earnings process for that element(s).

If any one of these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized on a straight-line basis or being deferred until the earlier of when such criteria are met or when the



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**Notes to Consolidated Financial Statements (continued)**

last undelivered element is delivered. If these criteria are met for each element and there is VSOE of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative VSOE of fair value. There may be cases, however, in which there is VSOE of fair value of the undelivered item(s) but no such evidence for the delivered item(s). In these cases, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate VSOE of fair value of the undelivered elements.

The company's multiple-deliverable arrangements may have a stand-alone software deliverable that is subject to the existing software revenue recognition guidance. The revenue for these multiple deliverable arrangements is allocated to the software deliverable and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy (VSOE, TPE or BESP) in the new amended revenue accounting guidance. In the limited circumstances where the company cannot determine VSOE or TPE of the selling price for all of the deliverables in the arrangement, including the software deliverable, BESP is used for the purposes of performing this allocation.

**Financing**

Financing income attributable to sales-type leases, direct financing leases and loans is recognized on the accrual basis using the effective interest method. Operating lease income is recognized on a straight-line basis over the term of the lease.

**Determination of Best Estimate of Selling Price**

In certain limited instances, the company is not able to establish VSOE for all elements in a multiple deliverable arrangement. When VSOE cannot be established, the company attempts to establish the selling price of each element based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately.

When the company is unable to establish selling price using VSOE or TPE, the company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the company would transact a sale if the product or service were sold on a stand-alone basis. Due to the fact that the company sells its products and services on a stand-alone basis, and therefore has established VSOE for its products and services offerings, the company expects to use BESP to determine the relative selling price for a product or service in a multiple-deliverable arrangement on an infrequent basis. An example of when BESP would be used is when the company sells a new product, for which VSOE and TPE does not exist, in a multiple deliverable arrangement prior to selling the new product on a stand-alone basis. During the third quarter and the first nine months of 2010, BESP was used in 8 and 17 transactions, respectively, and the effects of its use were immaterial.

The company determines BESP for a product or service by considering multiple factors including, but not limited to, overall market conditions, including geographic or regional specific market factors, competitive positioning, competitor actions, internal costs, profit objectives and pricing

practices. The determination of BESP is a formal process within the company that includes review and approval by the company's management. In addition, the company regularly reviews VSOE and TPE for its products and services, in addition to BESP.

#### **Effect of Adoption**

For transactions entered into prior to January 1, 2010, the company recognized revenue based on established revenue recognition guidance as it related to the elements within the arrangement. For the vast majority of the company's arrangements involving multiple deliverables, the fee from the arrangement was allocated to each respective element based on its relative fair value, using VSOE. In the limited circumstances when the company was not able to determine VSOE for all of the elements of the arrangement, but was able to obtain VSOE for any undelivered elements, revenue was allocated using the residual method. Under the residual method, the amount of revenue allocated to delivered elements equaled the total arrangement consideration less the aggregate fair value of any undelivered elements, and no revenue was recognized until all elements without VSOE had been delivered. If VSOE of any undelivered items did not exist, revenue from the entire arrangement was initially deferred and recognized at the earlier of: (i) delivery of those elements for which VSOE did not exist or (ii) when VSOE was established. The residual method and recognition of revenue on a ratable basis were generally used in circumstances where VSOE, as applicable, was unavailable.

The new amended accounting standards for multiple-deliverable revenue arrangements and changes to the scope of existing software revenue recognition guidance if applied to transactions in the year ended December 31, 2009 would not have resulted in a material change to the company's reported revenue for that fiscal year period.

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**Notes to Consolidated Financial Statements (continued)**

In addition, there would not have been a material impact to revenue, as reported during the three and nine months ended September 30, 2010, if the transactions entered into or materially modified on or after January 1, 2010 were subject to the previous accounting guidance.

As discussed in Note 2, Accounting Changes, on pages 7 and 8 there was no material impact in the third quarter or the first nine months of 2010, respectively, from the adoption of the amended revenue recognition guidance. In terms of the timing and pattern of revenue recognition, the new accounting guidance for revenue recognition is not expected to have a material impact on revenue in future periods.

See the company's 2009 Annual Report, Note A, Significant Accounting Policies, on pages 70 and 71 and Critical Accounting Estimates, on pages 52 and 53 for additional information.

**4. Fair Value:** Exit prices are used to measure assets and liabilities that fall within the scope of the fair value measurements guidance. Under this guidance, the company is required to classify certain assets and liabilities based on the following fair value hierarchy:

- Level 1 Quoted prices in active markets that are unadjusted and accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 Quoted prices for identical assets and liabilities in markets that are not active, quoted prices for similar assets and liabilities in active markets or financial instruments for which significant inputs are observable, either directly or indirectly; and
- Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

The guidance requires the use of observable market data if such data is available without undue cost and effort.

When available, the company uses unadjusted quoted market prices to measure the fair value and classifies such items within Level 1. If quoted market prices are not available, fair value is based upon internally developed models that use current market-based or independently sourced market parameters such as interest rates and currency rates. Items valued using internally generated models are classified according to the lowest level input or value driver that is significant to the valuation.

The determination of fair value considers various factors including interest rate yield curves and time value underlying the financial instruments. For derivatives and debt securities, the company uses a discounted cash flow analysis using discount rates commensurate with the duration of the instrument.

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In determining the fair value of financial instruments, the company considers certain market valuation adjustments to the base valuations calculated using the methodologies described below for several parameters that market participants would consider in determining fair value:

- Counterparty credit risk adjustments are applied to financial instruments, taking into account the actual credit risk of a counterparty as observed in the credit default swap market to determine the true fair value of such an instrument.
- Credit risk adjustments are applied to reflect the company's own credit risk when valuing all liabilities measured at fair value. The methodology is consistent with that applied in developing counterparty credit risk adjustments, but incorporates the company's own credit risk as observed in the credit default swap market.

As an example, the fair value of derivatives is derived by a discounted cash flow model using observable market inputs such as known notional value amounts, yield curves, spot and forward exchange rates as well as discount rates. These inputs relate to liquid, heavily traded currencies with active markets which are available for the full term of the derivative.

Certain financial assets are measured at fair value on a nonrecurring basis. These assets include equity method investments that are recognized at fair value at the end of the period to the extent that they are deemed to be other-than-temporarily impaired. Certain assets that are measured at fair value on a recurring basis can be subject to nonrecurring fair value measurements. These assets include public cost method investments that are deemed to be other-than-temporarily impaired. In the event of an other-than-temporary impairment of a financial investment, fair value is measured using a model described above.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

Non-financial assets such as property plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. See Note A, Significant Accounting Policies, on pages 70 to 79 in the 2009 Annual Report for further information. There were no material impairments of non-financial assets for the nine months ended September 30, 2010 and September 30, 2009, respectively.

The following tables present the company's financial assets and financial liabilities that are measured at fair value on a recurring basis at September 30, 2010 and December 31, 2009.

(Dollars in millions)					
At September 30, 2010		Level 1	Level 2	Level 3	Total
Assets:					
Cash and cash equivalents(1)					
Time deposits and certificates of deposit	\$	\$	3,020	\$	\$ 3,020
Commercial paper			1,832		1,832
Money market funds		2,012			2,012
U.S. Federal Government securities			450		450
Other securities			9		9
Total		2,012	5,311		7,323
Debt securities – current(2)					
Time deposits and certificates of deposit			150		150
Commercial paper			677		677
U.S. Federal Government securities			399		399
Other securities			1		1
Total			1,227		1,227
Debt securities – noncurrent(3)		1	7		8
Non-equity method alliance investments(3)		462	7		469
Derivative assets(4)					
Interest rate contracts			910		910
Foreign exchange contracts			570		570
Equity contracts			23		23
Total			1,503		1,503(6)
Total Assets	\$	2,475	\$ 8,055	\$	\$ 10,530
Liabilities:					
Derivative liabilities(5)					
Foreign exchange contracts	\$	\$	979	\$	\$ 979
Equity contracts			2		2
Total Liabilities	\$	\$	981	\$	\$ 981(6)

(1) Included within cash and cash equivalents in the Consolidated Statement of Financial Position.

(2) Reported as marketable securities in the Consolidated Statement of Financial Position.

(3) Included within investments and sundry assets in the Consolidated Statement of Financial Position.

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- (4) The gross balances of derivative assets contained in prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at September 30, 2010 are \$526 million and \$977 million, respectively.
- (5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other liabilities in the Consolidated Statement of Financial Position at September 30, 2010 are \$761 million and \$220 million, respectively.
- (6) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by \$480 million each.

Table of Contents**Notes to Consolidated Financial Statements (continued)****(Dollars in millions)****At December 31, 2009**

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Assets:</b>				
Cash and cash equivalents(1)				
Time deposits and certificates of deposit	\$	\$ 4,324	\$	\$ 4,324
Commercial paper		2,099		2,099
Money market funds	2,780			2,780
Other securities		74		74
Total	2,780	6,497		9,277
Debt securities current(2)				
Commercial paper		1,491		1,491
U.S. Federal Government securities		300		300
Total		1,791		1,791
Debt securities noncurrent(3)	3	6		9
Non-equity method alliance investments(3)	366	8		374
Derivative assets(4)				
Interest rate contracts		426		426
Foreign exchange contracts		407		407
Equity contracts		5		5
Total		838		838(6)
<b>Total Assets</b>	<b>\$ 3,149</b>	<b>\$ 9,140</b>	<b>\$</b>	<b>\$ 12,289</b>
<b>Liabilities:</b>				
Derivative liabilities(5)				
Interest rate contracts	\$	\$ 2	\$	\$ 2
Foreign exchange contracts		1,553		1,553
<b>Total Liabilities</b>	<b>\$</b>	<b>\$ 1,555</b>	<b>\$</b>	<b>\$ 1,555(6)</b>

(1) Included within cash and cash equivalents in the Consolidated Statement of Financial Position.

(2) Reported as marketable securities in the Consolidated Statement of Financial Position.

(3) Included within investments and sundry assets in the Consolidated Statement of Financial Position.

(4) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at December 31, 2009 are \$273 million and \$565 million, respectively.

(5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other liabilities in the Consolidated Statement of Financial Position at December 31, 2009 are \$906 million and \$649 million, respectively.

(6) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by \$573 million each.

There were no significant transfers between Levels 1 and 2 for the nine months ended September 30, 2010 and for the year ended December 31, 2009.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

**5. Financial Instruments (excluding derivatives):** Cash and cash equivalents, debt and marketable equity securities are recognized and measured at fair value in the company's consolidated financial statements. Notes and other accounts receivable and other investments are financial assets with carrying values that approximate fair value. Accounts payable, other accrued expenses and short-term debt are financial liabilities with carrying values that approximate fair value. In the absence of quoted prices in active markets, considerable judgment is required in developing estimates of fair value. Estimates are not necessarily indicative of the amounts the company could realize in a current market transaction. The following methods and assumptions are used to estimate fair values:

**Loans and Long-term Receivables**

Fair values are based on discounted future cash flows using current interest rates offered for similar loans to clients with similar credit ratings for the same remaining maturities.

**Long-term Debt**

Fair value of publicly-traded long-term debt is based on quoted market prices for the identical liability when traded as an asset in an active market. For other long-term debt for which a quoted market price is not available, an expected present value technique that uses rates currently available to the company for debt with similar terms and remaining maturities is used to estimate fair value. The carrying amount of long-term debt is \$21,899 million and \$21,932 million and the estimated fair value is \$24,404 million and \$23,748 million at September 30, 2010 and December 31, 2009, respectively.

**Debt and Marketable Equity Securities**

The following tables summarize the company's debt and marketable equity securities all of which are considered available-for-sale and recorded at fair value in the Consolidated Statement of Financial Position.

(Dollars in millions)		Adjusted		Gross		Gross		Fair
At September 30, 2010		Cost		Unrealized		Unrealized		Value
				Gains		Losses		
Cash and cash equivalents*								
Time deposits and certificates of deposit	\$	3,020	\$			(0)	\$	3,020
Commercial paper		1,832				(0)		1,832
Money market funds		2,012						2,012
U.S. Federal Government securities		450		0				450
Other securities		9						9
Total	\$	7,323	\$	0	\$	(0)	\$	7,323



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Debt securities current\*\*

Commercial paper	\$	677	\$		\$	(0)	\$	677
Time deposits and certificates of deposit		150		0				150
Other securities		1						1
U.S. Federal Government securities		399				(0)		399
Total	\$	1,227	\$	0	\$	(0)	\$	1,227

Debt securities noncurrent\*\*\*

Other securities	\$	7	\$	1	\$		\$	8
Total	\$	7	\$	1	\$		\$	8
Non-equity method alliance investments***	\$	206	\$	264	\$	(1)	\$	469

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\* Included within cash and cash equivalents in the Consolidated Statement of Financial Position.

\*\* Reported as marketable securities within the Consolidated Statement of Financial Position.

\*\*\* Included within investments and sundry assets in the Consolidated Statement of Financial Position.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

<b>(Dollars in millions)</b>					
<b>At December 31, 2009</b>	<b>Adjusted</b>	<b>Gross</b>	<b>Gross</b>	<b>Fair</b>	
	<b>Cost</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Value</b>	
		<b>Gains</b>	<b>Losses</b>		
<b>Cash and cash equivalents*</b>					
Time deposits and certificates of deposit	\$ 4,324	\$ 0	\$	\$	4,324
Commercial paper	2,099		(0)		2,099
Money market funds	2,780				2,780
Other securities	74				74
<b>Total</b>	<b>\$ 9,277</b>	<b>\$ 0</b>	<b>\$ (0)</b>	<b>\$</b>	<b>9,277</b>
<b>Debt securities current**</b>					
Commercial paper	\$ 1,491	\$	(0)		1,491
U.S. Federal Government securities	300	0			300
<b>Total</b>	<b>\$ 1,791</b>	<b>\$ 0</b>	<b>\$ (0)</b>	<b>\$</b>	<b>1,791</b>
<b>Debt securities noncurrent***</b>					
Other securities	\$ 9	\$ 0	(0)	\$	9
<b>Total</b>	<b>\$ 9</b>	<b>\$ 0</b>	<b>\$ (0)</b>	<b>\$</b>	<b>9</b>
Non-equity method alliance investments***	\$ 183	\$ 201	(10)	\$	374

\* Included within cash and cash equivalents in the Consolidated Statement of Financial Position.

\*\* Reported as marketable securities within the Consolidated Statement of Financial Position.

\*\*\* Included within investments and sundry assets in the Consolidated Statement of Financial Position.

Based on an evaluation of available evidence as of September 30, 2010, the company believes that unrealized losses on debt and marketable equity securities are temporary and do not represent a need for an other-than-temporary impairment.

Proceeds from sales of debt securities and marketable equity securities were approximately \$1 million and \$14 million for the third quarter and first nine months of 2010, respectively. The gross realized gains (before taxes) on these sales were less than \$1 million and \$5 million for the third quarter and first nine months of 2010, respectively. The gross realized losses (before taxes) on these sales were less than \$1 million in the third quarter and first nine months of 2010. Proceeds from the sales of debt securities and marketable equity securities were approximately \$12 million and \$23 million in the third quarter and first nine months of 2009, respectively. The gross realized gains (before taxes) on these sales totaled \$2 million in the third quarter and first nine months of 2009. The gross realized losses (before taxes) on these sales totaled \$19 million and \$40 million in the third quarter and first nine months of 2009, respectively. The company determines the cost of the securities sold based on the specific identification method.

The after tax net unrealized holding gains/(losses) on available-for-sale debt and marketable equity securities that have been included in accumulated other comprehensive income/(loss) and the after tax net gains/(losses) reclassified from accumulated other comprehensive income/(loss) into net income were as follows:

<b>(Dollars in millions)</b>				
<b>For the three months ended September 30:</b>		<b>2010</b>		<b>2009</b>
Net unrealized gains/(losses) arising during the period	\$	56	\$	9
Less: Net (losses)/gains included in net income for the period*		(0)		(25)

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<b>Net unrealized gains/(losses) on marketable securities</b>	\$	56	\$	34
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\* Includes writedowns of \$0.5 million and \$14.2 million for the three months ended September 30, 2010 and 2009, respectively.

(Dollars in millions)

**For the nine months ended September 30:**

	<b>2010</b>		<b>2009</b>	
Net unrealized gains/(losses) arising during the period	\$	50	\$	33
Less: Net (losses)/gains included in net income for the period*		(0)		(37)
<b>Net unrealized gains/(losses) on marketable securities</b>	\$	50	\$	70

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\* Includes writedowns of \$3.6 million and \$14.3 million for the nine months ended September 30, 2010 and 2009, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at September 30, 2010.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

**6. Financing Receivables:** The following table presents financing receivables, net of allowances for doubtful accounts, including residual values.

(Dollars in millions)	At September 30, 2010	At December 31, 2009
<b><u>Current:</u></b>		
Net investment in sales-type and direct financing leases	\$ 4,030	\$ 4,105
Commercial financing receivables	4,776	5,604
Client loan receivables	4,086	4,475
Installment payment receivables	700	730
Total	\$ 13,592	\$ 14,914
<b><u>Noncurrent:</u></b>		
Net investment in sales-type and direct financing leases	\$ 4,740	\$ 5,331
Commercial financing receivables	51	58
Client loan receivables	4,249	4,759
Installment payment receivables	409	496
Total	\$ 9,448	\$ 10,644

Net investment in sales-type and direct financing leases is for leases that relate principally to the company's systems products and are for terms ranging generally from two to six years. Net investment in sales-type and direct financing leases includes unguaranteed residual values of \$803 million and \$849 million at September 30, 2010 and December 31, 2009, respectively, and is reflected net of unearned income of \$761 million and \$905 million and of allowance for doubtful accounts receivable of \$151 million and \$159 million at those dates, respectively.

Commercial financing receivables relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and non-IBM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan receivables are loans that are provided by Global Financing primarily to clients to finance the purchase of software and services. Separate contractual relationships on these financing arrangements are for terms ranging generally from two to seven years. Each financing contract is priced independently at competitive market rates. The company has a history of enforcing the terms of these separate financing agreements.

The company utilizes certain of its financing receivables as collateral for non-recourse borrowings. Financing receivables pledged as collateral for borrowings were \$278 million and \$271 million at September 30, 2010 and December 31, 2009, respectively.

The company did not have any financing receivables held for sale as of September 30, 2010 and December 31, 2009.

**7. Derivatives and Hedging Transactions:** The company operates in multiple functional currencies and is a significant lender and borrower in the global markets. In the normal course of business, the company is exposed to the impact of interest rate changes and foreign currency fluctuations, and to a lesser extent equity and commodity price changes and client credit risk. The company limits these risks by following established risk management policies and procedures, including the use of derivatives, and, where cost effective, financing with debt in the currencies in which assets are denominated. For interest rate exposures, derivatives are used to better align rate movements between the interest rates associated with the company's lease and other financial assets and the interest rates associated with its financing debt. Derivatives are also used to manage the related cost of debt. For foreign currency exposures, derivatives are used to better manage the cash flow volatility arising from foreign exchange rate fluctuations.

As a result of the use of derivative instruments, the company is exposed to the risk that counterparties to derivative contracts will fail to meet their contractual obligations. To mitigate the counterparty credit risk, the company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors. The company's established policies and procedures for mitigating credit risk on principal transactions include reviewing and establishing limits for credit exposure and continually assessing the creditworthiness of counterparties. The right of set-off that exists under certain of these arrangements enables the legal entities of the company subject to the

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**Notes to Consolidated Financial Statements (continued)**

arrangement to net amounts due to and from the counterparty reducing the maximum loss from credit risk in the event of counterparty default. The company is also a party to collateral security arrangements with most of its major counterparties. These arrangements require the company to hold or post collateral (cash or U.S. Treasury securities) when the derivative fair values exceed contractually established thresholds. Posting thresholds can be fixed or can vary based on credit default swap pricing or credit ratings received from the major credit agencies. The aggregate fair value of all derivative instruments under these collateralized arrangements that were in a liability position at September 30, 2010 and December 31, 2009 was \$326 million and \$779 million, respectively, for which the company has posted collateral of \$21 million and \$37 million, respectively. Full collateralization of these agreements would be required in the event that the company's credit rating falls below investment grade or if its credit default swap spread exceeds 250 basis points, as applicable, pursuant to the terms of the collateral security arrangements. The aggregate fair value of derivative instruments in net asset positions as of September 30, 2010 and December 31, 2009 was \$1,503 million and \$838 million, respectively. This amount represents the maximum exposure to loss at the reporting date as a result of the counterparties failing to perform as contracted. This exposure is reduced by \$480 million and \$573 million at September 30, 2010 and December 31, 2009, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at September 30, 2010, this exposure is reduced by \$323 million of collateral received by the company. The company does not offset derivative assets against liabilities in master netting arrangements nor does it offset receivables or payables recognized upon payment or receipt of cash collateral against the fair values of the related derivative instruments. At September 30, 2010, \$21 million was recognized in other receivables for the right to reclaim cash collateral. At December 31, 2009, \$37 million was recorded in prepaid expenses and other current assets for the right to reclaim cash collateral. The amounts recognized in accounts payable for the obligation to return cash collateral totaled \$323 million at September 30, 2010. The company had no obligation to return cash collateral at December 31, 2009. The company restricts the use of cash collateral received to rehypothecation and therefore reports it in prepaid expenses and other current assets in the Consolidated Statement of Financial Position. At September 30, 2010, \$21 million was rehypothecated.

The company may employ derivative instruments to hedge the volatility in stockholders' equity resulting from changes in currency exchange rates of significant foreign subsidiaries of the company with respect to the U.S. dollar. These instruments, designated as net investment hedges, expose the company to liquidity risk as the derivatives have an immediate cash flow impact upon maturity which is not offset by a cash flow from the translation of the underlying hedged equity. The company monitors the cash loss potential on an ongoing basis and may discontinue some of these hedging relationships by de-designating the derivative instrument to manage this liquidity risk. Although not designated as accounting hedges, the company may utilize derivatives to offset the changes in fair value of the de-designated instruments from the date of de-designation until maturity.

In its hedging programs, the company uses forward contracts, futures contracts, interest-rate swaps and cross-currency swaps, depending upon the underlying exposure. The company is not a party to leveraged derivative instruments.

A brief description of the major hedging programs, categorized by underlying risk, follows.

**Interest Rate Risk**

*Fixed and Variable Rate Borrowings*

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The company issues debt in the global capital markets, principally to fund its financing lease and loan portfolio. Access to cost-effective financing can result in interest rate mismatches with the underlying assets. To manage these mismatches and to reduce overall interest cost, the company uses interest-rate swaps to convert specific fixed-rate debt issuances into variable-rate debt (i.e., fair value hedges) and to convert specific variable-rate debt issuances into fixed-rate debt (i.e., cash flow hedges). At September 30, 2010 and December 31, 2009, the total notional amount of the company's interest rate swaps was \$7.1 billion and \$9.1 billion, respectively.

### *Forecasted Debt Issuance*

The company is exposed to interest rate volatility on forecasted debt issuances. To manage this risk, the company may use forward starting interest-rate swaps to lock in the rate on the interest payments related to the forecasted debt issuance. These swaps are accounted for as cash flow hedges. The company did not have any derivative instruments relating to this program outstanding at September 30, 2010 and December 31, 2009.

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**Notes to Consolidated Financial Statements (continued)**

**Foreign Exchange Risk**

*Long-Term Investments in Foreign Subsidiaries (Net Investment)*

A large portion of the company's foreign currency denominated debt portfolio is designated as a hedge of net investment to reduce the volatility in stockholders' equity caused by changes in foreign currency exchange rates in the functional currency of major foreign subsidiaries with respect to the U.S. dollar. The company also uses cross-currency swaps and foreign exchange forward contracts for this risk management purpose. At September 30, 2010 and December 31, 2009, the total notional amount of derivative instruments designated as net investment hedges was \$2.8 billion and \$1.0 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2010 and December 31, 2009 was approximately 0.5 years and 1.6 years, respectively.

In addition, at September 30, 2010 and December 31, 2009, the company had liabilities of \$262 million and \$318 million, respectively, representing the fair value of derivative instruments that were previously designated in qualifying net investment hedging relationships but were de-designated prior to September 30, 2010 and December 31, 2009, respectively; of these amounts \$200 million and \$94 million are expected to mature over the next twelve months, respectively. The notional amount of these instruments at September 30, 2010 and December 31, 2009 was \$1.9 billion and \$2.3 billion, respectively, including original and offsetting transactions.

*Anticipated Royalties and Cost Transactions*

The company's operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company's non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is approximately four years. At September 30, 2010 and December 31, 2009, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$11.8 billion and \$18.7 billion, with a weighted-average remaining maturity of 0.8 years and 1.3 years, respectively.

*Foreign Currency Denominated Borrowings*

The company is exposed to exchange rate volatility on foreign currency denominated debt. To manage this risk, the company employs cross-currency swaps to convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is approximately 3.3 years. At September 30, 2010 and December 31, 2009, the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was \$0.2 billion and \$0.3 billion, respectively.



*Subsidiary Cash and Foreign Currency Asset/Liability Management*

The company uses its Global Treasury Centers to manage the cash of its subsidiaries. These centers principally use currency swaps to convert cash flows in a cost-effective manner. In addition, the company uses foreign exchange forward contracts to economically hedge, on a net basis, the foreign currency exposure of a portion of the company's nonfunctional currency assets and liabilities. The terms of these forward and swap contracts are generally less than two years. The changes in the fair values of these contracts and of the underlying hedged exposures are generally offsetting and are recorded in other (income) and expense in the Consolidated Statement of Earnings. At September 30, 2010 and December 31, 2009, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$13.0 billion and \$13.1 billion, respectively.

**Equity Risk Management**

The company is exposed to market price changes primarily related to certain obligations to employees. These exposures are primarily related to market price movements in certain broad market indices and in the company's own stock. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation

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**Notes to Consolidated Financial Statements (continued)**

obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company's common stock. They are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At September 30, 2010 and December 31, 2009, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$0.9 billion and \$0.8 billion, respectively.

**Other Risks**

The company holds warrants to purchase shares of common stock in connection with various investments that are deemed derivatives because they contain net share or net cash settlement provisions. The amount of shares to be purchased under these agreements was immaterial at September 30, 2010 and December 31, 2009. The company records the changes in the fair value of these warrants in other (income) and expense in the Consolidated Statement of Earnings.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company utilizes credit default swaps to economically hedge its credit exposures. These derivatives have terms of one year or less. The swaps are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any derivative instruments relating to this program outstanding at September 30, 2010 and December 31, 2009.

The tables on pages 20 to 23 provide a quantitative summary of the derivative and non-derivative instrument related risk management activity as of September 30, 2010 and December 31, 2009 as well as for the three months and nine months ended September 30, 2010 and 2009, respectively.

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## Notes to Consolidated Financial Statements (continued)

## Fair Value of Derivative Instruments

As of September 30, 2010

(Dollars in millions)	Fair value of derivative assets			Fair value of derivative liabilities		
	Designated as hedging instruments	Not designated as hedging instruments	Total	Designated as hedging instruments	Not designated as hedging instruments	Total
Interest rate contracts:						
Prepaid expenses and other current assets	\$ 10	\$	\$ 10	\$	\$	\$
Investments and sundry assets	901		901			
Other liabilities						
Foreign exchange contracts:						
Prepaid expenses and other current assets	227	267	494			
Investments and sundry assets	19	57	76			
Other accrued expenses and liabilities				451	309	760
Other liabilities				140	80	220
Equity contracts:						
Prepaid expenses and other current assets		23	23			
Other accrued expenses and liabilities					2	2
Fair value of derivative assets and liabilities						
	\$ 1,156	\$ 347	\$ 1,503	\$ 590	\$ 391	\$ 981
Total debt designated as hedging instruments:						
Short-term debt	NA	NA	NA	\$	\$	\$
Long-term debt	NA	NA	NA	2,582		2,582
Total			\$ 1,503			\$ 3,564

NA not applicable

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## Notes to Consolidated Financial Statements (continued)

## Fair Value of Derivative Instruments

As of December 31, 2009

(Dollars in millions)	Fair value of derivative assets			Fair value of derivative liabilities		
	Designated as hedging instruments	Not designated as hedging instruments	Total	Designated as hedging instruments	Not designated as hedging instruments	Total
Interest rate contracts:						
Prepaid expenses and other current assets	\$ 43	\$	\$ 43	\$	\$	\$
Investments and sundry assets	383		383			
Other liabilities				2		2
Foreign exchange contracts:						
Prepaid expenses and other current assets	74	151	225			
Investments and sundry assets	156	26	182			
Other accrued expenses and liabilities				602	304	906
Other liabilities				423	224	647
Equity contracts:						
Prepaid expenses and other current assets		5	5			
Other accrued expenses and liabilities					0	0
Fair value of derivative assets and liabilities	\$ 656	\$ 182	\$ 838	\$ 1,027	\$ 528	\$ 1,555
Total debt designated as hedging instruments:						
Short-term debt	NA	NA	NA	\$ 1,440	\$	\$ 1,440
Long-term debt	NA	NA	NA	2,618		2,618
Total			\$ 838			\$ 5,613

NA not applicable

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## Notes to Consolidated Financial Statements (continued)

## The Effect of Derivative Instruments on the Consolidated Statement of Earnings

For the three months ended September 30, 2010 and 2009

(Dollars in millions)	Consolidated Statement of Earnings line item	Gain (loss) recognized in earnings			
		Recognized on derivatives (2)		Attributable to risk being hedged (3)	
		2010	2009	2010	2009
<b>Derivative instruments in fair value hedges:</b>					
Interest Rate Contracts	Cost of financing	\$ 135	\$ 92	\$ (90)	\$ (41)
	Interest expense	86	63	(58)	(36)
<b>Derivative instruments not designated as hedging instruments: (1)</b>					
Foreign Exchange Contracts	Other (income) and expense	584	172	NA	NA
Equity Contracts	SG&A expense	76	91	NA	NA
Total		\$ 881	\$ 418	\$ (148)	\$ (77)

Gain (loss) recognized in earnings and other comprehensive income							
	Effective portion recognized in AOCI		Consolidated Statement of Earnings line item	Effective portion reclassified from AOCI to earnings		(Ineffectiveness) and amounts excluded from effectiveness testing (4)	
	2010	2009		2010	2009	2010	2009
Derivative instruments in cash flow hedges:							
Interest rate contracts	\$	\$	Interest expense	\$ (2)	\$ (2)	\$	\$
			Other (income)				
Foreign exchange contracts	(927)	(943)	and expense	(5)	(15)	4	0
			Cost of sales	1	5		
			SG&A expense	(2)	6		
Derivative instruments in net investment hedges:							
Foreign exchange contracts	\$ (440)	(224)	Interest expense	0		1	(1)
Total	\$ (1,367)	\$ (1,167)		\$ (7)	\$ (6)	\$ 5	\$ (1)

Note: AOCI represents Accumulated other comprehensive income/(loss) in the Consolidated Statement of Changes in Equity.

(1) See Note 7 for additional information on the company's purpose for entering into derivatives not designated as hedging instruments and its overall risk management strategies.

(2) The amount includes changes in clean fair values of the derivative instruments in fair value hedging relationships and the periodic accrual for coupon payments required under these derivative contracts.

(3) The amount includes basis adjustments to the carrying value of the hedged item recorded during the period and amortization of basis adjustments recorded on de-designated hedging

relationships during the period.

(4) The amount of gain/(loss) recognized in income represents ineffectiveness on hedge relationships.

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## Notes to Consolidated Financial Statements (continued)

**The Effect of Derivative Instruments on the Consolidated Statement of Earnings****For the nine months ended September 30, 2010 and 2009**

(Dollars in millions)	Consolidated Statement of Earnings line item	Gain (loss) recognized in earnings			
		Recognized on derivatives (2)		Attributable to risk being hedged (3)	
		2010	2009	2010	2009
<b>Derivative instruments in fair value hedges:</b>					
Interest Rate Contracts	Cost of financing	\$ 382	\$ (92)	\$ (251)	\$ 209
	Interest expense	245	(54)	(161)	123
<b>Derivative instruments not designated as hedging instruments: (1)</b>					
Foreign Exchange Contracts	Other (income) and expense	279	(69)	NA	NA
Equity Contracts	SG&A expense	34	138	NA	NA
Total		\$ 940	\$ (77)	\$ (412)	\$ 332

Gain (loss) recognized in earnings and other comprehensive income							
	Effective portion recognized in AOCI		Consolidated Statement of Earnings line item	Effective portion reclassified from AOCI to earnings		(Ineffectiveness) and amounts excluded from effectiveness testing (4)	
	2010	2009		2010	2009	2010	2009
Derivative instruments in cash flow hedges:							
Interest rate contracts	\$	\$ (0)	Interest expense	\$ (6)	\$ (12)	\$	\$
Foreign exchange contracts	464	(1,073)	Other (income) and expense	(19)	189	(3)	3
			Cost of sales	(81)	107		
			SG&A expense	(46)	74		
Derivative instruments in net investment hedges:							
Foreign exchange contracts	147	(268)	Interest expense	0		1	1
Total	\$ 611	\$ (1,341)		\$ (152)	\$ 358	\$ (2)	\$ 4

Note: AOCI represents Accumulated other comprehensive income/(loss) in the Consolidated Statement of Changes in Equity.

(1) See Note 7 for additional information on the company's purpose for entering into derivatives not designated as hedging instruments and its overall risk management strategies.

(2) The amount includes changes in clean fair values of the derivative instruments in fair value hedging relationships and the periodic accrual for coupon payments required under these

- (3) derivative contracts.  
The amount includes basis adjustments to the carrying value of the hedged item recorded during the period and amortization of basis adjustments recorded on de-designated hedging relationships during the period.
- (4) The amount of gain/(loss) recognized in income represents ineffectiveness on hedge relationships.



Table of Contents**Notes to Consolidated Financial Statements (continued)**

At September 30, 2010 and September 30, 2009, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of \$105 million and \$1,335 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts \$267 million and \$718 million of losses, respectively, are expected to be reclassified to net income within the next twelve months, providing an offsetting economic impact against the underlying anticipated transactions. At September 30, 2010 and September 30, 2009, net losses of approximately \$15 million and \$19 million (before taxes), respectively, were recorded in accumulated other comprehensive income/(loss) in connection with cash flow hedges of the company's borrowings. Within these amounts, \$9 million and \$9 million of losses, respectively, are expected to be reclassified to net income within the next twelve months, providing an offsetting economic impact against the underlying transactions.

For the nine months ending September 30, 2010, and September 30, 2009, there were no significant gains or losses recognized in earnings representing hedge ineffectiveness or excluded from the assessment of hedge effectiveness (for fair value hedges), or associated with an underlying exposure that did not or was not expected to occur (for cash flow hedges); nor are there any anticipated in the normal course of business.

Refer to the 2009 IBM Annual Report, Note A, Significant Accounting Policies on pages 76 and 77 for additional information on the company's use of derivative instruments.

**8. Stock-Based Compensation:** Stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized over the employee requisite service period. The following table presents total stock-based compensation cost included in the Consolidated Statement of Earnings:

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Cost	\$ 23	\$ 22	\$ 72	\$ 69
Selling, general and administrative	118	114	366	313
Research, development and engineering	12	11	36	34
Other (income) and expense*			(1)	
Pre-tax stock-based compensation cost	153	147	474	416
Income tax benefits	(57)	(52)	(174)	(147)
Total stock-based compensation cost	\$ 96	\$ 95	\$ 300	\$ 270

\* Reflects the one-time effects of the sale of the Product Lifecycle Management activities.

The increase in pre-tax stock-based compensation cost for the three months ended September 30, 2010, as compared to the corresponding period in the prior year, was principally the result of an increase in restricted and performance-based stock compensation costs (\$9 million), partially offset by a reduction in stock option compensation cost (\$3 million). The increase in pre-tax stock-based compensation cost for the nine months ended September 30, 2010, as compared to the corresponding period in the prior year, was principally the result of an increase related to restricted and performance-based stock compensation costs (\$76 million), partially offset by a reduction in stock option compensation cost (\$19 million).

As of September 30, 2010, the total unrecognized compensation cost of \$1,096 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately 2.5 years.

There were no significant capitalized stock-based compensation costs at September 30, 2010 and 2009.

**9. Segments:** The following tables reflect the results of operations of the segments consistent with the company's management and measurement system. These results are not necessarily a depiction that is in conformity with GAAP. Performance measurement is based on pre-tax income. These results are used, in part, by senior management, both in evaluating the performance of, and in allocating resources to, each of the segments.

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## Notes to Consolidated Financial Statements (continued)

## SEGMENT INFORMATION

(UNAUDITED)

	Global Services		Global Services		Global Services		Global Services		Global Services		Global Services	
	Global	Global	Global	Global	Global	Global	Global	Global	Global	Global	Global	Global
	Technology	Business	Business	Business	Business	Business	Business	Business	Business	Business	Business	Business
	Services	Services	Services	Services	Services	Services	Services	Services	Services	Services	Services	Services
	Software	Software	Software	Software	Software	Software	Software	Software	Software	Software	Software	Software
	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and	Systems and
	Technology	Technology	Technology	Technology	Technology	Technology	Technology	Technology	Technology	Technology	Technology	Technology
	Global	Global	Global	Global	Global	Global	Global	Global	Global	Global	Global	Global
	Financing	Financing	Financing	Financing	Financing	Financing	Financing	Financing	Financing	Financing	Financing	Financing
	Total	Total	Total	Total	Total	Total	Total	Total	Total	Total	Total	Total
	Segments	Segments	Segments	Segments	Segments	Segments	Segments	Segments	Segments	Segments	Segments	Segments
(Dollars in millions)												
For the three months ended September 30, 2010:												
External revenue	\$	9,496	\$	4,572	\$	5,151	\$	4,325	\$	529	\$	24,072
Internal revenue		362		199		728		196		432		1,917
Total revenue	\$	9,857	\$	4,771	\$	5,879	\$	4,521	\$	961	\$	25,990
Pre-tax income	\$	1,524	\$	695	\$	1,885	\$	327	\$	503	\$	4,933
Revenue year-to-year change		0.7%		4.8%		1.9%		8.2%		0.7%		3.0%
Pre-tax income year-to-year change		3.6%		5.3%		1.9%		45.6%		23.2%		6.9%
Pre-tax income margin		15.5%		14.6%		32.1%		7.2%		52.3%		19.0%
For the three months ended September 30, 2009:												
External revenue	\$	9,434	\$	4,338	\$	5,114	\$	3,917	\$	536	\$	23,339
Internal revenue		355		214		656		260		419		1,904
Total revenue	\$	9,789	\$	4,552	\$	5,770	\$	4,177	\$	955	\$	25,243
Pre-tax income	\$	1,471	\$	659	\$	1,850	\$	225	\$	408	\$	4,614
Pre-tax income margin		15.0%		14.5%		32.1%		5.4%		42.7%		18.3%

## Reconciliations to IBM as Reported:

(Dollars in millions)	Three Months Ended September 30, 2010		Three Months Ended September 30, 2009	
Revenue:				
Total reportable segments	\$	25,990	\$	25,243
Eliminations/other		(1,718)		(1,677)
Total IBM Consolidated	\$	24,271	\$	23,566
Pre-tax income:				
Total reportable segments	\$	4,933	\$	4,614
Eliminations/other		(256)		(241)
Total IBM Consolidated	\$	4,677	\$	4,373



Table of Contents**Notes to Consolidated Financial Statements (continued)****SEGMENT INFORMATION****(UNAUDITED)**

	Global Services						
(Dollars in millions)	Global Technology Services	Global Business Services	Software	Systems and Technology	Global Financing	Total Segments	
For the nine months ended September 30, 2010:							
External revenue	\$ 28,036	\$ 13,465	\$ 15,447	\$ 11,696	\$ 1,610	\$ 70,253	
Internal revenue	1,014	599	2,176	572	1,267	5,627	
Total revenue	\$ 29,050	\$ 14,064	\$ 17,623	\$ 12,267	\$ 2,877	\$ 75,880	
Pre-tax income	\$ 3,910	\$ 1,823	\$ 5,925	\$ 378	\$ 1,393	\$ 13,429	
Revenue year-to-year change	2.5%	2.3%	5.5%	5.0%	(2.1)%	3.4%	
Pre-tax income year-to-year change	(1.8)%	1.9%	17.6%	(35.4)%	13.0%	6.4%	
Pre-tax income margin	13.5%	13.0%	33.6%	3.1%	48.4%	17.7%	
For the nine months ended September 30, 2009:							
External revenue	\$ 27,296	\$ 13,074	\$ 14,820	\$ 11,000	\$ 1,682	\$ 67,872	
Internal revenue	1,039	670	1,883	679	1,255	5,527	
Total revenue	\$ 28,336	\$ 13,743	\$ 16,703	\$ 11,680	\$ 2,937	\$ 73,399	
Pre-tax income	\$ 3,980	\$ 1,789	\$ 5,037	\$ 586	\$ 1,233	\$ 12,625	
Pre-tax income margin	14.0%	13.0%	30.2%	5.0%	42.0%	17.2%	

**Reconciliations to IBM as Reported:**

(Dollars in millions)	Nine Months Ended September 30, 2010		Nine Months Ended September 30, 2009	
Revenue:				
Total reportable segments	\$	75,880	\$	73,399
Eliminations/other		(5,028)		(4,871)
Total IBM Consolidated	\$	70,852	\$	68,528
Pre-tax income:				
Total reportable segments	\$	13,429	\$	12,625
Eliminations/other		(662)		(868)
Total IBM Consolidated	\$	12,767	\$	11,757



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## Notes to Consolidated Financial Statements (continued)

**10. Equity Activity:**

(Dollars in millions)	Common Stock and Additional Paid -in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders Equity	Noncontrolling Interests	Total Equity
<b>Equity January 1, 2010</b>	\$ 41,810	\$ 80,900	\$ (81,243)	\$ (18,830)	\$ 22,637	\$ 118	\$ 22,755
Net income		9,576			9,576		9,576
Other comprehensive income/(loss), net of tax (total)				1,352	1,352		1,352
Cash dividends declared common stock		(2,369)			(2,369)		(2,369)
Stock transactions related to employee plans net	2,518	(11)	362		2,870		2,870
Other treasury shares purchased not retired			(11,827)		(11,827)		(11,827)
Changes in noncontrolling interests						2	2
<b>Equity September 30, 2010</b>	\$ 44,328	\$ 88,095	\$ (92,707)	\$ (17,479)	\$ 22,238	\$ 121	\$ 22,359

(Dollars in millions)	Common Stock and Additional Paid -in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders Equity	Noncontrolling Interests	Total Equity
<b>Equity January 1, 2009</b>	\$ 39,129	\$ 70,353	\$ (74,171)	\$ (21,845)	\$ 13,465	\$ 119	\$ 13,584
Net income		8,612			8,612		8,612
Other comprehensive income/(loss), net of tax (total)				1,358	1,358		1,358
Cash dividends declared common stock		(2,133)			(2,133)		(2,133)
Stock transactions related to employee plans net	1,353	(20)	166		1,499		1,499
Other treasury shares purchased not retired			(4,406)		(4,406)		(4,406)
Changes in noncontrolling interests						(22)	(22)
<b>Equity September 30, 2009</b>	\$ 40,482	\$ 76,812	\$ (78,411)	\$ (20,487)	\$ 18,396	\$ 98	\$ 18,493

Table of Contents**Notes to Consolidated Financial Statements (continued)**

The following table summarizes Net income plus other comprehensive income/(loss), a component of IBM stockholders' equity in the Consolidated Statement of Financial Position:

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income	\$ 3,589	\$ 3,214	\$ 9,576	\$ 8,612
Other comprehensive income/(loss) net of tax:				
Foreign currency translation adjustments	1,409	912	327	1,678
Net change in retirement-related benefit plans	167	212	559	563
Net unrealized gains/(losses) on marketable securities	56	34	50	70
Net unrealized gains/(losses) on cash flow hedge derivatives	(599)	(602)	416	(953)
Total other comprehensive income/(loss)	1,032	556	1,352	1,358
Net income plus other comprehensive income/(loss)	\$ 4,621	\$ 3,770	\$ 10,927	\$ 9,970

**11. Retirement-Related Benefits:** The company offers defined benefit pension plans, defined contribution pension plans, as well as nonpension postretirement plans primarily consisting of retiree medical benefits. The following tables provide the total retirement-related benefit plans impact on income before income taxes:

For the three months ended September 30: (Dollars in millions)	2010	2009*	Yr. to Yr. Percent Change
Retirement-related plans cost			
Defined benefit and contribution pension plans	\$ 246	\$ 258	(4.8)%
Nonpension postretirement plans	87	88	(0.8)
Total	\$ 333	\$ 346	(3.8)%

\* Reclassified to conform with 2010 presentation.

For the nine months ended September 30: (Dollars in millions)	2010	2009*	Yr. to Yr. Percent Change
Retirement-related plans cost			
Defined benefit and contribution pension plans	\$ 801	\$ 838	(4.5)%
Nonpension postretirement plans	260	261	(0.3)
Total	\$ 1,061	\$ 1,099	(3.5)%

\* Reclassified to conform with 2010 presentation.





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**Notes to Consolidated Financial Statements (continued)**

The following tables provide the components of the cost/(income) for the company's pension plans:

**Cost/(Income) of Pension Plans**

<b>(Dollars in millions)</b>		<b>U.S. Plans</b>		<b>Non-U.S. Plans</b>	
<b>For the three months ended September 30:</b>		<b>2010</b>	<b>2009*</b>	<b>2010</b>	<b>2009*</b>
Service cost	\$	\$	\$	126	\$ 152
Interest cost		650	671	456	490
Expected return on plan assets		(1,004)	(1,002)	(610)	(652)
Amortization of prior service cost/(credits)		2	2	(44)	(32)
Recognized actuarial losses		118	103	178	159
Curtailments/settlements				0	(3)
Multiemployer plan/other costs				27	27
Total net periodic pension (income)/cost of defined benefit plans		(234)	(226)	132	141
Cost of defined contribution plans		216	221	132	122
Total pension plan cost recognized in the Consolidated Statement of Earnings	\$	(18)	\$ (5)	\$ 264	\$ 263

\* Reclassified to conform with 2010 presentation.

<b>(Dollars in millions)</b>		<b>U.S. Plans</b>		<b>Non-U.S. Plans</b>	
<b>For the nine months ended September 30:</b>		<b>2010</b>	<b>2009*</b>	<b>2010</b>	<b>2009*</b>
Service cost	\$	\$	\$	377	\$ 435
Interest cost		1,951	2,012	1,369	1,396
Expected return on plan assets		(3,013)	(3,007)	(1,827)	(1,865)
Amortization of prior service cost/(credits)		7	7	(128)	(93)
Recognized actuarial losses		353	308	527	462
Curtailments/settlements				27	5
Multiemployer plan/other costs				78	71
Total net periodic pension (income)/cost of defined benefit plans		(702)	(679)	422	411
Cost of defined contribution plans		693	756	387	351
Total pension plan cost recognized in the Consolidated Statement of Earnings	\$	(8)	\$ 76	\$ 809	\$ 762

\*Reclassified to conform with 2010 presentation.

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In 2010, the company expects to contribute to its non-U.S. defined benefit plans approximately \$900 million, which is the legally mandated minimum contribution. Total contributions to the non-U.S. plans in the first nine months of 2010 were \$658 million.

The following tables provide the components of the cost for the company's nonpension postretirement plans:

### Cost of Nonpension Postretirement Plans

(Dollars in millions)	U.S. Plan		Non-U.S. Plans	
For the three months ended September 30:	2010	2009	2010	2009
Service cost	\$ 8	\$ 10	\$ 2	\$ 2
Interest cost	65	72	15	13
Expected return on plan assets			(2)	(2)
Amortization of prior service credits	(4)	(10)	(1)	(2)
Recognized actuarial losses			3	3
Curtailments/settlements	1			
Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings	\$ 71	\$ 73	\$ 16	\$ 15

Table of Contents**Notes to Consolidated Financial Statements (continued)**

(Dollars in millions)		U.S. Plan		Non-U.S. Plans	
For the nine months ended September 30:	2010		2009	2010	2009
Service cost	\$ 25	\$	31	\$ 7	\$ 7
Interest cost	196		217	44	37
Expected return on plan assets				(7)	(6)
Amortization of prior service credits	(11)		(29)	(4)	(5)
Recognized actuarial losses				9	8
Curtailments/settlements	1				
Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings	\$ 211	\$	219	\$ 49	\$ 42

The company received a \$17.2 million subsidy in the third quarter of 2010 and a \$38.3 million subsidy for the first nine months of 2010 in connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003. A portion of this amount is used by the company to reduce its obligation and expense related to the plan, and the remainder is contributed to the plan to reduce contributions required by the participants. For further information related to the Medicare Prescription Drug Act, see page 121 in the company's 2009 Annual Report.

**12. Acquisitions/Divestitures:**

Acquisitions: During the nine months ended September 30, 2010, the company completed 11 acquisitions at an aggregate cost of \$3,385 million.

Sterling Commerce - On August 27, 2010, the company completed the acquisition of 100 percent of Sterling Commerce, a wholly-owned subsidiary of AT&T, Inc., for cash consideration of \$1,415 million. Sterling Commerce will expand the company's ability to help clients accelerate their interactions with customers, partners and suppliers through dynamic business networks using either on-premise or cloud delivery models. Sterling Commerce was integrated into the Software segment upon acquisition, and goodwill, as reflected in the table on page 31, has been entirely assigned to the Software segment. It is expected that none of the goodwill will be deductible for tax purposes. The overall weighted average useful life of the intangible assets acquired, excluding goodwill, is 6.9 years.

Other acquisitions - The Software segment also completed acquisitions of seven privately held companies: in the first quarter, Lombardi Software, Inc., Intelliden Inc. and Initiate Systems, Inc.; in the second quarter, Cast Iron Systems; and in the third quarter, BigFix, Inc., Coremetrics and Datacap. Global Technology Services (GTS) completed one acquisition in the first quarter: the core operating assets of Wilshire Credit Corporation. Global Business Services (GBS) completed one acquisition in the first quarter: National Interest Security Company, LLC, a privately held company. Systems and Technology (STG) completed one acquisition in the third quarter: Storwize, a privately held company.

Each acquisition further complemented and enhanced the company's portfolio of product and services offerings. Lombardi is a leading provider of business process management software and services and became part of the application integration software portfolio. Intelliden is a leading provider of intelligent network automation software and will extend the network management offerings. Initiate is a market leader in data integrity software for information sharing among health care and government organizations. Cast Iron Systems, the leading Software as a

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Service (SaaS) and cloud application integration provider, enhances the industry-leading WebSphere business integration software portfolio. BigFix, Inc. is a leading provider of high-performance enterprise systems and security management solutions that revolutionizes the way IT organizations manage and secure their computing infrastructure. Coremetrics, a leader in web analytics software, will expand the company's business analytics capabilities by enabling organizations to use cloud computing services to develop faster, more targeted marketing campaigns. Datacap will strengthen the company's ability to help organizations digitize, manage and automate their information assets. Wilshire's mortgage servicing platform will continue the strategic focus on the mortgage services industry and strengthens the commitment to deliver mortgage business process outsourcing solutions. National Interest Security Company will strengthen the ability to deliver advanced analytics and IT solutions to the public sector. Storwize, a provider of in-line data compression appliance solutions, will help the company to make it more affordable for clients to analyze massive amounts of data in order to provide new insights and business outcomes. Purchase price consideration for the Other Acquisitions as reflected in the table on page 31, is paid primarily in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

The table on page 31 reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of September 30, 2010:

Table of Contents**Notes to Consolidated Financial Statements (continued)**

<b>(Dollars in millions)</b>	<b>Amortization Life (yrs.)</b>	<b>Sterling Commerce</b>	<b>Other Acquisitions</b>
Current assets		\$ 194	\$ 265
Fixed assets/noncurrent assets		116	103
Intangible assets:			
Goodwill	NA	1,022	1,435
Completed technology	3-7	218	283
Client relationships	2-7	244	187
In-process research and development	NA		4
Patents/trademarks	1-7	14	10
Total assets acquired		1,809	2,287
Current liabilities		(312)	(233)
Noncurrent liabilities		(82)	(84)
Total liabilities assumed		\$ (394)	\$ (317)
Total purchase price		\$ 1,415	\$ 1,970

NA not applicable

The acquisitions were accounted for as business combinations using the acquisition method, and accordingly, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired entities were recorded at their estimated fair values at the date of acquisition. The primary items that generated the goodwill are the value of the synergies between the acquired companies and IBM and the acquired assembled workforce, neither of which qualify as an amortizable intangible asset. For the Other Acquisitions, the overall weighted-average life of the identified amortizable intangible assets acquired is 6.3 years. With the exception of goodwill, these identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$1,435 million has been assigned to the Software (\$1,057 million), GTS (\$32 million), GBS (\$252 million) and STG (\$94 million) segments. It is expected that approximately 15 percent of the goodwill will be deductible for tax purposes.

On September 20, 2010, the company announced that it had entered into a definitive agreement to acquire Netezza, a publicly held company based in Marlborough, MA, for approximately \$1.7 billion (after adjusting for cash). Netezza will expand the company's business analytics initiatives to help clients gain faster insights into their business information, with increased performance at a lower cost. The acquisition is expected to close in the fourth quarter of 2010.

On September 27, 2010, the company announced that it had entered into a definitive agreement to acquire BLADE Network Technologies, a privately held company based in Santa Clara, CA. BLADE specializes in software and devices that route data and transactions to and from servers. The acquisition is expected to close in the fourth quarter of 2010.

On October 6, 2010, the company announced that it had completed the acquisition of Unica Corporation, a publicly-held software company based in Waltham, MA. Unica is a leading global provider of enterprise marketing management software designed to help businesses improve the efficiency, execution and measurability of their marketing operations.

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On October 13, 2010, the company announced that it had completed the acquisition of PSS Systems, a privately held company based in Mountain View, CA. PSS Systems' software helps organizations analyze, automate and implement information governance policies across massive amounts of electronic business information and dispose of that information in an automated way.

On October 21, 2010, the company announced that it had completed the acquisition of OpenPages, a privately held company based in Waltham, MA. OpenPages provides software that helps companies more easily identify and manage risk and compliance activities across the enterprise through a single management system.

On October 21, 2010, the company announced that it has completed the acquisition of Clarity Systems, a privately held company based in Toronto, Canada. Clarity Systems delivers financial governance software that enables organizations to automate the process of collecting, preparing, certifying and controlling financial statements for electronic filings, in support of mandates by the Securities and Exchange Commission (SEC) and other regulatory agencies.

At the date of issuance of these financial statements, the initial purchase accounting was not completed for the Unica Corporation, PSS Systems, OpenPages and Clarity Systems acquisitions.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

**Divestitures:** On March 31, 2010, the company completed the sale of its activities associated with the sales and support of Dassault Systemes (Dassault) product lifecycle management (PLM) software, including customer contracts and related assets to Dassault. The company received net proceeds of \$459 million and recognized a net gain of \$591 million on the transaction in the first quarter of 2010. The gain was net of the fair value of certain contractual terms, certain transaction costs and the assets and liabilities sold. The gain was recorded in other (income) and expense on the Consolidated Statement of Earnings and the net proceeds are reflected in proceeds from disposition of marketable securities and other investments within cash flow from investing activities on the Consolidated Statement of Cash Flows.

On March 16, 2009, the company completed the sale of certain processes, resources, assets and third-party contracts related to its core logistics operations to Geodis. The company received cash proceeds of \$365 million and recognized a net gain of \$298 million on the transaction in the first quarter of 2009. The gain was net of the fair value of certain contractual terms, certain transaction costs and related real estate charges. As part of this transaction, the company outsourced its logistics operations to Geodis which will enable the company to leverage industry-leading skills and scale and improve the productivity of the company's supply chain.

**13. Intangible Assets Including Goodwill:** The following table details the company's intangible asset balances by major asset class:

(Dollars in millions)		At September 30, 2010	
Intangible asset class	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Capitalized software	\$ 1,603	\$ (752)	\$ 851
Client relationships	1,552	(586)	966
Completed technology	1,700	(607)	1,092
In-process R&D	4	0	4
Patents/trademarks	189	(69)	120
Other(a)	40	(27)	13
Total	\$ 5,088	\$ (2,041)	\$ 3,047

(Dollars in millions)		At December 31, 2009	
Intangible asset class	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Capitalized software	\$ 1,765	\$ (846)	\$ 919
Client relationships	1,367	(677)	690
Completed technology	1,222	(452)	770
Patents/trademarks	174	(59)	115
Other(a)	94	(75)	19
Total	\$ 4,622	\$ (2,109)	\$ 2,513

(a) Other intangibles are primarily acquired proprietary and non-proprietary business processes, methodologies and systems.

The net carrying amount of intangible assets increased \$534 million during the first nine months of 2010, primarily due to acquired intangible asset additions, partially offset by amortization. The aggregate intangible amortization expense was \$289 million and \$859 million for the third



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quarter and first nine months of 2010, respectively, versus \$313 million and \$931 million for the third quarter and first nine months ended September 30, 2009, respectively. In addition, in the first nine months of 2010, the company retired \$910 million of fully amortized intangible assets, impacting both the gross carrying amount and accumulated amortization by this amount.

The amortization expense for each of the five succeeding years relating to intangible assets currently recorded in the Consolidated Statement of Financial Position is estimated to be the following at September 30, 2010:

(Dollars in millions)	Capitalized Software		Acquired Intangibles		Total	
2010 (for Q4)	\$	157	\$	141	\$	298
2011		453		524		977
2012		201		457		658
2013		40		416		456
2014				277		277

Table of Contents**Notes to Consolidated Financial Statements (continued)**

The changes in the goodwill balances by reportable segment, for the nine months ended September 30, 2010 and for the year ended December 31, 2009 are as follows:

(Dollars in millions) Segment	Balance 01/01/10	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation And Other Adjustments	Balance 09/30/10
Global Business Services	\$ 4,042	\$ 252	\$	\$	\$ 25	\$ 4,320
Global Technology Services	2,777	32	(1)		(122)	2,685
Software	12,605	2,079	(11)		166	14,839
Systems and Technology	766	94	(0)		(1)	859
Total	\$ 20,190	\$ 2,457	\$ (13)	\$	\$ 68	\$ 22,703

(Dollars in millions) Segment	Balance 01/01/09	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation And Other Adjustments	Balance 12/31/09
Global Business Services	\$ 3,870	\$	\$	\$	\$ 172	\$ 4,042
Global Technology Services	2,616	10	1		150	2,777
Software	10,966	994	(50)	(13)	708	12,605
Systems and Technology	772		(7)		1	766
Total	\$ 18,226	\$ 1,004	\$ (56)	\$ (13)	\$ 1,031	\$ 20,190

Purchase price adjustments recorded in the first nine months of 2010 and full year 2009 were related to acquisitions completed on or prior to December 31, 2009 or December 31, 2008, respectively, and were still subject to the measurement period that ends at the earlier of 12 months from the acquisition date or when information becomes available. There were no goodwill impairment losses recorded during the first nine months of 2010 or the full year 2009, and the company has no accumulated impairment losses.

**14. Restructuring-Related Liabilities:** The following table provides a roll forward of the current and noncurrent liability balances for actions taken in the following periods: (1) the second quarter of 2005 associated with Global Services, primarily in Europe; (2) the fourth quarter of 2002 associated with the acquisition of the PricewaterhouseCoopers consulting business; (3) the second quarter of 2002 associated with the Microelectronics Division and the rebalancing of the company's workforce and leased space resources; (4) the 2002 actions associated with the hard disk drive business for reductions in workforce, manufacturing capacity and space; (5) the actions taken in 1999; and (6) the actions that were executed prior to 1994.

(Dollars in millions)	Liability as of 01/01/2010	Payments	Other Adjustments*	Liability as of 09/30/2010
Current:				
Workforce	\$ 71	\$ (49)	\$ 2	\$ 25
Space	16	(14)	7	9

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Total Current	\$	87	\$	(62)	\$	9	\$	34
Noncurrent:								
Workforce	\$	427	\$		\$	(12)	\$	415
Space		14				(8)		6
Total Noncurrent	\$	441	\$		\$	(19)	\$	421

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\* Principally includes the reclassification of noncurrent to current, foreign currency translation adjustments and interest accretion.

**15. Contingencies:** As a company with a substantial employee population and with clients in more than 170 countries, IBM is involved, either as plaintiff or defendant, in a variety of ongoing claims, demands, suits, investigations, tax matters and proceedings that arise from time to time in the ordinary course of its business. The company is a leader in the information technology industry and, as such, has been and will continue to be subject to claims challenging its intellectual property (IP)

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**Notes to Consolidated Financial Statements (continued)**

rights and associated products and offerings, including claims of copyright and patent infringement and violations of trade secrets and other IP rights. In addition, the company enforces its own IP against infringement, through license negotiations, lawsuits or otherwise. Also, as is typical for companies of IBM's scope and scale, the company is party to actions and proceedings in various jurisdictions involving a wide range of labor and employment issues (including matters related to contested employment decisions, country-specific labor and employment laws, and the company's pension, retirement and other benefit plans), as well as actions with respect to contracts, product liability, securities, foreign operations, competition law and environmental matters. These actions may be commenced by a number of different parties, including competitors, partners, clients, current or former employees, government and regulatory agencies, stockholders and representatives of the locations in which the company does business. Some of the actions to which the company is party may involve particularly complex technical issues, and some actions may raise novel questions under the laws of the various jurisdictions in which these matters arise.

The following is a summary of the more significant legal matters involving the company.

The company is a defendant in an action filed on March 6, 2003 in state court in Salt Lake City, Utah by the SCO Group (SCO v. IBM). The company removed the case to Federal Court in Utah. Plaintiff is an alleged successor in interest to some of AT&T's UNIX IP rights, and alleges copyright infringement, unfair competition, interference with contract and breach of contract with regard to the company's distribution of AIX and Dynix and contribution of code to Linux. The company has asserted counterclaims, including breach of contract, violation of the Lanham Act, unfair competition, intentional torts, unfair and deceptive trade practices, breach of the General Public License that governs open source distributions, promissory estoppel and copyright infringement. Motions for summary judgment were heard in March 2007, and the court has not yet issued its decision. On September 14, 2007, plaintiff filed for bankruptcy protection, and all proceedings in this case were stayed. On August 25, 2009, the U.S. Bankruptcy Court for the District of Delaware approved the appointment of a Chapter 11 Trustee of SCO. The court in another suit, the SCO Group, Inc. v. Novell, Inc., held a trial in March 2010. The jury found that Novell is the owner of UNIX and UnixWare copyrights; the judge subsequently ruled that SCO is obligated to recognize Novell's waiver of SCO's claims against IBM and Sequent for breach of UNIX license agreements. In July 2010, SCO filed an appeal in connection with this matter.

On November 29, 2006, the company filed a lawsuit against Platform Solutions, Inc. (PSI) in the United States District Court for the Southern District of New York, alleging that PSI violated certain intellectual property rights of IBM. PSI asserted counterclaims against IBM. On January 11, 2008, the court permitted T3 Technologies, a reseller of PSI computer systems, to intervene as a counterclaim-plaintiff. T3 claimed that IBM violated certain antitrust laws by refusing to license its patents and trade secrets to PSI and by tying the sales of its mainframe computers to its mainframe operating systems. On June 30, 2008, IBM acquired PSI. As a result of this transaction, IBM and PSI dismissed all claims against each other, and PSI withdrew a complaint it had filed with the European Commission in October 2007 with regard to IBM. On September 30, 2009, the court granted IBM's motion for summary judgment and dismissed T3's claims against IBM. This decision has been appealed by T3. In January 2009, T3 filed a complaint with the European Commission alleging that IBM violated European Union competition law based on the facts alleged in the above-referenced U.S. litigation involving T3. Complaints concerning competition matters were also filed with the European Commission in March 2010 by TurboHercules SAS and in late July 2010 by Neon Enterprise Software, LLC (Neon). IBM has been notified that the U.S. Department of Justice (DOJ) is investigating possible antitrust violations by IBM, and the DOJ has requested certain information, including the production of materials from the litigation between T3 and IBM. In July 2010, the European Commission notified the company that it has decided to initiate proceedings to further investigate IBM regarding possible infringements of European Union competition law.

The company is a defendant in an action filed on December 14, 2009 in the United States District Court for the Western District of Texas by Neon, alleging that the company has interfered with Neon's efforts to license its zPrime software. It seeks damages and injunctive relief. In late January 2010, IBM filed its answer to Neon's complaint and asserted counterclaims against Neon. The case is set for trial in June 2011.

The company is a defendant in an action filed on April 2, 2009 in the United States District Court for the Eastern District of Texas by Acqis LLC, which alleges that certain IBM products infringe certain patents relating generally to modular computing devices. Acqis seeks damages and injunctive relief. The case is set for trial in February 2011.

The company is a defendant in an action filed on February 5, 2010 in the United States District Court for the Eastern District of Virginia by TecSec, Inc., which alleges that certain IBM products infringe certain patents relating generally to encryption. TecSec seeks damages and injunctive relief. A pretrial conference is scheduled for November 2010.

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**Notes to Consolidated Financial Statements (continued)**

In January 2004, the Seoul District Prosecutors Office in South Korea announced it had brought criminal bid-rigging charges against several companies, including IBM Korea and LG IBM (a joint venture between IBM Korea and LG electronics, which has since been dissolved, effective January, 2005) and had also charged employees of some of those entities with, among other things, bribery of certain officials of government-controlled entities in Korea and bid rigging. IBM Korea and LG IBM cooperated fully with authorities in these matters. A number of individuals, including former IBM Korea and LG IBM employees, were subsequently found guilty and sentenced. IBM Korea and LG IBM were also required to pay fines. Debarment orders were imposed at different times, covering a period of no more than a year from the date of issuance, which barred IBM Korea from doing business directly with certain government-controlled entities in Korea. All debarment orders have since expired and when they were in force did not prohibit IBM Korea from selling products and services to business partners who sold to government-controlled entities in Korea. In addition, the U.S. Department of Justice and the SEC have both contacted the company in connection with this matter. In March 2008, the company received a request from the SEC for additional information.

The company is a defendant in numerous actions filed after January 1, 2008 in the Supreme Court for the State of New York, county of Broome, on behalf of hundreds of plaintiffs. The complaints allege numerous and different causes of action, including for negligence and recklessness, private nuisance and trespass. Plaintiffs in these cases seek medical monitoring and claim damages in unspecified amounts for a variety of personal injuries and property damages allegedly arising out of the presence of groundwater contamination and vapor intrusion of groundwater contaminants into certain structures in which plaintiffs reside or resided, or conducted business, allegedly resulting from the release of chemicals into the environment by the company at its former manufacturing and development facility in Endicott. These complaints also seek punitive damages in an unspecified amount.

The company is party to, or otherwise involved in, proceedings brought by U.S. federal or state environmental agencies under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), known as Superfund, or laws similar to CERCLA. Such statutes require potentially responsible parties to participate in remediation activities regardless of fault or ownership of sites. The company is also conducting environmental investigations, assessments or remediations at or in the vicinity of several current or former operating sites globally pursuant to permits, administrative orders or agreements with country, state or local environmental agencies, and is involved in lawsuits and claims concerning certain current or former operating sites.

The company is also subject to ongoing tax examinations and governmental assessments in various jurisdictions. Along with many other U.S. companies doing business in Brazil, the company is involved in various challenges with Brazilian authorities regarding non-income tax assessments and non-income tax litigation matters. These matters include claims for taxes on the importation of computer software. In November 2008, the company won a significant case in the Superior Chamber of the federal administrative tax court in Brazil, and in late July 2009, the company received written confirmation regarding this decision. The total potential amount related to the remaining matters for all applicable years is approximately \$600 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

The company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and proceedings are reviewed at least quarterly and provisions are taken or adjusted to reflect the impact and status of settlements, rulings, advice of counsel and other information pertinent to a particular matter. Any recorded liabilities, including any changes to such liabilities for the quarter ended September 30, 2010, were not material to the Consolidated Financial Statements. Based on its experience, the company believes that the damage amounts claimed in the matters previously referred to are not a meaningful indicator of the potential liability. Claims, suits, investigations and proceedings are inherently uncertain and it is not possible to predict the ultimate outcome of the matters previously discussed. While the company will continue to defend itself vigorously, it is possible that the company's business, financial condition, results of operations or cash flows could be affected in any particular period by the resolution of one

or more of these matters.

Whether any losses, damages or remedies finally determined in any such claim, suit, investigation or proceeding could reasonably have a material effect on the company's business, financial condition, results of operations or cash flows will depend on a number of variables, including: the timing and amount of such losses or damages; the structure and type of any such remedies; the significance of the impact any such losses, damages or remedies may have on the Consolidated Financial Statements; and the unique facts and circumstances of the particular matter which may give rise to additional factors.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

**16. Commitments:** The company's extended lines of credit to third-party entities include unused amounts of \$3,784 million and \$3,576 million at September 30, 2010 and December 31, 2009, respectively. A portion of these amounts was available to the company's business partners to support their working capital needs. In addition, the company has committed to provide future financing to its clients in connection with client purchase agreements for approximately \$2,626 million and \$2,788 million at September 30, 2010 and December 31, 2009, respectively.

The company has applied the guidance requiring a guarantor to disclose certain types of guarantees, even if the likelihood of requiring the guarantor's performance is remote. The following is a description of arrangements in which the company is the guarantor.

The company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in the context of contracts entered into by the company, under which the company customarily agrees to hold the party harmless against losses arising from a breach of representations and covenants related to such matters as title to the assets sold, certain intellectual property (IP) rights, specified environmental matters, third-party performance of non-financial contractual obligations and certain income taxes. In each of these circumstances, payment by the company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the company to challenge the other party's claims. While typically indemnification provisions do not include a contractual maximum on the company's payment, the company's obligations under these agreements may be limited in terms of time and/or nature of claim, and in some instances, the company may have recourse against third parties for certain payments made by the company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements, due to the conditional nature of the company's obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the company under these agreements have not had a material effect on the company's business, financial condition or results of operations.

In addition, the company guarantees certain loans and financial commitments. The maximum potential future payment under these financial guarantees was \$85 million at September 30, 2010 and December 31, 2009, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position was not material.

Changes in the company's warranty liability for standard warranties and deferred income for extended warranty contracts are presented in the following tables:

**Standard Warranty Liability**

(Dollars in millions)	2010		2009	
Balance at January 1	\$	316	\$	358
Current period accruals		284		245
Accrual adjustments to reflect actual experience		31		(0)



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Charges incurred		(326)		(309)
Balance at September 30	\$	305	\$	293

**Extended Warranty Liability**

<b>(Dollars in millions)</b>		<b>2010</b>		<b>2009</b>
Aggregate deferred revenue at January 1	\$	665	\$	589
Revenue deferred for new extended warranty contracts		217		204
Amortization of deferred revenue		(221)		(181)
Other*		(29)		20
Aggregate deferred revenue at September 30	\$	632	\$	633
Current portion	\$	303	\$	298
Noncurrent portion		329		334
Aggregate deferred revenue at September 30	\$	632	\$	633

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\* Other primarily consists of foreign currency translation adjustments.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

**17. Subsequent Events:** On October 26, 2010, the company announced that the Board of Directors approved a quarterly dividend of \$0.65 per common share. The dividend is payable December 10, 2010 to stockholders of record on November 10, 2010.

On October 26, 2010, the company announced that the Board of Directors authorized \$10 billion in additional funds for use in the company's common stock repurchase program.

**Item 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION  
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010**

**Snapshot**

(Dollars in millions except per share amounts) For the three months ended September 30:	2010	2009	Yr. to Yr. Percent/ Margin Change
Revenue	\$ 24,271	\$ 23,566	3.0%*
Gross profit margin	45.3%	45.1%	0.2pts.
Total expense and other income	\$ 6,324	\$ 6,255	1.1%
Total expense and other income to revenue ratio	26.1%	26.5%	(0.5)pts.
Provision for income taxes	\$ 1,088	\$ 1,159	(6.1)%
Net income	\$ 3,589	\$ 3,214	11.7%
Net income margin	14.8%	13.6%	1.1pts.
Earnings per share:			
Assuming dilution	\$ 2.82	\$ 2.40	17.5%
Basic	\$ 2.86	\$ 2.44	17.2%
Weighted-average shares outstanding:			
Assuming dilution	1,272.8	1,338.2	(4.9)%
Basic	1,255.2	1,319.9	(4.9)%

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\* 3.6 percent adjusted for currency

Within the Management Discussion, selected references to adjusted for currency or at constant currency are made so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business

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performance. Financial results adjusted for currency are calculated by translating current period activity in local currency using the comparable prior year period's currency conversion rate. This approach is based on the pricing currency for each country, which is typically the functional currency.

In the third quarter of 2010, the company continued the trend of improving business performance, increasing constant currency revenue growth, expanding margins and again delivering double-digit earnings per share growth. Diluted earnings per share of \$2.82 increased 18 percent versus the third quarter of 2009; this growth was on top of very strong performance in the prior year third quarter, which was also up 18 percent year to year. The company delivered solid financial results while continuing to invest to drive future growth and delivering strong shareholder returns.

Total revenue increased 3.0 percent (4 percent adjusted for currency) compared to the third quarter of 2009. The revenue growth at constant currency was 2 points better than the constant currency performance in the second quarter. Revenue performance in the third quarter was driven by the company's growth markets, Systems and Technology, Global Business Services and business analytics offerings. Total revenue from the growth markets increased 15.7 percent (13 percent adjusted for currency) driven by the BRIC countries (Brazil, Russia, India and China) which increased 28.8 percent (26 percent adjusted for currency). In the growth markets, the company has focused its investments on expanding into new countries and new territories and building out the IT infrastructure in these regions in support of economic growth. The company has prioritized 16 countries for investment beyond the BRICs. In the third quarter, together with the BRICs, the Growth Markets 20 grew revenue 17 percent (13 percent adjusted for currency) and the company had 32 countries within the growth markets that increased revenue at a double-digit rate. Systems and Technology had its best revenue growth in six years at 10.4 percent (11 percent adjusted for currency) capitalizing on new product introductions and continued strong

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growth in System x, midrange Power Systems and Storage. Business analytics is a key growth area for the company. In the third quarter, business analytics revenue increased 14 percent compared to the prior year which contributed to strong performance in Global Business Services. Global Business Services revenue growth improved to 5.4 percent (5 percent adjusted for currency).

The consolidated gross profit margin increased 0.2 points versus the third quarter of 2009 to 45.3 percent driven by improved margins in Software, Systems and Technology and Global Financing, partially offset by revenue mix. Gross profit margin performance by segment and the impact to the consolidated gross margin was as follows:

	<b>Gross Margin</b>	<b>Yr.-to-Yr. Change</b>	<b>Consolidated Impact</b>
Global Technology Services	35.3%	(0.2)pts.	(0.0)pts.
Global Business Services	28.9%	0.2pts.	(0.0)pts.
Software	86.7%	1.1pts.	0.0pts.
Systems & Technology	36.8%	1.2pts.	0.1pts.
Global Financing	53.3%	8.9pts.	0.2pts.

Total expense and other income increased 1.1 percent in the third quarter compared to the prior year. The year-to-year drivers were approximately:

- Operational expense, (1) point
- Currency, (1) point
- Acquisitions, 3 points

Pre-tax income grew 7.0 percent and the pre-tax margin was 19.3 percent, an increase of 0.7 points versus the third quarter of 2009. Net income increased 11.7 percent reflecting an improvement in the tax rate. The effective tax rate was 23.3 percent, compared with 26.5 percent in the prior year. Net income margin improved 1.1 points to 14.8 percent.

Diluted earnings per share improved 17.5 percent reflecting the growth in net income and the benefits of the common stock repurchase program. In the third quarter, the company repurchased 28.0 million shares of its common stock. Diluted earnings per share of \$2.82 increased \$0.42 from the prior year driven by the following factors:

- Revenue increase at actual rates:	\$	0.07
- Operating leverage:	\$	0.21
- Common stock repurchases:	\$	0.14

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In the third quarter, the improvement in earnings per share was driven by a combination of revenue growth, operating leverage and an effective use of cash.

The company generated \$4,551 million in cash flow provided by operating activities, a decrease of \$647 million compared to the third quarter of 2009, driven primarily by sales cycle working capital (\$467 million) and financing receivables (\$443 million), partially offset by the increase in net income (\$375 million). Net cash used in investing activities of \$1,780 million decreased \$557 million primarily due to the net benefit of \$2,600 million from purchases and sales of marketable securities and other investments in the third quarter of 2010 versus 2009, partially offset by increased acquisitions of \$1,959 million. Net cash used in financing activities of \$3,455 million decreased \$1,712 million compared to the prior year primarily due to an increased net benefit associated with debt (\$4,709 million), partially offset by higher payments to repurchase common stock (\$2,724 million), lower cash from other common stock transactions (\$182 million) and increased dividend payments (\$91 million).

Total Global Services signings of \$11,037 million decreased 6.5 percent (6 percent adjusted for currency) compared to the third quarter of 2009. Outsourcing signings declined 14.9 percent (14 percent adjusted for currency). Transactional signings increased 4.3 percent (4 percent adjusted for currency) driven by Global Business Services (increased 7 percent). The company signed 10 deals larger than \$100 million in the third quarter of 2010. On October 8, 2010, the company signed a significant outsourcing deal which would have increased total signings to \$12.7 billion and outsourcing signings would have increased 14 percent year-to-year, at constant currency, if this deal was included in the third quarter total. The estimated Global Services backlog at actual currency rates was \$134 billion at September 30, 2010, flat, at both actual rates and adjusted for currency,

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**Management Discussion (continued)**

compared to the September 30, 2009 level and an increase of \$5 billion (decrease of \$2 billion adjusted for currency) from June 30, 2010.

(Dollars in millions except per share amounts) For the nine months ended September 30:				Yr. to Yr. Percent/ Margin Change
	2010	2009		
Revenue	\$ 70,852	\$ 68,528		3.4%*
Gross profit margin	44.9%	44.7%		0.2pts.
Total expense and other income	\$ 19,019	\$ 18,882		0.7%
Total expense and other income to revenue ratio	26.8%	27.6%		(0.7)pts.
Provision for income taxes	\$ 3,192	\$ 3,145		1.5%
Net income	\$ 9,576	\$ 8,612		11.2%
Net income margin	13.5%	12.6%		0.9pts.
Earnings per share:				
Assuming dilution	\$ 7.38	\$ 6.42		15.0%
Basic	\$ 7.49	\$ 6.47		15.8%
Weighted-average shares outstanding:				
Assuming dilution	1,297.0	1,341.6		(3.3)%
Basic	1,278.3	1,330.1		(3.9)%

  

	09/30/10	12/31/09	
Assets	\$ 107,174	\$ 109,022	(1.7)%
Liabilities	\$ 84,815	\$ 86,267	(1.7)%
Equity	\$ 22,359	\$ 22,755	(1.7)%

\* 1.7 percent adjusted for currency

In the first nine months of 2010, the company delivered diluted earnings per share of \$7.38, an increase of 15.0 percent compared to the first nine months of 2009. Performance was consistent with earnings per share growth of 15.9 percent in the first quarter, 12.5 percent in the second quarter and 17.5 percent in the third quarter. The company continues to demonstrate steady improvement in the business - in both revenue growth and margin expansion. The company utilizes its strong profit and cash position to invest and expand its base of opportunity while returning capital to its shareholders through dividends and common stock repurchases.

Total revenue increased 3.4 percent (2 percent adjusted for currency) compared to the first nine months of 2009. Revenue performance in the company's key growth areas was strong. Revenue from the growth markets increased 16.3 percent (10 percent adjusted for currency) driven by the BRIC countries which increased 24.8 percent (19 percent adjusted for currency). Key branded middleware software increased 9.5 percent (9 percent adjusted for currency). On a segment basis, Global Technology Services revenue increased 2.7 percent (flat adjusted for currency), Global Business Services 3.0 percent (1 percent adjusted for currency), Software 4.2 percent (3 percent adjusted for currency) and Systems and Technology 6.3 percent (6 percent adjusted for currency). Global Financing revenue declined 4.3 percent (6 percent adjusted for currency) versus the prior year.

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The consolidated gross profit margin increased 0.2 points versus the first nine months of 2009 to 44.9 percent. Gross profit margin performance by segment and the impact to the consolidated gross margin for the year-to-date period was as follows:

	<b>Gross Margin</b>	<b>Yr.-to-Yr. Change</b>	<b>Consolidated Impact</b>
Global Technology Services	34.7%	(0.0)pts.	0.0pts.
Global Business Services	28.2%	0.8pts.	0.2pts.
Software	86.1%	0.9pts.	0.3pts.
Systems & Technology	35.6%	(0.0)pts.	(0.0)pts.
Global Financing	51.1%	5.2pts.	0.1pts.

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**Management Discussion (continued)**

Total expense and other income increased 0.7 percent in the first nine months of 2010 versus the prior year. The year-to-year drivers were approximately:

- Operational expense, (4) points
- Currency, 3 points
- Acquisitions, 2 points

Pre-tax income grew 8.6 percent and the pre-tax margin was 18.0 percent, an increase of 0.9 points versus the first nine months of 2009. Net income increased 11.2 percent reflecting an improvement in the tax rate. The effective tax rate was 25.0 percent, compared with 26.8 percent in the prior year. Net income margin improved 0.9 points to 13.5 percent.

Diluted earnings per share improved 15.0 percent reflecting the growth in net income and the benefits of the common stock repurchase program. In the first nine months of 2010, the company repurchased 92.6 million shares of its common stock. Diluted earnings per share of \$7.38 increased \$0.96 from the prior year driven by the following factors:

- Revenue increase at actual rates:	\$	0.22
- Operating leverage:	\$	0.50
- Common stock repurchases:	\$	0.25

In the first nine months, the improvement in earnings per share was balanced with contribution from revenue growth, operating leverage and an effective use of cash.

At September 30, 2010, the balance sheet and liquidity positions remain strong and are well-positioned to support the company's objectives. Key drivers in the balance sheet and total cash flows are highlighted below.

Total assets decreased \$1,848 million (\$2,124 million adjusted for currency) from December 31, 2009 driven by:

- Decreases in total receivables (\$3,494 million) and cash and marketable securities (\$2,887 million), partially offset by;
- Increased goodwill (\$2,513 million), pension assets (\$1,378 million), and intangible assets (\$534 million).

The company had \$11,086 million in cash and marketable securities at September 30, 2010.



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Total liabilities decreased \$1,453 million (\$1,539 million adjusted for currency) from December 31, 2009 driven by:

- Decreases in taxes (\$918 million), pension and retiree benefits (\$808 million), other liabilities (\$454 million), and deferred income (\$421 million), partially offset by;
- Increased debt (\$1,355 million).

Total equity of \$22,359 million decreased \$396 million from December 31, 2009 as a result of:

- Increased treasury stock (\$11,464 million), partially offset by;
- Higher retained earnings (\$7,196 million), common stock (\$2,518 million), lower pension adjustments (\$559 million), decreased losses on cash flow hedge derivatives (\$416 million) and higher foreign currency translation adjustments (\$327 million).

The company generated \$12,754 million in cash flow provided by operating activities, a decrease of \$1,571 million, compared to the first nine months of 2009, primarily driven by financing receivables (\$1,574 million), higher income tax payments (\$800 million) and lower tax refunds in 2010 (approximately \$600 million), partially offset by an increase in net income (\$963 million) and less deferred income (\$496 million). Net cash used in investing activities of \$4,425 million was \$191 million higher than the first nine months of 2009, primarily due to increased acquisitions (\$2,868 million), decreased cash from divestitures (\$406 million) and higher capital investments (\$327 million), partially offset by the net benefit of \$3,367 million from purchases and sales of marketable securities and other investments in 2010 versus 2009. Net cash used in financing activities of \$10,569 million was \$2,924 million lower, compared to the first nine months of 2009, primarily due to an increased net benefit associated with debt (\$9,445 million) and higher receipts of cash from other

Table of Contents**Management Discussion (continued)**

common stock transactions (\$1,123 million), partially offset by higher payments to repurchase common stock (\$7,408 million) and increased dividend payments (\$235 million).

In October 2010, the company increased its expectation for 2010 to at least \$11.40 in earnings per diluted share for the full year.

**Third Quarter and First Nine Months in Review***Results of Operations*Segment Details

The following is an analysis of the third quarter and the first nine months of 2010 versus the third quarter and first nine months of 2009 reportable segment external revenue and gross margin results. Segment pre-tax income includes transactions between the segments that are intended to reflect an arms-length transfer price and excludes certain unallocated corporate items.

(Dollars in millions)				Yr. To Yr. Percent/Margin Change	Yr. To Yr. Percent Change Adjusted for Currency
For the three months ended September 30:	2010	2009			
Revenue:					
Global Technology Services	\$ 9,496	\$ 9,434		0.7%	1.1%
Gross margin	35.3%	35.5%		(0.2)pts.	
Global Business Services	4,572	4,338		5.4%	5.3%
Gross margin	28.9%	28.7%		0.2pts.	
Software	5,151	5,114		0.7%	2.1%
Gross margin	86.7%	85.7%		1.1pts.	
Systems and Technology	4,325	3,917		10.4%	11.1%
Gross margin	36.8%	35.6%		1.2pts.	
Global Financing	529	536		(1.3)%	(1.3)%
Gross margin	53.3%	44.4%		8.9pts.	
Other	199	227		(12.2)%	(11.3)%
Gross margin	(4.7)%	8.5%		(13.2)pts.	
Total revenue	\$ 24,271	\$ 23,566		3.0%	3.6%
Gross profit	\$ 11,001	\$ 10,627		3.5%	
Gross margin	45.3%	45.1%		0.2pts.	

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(Dollars in millions)				Yr. to Yr. Percent Change	Yr. to Yr. Percent Change Adjusted for Currency
For the nine months ended September 30:	2010	2009		Percent/Margin Change	
Revenue:					
Global Technology Services	\$ 28,036	\$ 27,296		2.7%	0.4%
Gross margin	34.7%	34.7%		(0.0)pts.	
Global Business Services	13,465	13,074		3.0%	0.9%
Gross margin	28.2				