

INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
April 29, 2014

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 MARCH 31, 2014

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York

13-0871985

(State of incorporation)

(IRS employer identification number)

Armonk, New York

10504

(Address of principal executive offices)

(Zip Code)

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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a 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 had 1,012,183,432 shares of common stock outstanding at March 31, 2014.

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Part I - Financial Information

Item 1. Consolidated Financial Statements:

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF EARNINGS
(UNAUDITED)**

Three Months Ended March 31,

(Dollars in millions except per share amounts)

2014

2013

Revenue:

Services

\$

13,982

\$

	14,274
Sales	
	7,984
	8,629
Financing	
	517
	505
Total revenue	
	22,484
	23,408
Cost:	

Services

9,101

9,526

Sales

2,561

2,931

Financing

278

	273
Total cost	
	11,941
	12,730
Gross profit	
	10,543
	10,678
Expense and other (income):	

Selling, general and administrative

	6,289
	5,577
Research, development and engineering	
	1,501
	1,644
Intellectual property and custom development income	
	(207)
	(183)
Other (income) and expense	

	(126)
	(60)
Interest expense	
	105
	94
Total expense and other (income)	
	7,563
	7,072
Income before income taxes	
	2,980
	3,606
	18

Provision for income taxes

596

574

Net income

\$

2,384

\$

3,032

Earnings per share of common stock:

Assuming dilution

\$ 2.29

\$ 2.70

Basic

\$ 2.30

\$ 2.72

Weighted-average number of common shares outstanding: (millions)

Assuming dilution

1,041.8

1,124.0

Basic

1,035.2

1,113.7

Cash dividend per common share

\$

0.95

\$

0.85

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(UNAUDITED)**

Three Months Ended March 31,

(Dollars in millions)

2014

2013

Net income

\$

2,384

\$

3,032

Other comprehensive income/(loss), before tax:

Foreign currency translation adjustments

(61)

Net changes related to available-for-sale securities:

Unrealized gains/(losses) arising during the period

0

(3)

Reclassification of (gains)/losses to net income

4

1

Subsequent changes in previously impaired securities arising during the period

—

1

Total net changes related to available-for-sale securities

4

(1)

Unrealized gains/(losses) on cash flow hedges:

Unrealized gains/(losses) arising during the period

88

360

Reclassification of (gains)/losses to net income

(1)

(56)

Total unrealized gains/(losses) on cash flow hedges

87

305

28

Retirement-related benefit plans:

Prior service costs/(credits)

1

33

Net (losses)/gains arising during the period

32

(15)

29

Curtailments and settlements

4

—

Amortization of prior service (credits)/cost

(29)

(30)

Amortization of net (gains)/losses

649

886

Total retirement-related benefit plans

656

875

Other comprehensive income/(loss), before tax

687

773

Income tax (expense)/benefit related to items of other comprehensive income

(241)

(480)

Other comprehensive income/(loss)

446

293

Total comprehensive income/(loss)

\$

2,830

\$

3,325

(Amounts may not add due to rounding)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

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

ASSETS

At March 31,

At December 31,

(Dollars in millions)

2014

2013

Assets:

Current assets:

Cash and cash equivalents

\$ 9,409

\$ 10,716

Marketable securities

295

Notes and accounts receivable - trade (net of allowances of \$305

in 2014 and \$291 in 2013)

9,682

10,465

Short-term financing receivables (net of allowances of \$317 in 2014

and \$308 in 2013)

18,329

19,787

Other accounts receivable (net of allowances of \$36 in 2014 and

\$36 in 2013)

1,650

1,584

Inventories, at lower of average cost or market:

Finished goods

472

444

38

Work in process and raw materials

1,984

1,866

Total inventories

2,456

2,310

Deferred taxes

1,708

	1,651
Prepaid expenses and other current assets	
	4,430
	4,488
Total current assets	
	47,959
	51,350

Property, plant and equipment

40,478

40,475

Less: Accumulated depreciation

26,795

26,654

Property, plant and equipment — net

13,683

13,821

Long-term financing receivables (net of allowances of \$93 in 2014

and \$80 in 2013)

11,918

12,755

Prepaid pension assets

6,110

	5,551
Deferred taxes	
	3,034
	3,051
Goodwill	
	31,214
	31,184
Intangible assets — net	
	3,698
	3,871

Investments and sundry assets

5,030

4,639

Total assets

\$

122,646

\$

126,223

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

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

LIABILITIES AND EQUITY

(Dollars in millions)

At March 31,

At December 31,

2014

2013

Liabilities:

Current liabilities:

Taxes

\$

2,245

\$

4,633

Short-term debt

9,312

6,862

Accounts payable

	6,865
	7,461
Compensation and benefits	
	3,664
	3,893
Deferred income	
	13,681
	12,557
Other accrued expenses and liabilities	

	5,292
	4,748
Total current liabilities	
	41,058
	40,154
Long-term debt	
	34,668
	32,856
Retirement and nonpension postretirement benefit obligations	

	16,031
	16,242
Deferred income	
	4,042
	4,108
Other liabilities	
	10,106
	9,934
Total liabilities	
	105,906

103,294

Equity:

IBM stockholders' equity:

Common stock, par value \$0.20 per share, and additional paid-in capital

51,943

51,594

Shares authorized: 4,687,500,000

Shares issued: 2014 - 2,210,627,775

2013 - 2,207,522,548

Retained earnings

131,431

130,042

Treasury stock - at cost

(145,612)

(137,242)

Shares: 2014 - 1,198,444,343

2013 - 1,153,131,611

Accumulated other comprehensive income/(loss)

(21,156)

(21,602)

Total IBM stockholders' equity

16,607

22,792

Noncontrolling interests

133

137

Total equity

16,740

22,929

Total liabilities and equity

\$

122,646

\$

126,223

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF CASH FLOWS
(UNAUDITED)**

Three Months Ended March 31,

(Dollars in millions)

2014

2013

Cash flows from operating activities:

Net income

\$ 2,384

\$ 3,032

Adjustments to reconcile net income to cash provided by operating activities

Depreciation 802

822

Amortization of intangibles 339

59

	331
Stock-based compensation	
	124
	144
Net (gain)/loss on asset sales and other	
	(161)
	(62)
Changes in operating assets and liabilities, net of acquisitions/divestitures	
	(162)

(244)

Net cash provided by operating activities

3,326

4,023

Cash flows from investing activities:

Payments for property, plant and equipment

	(849)
	(714)
Proceeds from disposition of property, plant and equipment	
	74
	123
Investment in software	
	(112)
	(139)
Acquisition of businesses, net of cash acquired	

(264)

(58)

Divestitures of businesses, net of cash transferred

391

10

Non-operating finance receivables — net

665

732

Purchases of marketable securities and other investments

(477)

(2,136)

Proceeds from disposition of marketable securities and other investments

608

1,169

Net cash provided by/(used in) investing activities

35

(1,012)

Cash flows from financing activities:

Proceeds from new debt

4,875

2,685

Payments to settle debt

(1,507)

(857)

Short-term borrowings/(repayments) less than 90 days — net

	845
	(1,359)
Common stock repurchases	
	(8,166)
	(2,593)
Common stock transactions — other	
	270
	356
Cash dividends paid	
	(990)

(948)

Net cash used in financing activities

(4,673)

(2,716)

Effect of exchange rate changes on cash and cash equivalents

5

(121)

67

Net change in cash and cash equivalents

(1,307)

173

Cash and cash equivalents at January 1

10,716

10,412

Cash and cash equivalents at March 31

\$

9,409

\$

10,585

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(UNAUDITED)**

Common

Stock and

Accumulated

Additional

Other

Total IBM

Non-

Paid-in

Retained

Treasury

Comprehensive

Stockholders'

Controlling

Total

(Dollars in millions)

Capital

Earnings

Stock

Income/(Loss)

Equity

Interests

Equity

Equity - January 1, 2014

\$	51,594
\$	130,042
\$	(137,242)
\$	(21,602)
\$	22,792
\$	137
\$	22,929
Net income plus other	

comprehensive income/(loss)

Net income

2,384

2,384

2,384

Other comprehensive income/(loss)

446

446

Total comprehensive income/(loss)

\$

2,830

\$

2,830

Cash dividends paid –

common stock

(990)

(990)

(990)

Common stock issued under

employee plans (3,105,227 shares)

333

333

Purchases (488,203 shares) and

sales (328,673 shares) of treasury

stock under employee plans – net

(5)

(46)

(51)

(51)

Other treasury shares purchased,

not retired (45,153,202 shares)

(8,324)

(8,324)

(8,324)

Changes in other equity

16

86

16

16

Changes in noncontrolling interests

(4)

(4)

Equity - March 31, 2014

\$

51,943

\$

131,431

\$

(145,612)

\$

(21,156)

\$ 16,607

\$ 133

\$ 16,740

Common

Stock and

Accumulated

Additional

Other

Total IBM

Non-

Paid-in

Retained

Treasury

Comprehensive

Stockholders'

Controlling

Total

(Dollars in millions)

Capital

Earnings

Stock

Income/(Loss)

Equity

Interests

Equity

Equity - January 1, 2013

\$ 50,110

\$ 117,641

\$ (123,131)

\$ (25,759)

\$ 18,860

\$ 124

\$

18,984

Net income plus other

comprehensive income/(loss)

Net income

3,032

3,032

3,032

Other comprehensive income/(loss)

293

293

293

Total comprehensive income/(loss)

\$ 3,325

\$ 3,325

Cash dividends paid –

common stock

(948)

(948)

Common stock issued under

employee plans (3,726,163 shares)

Purchases (629,550 shares) and

sales (648,990 shares) of treasury

stock under employee plans – net

(12)

(53)

(65)

Other treasury shares purchased,

(65)

not retired (12,318,883 shares)

(2,493)

(2,493)

(2,493)

Changes in other equity

Changes in noncontrolling interests

(1)

(1)

Equity - March 31, 2013

\$

50,522

\$

119,713

\$

(125,677)

\$

(25,466)

\$

19,092

\$

122

\$

19,214

(Amounts may not add due to rounding.)

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

Notes to Consolidated Financial Statements:

1. Basis of Presentation: The accompanying Consolidated Financial Statements and footnotes 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 only 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 amount of assets, liabilities, revenue, costs, expenses and other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management's best knowledge of current events, historical experience, actions that the company may undertake in the future and on various other assumptions that are believed to be reasonable under the circumstances. As a result, actual results may be different from these estimates. See the company's 2013 Annual Report on pages 67 to 70 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 2013 Annual Report.

Noncontrolling interest amounts in income of \$(0.5) million and \$1.4 million, net of tax, for the three months ended March 31, 2014 and 2013, respectively, are included in the Consolidated Statement of Earnings within the other (income) and expense line item.

Within the financial statements and 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 April 2014, the Financial Accounting Standards Board (FASB) issued guidance that changes the criteria for reporting a discontinued operation. According to the new guidance, only disposals of a component that represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results is a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations and disposals of a significant part of an entity that does not qualify for discontinued operations reporting. The guidance is effective beginning January 1, 2015 with early adoption permitted, but only for disposals (or classifications as held for sale) that have not been reported in previously-issued financial statements. The impact to the company will be dependent on any transaction that is within the scope of the new guidance.

In July 2013, the FASB issued guidance regarding the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Under certain circumstances, unrecognized tax benefits should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The guidance was effective January 1, 2014, and was adopted by the company in the first quarter. The guidance is a change in financial statement presentation only and had no material impact in the consolidated financial results.

In March 2013, the FASB issued guidance on when foreign currency translation adjustments should be released to net income. When a parent entity ceases to have a controlling financial interest in a subsidiary or group of assets that is a business within a foreign entity, the parent is required to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The guidance was effective January 1, 2014 and did not have a material impact in the Consolidated Statement of Financial Position.

In February 2013, the FASB issued guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of the guidance is fixed at the reporting date. Examples include debt arrangements, other contractual obligations and settled litigation matters. The guidance requires an entity to measure such obligations as the sum of the amount that the reporting entity agreed to pay on the basis of its arrangement among its co-obligors plus additional amounts the reporting entity expects to pay on behalf of its co-obligors. The guidance was effective January 1, 2014 and did not have a material impact in the consolidated financial results.

Notes to Consolidated Financial Statements – (continued)

3. Financial Instruments:

Fair Value Measurements

Accounting guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Under this guidance, the company is required to classify certain assets and liabilities based on the following fair value hierarchy:

- Level 1—Quoted prices (unadjusted) in active markets for identical assets or liabilities that can be accessed at the measurement date;
- Level 2—Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and
- Level 3—Unobservable inputs for the asset or liability.

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 in active markets 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.

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 utilizing a discounted cash flow model that uses 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 measurement date 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 available-for-sale equity 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.

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 - Impairment," on page 88 in the company's 2013 Annual Report for additional information. There were no material impairments of non-financial assets for the three months ended March 31, 2014 and 2013, respectively.

Accounting guidance permits the measurement of eligible financial assets, financial liabilities and firm commitments at fair value, on an instrument-by-instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. This election is irrevocable. The company has not applied the fair value option to any eligible assets or liabilities.

The following tables present the company's financial assets and financial liabilities that are measured at fair value on a recurring basis at March 31, 2014 and December 31, 2013.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)

At March 31, 2014

Level 1

Level 2

Level 3

Total

Assets:

Cash equivalents (1)

Time deposits and certificates of deposit

\$	—
\$	4,619
\$	—
\$	4,619

Commercial paper

—

559

—

559

Money market funds

988

—

—

120

988

U.S. government securities

—

599

—

599

Canadian government securities

—

121

226

—

226

Other securities

—

40

—

40

122

Total

988

6,044

—

7,032

(6)

Debt securities - current (2)

—

295

—

123

295

(6)

Debt securities - noncurrent (3)

1

8

—

9

Trading securities investments (3)

—

77

—

77

Available-for-sale equity investments (3)

4

—

—

4

Derivative assets (4)

Interest rate contracts

—

363

—

126

Foreign exchange contracts

—

297

—

297

Equity contracts

—

17

—

17

Total

—

678

—

678

(7)

Total assets

\$

128

993

\$

7,102

\$

—

\$

8,095

(7)

Liabilities:

Derivative liabilities (5)

Foreign exchange contracts

\$ —

\$ 427

\$ —

\$

427

Equity contracts

—

2

—

2

Interest rate contracts

—

12

—

12

Total liabilities

\$

—

\$

441

\$

—

\$

441

(7)

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

(2) Commercial paper and certificates of deposit 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 March 31, 2014 were \$202 million and

\$476 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 March 31, 2014 were \$370 million and \$71 million, respectively.

(6) Available-for-sale securities with carrying values that approximate fair value.

(7) 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 \$221 million each.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)

At December 31, 2013

Level 1

Level 2

Level 3

Total

Assets:

Cash equivalents (1)

Time deposits and certificates of deposit

\$	—
\$	4,754
\$	—
\$	4,754

Commercial paper

—

1,507

—

1,507

Money market funds

1,728

—

—

1,728

Other securities

—

8

—

8

Total

1,728

138

6,269

—

7,997

(6)

Debt securities - current (2)

—

350

—

350

(6)

Debt securities - noncurrent (3)

139

1

7

—

9

Available-for-sale equity investments (3)

18

—

—

Derivative assets (4)

Interest rate contracts

—

—

308

Foreign exchange contracts

—

375

—

375

Equity contracts

142

—

36

—

36

Total

—

719

—

143

(7)

Total assets

\$

1,747

\$

7,345

\$

—

\$

9,092

(7)

Liabilities:

Derivative liabilities (5)

Interest rate contracts

\$

\$ 13

\$ —

\$ 13

Foreign exchange contracts

—

484

—

484

146

Equity contracts

—

4

—

4

Total liabilities

\$

—

\$

501

\$

—

\$

501

(7)

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

(2) Commercial paper and certificates of deposit 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, 2013 were \$318 million and

\$401 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, 2013 were \$375 million and \$126 million, respectively.
- (6) Available-for-sale securities with carrying values that approximate fair value.
- (7) 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 \$251 million each.

There were no transfers between Levels 1 and 2 for the three months ended March 31, 2014 and the year ended December 31, 2013.

Financial Assets and Liabilities Not Measured at Fair Value

Short-Term Receivables and Payables

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 (excluding the current portion of long-term debt) are financial liabilities with carrying values that approximate fair value. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

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. At March 31, 2014 and December 31, 2013, the difference between the carrying amount and estimated fair value for loans and long-term receivables was immaterial. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

Notes to Consolidated Financial Statements – (continued)

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 was \$34,668 million and \$32,856 million, and the estimated fair value was \$36,808 million and \$34,555 million at March 31, 2014 and December 31, 2013, respectively. If measured at fair value in the financial statements, long-term debt (including the current portion) would be classified as Level 2 in the fair value hierarchy.

Debt and Marketable Equity Securities

The company's cash equivalents and current debt securities are considered available-for-sale and recorded at fair value, which is not materially different from carrying value, in the Consolidated Statement of Financial Position.

During the quarter, the company acquired equity investments in conjunction with the sale of the customer care business which are classified as trading securities. At March 31, 2014, unrealized gains related to trading securities of \$6 million were recorded in other (income) and expense in the Consolidated Statement of Earnings.

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

Gross

Gross

(Dollars in millions)

Adjusted

Unrealized

Unrealized

Fair

At March 31, 2014:

Cost

Gains

Losses

Value

Debt securities – noncurrent(1)

\$	8
\$	2
\$	—
\$	9
Available-for-sale equity investments(1)	
\$	2
\$	2
\$	
0	
\$	4

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

Gross

Gross

(Dollars in millions)

Adjusted

Unrealized

Unrealized

Fair

At December 31, 2013:

Cost

Gains

Losses

Value

Debt securities – noncurrent(1)

\$

	\$	1
	\$	—
	\$	9
Available-for-sale equity investments(1)		
	\$	20
	\$	2
	\$	4
	\$	18

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

Based on an evaluation of available evidence as of March 31, 2014 and December 31, 2013, the company believes that unrealized losses on debt and available-for-sale equity investments were temporary and did not represent a need for an other-than-temporary impairment.

Sales of debt and available-for-sale equity investments during the period were as follows:

(Dollars in millions)

For the three months ended March 31:

2014

2013

Proceeds

\$

14

\$

18

Gross realized gains (before taxes)

—

3

Gross realized losses (before taxes)

(Dollars in millions)

For the three months ended March 31:

2014

2013

Net unrealized gains/(losses) arising during the period

\$

0

\$

\$ (1)

Net unrealized (gains)/losses reclassified to net income*

3

0

* There were no writedowns for the three months ended March 31, 2014 and 2013.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at March 31, 2014.

Notes to Consolidated Financial Statements – (continued)**Derivative Financial Instruments**

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 overall credit profile. 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 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 derivative 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 March 31, 2014 and December 31, 2013 was \$201 million and \$216 million, respectively, for which no collateral was posted at March 31, 2014 and December 31, 2013. 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 March 31, 2014 and December 31, 2013 was \$678 million and \$719 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 was reduced by \$221 million and \$251 million at March 31, 2014 and December 31, 2013, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at March 31, 2014 and December 31, 2013, this exposure was reduced by \$23 million and \$29 million of cash collateral, respectively, received by the company. At March 31, 2014 and December 31, 2013, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was \$434 million and \$439 million, respectively. At March 31, 2014 and December 31, 2013, the net amount related to derivative liabilities recorded in the Consolidated Statement of Financial Position was \$220 million and \$250 million, respectively.

In the Consolidated Statement of Financial Position, 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. No amount was recognized in other receivables at March 31, 2014 or December 31, 2013 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral totaled \$23 million and \$29 million at March 31, 2014 and December 31, 2013, respectively. 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. No amount was rehypothecated at March 31, 2014 or at December 31, 2013. At March 31, 2014 and December 31, 2013, no amounts of non-cash collateral were held.

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 this cash loss potential on an ongoing basis and may discontinue some of these hedging relationships by de-designating or terminating the derivative instrument in order to manage the liquidity risk. Although not designated as accounting hedges, the company may utilize derivatives to offset the changes in the 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.

Notes to Consolidated Financial Statements – (continued)

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

Interest Rate Risk

Fixed and Variable Rate Borrowings

The company issues debt in the global capital markets, principally to fund its financing lease and loan portfolios. 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 March 31, 2014 and December 31, 2013, the total notional amount of the company's interest rate swaps was \$5.9 billion and \$3.1 billion, respectively. The weighted-average remaining maturity of these instruments at March 31, 2014 and December 31, 2013 was approximately 9.5 years and 10.6 years, respectively.

Forecasted Debt Issuance

The company is exposed to interest rate volatility on future 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 March 31, 2014 and December 31, 2013.

At March 31, 2014 and December 31, 2013, net gains of approximately \$1 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, gains of less than \$1 million, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying transactions.

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 in foreign subsidiaries 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 March 31, 2014 and December 31, 2013, the total notional amount of derivative instruments designated as net investment hedges was \$3.4 billion and \$3.0 billion, respectively. The weighted-average remaining maturity of these instruments at March 31, 2014 and December 31, 2013 was approximately 0.4 years for both periods.

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 four years. At March 31, 2014 and December 31, 2013, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$10.2 billion with a weighted-average remaining maturity of 0.7 years for both periods.

At March 31, 2014 and December 31, 2013, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of \$169 million and \$252 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$155 million and \$166 million of losses, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

Notes to Consolidated Financial Statements – (continued)

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. Currently, the maximum length of time over which the company has hedged its exposure to variability in future cash flows is approximately seven years. At March 31, 2014 and December 31, 2013, the total notional amount of cross currency swaps designated as cash flow hedges of foreign currency denominated debt was \$1.2 billion for both periods.

At March 31, 2014 and December 31, 2013, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of \$6 million (before taxes) and \$9 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$3 million of losses in both periods is expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying exposure.

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 one year. 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 March 31, 2014 and December 31, 2013, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$16.3 billion and \$14.7 billion, respectively.

Equity Risk Management

The company is exposed to market price changes in certain broad market indices and in the company's own stock primarily related to certain obligations to employees. 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 obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company's common stock, and are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings.

At March 31, 2014 and December 31, 2013, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.2 billion and \$1.3 billion, respectively.

Other Risks

The company may hold 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 company records the changes in the fair value of these warrants in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any warrants qualifying as derivatives outstanding at March 31, 2014 and December 31, 2013.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company may utilize credit default swaps to economically hedge its credit exposures. 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 March 31, 2014 and December 31, 2013.

The following tables provide a quantitative summary of the derivative and non-derivative instrument- related risk management activity as of March 31, 2014 and December 31, 2013 as well as for the three months ended March 31, 2014 and 2013, respectively:

Notes to Consolidated Financial Statements – (continued)

Fair Values of Derivative Instruments in the Consolidated Statement of Financial Position

As of March 31, 2014 and December 31, 2013

(Dollars in millions)

Fair Value of Derivative Assets

Fair Value of Derivative Liabilities

Balance Sheet

Balance Sheet

Classification

3/31/2014

12/31/2013

Classification

3/31/2014

12/31/2013

Designated as hedging

instruments:

Interest rate contracts:

Prepaid expenses and

Other accrued

other current assets

\$ —

\$ —

expenses and liabilities

\$ —

\$ 0

Investments and sundry

assets

363

308

Other liabilities

12

13

Foreign exchange

Prepaid expenses and

Other accrued

contracts:

other current assets

110

187

expenses and liabilities

270

331

172

Investments and sundry

assets

54

26

Other liabilities

173

Fair value of derivative

Fair value of derivative

assets

\$ 528

\$ 522

liabilities

\$ 337

\$ 175

Not designated as

hedging instruments:

Foreign exchange

Prepaid expenses and

Other accrued

contracts:

other current assets

\$ 74

\$ 94

expenses and liabilities

\$ 98

\$

40

Investments and sundry

assets

59

179

Other liabilities

4

1

Equity contracts:

Prepaid expenses and

Other accrued

other current assets

17

36

expenses and liabilities

2

4

Fair value of derivative

Fair value of derivative

assets

\$ 151

\$ 197

liabilities

\$ 104

\$ 45

Total debt designated as

hedging instruments:

Short-term debt

N/A

N/A

\$ —

\$ 190

Long-term debt N/A

N/A

6,116

6,111

Total

\$ 678

\$ 719

\$ 6,557

\$ 6,802

N/A-not applicable

Notes to Consolidated Financial Statements – (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings

For the three months ended March 31, 2014 and 2013

(Dollars in millions)

Gain (Loss) Recognized in Earnings

Consolidated

Statement of

Recognized on

Attributable to Risk

Earnings Line Item

Derivatives(1)

Being Hedged(2)

For the three months ended March 31:

2014

2013

2014

2013

Derivative instruments in fair value hedges:

Interest rate contracts

Cost of financing

\$ 48

\$ (20)

\$ (23)

\$ 46

Interest expense

33

(13)

(15)

194

Derivative instruments not designated as

hedging instruments(1):

Foreign exchange contracts

Other (income)

and expense

(34)

(439)

N/A

N/A

Equity contracts

SG&A expense

21

85

N/A

197

N/A

Total

\$

68

\$

198

(387)

\$

(38)

\$

76

Gain (Loss) Recognized in Earnings and Other Comprehensive Income

Consolidated

(Ineffectiveness) and

Effective Portion

Statement of

Effective Portion Reclassified

Amounts Excluded from

Recognized in OCI

Earnings Line Item

from AOCI

Effectiveness Testing(3)

For the three months

ended March 31:

2014

2013

2014

2013

2014

2013

Derivative instruments

in cash flow hedges:

Interest rate contracts

\$ —

\$ —

Interest expense

\$ —

\$ —

\$ —

\$

Other (income)

Foreign exchange

88

360

and expense

29

37

(0)

1

contracts

Cost of sales

(26)

9

—

—

SG&A expense

(2)

10

—

—

Instruments in net

investment hedges(4):

Foreign exchange

contracts

(26)

219

Interest expense

—

—

0

(1)

Total

\$

62

\$

579

212

\$	1
\$	56
\$	(0)
\$	0

N/A-not applicable

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

- (1) 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.
- (2) 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.
- (3) The amount of gain (loss) recognized in income represents ineffectiveness on hedge relationships.
- (4) Instruments in net investment hedges include derivative and non-derivative instruments.

For the three months ending March 31, 2014 and 2013, 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.

Notes to Consolidated Financial Statements – (continued)

Refer to the company's 2013 Annual Report, Note A, "Significant Accounting Policies – Derivative Financial Instruments," on pages 90 to 91 for additional information.

4. Financing Receivables: The following table presents financing receivables, net of allowances for credit losses, including residual values.

At March 31,

At December 31,

(Dollars in millions)

2014

2013

Current:

Net investment in sales-type and direct financing leases

\$ 4,096

\$ 4,004

Commercial financing receivables

7,024

8,541

Client loan receivables

5,797

5,854

Installment payment receivables

1,412

Total 1,389

\$ 18,329

\$ 19,787

Noncurrent:

Net investment in sales-type and direct financing leases 5,152

\$ 5,700

Commercial financing receivables —

	—
Client loan receivables	
	6,147
	6,360
Installment payment receivables	
	619
	695
Total	
\$	11,918
\$	12,755
	218

Net investment in sales-type and direct financing leases relates 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 \$698 million and \$737 million at March 31, 2014 and December 31, 2013, respectively, and is reflected net of unearned income of \$634 million and \$672 million, and net of the allowance for credit losses of \$131 million and \$123 million at those dates, respectively.

Commercial financing receivables, net of allowance for credit losses of \$16 million and \$23 million at March 31, 2014 and December 31, 2013, respectively, relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and OEM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan receivables, net of allowance for credit losses of \$222 million and \$201 million at March 31, 2014 and December 31, 2013, respectively, are loans that are provided primarily to clients to finance the purchase of software and services. Separate contractual relationships on these financing arrangements are for terms ranging generally from one to seven years.

Installment payment receivables, net of allowance for credit losses of \$41 million and \$41 million at March 31, 2014 and December 31, 2013, respectively, are loans that are provided primarily to clients to finance hardware, software and services ranging generally from one to three years.

Client loan receivables and installment payment receivables financing contracts are 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 nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were \$756 million and \$769 million at March 31, 2014 and December 31, 2013, respectively.

The company did not have any financing receivables held for sale as of March 31, 2014 and December 31, 2013.

Financing Receivables by Portfolio Segment

The following tables present financing receivables on a gross basis, excluding the allowance for credit losses and residual value, by portfolio segment and by class, excluding current commercial financing receivables and other miscellaneous current financing receivables at March 31, 2014 and December 31, 2013. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further

segments the

Notes to Consolidated Financial Statements – (continued)

portfolio into two classes: major markets and growth markets. For additional information on the company's accounting policies for the allowance for credit losses, see the company's 2013 Annual Report on pages 92 and 93.

(Dollars in millions)

Major

Growth

At March 31, 2014

Markets

Markets

Total

Financing receivables:

Lease receivables

\$	6,356
\$	2,235
\$	8,591

Loan receivables

	9,980
	4,259
	14,239
Ending balance	
\$	
	16,336
\$	
	6,494
\$	
	22,831
Collectively evaluated for impairment	
\$	
	16,223
\$	

6,270

\$

22,494

Individually evaluated for impairment

\$

113

\$

224

\$

337

Allowance for credit losses:

Beginning balance at January 1, 2014

Lease receivables

\$ 42

\$ 80

\$ 123

Loan receivables

95

225

	147
	242
Total	
\$	137
\$	228
\$	365
Write-offs	
	(5)
	(3)
	(8)
	226

Provision

3

36

39

Other

(0)

(1)

(1)

Ending balance at March 31, 2014

\$

134

227

\$ 260

\$ 394

Lease receivables

\$ 41

\$ 90

\$ 131

Loan receivables

\$ 93

\$ 171

\$ 228

Collectively evaluated for impairment

\$ 41

\$ 47

\$ 89

Individually evaluated for impairment

\$ 93

\$

213

\$

306

(Dollars in millions)

Major

Growth

At December 31, 2013

Markets

Markets

Total

Financing receivables:

Lease receivables

\$ 6,796

\$ 2,200

\$ 8,996

Loan receivables

10,529

4,012

14,542

Ending balance

\$ 17,325

\$ 6,212

\$ 23,537

Collectively evaluated for impairment

\$ 17,206

\$ 6,013

\$ 23,219

Individually evaluated for impairment

\$ 119

\$ 199

\$

318

Allowance for credit losses:

Beginning balance at January 1, 2013

Lease receivables

\$

234

	59
\$	
	55
\$	
	114
Loan receivables	
	121
	84
	204
Total	
\$	
	180
\$	
	138
	235

\$	318
Write-offs	(23)
	(10)
	(33)
Provision	(21)
	105
	84
Other	236

1

(6)

(5)

Ending balance at December 31, 2013

\$

137

\$

228

\$

365

Lease receivables

\$

42

\$

237

80

\$

123

Loan receivables

\$

95

\$

147

\$

242

Collectively evaluated for impairment

\$ 45

\$ 48

\$ 93

Individually evaluated for impairment

\$ 93

\$ 179

\$ 272

When determining the allowances, financing receivables are evaluated either on an individual or a collective basis. For individually evaluated receivables, the company determines the expected cash flow for the receivable and calculates an estimate of the potential loss and the probability of loss. For those accounts in which the loss is probable, the company records a specific reserve. In addition, the company records an unallocated reserve that is determined by applying a reserve rate to its different portfolios, excluding accounts that have been specifically reserved. This reserve rate is based upon credit rating, probability of default, term, characteristics (lease/loan) and loss history.

Notes to Consolidated Financial Statements – (continued)

Financing Receivables on Non-Accrual Status

Certain receivables for which the company has recorded a specific reserve may also be placed on non-accrual status. Non-accrual assets are those receivables with specific reserves and other accounts for which it is likely that the company will be unable to collect all amounts due according to original terms of the lease or loan agreement. Income recognition is discontinued on these receivables.

The following table presents the recorded investment in financing receivables which were on non-accrual status at March 31, 2014 and December 31, 2013.

At March 31,

At December 31,

(Dollars in millions)

2014

2013

Major markets

\$ 24

\$ 25

Growth markets

62

34

Total lease receivables

\$ 85

\$ 59

Major markets

\$ 41

\$ 40

Growth markets

116

92

Total loan receivables

\$ 157

\$ 132

Total receivables

\$ 242

\$ 191

Impaired Loans

The company considers any loan with an individually evaluated reserve as an impaired loan. Depending on the level of impairment, loans will also be placed on non-accrual status.

The following tables present impaired client loan receivables.

At March 31, 2014

At December 31, 2013

Recorded

Related

Recorded

Related

(Dollars in millions)

Investment

Allowance

Investment

Allowance

Major markets

\$

\$	63
\$	79
\$	67
Growth markets	
	147
	136
	122
	116
Total	
\$	222
	246

\$ 199

\$ 201

\$ 183

Interest

Average

Interest

Income

(Dollars in millions)

Recorded

Income

Recognized on

For the three months ended March 31, 2014:

Investment

Recognized

Cash Basis

Major markets

\$

77

\$

0

\$

0

Growth markets

134

0

0

Total

\$

211

\$

0

\$

249

Interest

Average

Interest

Income

(Dollars in millions)

Recorded

Income

Recognized on

For the three months ended March 31, 2013:

Investment

Recognized

Cash Basis

Major markets

\$

79

\$

0

\$

0

Growth markets

251

	79
	0
	0
Total	
\$	
	158
\$	
	0
\$	
	0

Credit Quality Indicators

The company's credit quality indicators, which are based on rating agency data, publicly available information and information provided by customers, are reviewed periodically based on the relative level of risk. The resulting indicators are a numerical rating system that maps to Standard & Poor's Ratings Services credit ratings as shown below. Standard & Poor's does not provide credit ratings to the company on its customers.

Notes to Consolidated Financial Statements – (continued)

The following tables present the gross recorded investment for each class of receivables, by credit quality indicator, at March 31, 2014 and December 31, 2013. Receivables with a credit quality indicator ranging from AAA to BBB- are considered investment grade. All others are considered non-investment grade. The credit quality indicators do not reflect mitigation actions that the company may take to transfer credit risk to third parties.

Lease Receivables

Loan Receivables

(Dollars in millions)

Major

Growth

Major

Growth

At March 31, 2014:

Markets

Markets

Markets

Markets

Credit Rating:

AAA – AA-

\$

648

\$

63

255

\$ 1,017

\$ 119

A+ – A- 1,243

168

1,952

320

BBB+ – BBB- 2,172

256

	1,025
	3,411
	1,953
BB+ – BB	
	1,349
	333
	2,119
	634
BB- – B+	
	519
	257

350

814

666

B – B-

354

218

555

414

CCC+ – D

258

	71
	80
	111
	152
Total	
\$	6,356
\$	2,235
\$	9,980
\$	4,259
	259

At March 31, 2014, the industries which made up Global Financing's receivables portfolio consisted of: Financial (39 percent), Government (15 percent), Manufacturing (13 percent), Retail (9 percent), Services (8 percent), Communications (6 percent), Healthcare (5 percent) and Other (4 percent).

Lease Receivables

Loan Receivables

(Dollars in millions)

Major

Growth

Major

Growth

At December 31, 2013:

Markets

Markets

Markets

Markets

Credit Rating:

AAA – AA-

\$ 743

\$ 68

\$ 1,151

\$ 261

125

A+ – A-

1,513

168

2,344

307

BBB+ – BBB-

2,111

957

3,271

262

	1,745
BB+ – BB	
	1,393
	350
	2,158
	638
BB- – B+	
	595
	368
	263

922

672

B – B-

365

214

565

391

CCC+ – D

76

264

74

118

134

Total

\$

6,796

\$

2,200

\$

10,529

\$

4,012

At December 31, 2013, the industries which made up Global Financing’s receivables portfolio consisted of: Financial (39 percent), Government (14 percent), Manufacturing (14 percent), Retail (8 percent), Services (8 percent), Healthcare (6 percent), Communications (6 percent) and Other (4 percent).

Past Due Financing Receivables

The company views receivables as past due when payment has not been received after 90 days, measured from the billing date.

Notes to Consolidated Financial Statements – (continued)

Recorded

Total

Total

Investment

(Dollars in millions)

Past Due

Financing

> 90 Days

At March 31, 2014:

> 90 days*

Current

Receivables

and Accruing

Major markets

\$

8

\$

6,348

\$

6,356

\$

8

Growth markets

17

2,218

269

	2,235
	10
Total lease receivables	
\$	
	25
\$	
	8,566
\$	
	8,591
\$	
	18

Major markets

\$ 11

\$ 9,969

\$ 9,980

\$ 11

Growth markets

31

4,228

271

	4,259
	6
Total loan receivables	
\$	
	43
\$	
	14,197
\$	
	14,239
\$	
	18

Total

\$	68
\$	22,763
\$	22,831
\$	35

* Does not include accounts that are fully reserved.

Recorded

Total

Total

Investment

(Dollars in millions)

Past Due

Financing

> 90 Days

At December 31, 2013:

> 90 days*

Current

Receivables

and Accruing

Major markets

\$

\$ 6,789

\$ 6,796

\$ 5

Growth markets

19

2,181

2,200

11

Total lease receivables

\$ 25

277

\$ 8,970

\$ 8,996

\$ 16

Major markets

\$ 9

\$		10,520
\$		10,529
\$		6
Growth markets		
		34
		3,979
		4,012
		18
Total loan receivables		
\$		43
		279

\$ 14,499

\$ 14,542

\$ 25

Total

\$ 68

280

\$	23,469
\$	23,537
\$	41

* Does not include accounts that are fully reserved.

Troubled Debt Restructurings

The company did not have any troubled debt restructurings during the three months ended March 31, 2014 and for the year ended December 31, 2013.

5. 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)

For the three months ended March 31:

2014

2013

Cost			
\$			31
\$			31
Selling, general and administrative			88
			283

	99
Research, development and engineering	
	14
	14
Other (income) and expense*	(9)
	—
Pre-tax stock-based compensation cost	
	124
	144
Income tax benefits	
	284

(41)

(50)

Total stock-based compensation cost

\$

83

\$

94

* Reflects the one-time effects related to the divestiture of the customer care business.

Notes to Consolidated Financial Statements – (continued)

The decrease in pre-tax stock-based compensation cost for the three months ended March 31, 2014, as compared to the corresponding period in the prior year, was due to decreases related to restricted stock units (\$9 million), performance share units (\$7 million) and the company's assumption of stock-based awards previously issued by acquired entities (\$4 million).

As of March 31, 2014, the total unrecognized compensation cost of \$853 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately 2.4 years.

There was no significant capitalized stock-based compensation cost at March 31, 2014 and 2013.

6. Segments: The table on page 25 reflects the results of operations of the company's segments consistent with the management and measurement system utilized within the company. 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.

Notes to Consolidated Financial Statements – (continued)

SEGMENT INFORMATION

Global Services

Global

Global

Technology

Business

Systems and

Global

Total

(Dollars in millions)

Services

Services

Software

Technology

Financing

Segments

For the three months

ended March 31, 2014:

External revenue

\$

9,330

\$

294

	4,483
\$	
	5,661
\$	
	2,391
\$	
	512
\$	
	22,376
Internal revenue	
	241
	141
	932
	295

168

617

2,099

Total revenue

\$

9,570

\$

4,624

\$

6,593

\$

2,559

\$

1,129

\$

296

24,476

Pre-tax income

\$ 1,345

\$ 628

\$ 1,918

\$ (660)

\$ 596

\$ 3,828

Revenue year-to-year change

(2.9)

297

%	(0.9)
%	3.0
%	(20.7)
%	8.6
%	(2.8)
Pre-tax income year-to-year	

change

(15.1)

%

(10.6)

%

(4.7)

%

(63.1)

%

	10.7
%	
	(13.7)
%	
Pre-tax income margin	
	14.1
%	
	13.6
%	
	29.1
%	
	(25.8)
%	
	52.8
%	
	15.6
%	
	300

nm - not meaningful

For the three months

ended March 31, 2013:

External revenue

\$ 9,605

\$ 4,484

\$ 5,572

\$ 3,106

\$ 499

\$ 23,266

Internal revenue

248

180

305

	831
	120
	541
	1,919
Total revenue	
\$	9,852
\$	4,664
\$	6,403
\$	3,226
	306

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\$	1,040
\$	25,185
Pre-tax income	
\$	1,585
\$	703
\$	2,014
\$	(405)
\$	538
\$	4,435
	307

Pre-tax income margin

16.1

%

308

	15.1
%	
	31.5
%	
	(12.5)
%	
	51.8
%	
	17.6
%	

Reconciliations to IBM as Reported:

(Dollars in millions)

For the three months ended March 31:

2014

2013

Revenue:

Total reportable segments

\$		24,476
----	--	--------

\$		25,185
----	--	--------

Eliminations of internal transactions

(2,099)

(1,919)

Other revenue adjustments

107

142

Total IBM Consolidated

\$

22,484

\$

23,408

313

Pre-tax income:

Total reportable segments

\$

3,828

\$

4,435

Amortization of acquired intangible assets

(194)

(183)

Acquisition-related charges

(8)

(11)

Non-operating retirement-related (costs)/income

(123)

315

(283)

Eliminations of internal transactions

(524)

(339)

Unallocated corporate amounts

0

(13)

Total IBM Consolidated

\$

316

2,980

\$

3,606

Notes to Consolidated Financial Statements – (continued)

7. Equity Activity:

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions)

Before Tax

Tax (Expense)/

Net of Tax

For the three months ended March 31, 2014:

Amount

Benefit

Amount

Other comprehensive income/(loss):

Foreign currency translation adjustments

\$	(61)
\$	10
\$	(51)

Net changes related to available-for-sale securities:

Unrealized gains/(losses) arising during the period

\$
0

\$
(0)

0

\$

Reclassification of (gains)/losses to other (income) and expense

4

(2)

3

Subsequent changes in previously impaired securities arising during

the period

—

—

Total net changes related to available-for-sale securities

\$

4

\$

(2)

\$

3

Unrealized gains/(losses) on cash flow hedges:

Unrealized gains/(losses) arising during the period

\$ 88

\$ (33)

\$ 54

Reclassification of (gains)/losses to:

Cost of sales

26

(10)

16

SG&A expense

2

0

2

Other (income) and expense

(29)

11

(18)

Interest expense

0

(0)

0

Total unrealized gains/(losses) on cash flow hedges

\$

87

\$

328

(32)

\$

55

Retirement-related benefit plans(1):

Prior service costs/(credits)

\$

1

\$

(0)

\$

329

Net (losses)/gains arising during the period

32

(11)

21

Curtailments and settlements

4

(1)

3

330

Amortization of prior service (credits)/costs

(29)

10

(20)

Amortization of net (gains)/losses

649

(214)

434

Total retirement-related benefit plans

331

\$ 656

\$ (217)

\$ 439

Other comprehensive income/(loss)

\$ 687

\$ (241)

\$ 446

(1) These AOCI components are included in the computation of net periodic pension cost. (See note 8, "Retirement-Related Benefits,"

for additional information.)

Notes to Consolidated Financial Statements – (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions)

Before Tax

Tax (Expense)/

Net of Tax

For the three months ended March 31, 2013:

Amount

Benefit

Amount

Other comprehensive income/(loss):

Foreign currency translation adjustments

\$ (405)

\$ (84)

\$ (489)

Net changes related to available-for-sale securities:

Unrealized gains/(losses) arising during the period

\$ (3)

\$ 1

\$ (2)

Reclassification of (gains)/losses to other (income) and expense

(0)

0

Subsequent changes in previously impaired securities arising during

the period

1

(0)

1

Total net changes related to available-for-sale securities

\$

(1)

\$

0

\$

(0)

Unrealized gains/(losses) on cash flow hedges:

Unrealized gains/(losses) arising during the period

\$ 360

\$ (128)

\$ 232

Reclassification of (gains)/losses to:

Cost of sales

(9)

3

(6)

SG&A expense

(10)

3

(7)

Other (income) and expense

(37)

14

(23)

Interest expense

0

—

0

Total unrealized gains/(losses) on cash flow hedges

\$

305

342

\$ (108)

\$ 197

Retirement-related benefit plans(1):

Prior service costs/(credits)
\$ 33

\$ (11)

343

\$

22

Net (losses)/gains arising during the period

(15)

5

(10)

Curtailments and settlements

—

—

—

Amortization of prior service (credits)/costs

(30)

10

(20)

Amortization of net (gains)/losses

886

(293)

594

Total retirement-related benefit plans

345

\$ 875

\$ (289)

\$ 586

Other comprehensive income/(loss)

\$ 773

\$ (480)

\$ 293

(1) These AOCI components are included in the computation of net periodic pension cost. (See note 8, "Retirement-Related Benefits,"

for additional information.)

Notes to Consolidated Financial Statements – (continued)

Accumulated Other Comprehensive Income/(Loss) (net of tax)

Net Change

Net Unrealized

Net Unrealized

Foreign

Retirement-

Gains/(Losses)

Accumulated

Gains/(Losses)

Currency

Related

on Available-

Other

on Cash Flow

Translation

Benefit

For-Sale

Comprehensive

(Dollars in Millions)

Hedges

Adjustments*

Plans

Securities

Income/(Loss)

January 1, 2014

\$ (165)

\$ 332

\$ (21,767)

\$ 351

(1)

\$

(21,602)

Other comprehensive income before

reclassifications

54

352

(51)

21

0

24

Amount reclassified from accumulated

other comprehensive income

1

0

417

3

421

Total change for the period

55

(51)

354

439

3

446

March 31, 2014

\$

(111)

\$

281

\$

(21,328)

\$

2

\$

(21,156)

Net Change

Net Unrealized

Net Unrealized

Foreign

Retirement-

Gains/(Losses)

Accumulated

Gains/(Losses)

Currency

Related

on Available-

Other

on Cash Flow

Translation

Benefit

For-Sale

Comprehensive

(Dollars in Millions)

Hedges

Adjustments*

Plans

Securities

Income/(Loss)

January 1, 2013

\$	(90)
\$	1,733
\$	(27,406)
\$	4
\$	(25,759)
Other comprehensive income before	

reclassifications

232

(489)

12

(1)

(245)

Amount reclassified from accumulated

360

other comprehensive income

(35)

0

574

0

361

	539
Total change for the period	
	197
	(489)
	586
	(0)
	293
March 31, 2013	
\$	
	107
\$	
	1,243
\$	
	362

(26,820)

\$

4

\$

(25,466)

* Foreign currency translation adjustments are presented gross except for any associated hedges which are presented net of tax.

8. 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 table provides the total retirement-related benefit plans' impact on income before income taxes:

Yr. to Yr.

(Dollars in millions)

Percent

For the three months ended March 31:

2014

2013

Change

Retirement-related plans – cost

Defined benefit and contribution pension plans – cost

\$

474

\$

674

365

	(29.6)
%	
Nonpension postretirement plans – cost	
	67
	80
	(16.0)
Total	
\$	541
\$	754
	366

%

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

(Dollars in millions)

U.S. Plans

Non-U.S. Plans

For the three months ended March 31:

2014

2013

2014

2013

Service cost

\$ —

\$ —

\$ 116

\$ 131

Interest cost

	555
	496
	390
	382
Expected return on plan assets	
	(1,024)
	(995)
	(572)
	(554)
Amortization of prior service costs/(credits)	
	372

2

2

(29)

(31)

Recognized actuarial losses

269

451

360

404

373

Curtailments and settlements

—

—

4

0

Multi-employer plans/other costs

—

—

79

374

Total net periodic pension (income)/cost of defined

benefit plans

(198)

(46)

375

348

363

Cost of defined contribution plans

191

206

133

151

Total defined benefit and contribution plans cost recognized

376

in the Consolidated Statement of Earnings

\$	(7)
\$	160
\$	481
\$	514

On March 24, 2014, the Supreme Court of Spain issued a ruling against IBM Spain in litigation involving its defined benefit and defined contributions plans. See page 35 for additional information. As a result of the ruling, the company recorded an additional pre-tax retirement-related obligation of \$55 million in the first quarter of 2014 in selling, general and administrative expense in the Consolidated Statement of Earnings. This charge is not reflected in operating (non-GAAP) expense. This obligation is reflected in "Non-U.S. Plans - Multi-employer plans/other costs" in the table above. To date, the rulings in this case are declaratory only and there have been no quantifications of any individual remedies.

In March 2014, the company initiated a change to the investment strategy of its U.S. defined benefit plan. The 2014 target asset allocation was modified, primarily by reducing equity securities from 42 percent to 32 percent, and increasing debt securities from 47 percent to 57 percent of total plan assets, respectively. The asset allocation change was substantially completed by March 31, 2014. This change is designed to reduce the potential negative impact that equity markets might have on the funded status of the U.S. defined benefit plan. The change is expected to reduce the 2015 expected long-term rate of return on assets to approximately 7.75 percent. See note S, "Retirement-Related Benefits," on page 135 in the company's 2013 Annual Report for additional information regarding the company's investment strategy.

In 2014, the company expects to contribute to its non-U.S. defined benefit and multi-employer plans approximately \$600 million, which will be mainly contributed to the defined benefit pension plans in Japan, the UK, Switzerland and the Netherlands. This amount represents the legally mandated minimum contributions. Total net contributions to the non-U.S. plans in the first three months of 2014 were \$126 million.

The following table provides the components of the cost/(income) for the company's nonpension postretirement plans:

Cost of Nonpension Postretirement Plans

U.S. Plan

Non-U.S. Plans

(Dollars in millions)

2014

2013

2014

2013

For the three months ended March 31:

Service cost

\$

7

\$

9

\$

2

\$

3

Interest cost

45

42

381

16

16

Expected return on plan assets

0

(0)

(2)

(2)

Amortization of prior service costs/(credits)

(2)

—

	(1)
	(1)
Recognized actuarial losses	
	0
	8
	3
	6
Total nonpension postretirement plan cost recognized in	

Consolidated Statement of Earnings

\$	50
\$	58
\$	17
\$	22

Notes to Consolidated Financial Statements – (continued)

In connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the ‘Act’), the company qualified to receive a subsidy through 2013. Due to benefit plan changes effective January 1, 2014, the company no longer qualifies for the subsidy as of that date. The company is expected to receive additional subsidies after 2013 to true up the final subsidy amount due to IBM under the Act. The company received a \$5.4 million subsidy in the first quarter of 2014 and a \$6.1 million subsidy in the first quarter of 2013. For further information related to the Act, see page 141 in the company’s 2013 Annual Report.

9. Acquisitions/Divestitures:

Acquisitions: During the three months ended March 31, 2014, the company completed two acquisitions at an aggregate cost of \$286 million.

The Software segment completed acquisitions of two privately held companies in the first quarter: Aspera, Inc. (Aspera) and Cloudant, Inc. (Cloudant). Both acquisitions were for 100 percent of the acquired companies.

The table below reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of March 31, 2014:

Amortization

Total

(Dollars in millions)

Life (in yrs.)

Acquisitions

Current assets

\$

Fixed assets/noncurrent assets

Intangible assets:

Goodwill

N/A

239

Completed technology

7

33

Client relationships

389

7

1

Patents/trademarks

5-7

8

Total assets acquired

Current liabilities

Noncurrent liabilities

(22)

Total liabilities assumed

(33)

Total purchase price

\$

286

392

N/A - not applicable

Each acquisition further complemented and enhanced the company's portfolio of product and services offerings.

Aspera's technology makes cloud computing faster, more predictable and more cost effective for big data transfers such as enterprise storage, sharing virtual images or accessing the cloud for increased computing capacity. The acquisition of Cloudant will extend the company's mobile and cloud platforms by enabling developers to easily and quickly create next generation mobile and web-based applications. Purchase price consideration for these acquisitions as reflected in the table above, was paid primarily in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

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 entity was 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 work-force, neither of which qualify as an amortizable intangible asset. The overall weighted-average life of the identified amortizable intangible

assets acquired is 6.8 years. These identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$239 million has been assigned to the Software segment. It is expected that none of the goodwill will be deductible for tax purposes.

On April 10, 2014, the company announced that it had entered into a definitive agreement to acquire Silverpop, a privately held company based in Atlanta, GA. Silverpop is a provider of cloud-based capabilities that deliver personalized customer engagements in highly scalable environments. The acquisition is expected to close in the second quarter of 2014.

Notes to Consolidated Financial Statements – (continued)

Divestitures:

On January 23, 2014, IBM and Lenovo Group Limited (Lenovo) announced a definitive agreement in which Lenovo will acquire the company's x86 server portfolio for \$2.3 billion, consisting of approximately \$2 billion in cash, with the balance in Lenovo stock. The stock will represent less than 5 percent equity ownership in Lenovo. The company will sell to Lenovo its System x, BladeCenter and Flex System blade servers and switches, x86-based Flex integrated systems, NeXtScale and iDataPlex servers and associated software, blade networking and maintenance operations.

IBM and Lenovo plan to enter into a strategic relationship which will include a global OEM and reseller agreement for sales of IBM's industry-leading entry and midrange Storwize disk storage systems, tape storage systems, General Parallel File System software, SmartCloud Entry offering, and elements of IBM's system software, including Systems Director and Platform Computing solutions. Following the closing of the transaction, Lenovo will assume related customer service and maintenance operations. IBM will continue to provide maintenance delivery on Lenovo's behalf for an extended period of time.

The transaction will be completed as soon as is practical, subject to the satisfaction of regulatory requirements, customary closing conditions and any other required approvals. At March 31, 2014, the company is engaged in the regulatory review process and in the activities necessary to separate the tangible assets in order to close the transaction. The transaction is expected to be completed in phases, with the initial closing expected in the second half of 2014. Subsequent local closings will occur subject to similar conditions, agreements and the information and consultation process in applicable countries.

The company expects to recognize a total pre-tax gain on the sale of approximately \$1 billion. This gain will be recognized consistent with the closing schedule for the transaction. The exact amount of the gain and the breakdown by closing date is not yet determinable. The variables that can impact the final gain include the valuation of the final balance sheet transferred, the valuation of other related agreements and transaction-related expenses.

The company's worldwide x86 business is reported in the Systems and Technology segment, and the associated maintenance operations are part of the Global Technology Services segment. In 2013, this combined business delivered approximately \$4.6 billion of revenue, was essentially breakeven on a pre-tax income basis and had approximately \$100 million in tangible assets.

On September 10, 2013, IBM and SYNnex announced a definitive agreement in which SYNnex will acquire the company's worldwide customer care business process outsourcing services business for \$501 million, consisting of approximately \$430 million in cash, net of balance sheet adjustments, and \$71 million in SYNnex stock, which

represents less than 5 percent equity ownership in SYNnex. As part of the transaction, SYNnex entered into a multi-year agreement with the company, and Concentrix, SYNnex's outsourcing business, has become an IBM strategic business partner for global customer care business process outsourcing services.

The transaction is being completed in phases – the initial closing was completed on January 31, 2014, with subsequent closings expected to be completed in the second quarter of 2014, subject to customary closing conditions, local agreements and the information and consultation process in applicable countries. The company expects to recognize a total pre-tax gain on the sale of between \$200 million and \$225 million. The gain recognized in the first quarter of 2014 was \$98 million. The company's worldwide customer care business process outsourcing services and industry process services was reported in the Global Technology Services segment. In 2013, the divested business delivered approximately \$1.3 billion of revenue, approximately \$0.1 billion of pre-tax income and had approximately \$50 million in tangible assets.

On April 17, 2012, the company announced that it had signed a definitive agreement with Toshiba TEC for the sale of its Retail Store Solutions business. As part of the transaction, the company agreed to transfer the maintenance business to Toshiba TEC within three years of the original closing of the transaction.

In first quarter 2014, the company completed the first phase of the transfer of the maintenance workforce to Toshiba. Subsequent wave closings are scheduled to be completed through the first quarter of 2015 along with associated parts and inventory transfer. The first phase transfer and an assessment of the ongoing contractual terms of the overall transaction resulted in the recognition of an additional pre-tax gain of \$34 million in the first quarter of 2014.

The company expects to close the final phase of the divestiture in the first quarter of 2015. Overall, the company expects to recognize a cumulative total pre-tax gain on the sale of approximately \$508 million.

Notes to Consolidated Financial Statements – (continued)

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

At March 31, 2014

(Dollars in millions)

Gross Carrying

Accumulated

Net Carrying

Intangible asset class

Amount

Amortization

Amount

Capitalized software

\$ 1,471

\$ (696)

\$ 775

Client relationships

2,149

(1,050)

1,099

Completed technology

399

	2,935
	(1,312)
	1,623
In-process R&D	
	2
	—
	2
Patents/trademarks	
	366
	(169)
	400

Other* 198

7

(5)

2

Total

\$

6,929

\$

(3,231)

\$

3,698

At December 31, 2013

(Dollars in millions)

Gross Carrying

Accumulated

Net Carrying

Intangible asset class

Amount

Amortization

Amount

Capitalized software

\$

	1,494
\$	
	(699)
\$	
	794
Client relationships	
	2,148
	(977)
	1,171
Completed technology	
	2,910
	(1,224)

	1,687
In-process R&D	
	13
	—
	13
Patents/trademarks	
	358
	(154)
	204
Other*	
	7
	404

	(5)
	2
Total	
\$	
	6,930
\$	
	(3,059)
\$	
	3,871

* Other intangibles are primarily acquired proprietary and nonproprietary business processes, methodologies and systems.

The net carrying amount of intangible assets decreased \$173 million during the first quarter of 2014, primarily due to amortization, partially offset by intangible asset additions resulting from acquisitions. The aggregate intangible amortization expense for acquired intangibles (excluding capitalized software) was \$339 million and \$331 million for the quarters ended March 31, 2014 and 2013, respectively. In addition, in the first three months of 2014, the company retired \$164 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 March 31, 2014:

Capitalized

Acquired

(Dollars in millions)

Software

Intangibles

Total

2014 (for Q2-Q4)

\$	377
\$	619
\$	997
	407

2015	294
	642
	936
2016	96
	601
	697
2017	408

8

479

487

2018

—

328

328

409

The change in the goodwill balances by reportable segment, for the three months ended March 31, 2014 and for the year ended December 31, 2013 are as follows:

Foreign

Currency

Purchase

Translation

(Dollars in millions)

	Balance
	Goodwill
	Price
	And Other
	Balance
Segment	01/01/14
	Additions
	Adjustments
	Divestitures
	Adjustments

3/31/14

Global Business Services

\$ 4,334

\$ —

\$ —

\$ —

\$ 4

\$ 4,337

Global Technology Services

4,129

Software

—
—
(52)

16

4,094

21,121

239

0

—
415

	(170)
	21,190
Systems and Technology	
	1,601
	—
	—
	—
	(8)
	1,593
Total	416

\$	31,184
\$	239
\$	0
\$	(52)
\$	(158)
\$	31,214

Notes to Consolidated Financial Statements – (continued)

Foreign

Currency

Purchase

Translation

(Dollars in millions)

Balance

Goodwill

Price

And Other

Balance

Segment

01/01/13

Additions

Adjustments

Divestitures

Adjustments

12/31/13

Global Business Services

\$		4,357
\$		—
\$		(0)
\$		(3)
\$		(21)
\$		4,334
Global Technology Services		
		2,916
		1,246
		423

17

—

(50)

4,129

Software

20,405

987

11

(4)

(279)

424

21,121
Systems and Technology

1,568

13

33

—

(14)

Total

1,601

\$

29,247

425

\$	2,246
\$	61
\$	(7)
\$	(363)
\$	31,184

Purchase price adjustments recorded in the first three months of 2014 and full year 2013 were related to acquisitions that were completed on or prior to December 31, 2013 or December 31, 2012, 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 three months of 2014 or the full year of 2013 and the company has no accumulated impairment losses.

11. Restructuring-Related Liabilities: The following table provides a roll forward of the current and noncurrent liabilities for special restructuring-related actions taken prior to 2006.

Liability

Liability

as of

Other

as of

(Dollars in millions)

01/01/14

Payments

Adjustments*

3/31/2014

Current:

Workforce

\$ 27

\$ (7)

\$ 8

\$ 28

Total current

\$ 27

\$ (7)

\$ 8

\$ 28

Noncurrent:

Workforce

\$ 430

	440
\$	—
\$	(3)
\$	437
Total noncurrent	
\$	440
\$	—
\$	(3)
\$	437
	431

* Other Adjustments principally include the reclassification of noncurrent to current, remeasurement of actuarial assumptions,

foreign currency translation adjustments and interest accretion.

12. Contingencies: As a company with a substantial employee population and with clients in more than 175 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 IP 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, 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 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. Any recorded liabilities, including any changes to such liabilities for the quarter ended March 31, 2014 were not material to the Consolidated Financial Statements.

In accordance with the relevant accounting guidance, the company provides disclosures of matters for which the likelihood of material loss is at least reasonably possible. In addition, the company also discloses matters based on its consideration of other matters and qualitative factors, including the experience of other companies in the industry, and investor, customer and employee relations considerations.

With respect to certain of the claims, suits, investigations and proceedings discussed herein, the company believes at this time that the likelihood of any material loss is remote, given, for example, the procedural status, court rulings, and/or the

Notes to Consolidated Financial Statements – (continued)

strength of the company's defenses in those matters. With respect to the remaining claims, suits, investigations and proceedings discussed in this note, the company is unable to provide estimates of reasonably possible losses or range of losses, including losses in excess of amounts accrued, if any, for the following reasons. Claims, suits, investigations and proceedings are inherently uncertain, and it is not possible to predict the ultimate outcome of these matters. It is the company's experience that damage amounts claimed in litigation against it are unreliable and unrelated to possible outcomes, and as such are not meaningful indicators of the company's potential liability. Further, the company is unable to provide such an estimate due to a number of other factors with respect to these claims, suits, investigations and proceedings, including considerations of the procedural status of the matter in question, the presence of complex or novel legal theories, and/or the ongoing discovery and development of information important to the matters. The company reviews claims, suits, investigations and proceedings at least quarterly, and decisions are made with respect to recording or adjusting provisions and disclosing reasonably possible losses or range of losses (individually or in the aggregate), to reflect the impact and status of settlement discussions, discovery, procedural and substantive rulings, reviews by counsel and other information pertinent to a particular matter.

Whether any losses, damages or remedies finally determined in any 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 in the Consolidated Financial Statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors. 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.

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 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. On August 30, 2011, the Tenth Circuit Court of Appeals affirmed the district court's ruling and denied SCO's appeal of this matter. In June 2013, the Federal Court in Utah granted SCO's motion to reopen the SCO v. IBM case. On July 10, 2013, the Court entered an order dismissing seven of SCO's ten claims, specifically its breach of contract and copyright claims, and one tortious interference claim.

On May 13, 2010, IBM and the State of Indiana (acting on behalf of the Indiana Family and Social Services Administration) sued one another in a dispute over a 2006 contract regarding the modernization of social service program processing in Indiana. The State terminated the contract, claiming that IBM was in breach, and the State is seeking damages. IBM believes the State's claims against it are without merit and is seeking payment of termination amounts specified in the contract. After six weeks of trial, on July 18, 2012, the Indiana Superior Court in Marion County rejected the State's claims in their entirety and awarded IBM \$52 million plus interest and costs. On February 13, 2014, the Indiana Court of Appeals reversed portions of the trial judge's findings, found IBM in material breach, and ordered the case remanded to the trial judge to determine the State's damages, if any. The Indiana Court of Appeals also affirmed approximately \$50 million of the trial court's award of damages to IBM. This matter remains pending in the Indiana courts.

On April 16, 2014, Iusacell SA de C.V. (Iusacell) sued IBM, claiming that IBM made fraudulent misrepresentations that induced Iusacell to enter into an agreement with IBM Mexico. Iusacell claims \$2.5 billion in damages for lost profits. Iusacell's complaint relates to a contractual dispute in Mexico, which is the subject of a pending arbitration proceeding in Mexico initiated by IBM Mexico against Iusacell for breach of the underlying agreement.

IBM United Kingdom Limited (IBM UK) initiated legal proceedings in May 2010 before the High Court in London against the IBM UK Pensions Trust (the UK Trust) and two representative beneficiaries of the UK Trust membership. IBM UK is seeking a declaration that it acted lawfully both in notifying the Trustee of the UK Trust that it was closing its UK

Notes to Consolidated Financial Statements – (continued)

defined benefit plans to future accruals for most participants and in implementing the company's new retirement policy. On April 4, 2014, the High Court acknowledged that the changes made to its UK defined benefit plans were within IBM's discretion, but ruled that IBM breached its implied duty of good faith both in implementing these changes and in the manner in which it consulted with employees. This judgment contemplates a future hearing to determine what remedies are available. In addition, IBM UK is a defendant in approximately 290 individual actions brought since early 2010 by participants of the defined benefits plans who left IBM UK. These actions, which allege constructive dismissal and age discrimination, are pending before the Employment Tribunal in Southampton UK and are currently stayed.

In a separate but related proceeding, in March 2011, the Trustee of the IBM UK Trust was granted leave to initiate a claim before the High Court in London against IBM UK and one member of the UK Trust membership, seeking an order modifying certain documents and terms relating to retirement provisions in IBM UK's largest defined benefit plan (the C Plan) dating back to 1983. The trial of these proceedings began in May 2012 and finished in early June. On October 12, 2012, the High Court in London issued its ruling, holding that the 1983 Trust Deeds and Rules should be modified to allow certain categories of current IBM UK employees who are members of the C Plan to retire from the age of 60 (rather than from the age of 63) without actuarial reduction of their defined benefit pension. In a supplementary ruling on December 13, 2012, the Court declined to similarly modify the Trust Deeds and Rules for former employees who were C Plan members and who left the company prior to retirement. On February 7, 2013, the Court issued an order agreed to by all parties, under which there will be no appeals of the October 2012 and December 2012 judgments. As a result of the October 2012 ruling, IBM recorded an additional pre-tax retirement-related obligation of \$162 million in the third quarter of 2012.

On March 24, 2014, in a suit brought by local Works Councils, the Supreme Court of Spain held that IBM Spain's defined contribution (DC) plan implemented in 1993 was null and void, and held that current employees could reinstate their rights to a defined benefit (DB) plan, although with an offset for DC contributions paid to date. The Court held that IBM Spain did not consult with the Works Councils in seeking the voluntary participation of employees in changing the pension scheme, and recommended that IBM Spain and the Works Councils engage in discussions over how to carry out the offset. The ruling is declaratory only and there have been no quantifications of, or suits for, individual remedies. IBM Spain is considering its options for appeal.

In March 2011, the company announced that it had agreed to settle a civil enforcement action with the Securities and Exchange Commission (SEC) relating to alleged violations of the Foreign Corrupt Practices Act of 1977 (FCPA). On July 25, 2013, the court approved that 2011 settlement and required that for a two-year period IBM make reports to the SEC and the court on certain matters, including those relating to compliance with the FCPA. In early 2012, IBM notified the SEC of an investigation by the Polish Central Anti-Corruption Bureau involving allegations of illegal activity by a former IBM Poland employee in connection with sales to the Polish government. IBM is cooperating with the SEC and Polish authorities in this matter. In April 2013, IBM learned that the U.S. Department of Justice (DOJ) is also investigating allegations related to the Poland matter, as well as allegations relating to transactions in Argentina, Bangladesh and Ukraine. The DOJ is also seeking information regarding the company's global FCPA compliance program and its public sector business. The company is cooperating with the DOJ in this matter.

In May 2013, IBM learned that the SEC is conducting an investigation into how IBM reports cloud revenue. IBM is cooperating with the SEC in this matter.

In December 2013, a putative class action lawsuit was filed in the United States District Court for the Southern District of New York related to the company's third-quarter 2013 financial results disclosure. The company, its Chairman, President and Chief Executive Officer, and a former Senior Vice President and Chief Financial Officer of the company are named as defendants. Plaintiffs allege that defendants violated Section 20(a) and Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.

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

Notes to Consolidated Financial Statements – (continued)

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 \$720 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

13. Commitments: The company's extended lines of credit to third-party entities include unused amounts of \$6,103 million and \$5,028 million at March 31, 2014 and December 31, 2013, 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 \$1,589 million and \$1,769 million at March 13, 2014 and December 31, 2013, 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 nonfinancial 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, the procedures of which 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 \$45 million and \$44 million at March 13, 2014 and December 31, 2013, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position is 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:

Notes to Consolidated Financial Statements – (continued)

Standard Warranty Liability

(Dollars in millions)

2014

2013

Balance at January 1

\$

	376
\$	
	394
Current period accruals	
	54
	71
Accrual adjustments to reflect actual experience	
	(3)
	9
Charges incurred	
	(85)
	(93)
Balance at March 31	
	441

\$ 342

\$ 381

Extended Warranty Liability

(Dollars in millions)

2014

2013

Aggregate deferred revenue at January 1

\$

579

\$

606

Revenue deferred for new extended warranty contracts

54

47

Amortization of deferred revenue

(73)

443

Other* (82)

(11)

Aggregate deferred revenue at March 31

(7)

\$

548

\$

565

Current portion

\$

444

	268
\$	
	286
Noncurrent portion	
	280
	278
Aggregate deferred revenue at March 31	
\$	
	548
\$	
	565

* Other primarily consists of foreign currency translation adjustments.

14. Subsequent Events: On April 29, 2014, the company announced that the Board of Directors approved a quarterly dividend of \$1.10 per common share. The dividend is payable June 10, 2014 to shareholders of record on May 9, 2014. The dividend declaration represents an increase of \$0.15 per common share, which is 16 percent higher than the prior quarterly dividend of \$0.95 per common share.

Item 2.

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION
FOR THE THREE MONTHS ENDED MARCH 31, 2014**

Snapshot

Financial Results Summary:

Yr. to Yr.

Percent/

(Dollars in millions except per share amounts)

Margin

For the three months ended March 31:

2014

2013

Change

Revenue

\$

22,484

\$

23,408

%*

(3.9)

Gross profit margin

46.9

%

45.6

%

450

	1.3
pts.	
Total expense and other (income)	
\$	
	7,563
\$	
	7,072
	6.9
%	
Total expense and other (income)-to-revenue ratio	
	33.6
%	
	30.2
%	
	3.4
	451

pts.

Provision for income taxes

\$

596

\$

574

3.8

%

Net income

\$

2,384

\$

3,032

(21.4)

%

Net income margin

452

	10.6
%	
	13.0
%	
	(2.3)
pts.	
Earnings per share:	

Assuming dilution

\$ 2.29

\$ 2.70

% (15.2)

Basic

\$ 2.30

\$ 2.72

% (15.4)

Weighted-average shares outstanding:

Assuming dilution

1,041.8

1,124.0

(7.3)

%

Basic

1,035.2

1,113.7

(7.0)

%

12/31/13

Assets

\$ 122,646

\$ 126,223

(2.8)

%

Liabilities

\$ 105,906

\$ 457

103,294

2.5

%

Equity

\$

16,740

\$

22,929

(27.0)

%

* 2.4 percent decrease adjusted for currency

Currency:

The references to "adjusted for currency" or "at constant currency" in the Management Discussion do not include operational impacts that could result from fluctuations in foreign currency rates. Certain financial results are adjusted based on a simple mathematical model that translates current period results in local currency using the comparable prior year period's currency conversion rate. This approach is used for countries where the functional currency is the local country currency. This information is provided 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 performance. See "Currency Rate Fluctuations" on pages 57 and 58 for additional information.

Operating (non-GAAP) Earnings:

In an effort to provide better transparency into the operational results of the business, the company separates business results into operating and non-operating categories. Operating earnings is a non-GAAP measure that excludes the effects of certain acquisition-related charges and retirement-related costs, and their related tax impacts. For acquisitions, operating earnings exclude the amortization of purchased intangible assets and acquisition-related charges such as in-process research and development, transaction costs, applicable restructuring and related expenses and tax charges related to acquisition integration. For retirement-related costs, the company characterizes certain items as operating and others as non-operating. The company includes defined benefit plan and nonpension postretirement benefit plan service cost, amortization of prior service cost and the cost of defined contribution plans in operating earnings. Non-operating retirement-related cost includes defined benefit plan and nonpension postretirement benefit plan interest cost, expected return on plan assets, amortized actuarial gains/losses, the impacts of any plan curtailments/settlements and multi-employer plan costs, pension insolvency costs and other costs. Non-operating costs are primarily related to changes in pension plan assets and liabilities which are tied to financial market performance and the company considers these costs to be outside the operational performance of the business.

Management Discussion – (continued)

Overall, the company believes that providing investors with a view of operating earnings as described above provides increased transparency and clarity into both the operational results of the business and the performance of the company's pension plans; improves visibility to management decisions and their impacts on operational performance; enables better comparisons to peer companies; and allows the company to provide a long-term strategic view of the business going forward. For its 2015 road map, the company is utilizing an operating view to establish its objectives and track its progress. The company's reportable segment financial results reflect operating earnings, consistent with the company's management and measurement system.

The following table provide the company's (non-GAAP) operating earnings for the first quarter of 2014 and 2013.

Yr. to Yr.

(Dollars in millions except per share amounts)

Percent

For the three months ended March 31:

2014

2013

Change

Net income as reported

\$ 2,384

\$ 3,032

% (21.4)

Non-operating adjustments (net of tax):

Acquisition-related charges

161

140

15.2

Non-operating retirement-related costs/(income)

98

204

(51.9)

Operating (non-GAAP) earnings*

\$

2,643

464

\$ 3,376

(21.7)

%
Diluted operating (non-GAAP) earnings per share

\$ 2.54

\$ 3.00

(15.3)

%

* See page 66 for a more detailed reconciliation of net income to operating earnings.

Financial Performance Summary:

In the first quarter of 2014, the company reported \$22.5 billion in revenue, expanded gross margin and delivered diluted earnings per share of \$2.29 as reported and \$2.54 on an operating (non-GAAP) basis. The company generated \$3.3 billion in cash from operations and \$0.6 billion in free cash flow in the first quarter driving shareholder returns of \$9.2 billion in gross common stock repurchases and dividends.

The company's performance in the first quarter reflects the actions it is taking to transition to key growth areas and to transform parts of the business. In the first quarter the company:

- Announced a \$1.2 billion investment to globally expand its SoftLayer cloud hubs.
- Launched BlueMix, a new platform-as-a-service to speed deployment of hybrid clouds.
- Acquired Aspera and Cloudant to extend the company's big data and cloud capabilities.
- Expanded the ecosystem around OpenPOWER.
- Created an integrated business unit around IBM Watson and announced a \$1 billion investment to bring cognitive capabilities to the enterprise.

The company is also taking portfolio actions to divest businesses that no longer fit its strategic portfolio. In January 2014, the company:

- Completed the initial closing for the divestiture of the customer care business process outsourcing business.
- Announced an agreement to sell its x86 industry standard server business to Lenovo.

In addition, as expected, the company took a substantial workforce rebalancing charge to align its resources and skills to the demand profile. This charge significantly impacted the financial results in the first quarter, but the company expects the action to pay back within the current year. Many of the actions taken in the first quarter will impact the company's revenue and profit in the short term, but are expected to have long term benefits.

The company has continued to shift its investments to address the key trends in information technology (IT) – driven by data and cloud and changes in the way individuals are engaging. Across the business, the company had good

performance in the first quarter of 2014 in the offerings that address these shifts. Business analytics revenue increased 5 percent as reported and 6 percent at constant currency on a large base. Cloud revenue increased over 50 percent, with the cloud delivered as a service content doubling year to year. In addition, in the first quarter, the company had strong growth in mobile and security compared to the prior year.

Management Discussion – (continued)

Segment revenue was led by Software which increased 1.6 percent (2 percent adjusted for currency), driven by key branded middleware which increased 4.4 percent (5 percent adjusted for currency). The company is continuing to see strong client demand and strong results in the key areas of mobile, cloud and security where it has been targeting its investments. Total Global Services revenue declined 2.0 percent as reported, but increased 0.3 percent at constant currency; adjusting for the divested customer care business, total Global Services revenue increased 2 percent at constant currency with growth in both Global Technology Services and Global Business Services. The first quarter growth reflects the company's expanded cloud offerings, contribution from some of the large outsourcing contracts signed in 2013, and good performance in Consulting and Systems Integration. Systems and Technology revenue decreased 23.0 percent (23 percent adjusted for currency) from a combination of secular and cyclical challenges. The company is dealing with challenges in its hardware business models specific to Power, Storage and System x. The business has taken actions to address these business model challenges including; 1) selling the industry standard server business to Lenovo, 2) repositioning Power and building an ecosystem around OpenPOWER, and 3) rightsizing the Power and Storage businesses to the market dynamics. System z mainframe revenue decreased 39.7 percent (40 percent adjusted for currency). The decline in System z revenue reflects that the product is six quarters into this product cycle, though on solid ground secularly.

From a geographic perspective, revenue in the growth markets declined 10.7 percent as reported and 5 percent adjusted for currency, a one point improvement from the fourth quarter at constant currency. The company views the bulk of the challenges in the growth markets as cyclical, and believes that the opportunity in the growth markets remains attractive over the long term. The company is continuing to invest in these key markets to capture that opportunity.

In the first quarter, total consolidated revenue decreased 3.9 percent, 2.4 percent at constant currency. Adjusting for the divested customer care business, revenue decreased 1 percent at constant currency. This performance represents a 2 point sequential improvement at constant currency from the fourth quarter of 2013. The constant currency growth in Software, Global Services and Global Financing was offset by the decline in Systems & Technology. The currency impact to revenue was 1.6 points in the first quarter of 2014. Currency was also a headwind to profit performance — reflecting impacts from the Yen and the devaluation of the Venezuelan currency.

The consolidated gross profit margin increased 1.3 points versus the first quarter of 2013 to 46.9 percent. The operating (non-GAAP) gross margin of 47.6 percent increased 0.9 points year to year. The improvement in gross margin was driven by margin improvements in Global Services and an improved mix toward Software, partially offset by a margin decline in Systems & Technology.

Total expense and other (income) increased 6.9 percent in the first quarter of 2014 compared to the prior year. Total operating (non-GAAP) expense and other (income) increased 7.9 percent year to year. The year-to-year drivers were approximately:

Total

Operating

Consolidated

(non-GAAP)

Currency*

0

points

0

points

Acquisitions **

2

points

2

points

Base expense

points

points

*

Reflects impacts of translation and hedging programs.

**

Includes acquisitions completed in prior 12-month period; operating (non-GAAP) is net of non-operating acquisition-related

charges.

There were several items that had an impact on total expense and other (income) year to year. Workforce rebalancing charges in the first quarter of 2014 were \$873 million, an increase of \$853 million versus the first quarter of 2013. In the first quarter of 2014, the company recorded a gain of \$98 million related to the divestiture of the customer care business. A gain of a similar amount is expected in the second quarter of 2014 as the remaining country closings are completed. Adjusting for these items, operating (non-GAAP) base expense would have improved by 4 points compared to the 7 point impact as highlighted above. The 4 point improvement is more indicative of the productivity in the base expense. Within base expense, the company is continuing to shift spending to areas where it sees future growth. As an example, the \$1.5 billion of research and development spending in the first quarter of 2014 reflects the shift of development priorities to the growth areas. The recent launch of BlueMix is a great example — the company will be investing \$1 billion to deliver unique platform-as-a-service capabilities to connect enterprise data and applications to the cloud.

Management Discussion – (continued)

Pre-tax income decreased 17.3 percent year to year and the pre-tax margin was 13.3 percent, a decrease of 2.1 points versus the first quarter of 2013. Net income decreased 21.4 percent and the net income margin was 10.6 percent, a decrease of 2.3 points year to year. The effective tax rate for the first quarter was 20.0 percent, an increase of 4.1 points year to year. Operating (non-GAAP) pre-tax income decreased 19.1 percent year to year and the operating (non-GAAP) pre-tax margin was 14.7 percent, a decrease of 2.7 points year to year. Operating (non-GAAP) net income decreased 21.7 percent and the operating (non-GAAP) net income margin of 11.8 percent decreased 2.7 points compared to the prior year. The operating (non-GAAP) effective tax rate was 20.0 percent versus 17.3 percent in the first quarter of 2013.

Diluted earnings per share of \$2.29 decreased 15.2 percent versus the prior year. Operating (non-GAAP) diluted earnings per share of \$2.54 decreased \$0.46 or 15.3 percent versus the first quarter of 2013. In the first quarter, the company repurchased 45.2 million shares of its common stock.

At March 31, 2014, the company's balance sheet and liquidity positions remained strong and are well positioned to support the business over the long term. Cash and marketable securities at quarter end were \$9,704 million, a decrease of \$1,361 million from December 31, 2013. Key drivers in the balance sheet and total cash flows are:

Total assets decreased \$3,577 million (\$3,648 million adjusted for currency) from December 31, 2013 driven by:

- Decreases in total receivables (\$3,012 million) and cash and cash equivalents (\$1,307 million); partially offset by
- Increased prepaid pension assets (\$559 million).

Total liabilities increased \$2,612 million (\$2,493 million adjusted for currency) from December 31, 2013 driven by:

- Increases in total debt (\$4,262 million), deferred income (\$1,058 million) and other accrued expenses and liabilities (\$717 million); partially offset by
- Decreases in taxes payable (\$2,388 million) and accounts payable (\$596 million).

Total equity of \$16,740 million decreased \$6,189 million from December 31, 2013 as a result of:

- Increased treasury stock (\$8,370 million) driven by share repurchases; partially offset by
- Higher retained earnings (\$1,390 million), decreased losses in accumulated other comprehensive income/(loss) (\$446 million) and higher common stock (\$349 million).

The company generated \$3,326 million in cash flow provided by operating activities, a decrease of \$697 million compared to the first quarter of 2013, driven primarily by cash tax payments of \$2,594 million, an increase in the use of cash of \$1,375 million. Investing activities provided \$35 million in cash flow in the first quarter of 2014 compared to a use of cash of \$1,012 million in the first quarter of 2013. This year-to-year decrease in the use of cash was primarily due to lower cash used for net purchases of marketable securities and other investments (\$1,098 million). Net cash used in financing activities of \$4,673 million increased \$1,957 million compared to the prior year, primarily due to increased cash used for gross common stock repurchases (\$5,572 million), partially offset by higher net cash proceeds from total debt (\$3,743 million).

In April 2014, the company stated that it is expecting GAAP earnings per share of at least \$17.00 and operating (non-GAAP) earnings of at least \$18.00 per diluted share for the full year 2014. The company also stated that its earnings per share expectation does not include the expected gain from the divestiture of its System x server business to Lenovo due to the uncertainty of the timing and the amount. The gain will ultimately be reflected in the company's results, and the company will provide an update later in the year.

Management Discussion – (continued)

First Quarter in Review

Results of Operations

Segment Details

The following is an analysis of the first quarter of 2014 versus the first quarter of 2013 reportable segment external revenue and gross margin results. Segment pre-tax income includes transactions between the segments that are intended to reflect an arm's-length transfer price and excludes certain unallocated corporate items.

Yr. to Yr.

Percent

Yr. to Yr.

Change

(Dollars in millions)

Percent/Margin

Adjusted For

For the three months ended March 31:

2014

2013

Change

Currency

Revenue:

Global Technology Services

\$	9,330
\$	9,605
	(2.9)
	479

% (0.5)

%

Gross margin

% 37.9

% 36.7

pts. 1.2

Global Business Services

4,483

480

	4,484
	(0.0)
%	
	2.0
%	
Gross margin	
	30.0
%	
	28.6
%	
pts.	1.4
Software	
	481

5,661

5,572

1.6

%

2.1

%

Gross margin

87.5

%

87.2

%

0.3

482

pts.

Systems and Technology

2,391

3,106

(23.0)

%

(22.9

)%

Gross margin

27.0

%

32.3
%

(5.3)
pts.

Global Financing

512

499

2.6
%

6.2
%

Gross margin

484

	46.1
%	
	45.8
%	
	0.4
pts.	
Other	
	107
	142
	(24.4
)%	
	485

(22.8

)%

Gross margin

(163.7)

%

(158.5)

%

(5.2)

pts.

Total consolidated revenue

\$

22,484

\$

23,408

486

	(3.9)
%	
	(2.4)
%	
Total consolidated gross profit	
\$	
	10,543
\$	
	10,678
	(1.3)
%	
Total consolidated gross margin	
	46.9
%	
	487

45.6
%

1.3
pts.

Non-operating adjustments:

Amortization of acquired intangible assets

102

94

9.0

%

Acquisition-related charges

2

1

13.7

489

Retirement-related costs/(income)

52

164

(68.1

)

Operating (non-GAAP) gross profit

\$

10,699

\$

10,937

490

(2.2)

%

Operating (non-GAAP) gross margin

47.6

%

46.7

%

0.9

pts.

Global Services

In the first quarter of 2014, the Global Services segments, Global Technology Services (GTS) and Global Business Services (GBS), delivered revenue of \$13,813 million, a decrease of 2.0 percent as reported, but up 0.3 percent at constant currency compared to the prior year. Normalizing for the divestiture of the company's customer care business, Global Services revenue decreased 0.5 percent as reported, but increased 2 percent adjusted for currency. Adjusted for the divestiture, this is the third consecutive quarter of constant currency growth in total Global Services. Pre-tax income in the first quarter declined 13.7 percent and pre-tax margin declined 1.9 points to 13.9 percent; excluding workforce rebalancing charges in both periods, pre-tax income increased 7.1 percent with a pre-tax margin of 17.3 percent, up 1.5 points year to year.

Management Discussion – (continued)

Yr. to Yr.

Percent

Yr. to Yr.

Change

(Dollars in millions)

Percent

Adjusted For

For the three months ended March 31:

2014

2013

Change

Currency

Global Services external revenue:

\$		13,813
\$		14,089
		(2.0)
		495

% 0.3

%

Global Technology Services

\$ 9,330

\$ 9,605

(2.9)

% (0.5)

%

Outsourcing

5,280

5,558

496

(5.0)

(2.8)

Integrated Technology Services

2,329

2,277

2.3

4.7

Maintenance

1,721

1,770

(2.8)

(0.1)

Global Business Services

\$

4,483

\$

4,484

(0.0)

%

2.0

%

498

Outsourcing

934

1,041

(10.3)

(7.7)

Consulting and Systems Integration

3,549

3,443

3.1

499

Global Technology Services revenue of \$9,330 million decreased 2.9 percent (1 percent adjusted for currency) in the first quarter of 2014. Normalizing for the divestiture of the customer care business, revenue decreased 0.7 percent, but increased 2 percent adjusted for currency. Within GTS, the Softlayer platform, which provides a highly differentiated solution for clients looking to deploy across public, private or hybrid clouds all unified on one platform, continued to perform well and contributed about 1 point of constant currency growth for total GTS in the first quarter. The company announced it will invest \$1.2 billion to expand its global cloud footprint and will double the number of its Softlayer centers — with 40 cloud centers in 15 countries, they will be located in every major geography and key financial center. GTS Outsourcing revenue declined 5.0 percent (3 percent adjusted for currency) compared with the prior year. Normalizing for the customer care divestiture, revenue declined 1.3 percent as reported, but returned to growth on a constant currency basis with an increase of 1 percent year to year. This growth was driven by new contracts that were brought on during 2013.

Global Business Services revenue of \$4,483 million was flat year to year, but increased 2 percent at constant currency. Consulting and Systems Integration (C&SI) revenue grew 3.1 percent (5 percent adjusted for currency). This growth was driven by the practices that address the Digital Front Office. The company delivered growth across cloud and business analytics, and in projects for clients on systems of engagement and helping clients connect these front-end capabilities to their back-end systems and processes. A good indication of this success is the company's number one ranking in both Overall Business Consulting and Cloud Professional Services by IDC, and Mobility Consulting Services by Forrester. The company continues to invest strategically and committed \$100 million in March, 2014 to expand its consulting services capability with ten new IBM Interactive Labs and 1,000 experts to address client experience design and engagement. Application Outsourcing revenue decreased 10.3 percent (8 percent adjusted for currency) reflecting increased pricing pressure and client contract renegotiations, as well as a reduction in elective projects.

Yr. to Yr.

Percent/

(Dollars in millions)

Margin

For the three months ended March 31:

2014

2013

Change

Global Technology Services:

External gross profit

\$

3,539

\$

3,529

502

	0.3
%	
External gross profit margin	
	37.9
%	
	36.7
%	
	1.2
pts.	
Pre-tax income	
\$	1,345
\$	1,585
	503

(15.1)

%

Pre-tax margin

14.1

%

16.1

%

(2.0)

pts.

Global Business Services:

External gross profit

\$

1,343

\$

1,283

%

4.7

External gross profit margin

%

30.0

%

28.6

pts.

1.4

Pre-tax income

505

\$	628
\$	703
	(10.6)
%	
Pre-tax margin	
	13.6
%	
	15.1
%	
	(1.5)
pts.	

GTS first quarter gross profit grew 0.3 percent and its gross profit margin improved 1.2 points to 37.9 percent versus the prior year. Pre-tax income decreased 15.1 percent to \$1,345 million and the pre-tax margin declined 2.0 points to 14.1 percent. Normalizing for workforce rebalancing charges of \$325 million and \$4 million in the first quarter of 2014 and 2013, respectively, GTS pre-tax income grew 5.2 percent and pre-tax margin expanded 1.3 points. GTS pre-tax income for the quarter included a gain of \$98 million related to the customer care divestiture, however the business performance has also been impacted by the divestiture of those operations. The company continues to make investments in key growth areas such as mobile, security and cloud. These initiatives are gaining traction, but

they are not yet at scale.

Management Discussion – (continued)

GBS first quarter gross profit grew 4.7 percent and its gross profit margin improved 1.4 points to 30.0 percent versus the prior year. Pre-tax income decreased 10.6 percent to \$628 million and the pre-tax margin declined 1.5 points to 13.6 percent. Normalizing for workforce rebalancing charges of \$159 million and \$3 million in the first quarter of 2014 and 2013, respectively, GBS pre-tax income grew 11.5 percent and pre-tax margin expanded 1.9 points reflecting improved productivity in the base.

Global Services Backlog

The estimated Global Services backlog at March 31, 2014 was \$138 billion, a decrease of 2.3 percent (2 percent adjusted for currency) compared to the March 31, 2013 balance. This includes a backlog reduction of \$3.8 billion associated with the customer care divestiture. Normalizing for this divestiture, backlog was up 0.4 percent (1 percent adjusted for currency) year to year. The estimated transactional backlog at March 31, 2014 increased 5.4 percent (6 percent adjusted for currency) from the March 31, 2013 levels. The estimated outsourcing backlog decreased 5.3 percent (5 percent adjusted for currency) including the backlog reduction from the customer care divestiture. Normalizing for this divestiture, the estimated outsourcing backlog decreased 1.2 percent (1 percent adjusted for currency) compared to the March 31, 2013 balance.

Yr. to Yr.

Percent

Yr. to Yr.

Change

At March 31,

At March 31,

Percent

Adjusted For

(Dollars in billions)

2014

2013

Change

Currency

Backlog:

Total backlog

\$

137.6

511

\$ 140.8

% (2.3)

% (2.1)

excl. customer care

% 0.4

% 0.6

Outsourcing backlog

\$ 86.2

\$ 91.0

% (5.3)

% (5.2)

excl. customer care

% (1.2)

(1.0)

%

Total Global Services backlog includes GTS Outsourcing, ITS, GBS Outsourcing, Consulting and Systems Integration and Maintenance. Outsourcing backlog includes GTS Outsourcing and GBS Outsourcing. Transactional backlog includes ITS and Consulting and Systems Integration. Total backlog is intended to be a statement of overall work under contract and therefore does include Maintenance. Backlog estimates are subject to change and are affected by several factors, including terminations, changes in the scope of contracts, periodic revalidations, adjustments for revenue not materialized and adjustments for currency.

Global Services signings are management's initial estimate of the value of a client's commitment under a Global Services contract. There are no third-party standards or requirements governing the calculation of signings. The calculation used by management involves estimates and judgments to gauge the extent of a client's commitment, including the type and duration of the agreement, and the presence of termination charges or wind-down costs.

Signings include GTS Outsourcing, ITS, GBS Outsourcing and Consulting and Systems Integration contracts. Contract extensions and increases in scope are treated as signings only to the extent of the incremental new value. Maintenance is not included in signings as maintenance contracts tend to be more steady state, where revenues equal renewals.

Contract portfolios purchased in an acquisition are treated as positive backlog adjustments provided those contracts meet the company's requirements for initial signings. A new signing will be recognized if a new services agreement is signed incidental or coincidental to an acquisition or divestiture.

Yr. to Yr.

Percent

Yr. to Yr.

Change

(Dollars in millions)

Percent

Adjusted For

For the three months ended March 31:

2014

2013

Change

Currency

Total signings:

\$ 11,153

\$ 16,930

(34.1)

% (33.0)

%

Outsourcing signings

\$ 5,488

\$ 10,732

(48.9)

% (47.8)

517

%

Transactional signings

5,665

6,198

(8.6)

%

(7.5)

%

Management Discussion – (continued)

Software

Yr. to Yr.

Percent

Yr. to Yr.

Change

(Dollars in millions)

Percent

Adjusted For

For the three months ended March 31:

2014

2013

Change

Currency

Software external revenue:

\$

5,661

\$ 5,572

% 1.6

% 2.1

Middleware:

\$ 4,695

\$ 4,547

% 3.3

% 3.7

Key branded middleware:

3,656

3,504

4.4

4.8

WebSphere Family

12.0

12.4

523

Information Management

1.3

1.9

Workforce Solutions

(4.4)

(4.2)

Tivoli

6.6

6.9

Rational

	1.0
	1.9
Other middleware	
	1,039
	1,044
	(0.5)
	(0.1)
	526

Operating systems

519

578

(10.2)

(9.5)

Other

447

447

0.0

527

Software revenue of \$5,661 million increased 1.6 percent (2 percent adjusted for currency) year to year in the first quarter of 2014. As enterprise clients continue to rely on the company's middleware solutions to transform their infrastructure and handle their business critical transactions, first quarter growth was led by key branded middleware. The company delivers software solutions through a combination of on-premise and software-as-a-solution (SaaS) offerings. SaaS offerings span across the software brands — and in the first quarter SaaS revenue grew more than 25 percent year to year.

Key branded middleware revenue, which accounted for 65 percent of the total software revenue this quarter, increased 4.4 percent (5 percent adjusted for currency) year to year.

WebSphere had a strong quarter with revenue increasing 12.0 percent (12 percent adjusted for currency). For the thirteenth consecutive year, Gartner designated the company the market share leader in the application infrastructure and middleware segment. The company's market share of 30 percent is nearly double the size of its closest competitor. The first quarter performance included continued strong growth in MobileFirst, the comprehensive portfolio of mobile software and services that enable clients to manage, integrate and leverage mobile devices. The company has been building capabilities to address this space and now has over 3,000 mobile experts. Across software and services, the company's mobile business doubled in the first quarter compared to the prior year. The application server business, which is an example of clients utilizing on-premise software to manage the infrastructure workloads driven by mobile, big data and analytics, delivered strong growth for the fourth consecutive quarter.

Information Management revenue increased 1.3 percent (2 percent adjusted for currency) in the first quarter of 2014. This growth was led by distributed database and master data management which are key elements of the company's big data and analytics solutions. With the first quarter acquisition of Cloudant, the company has added DataBase-as-a-Service capability. Cloudant extends the company's mobile and cloud platforms by enabling developers to easily and quickly create next generation mobile and web-based applications.

Tivoli revenue increased 6.6 percent (7 percent adjusted for currency) compared to the prior year with growth in all three product segments. Performance was led by Tivoli security which increased 27.0 percent (28 percent adjusted for currency) year to year, marking the sixth consecutive quarter of double-digit growth at constant currency. These strong results are being driven, in part, by incremental requirements for security as clients expand into cloud and mobile computing. Across the company, the portfolio of security offerings grew more than 20 percent in the first quarter versus the prior year. Tivoli storage, which enables customers to manage their rapidly growing data, was up 3.7 percent (4 percent adjusted for currency), and Tivoli systems management increased 2.4 percent (2 percent adjusted for currency) year to year.

Workforce Solutions revenue decreased 4.4 percent (4 percent adjusted for currency) in the first quarter. Although there was strong growth in SaaS offerings, it was more than offset by a decline in the on-premise Notes business. The company is working to transform this business and build recurring revenue streams from the SaaS offerings.

Rational revenue increased 1.0 percent (2 percent adjusted for currency) year to year in the first quarter.

Management Discussion – (continued)

Operating systems revenue decreased 10.2 percent (9 percent adjusted for currency) and other software revenue was flat (increased 1 percent adjusted for currency) year to year in the first quarter.

In the first quarter of 2014, the company launched BlueMix which will make the company's middleware portfolio accessible via the cloud. With BlueMix, developers can efficiently build cloud applications with reusable pieces of code tied to their enterprise systems. This enables businesses to leverage the flexibility that cloud applications provide.

Yr. to Yr.

Percent/

(Dollars in millions)

Margin

For the three months ended March 31:

2014

2013

Change

Software:

External gross profit

\$ 4,956

\$ 4,860

% 2.0

External gross profit margin

% 87.5

87.2

532

pts.

The Software gross profit margin improved 0.3 points to 87.5 percent year to year in the first quarter of 2014. Software pre-tax income of \$1,918 million decreased 4.7 percent and the pre-tax margin of 29.1 percent declined 2.4 points. Normalized for workforce rebalancing charges of \$165 million and \$7 million in the first quarter of 2014 and 2013, respectively, Software pre-tax income was up 3.1 percent and the pre-tax margin was flat year to year.

Systems and Technology

Yr. to Yr.

Percent

Yr. to Yr.

Change

(Dollars in millions)

Percent

Adjusted For

For the three months ended March 31:

2014

2013

Change

Currency

Systems and Technology external revenue:

\$

2,391

\$

3,106

%

(23.0)

%

(22.9)

System z

%

(39.7)

%

(40.2)

Power Systems

(21.7)

(21.3)

System x

(17.6)

(17.1)

Storage

(22.9)

(22.9)

Total Systems

(24.0)

(23.8)

Microelectronics OEM

(15.9)

(15.9)

Systems and Technology revenue decreased 23.0 percent (23 percent adjusted for currency) in the first quarter of 2014 versus the same period in 2013. The decline in revenue reflects both the product cycle of System z and the secular challenges in Power, Storage and System x. In January 2014, the company entered into a definitive agreement with Lenovo to divest its System x business. Also, in the first quarter, the company continued to reposition offerings in other parts of its hardware business to make them more relevant, in addition to taking actions to realign its structure to the demand profile the company projects going forward.

System z revenue decreased 39.7 percent (40 percent adjusted for currency) in the first quarter of 2014 versus the first quarter of 2013. MIPS (millions of instructions per second) shipments decreased 19 percent in the first quarter of 2014 versus the same period in 2013. The decline in System z revenue was expected as the product is in the sixth quarter of the product cycle since general availability. In the current mainframe cycle, the company has shipped approximately 26 percent more MIPS compared to the same period in the prior cycle. System z is a core franchise which provides mission critical infrastructure for the company's clients, and the company continues to invest in the platform. In April 2014, the company celebrated the mainframe's 50th year.

Power Systems revenue decreased 21.7 percent (21 percent adjusted for currency) in the first quarter of 2014 versus the first quarter of 2013. The company is aggressively repositioning this platform with a couple of key initiatives. First, the OpenPOWER consortium makes Power technology available to an open development alliance. In the first quarter of 2014, the company expanded its OpenPOWER ecosystem. Second, the company is expanding its Linux capabilities through its POWER8 launch this year. POWER8 is the first processor built for big data, and delivers better cloud economics.

Management Discussion – (continued)

System x revenue decreased 17.6 percent (17 percent adjusted for currency) in the first quarter of 2014 versus the first quarter of 2013.

Storage revenue decreased 22.9 percent (23 percent adjusted for currency) in the first quarter versus the comparable period in 2013. The company's Flash solutions contributed growth again this quarter, but high-end storage experienced substantial weakness versus the first quarter of 2013.

Microelectronics OEM revenue decreased 15.9 percent (16 percent adjusted for currency) in the first quarter of 2014 versus the comparable period of 2013.

Yr. to Yr.

Percent/

(Dollars in millions)

Margin

For the three months ended March 31:

2014

2013

Change

Systems and Technology:

External gross profit

\$ 645

\$ 1,003

% (35.7)

External gross profit margin

% 27.0

	32.3
%	
	(5.3)
pts.	
Pre-tax income	
\$	(660)
\$	(405)
	(63.1)
%	
Pre-tax margin	
	(25.8)
%	
	(12.5)
	545

%

(13.2)

pts.

Systems and Technology's gross profit margin decreased 5.3 points in the first quarter of 2014 versus the prior year. The decrease was driven by a decline due to revenue mix as a result of less mainframe content (2.3 points), lower margins in Power Systems (1.7 points), Microelectronics (1.3 points) and Storage (0.9 points), partially offset by higher margins in System z (0.2 points) and System x (0.1 points).

Systems and Technology's pre-tax loss increased \$255 million to a loss of \$660 million in the first quarter 2014, when compared to the prior year. Pre-tax margin decreased 13.2 points in the first quarter versus the prior year period. Normalized for workforce rebalancing charges of \$218 million and \$3 million in the first quarter of 2014 and 2013, respectively, Systems and Technology's first quarter pre-tax income was a loss of \$442 million compared to a loss of \$402 million in the prior year, and the pre-tax margin declined 4.8 points.

Global Financing

See pages 60 to 65 for a discussion of Global Financing's segment results.

Geographic Revenue

In addition to the revenue presentation by reportable segment, the company also measures revenue performance on a geographic basis. The following geographic, regional and country-specific revenue performance excludes OEM revenue, which is discussed separately.

Yr. to Yr.

Percent

Yr. to Yr.

Change

(Dollars in millions)

Percent

Adjusted For

For the three months ended March 31:

2014

2013

Change

Currency

Total Revenue

\$ 22,484

\$ 23,408

% (3.9)

% (2.4)

Geographies:

\$ 22,129

\$ 22,981

	(3.7)
%	
	(2.1)
%	
Americas	
	9,596
	10,042
	(4.4)
	(2.2)
Europe/Middle East/Africa (EMEA)	
	7,578
	550

7,278

4.1

0.7

Asia Pacific

4,955

5,661

(12.5)

(5.6)

Major markets

	(1.6)
%	
	(1.2)
%	

Growth markets

(10.7)

%

(5.0)

%

BRIC countries

(11.2)

%

(6.0)

%

Management Discussion – (continued)

Total geographic revenue of \$22,129 million decreased 3.7 percent (2 percent adjusted for currency) in the first quarter of 2014 compared to the prior year. While as reported revenue for the quarter decreased year to year in both the major markets and growth markets, both markets improved their growth rate at constant currency compared to the fourth quarter of 2013.

Growth markets revenue across all geographies decreased 10.7 percent as reported and 5 percent at constant currency in the first quarter. Revenue grew at a high single-digit rate on a constant currency basis in Latin America, but revenue in the Asia Pacific countries was down driven by continued weakness in China which declined at a double-digit rate. This performance is consistent with the past two quarters and it is expected to take some time for business to improve in China. The company still sees good opportunity in the growth markets over the long term and continues to invest in these key markets to capture this opportunity.

Americas revenue decreased 4.4 percent (2 percent adjusted for currency) compared to the first quarter of 2013. This is consistent with performance in the fourth quarter of 2013 on a constant currency basis. Within the major markets, the U.S. was down 3.6 percent and Canada was down 9.6 percent (1 percent adjusted for currency). There was strong growth in software, but hardware performance, especially in the U.S., remained a challenge. Revenue in the Latin America growth markets decreased 2.8 percent as reported, but increased 8 percent adjusted for currency. This performance was led by Brazil which was flat year to year as reported, but increased 12 percent on a constant currency basis.

EMEA revenue increased 4.1 percent (1 percent adjusted for currency) year to year in the first quarter of 2014. This represents a 3 point improvement compared to last quarter's growth rate. This improvement was driven by growth in Germany and Italy. Germany grew 13.1 percent (9 percent adjusted for currency) and Italy increased 9.4 percent (5 percent adjusted for currency). The UK increased 0.4 percent as reported, but decreased 6 percent year to year on a constant currency basis. Revenue in the EMEA growth markets decreased 2.0 percent (increased 1 percent adjusted for currency). Russia had strong performance compared to recent quarters with growth of 12.4 percent (17 percent adjusted for currency).

Asia Pacific first quarter revenue decreased 12.5 percent (6 percent adjusted for currency) year over year. Japan revenue decreased 7.8 percent as reported, but increased 2 percent on a constant currency basis. Adjusted for currency, this was the sixth consecutive quarter of revenue growth in Japan. The Asia Pacific growth markets decrease of 15.8 percent (11 percent adjusted for currency) was driven by China which declined 19.4 percent (20 percent adjusted for currency). India was down 17.4 percent (6 percent adjusted for currency) on a year-to-year basis.

OEM revenue decreased 16.8 percent (17 percent adjusted for currency) year to year in the first quarter of 2013, driven by the Microelectronics OEM business.

Expense

Total Expense and Other (Income)

Yr. to Yr.

(Dollars in millions)

Percent

For the three months ended March 31:

2014

2013

Change

Total consolidated expense and other (income)

\$

7,563

\$

7,072

6.9

557

%

Non-operating adjustments:

Amortization of acquired intangible assets

(92)

(90)

2.1

Acquisition-related charges

(6)

(9)

(35.4)

Non-operating retirement-related (costs)/income

(70)

(120)

(41.3)

Operating (non-GAAP) expense and other (income)

\$

7,395

\$

6,853

559

7.9

%

Total consolidated expense-to-revenue ratio

33.6

%

30.2

%

3.4

pts.

Operating (non-GAAP) expense-to-revenue ratio

32.9

%

29.3

%

3.6

pts.

Management Discussion – (continued)

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Total expense and other (income) increased 6.9 percent in the first quarter compared to the prior year. Total operating (non-GAAP) expense and other (income) increased 7.9 percent versus the first quarter of 2013. The key drivers of the year-to-year change in total expense and other (income) were approximately:

	Total	Operating
	<u>Consolidated</u>	<u>(non-GAAP)</u>
• Currency *	0 points	0 points
• Acquisitions**	2 points	2 points
• Base expense	5 points	7 points

* Reflects impacts of translation and hedging programs.

** Includes acquisitions completed in prior 12-month period; operating (non-GAAP) is net of non-operating acquisition-related charges.

For additional information regarding total expense and other (income) for both expense presentations, see the following analyses by category.

Selling, general and administrative expense

Yr. to Yr.

(Dollars in millions)

Percent

For the three months ended March 31:

2014

2013

Change

Selling, general and administrative expense:

Selling, general and administrative – other

\$		4,612
\$		4,759
		(3.1)
		565

%

Advertising and promotional expense

338

323

4.6

Workforce rebalancing charges

873

20

nm

Retirement-related costs

566

	231
	264
	(12.4)
Amortization of acquired intangible assets	
	92
	90
	2.1
Stock-based compensation	
	88
	567

99

(10.5)

Bad debt expense

55

23

140.9

Total consolidated selling, general and administrative expense

\$

6,289

\$

5,577

12.8

%

568

Non-operating adjustments:

Amortization of acquired intangibles assets

(92)

(90)

2.1

Acquisition-related charges

(6)

(3)

117.1

Non-operating retirement-related (costs)/income

(87)

(104)

(15.8)

Operating (non-GAAP) selling, general and administrative expense

\$

6,104

\$

5,381

570

%

nm – not meaningful

Total Selling, general and administrative (SG&A) expense increased 12.8 percent (14 percent adjusted for currency) in the first quarter of 2014 versus the first quarter of 2013. The increase was primarily driven by higher base expense (12 points) and acquisition-related spending (2 points), partially offset by the effects of currency (1 point). Operating (non-GAAP) SG&A expense increased 13.4 percent (15 percent adjusted for currency) primarily driven by higher base expense (13 points) and acquisition-related spending (2 points), partially offset by the effects of currency (1 point). Base expense includes workforce rebalancing charges in the first quarter of 2014 of \$873 million, an increase of \$853 million year to year, which resulted in a 16 point year-to-year impact in the operating (non-GAAP) SG&A base performance. Normalized for the workforce rebalancing charges in both first-quarter periods, operating (non-GAAP) SG&A base expense decreased 3 points year to year compared to the 13 point impact above. Bad debt expense increased \$32 million year to year driven by specific provision additions. The receivables provision coverage was 1.8 percent at March 31, 2014, an increase of 20 basis points from year-end 2013 and 30 basis points from March 31, 2013.

Management Discussion – (continued)

Other (income) and expense

Yr. to Yr.

(Dollars in millions)

Percent

For the three months ended March 31:

2014

2013

Change

Other (income) and expense:

Foreign currency transaction losses/(gains)

\$

43

\$

(415)

574

nm

%

(Gains)/losses on derivative instruments

5

402

(98.7)

Interest income

(22)

(23)

(4.9)

575

Net (gains)/losses from securities and investment assets

6

(5)

nm

Other

(158)

(19)

710.2

Total consolidated other (income) and expense

\$

(126)

576

\$ (60)

% 108.2

Non-operating adjustment:

Acquisition-related charges

0

(7)

577

Operating (non-GAAP) other (income) and expense

\$ (126)

\$ (67)

% 87.6

nm - not meaningful

Other (income) and expense was income of \$126 million and \$60 million in the first quarter of 2014 and 2013, respectively. The increase in income of \$65 million year over year was primarily driven by the gain associated with the divestiture of the customer care business (\$98 million) in the first quarter of 2014 reflected in Other in the table above. In addition, a reduction in losses on derivative instruments (\$397 million) year to year was more than offset by lower foreign currency transaction gains (\$458 million) year to year due to foreign currency rate volatility.

Research, Development and Engineering

Yr. to Yr.

(Dollars in millions)

Percent

For the three months ended March 31:

2014

2013

Change

Total consolidated research, development and engineering expense

\$

1,501

\$

1,644

(8.7)

%

Non-operating adjustment:

Non-operating retirement-related (costs)/income

17

(16)

nm

Operating (non-GAAP) research, development and engineering expense

\$

1,518