

INTERNATIONAL BUSINESS MACHINES CORP

Form 10-Q

July 25, 2017

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

WASHINGTON, DC 20549

**FORM 10 - Q**

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

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTER ENDED JUNE 30, 2017**

**1-2360**

(Commission file number)

**INTERNATIONAL BUSINESS MACHINES CORPORATION**

(Exact name of registrant as specified in its charter)

**New York**

(State of incorporation)

**13-0871985**

(IRS employer identification number)

**Armonk, New York**

(Address of principal executive offices)

**10504**

(Zip Code)

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914-499-1900

(Registrant's telephone number)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act).

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 931,940,297 shares of common stock outstanding at June 30, 2017.

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

(Dollars in millions except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
<b>Revenue:</b>				
Services	\$ 12,547	\$ 13,018	\$ 24,889	\$ 25,409
Sales	6,324	6,792	11,727	12,671
Financing	418	429	827	843
<b>Total revenue</b>	<b>19,289</b>	<b>20,238</b>	<b>37,443</b>	<b>38,923</b>
<b>Cost:</b>				
Services	8,523	8,691	17,076	17,074
Sales	1,684	1,582	3,234	2,960
Financing	289	263	568	501
<b>Total cost</b>	<b>10,495</b>	<b>10,536</b>	<b>20,878</b>	<b>20,535</b>
<b>Gross profit</b>	<b>8,794</b>	<b>9,702</b>	<b>16,565</b>	<b>18,388</b>
<b>Expense and other (income):</b>				
Selling, general and administrative	5,160	5,349	10,312	11,361
Research, development and engineering	1,484	1,465	3,018	2,923
Intellectual property and custom development income	(365)	(365)	(810)	(582)
Other (income) and expense	(76)	37	(104)	289
Interest expense	147	167	283	315
<b>Total expense and other (income)</b>	<b>6,351</b>	<b>6,653</b>	<b>12,699</b>	<b>14,306</b>
<b>Income from continuing operations before income taxes</b>	<b>2,443</b>	<b>3,049</b>	<b>3,867</b>	<b>4,082</b>
Provision for/(benefit from) income taxes	111	544	(218)	(439)
<b>Income from continuing operations</b>	<b>\$ 2,332</b>	<b>\$ 2,505</b>	<b>\$ 4,085</b>	<b>\$ 4,521</b>
Loss from discontinued operations, net of tax	(1)	0	(3)	(3)
<b>Net income</b>	<b>\$ 2,331</b>	<b>\$ 2,504</b>	<b>\$ 4,082</b>	<b>\$ 4,518</b>
<b>Earnings/(loss) per share of common stock:</b>				
<b>Assuming dilution:</b>				
Continuing operations	\$ 2.48	\$ 2.61	\$ 4.32	\$ 4.69
Discontinued operations	0.00	0.00	0.00	0.00
<b>Total</b>	<b>\$ 2.48</b>	<b>\$ 2.61</b>	<b>\$ 4.32</b>	<b>\$ 4.69</b>
<b>Basic:</b>				
Continuing operations	\$ 2.49	\$ 2.62	\$ 4.35	\$ 4.71
Discontinued operations	0.00	0.00	0.00	0.00
<b>Total</b>	<b>\$ 2.49</b>	<b>\$ 2.62</b>	<b>\$ 4.35</b>	<b>\$ 4.71</b>

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

Assuming dilution	939.6	960.5	943.7	962.4
Basic	934.9	957.4	938.7	959.5

<b>Cash dividend per common share</b>	\$	1.50	\$	1.40	\$	2.90	\$	2.70
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(Amounts may not add due to rounding.)

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

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

(Dollars in millions)	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
<b>Net income</b>	\$ 2,331	\$ 2,504	\$ 4,082	\$ 4,518
<b>Other comprehensive income/(loss), before tax:</b>				
<b>Foreign currency translation adjustments</b>	(38)	(248)	124	(10)
<b>Net changes related to available-for-sale securities:</b>				
Unrealized gains/(losses) arising during the period	4	1	3	(35)
Reclassification of (gains)/losses to net income	0	0	1	37
<b>Total net changes related to available-for-sale securities</b>	3	1	4	2
<b>Unrealized gains/(losses) on cash flow hedges:</b>				
Unrealized gains/(losses) arising during the period	(96)	9	(128)	(256)
Reclassification of (gains)/losses to net income	(176)	102	(274)	11
<b>Total unrealized gains/(losses) on cash flow hedges</b>	(272)	111	(402)	(245)
<b>Retirement-related benefit plans:</b>				
Prior service costs/(credits)			0	
Net (losses)/gains arising during the period	44	78	105	(68)
Curtailments and settlements	3	10	1	14
Amortization of prior service (credits)/costs	(22)	(27)	(44)	(53)
Amortization of net (gains)/losses	713	693	1,423	1,383
<b>Total retirement-related benefit plans</b>	738	754	1,486	1,277
<b>Other comprehensive income/(loss), before tax</b>	432	617	1,211	1,023
<b>Income tax (expense)/benefit related to items of other comprehensive income</b>				
	88	(223)	(3)	(21)
<b>Other comprehensive income/(loss)</b>	520	394	1,208	1,002
<b>Total comprehensive income/(loss)</b>	\$ 2,852	\$ 2,899	\$ 5,290	\$ 5,520

(Amounts may not add due to rounding.)

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

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

**ASSETS**

(Dollars in millions)	At June 30, 2017	At December 31, 2016
<b>Assets:</b>		
Current assets:		
Cash and cash equivalents	\$ 11,696	\$ 7,826
Marketable securities	599	701
Notes and accounts receivable - trade (net of allowances of \$304 in 2017 and \$290 in 2016)	8,401	9,182
Short-term financing receivables (net of allowances of \$272 in 2017 and \$337 in 2016)	17,563	19,006
Other accounts receivable (net of allowances of \$38 in 2017 and \$48 in 2016)	994	1,057
Inventories, at lower of average cost or market:		
Finished goods	424	358
Work in process and raw materials	1,180	1,195
Total inventories	1,604	1,553
Prepaid expenses and other current assets	4,155	4,564
Total current assets	45,013	43,888
Property, plant and equipment	31,291	30,133
Less: Accumulated depreciation	20,388	19,303
Property, plant and equipment net	10,903	10,830
Long-term financing receivables (net of allowances of \$122 in 2017 and \$101 in 2016)	8,296	9,021
Prepaid pension assets	4,015	3,034
Deferred taxes	6,812	5,224
Goodwill	36,517	36,199
Intangible assets net	4,179	4,688
Investments and sundry assets	4,759	4,585
<b>Total assets</b>	<b>\$ 120,495</b>	<b>\$ 117,470</b>

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION**  
**AND SUBSIDIARY COMPANIES**  
**CONSOLIDATED STATEMENT OF FINANCIAL POSITION (CONTINUED)**  
**(UNAUDITED)**

**LIABILITIES AND EQUITY**

(Dollars in millions)	At June 30, 2017	At December 31, 2016
<b>Liabilities:</b>		
Current liabilities:		
Taxes	\$ 2,779	\$ 3,235
Short-term debt	8,061	7,513
Accounts payable	5,126	6,209
Compensation and benefits	3,865	3,577
Deferred income	11,541	11,035
Other accrued expenses and liabilities	4,594	4,705
<b>Total current liabilities</b>	<b>35,966</b>	<b>36,275</b>
Long-term debt	37,612	34,655
Retirement and nonpension postretirement benefit obligations	17,320	17,070
Deferred income	3,617	3,600
Other liabilities	7,437	7,477
<b>Total liabilities</b>	<b>101,951</b>	<b>99,078</b>
<b>Equity:</b>		
IBM stockholders' equity:		
Common stock, par value \$0.20 per share, and additional paid-in capital	54,235	53,935
Shares authorized: 4,687,500,000		
Shares issued: 2017 - 2,228,061,851		
2016 - 2,225,116,815		
Retained earnings	154,234	152,759
Treasury stock - at cost	(161,860)	(159,050)
Shares: 2017 - 1,296,121,555		
2016 - 1,279,249,412		
Accumulated other comprehensive income/(loss)	(28,189)	(29,398)
<b>Total IBM stockholders' equity</b>	<b>18,419</b>	<b>18,246</b>
Noncontrolling interests	125	146
<b>Total equity</b>	<b>18,544</b>	<b>18,392</b>
<b>Total liabilities and equity</b>	<b>\$ 120,495</b>	<b>\$ 117,470</b>

(Amounts may not add due to rounding.)

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





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## INTERNATIONAL BUSINESS MACHINES CORPORATION

## AND SUBSIDIARY COMPANIES

## CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)

(Dollars in millions)	Six Months Ended June 30,	
	2017	2016
<b>Cash flows from operating activities:</b>		
Net income	\$ 4,082	\$ 4,518
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation	1,439	1,382
Amortization of intangibles	777	745
Stock-based compensation	265	261
Net (gain)/loss on asset sales and other	74	167
Changes in operating assets and liabilities, net of acquisitions/divestitures	785	1,915* **
<b>Net cash provided by operating activities</b>	<b>7,421</b>	<b>8,988* **</b>
<b>Cash flows from investing activities:</b>		
Payments for property, plant and equipment	(1,425)	(1,826)
Proceeds from disposition of property, plant and equipment	136	172
Investment in software	(278)	(295)
Acquisition of businesses, net of cash acquired	(169)	(5,405)
Divestitures of businesses, net of cash transferred	29	35
Non-operating finance receivables net	816	1,340*
Purchases of marketable securities and other investments	(2,346)	(2,386)
Proceeds from disposition of marketable securities and other investments	1,883	2,028
<b>Net cash used in investing activities</b>	<b>(1,355)</b>	<b>(6,338)*</b>
<b>Cash flows from financing activities:</b>		
Proceeds from new debt	5,835	8,263
Payments to settle debt	(2,106)	(3,425)
Short-term borrowings/(repayments) less than 90 days net	(973)	(909)
Common stock repurchases	(2,725)	(1,775)
Common stock repurchases for tax withholdings	(147)	(112)**
Common stock transactions other	97	115
Cash dividends paid	(2,724)	(2,590)
<b>Net cash used in financing activities</b>	<b>(2,743)</b>	<b>(434)**</b>
Effect of exchange rate changes on cash and cash equivalents	547	114
Net change in cash and cash equivalents	3,870	2,330
Cash and cash equivalents at January 1	7,826	7,686
<b>Cash and cash equivalents at June 30</b>	<b>\$ 11,696</b>	<b>\$ 10,017</b>

\* Revised classification of certain financing receivables.

\*\* Reclassified to reflect adoption of the FASB guidance on share-based compensation.

(Amounts may not add due to rounding.)

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

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

(Dollars in millions)	Common Stock and Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders Equity	Non- Controlling Interests	Total Equity
<b>Equity - January 1, 2017</b>	\$ 53,935	\$ 152,759	\$ (159,050)	\$ (29,398)	\$ 18,246	\$ 146	\$ 18,392
Cumulative effect of change in accounting principle *		102			102		102
Net income		4,082			4,082		4,082
Other comprehensive income/(loss)				1,208	1,208		1,208
Total comprehensive income/(loss)					\$ 5,290		\$ 5,290
Cash dividends paid common stock		(2,724)			(2,724)		(2,724)
Common stock issued under employee plans (2,945,036 shares)	300				300		300
Purchases (920,968 shares) and sales (347,939 shares) of treasury stock under employee plans net		15	(103)		(88)		(88)
Other treasury shares purchased, not retired (16,299,114 shares)			(2,708)		(2,708)		(2,708)
Changes in noncontrolling interests						(21)	(21)
<b>Equity - June 30, 2017</b>	\$ 54,235	\$ 154,234	\$ (161,860)	\$ (28,189)	\$ 18,419	\$ 125	\$ 18,544

(Dollars in millions)	Common Stock and Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders Equity	Non- Controlling Interests	Total Equity
<b>Equity - January 1, 2016</b>	\$ 53,262	\$ 146,124	\$ (155,518)	\$ (29,607)	\$ 14,262	\$ 162	\$ 14,424
Net income		4,518			4,518		4,518
Other comprehensive income/(loss)				1,002	1,002		1,002
Total comprehensive income/(loss)					\$ 5,520		\$ 5,520
Cash dividends paid common stock		(2,590)			(2,590)		(2,590)
	321				321		321

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Common stock issued under employee plans (2,867,128 shares)								
Purchases (769,837 shares) and sales (323,578 shares) of treasury stock under employee plans net		16	(71)		(56)			(56)
Other treasury shares purchased, not retired (12,305,377 shares)			(1,709)		(1,709)			(1,709)
Changes in other equity	(18)	2			(16)			(16)
Changes in noncontrolling interests							(6)	(6)
<b>Equity - June 30, 2016</b>	\$	53,565 \$	148,071 \$	(157,298) \$	(28,604) \$	15,733 \$	156 \$	15,889

\* Reflects the adoption of the FASB guidance on intra-entity transfers of assets in the first-quarter 2017.

(Amounts may not add due to rounding.)

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

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**Notes to Consolidated Financial Statements:**

**1. Basis of Presentation:** The accompanying Consolidated Financial Statements and footnotes 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. Refer to the company's 2016 Annual Report on pages 71 to 74, for a discussion of the company's critical accounting estimates.

The company revised the classification of certain financing receivables for the three and six months ended June 30, 2016, decreasing net cash provided by operating activities and net cash used in investing activities in the amount of \$70 million and \$212 million, respectively, which the company concluded to be immaterial to the periods presented. The twelve-month revision for the period ended December 31, 2016 was provided in the company's 2016 Annual Report on page 26. There was no impact to total GAAP cash flows or free cash flow.

In the first quarter of 2017, the company reported a benefit from income taxes of \$329 million, and its effective tax rate was (23.1) percent. This was primarily driven by a discrete tax benefit of \$582 million from a first-quarter 2017 transaction accounted for under the new Financial Accounting Standards Board (FASB) guidance related to intra-entity transfers of assets. This benefit was partially offset by a discrete tax charge related to foreign audit activity of \$99 million. The company had additional discrete tax benefits of \$170 million in second-quarter 2017. For the six months ended June 30, 2017, the company reported a benefit from income taxes of \$218 million and its effective tax rate was (5.6) percent. The negative effective tax rate in the comparable period of 2016 was due to the resolution of a long-standing Japan tax matter in February 2016. Refer to note 2, Accounting Changes, and the Taxes section of the Management Discussion for additional information.

Noncontrolling interest amounts of \$3.5 million and \$3.0 million, net of tax, for the three months ended June 30, 2017 and 2016, respectively, and \$7.1 million and \$4.4 million, net of tax, for the six months ended June 30, 2017 and 2016, respectively, are included as a reduction within other (income) and expense in the Consolidated Statement of Earnings.

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 2016 Annual Report.

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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:**

#### **New Standards to be Implemented**

In March 2017, the FASB issued guidance that impacts the presentation of net periodic pension and postretirement benefit costs. Under the guidance, the service cost component of net benefit cost will continue to be presented in the same line items as other employee compensation costs, unless eligible for capitalization in the Consolidated Statement of Financial Position. The other components of net benefit costs will be presented separately from service cost as non-operating costs in the Consolidated Statement of Earnings or Notes to the Consolidated Financial Statements. The guidance is effective January 1, 2018 with early adoption permitted. The company will adopt the guidance as of the effective date. The guidance is primarily a change in financial statement presentation and is not expected to have a material impact in the consolidated financial results.

In June 2016, the FASB issued guidance for credit impairment based on an expected loss model rather than an incurred loss model. The guidance requires the consideration of all available relevant information when estimating expected credit losses, including past events, current conditions and forecasts and their implications for expected credit losses. The guidance

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

is effective January 1, 2020 with a one year early adoption permitted. The company is evaluating the impact of the new guidance.

In February 2016, the FASB issued guidance which changes the accounting for leases. The guidance requires lessees to recognize right-of-use assets and lease liabilities for most leases in the Consolidated Statement of Financial Position. The guidance makes some changes to lessor accounting, including the elimination of the use of third-party residual value guarantee insurance in the capital lease test, and overall aligns with the new revenue recognition guidance. The guidance also requires qualitative and quantitative disclosures to assess the amount, timing and uncertainty of cash flows arising from leases. The guidance is effective January 1, 2019 and early adoption is permitted. The company will adopt the guidance as of the effective date. A cross-functional implementation team has been established which is evaluating the lease portfolio, system, process and policy change requirements. The company is currently evaluating the impact of the new guidance on its consolidated financial results and expects it will have a material impact on the Consolidated Statement of Financial Position. The company's operating lease commitments were \$6.9 billion at December 31, 2016. In 2016, the use of third-party residual value guarantee insurance resulted in the company recognizing \$220 million of sales-type lease revenue that would otherwise have been recognized over the lease period as operating lease revenue.

In January 2016, the FASB issued guidance which addresses aspects of recognition, measurement, presentation and disclosure of financial instruments. Certain equity investments will be measured at fair value with changes recognized in net income. The amendment also simplifies the impairment test of equity investments that lack readily determinable fair value. The guidance is effective January 1, 2018 and early adoption is not permitted except for limited provisions. The guidance is not expected to have a material impact in the consolidated financial results.

The FASB issued guidance on the recognition of revenue from contracts with customers in May 2014 with amendments in 2015 and 2016. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the cumulative catch-up transition method). The company will adopt the guidance on January 1, 2018 and apply the cumulative catch-up transition method. The transition adjustment to be recorded to stockholders' equity upon adoption of the new standard is not expected to be material.

Given the scope of work required to implement the recognition and disclosure requirements under the new standard, the company began its assessment process in 2014 and has since made significant progress, including identification of changes to policy, processes, systems and controls. This also includes the assessment of data availability and presentation necessary to meet the additional disclosure requirements of the guidance in the Notes to the Consolidated Financial Statements.

The company expects revenue recognition for its broad portfolio of hardware, software and services offerings to remain largely unchanged. However, the guidance is expected to change the timing of revenue recognition in certain areas, including accounting for certain software licenses. These impacts are not expected to be material. The company expects to continue to recognize revenue for term license (recurring license charge) software arrangements on a monthly basis over the period that the client is entitled to use the license due to the contractual terms in these arrangements.



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Since the company currently expenses sales commissions as incurred, the requirement in the new standard to capitalize certain in-scope sales commissions will result in an accounting change for the company. However, the impact to the consolidated financial statements is not expected to be material, with no impact to cash flows.

The company continues to assess all potential impacts of the guidance and given normal ongoing business dynamics, preliminary conclusions are subject to change.

### **Standards Implemented**

In January 2017, the FASB issued guidance which clarifies the definition of a business. The guidance provides a more robust framework to use in determining when a set of assets and activities acquired or sold is a business. The guidance is effective January 1, 2018 and early adoption is permitted. The company adopted the guidance effective January 1, 2017, and it did not have a material impact in the consolidated financial results.

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

In October 2016, the FASB issued guidance which requires an entity to recognize the income tax consequences of intra-entity transfers of assets, other than inventory, at the time of transfer. Assets within the scope of the guidance include intellectual property and property, plant and equipment. The guidance is effective January 1, 2018 and early adoption is permitted. The company adopted the guidance on January 1, 2017 using the required modified retrospective method. At adoption, \$95 million and \$47 million were reclassified from investments and sundry assets and prepaid expenses and other current assets, respectively into retained earnings. Additionally, net deferred taxes of \$244 million were established in deferred taxes in the Consolidated Statement of Financial Position, resulting in a cumulative-effect net credit to retained earnings of \$102 million. In January 2017, the company had one transaction that generated a \$582 million benefit to income tax expense, income from continuing operations and net income and a benefit to both basic and diluted earnings per share of \$0.62 per share for the six months ended June 30, 2017. There was no impact in the consolidated financial results for the three months ended June 30, 2017. The ongoing impact of this guidance will be dependent on any transaction that is within its scope.

In March 2016, the FASB issued guidance which changes the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification in the Consolidated Statement of Cash Flows. The guidance was effective and adopted by the company on January 1, 2017, and it did not have a material impact in the Consolidated Statement of Financial Position. The ongoing impact of the guidance could result in increased volatility in the provision for income taxes and earnings per share in the Consolidated Statement of Earnings, depending on the company's share price at exercise or vesting of share-based awards compared to grant date, however these impacts are not expected to be material. These impacts are recorded on a prospective basis. See note 5, Stock-Based Compensation, for additional information. The company continues to estimate forfeitures in conjunction with measuring stock-based compensation cost. The guidance also requires cash payments on behalf of employees for shares directly withheld for taxes to be presented as financing outflows in the Consolidated Statement of Cash Flows. Prior to adoption, the company reported this activity as an operating cash outflow and as a result, prior periods have been reclassified as required. The FASB also issued guidance in May 2017, which relates to the accounting for modifications of share-based payment awards. The company adopted the guidance in the second quarter of 2017. The guidance had no impact in the consolidated financial results.

In September 2015, the FASB issued guidance eliminating the requirement that an acquirer in a business combination account for a measurement-period adjustment retrospectively. Instead, an acquirer will recognize a measurement-period adjustment during the period in which the amount of the adjustment is determined. In addition, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date should be presented separately on the face of the income statement or disclosed in the notes. The guidance was effective January 1, 2016 on a prospective basis. The guidance did not have a material impact in the consolidated financial results.

In May 2015, the FASB issued guidance which removed the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also removed the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The guidance was effective January 1, 2016. The guidance was a change in disclosure only and did not have an impact in the consolidated financial results.

In April 2015, the FASB issued guidance about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a services contract. All software licenses recognized under this guidance will be accounted for consistent with other licenses of intangible assets. The guidance was effective January 1, 2016 and the company adopted it on a prospective basis. The guidance did not have a

material impact in the consolidated financial results.

**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:

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

- 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 as 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. During the six months ended June 30, 2016, a pre-tax impairment charge related to certain property, plant and equipment of \$252 million was recorded. There were no material impairments of non-financial assets for the six months ended June 30, 2017.

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 June 30, 2017 and December 31, 2016.

Table of Contents**Notes to Consolidated Financial Statements (continued)****(Dollars in millions)****At June 30, 2017**

	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Cash equivalents (1)				
Time deposits and certificates of deposit	\$	\$ 7,285	\$	\$ 7,285
Money market funds	1,368			1,368
Canadian government securities		231		231
Total	1,368	7,516		8,884(6)
Debt securities - current (2)		599		599(6)
Debt securities - noncurrent (3)	4	6		10
Available-for-sale equity investments (3)	6			6
Derivative assets (4)				
Interest rate contracts		557		557
Foreign exchange contracts		297		297
Equity contracts		2		2
Total		856		856(7)
<b>Total assets</b>	<b>\$ 1,378</b>	<b>\$ 8,977</b>	<b>\$</b>	<b>\$ 10,355(7)</b>
<b>Liabilities:</b>				
Derivative liabilities (5)				
Foreign exchange contracts	\$	\$ 294	\$	\$ 294
Equity contracts		7		7
Interest rate contracts		3		3
<b>Total liabilities</b>	<b>\$</b>	<b>\$ 304</b>	<b>\$</b>	<b>\$ 304(7)</b>

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

(2) U.S. government securities 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 June 30, 2017 were \$207 million and \$649 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 June 30, 2017 were \$298 million and \$6 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 each would have been reduced by \$221 million.

Table of Contents**Notes to Consolidated Financial Statements (continued)****(Dollars in millions)****At December 31, 2016**

	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Cash equivalents (1)				
Time deposits and certificates of deposit	\$	\$ 3,629	\$	\$ 3,629
Money market funds	1,204			1,204
<b>Total</b>	<b>1,204</b>	<b>3,629</b>		<b>4,832(6)</b>
Debt securities - current (2)		699		699(6)
Debt securities - noncurrent (3)	1	6		8
Available-for-sale equity investments (3)	7			7
<b>Derivative assets (4)</b>				
Interest rate contracts		555		555
Foreign exchange contracts		560		560
Equity contracts		11		11
<b>Total</b>		<b>1,126</b>		<b>1,126(7)</b>
<b>Total assets</b>	<b>\$ 1,212</b>	<b>\$ 5,460</b>	<b>\$</b>	<b>\$ 6,672(7)</b>
<b>Liabilities:</b>				
<b>Derivative liabilities (5)</b>				
Foreign exchange contracts	\$	\$ 188	\$	\$ 188
Equity contracts		10		10
Interest rate contracts		8		8
<b>Total liabilities</b>	<b>\$</b>	<b>\$ 206</b>	<b>\$</b>	<b>\$ 206(7)</b>

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

(2) U.S government securities 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, 2016 were \$532 million and \$594 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, 2016 were \$145 million and \$61 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 each would have been reduced by \$116 million.

There were no transfers between Levels 1 and 2 for the six months ended June 30, 2017 and the year ended December 31, 2016.

**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, except for short-term debt, which would be classified as Level 2.

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 June 30, 2017 and December 31, 2016, 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.



Table of Contents**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 \$37,612 million and \$34,655 million, and the estimated fair value was \$39,756 million and \$36,838 million at June 30, 2017 and December 31, 2016, 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.

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

(Dollars in millions) At June 30, 2017:	Adjusted Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Debt securities noncurrent(1)	\$ 7	\$	3	\$	\$	\$	10
Available-for-sale equity investments(1)	\$ 1	\$	5	\$	0	\$	6

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

(Dollars in millions) At December 31, 2016:	Adjusted Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Debt securities noncurrent(1)	\$ 5	\$	3	\$	\$	\$	8
Available-for-sale equity investments(1)	\$ 3	\$	5	\$	0	\$	7

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

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

(Dollars in millions)

For the three months ended June 30:

	2017		2016	
Proceeds	\$	0	\$	1
Gross realized gains (before taxes)		0		0
Gross realized losses (before taxes)				0

(Dollars in millions)

For the six months ended June 30:

	2017		2016	
Proceeds	\$	5	\$	149
Gross realized gains (before taxes)		1		0
Gross realized losses (before taxes)		2		37

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

Table of Contents**Notes to Consolidated Financial Statements (continued)****(Dollars in millions)****For the three months ended June 30:**

	2017		2016
Net unrealized gains/(losses) arising during the period	\$ 2	\$	1
Net unrealized (gains)/losses reclassified to net income*	0		0

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\*There were no writedowns for the three months ended June 30, 2017 and 2016, respectively.

**(Dollars in millions)****For the six months ended June 30:**

	2017		2016
Net unrealized gains/(losses) arising during the period	\$ 2	\$	(22)
Net unrealized (gains)/losses reclassified to net income*	1		23

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\* There were no writedowns for the six months ended June 30, 2017 and 2016, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at June 30, 2017.

**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.

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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 June 30, 2017 and December 31, 2016 was \$53 million and \$11 million, respectively, for which no collateral was posted at either date. 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 asset positions as of June 30, 2017 and December 31, 2016 was \$856 million and \$1,126 million, respectively. This amount represents the maximum exposure to loss at the reporting date if the counterparties failed to perform as contracted. This exposure was reduced by \$221 million and \$116 million at June 30, 2017 and December 31, 2016, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at June 30, 2017 and December 31, 2016, this exposure was reduced by \$117 million and \$141 million of cash collateral, respectively, and \$35 million of non-cash collateral in U.S. Treasury securities at December 31, 2016. There were no non-cash collateral balances in U.S. Treasury securities at June 30, 2017. At June 30, 2017 and December 31, 2016, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was \$518 million and \$834 million, respectively. At June 30, 2017 and December 31, 2016, the net position related to derivative liabilities recorded in the Consolidated Statement of Financial Position was \$82 million and \$90 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 June 30, 2017 or December 31, 2016 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation

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

to return cash collateral was \$117 million and \$141 million at June 30, 2017 and December 31, 2016, 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 June 30, 2017 and December 31, 2016.

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, cross-currency swaps, and options depending upon the underlying exposure. The company is not a party to leveraged derivative instruments.

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

**Interest Rate Risk**

**Fixed and Variable Rate Borrowings**

The company issues debt in the global capital markets to fund its operations and financing business. 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 June 30, 2017 and December 31, 2016, the total notional amount of the company's interest rate swaps was \$7.3 billion at both periods. The weighted-average remaining maturity of these instruments at June 30, 2017 and December 31, 2016 was approximately 5.7 years and 6.2 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 June 30, 2017 and December 31, 2016.

At June 30, 2017 and December 31, 2016, net gains of less than \$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, less than \$1 million of gains, 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 June 30, 2017 and December 31, 2016, the total notional amount of derivative instruments designated as net investment hedges was \$6.9 billion and \$6.7 billion, respectively. At June 30, 2017 and December 31, 2016, the weighted-average remaining maturity of these instruments was approximately 0.2 years at 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 company. In

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

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 has hedged its exposure to the variability in future cash flows is four years. At June 30, 2017 and December 31, 2016, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$8.0 billion and \$8.3 billion, respectively. The weighted-average remaining maturity of these instruments at June 30, 2017 and December 31, 2016 was 0.7 years at both periods.

At June 30, 2017 and December 31, 2016, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net gains of \$82 million and \$462 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$17 million of losses and \$397 million of gains, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

**Foreign Currency Denominated Borrowings**

The company is exposed to exchange rate volatility on foreign currency denominated debt. To manage this risk, the company employs cross-currency swaps to convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. The maximum length of time over which the company has hedged its exposure to the variability in future cash flows is approximately nine years. At June 30, 2017 and December 31, 2016, the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was \$1.4 billion at both periods.

At June 30, 2017 and December 31, 2016, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net gains of \$7 million and net gains of \$29 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$30 million of gains and \$27 million of gains, respectively, are 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 June 30, 2017 and December 31, 2016, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$8.9 billion and \$12.7 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 June 30, 2017 and December 31, 2016, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.2 billion at both periods.

**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 June 30, 2017 and December 31, 2016.



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

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 June 30, 2017 and December 31, 2016.

The company is exposed to market volatility on certain investment securities. The company may utilize options or forwards to economically hedge its market exposure. The derivatives are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. At June 30, 2017 and December 31, 2016, the company did not have any derivative instruments relating to this program outstanding.

The following tables provide a quantitative summary of the derivative and non-derivative instrument-related risk management activity as of June 30, 2017 and December 31, 2016, as well as for the three and six months ended June 30, 2017 and 2016, respectively.

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## Notes to Consolidated Financial Statements (continued)

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

As of June 30, 2017 and December 31, 2016

(Dollars in millions)	Fair Value of Derivative Assets			Fair Value of Derivative Liabilities		
	Balance Sheet Classification	6/30/2017	12/31/2016	Balance Sheet Classification	6/30/2017	12/31/2016
<b>Designated as hedging instruments:</b>						
Interest rate contracts:						
	Prepaid expenses and other current assets	\$ 2	\$	Other accrued expenses and liabilities	\$	\$
	Investments and sundry assets	555	555	Other liabilities	3	8
Foreign exchange contracts:						
	Prepaid expenses and other current assets	155	421	Other accrued expenses and liabilities	257	46
	Investments and sundry assets	94	17	Other liabilities	3	35
	<b>Fair value of derivative assets</b>	<b>\$ 805</b>	<b>\$ 993</b>	<b>Fair value of derivative liabilities</b>	<b>\$ 263</b>	<b>\$ 89</b>
<b>Not designated as hedging instruments:</b>						
Foreign exchange contracts:						
	Prepaid expenses and other current assets	\$ 48	\$ 100	Other accrued expenses and liabilities	\$ 34	\$ 89
	Investments and sundry assets		22	Other liabilities		18
Equity contracts:						
	Prepaid expenses and other current assets	2	11	Other accrued expenses and liabilities	7	10
	Investments and sundry assets			Other liabilities		
	<b>Fair value of derivative assets</b>	<b>\$ 51</b>	<b>\$ 133</b>	<b>Fair value of derivative liabilities</b>	<b>\$ 41</b>	<b>\$ 117</b>
Total Derivatives		\$ 856	\$ 1,126		\$ 304	\$ 206
<b>Total debt designated as hedging instruments:</b>						
Short-term debt		N/A	N/A		\$ 378	\$ 1,125
Long-term debt		N/A	N/A		10,683	7,844
		N/A	N/A		\$ 11,061	\$ 8,969
Total		\$ 856	\$ 1,126		\$ 11,365	\$ 9,175

N/A - not applicable



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## Notes to Consolidated Financial Statements (continued)

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

For the three months ended June 30, 2017 and 2016

(Dollars in millions) For the three months ended June 30:	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings Recognized on Derivatives		Attributable to Risk Being Hedged(2)	
		2017	2016	2017	2016
<b>Derivative instruments in fair value hedges (1) (5):</b>					
Interest rate contracts	Cost of financing	\$ 42	\$ 77	\$ (22)	\$ (55)
	Interest expense	36	88	(19)	(63)
<b>Derivative instruments not designated as hedging instruments:</b>					
Foreign exchange contracts	Other (income) and expense	185	184	N/A	N/A
Interest rate contracts	Other (income) and expense		0	N/A	N/A
Equity contracts	SG&A expense	11	21	N/A	N/A
	Other (income) and expense		0	N/A	N/A
<b>Total</b>		<b>\$ 275</b>	<b>\$ 370</b>	<b>\$ (41)</b>	<b>\$ (118)</b>

## Gain (Loss) Recognized in Earnings and Other Comprehensive Income

(Dollars in millions) For the three months ended June 30:	Effective Portion Recognized in OCI		Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI		Ineffectiveness and Amounts Excluded from Effectiveness Testing(3)	
	2017	2016		2017	2016	2017	2016
<b>Derivative instruments in cash flow hedges:</b>							
Interest rate contracts	\$	\$	Interest expense	\$ (7)	\$ (7)	\$	\$
Foreign exchange contracts	(96)	9	Other (income) and expense	146	(75)	2	(1)
			Cost of sales*	10	(8)		
			Cost of services*	18	(5)		
			SG&A expense	8	(7)		
<b>Instruments in net investment hedges(4):</b>							
Foreign exchange contracts	(724)	(247)	Interest expense			7	16
<b>Total</b>	<b>\$ (820)</b>	<b>\$ (238)</b>		<b>\$ 176</b>	<b>\$ (102)</b>	<b>\$ 9</b>	<b>\$ 15</b>

\* Reclassified to conform to 2017 presentation

N/A - not applicable

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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.
- (5) For the three month periods ended June 30, 2017 and 2016, fair value hedges resulted in a loss of less than \$1 million and a gain of \$1 million in ineffectiveness, respectively.

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## Notes to Consolidated Financial Statements (continued)

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

For the six months ended June 30, 2017 and 2016

(Dollars in millions) For the six months ended June 30:	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings Recognized on Derivatives		Attributable to Risk Being Hedged(2)	
		2017	2016	2017	2016
<b>Derivative instruments in fair value hedges(1)(5):</b>					
Interest rate contracts	Cost of financing	\$ 41	\$ 213	\$ 1	\$ (166)
	Interest expense	35	236	1	(184)
<b>Derivative instruments not designated as hedging instruments:</b>					
Foreign exchange contracts	Other (income) and expense	108	305	N/A	N/A
Interest rate contracts	Other (income) and expense		0	N/A	N/A
Equity contracts	SG&A expense	58	43	N/A	N/A
	Other (income) and expense		(1)	N/A	N/A
<b>Total</b>		<b>\$ 243</b>	<b>\$ 796</b>	<b>\$ 1</b>	<b>\$ (350)</b>

## Gain (Loss) Recognized in Earnings and Other Comprehensive Income

(Dollars in millions) For the six months ended June 30:	Effective Portion Recognized in OCI		Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI		Ineffectiveness and Amounts Excluded from Effectiveness Testing(3)	
	2017	2016		2017	2016	2017	2016
<b>Derivative instruments in cash flow hedges:</b>							
Interest rate contracts	\$	\$	Interest expense	\$ (14)	\$ (9)	\$	\$
Foreign exchange contracts	(128)	(256)	Other (income) and expense	211	12	3	0
			Cost of sales*	22	1		
			Cost of services*	27	(11)		
			SG&A expense	29	(3)		
<b>Instruments in net investment hedges(4):</b>							
Foreign exchange contracts	(1,006)	(940)	Interest expense			27	26
<b>Total</b>	<b>\$ (1,134)</b>	<b>\$ (1,197)</b>		<b>\$ 274</b>	<b>\$ (11)</b>	<b>\$ 29</b>	<b>\$ 26</b>

\* Reclassified to conform to 2017 presentation.

N/A-not applicable

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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.
- (5) For the six month periods ended June 30, 2017 and 2016, fair value hedges resulted in a loss of less than \$1 million and a gain of \$3 million in ineffectiveness, respectively.

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

For the three and six months ending June 30, 2017 and 2016, there were no significant gains or losses 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.

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

(Dollars in millions)	At June 30, 2017	At December 31, 2016
<b>Current:</b>		
Net investment in sales-type and direct financing leases	\$ 2,846	\$ 2,909
Commercial financing receivables	8,178	9,706
Client loan and installment payment receivables (loans)	6,539	6,390
<b>Total</b>	<b>\$ 17,563</b>	<b>\$ 19,006</b>
<b>Noncurrent:</b>		
Net investment in sales-type and direct financing leases	\$ 3,627	\$ 3,950
Client loan and installment payment receivables (loans)	4,669	5,071
<b>Total</b>	<b>\$ 8,296</b>	<b>\$ 9,021</b>

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 \$570 million and \$585 million at June 30, 2017 and December 31, 2016, respectively, and is reflected net of unearned income of \$475 million and \$513 million, and net of allowance for credit losses of \$121 million and \$133 million at those dates, respectively.

Commercial financing receivables, net of allowance for credit losses of \$26 million and \$28 million at June 30, 2017 and December 31, 2016, 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 and installment payment receivables (loans), net of allowance for credit losses of \$246 million and \$276 million at June 30, 2017 and December 31, 2016, respectively, are loans that are provided primarily to clients to finance the purchase of hardware, software and services. Payment terms on these financing arrangements are generally for terms up to seven years.

Client loan and installment payment financing contracts are priced independently at competitive market rates. The company has a history of enforcing the terms of these financing agreements.



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The company utilizes certain of its financing receivables as collateral for nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were \$737 million and \$689 million at June 30, 2017 and December 31, 2016, respectively.

The company did not have any financing receivables held for sale as of June 30, 2017 and December 31, 2016.

### **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 commercial financing receivables and other miscellaneous financing receivables at June 30, 2017 and December 31, 2016. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further segments the portfolio into three classes: Americas, Europe/Middle East/Africa (EMEA), and Asia Pacific. This portfolio segmentation was changed from growth markets and major markets in 2017 as the company no longer manages the business under those market delineations. There was no impact to segment reporting or the company's Consolidated Financial Statements.

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

<b>At June 30, 2017</b>	<b>Americas</b>	<b>EMEA</b>	<b>Asia Pacific</b>	<b>Total</b>
<b>Financing receivables</b>				
Lease receivables	\$ 3,442	\$ 1,202	\$ 1,302	\$ 5,946
Loan receivables	6,014	3,101	2,340	11,455
Ending balance	\$ 9,456	\$ 4,303	\$ 3,642	\$ 17,401
Collectively evaluated for impairment	\$ 9,284	\$ 4,272	\$ 3,541	\$ 17,097
Individually evaluated for impairment	\$ 173	\$ 31	\$ 100	\$ 304
<b>Allowance for credit losses</b>				
Beginning balance at January 1, 2017				
Lease receivables	\$ 54	\$ 4	\$ 76	\$ 133
Loan receivables	169	18	89	276
Total	\$ 223	\$ 22	\$ 165	\$ 410
Write-offs	\$ (11)	\$ 0	\$ (59)	\$ (70)
Recoveries	0	0	0	0
Provision	13	9	(4)	17
Other	(1)	4	7	10
Ending balance at June 30, 2017	\$ 224	\$ 35	\$ 109	\$ 368
Lease receivables	\$ 69	\$ 4	\$ 48	\$ 121
Loan receivables	\$ 154	\$ 31	\$ 61	\$ 246
Collectively evaluated for impairment	\$ 62	\$ 14	\$ 15	\$ 91
Individually evaluated for impairment	\$ 162	\$ 21	\$ 94	\$ 277

**(Dollars in millions)**

<b>At December 31, 2016:*</b>	<b>Americas</b>	<b>EMEA</b>	<b>Asia Pacific</b>	<b>Total</b>
<b>Financing receivables:</b>				
Lease receivables	\$ 3,830	\$ 1,171	\$ 1,335	\$ 6,336
Loan receivables	6,185	3,309	2,243	11,737
Ending balance	\$ 10,015	\$ 4,480	\$	\$