

INTERNATIONAL BUSINESS MACHINES CORP

Form 10-Q

October 28, 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 SEPTEMBER 30, 2014

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)

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 989,660,472 shares of common stock outstanding at September 30, 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 September 30,		Nine Months Ended September 30,	
(Dollars in millions except per share amounts)	2014	2013*	2014	2013*
Revenue:				
Services	\$ 13,869	\$ 14,225	\$ 41,979	\$ 42,811
Sales	8,034	8,604	25,180	26,665
Financing	494	509	1,521	1,506
Total revenue	22,397	23,338	68,680	70,982
Cost:				
Services	8,868	9,098	27,100	27,950
Sales	2,398	2,542	7,269	7,881
Financing	257	268	765	805
Total cost	11,523	11,908	35,135	36,635
Gross profit	10,874	11,429	33,545	34,347
Expense and other (income):				
Selling, general and administrative	5,281	5,260	17,146	17,463
Research, development and engineering	1,354	1,356	4,117	4,291
Intellectual property and custom development income	(145)	(191)	(543)	(621)
Other (income) and expense	(103)	(63)	(433)	(217)
Interest expense	126	97	367	289
Total expense and other (income)	6,513	6,458	20,654	21,205
Income from continuing operations before income taxes	4,361	4,972	12,891	13,142
Provision for income taxes	906	832	2,655	2,478
Income from continuing operations	\$ 3,455	\$ 4,139	\$ 10,237	\$ 10,665
Discontinued operations:				
Loss from discontinued operations, net of tax	(3,437)	(98)	(3,698)	(366)
Net income	\$ 18	\$ 4,041	\$ 6,539	\$ 10,299
Earnings/(loss) per share of common stock:				
Assuming dilution:				
Continuing operations	\$ 3.46	\$ 3.77	\$ 10.09	\$ 9.60

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	Discontinued operations	(3.44)	(0.09)	(3.65)	(0.33)
Total Basic:		\$ 0.02	\$ 3.68	\$ 6.44	\$ 9.27
	Continuing operations	\$ 3.48	\$ 3.79	\$ 10.15	\$ 9.68
	Discontinued operations	(3.46)	(0.09)	(3.67)	(0.33)
Total		\$ 0.02	\$ 3.70	\$ 6.48	\$ 9.35
Weighted-average number of common shares outstanding: (millions)					
	Assuming dilution	997.7	1,098.8	1,014.9	1,110.7
	Basic	991.8	1,090.9	1,008.9	1,101.8
Cash dividend per common share		\$ 1.10	\$ 0.95	\$ 3.15	\$ 2.75

* Reclassified to reflect discontinued operations presentation. See note 1 on page 9 for additional information.

(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)**

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$ 18	\$ 4,041	\$ 6,539	\$ 10,299
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	(1,126)	382	(848)	(959)
Net changes related to available-for-sale securities:				
Unrealized gains/(losses) arising during the period	0	3	1	0
Reclassification of (gains)/losses to net income	0	(5)	5	(5)
Subsequent changes in previously impaired securities arising during the period	—	1	—	3
Total net changes related to available-for-sale securities	0	(1)	6	(1)
Unrealized gains/(losses) on cash flow hedges:				
Unrealized gains/(losses) arising during the period	524	(409)	596	(58)
Reclassification of (gains)/losses to net income	58	(27)	91	(130)
Total unrealized gains/(losses) on cash flow hedges	582	(436)	687	(188)
Retirement-related benefit plans:				
Prior service costs/(credits)	0	0	1	33
Net (losses)/gains arising during the period	1	105	48	300
Curtailments and settlements	7	0	20	0
Amortization of prior service (credits)/costs	(29)	(28)	(88)	(86)
Amortization of net (gains)/losses	635	872	1,923	2,623
Total retirement-related benefit plans	615	949	1,905	2,869
Other comprehensive income/(loss), before tax	71	895	1,749	1,721
Income tax (expense)/benefit related to items of other comprehensive income	(680)	(91)	(1,126)	(933)
Other comprehensive income/(loss)	(609)	804	623	788
Total comprehensive income/(loss)	\$ (591)	\$ 4,844	\$ 7,162	\$ 11,087

(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

(Dollars in millions)	At September 30, 2014	At December 31, 2013
Assets:		
Current assets:		
Cash and cash equivalents	\$ 9,561	\$ 10,716
Marketable securities	4	350
Notes and accounts receivable - trade (net of allowances of \$316		
in 2014 and \$291 in 2013)	9,122	10,465
Short-term financing receivables (net of allowances of \$432 in 2014		
and \$308 in 2013)	17,411	19,787
Other accounts receivable (net of allowances of \$46 in 2014 and		
\$36 in 2013)	1,469	1,584
Inventories, at lower of average cost or market:		
Finished goods	508	444
Work in process and raw materials	1,848	1,866
Total inventories	2,356	2,310
Deferred taxes	2,219	1,651
Prepaid expenses and other current assets	5,022	4,488
Total current assets	47,163	51,350
Property, plant and equipment	39,950	40,475
Less: Accumulated depreciation	28,882	26,654
Property, plant and equipment — net	11,068	13,821
Long-term financing receivables (net of allowances of \$87 in 2014 and \$80 in 2013)	10,993	12,755
Prepaid pension assets	7,443	5,551
Deferred taxes	2,697	3,051
Goodwill	31,045	31,184
Intangible assets — net	3,373	3,871
Investments and sundry assets	5,126	4,639
Total assets	\$ 118,911	\$ 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 September 30, 2014	At December 31, 2013
Liabilities:		
Current liabilities:		
Taxes	\$ 2,475	\$ 4,633
Short-term debt	12,876	6,862
Accounts payable	5,855	7,461
Compensation and benefits	3,965	3,893
Deferred income	11,346	12,557
Other accrued expenses and liabilities	5,788	4,748
Total current liabilities	42,306	40,154
Long-term debt	32,821	32,856
Retirement and nonpension postretirement benefit obligations	15,093	16,242
Deferred income	3,683	4,108
Other liabilities	10,613	9,934
Total liabilities	104,515	103,294
Equity:		
IBM stockholders' equity:		
Common stock, par value \$0.20 per share, and additional paid-in capital	52,446	51,594
Shares authorized: 4,687,500,000		
Shares issued: 2014 - 2,213,876,635		
2013 - 2,207,522,548		
Retained earnings	133,403	130,042
Treasury stock - at cost	(150,616)	(137,242)
Shares: 2014 - 1,224,216,164		
2013 - 1,153,131,611		
Accumulated other comprehensive income/(loss)	(20,978)	(21,602)
Total IBM stockholders' equity	14,255	22,792
Noncontrolling interests	140	137
Total equity	14,395	22,929
Total liabilities and equity	\$ 118,911	\$ 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)**

(Dollars in millions)	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	\$ 6,539	\$ 10,299
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation	2,428	2,457
Amortization of intangibles	1,018	1,007
Stock-based compensation	416	455
Net (gain)/loss on asset sales and other	(262)	(139)
Loss on microelectronics business disposal	3,346	—
Changes in operating assets and liabilities, net of acquisitions/divestitures	(2,675)	(3,121)
Net cash provided by operating activities	10,809	10,957
Cash flows from investing activities:		
Payments for property, plant and equipment	(2,793)	(2,559)
Proceeds from disposition of property, plant and equipment	325	256
Investment in software	(336)	(406)
Acquisition of businesses, net of cash acquired	(650)	(2,562)
Divestitures of businesses, net of cash transferred	489	247
Non-operating finance receivables — net	948	284
Purchases of marketable securities and other investments	(1,513)	(3,718)
Proceeds from disposition of marketable securities and other investments	1,765	4,035
Net cash used in investing activities	(1,765)	(4,423)
Cash flows from financing activities:		
Proceeds from new debt	5,642	10,066
Payments to settle debt	(3,108)	(7,740)
Short-term borrowings/(repayments) less than 90 days — net	3,888	1,074
Common stock repurchases	(13,547)	(8,062)
Common stock transactions — other	549	826
Cash dividends paid	(3,176)	(3,033)
Net cash used in financing activities	(9,753)	(6,870)
Effect of exchange rate changes on cash and cash equivalents	(447)	(4)
Net change in cash and cash equivalents	(1,155)	(340)
Cash and cash equivalents at January 1	10,716	10,412
Cash and cash equivalents at September 30	\$ 9,561	\$ 10,072

(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 Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholder Equity	Non- Controlling Interests	Total Equity
(Dollars in millions)							
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		6,539			6,539		6,539
Other comprehensive income/(loss)				623	623		623
Total comprehensive income/(loss)					\$ 7,162		\$ 7,162
Cash dividends paid – common stock		(3,176)			(3,176)		(3,176)
Common stock issued under employee plans (6,354,088 shares)	792				792		792
Purchases (1,124,077 shares) and sales (894,291 shares) of treasury stock under employee plans – net		(1)	(95)		(96)		(96)
Other treasury shares purchased, not retired (70,854,767 shares)			(13,280)		(13,280)		(13,280)
Changes in other equity	60				60		60
Changes in noncontrolling interests						3	3
Equity - September 30, 2014	\$ 52,446	\$ 133,403	\$ (150,616)	\$ (20,978)	\$ 14,255	\$ 140	\$ 14,395

	Common Stock and Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholder Equity	Non- Controlling Interests	Total Equity
(Dollars in millions)							
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		10,299			10,299		10,299
Other comprehensive income/(loss)				788	788		788
Total comprehensive income/(loss)					\$ 11,087		\$ 11,087
Cash dividends paid – common stock		(3,033)			(3,033)		(3,033)
Common stock issued under							

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employee plans (8,258,027 shares)	930				930			930
Purchases (1,419,498 shares) and sales (1,574,179 shares) of treasury stock under employee plans – net		(22)	(106)		(127)			(127)
Other treasury shares purchased, not retired (39,926,001 shares)			(8,003)		(8,003)			(8,003)
Changes in other equity	164				164			164
Changes in noncontrolling interests						7		7
Equity - September 30, 2013	\$ 51,203	\$ 124,885	\$ (131,240)	\$ (24,971)	\$ 19,877	\$ 131	\$ 20,008	

(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. Refer to the company's 2013 Annual Report on pages 67 to 70 for a discussion of the company's critical accounting estimates.

On October 20, 2014, the company announced a definitive agreement to divest its Microelectronics business and manufacturing operations to GLOBALFOUNDRIES. The Microelectronics business was part of the Systems and Technology reportable segment. In the third quarter of 2014, the company recorded a pre-tax charge reflecting the fair value less estimated costs to sell the Microelectronics business, which included an impairment of the semiconductor-related long-lived assets, cash consideration and related disposal costs. The assets and liabilities of the Microelectronics business are reported as held for sale at September 30, 2014. The operating results of the Microelectronics business, including the noted charge, have been reported as discontinued operations. Prior periods have been reclassified to conform to this presentation to allow for a meaningful comparison of continuing operations. Refer to Note 9, "Acquisitions/Divestitures," for additional information on the transaction.

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 \$2.4 million and \$1.8 million, net of tax, for the three months ended September 30, 2014 and 2013, respectively, and \$4.2 million and \$4.2 million, net of tax, for the nine months ended September 30, 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 May 2014, the Financial Accounting Standards Board (FASB) issued guidance on the recognition of revenue from contracts with customers. 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 guidance is effective January 1, 2017 and early adoption is not permitted. The company is currently evaluating the impact of the new guidance and the method of adoption in the consolidated financial results.

In April 2014, the FASB issued guidance that changed the criteria for reporting a discontinued operation. 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 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 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 company will adopt the new guidance on January 1, 2015. 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

Notes to Consolidated Financial Statements – (continued)

carryforward, a similar tax loss, or a tax credit carryforward. The guidance was effective January 1, 2014. The guidance was a change in financial statement presentation only and did not have a 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.

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 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.

Notes to Consolidated Financial Statements – (continued)

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. In the third quarter of 2014, the company recorded an impairment on certain assets that were reported as held for sale at September 30, 2014. See note 9, “Acquisitions/Divestitures,” for additional information. There were no material impairments of non-financial assets for the nine months ended September 30, 2013.

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 September 30, 2014 and December 31, 2013.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)

At September 30, 2014

	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	\$ —	\$ 5,518	\$ —	\$ 5,518
Commercial paper	—	382	—	382
Money market funds	1,266	—	—	1,266
U.S. government securities	—	250	—	250
Other securities	—	7	—	7
Total	1,266	6,157	—	7,423(6)
Debt securities - current (2)	—	4	—	4(6)
Debt securities - noncurrent (3)	1	8	—	9
Trading securities investments (3)	61	—	—	61
Available-for-sale equity investments (3)	7	—	—	7
Derivative assets (4)				
Interest rate contracts	—	465	—	465
Foreign exchange contracts	—	684	—	684
Equity contracts	—	4	—	4
Total	—	1,153	—	1,153(7)
Total assets	\$ 1,336	\$ 7,322	\$ —	\$ 8,658(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	\$ —	\$ 287	\$ —	\$ 287
Equity contracts	—	28	—	28
Interest rate contracts	—	7	—	7
Total liabilities	\$ —	\$ 322	\$ —	\$ 322(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 September 30, 2014 were \$638 million and \$515 million respectively.

(5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other

Liabilities in the Consolidated Statement of Financial Position at September 30, 2014 were \$284 million and \$38 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 \$128 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	6,269	—	7,997(6)
Debt securities - current (2)	—	350	—	350(6)
Debt securities - noncurrent (3)	1	7	—	9
Available-for-sale equity investments (3)	18	—	—	18
Derivative assets (4)				
Interest rate contracts	—	308	—	308
Foreign exchange contracts	—	375	—	375
Equity contracts	—	36	—	36
Total	—	719	—	719(7)
Total assets	\$ 1,747	\$ 7,345	\$ —	\$ 9,092(7)
Liabilities:				
Derivative liabilities (5)				
Interest rate contracts	\$ —	\$ 13	\$ —	\$ 13
Foreign exchange contracts	—	484	—	484
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.

During the quarter ended September 30, 2014, the company transferred trading securities investments valued at \$61 million from Level 2 to Level 1 due to the expiration of certain regulatory restrictions. There were no transfers between Levels 1 and 2 for 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 September 30, 2014 and December 31, 2013, the difference

Notes to Consolidated Financial Statements – (continued)

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.

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 \$32,821 million and \$32,856 million, and the estimated fair value was \$35,165 million and \$34,555 million at September 30, 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 first quarter of 2014, the company acquired equity investments in conjunction with the sale of the customer care business which are classified as trading securities. Unrealized losses related to trading securities of \$8 million and unrealized gains of \$8 million for the three months ended September 30, 2014 and nine months ended September 30, 2014, respectively, 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 considered available-for-sale and recorded at fair value in the Consolidated Statement of Financial Position.

(Dollars in millions)	Adjusted	Gross	Gross	Fair
At September 30, 2014:	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
Debt securities – noncurrent(1)	\$ 7	\$ 2	\$ —	\$ 9
Available-for-sale equity investments(1)	\$ 6	\$ 2	\$ 0	\$ 7

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

(Dollars in millions)					
At December 31, 2013:	Adjusted	Gross	Gross		Fair
	Cost	Unrealized	Unrealized		Value
		Gains	Losses		
Debt securities – noncurrent(1)	\$ 7	\$ 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 September 30, 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 September 30:		2014		2013
Proceeds	\$	1	\$	8
Gross realized gains (before taxes)		0		5
Gross realized losses (before taxes)		0		0

Notes to Consolidated Financial Statements – (continued)**(Dollars in millions)****For the nine months ended September 30:**

	2014		2013
Proceeds	\$ 16	\$	28
Gross realized gains (before taxes)	0		9
Gross realized losses (before taxes)	5		4

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:

(Dollars in millions)**For the three months ended September 30:**

	2014		2013
Net unrealized gains/(losses) arising during the period	\$ 0	\$	3
Net unrealized (gains)/losses reclassified to net income*	0		(3)

*There were no writedowns for the three months ended September 30, 2014 and 2013, respectively.

(Dollars in millions)**For the nine months ended September 30:**

	2014		2013
Net unrealized gains/(losses) arising during the period	\$ 1	\$	2
Net unrealized (gains)/losses reclassified to net income*	3		(3)

* There were no writedowns for the nine months ended September 30, 2014 and 2013, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at September 30, 2014.

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 September 30, 2014 and December 31, 2013 was \$14 million and \$216 million, respectively, for which no collateral was posted at September 30, 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 September 30, 2014 and December 31, 2013 was \$1,153 million and \$719 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 \$128 million and \$251 million at September 30, 2014 and December 31, 2013, respectively, of liabilities included in master netting

Notes to Consolidated Financial Statements – (continued)

arrangements with those counterparties. Additionally, at September 30, 2014 and December 31, 2013, this exposure was reduced by \$210 million and \$29 million of cash collateral, respectively, received by the company. At September 30, 2014 and December 31, 2013, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was \$811 million and \$439 million, respectively. At September 30, 2014 and December 31, 2013, the net exposure related to derivative liabilities recorded in the Consolidated Statement of Financial Position was \$194 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 September 30, 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 \$210 million and \$29 million at September 30, 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 September 30, 2014 or at December 31, 2013. At September 30, 2014, the company held \$3 million in non-cash collateral in U.S. Treasury securities, and at 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, 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, 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 September 30, 2014 and December 31, 2013, the total notional amount of the company's interest rate swaps was \$5.8 billion and \$3.1 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2014 and December 31, 2013 was approximately 9.0 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 September 30, 2014 and December 31, 2013.

At September 30, 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.

Notes to Consolidated Financial Statements – (continued)

Foreign Exchange Risk

Long-Term Investments in Foreign Subsidiaries (Net Investment)

A large portion of the company's foreign currency denominated debt portfolio is designated as a hedge of net investment 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 September 30, 2014 and December 31, 2013, the total notional amount of derivative instruments designated as net investment hedges was \$3.1 billion and \$3.0 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2014 and December 31, 2013 was approximately 0.2 years and 0.4 years, respectively.

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 has hedged its exposure to the variability in future cash flows is four years. At September 30, 2014 and December 31, 2013, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$9.7 billion and \$10.2 billion, respectively, with a weighted-average remaining maturity of 0.6 years and 0.7 years, respectively.

At September 30, 2014 and December 31, 2013, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net gains of \$428 million and net losses of \$252 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$410 million of gains 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.

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 seven years. At 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. At September 30, 2014, no amounts were outstanding under this program.

At September 30, 2014 and December 31, 2013, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of \$2 million (before taxes) and \$9 million (before taxes) in accumulated other comprehensive income/(loss), respectively. Within these amounts, less than \$1 million and \$3 million of losses, respectively, 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 September 30, 2014 and December 31, 2013, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$16.1 billion and \$14.7 billion, respectively.

Notes to Consolidated Financial Statements – (continued)

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 September 30, 2014 and December 31, 2013, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.3 billion for 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 September 30, 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 September 30, 2014 and December 31, 2013.

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 September 30, 2014, the total notional amount of derivative instruments in economic hedges of investment securities was \$0.1 billion. No amounts were outstanding under this program at December 31, 2013.

The following tables provide a quantitative summary of the derivative and non-derivative instrument-related risk management activity as of September 30, 2014 and December 31, 2013, as well as for the three and nine months ended September 30, 2014 and 2013, respectively:

Notes to Consolidated Financial Statements – (continued)

Fair Values of Derivative Instruments in the Consolidated Statement of Financial Position
As of September 30, 2014 and December 31, 2013

(Dollars in millions)		Fair Value of Derivative Assets		Fair Value of Derivative Liabilities	
	Balance Sheet Classification	9/30/2014	12/31/2013	Balance Sheet Classification	9/30/2014
Designated as hedging instruments:					
Interest rate contracts:	Prepaid expenses and other current assets	\$ 5	\$ 5	Other accrued expenses and liabilities	\$ 0
	Investments and sundry assets	460	308	Other liabilities	7
Foreign exchange contracts:	Prepaid expenses and other current assets	513	187	Other accrued expenses and liabilities	63
	Investments and sundry assets	20	26	Other liabilities	28
Fair value of derivative assets		\$ 998	\$ 522	Fair value of derivative liabilities	\$ 98
Not designated as hedging instruments:					
Foreign exchange contracts:	Prepaid expenses and other current assets	\$ 117	\$ 94	Other accrued expenses and liabilities	\$ 194
	Investments and sundry assets	34	67	Other liabilities	2
Equity contracts:	Prepaid expenses and other current assets	3	36	Other accrued expenses and liabilities	27
	Investments and sundry assets	1	0	Other liabilities	1
Fair value of derivative assets		\$ 155	\$ 197	Fair value of derivative liabilities	\$ 224
Total debt designated as hedging instruments:					
	Short-term debt	N/A	N/A		\$ 19
	Long-term debt	N/A	N/A		6,870
Total		\$ 1,153	\$ 719		\$ 7,192

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 September 30, 2014 and 2013**

(Dollars in millions)

Gain (Loss) Recognized in Earnings

	Consolidated Statement of Earnings Line Item	Recognized on Derivatives(1)		Attributable to Risk Being Hedged(2)	
For the three months ended September 30:		2014	2013	2014	2013
Derivative instruments in fair value hedges(5):					
Interest rate contracts	Cost of financing	\$ 16	\$ 5	\$ 11	\$ 19
	Interest expense	15	3	10	12
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	(452)	254	N/A	N/A
Interest rate contracts	Other (income) and expense	(3)	—	N/A	N/A
Equity contracts	SG&A expense	(14)	46	N/A	N/A
	Other (income) and expense	5	—	N/A	N/A
Total		\$ (433)	\$ 308	\$ 21	\$ 31

Gain (Loss) Recognized in Earnings and Other Comprehensive Income

	Effective Portion		Consolidated	Effective Portion		(Ineffectiveness) and	
	Recognized in OCI		Statement of	Reclassified		Amounts	
			Earnings Line Item	from AOCI		Excluded from Effectiveness Testing(3)	
For the three months ended September 30:	2014	2013		2014	2013	2014	2013
Derivative instruments in cash flow hedges:							
Interest rate contracts	\$ —	\$ —	Interest expense	\$ (1)	\$ —	\$ —	\$ —
			Other (income)				
Foreign exchange contracts	524	(409)	and expense	(57)	30	(1)	0
			Cost of sales	(4)	(17)	—	—
			SG&A expense	3	13	—	—
Instruments in net investment hedges(4):							
Foreign exchange contracts	700	(223)	Interest expense	—	—	0	1

Total	\$	1,224	\$	(632)	\$	(58)	\$	27	\$	(1)	\$	1
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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.
- (5) For the three month period ended September 30, 2014, fair value hedges resulted in a gain of \$2 million in ineffectiveness. There were no amounts recorded as ineffectiveness on fair value hedges for the three month period ended September 30, 2013.

Notes to Consolidated Financial Statements – (continued)

**The Effect of Derivative Instruments in the Consolidated Statement of Earnings
For the nine months ended September 30, 2014 and 2013**

(Dollars in millions)

(Dollars in millions)	Gain (Loss) Recognized in Earnings					
	Consolidated Statement of Earnings Line Item	Recognized on Derivatives(1)		Attributable to Risk Being Hedged(2)		
For the nine months ended September 30:		2014	2013	2014	2013	
Derivative instruments in fair value hedges(5):						
Interest rate contracts	Cost of financing	\$ 129	\$ (82)	\$ (53)	\$ 156	
	Interest expense	116	(53)	(47)	101	
Derivative instruments not designated as hedging instruments(1):						
Foreign exchange contracts	Other (income) and expense	(533)	(265)	N/A	N/A	
Interest rate contracts	Other (income) and expense	37	—	N/A	N/A	
Equity contracts	SG&A expense	39	105	N/A	N/A	
	Other (income) and expense	3	—	N/A	N/A	
Total		\$ (209)	\$ (295)	\$ (100)	\$ 257	

**Gain (Loss) Recognized in Earnings and Other Comprehensive Income
(Ineffectiveness)**

	Consolidated		Effective Portion		(Ineffectiveness)	
	Statement of		Reclassified		and Amounts Excluded from Effectiveness Testing(3)	
	Effective Portion Recognized in OCI	Earnings Line Item	from AOCI			
For the nine months ended September 30:	2014	2013	2014	2013	2014	2013
Derivative instruments in cash flow hedges:						
Interest rate contracts	\$ —	\$ —	Interest expense	\$ (1)	\$ —	\$ —
			Other (income)			
Foreign exchange contracts	596	(59)	and expense	(33)	115	(1)
			Cost of sales	(53)	(15)	—
			SG&A expense	(5)	29	—
Instruments in net investment hedges(4):						
Foreign exchange contracts	624	58	Interest expense	—	—	(1)
						3

Total	\$	1,220	\$	(1)	\$	(91)	\$	129	\$	(2)	\$	3
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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.
- (5) For the nine month period ended September 30, 2014, fair value hedges resulted in a gain of \$2 million in ineffectiveness. There were no amounts recorded as ineffectiveness on fair value hedges for the nine month period ended September 30, 2013.

For the three and nine months ending September 30, 2014 and 2013, 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.

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.

(Dollars in millions)	At September 30, 2014	At December 31, 2013
<u>Current:</u>		
Net investment in sales-type and direct financing leases	\$ 3,963	\$ 4,004
Commercial financing receivables	6,437	8,541
Client loan and installment payment receivables (loans)	7,011	7,243
Total	\$ 17,411	\$ 19,787
<u>Noncurrent:</u>		
Net investment in sales-type and direct financing leases	\$ 4,641	\$ 5,700
Client loan and installment payment receivables (loans)	6,352	7,055
Total	\$ 10,993	\$ 12,755

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 \$689 million and \$737 million at September 30, 2014 and December 31, 2013, respectively, and is reflected net of unearned income of \$560 million and \$672 million, and net of the allowance for credit losses of \$161 million and \$123 million at those dates, respectively.

Commercial financing receivables, net of the allowance for credit losses of \$16 million and \$23 million at September 30, 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 and installment payment receivables (loans), net of the allowance for credit losses of \$343 million and \$242 million at September 30, 2014 and December 31, 2013, 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 receivables financing contracts are priced independently at competitive market rates. The company has a history of enforcing the terms of these financing agreements.

The company utilizes certain of its financing receivables as collateral for nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were \$685 million and \$769 million at September 30, 2014 and December 31, 2013, respectively.

The company did not have any financing receivables held for sale as of September 30, 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 September 30, 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 portfolio into two classes: major markets and growth markets. For additional information on the company's accounting policies for the allowance for credit losses, refer to the company's 2013 Annual Report on pages 92 and 93.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)
At September 30, 2014

Financing receivables:

	Major Markets	Growth Markets	Total
Lease receivables	\$ 5,926	\$ 2,069	\$ 7,995
Loan receivables	9,250	4,456	13,706
Ending balance	\$ 15,176	\$ 6,525	\$ 21,701
Collectively evaluated for impairment	\$ 15,081	\$ 6,128	\$ 21,209
Individually evaluated for impairment	\$ 95	\$ 397	\$ 492
<u>Allowance for credit losses:</u>			
Beginning balance at January 1, 2014			
Lease receivables	\$ 42	\$ 80	\$ 123
Loan receivables	95	147	242
Total	\$ 137	\$ 228	\$ 365
Write-offs	(14)	(5)	(19)
Provision	1	169	170
Other	(8)	(4)	(12)
Ending balance at September 30, 2014	\$ 116	\$ 388	\$ 504
Lease receivables	\$ 34	\$ 127	\$ 161
Loan receivables	\$ 82	\$ 261	\$ 343
Collectively evaluated for impairment	\$ 40	\$ 35	\$ 75
Individually evaluated for impairment	\$ 76	\$ 352	\$ 428

(Dollars in millions)
At December 31, 2013

Financing receivables:

	Major Markets	Growth Markets	Total
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
<u>Allowance for credit losses:</u>			
Beginning balance at January 1, 2013			
Lease receivables	\$ 59	\$ 55	\$ 114
Loan receivables	121	84	204
Total	\$ 180	\$ 138	\$ 318
Write-offs	(23)	(10)	(33)
Provision	(21)	105	84
Other	1	(6)	(5)
Ending balance at December 31, 2013	\$ 137	\$ 228	\$ 365
Lease receivables	\$ 42	\$ 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.

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

Notes to Consolidated Financial Statements – (continued)

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 September 30, 2014 and December 31, 2013.

(Dollars in millions)	At September 30, 2014		At December 31, 2013	
Major markets	\$	16	\$	25
Growth markets		57		34
Total lease receivables	\$	73	\$	59
Major markets	\$	32	\$	40
Growth markets		181		92
Total loan receivables	\$	213	\$	132
Total receivables	\$	285	\$	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.

(Dollars in millions)	At September 30, 2014		At December 31, 2013	
	Recorded Investment	Related Allowance	Recorded Investment	Related Allowance
Major markets	\$ 65	\$ 55	\$ 79	\$ 67
Growth markets	280	237	122	116
Total	\$ 345	\$ 292	\$ 201	\$ 183

	Average	Interest	Interest Income
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(Dollars in millions)

For the three months ended September 30, 2014:

	Recorded Investment	Income Recognized	Recognized on Cash Basis
Major markets	\$ 67	\$ 0	\$ 0
Growth markets	235	0	0
Total	\$ 302	\$ 0	\$ 0

(Dollars in millions)

For the three months ended September 30, 2013:

	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	\$ 73	\$ 0	\$ 0
Growth markets	102	0	0
Total	\$ 174	\$ 0	\$ 0

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
For the nine months ended September 30, 2014:			
Major markets	\$ 72	\$ 0	\$ 0
Growth markets	185	0	0
Total	\$ 256	\$ 0	\$ 0

(Dollars in millions)	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
For the nine months ended September 30, 2013:			
Major markets	\$ 76	\$ 0	\$ 0
Growth markets	90	0	0
Total	\$ 166	\$ 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. The company uses information provided by Standard & Poor's, where available, as one of many inputs in its determination of customer credit ratings.

The following tables present the gross recorded investment for each class of receivables, by credit quality indicator, at September 30, 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.

(Dollars in millions)	Lease Receivables		Loan Receivables	
	Major Markets	Growth Markets	Major Markets	Growth Markets
At September 30, 2014:				
Credit Rating:				
AAA – AA-	\$ 501	\$ 50	\$ 782	\$ 107
A+ – A-	1,460	140	2,279	302
BBB+ – BBB-	1,732	1,048	2,703	2,256
BB+ – BB	1,253	347	1,957	747
BB- – B+	547	247	854	532
B – B-	380	148	593	318
CCC+ – D	53	90	83	194
Total	\$ 5,926	\$ 2,069	\$ 9,250	\$ 4,456

At September 30, 2014, the industries which made up Global Financing's receivables portfolio consisted of: Financial (40 percent), Government (16 percent), Manufacturing (14 percent), Retail (8 percent), Services (7 percent), Communications (6 percent), Healthcare (5 percent) and Other (4 percent).

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions) At December 31, 2013:	Lease Receivables		Loan Receivables	
	Major Markets	Growth Markets	Major Markets	Growth Markets
Credit Rating:				
AAA – AA-	\$ 743	\$ 68	\$ 1,151	\$ 125
A+ – A-	1,513	168	2,344	307
BBB+ – BBB-	2,111	957	3,271	1,745
BB+ – BB	1,393	350	2,158	638
BB- – B+	595	368	922	672
B – B-	365	214	565	391
CCC+ – D	76	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 financing receivables as past due when payment has not been received after 90 days, measured from the billing date.

(Dollars in millions)	Total Past Due		Total Financing Receivables	Recorded Investment > 90 Days and Accruing
At September 30, 2014:	> 90 days*	Current		
Major markets	\$ 8	\$ 5,918	\$ 5,926	\$ 8
Growth markets	25	2,044	2,069	12
Total lease receivables	\$ 33	\$ 7,962	\$ 7,995	\$ 20
Major markets	\$ 12	\$ 9,238	\$ 9,250	\$ 12
Growth markets	44	4,412	4,456	19
Total loan receivables	\$ 57	\$ 13,649	\$ 13,706	\$ 31
Total	\$ 90	\$ 21,611	\$ 21,701	\$ 51

* Does not include accounts that are fully reserved.

(Dollars in millions)	Total Past Due		Total Financing	Recorded Investment > 90 Days and Accruing
At December 31, 2013:	> 90 days*	Current	Receivables	
Major markets	\$ 6	\$ 6,789	\$ 6,796	\$ 5
Growth markets	19	2,181	2,200	11
Total lease receivables	\$ 25	\$ 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	\$ 14,499	\$ 14,542	\$ 25
Total	\$ 68	\$ 23,469	\$ 23,537	\$ 41

* Does not include accounts that are fully reserved.

Notes to Consolidated Financial Statements – (continued)

Troubled Debt Restructurings

The company did not have any troubled debt restructurings during the nine months ended September 30, 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 income from continuing operations:

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Cost	\$ 33	\$ 27	\$ 92	\$ 89
Selling, general and administrative	105	110	293	324
Research, development and engineering	13	12	41	42
Other (income) and expense*	—	—	(9)	—
Pre-tax stock-based compensation cost	150	150	416	455
Income tax benefits	(51)	(52)	(141)	(157)
Total stock-based compensation cost	\$ 99	\$ 98	\$ 276	\$ 297

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

Pre-tax stock-based compensation cost for the three months ended September 30, 2014 was flat compared to the corresponding period in the prior year. The decrease in the pre-tax stock-based compensation cost for the nine months ended September 30, 2014, as compared to the corresponding period in the prior year, was due to decreases related to restricted stock units (\$21 million), performance share units (\$4 million) and the company's assumption of stock-based awards previously issued by acquired entities (\$13 million).

The amount of stock-based compensation cost included in the loss from discontinued operations, net of tax was immaterial.

As of September 30, 2014, the total unrecognized compensation cost of \$1,057 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately 2.5 years.

There was no significant capitalized stock-based compensation cost at September 30, 2014 and 2013.

6. Segments: The tables on pages 28 and 29 reflect 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 from continuing operations. 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