INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
October 29, 2013

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, 2013

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York	**13-0871985**
(State of incorporation)	(IRS employer identification number)
Armonk, New York	**10504**
(Address of principal executive offices)	(Zip Code)

914-499-1900

(Registrant’s telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section l3 or l5(d) of the Securities Exchange Act of 1934 during the preceding l2 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 ý 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 ý 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 ý	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The registrant has 1,085,854,383 shares of common stock outstanding at September 30, 2013.

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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)**

(Dollars in millions except per share amounts)	**Three Months Ended September 30, 2013**	**Three Months Ended September 30, 2012**	**Nine Months Ended September 30, 2013**	**Nine Months Ended September 30, 2012**
Revenue:				
Services	$ 14,225	$ 14,626	$ 42,811	$ 44,279
Sales	8,987	9,642	27,735	29,424
Financing	509	479	1,506	1,500
Total revenue	23,720	24,747	72,052	75,203
Cost:				
Services	9,098	9,515	27,950	29,285
Sales	2,975	3,242	9,108	10,003
Financing	268	258	805	784
Total cost	12,341	13,016	37,863	40,072
Gross profit	11,380	11,732	34,189	35,131
Expense and other income:				
Selling, general and administrative	5,255	5,908	17,512	17,632
Research, development and engineering	1,468	1,534	4,661	4,722
Intellectual property and custom development income	(191)	(303)	(621)	(847)
Other (income) and expense	(62)	(606)	(214)	(796)
Interest expense	97	124	289	350
Total expense and other income	6,567	6,657	21,627	21,060
Income before income taxes	4,812	5,074	12,562	14,071
Provision for income taxes	772	1,251	2,263	3,300
Net income	$ 4,041	$ 3,824	$ 10,299	$ 10,771
Earnings per share of common stock:				
Assuming dilution	$ 3.68	$ 3.33	$ 9.27	$ 9.27
Basic	$ 3.70	$ 3.36	$ 9.35	$ 9.38
Weighted-average number of common shares outstanding: (millions)				
Assuming dilution	1,098.8	1,149.3	1,110.7	1,161.8
Basic	1,090.9	1,137.2	1,101.8	1,148.4
Cash dividend per common share	$ 0.95	$ 0.85	$ 2.75	$ 2.45

(Amounts may not add due to rounding.)

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

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	**2013**	**2012**	**2013**	**2012**
Net income	$ 4,041	$ 3,824	$ 10,299	$ 10,771
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	382	501	(959)	164
Net changes related to available-for-sale securities:				
Unrealized gains/(losses) arising during the period	3	11	0	13
Reclassification of (gains)/losses to net income	(5)	(27)	(5)	(43)
Subsequent changes in previously impaired securities arising during the period	1	(7)	3	20
Total net changes related to available-for-sale securities	(1)	(24)	(1)	(10)
Unrealized gains/(losses) on cash flow hedges:				
Unrealized gains/(losses) arising during the period	(409)	(54)	(58)	65
Reclassification of (gains)/losses to net income	(27)	(112)	(130)	(246)
Total unrealized gains/(losses) on cash flow hedges	(436)	(165)	(188)	(181)
Retirement-related benefit plans:				
Prior service costs/(credits)	0	0	33	0
Net (losses)/gains arising during the period	105	1	300	66
Curtailments and settlements	0	(2)	0	(1)
Amortization of prior service (credits)/costs	(28)	(37)	(86)	(112)
Amortization of net (gains)/losses	872	613	2,623	1,846
Total retirement-related benefit plans	949	575	2,869	1,799
Other comprehensive income/(loss), before tax	895	887	1,721	1,771
Income tax (expense)/benefit related to items of other comprehensive income	(91)	(109)	(933)	(606)
Other comprehensive income/(loss)	804	778	788	1,165
Total comprehensive income/(loss)	$ 4,844	$ 4,601	$ 11,087	$ 11,936

(Amounts may not add due to rounding.)

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

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(UNAUDITED)

ASSETS

					At September 30,		At December 31,

(Dollars in millions)		2013		2012
Assets:				
Current assets:				
Cash and cash equivalents	$	10,072	$	10,412
Marketable securities		160		717
Notes and accounts receivable - trade (net of allowances of $273 in 2013 and $255 in 2012)		9,865		10,667
Short-term financing receivables (net of allowances of $280 in 2013 and $288 in 2012)		16,786		18,038
Other accounts receivable (net of allowances of $29 in 2013 and $17 in 2012)		1,683		1,873
Inventories, at lower of average cost or market:				
Finished goods		528		475
Work in process and raw materials		1,964		1,812
Total inventories		2,492		2,287
Deferred taxes		1,752		1,415
Prepaid expenses and other current assets		4,723		4,024
Total current assets		47,533		49,433
Property, plant and equipment		40,808		40,501
Less: Accumulated depreciation		26,931		26,505
Property, plant and equipment — net		13,877		13,996
Long-term financing receivables (net of allowances of $72 in 2013 and $66 in 2012)		11,675		12,812
Prepaid pension assets		1,476		945
Deferred taxes		3,682		3,973
Goodwill		30,882		29,247
Intangible assets — net		4,003		3,787
Investments and sundry assets		4,718		5,021
Total assets	$	117,845	$	119,213

(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

		At September 30, 2013		At December 31, 2012

(Dollars in millions)				
Liabilities:				
Current liabilities:				
Taxes	$	4,746	$	4,948
Short-term debt		7,702		9,181
Accounts payable		6,263		7,952
Compensation and benefits		4,210		4,745
Deferred income		11,658		11,952
Other accrued expenses and liabilities		4,643		4,847
Total current liabilities		39,222		43,625
Long-term debt		28,478		24,088
Retirement and nonpension postretirement benefit obligations		17,994		20,418
Deferred income		4,087		4,491
Other liabilities		8,057		7,607
Total liabilities		97,837		100,229
Equity:				
IBM stockholders' equity:				
Common stock, par value $0.20 per share, and additional paid-in capital		51,203		50,110
Shares authorized: 4,687,500,000				
Shares issued: 2013 - 2,205,819,186				
2012 - 2,197,561,159				
Retained earnings		124,885		117,641
Treasury stock - at cost		(131,240)		(123,131)
Shares: 2013 - 1,119,964,803				
2012 - 1,080,193,483				
Accumulated other comprehensive income/(loss)		(24,971)		(25,759)
Total IBM stockholders' equity		19,877		18,860
Noncontrolling interests		131		124
Total equity		20,008		18,984
Total liabilities and equity	$	117,845	$	119,213

(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)

				Nine Months Ended September 30,

(Dollars in millions)		**2013**		**2012**
Cash flows from operating activities:				
Net income	$	10,299	$	10,771
Adjustments to reconcile net income to cash provided by operating activities				
Depreciation		2,457		2,572
Amortization of intangibles		1,007		952
Stock-based compensation		455		510
Net (gain)/loss on asset sales and other		(139)		(697)
Changes in operating assets and liabilities, net of acquisitions/divestitures		(3,121)		(868)
Net cash provided by operating activities		10,957		13,240
Cash flows from investing activities:				
Payments for property, plant and equipment		(2,559)		(3,082)
Proceeds from disposition of property, plant and equipment		256		233
Investment in software		(406)		(476)
Acquisition of businesses, net of cash acquired		(2,562)		(2,266)
Divestitures of businesses, net of cash transferred		247		587
Non-operating finance receivables — net		284		718
Purchases of marketable securities and other investments		(3,718)		(2,596)
Proceeds from disposition of marketable securities and other investments		4,035		1,971
Net cash used in investing activities		(4,423)		(4,912)
Cash flows from financing activities:				
Proceeds from new debt		10,066		9,589
Payments to settle debt		(7,740)		(4,991)
Short-term borrowings/(repayments) less than 90 days — net		1,074		(2,177)
Common stock repurchases		(8,062)		(8,988)
Common stock transactions — other		826		1,198
Cash dividends paid		(3,033)		(2,816)
Net cash used in financing activities		(6,870)		(8,185)
Effect of exchange rate changes on cash and cash equivalents		(4)		(156)
Net change in cash and cash equivalents		(340)		(13)
Cash and cash equivalents at January 1		10,412		11,922
Cash and cash equivalents at September 30	$	10,072	$	11,909
(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)

(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
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 declared – common stock		(3,033)			(3,033)		(3,033)
Common stock issued under 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

(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
Equity - January 1, 2012	$ 48,129	$ 104,857	$ (110,963)	$ (21,885)	$ 20,138	$ 97	$ 20,236
Net income plus other comprehensive income/(loss)							
Net income		10,771			10,771		10,771
Other comprehensive income/(loss)				1,165	1,165		1,165
Total comprehensive income/(loss)					$ 11,936		$ 11,936
Cash dividends declared – common stock		(2,816)			(2,816)		(2,816)
Common stock issued under employee plans (12,322,115 shares)	1,149				1,149		1,149
Purchases (2,092,008 shares) and sales (2,358,099 shares) of treasury stock under employee plans – net		(40)	(145)		(185)		(185)
Other treasury shares purchased, not retired (45,838,313 shares)			(9,007)		(9,007)		(9,007)

Changes in other equity	324				324		324
Changes in noncontrolling interests						29	29
Equity - September 30, 2012	$ 49,603	$ 112,773	$ (120,115)	$ (20,720)	$ 21,541	$ 126	$ 21,666
(Amounts may not add due to rounding.)							
(The accompanying notes are an integral part of the financial statements.)							

Notes to Consolidated Financial Statements:

1. <u>Basis of Presentation:</u> 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 assets, liabilities, revenue, costs, expenses and accumulated other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management's best knowledge of current events, historical experience, actions that the company may undertake in the future and on various other assumptions that are believed to be reasonable under the circumstances. As a result, actual results may be different from these estimates. See the company's 2012 Annual Report on pages 59 to 61 for a discussion of the company's critical accounting estimates.

Interim results are not necessarily indicative of financial results for a full year. The information included in this Form 10-Q should be read in conjunction with the company's 2012 Annual Report.

Noncontrolling interest amounts in income of $1.8 million and $3.0 million, net of tax, for the three months ended September 30, 2013 and 2012, respectively, and $4.2 million and $8.6 million, net of tax, for the nine months ended September 30, 2013 and 2012, 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. <u>Accounting Changes:</u> In July 2013, the Financial Accounting Standards Board (FASB) issued guidance allowing the use of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark interest rate for hedge accounting purposes in addition to interest rates on direct Treasury obligations of the United States government and the LIBOR. In addition, the guidance removes the restriction on using different benchmark rates for similar hedges. The guidance became effective on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013, and did not have a material impact in the consolidated financial results.

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

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 is effective prospectively beginning January 1, 2014. It is not expected to have a material impact in the consolidated financial results.

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. 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 is effective January 1, 2014 and is not expected to have a material impact in the consolidated financial results.

Notes to Consolidated Financial Statements – (continued)

3. Financial Instruments:

Fair Value Measurements

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

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

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

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

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

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

- Counterparty credit risk adjustments are applied to financial instruments, taking into account the actual credit risk of a counterparty as observed in the credit default swap market to determine the true fair value of such an instrument.

- Credit risk adjustments are applied to reflect the company's own credit risk when valuing all liabilities measured at fair value. The methodology is consistent with that applied in developing counterparty credit risk adjustments, but incorporates the company's own credit risk as observed in the credit default swap market.

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

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

Non-financial assets such as property, plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. See Note A,"Significant Accounting Policies," on pages 76 to 86 in the company's 2012 Annual Report for further information. There were no material impairments of non-financial assets for the nine months ended September 30, 2013 and 2012, respectively.

Accounting guidance permits the measurement of eligible financial assets, financial liabilities and firm commitments at fair value, on an instrument-by-instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. This election is irrevocable. The company does not apply 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, 2013 and December 31, 2012.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)					
At September 30, 2013	**Level 1**	**Level 2**	**Level 3**	**Total**	
Assets:					
Cash equivalents(1)					
Time deposits and certificates of deposit	$ —	$ 4,422	$ —	$ 4,422	
Commercial paper	—	992	—	992	
Money market funds	1,713	—	—	1,713	
U.S. government securities	—	800	—	800	
Other securities	—	10	—	10	
Total	1,713	6,225	—	7,938	(6)
Debt securities - current (2)	—	160		160	(6)
Debt securities - noncurrent (3)	1	8	—	9	
Available-for-sale equity investments (3)	32	—	—	32	
Derivative assets (4)					
Interest rate contracts	—	412	—	412	
Foreign exchange contracts	—	371	—	371	
Equity contracts	—	9	—	9	
Total	—	793	—	793	(7)
Total assets	$ 1,747	$ 7,185	$ —	$ 8,932	(7)
Liabilities:					
Derivative liabilities (5)					
Foreign exchange contracts	$ —	$ 575	$ —	$ 575	
Equity contracts	—	7	—	7	
Total liabilities	$ —	$ 581	$ —	$ 581	(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, 2013 were $396 million and $397 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, 2013 were $432 million and $150 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 $343 million each.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)						
At December 31, 2012	**Level 1**	**Level 2**	**Level 3**	**Total**	
Assets:					
Cash equivalents(1)					
Time deposits and certificates of deposit	$ —	$ 3,694	$ —	$ 3,694	
Commercial paper	—	2,098	—	2,098	
Money market funds	1,923	—	—	1,923	
Other securities	—	30	—	30	
Total	1,923	5,823	—	7,746	(6)
Debt securities - current (2)	—	717	—	717	(6)
Debt securities - noncurrent (3)	2	8	—	10	
Available-for-sale equity investments (3)	34	—	—	34	
Derivative assets (4)					
Interest rate contracts	—	604	—	604	
Foreign exchange contracts	—	305	—	305	
Equity contracts	—	9	—	9	
Total	—	918	—	918	(7)
Total assets	$ 1,959	$ 7,466	$ —	$ 9,424	(7)
Liabilities:					
Derivative liabilities (5)					
Foreign exchange contracts	$ —	$ 496	$ —	$ 496	
Equity contracts	—	7	—	7	
Total liabilities	$ —	$ 503	$ —	$ 503	(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, 2012 were $333 million and $585 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, 2012 were $426 million and $78

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 $262 million each.

There were no transfers between Levels 1 and 2 for the nine months ended September 30, 2013 and the year ended December 31, 2012.

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, 2013 and December 31, 2012, the difference between the carrying amount and estimated fair value for loans and long-term receivables was immaterial. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

Notes to Consolidated Financial Statements – (continued)

Long-term Debt

Fair value of publicly-traded long-term debt is based on quoted market prices for the identical liability when traded as an asset in an active market. For other long-term debt for which a quoted market price is not available, an expected present value technique that uses rates currently available to the company for debt with similar terms and remaining maturities is used to estimate fair value. The carrying amount of long-term debt was $28,478 million and $24,088 million and the estimated fair value was $30,409 million and $27,119 million at September 30, 2013 and December 31, 2012, 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 also considered available-for-sale and recorded at fair value in the Consolidated Statement of Financial Position.

		Gross	Gross		
(Dollars in millions)	**Adjusted**	**Unrealized**	**Unrealized**	**Fair**
At September 30, 2013:	**Cost**	**Gains**	**Losses**	**Value**
Debt securities – noncurrent(1)	$ 7	$ 2	$ —	$ 9
Available-for-sale equity investments(1)	$ 29	$ 4	$ 1	$ 32

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

		Gross	Gross	
(Dollars in millions)	**Adjusted**	**Unrealized**	**Unrealized**	**Fair**
At December 31, 2012:	**Cost**	**Gains**	**Losses**	**Value**
Debt securities – noncurrent(1)	$ 8	$ 2	$ —	$ 10
Available-for-sale equity investments(1)	$ 31	$ 4	$ 1	$ 34

(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, 2013 and December 31, 2012, 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:	**2013**	**2012**
Proceeds	$ 8	$ 36
Gross realized gains (before taxes)	5	27
Gross realized losses (before taxes)	0	—

(Dollars in millions)		
For the nine months ended September 30:	**2013**	**2012**
Proceeds	$ 28	$ 87
Gross realized gains (before taxes)	9	43
Gross realized losses (before taxes)	4	0

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:

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)			
For the three months ended September 30:	**2013**		**2012**
Net unrealized gains/(losses) arising during the period	$ 3		$ 2
Net unrealized (gains)/losses reclassified to net income*	(3)		(17)
*There were no writedowns for the three months ended September 30, 2013 and 2012, respectively.			
(Dollars in millions)			
For the nine months ended September 30:	**2013**		**2012**
Net unrealized gains/(losses) arising during the period	$ 2		$ 20
Net unrealized (gains)/losses reclassified to net income*	(3)		(26)
* There were no significant writedowns for the nine months ended September 30, 2013 and 2012, respectively.			

The contractual maturities of substantially all available-for-sale debt securities are less than one year at September 30, 2013.

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 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, 2013 and December 31, 2012 was $222 million and $94 million, respectively, for which no collateral was posted at September 30, 2013 and December 31, 2012. 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, 2013 and December 31, 2012 was $793 million and $918 million, respectively. This amount represents the maximum exposure to loss at the reporting date as a result of the counterparties failing to perform as contracted. This exposure was reduced by $343 million and $262 million at September 30, 2013 and December 31, 2012, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at September 30, 2013 and December 31, 2012, this exposure was reduced by $45 million and $69 million of cash collateral, respectively, received by the company. At September 30, 2013 and December 31, 2012, the net exposure related to derivative assets recorded in the Statement of Financial Position was $404 million and $587 million respectively. At September 30, 2013 and December 31, 2012, the net amount related to derivative liabilities recorded in the Statement of Financial Position was $239 million and $242 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, 2013 or December 31, 2012 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral totaled $45 million and $69 million at September 30, 2013 and December 31, 2012,

Notes to Consolidated Financial Statements – (continued)

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, 2013 or at December 31, 2012. Additionally, the company's exposure is further reduced by holding non-cash collateral. At September 30, 2013, no amounts of non-cash collateral were held, and at December 31, 2012, $31 million was held in U.S. Treasury securities. Per accounting guidance, non-cash collateral is not recorded on the Statement of Financial Position.

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

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

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, 2013 and December 31, 2012, the total notional amount of the company's interest rate swaps was $4.5 billion and $4.3 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2013 and December 31, 2012 was approximately 7.5 years and 5.1 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, 2013 and December 31, 2012.

At September 30, 2013 and December 31, 2012, net gains of approximately $1 million (before taxes), respectively, were recorded in accumulated other comprehensive income/(loss) in connection with cash flow hedges of the company’s borrowings. Within these amounts, gains of less than $1 million, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying transactions.

Foreign Exchange Risk

Long-Term Investments in Foreign Subsidiaries (Net Investment)

A large portion of the company’s foreign currency denominated debt portfolio is designated as a hedge of net investment in foreign subsidiaries to reduce the volatility in stockholders’ equity caused by changes in foreign currency exchange rates in the functional currency of major foreign subsidiaries with respect to the U.S. dollar. The company also uses cross-currency swaps and foreign exchange forward contracts for this risk management purpose. At September 30, 2013 and December 31, 2012, the total notional amount of derivative instruments designated as net investment hedges was $5.3 billion and $3.3 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2013 and December 31, 2012 was approximately 0.2 years and 0.4 years, respectively.

Notes to Consolidated Financial Statements – (continued)

Anticipated Royalties and Cost Transactions

The company's operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company's non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is four years. At September 30, 2013 and December 31, 2012, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was $10.7 billion and $10.7 billion, respectively, with a weighted-average remaining maturity of 0.7 years and 0.7 years, respectively.

At September 30, 2013 and December 31, 2012, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of $326 million and net losses of $138 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $197 million of losses and $79 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. At September 30, 2013 and December 31, 2012, no instruments relating to this program were outstanding.

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, 2013 and December 31, 2012, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was $14.6 billion and $12.9 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. They are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At September 30, 2013 and December 31, 2012, the total notional amount of derivative instruments in economic hedges of these compensation obligations was $1.2 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, 2013 and December 31, 2012.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company utilizes credit default swaps to economically hedge its credit exposures. 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, 2013 and December 31, 2012.

Notes to Consolidated Financial Statements – (continued)

The following tables provide a quantitative summary of the derivative and non-derivative instrument related risk management activity as of September 30, 2013 and December 31, 2012 as well as for the three and nine months ended September 30, 2013 and 2012, respectively:

Fair Values of Derivative Instruments in the Consolidated Statement of Financial Position
As of September 30, 2013 and December 31, 2012

(Dollars in millions)	Fair Value of Derivative Assets			Fair Value of Derivative Liabilities		
	Balance Sheet Classification	9/30/2013	12/31/2012	Balance Sheet Classification	9/30/2013	12/3
Designated as hedging instruments:						
Interest rate contracts:	Prepaid expenses and other current assets	$ 41	$ 47	Other accrued expenses and liabilities	$ —	$
	Investments and sundry assets	371	557	Other liabilities	—	
Foreign exchange contracts:	Prepaid expenses and other current assets	138	135	Other accrued expenses and liabilities	378	
	Investments and sundry assets	—	5	Other liabilities	150	
Fair value of derivative assets		$ 550	$ 744	**Fair value of derivative liabilities**	$ 528	$
Not designated as hedging instruments:						
Foreign exchange contracts:	Prepaid expenses and other current assets	$ 208	$ 142	Other accrued expenses and liabilities	$ 47	$
	Investments and sundry assets	25	23	Other liabilities	—	
Equity contracts:	Prepaid expenses and other current assets	9	9	Other accrued expenses and liabilities	7	
Fair value of derivative assets		$ 242	$ 174	**Fair value of derivative liabilities**	$ 53	$
Total debt designated as hedging instruments:						
	Short-term debt	N/A	N/A		$ 1,219	$
	Long-term debt	N/A	N/A		2,297	

Total		$	793	$	918		$	4,097	$	4
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, 2013 and 2012

(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:		2013	2012	2013	2012
Derivative instruments in fair value hedges:					
Interest rate contracts	Cost of financing	$ 5	$ 13	$ 19	$ 19
	Interest expense	3	11	12	16
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	254	148	N/A	N/A
Equity contracts	SG&A expense	46	54	N/A	N/A
Total		$ 308	$ 226	$ 31	$ 35

	Gain (Loss) Recognized in Earnings and Other Comprehensive Income						
	Effective Portion Recognized in OCI		Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI		(Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3)	
For the three months ended September 30:	2013	2012		2013	2012	2013	2012
Derivative instruments in cash flow hedges:							
Interest rate contracts	$ —	$ —	Interest expense	$ —	$ (2)	$ —	$ —
Foreign exchange contracts	(409)	(54)	Other (income) and expense	30	102	0	0
			Cost of sales	(17)	6	—	—
			SG&A expense	13	5	—	—

Instruments in net investment hedges(4):							
Foreign exchange contracts	(223)	(136)	Interest expense	—	—	1	6
Total	$ (632)	$ (190)		$ 27	$ 112	$ 1	$ 6

N/A-not applicable

Note: 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.

Notes to Consolidated Financial Statements – (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings
For the nine months ended September 30, 2013 and 2012

(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:		**2013**	**2012**	**2013**	**2012**
Derivative instruments in fair value hedges:					
Interest rate contracts	Cost of financing	$ (82)	$ 68	$ 156	$ 27
	Interest expense	(53)	58	101	23
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	(265)	(56)	N/A	N/A
Equity contracts	SG&A expense	105	116	N/A	N/A
Total		$ (295)	$ 186	$ 257	$ 50

	Gain (Loss) Recognized in Earnings and Other Comprehensive Income						
	Effective Portion Recognized in OCI		Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI		(Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3)	
For the nine months ended September 30:	**2013**	**2012**		**2013**	**2012**	**2013**	**2012**
Derivative instruments in cash flow hedges:							
Interest rate contracts	$ —	$ —	Interest expense	$ —	$ (6)	$ —	$ —
Foreign exchange contracts	(59)	65	Other (income) and expense	115	209	(0)	3
			Cost of sales	(15)	22	—	—
			SG&A expense	29	21	—	—

Instruments in net investment hedges(4):							
Foreign exchange contracts	58	(23)	Interest expense	—	—	3	9
Total	$ (1)	$ 42		$ 129	$ 246	$ 3	$ 12

N/A-not applicable

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

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

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

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

(4) Instruments in net investment hedges include derivative and non-derivative instruments.

For the three and nine months ending September 30, 2013 and 2012, there were no significant gains or losses recognized in earnings representing hedge ineffectiveness or excluded from the assessment of hedge effectiveness (for fair value hedges), or associated with an underlying exposure that did not or was not expected to occur (for cash flow hedges); nor are there any anticipated in the normal course of business.

Refer to the company’s 2012 Annual Report, Note A, “Significant Accounting Policies,” on page 83 for additional information on the company’s use of derivative financial instruments.

Notes to Consolidated Financial Statements – (continued)

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

(Dollars in millions)		At September 30, 2013		At December 31, 2012
Current:				
Net investment in sales-type and direct financing leases	$	4,078	$	3,862
Commercial financing receivables		6,278		7,750
Client loan receivables		5,218		5,395
Installment payment receivables		1,212		1,031
Total	$	16,786	$	18,038
Noncurrent:				
Net investment in sales-type and direct financing leases	$	5,454	$	6,107
Commercial financing receivables		—		5
Client loan receivables		5,555		5,966
Installment payment receivables		666		733
Total	$	11,675	$	12,812

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 $734 million and $794 million at September 30, 2013 and December 31, 2012, respectively, and is reflected net of unearned income of $676 million and $728 million, and net of the allowance for credit losses of $106 million and $114 million at those dates, respectively.

Commercial financing receivables, net of allowance for credit losses of $27 million and $46 million at September 30, 2013 and December 31, 2012, respectively, relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and OEM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan receivables, net of allowance for credit losses of $182 million and $155 million at September 30, 2013 and December 31, 2012, respectively, are loans that are provided primarily to clients to finance the purchase of software and services. Separate contractual relationships on these financing arrangements are for terms ranging generally from one to seven years.

Installment payment receivables, net of allowance for credit losses of $36 million and $39 million at September 30, 2013 and December 31, 2012, respectively, are loans that are provided primarily to clients to finance hardware, software and services ranging generally from one to three years.

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

The company utilizes certain of its financing receivables as collateral for non-recourse borrowings. Financing receivables pledged as collateral for borrowings were $701 million and $650 million at September 30, 2013 and December 31, 2012, respectively.

The company did not have any financing receivables held for sale as of September 30, 2013 and December 31, 2012.

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, 2013 and December 31, 2012. 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, see the company's 2012 Annual Report beginning on page 85.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions) At September 30, 2013		**Major Markets**		**Growth Markets**		**Total**
Financing receivables:						
	Lease receivables	$ 6,705		$ 2,104		$ 8,809
	Loan receivables	9,042		3,830		12,871
Ending balance		$ 15,747		$ 5,934		$ 21,681
Collectively evaluated for impairment		$ 15,629		$ 5,767		$ 21,395
Individually evaluated for impairment		$ 118		$ 167		$ 285
Allowance for credit losses:						
Beginning balance at January 1, 2013						
	Lease receivables	$ 59		$ 55		$ 114
	Loan receivables	121		84		204
Total		$ 180		$ 138		$ 318
	Write-offs	(21)		(9)		(30)
	Provision	(26)		66		40
	Other	—		(4)		(4)
Ending balance at September 30, 2013		$ 134		$ 190		$ 324
	Lease receivables	$ 42		$ 64		$ 106
	Loan receivables	$ 92		$ 126		$ 218
Collectively evaluated for impairment		$ 40		$ 37		$ 77
Individually evaluated for impairment		$ 94		$ 153		$ 247

(Dollars in millions) At December 31, 2012		**Major Markets**		**Growth Markets**		**Total**
Financing receivables:						
	Lease receivables	$ 7,036		$ 2,138		$ 9,174
	Loan receivables	9,666		3,670		13,336
Ending balance		$ 16,701		$ 5,808		$ 22,510
Collectively evaluated for impairment		$ 16,570		$ 5,684		$ 22,254
Individually evaluated for impairment		$ 131		$ 125		$ 256
Allowance for credit losses:						
Beginning balance at January 1, 2012						
	Lease receivables	$ 79		$ 40		$ 118
	Loan receivables	125		64		189
Total		$ 203		$ 104		$ 307
	Write-offs	(14)		(1)		(15)
	Provision	(9)		38		28
	Other	0		(2)		(2)
Ending balance at December 31, 2012		$ 180		$ 138		$ 318
	Lease receivables	$ 59		$ 55		$ 114
	Loan receivables	$ 121		$ 84		$ 204

Collectively evaluated for impairment	$ 69	$ 29	$ 98
Individually evaluated for impairment	$ 111	$ 109	$ 220

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

Notes to Consolidated Financial Statements – (continued)

Financing Receivables on Non-Accrual Status

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

The following table presents the recorded investment in financing receivables which were on non-accrual status at September 30, 2013 and December 31, 2012.

(Dollars in millions)	At September 30, 2013		At December 31, 2012	
Major markets	$	21	$	27
Growth markets		24		21
Total lease receivables	$	45	$	47
Major markets	$	48	$	67
Growth markets		79		25
Total loan receivables	$	127	$	92
Total receivables	$	172	$	139

Impaired Loans

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

The following tables present impaired client loan receivables.

	At September 30, 2013				At December 31, 2012			
(Dollars in millions)	Recorded Investment		Related Allowance		Recorded Investment		Related Allowance	
Major markets	$	74	$	68	$	88	$	77
Growth markets		109		102		72		65
Total	$	183	$	170	$	160	$	143

	Average	Interest	Interest Income

(Dollars in millions)	Recorded	Income	Recognized on
For the three months ended September 30, 2013:	**Investment**	**Recognized**	**Cash Basis**
Major markets	$ 73	$ 0	$ 0
Growth markets	102	0	0
Total	$ 174	$ 0	$ 0
			Interest
	Average	**Interest**	**Income**
(Dollars in millions)	**Recorded**	**Income**	**Recognized on**
For the three months ended September 30, 2012:	**Investment**	**Recognized**	**Cash Basis**
Major markets	$ 84	$ 0	$ 0
Growth markets	63	0	0
Total	$ 147	$ 0	$ 0

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions) For the nine months ended September 30, 2013:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 76	$ 0	$ 0
Growth markets	90	0	0
Total	$ 166	$ 0	$ 0

(Dollars in millions) For the nine months ended September 30, 2012:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 91	$ 0	$ 0
Growth markets	64	0	0
Total	$ 154	$ 0	$ 0

Credit Quality Indicators

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

The following tables present the gross recorded investment for each class of receivables, by credit quality indicator, at September 30, 2013 and December 31, 2012. Receivables with a credit quality indicator ranging from AAA to BBB- are considered investment grade. All others are considered non-investment grade. The credit quality indicators do not reflect mitigation actions that the company may take to transfer credit risk to third parties.

		Lease Receivables		Loan Receivables	
(Dollars in millions)		Major	Growth	Major	Growth
At September 30, 2013:		Markets	Markets	Markets	Markets
Credit Rating:					
	AAA – AA-	$ 606	$ 71	$ 817	$ 129
	A+ – A-	1,520	178	2,049	324

	BBB+ – BBB-			2,154			875			2,904		1,593
	BB+ – BB			1,421			306			1,916		557
	BB- – B+			533			412			719		750
	B – B-			356			198			480		361
	CCC+ – D			115			64			155		116
Total			$	6,705		$	2,104		$	9,042	$	3,830

At September 30, 2013, the industries which made up Global Financing's receivables portfolio consisted of: Financial (38 percent), Government (15 percent), Manufacturing (14 percent), Retail (8 percent), Services (7 percent), Communications (7 percent), Healthcare (6 percent) and Other (4 percent).

Notes to Consolidated Financial Statements – (continued)

			Lease Receivables		Loan Receivables

(Dollars in millions) At December 31, 2012:		Major Markets	Growth Markets	Major Markets	Growth Markets
Credit Rating:					
	AAA – AA-	$ 646	$ 86	$ 887	$ 148
	A+ – A-	1,664	223	2,286	382
	BBB+ – BBB-	2,285	776	3,139	1,333
	BB+ – BB	1,367	450	1,878	773
	BB- – B+	552	418	758	718
	B – B-	399	127	548	218
	CCC+ – D	124	58	170	99
Total		$ 7,036	$ 2,138	$ 9,666	$ 3,670

At December 31, 2012, the industries which made up Global Financing's receivables portfolio consisted of: Financial (38 percent), Government (16 percent), Manufacturing (14 percent), Retail (9 percent), Services (7 percent), Healthcare (6 percent), Communications (6 percent) and Other (4 percent).

Past Due Financing Receivables

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

(Dollars in millions) At September 30, 2013:	Total Past Due > 90 days*	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Major markets	$ 9	$ 6,696	$ 6,705	$ 9
Growth markets	16	2,089	2,104	11
Total lease receivables	$ 25	$ 8,785	$ 8,809	$ 20
Major markets	$ 15	$ 9,027	$ 9,042	$ 14
Growth markets	29	3,801	3,830	10
Total loan receivables	$ 43	$ 12,828	$ 12,871	$ 24
Total	$ 68	$ 21,612	$ 21,681	$ 44

* Does not include accounts that are fully reserved.

(Dollars in millions) At December 31, 2012:	Total Past Due > 90 days*	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Major markets	$ 8	$ 7,028	$ 7,036	$ 5
Growth markets	11	2,127	2,138	8
Total lease receivables	$ 20	$ 9,154	$ 9,174	$ 13
Major markets	$ 27	$ 9,639	$ 9,666	$ 8
Growth markets	36	3,634	3,670	31
Total loan receivables	$ 63	$ 13,273	$ 13,336	$ 39
Total	$ 82	$ 22,428	$ 22,510	$ 52

* 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, 2013 and for the year ended December 31, 2012.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	**2013**	**2012**	**2013**	**2012**
Cost	$ 27	$ 34	$ 89	$ 99
Selling, general and administrative	110	133	324	370
Research, development and engineering	12	15	42	43
Other (income) and expense	—	0	—	0
Pre-tax stock-based compensation cost	150	183	455	510
Income tax benefits	(52)	(64)	(157)	(179)
Total stock-based compensation cost	$ 98	$ 119	$ 297	$ 331

The decrease in pre-tax stock-based compensation cost for the three months ended September 30, 2013, as compared to the corresponding period in the prior year, was due to decreases related to performance share units ($23 million), restricted stock units ($7 million) and the company’s assumption of stock-based awards previously issued by acquired entities ($4 million). The decrease in pre-tax stock-based compensation cost for the nine months ended September 30, 2013, as compared to the corresponding period in the prior year, was due to decreases related to performance share units ($34 million), the company’s assumption of stock-based awards previously issued by acquired entities ($11 million) and restricted stock units ($12 million).

As of September 30, 2013, the total unrecognized compensation cost of $1,088 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, 2013 and 2012.

6. Segments: The tables on pages 26 and 27 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. 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

(Dollars in millions)	Global Services: Global Technology Services	Global Services: Global Business Services	Software	Systems and Technology	Global Financing	Total Segments
For the three months ended September 30, 2013:						
External revenue	$ 9,494	$ 4,558	$ 5,798	$ 3,247	$ 502	$ 23,599
Internal revenue	262	177	744	168	512	1,863
Total revenue	$ 9,755	$ 4,735	$ 6,542	$ 3,415	$ 1,015	$ 25,461
Pre-tax income	$ 1,895	$ 948	$ 2,410	$ (167)	$ 494	$ 5,579
Revenue year-to-year change	(4.4) %	0.4 %	(1.0) %	(16.2) %	5.3 %	(4.2) %
Pre-tax income year-to-year change	11.7 %	28.4 %	2.3 %	nm	3.8 %	3.5 %
Pre-tax income margin	19.4 %	20.0 %	36.8 %	(4.9) %	48.7 %	21.9 %
nm - not meaningful						
For the three months ended September 30, 2012:						
External revenue	$ 9,922	$ 4,542	$ 5,763	$ 3,895	$ 472	$ 24,594
Internal revenue	285	175	843	181	491	1,976
Total revenue	$ 10,206	$ 4,717	$ 6,606	$ 4,076	$ 963	$ 26,570
Pre-tax income	$ 1,697	$ 738	$ 2,355	$ 124	$ 476	$ 5,389
	16.6 %	15.6 %	35.6 %	3.0 %	49.4 %	20.3 %

Pre-tax income margin		

Reconciliations to IBM as Reported:		
(Dollars in millions)		
For the three months ended September 30:	**2013**	**2012**
Revenue:		
Total reportable segments	$ 25,461	$ 26,570
Eliminations of internal transactions	(1,863)	(1,976)
Other revenue adjustments	122	154
Total IBM Consolidated	$ 23,720	$ 24,747
Pre-tax income:		
Total reportable segments	$ 5,579	$ 5,389
Amortization of acquired intangible assets	(201)	(178)
Acquisition-related charges	(13)	(10)
Non-operating retirement-related (costs)/income	(257)	(258)
Eliminations of internal transactions	(280)	(322)
Unallocated corporate amounts	(15)	453*
Total IBM Consolidated	$ 4,812	$ 5,074

* Includes Retail Store Solutions divestiture gain of $447 million.

Notes to Consolidated Financial Statements – (continued)

SEGMENT INFORMATION

	Global Services: Global Technology Services	Global Services: Global Business Services	Software	Systems and Technology	Global Financing	Total Segments
(Dollars in millions)						
For the nine months ended September 30, 2013:						
External revenue	$ 28,634	$ 13,649	$ 17,792	$10,111	$ 1,488	$ 71,674
Internal revenue	801	545	2,312	423	1,628	5,710
Total revenue	$ 29,435	$ 14,194	$			