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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10 - Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED JUNE 30, 2014

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

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

914-499-1900

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 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 had 997,592,162 shares of common stock outstanding at June 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 June 30,		Six Months Ended June 30,	
(Dollars in millions except per share amounts)	**2014**	**2013**	**2014**	**2013**
Revenue:				
Services	$ 14,128	$ 14,312	$ 28,110	$ 28,586
Sales	9,726	10,119	17,711	18,748
Financing	509	493	1,027	998
Total revenue	24,364	24,924	46,848	48,332
Cost:				
Services	9,131	9,326	18,232	18,852
Sales	3,029	3,202	5,590	6,133
Financing	230	264	508	537
Total cost	12,389	12,792	24,330	25,522
Gross profit	11,975	12,132	22,518	22,810
Expense and other (income):				
Selling, general and administrative	5,603	6,680	11,892	12,257
Research, development and engineering	1,457	1,548	2,958	3,193
Intellectual property and custom development income	(191)	(247)	(398)	(430)
Other (income) and expense	(201)	(91)	(326)	(151)
Interest expense	136	98	240	192
Total expense and other (income)	6,804	7,988	14,367	15,060
Income before income taxes	5,171	4,144	8,151	7,750
Provision for income taxes	1,034	918	1,630	1,492
Net income	$ 4,137	$ 3,226	$ 6,521	$ 6,258
Earnings per share of common stock:				
Assuming dilution	$ 4.12	$ 2.91	$ 6.37	$ 5.60
Basic	$ 4.14	$ 2.93	$ 6.41	$ 5.65
Weighted-average number of common shares outstanding: (millions)				
Assuming dilution	1,005.1	1,109.4	1,023.5	1,116.7
Basic	999.6	1,100.9	1,017.4	1,107.3

Cash dividend per common share	$ 1.10	$ 0.95	$ 2.05	$ 1.80

(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 June 30,		Six Months Ended June 30,	
(Dollars in millions)	**2014**	**2013**	**2014**	**2013**
Net income	$ 4,137	$ 3,226	$ 6,521	$ 6,258
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	339	(936)	278	(1,341)
Net changes related to available-for-sale securities:				
Unrealized gains/(losses) arising during the period	1	0	1	(2)
Reclassification of (gains)/losses to net income	0	0	5	0
Subsequent changes in previously impaired securities arising during the period	–	0	–	1
Total net changes related to available-for-sale securities	1	0	5	(1)
Unrealized gains/(losses) on cash flow hedges:				
Unrealized gains/(losses) arising during the period	(16)	(10)	72	350
Reclassification of (gains)/losses to net income	34	(47)	33	(103)
Total unrealized gains/(losses) on cash flow hedges	18	(57)	104	247
Retirement-related benefit plans:				
Prior service costs/(credits)	0	0	1	33
Net (losses)/gains arising during the period	15	210	47	195
Curtailments and settlements	8	0	13	0
Amortization of prior service (credits)/costs	(29)	(28)	(59)	(58)
Amortization of net (gains)/losses	639	864	1,288	1,750
Total retirement-related benefit plans	633	1,045	1,290	1,920
Other comprehensive income/(loss), before tax	991	53	1,678	826
Income tax (expense)/benefit related to items of other comprehensive income	(205)	(361)	(445)	(842)
Other comprehensive income/(loss)	787	(309)	1,232	(16)
Total comprehensive income/(loss)	$ 4,923	$ 2,917	$ 7,753	$ 6,242

(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 June 30, 2014	At December 31, 2013
Assets:		
Current assets:		
Cash and cash equivalents	$ 9,715	$ 10,716
Marketable securities	5	350
Notes and accounts receivable - trade (net of allowances of $294 in 2014 and $291 in 2013)	9,902	10,465
Short-term financing receivables (net of allowances of $404 in 2014 and $308 in 2013)	18,620	19,787
Other accounts receivable (net of allowances of $45 in 2014 and $36 in 2013)	1,555	1,584
Inventories, at lower of average cost or market:		
Finished goods	449	444
Work in process and raw materials	1,889	1,866
Total inventories	2,338	2,310
Deferred taxes	1,783	1,651
Prepaid expenses and other current assets	4,263	4,488
Total current assets	48,182	51,350
Property, plant and equipment	40,936	40,475
Less: Accumulated depreciation	27,188	26,654
Property, plant and equipment — net	13,748	13,821
Long-term financing receivables (net of allowances of $68 in 2014 and $80 in 2013)	12,140	12,755
Prepaid pension assets	6,894	5,551
Deferred taxes	2,828	3,051
Goodwill	31,568	31,184
Intangible assets — net	3,585	3,871
Investments and sundry assets	5,369	4,639
Total assets	$ 124,314	$ 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 June 30, 2014	At December 31, 2013
Liabilities:		
Current liabilities:		
Taxes	$ 2,335	$ 4,633
Short-term debt	12,462	6,862
Accounts payable	6,271	7,461
Compensation and benefits	4,037	3,893
Deferred income	12,591	12,557
Other accrued expenses and liabilities	4,737	4,748
Total current liabilities	42,433	40,154
Long-term debt	34,008	32,856
Retirement and nonpension postretirement benefit obligations	15,984	16,242
Deferred income	4,152	4,108
Other liabilities	10,224	9,934
Total liabilities	106,801	103,294
Equity:		
IBM stockholders' equity:		
Common stock, par value $0.20 per share, and additional paid-in capital	52,163	51,594
Shares authorized: 4,687,500,000		
Shares issued: 2014 - 2,212,895,614		
2013 - 2,207,522,548		
Retained earnings	134,483	130,042
Treasury stock - at cost	(148,900)	(137,242)
Shares: 2014 - 1,215,303,453		
2013 - 1,153,131,611		
Accumulated other comprehensive income/(loss)	(20,369)	(21,602)
Total IBM stockholders' equity	17,377	22,792
Noncontrolling interests	136	137
Total equity	17,513	22,929
Total liabilities and equity	$ 124,314	$ 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)

	Six Months Ended June 30,	
(Dollars in millions)	**2014**	**2013**
Cash flows from operating activities:		
Net income	$ 6,521	$ 6,258
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation	1,628	1,632
Amortization of intangibles	679	657
Stock-based compensation	266	305
Net (gain)/loss on asset sales and other	(425)	(10)
Changes in operating assets and liabilities, net of acquisitions/divestitures	(1,763)	(1,644)
Net cash provided by operating activities	6,905	7,197
Cash flows from investing activities:		
Payments for property, plant and equipment	(1,757)	(1,574)
Proceeds from disposition of property, plant and equipment	183	181
Investment in software	(222)	(275)
Acquisition of businesses, net of cash acquired	(603)	(179)
Divestitures of businesses, net of cash transferred	408	12
Non-operating finance receivables — net	619	336
Purchases of marketable securities and other investments	(836)	(3,135)
Proceeds from disposition of marketable securities and other investments	1,242	2,759
Net cash used in investing activities	(965)	(1,876)
Cash flows from financing activities:		
Proceeds from new debt	5,397	6,694
Payments to settle debt	(2,808)	(4,876)
Short-term borrowings/(repayments) less than 90 days — net	3,991	(376)
Common stock repurchases	(11,828)	(6,145)
Common stock transactions — other	401	657
Cash dividends paid	(2,086)	(1,996)
Net cash used in financing activities	(6,933)	(6,043)
Effect of exchange rate changes on cash and cash equivalents	(8)	(133)
Net change in cash and cash equivalents	(1,000)	(854)
Cash and cash equivalents at January 1	10,716	10,412
Cash and cash equivalents at June 30	$ 9,715	$ 9,558

(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, 2014	$ 51,594	$ 130,042	$ (137,242)	$ (21,602)	$ 22,792	$ 137	$ 22,929
Net income plus other comprehensive income/(loss)							
Net income		6,521			6,521		6,521
Other comprehensive income/(loss)				1,232	1,232		1,232
Total comprehensive income/(loss)					$ 7,753		$ 7,753
Cash dividends paid – common stock		(2,086)			(2,086)		(2,086)
Common stock issued under employee plans (5,373,067 shares)	530				530		530
Purchases (1,095,148 shares) and sales (688,444 shares) of treasury stock under employee plans – net		6	(115)		(109)		(109)
Other treasury shares purchased, not retired (61,765,138 shares)			(11,544)		(11,544)		(11,544)
Changes in other equity	39				39		39
Changes in noncontrolling interests						(1)	(1)
Equity - June 30, 2014	$ 52,163	$ 134,483	$ (148,900)	$ (20,369)	$ 17,377	$ 136	$ 17,513

(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		6,258			6,258		6,258
Other comprehensive income/(loss)				(16)	(16)		(16)
Total comprehensive income/(loss)					$ 6,242		$ 6,242
Cash dividends paid – common stock		(1,996)			(1,996)		(1,996)
Common stock issued under employee plans (7,367,440 shares)	668				668		668
Purchases (1,399,751 shares) sales (1,480,251 shares) of treasury							

stock under employee plans – net		(19)	(113)		(132)		(132)
Other treasury shares purchased,							
not retired (29,389,794 shares)			(5,994)		(5,994)		(5,994)
Changes in other equity	108				108		108
Changes in noncontrolling interests						4	4
Equity - June 30, 2013	$ 50,886	$ 121,883	$ (129,239)	$ (25,774)	$ 17,756	$ 127	$ 17,883

(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.

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 $0.9 million, net of tax, for the three months ended June 30, 2014 and 2013, respectively, and $1.9 million and $2.3 million, net of tax, for the six months ended June 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 impact to the company will be dependent on any transaction that is within the scope of the new guidance.

In July 2013, the FASB issued guidance regarding the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Under certain circumstances, unrecognized tax benefits should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The guidance was effective January 1, 2014. 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

Notes to Consolidated Financial Statements – (continued)

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.

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

Non-financial assets such as property, plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. See note A, “Significant Accounting Policies - Impairment,” on page 88 in the company’s 2013 Annual Report for additional information. There were no material impairments of non-financial assets for the six months ended June 30, 2014 and 2013, respectively.

Notes to Consolidated Financial Statements – (continued)

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

The following tables present the company's financial assets and financial liabilities that are measured at fair value on a recurring basis at June 30, 2014 and December 31, 2013.

(Dollars in millions) **At June 30, 2014**	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	$ —	$ 5,056	$ —	$ 5,056
Commercial paper	—	615	—	615
Money market funds	1,260	—	—	1,260
U.S. government securities	—	300	—	300
Canadian government securities	—	234	—	234
Other securities	—	8	—	8
Total	1,260	6,213	—	7,474(6)
Debt securities - current (2)	—	5	—	5(6)
Debt securities - noncurrent (3)	1	8	—	9
Trading securities investments (3)	—	92	—	92
Available-for-sale equity investments (3)	8	—	—	8
Derivative assets (4)				
Interest rate contracts	—	490	—	490
Foreign exchange contracts	—	268	—	268
Equity contracts	—	15	—	15
Total	—	772	—	772(7)
Total assets	**$** 1,270	$ 7,091	$ —	$ 8,362(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	$ —	$ 328	$ —	$ 328
Equity contracts	—	13	—	13
Interest rate contracts	—	0	—	0
Total liabilities	**$** —	$ 341	$ —	$ 341(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 June 30, 2014 were $176 million and

$596 million respectively.

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

Liabilities in the Consolidated Statement of Financial Position at June 30, 2014 were $309 million and $32

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 $184

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.

There were no transfers between Levels 1 and 2 for the six months ended June 30, 2014 and the year ended December 31, 2013.

Financial Assets and Liabilities Not Measured at Fair Value

Short-Term Receivables and Payables

Notes and other accounts receivable and other investments are financial assets with carrying values that approximate fair value. Accounts payable, other accrued expenses and short-term debt (excluding the current portion of long-term debt) are financial liabilities with carrying values that approximate fair value. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

Loans and Long-term Receivables

Fair values are based on discounted future cash flows using current interest rates offered for similar loans to clients with similar credit ratings for the same remaining maturities. At June 30, 2014 and December 31, 2013, the difference between the carrying amount and estimated fair value for loans and long-term receivables was immaterial. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

Notes to Consolidated Financial Statements – (continued)

Long-term Debt

Fair value of publicly-traded long-term debt is based on quoted market prices for the identical liability when traded as an asset in an active market. For other long-term debt for which a quoted market price is not available, an expected present value technique that uses rates currently available to the company for debt with similar terms and remaining maturities is used to estimate fair value. The carrying amount of long-term debt was $34,008 million and $32,856 million, and the estimated fair value was $36,367 million and $34,555 million at June 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 gains related to trading securities of $15 million and $21 million for the three months ended June 30, 2014 and six months ended June 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) At June 30, 2014:	**Adjusted Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Debt securities – noncurrent(1)	$ 7	$ 2	$ —	$ 9
Available-for-sale equity investments(1)	$ 6	$ 2	$ 0	$ 8

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

(Dollars in millions) At December 31, 2013:	**Adjusted Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**

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 June 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 June 30:**	**2014**	**2013**
Proceeds	$ 1	$ 2
Gross realized gains (before taxes)	0	1
Gross realized losses (before taxes)	0	0

(Dollars in millions) **For the six months ended June 30:**	**2014**	**2013**
Proceeds	$ 15	$ 20
Gross realized gains (before taxes)	0	4
Gross realized losses (before taxes)	5	4

Notes to Consolidated Financial Statements – (continued)

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 June 30:**	**2014**	**2013**
Net unrealized gains/(losses) arising during the period	$ 0	$ 0
Net unrealized (gains)/losses reclassified to net income*	0	0

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

(Dollars in millions) **For the six months ended June 30:**	**2014**	**2013**
Net unrealized gains/(losses) arising during the period	$ 1	$ 0
Net unrealized (gains)/losses reclassified to net income*	3	0

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

The contractual maturities of substantially all available-for-sale debt securities are less than one year at June 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 June 30, 2014 and December 31, 2013 was $150 million and $216 million, respectively, for which no collateral was posted at June 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 June 30, 2014 and December 31, 2013 was $772 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 $184 million and $251 million at June 30, 2014 and December 31, 2013, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at June 30, 2014 and December 31, 2013, this exposure was reduced by $42 million and $29 million of cash collateral, respectively, received by the company. At June 30, 2014 and December 31, 2013, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was $528 million and $439 million, respectively. At June 30, 2014 and December 31, 2013, the net exposure related to derivative liabilities recorded in the Consolidated Statement of Financial Position was $158 million and $250 million, respectively.

Notes to Consolidated Financial Statements – (continued)

In the Consolidated Statement of Financial Position, the company does not offset derivative assets against liabilities in master netting arrangements nor does it offset receivables or payables recognized upon payment or receipt of cash collateral against the fair values of the related derivative instruments. No amount was recognized in other receivables at June 30, 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 $42 million and $29 million at June 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 June 30, 2014 or at December 31, 2013. At June 30, 2014, the company held $19 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 June 30, 2014 and December 31, 2013, the total notional amount of the company's interest rate swaps was $5.9 billion and $3.1 billion, respectively. The weighted-average remaining maturity of these instruments at June 30, 2014 and December 31, 2013 was approximately 9.2 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 June 30, 2014 and December 31, 2013.

At June 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.

Foreign Exchange Risk

Long-Term Investments in Foreign Subsidiaries (Net Investment)

A large portion of the company's foreign currency denominated debt portfolio is designated as a hedge of net investment in foreign subsidiaries to reduce the volatility in stockholders' equity caused by changes in foreign currency exchange rates in the functional currency of major foreign subsidiaries with respect to the U.S. dollar. The company also uses cross-currency swaps and foreign exchange forward contracts for this risk management purpose. At June 30, 2014 and December 31, 2013, the total notional amount of derivative instruments designated as net investment hedges was $4.1 billion and $3.0 billion, respectively. The weighted-average remaining maturity of these instruments at June 30, 2014 and December 31, 2013 was approximately 0.3 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 has hedged its exposure to the variability in future cash flows is four years. At June 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 $9.9 billion and $10.2 billion, respectively, with a weighted-average remaining maturity of 0.7 years for both periods.

At June 30, 2014 and December 31, 2013, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of $131 million and $252 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $152 million and $166 million of losses, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

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 June 30, 2014 and December 31, 2013, the total notional amount of cross currency swaps designated as cash flow hedges of foreign currency denominated debt was $1.2 billion for both periods.

At June 30, 2014 and December 31, 2013, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of $26 million (before taxes) and $9 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $4 million of losses 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 June 30, 2014 and December 31, 2013, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was $16.6 billion and $14.7 billion, respectively.

Equity Risk Management

The company is exposed to market price changes in certain broad market indices and in the company's own stock primarily related to certain obligations to employees. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company's common stock, and are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At June 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.

Notes to Consolidated Financial Statements – (continued)

Other Risks

The company may hold warrants to purchase shares of common stock in connection with various investments that are deemed derivatives because they contain net share or net cash settlement provisions. The company records the changes in the fair value of these warrants in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any warrants qualifying as derivatives outstanding at June 30, 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 June 30, 2014 and December 31, 2013.

The company is exposed to market volatility on certain investment securities. The company may utilize options to economically hedge its market exposure. The options are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. At June 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 June 30, 2014 and December 31, 2013, as well as for the three and six months ended June 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 June 30, 2014 and December 31, 2013

(Dollars in millions)	Fair Value of Derivative Assets			Fair Value of Derivative Liabilities		
	Balance Sheet Classification	6/30/2014	12/31/2013	Balance Sheet Classification	6/30/2014	12/31/201
Designated as hedging instruments:						
Interest rate contracts:	Prepaid expenses and other current assets	$ 5	$ —	Other accrued expenses and liabilities	$ —	$ 0
	Investments and sundry assets	485	308	Other liabilities	—	13
Foreign exchange contracts:	Prepaid expenses and other current assets	43	187	Other accrued expenses and liabilities	223	331
	Investments and sundry assets	78	26	Other liabilities	32	112
Fair value of derivative assets		$ 611	$ 522	**Fair value of derivative liabilities**	$ 255	$ 456
Not designated as hedging instruments:						
Foreign exchange contracts:	Prepaid expenses and other current assets	$ 113	$ 94	Other accrued expenses and liabilities	$ 73	$ 40
	Investments and sundry assets	34	67	Other liabilities	0	1
Equity contracts:	Prepaid expenses and other current assets	15	36	Other accrued expenses and liabilities	13	4
Fair value of derivative assets		$ 161	$ 197	**Fair value of derivative liabilities**	$ 87	$ 45
Total debt designated as hedging instruments:						
	Short-term debt	N/A	N/A		$ —	$ 190
	Long-term debt	N/A	N/A		6,114	6,111
Total		$ 772	$ 719		$ 6,456	$ 6,802

N/A-not applicable

Notes to Consolidated Financial Statements – (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings
For the three months ended June 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 June 30:		2014	2013	2014	2013
Derivative instruments in fair value hedges:					
Interest rate contracts	Cost of financing	$ 71	$ (68)	$ (45)	$ 92
	Interest expense	62	(44)	(38)	59
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	(49)	(80)	N/A	N/A
Interest rate contracts	Other (income) and expense	41	—	N/A	N/A
Equity contracts	SG&A expense	32	(26)	N/A	N/A
	Other (income) and expense	(2)	—	N/A	N/A
Total		$ 155	$ (218)	$ (83)	$ 151

	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 June 30:	2014	2013		2014	2013	2014	2013
Derivative instruments in cash flow hedges:							
Interest rate contracts	$ —	$ —	Interest expense	$ 1	$ —	$ —	$ —
Foreign exchange contracts	(16)	(10)	Other (income) and expense	(5)	48	0	(1)
			Cost of sales	(23)	(7)	—	—
			SG&A expense	(7)	5	—	—
Instruments in net investment hedges(4):							

Foreign exchange contracts		(51)		62	Interest expense		—		—		(1)	3
Total	$	(67)	$	52		$	(34)	$	47	$	(1)	$ 2

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.

Notes to Consolidated Financial Statements – (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings
For the six months ended June 30, 2014 and 2013

(Dollars in millions)	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings: Recognized on Derivatives(1) 2014	Recognized on Derivatives(1) 2013	Attributable to Risk Being Hedged(2) 2014	Attributable to Risk Being Hedged(2) 2013
For the six months ended June 30:					
Derivative instruments in fair value hedges:					
Interest rate contracts	Cost of financing	$ 115	$ (88)	$ (65)	$ 138
	Interest expense	99	(56)	(56)	88
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	(81)	(519)	N/A	N/A
Interest rate contracts	Other (income) and expense	40	—	N/A	N/A
Equity contracts	SG&A expense	53	60	N/A	N/A
	Other (income) and expense	(2)	—	N/A	N/A
Total		$ 224	$ (603)	$ (121)	$ 226

Gain (Loss) Recognized in Earnings and Other Comprehensive Income

For the six months ended June 30:	Effective Portion Recognized in OCI 2014	Effective Portion Recognized in OCI 2013	Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI 2014	Effective Portion Reclassified from AOCI 2013	(Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3) 2014	(Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3) 2013
Derivative instruments in cash flow hedges:							
Foreign exchange contracts	72	350	Other (income) and expense	24	85	(1)	(1)
			Cost of sales	(49)	2	—	—
			SG&A expense	(8)	15	—	—
Instruments in net investment hedges(4):							
Foreign exchange contracts	(76)	282	Interest expense	—	—	(1)	2
Total	$ (4)	$ 632		$ (33)	$ 103	$ (2)	$ 1

N/A-not applicable

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

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

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

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

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

For the three and six months ending June 30, 2014 and 2013, there were no significant gains or losses recognized in earnings representing hedge ineffectiveness or excluded from the assessment of hedge effectiveness (for fair value hedges), or associated with an underlying exposure that did not or was not expected to occur (for cash flow hedges); nor are there any anticipated in the normal course of business.

Notes to Consolidated Financial Statements – (continued)

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

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

(Dollars in millions)		At June 30, 2014		At December 31, 2013
Current:				
Net investment in sales-type and direct financing leases	$	4,131	$	4,004
Commercial financing receivables		7,064		8,541
Client loan and installment payment receivables (loans)		7,425		7,243
Total	$	18,620	$	19,787
Noncurrent:				
Net investment in sales-type and direct financing leases	$	5,170	$	5,700
Commercial financing receivables		—		—
Client loan and installment payment receivables (loans)		6,969		7,055
Total	$	12,140	$	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 $730 million and $737 million at June 30, 2014 and December 31, 2013, respectively, and is reflected net of unearned income of $612 million and $672 million, and net of the allowance for credit losses of $149 million and $123 million at those dates, respectively.

Commercial financing receivables, net of allowance for credit losses of $18 million and $23 million at June 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 allowance for credit losses of $306 million and $242 million at June 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 for terms ranging generally from one 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 $671 million and $769 million at June 30, 2014 and December 31, 2013, respectively.

The company did not have any financing receivables held for sale as of June 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 June 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 June 30, 2014**	**Major Markets**	**Growth Markets**	**Total**
Financing receivables:			
Lease receivables	$ 6,371	$ 2,264	$ 8,635
Loan receivables	10,136	4,565	14,700
Ending balance	$ 16,507	$ 6,828	$ 23,335
Collectively evaluated for impairment	$ 16,398	$ 6,547	$ 22,945
Individually evaluated for impairment	$ 108	$ 281	$ 390
Allowance for credit losses:			
Beginning balance at January 1, 2014			
Lease receivables	$ 42	$ 80	$ 123
Loan receivables	95	147	242
Total	$ 137	$ 228	$ 365
Write-offs	(10)	(3)	(13)
Provision	6	97	103
Other	0	0	0
Ending balance at June 30, 2014	$ 133	$ 321	$ 454
Lease receivables	$ 38	$ 111	$ 149
Loan receivables	$ 95	$ 210	$ 306
Collectively evaluated for impairment	$ 44	$ 48	$ 92
Individually evaluated for impairment	$ 89	$ 273	$ 363

(Dollars in millions) **At December 31, 2013**	**Major Markets**	**Growth Markets**	**Total**
Financing receivables:			
Lease receivables	$ 6,796	$ 2,200	$ 8,996
Loan receivables	10,529	4,012	14,542
Ending balance	$ 17,325	$ 6,212	$ 23,537
Collectively evaluated for impairment	$ 17,206	$ 6,013	$ 23,219
Individually evaluated for impairment	$ 119	$ 199	$ 318
Allowance for credit losses:			
Beginning balance at January 1, 2013			
Lease receivables	$ 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 June 30, 2014 and December 31, 2013.

(Dollars in millions)	At June 30, 2014	At December 31, 2013
Major markets	$ 17	$ 25
Growth markets	45	34
Total lease receivables	$ 62	$ 59
Major markets	$ 35	$ 40
Growth markets	90	92
Total loan receivables	$ 126	$ 132
Total receivables	$ 188	$ 191

Impaired Loans

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

The following tables present impaired client loan receivables.

	At June 30, 2014		At December 31, 2013	
(Dollars in millions)	Recorded Investment	Related Allowance	Recorded Investment	Related Allowance
Major markets	$ 68	$ 60	$ 79	$ 67
Growth markets	190	179	122	116
Total	$ 258	$ 239	$ 201	$ 183

	Average	Interest	Interest Income

(Dollars in millions) For the three months ended June 30, 2014:	Recorded Investment	Income Recognized	Recognized on Cash Basis
Major markets	$ 71	$ 0	$ 0
Growth markets	169	0	0
Total	$ 240	$ 0	$ 0

(Dollars in millions) For the three months ended June 30, 2013:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 70	$ 0	$ 0
Growth markets	90	0	0
Total	$ 161	$ 0	$ 0

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions) For the six months ended June 30, 2014:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 74	$ 0	$ 0
Growth markets	153	0	0
Total	$ 227	$ 0	$ 0

(Dollars in millions) For the six months ended June 30, 2013:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 76	$ 0	$ 0
Growth markets	84	0	0
Total	$ 161	$ 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 June 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	
At June 30, 2014:	Major Markets	Growth Markets	Major Markets	Growth Markets
Credit Rating:				
AAA – AA-	$ 484	$ 75	$ 770	$ 150
A+ – A-	931	147	1,481	297
BBB+ – BBB-	2,472	947	3,933	1,909
BB+ – BB	1,380	387	2,195	781
BB- – B+	692	362	1,101	729
B – B-	348	266	554	536
CCC+ – D	64	81	102	163

Total	$ 6,371	$ 2,264	$ 10,136	$ 4,565

At June 30, 2014, the industries which made up Global Financing's receivables portfolio consisted of: Financial (39 percent), Government (15 percent), Manufacturing (14 percent), Services (9 percent), Retail (8 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 Major Markets	Lease Receivables Growth Markets	Loan Receivables Major Markets	Loan Receivables 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 receivables as past due when payment has not been received after 90 days, measured from the billing date.

(Dollars in millions) At June 30, 2014:	Total Past Due > 90 days*	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Major markets	$ 8	$ 6,363	$ 6,371	$ 8
Growth markets	23	2,241	2,264	15
Total lease receivables	$ 31	$ 8,604	$ 8,635	$ 23
Major markets	$ 12	$ 10,123	$ 10,136	$ 12
Growth markets	57	4,508	4,565	20
Total loan receivables	$ 69	$ 14,631	$ 14,700	$ 33
Total	$ 100	$ 23,235	$ 23,335	$ 55

* Does not include accounts that are fully reserved.

(Dollars in millions) At December 31, 2013:	Total Past Due > 90 days*	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
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 six months ended June 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 the Consolidated Statement of Earnings:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in millions)	**2014**	**2013**	**2014**	**2013**
Cost	$ 28	$ 30	$ 59	$ 61
Selling, general and administrative	100	115	188	214
Research, development and engineering	14	15	28	30
Other (income) and expense*	—	—	(9)	—
Pre-tax stock-based compensation cost	142	161	266	305
Income tax benefits	(48)	(56)	(89)	(106)
Total stock-based compensation cost	$ 94	$ 105	$ 176	$ 199

* Reflects the one-time effects related to the divestiture of the customer care business in the six months ended June 30, 2014.

The decrease in pre-tax stock-based compensation cost for the three months ended June 30, 2014, as compared to the corresponding period in the prior year, was due to decreases related to restricted stock units ($10 million), performance share units ($5 million) and the company's assumption of stock-based awards previously issued by acquired entities ($4 million). The decrease in the pre-tax stock-based compensation cost for the six months ended June 30, 2014, as compared to the corresponding period in the prior year, was due to decreases related to restricted stock units ($19 million), performance share units ($12 million) and the company's assumption of stock-based awards previously issued by acquired entities ($8 million).

As of June 30, 2014, the total unrecognized compensation cost of $1,184 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately 2.6 years.

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

6. Segments: The tables on pages 27 and 28 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 June 30, 2014:						
External revenue	$ 9,414	$ 4,534	$ 6,488	$ 3,331	$ 504	$ 24,271
Internal revenue	247	140	857	190	685	2,119
Total revenue	$ 9,661	$ 4,674	$ 7,345	$ 3,521	$ 1,189	$ 26,390
Pre-tax income	$ 1,850	$ 832	$ 2,683	$ 25	$ 593	$ 5,983
Revenue year-to-year change	(1.7) %	(2.5) %	2.6 %	(9.5) %	12.0 %	(1.3) %
Pre-tax income year-to-year change	22.2 %	33.7 %	9.8 %	117.9 %	7.7 %	19.9 %
Pre-tax income margin	19.2 %	17.8 %	36.5 %	0.7 %	49.8 %	22.7 %
For the three months ended June 30, 2013:						
External revenue	$ 9,536	$ 4,606	$ 6,423	$ 3,758	$ 487	$ 24,809
Internal revenue	292	188	738	135	575	1,928
Total revenue	$ 9,828	$ 4,795	$ 7,161	$ 3,893	$ 1,061	$ 26,737
Pre-tax income	$ 1,514	$ 623	$ 2,443	$ (141)	$ 550	$ 4,989
Pre-tax income margin	15.4 %	13.0 %	34.1 %	(3.6) %	51.8 %	18.7 %

Reconciliations to IBM as Reported:

(Dollars in millions) For the three months ended June 30:	2014	2013
Revenue:		
Total reportable segments	$ 26,390	$ 26,737
Eliminations of internal transactions	(2,119)	(1,928)
Other revenue adjustments	93	115
Total IBM Consolidated	$ 24,364	$ 24,924
Pre-tax income:		
Total reportable segments	$ 5,983	$ 4,989
Amortization of acquired intangible assets	(200)	(178)
Acquisition-related charges	(4)	(4)
Non-operating retirement-related (costs)/income	(52)	(262)

Eliminations of internal transactions	(507)	(379)
Unallocated corporate amounts	(50)	(22)
Total IBM Consolidated	$ 5,171	$ 4,144

Notes to Consolidated Financial Statements – (continued)

SEGMENT INFORMATION

	Global Services					
(Dollars in millions)	**Global Technology Services**	**Global Business Services**	**Software**	**Systems and Technology**	**Global Financing**	**Total Segments**
For the six months ended June 30, 2014:						
External revenue	$ 18,744	$ 9,017	$ 12,149	$ 5,722	$ 1,016	$ 46,648
Internal revenue	488	281	1,789	358	1,303	4,218
Total revenue	$ 19,232	$ 9,298	$ 13,939	$ 6,080	$ 2,318	$ 50,866
Pre-tax income	$ 3,196	$ 1,461	$ 4,601	$ (635)	$ 1,188	$ 9,812
Revenue year-to-year change	(2.3) %	(1.7) %	2.8 %	(14.6) %	10.3 %	(2.0) %
Pre-tax income year-to-year change	3.1 %	10.2 %	3.2 %	16.3 %	9.2 %	4.1 %
Pre-tax income margin	16.6 %	15.7 %	33.0 %	(10.4) %	51.3 %	19.3 %

nm - not meaningful

For the six months ended June 30, 2013:						
External revenue	$ 19,140	$ 9,091	$ 11,995	$ 6,864	$ 985	$ 48,075
Internal revenue	540	368	1,569	255	1,116	3,847
Total revenue	$ 19,680	$ 9,459	$ 13,563	$ 7,118	$ 2,101	$ 51,922
Pre-tax income	$ 3,099	$ 1,326	$ 4,457	$ (546)	$ 1,088	$ 9,425
Pre-tax income margin	15.7 %	14.0 %	32.9 %	(7.7) %	51.8 %	18.2 %

Reconciliations to IBM as Reported:

(Dollars in millions)		
For the six months ended June 30:	**2014**	**2013**
Revenue:		
Total reportable segments	$ 50,866	$ 51,922
Eliminations of internal transactions	(4,218)	(3,847)
Other revenue adjustments	200	257
Total IBM Consolidated	$ 46,848	$ 48,332
Pre-tax income:		
Total reportable segments	$ 9,812	$ 9,425
Amortization of acquired intangible assets	(395)	(361)
Acquisition-related charges	(10)	(15)

Non-operating retirement-related (costs)/income		(175)		(546)
Eliminations of internal transactions		(1,031)		(718)
Unallocated corporate amounts		(50)		(35)
Total IBM Consolidated	$	8,151	$	7,750

Notes to Consolidated Financial Statements – (continued)

7. Equity Activity:

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) For the three months ended June 30, 2014:	Before Tax Amount	Tax (Expense)/ Benefit	Net of Tax Amount
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ 339	$ 19	$ 358
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	1	$ 0	$ 0
Reclassification of (gains)/losses to other (income) and expense	0	0	0
Subsequent changes in previously impaired securities arising during the period	—	—	—
Total net changes related to available-for-sale securities	$ 1	$ 0	$ 1
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ (16)	$ 2	$ (14)
Reclassification of (gains)/losses to:			
Cost of sales	23	(7)	16
SG&A expense	7	(1)	5
Other (income) and expense	5	(2)	3
Interest expense	(1)	0	(1)
Total unrealized gains/(losses) on cash flow hedges	$ 18	$ (8)	$ 10
Retirement-related benefit plans(1):			
Prior service costs/(credits)	$ 0	$ 0	$ 0
Net (losses)/gains arising during the period	15	(5)	10
Curtailments and settlements	8	(3)	6
Amortization of prior service (credits)/costs	(29)	10	(19)
Amortization of net (gains)/losses	639	(218)	422
Total retirement-related benefit plans	$ 633	$ (216)	$ 418
Other comprehensive income/(loss)	$ 991	$ (205)	$ 787

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

Notes to Consolidated Financial Statements – (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) **For the three months ended June 30, 2013:**	**Before Tax Amount**	**Tax (Expense)/ Benefit**	**Net of Tax Amount**
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ (936)	$ (23)	$ (959)
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ 0	$ 0	$ 0
Reclassification of (gains)/losses to other (income) and expense	0	0	0
Subsequent changes in previously impaired securities arising during the period	0	0	0
Total net changes related to available-for-sale securities	$ 0	$ 0	$ 0
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ (10)	$ 9	$ (1)
Reclassification of (gains)/losses to:			
Cost of sales	7	(2)	4
SG&A expense	(5)	2	(3)
Other (income) and expense	(48)	19	(30)
Interest expense	0	0	0
Total unrealized gains/(losses) on cash flow hedges	$ (57)	$ 28	$ (29)
Retirement-related benefit plans(1):			
Prior service costs/(credits)	$ 0	$ 0	$ 0
Net (losses)/gains arising during the period	210	(71)	138
Amortization of prior service (credits)/costs	(28)	10	(18)
Amortization of net (gains)/losses	864	(304)	559
Total retirement-related benefit plans	$ 1,045	$ (366)	$ 679
Other comprehensive income/(loss)	$ 53	$ (361)	$ (309)

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

Notes to Consolidated Financial Statements – (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) **For the six months ended June 30, 2014:**	**Before Tax Amount**	**Tax (Expense)/ Benefit**	**Net of Tax Amount**
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ 278	$ 29	$ 307
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ 1	$ 0	$ 1
Reclassification of (gains)/losses to other (income) and expense	5	(2)	3
Subsequent changes in previously impaired securities arising during the period	—	—	—
Total net changes related to available-for-sale securities	$ 5	$ (2)	$ 3
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ 72	$ (31)	$ 41
Reclassification of (gains)/losses to:			
Cost of sales	49	(17)	32
SG&A expense	8	(1)	7
Other (income) and expense	(24)	9	(15)
Interest expense	0	0	0
Total unrealized gains/(losses) on cash flow hedges	$ 104	$ (40)	$ 64
Retirement-related benefit plans(1):			
Prior service costs/(credits)	$ 1	$ 0	$ 0
Net (losses)/gains arising during the period	47	(16)	31
Curtailments and settlements	13	(4)	8
Amortization of prior service (credits)/costs	(59)	20	(39)
Amortization of net (gains)/losses	1,288	(432)	856
Total retirement-related benefit plans	$ 1,290	$ (433)	$ 857
Other comprehensive income/(loss)	$ 1,678	$ (445)	$ 1,232

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

Notes to Consolidated Financial Statements – (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) For the six months ended June 30, 2013:	Before Tax Amount	Tax (Expense)/ Benefit	Net of Tax Amount
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ (1,341)	$ (107)	$ (1,448)
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ (2)	$ 1	$ (2)
Reclassification of (gains)/losses to other (income) and expense	0	0	0
Subsequent changes in previously impaired securities arising during the period	1	0	1
Total net changes related to available-for-sale securities	$ (1)	$ 1	$ 0
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ 350	$ (119)	$ 231
Reclassification of (gains)/losses to:			
Cost of sales	(3)	1	(2)
SG&A expense	(15)	6	(10)
Other (income) and expense	(85)	33	(52)
Interest expense	0	0	0
Total unrealized gains/(losses) on cash flow hedges	$ 247	$ (79)	$ 168
Retirement-related benefit plans(1):			
Prior service costs/(credits)	$ 33	$ (11)	$ 21
Net (losses)/gains arising during the period	195	(67)	129
Amortization of prior service (credits)/costs	(58)	20	(38)
Amortization of net (gains)/losses	1,750	(597)	1,153
Total retirement-related benefit plans	$ 1,920	$ (655)	$ 1,265
Other comprehensive income/(loss)	$ 826	$ (842)	$ (16)

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

Notes to Consolidated Financial Statements – (continued)

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

(Dollars in Millions)	Net Unrealized Gains/(Losses) on Cash Flow Hedges	Foreign Currency Translation Adjustments*	Net Change Retirement-Related Benefit Plans	Net Unrealized Gains/(Losses) on Available-For-Sale Securities	Accumulated Other Comprehensive Income/(Loss)
January 1, 2014	$ (165)	$ 332	$ (21,767)	$ (1)	$ (21,602)
Other comprehensive income before reclassifications	41	307	31	1	379
Amount reclassified from accumulated other comprehensive income	24	0	825	3	853
Total change for the period	64	307	857	3	1,232
June 30, 2014	$ (101)	$ 639	$ (20,910)	$ 3	$ (20,369)

(Dollars in Millions)	Net Unrealized Gains/(Losses) on Cash Flow Hedges	Foreign Currency Translation Adjustments*	Net Change Retirement-Related Benefit Plans	Net Unrealized Gains/(Losses) on Available-For-Sale Securities	Accumulated Other Comprehensive Income/(Loss)
January 1, 2013	$ (90)	$ 1,733	$ (27,406)	$ 4	$ (25,759)
Other comprehensive income before reclassifications	231	(1,448)	150	0	(1,067)
Amount reclassified from accumulated other comprehensive income	(63)	0	1,115	0	1,050
Total change for the period	168	(1,448)	1,265	0	(16)
June 30, 2013	$ 78	$ 284	$ (26,141)	$ 4	$ (25,774)

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

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

(Dollars in millions) **For the three months ended June 30:**		**2014**		**2013**	**Yr. to Yr. Percent Change**
Retirement-related plans – cost					
Defined benefit and contribution pension plans – cost	$	398	$	636	(37.4) %
Nonpension postretirement plans – cost		70		71	(1.4)
Total	$	468	$	706	(33.8) %

(Dollars in millions) **For the six months ended June 30:**		**2014**		**2013**	**Yr. to Yr. Percent Change**
Retirement-related plans – cost					
Defined benefit and contribution pension plans – cost	$	872	$	1,310	(33.4) %
Nonpension postretirement plans – cost		137		151	(9.1)
Total	$	1,009	$	1,460	(30.9) %

Notes to Consolidated Financial Statements – (continued)

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

Cost/(Income) of Pension Plans

(Dollars in millions)	**U.S. Plans**		**Non-U.S. Plans**	
For the three months ended June 30:	**2014**	**2013**	**2014**	**2013**
Service cost	$ —	$ —	$ 118	$ 120
Interest cost	551	494	394	376
Expected return on plan assets	(1,024)	(995)	(578)	(537)
Amortization of prior service costs/(credits)	2	2	(28)	(29)
Recognized actuarial losses	259	444	361	394
Curtailments and settlements	—	—	8	0
Multi-employer plans/other costs	—	—	16	25
Total net periodic pension (income)/cost of defined benefit plans	(211)	(55)	290	349
Cost of defined contribution plans	183	193	136	148
Total defined benefit and contribution plans cost recognized in the Consolidated Statement of Earnings	$ (28)	$ 138	$ 426	$ 497

(Dollars in millions)	**U.S. Plans**		**Non-U.S. Plans**	
For the six months ended June 30:	**2014**	**2013**	**2014**	**2013**
Service cost	$ —	$ —	$ 233	$ 251
Interest cost	1,106	990	785	758
Expected return on plan assets	(2,048)	(1,991)	(1,150)	(1,091)
Amortization of prior service costs/(credits)	5	5	(57)	(60)
Recognized actuarial losses	528	895	721	798
Curtailments and settlements	—	—	13	—
Multi-employer plan/other costs	—	—	95	55
Total net periodic pension (income)/cost of defined benefit plans	(409)	(101)	638	711
Cost of defined contribution plans	375	399	269	300
Total defined benefit and contribution plans cost recognized in the Consolidated Statement of Earnings	$ (35)	$ 298	$ 907	$ 1,011

On March 24, 2014, the Supreme Court of Spain issued a ruling against IBM Spain in litigation involving its defined benefit and defined contribution plans. See page 43 for additional information. As a result of the ruling, the company recorded an additional pre-tax retirement-related obligation of $55 million in the first quarter of 2014 in selling, general and administrative expense in the Consolidated Statement of Earnings. This charge is not reflected in operating (non-GAAP) expense. This obligation is reflected in "Non-U.S. Plans - Multi-employer plans/other costs" in the six months table above. To date, the rulings in this case are declaratory only and there have been no quantifications of any individual remedies.

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

In 2014, the company expects to contribute to its non-U.S. defined benefit and multi-employer plans approximately $600 million, which will be mainly contributed to the defined benefit pension plans in Japan, the UK, Switzerland and the Netherlands. This amount represents the legally mandated minimum contributions. Total net contributions to the non-U.S. plans in the first six months of 2014 were $257 million.

Notes to Consolidated Financial Statements – (continued)

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

Cost of Nonpension Postretirement Plans

	U.S. Plan		Non-U.S. Plans	
(Dollars in millions)	**2014**	**2013**	**2014**	**2013**
For the three months ended June 30:				
Service cost	$ 6	$ 9	$ 2	$ 2
Interest cost	48	40	16	15
Expected return on plan assets	0	0	(2)	(2)
Amortization of prior service costs/(credits)	(2)	—	(1)	(1)
Recognized actuarial losses	0	2	3	6
Total nonpension postretirement plan cost recognized in Consolidated Statement of Earnings	$ 53	$ 51	$ 17	$ 20

(Dollars in millions)	U.S. Plan		Non-U.S. Plans	
For the six months ended June 30:	**2014**	**2013**	**2014**	**2013**
Service cost	$ 13	$ 17	$ 4	$ 5
Interest cost	94	82	32	31
Expected return on plan assets	0	(1)	(5)	(5)
Amortization of prior service costs/(credits)	(4)	—	(3)	(2)
Recognized actuarial losses	0	11	5	12
Curtailments and settlements	0	—	0	0
Total nonpension postretirement plan cost recognized in Consolidated Statement of Earnings	$ 103	$ 109	$ 34	$ 41

In connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the 'Act'), the company qualified to receive a subsidy through 2013. Due to benefit plan changes effective January 1, 2014, the company no longer qualifies for the subsidy as of that date. The company is expected to receive additional subsidies after 2013 to true up the final subsidy amount due to IBM under the Act. The company received a $17.6 million subsidy in the second quarter of 2014 and a $23.0 million subsidy for the first six months of 2014. For further information related to the Act, refer to page 141 in the company's 2013 Annual Report.

9. Acquisitions/Divestitures:

Acquisitions: During the six months ended June 30, 2014, the company completed four acquisitions at an aggregate cost of $571 million.

The Software segment completed acquisitions of four privately held companies: in the first quarter, Aspera, Inc. (Aspera) and Cloudant, Inc. (Cloudant); and in the second quarter, Silverpop Systems, Inc. (Silverpop) and Cognea Group Pty LTD (Cognea). All acquisitions were for 100 percent of the acquired companies.

The following table reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of June 30, 2014:

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)	Amortization Life (in yrs.)	Total Acquisitions
Current assets		$ 55
Fixed assets/noncurrent assets		39
Intangible assets:		
Goodwill	N/A	417
Completed technology	5-7	62
Client relationships	7	72
Patents/trademarks	1-7	18
Total assets acquired		664
Current liabilities		(23)
Noncurrent liabilities		(69)
Total liabilities assumed		(93)
Total purchase price		$ 571

N/A - not applicable

Each acquisition further complemented and enhanced the company's portfolio of product and services offerings. Aspera's technology makes cloud computing faster, more predictable and more cost effective for big data transfers such as enterprise storage, sharing virtual images or accessing the cloud for increased computing capacity. Cloudant will extend the company's mobile and cloud platform by enabling developers to easily and quickly create next generation mobile and web-based applications. Silverpop is a provider of cloud-based capabilities that deliver personalized customer engagements in highly scalable environments. Cognea offers personalized artificial intelligence capabilities designed to serve as an intuitive interface between human users and data-driven information. Purchase price consideration for all acquisitions as reflected in the table above, is paid primarily in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

The acquisitions were accounted for as business combinations using the acquisition method, and accordingly, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired entity was recorded at their estimated fair values at the date of acquisition. The primary items that generated the goodwill are the value of the synergies between the acquired companies and IBM and the acquired assembled workforce, neither of which qualify as an amortizable intangible asset. The overall weighted-average life of the identified amortizable intangible assets acquired is 6.8 years. These identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of $417 million has been assigned to the Software segment. It is expected that none of the goodwill will be deductible for tax purposes.

Divestitures:

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

networking and maintenance operations.

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

The transaction will be completed as soon as is practical, subject to the satisfaction of regulatory requirements, customary closing conditions and any other required approvals. At June 30, 2014, the company is engaged in the regulatory review process and in the activities necessary to separate the tangible assets and prepare such assets for sale in order to close the transaction. The transaction is expected to be completed in phases, with the initial closing expected in the second half of 2014. Subsequent local closings will occur subject to similar conditions, agreements and the information and consultation process in applicable countries.

Notes to Consolidated Financial Statements – (continued)

The company expects to recognize a total pre-tax gain on the sale of approximately $1 billion. This gain will be recognized consistent with the closing schedule for the transaction. The exact amount of the gain and the breakdown by closing date is not yet determinable. The variables that can impact the final gain and the financial statements overall include the valuation of the final balance sheet transferred, the valuation of other related agreements, any impacts resulting from the finalization of regulatory reviews and transaction-related expenses. In addition, the total impact to pre-tax income as a result of the divestiture will reflect other costs, such as performance-related compensation, to the extent impacted by the recognition of the divestiture gain.

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

On September 10, 2013, IBM and SYNNEX announced a definitive agreement in which SYNNEX will acquire the company's worldwide customer care business process outsourcing services business for $501 million, consisting of approximately $430 million in cash, net of balance sheet adjustments, and $71 million in SYNNEX common stock, which represents less than 5 percent equity ownership in SYNNEX. As part of the transaction, SYNNEX entered into a multi-year agreement with the company, and Concentrix, SYNNEX's outsourcing business, has become an IBM strategic business partner for global customer care business process outsourcing services.

The transaction is being completed in phases. The initial closing was completed in January 2014 and the company recognized a pre-tax gain of $98 million in the first quarter. In April 2014, the company completed the second closing which resulted in an additional pre-tax gain of $121 million. A final closing is expected to occur in the second half of 2014, with a minimal amount of additional pre-tax gain expected to be recognized.

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

In the second quarter of 2014, the company completed the second phase of the transfer of the maintenance workforce to Toshiba. Subsequent wave closings are scheduled to be completed through the first quarter of 2015 along with associated parts and inventory transfer. The second phase transfer and an assessment of the ongoing contractual terms of the overall transaction resulted in the recognition of an additional pre-tax gain of $2 million in the second quarter of 2014. For the first six months of 2014, the company has recognized a total pre-tax gain of $36 million.

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

On June 30, 2014, the company completed the divestiture of its Solid DB suite of products to UNICOM. The company acquired this product set through the acquisition of Solid Information Technology in 2008, which is within the Software segment. Also on June 30, 2014, the company completed the divestiture of its Human Capital Management business line in France to Sopra Group. This business line was within the Global Business Services segment. Financial details for both transactions were not material.

Notes to Consolidated Financial Statements – (continued)

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

		At June 30, 2014	
(Dollars in millions)	**Gross Carrying**	**Accumulated**	**Net Carrying**
Intangible asset class	**Amount**	**Amortization**	**Amount**
Capitalized software	$ 1,435	$ (689)	$ 746
Client relationships	2,219	(1,128)	1,092
Completed technology	2,939	(1,393)	1,546
In-process R&D	2	—	2
Patents/trademarks	376	(184)	192
Other*	13	(5)	7
Total	$ 6,984	$ (3,399)	$ 3,585

		At December 31, 2013	
(Dollars in millions)	**Gross Carrying**	**Accumulated**	**Net Carrying**
Intangible asset class	**Amount**	**Amortization**	**Amount**
Capitalized software	$ 1,494	$ (699)	$ 794
Client relationships	2,148	(977)	1,171
Completed technology	2,910	(1,224)	1,687
In-process R&D	13	—	13
Patents/trademarks	358	(154)	204
Other*	7	(5)	2
Total	$ 6,930	$ (3,059)	$ 3,871

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

The net carrying amount of intangible assets decreased $286 million during the first six months of 2014, primarily due to amortization, partially offset by intangible asset additions resulting from acquisitions. The aggregate intangible amortization expense was $340 million and $679 million for the second quarter and first six months of 2014, respectively, versus $326 million and $657 million for the second quarter and first six months of 2013, respectively. In addition, in the first six months of 2014, the company retired $337 million of fully amortized intangible assets, impacting both the gross carrying amount and accumulated amortization by this amount.

The amortization expense for each of the five succeeding years relating to intangible assets currently recorded in the Consolidated Statement of Financial Position is estimated to be the following at June 30, 2014:

	Capitalized	**Acquired**

(Dollars in millions)	Software	Intangibles	Total
2014 (for Q3-Q4)	$ 259	$ 404	$ 663
2015	337	663	1,000
2016	131	621	752
2017	19	503	523
2018	—	348	348

Notes to Consolidated Financial Statements – (continued)

The change in the goodwill balances by reportable segment, for the six months ended June 30, 2014 and for the year ended December 31, 2013 are as follows:

(Dollars in millions) Segment	Balance 01/01/14	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation And Other Adjustments	Balance 6/30/14
Global Business Services	$ 4,334	$ —	$ —	$ —	$ 26	$ 4,360
Global Technology Services	4,129	—	21	(52)	24	4,122
Software	21,121	417	(7)	(3)	(41)	21,487
Systems and Technology	1,601	—	—	—	(1)	1,600
Total	$ 31,184	$ 417	$ 13	$ (55)	$ 8	$ 31,568

(Dollars in millions) Segment	Balance 01/01/13	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation And Other Adjustments	Balance 12/31/13
Global Business Services	$ 4,357	$ —	$ 0	$ (3)	$ (21)	$ 4,334
Global Technology Services	2,916	1,246	17	—	(50)	4,129
Software	20,405	987	11	(4)	(279)	21,121
Systems and Technology	1,568	13	33	—	(14)	1,601
Total	$ 29,247	$ 2,246	$ 61	$ (7)	$ (363)	$ 31,184

Purchase price adjustments recorded in the first six months of 2014 and full year 2013 were related to acquisitions that were completed on or prior to December 31, 2013 or December 31, 2012, respectively, and were still subject to the measurement period that ends at the earlier of 12 months from the acquisition date or when information becomes available. There were no goodwill impairment losses recorded during the first six months of 2014 or the full year of 2013 and the company has no accumulated impairment losses.

11. Borrowings:

Short-Term Debt

(Dollars in millions)	At June 30, 2014	At December 31, 2013
Commercial paper	$ 6,549	$ 2,458
Short-term loans	437	551
Long-term debt—current maturities	5,477	3,854
Total	$ 12,462	$ 6,862

The weighted-average interest rate for commercial paper at June 30, 2014 and December 31, 2013 was 0.1 percent and 0.1 percent, respectively. The weighted-average interest rate for short-term loans was 7.2 percent and 5.1 percent at June 30, 2014 and December 31, 2013, respectively.

Notes to Consolidated Financial Statements – (continued)

Long-Term Debt

Pre-Swap Borrowing

(Dollars in millions)	**Maturities**	**Balance 6/30/2014**	**Balance 12/31/2013**
U.S. dollar notes and debentures (average interest rate at June 30, 2014):			
0.62%	2014–2015	$ 4,775	$ 6,456
2.59%	2016–2017	10,118	8,465
3.34%	2018–2021	8,056	6,206
1.88%	2022	1,000	1,000
3.38%	2023	1,500	1,500
3.63%	2024	2,000	–
7.00%	2025	600	600
6.22%	2027	469	469
6.50%	2028	313	313
5.88%	2032	600	600
8.00%	2038	83	83
5.60%	2039	745	745
4.00%	2042	1,107	1,107
7.00%	2045	27	27
7.13%	2096	316	316
		$ 31,709	$ 27,887
Other currencies (average interest rate at June 30, 2014, in parentheses):		\	
Euros (2.0%)	2015–2025	4,815	5,894
Pound sterling (2.75%)	2017–2020	1,293	1,254
Japanese yen (0.5%)	2017	867	1,057
Swiss francs (3.8%)	2015–2020	181	181
Canadian (2.2%)	2017	469	471
Other (9.06%)	2015–2018	350	291
		$ 39,684	$ 37,036
Less: net unamortized discount		866	872
Add: fair value adjustment*		667	546
		$ 39,485	$ 36,710
Less: current maturities		5,477	3,854
Total		$ 34,008	$ 32,856

Note: The 2014-2015 maturities at 12/31/2013 includes $17 million of debt securities issued by IBM International Group Capital, LLC, which is an indirect, 100 percent owned finance subsidiary of the company which matured in the first half of 2014. Debt securities issued by IBM International Group Capital LLC are fully and unconditionally guaranteed by the company.

* The portion of the company's fixed-rate debt obligations that is hedged is reflected in the Consolidated Statement of Financial Position as an amount equal to the sum of the debt's carrying value plus a fair value adjustment

representing changes in the fair value of the hedged debt obligations attributable to movements in benchmark interest rates.

The company's indenture governing its debt securities and its various credit facilities each contain significant covenants which obligate the company to promptly pay principal and interest, limit the aggregate amount of secured indebtedness and sale and leaseback transactions to 10 percent of the company's consolidated net tangible assets, and restrict the company's ability to merge or consolidate unless certain conditions are met. The credit facilities also include a covenant on the company's consolidated net interest expense ratio, which cannot be less than 2.20 to 1.0, as well as a cross default provision with respect to other defaulted indebtedness of at least $500 million.

The company is in compliance with all of its significant debt covenants and provides periodic certifications to its lenders. The failure to comply with its debt covenants could constitute an event of default with respect to the debt to which such provisions apply. If certain events of default were to occur, the principal and interest on the debt to which such event of default applied would become immediately due and payable.

Notes to Consolidated Financial Statements – (continued)

Pre-swap annual contractual maturities of long-term debt outstanding at June 30, 2014, are as follows:

(Dollars in millions)		**Total**
2014 (for Q3-Q4)	$	1,418
2015		4,876
2016		5,118
2017		5,374
2018		2,603
2019 and beyond		20,294
Total	$	39,684

Interest on Debt

(Dollars in millions) **For the six months ended June 30:**		**2014**		**2013**
Cost of financing	$	279	$	299
Interest expense		239		194
Net investment derivative activity		1		(2)
Interest capitalized		3		17
Total interest paid and accrued	$	522	$	508

Refer to the company's 2013 Annual Report, note T, "Segment Information," on page 143 for total interest expense of the Global Financing segment. See note 3, "Financial Instruments," for a discussion of the use of currency and interest rate swaps in the company's debt risk management program.

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

(Dollars in millions)		**Liability as of 01/01/14**		**Payments**		**Other Adjustments***		**Liability as of 6/30/2014**
Current:								
Workforce	$	27	$	(15)	$	16	$	29
Total current	$	27	$	(15)	$	16	$	29
Noncurrent:								
Workforce	$	440	$	—	$	(9)	$	431
Total noncurrent	$	440	$	—	$	(9)	$	431

* Other Adjustments principally includes the reclassification of noncurrent to current, remeasurement of actuarial assumptions,
foreign currency translation adjustments and interest accretion.

13. Contingencies: As a company with a substantial employee population and with clients in more than 175 countries, IBM is involved, either as plaintiff or defendant, in a variety of ongoing claims, demands, suits, investigations, tax matters and proceedings that arise from time to time in the ordinary course of its business. The company is a leader in the information technology industry and, as such, has been and will continue to be subject to claims challenging its IP rights and associated products and offerings, including claims of copyright and patent infringement and violations of trade secrets and other IP rights. In addition, the company enforces its own IP against infringement, through license negotiations, lawsuits or otherwise. Also, as is typical for companies of IBM's scope and scale, the company is party to actions and proceedings in various jurisdictions involving a wide range of labor and employment issues (including matters related to contested employment decisions, country-specific labor and employment laws, and the company's pension, retirement and other benefit plans), as well as actions with respect to contracts, product liability, securities, foreign operations, competition law and environmental matters. These actions may be commenced by a number of different parties, including competitors, clients, current or former employees, government and regulatory agencies, stockholders and representatives of the locations in which the company does business. Some of the actions to which the company is party may involve particularly complex technical issues, and some actions may raise novel questions under the laws of the various jurisdictions in which these matters arise.

The company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Any recorded liabilities, including any changes to such liabilities for the quarter ended June 30, 2014 were not material to the Consolidated Financial Statements.

Notes to Consolidated Financial Statements – (continued)

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

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

Whether any losses, damages or remedies finally determined in any claim, suit, investigation or proceeding could reasonably have a material effect on the company's business, financial condition, results of operations or cash flows will depend on a number of variables, including: the timing and amount of such losses or damages; the structure and type of any such remedies; the significance of the impact any such losses, damages or remedies may have in the Consolidated Financial Statements; and the unique facts and circumstances of the particular matter that may give rise to additional factors. While the company will continue to defend itself vigorously, it is possible that the company's business, financial condition, results of operations or cash flows could be affected in any particular period by the resolution of one or more of these matters.

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

The company is a defendant in an action filed on March 6, 2003 in state court in Salt Lake City, Utah by the SCO Group (SCO v. IBM). The company removed the case to Federal Court in Utah. Plaintiff is an alleged successor in interest to some of AT&T's UNIX IP rights, and alleges copyright infringement, unfair competition, interference with contract and breach of contract with regard to the company's distribution of AIX and Dynix and contribution of code to Linux. The company has asserted counterclaims, including breach of contract, violation of the Lanham Act, unfair competition, intentional torts, unfair and deceptive trade practices, breach of the General Public License that governs

open source distributions, promissory estoppel and copyright infringement. Motions for summary judgment were heard in March 2007, and the court has not yet issued its decision. On September 14, 2007, plaintiff filed for bankruptcy protection, and all proceedings in this case were stayed. On August 25, 2009, the U.S. Bankruptcy Court for the District of Delaware approved the appointment of a Trustee of SCO. The court in another suit, the SCO Group, Inc. v. Novell, Inc., held a trial in March 2010. The jury found that Novell is the owner of UNIX and UnixWare copyrights; the judge subsequently ruled that SCO is obligated to recognize Novell's waiver of SCO's claims against IBM and Sequent for breach of UNIX license agreements. On August 30, 2011, the Tenth Circuit Court of Appeals affirmed the district court's ruling and denied SCO's appeal of this matter. In June 2013, the Federal Court in Utah granted SCO's motion to reopen the SCO v. IBM case. On July 10, 2013, the Court entered an order dismissing 7 of SCO's 10 claims, specifically its breach of contract and copyright claims, and one tortious interference claim.

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

Notes to Consolidated Financial Statements – (continued)

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

IBM United Kingdom Limited (IBM UK) initiated legal proceedings in May 2010 before the High Court in London against the IBM UK Pensions Trust (the UK Trust) and two representative beneficiaries of the UK Trust membership. IBM UK is seeking a declaration that it acted lawfully both in notifying the Trustee of the UK Trust that it was closing its UK defined benefit plans to future accruals for most participants and in implementing the company's new retirement policy. On April 4, 2014, the High Court acknowledged that the changes made to its UK defined benefit plans were within IBM's discretion, but ruled that IBM breached its implied duty of good faith both in implementing these changes and in the manner in which it consulted with employees. Proceedings to determine remedies began on July 21, 2014. In addition, IBM UK is a defendant in approximately 290 individual actions brought since early 2010 by participants of the defined benefits plans who left IBM UK. These actions, which allege constructive dismissal and age discrimination, are pending before the Employment Tribunal in Southampton UK.

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

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

In March 2011, the company announced that it had agreed to settle a civil enforcement action with the Securities and Exchange Commission (SEC) relating to alleged violations of the Foreign Corrupt Practices Act of 1977. On July

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

In May 2013, IBM learned that the SEC was conducting an investigation into how IBM reports cloud revenue. On May 30, 2014, the Division of Enforcement of the SEC informed IBM that it had concluded its investigation. IBM was notified that based on the information to date, the Division of Enforcement did not intend to recommend any enforcement action by the SEC against IBM.

In December 2013, a putative class action lawsuit was filed in the United States District Court for the Southern District of New York related to the company's third-quarter 2013 financial results disclosure. On May 2, 2014, plaintiffs voluntarily dismissed the suit without prejudice.

The company is a defendant in numerous actions filed after January 1, 2008 in the Supreme Court for the State of New York, county of Broome, on behalf of hundreds of plaintiffs. The complaints allege numerous and different causes of action, including for negligence and recklessness, private nuisance and trespass. Plaintiffs in these cases seek medical monitoring

Notes to Consolidated Financial Statements – (continued)

and claim damages in unspecified amounts for a variety of personal injuries and property damages allegedly arising out of the presence of groundwater contamination and vapor intrusion of groundwater contaminants into certain structures in which plaintiffs reside or resided, or conducted business, allegedly resulting from the release of chemicals into the environment by the company at its former manufacturing and development facility in Endicott. These complaints also seek punitive damages in an unspecified amount.

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

The company is also subject to ongoing tax examinations and governmental assessments in various jurisdictions. Along with many other U.S. companies doing business in Brazil, the company is involved in various challenges with Brazilian authorities regarding non-income tax assessments and non-income tax litigation matters. The total potential amount related to these matters for all applicable years is approximately $710 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

14. Commitments: The company's extended lines of credit to third-party entities include unused amounts of $5,610 million and $5,028 million at June 30, 2014 and December 31, 2013, respectively. A portion of these amounts was available to the company's business partners to support their working capital needs. In addition, the company has committed to provide future financing to its clients in connection with client purchase agreements for approximately $1,759 million and $1,769 million at June 30, 2014 and December 31, 2013, respectively.

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

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

time and/or nature of claim, and in some instances, the company may have recourse against third parties for certain payments made by the company.

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

In addition, the company guarantees certain loans and financial commitments. The maximum potential future payment under these financial guarantees was $43 million and $44 million at June 30, 2014 and December 31, 2013, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position is not material.

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

Notes to Consolidated Financial Statements – (continued)

Standard Warranty Liability

(Dollars in millions)	**2014**	**2013**
Balance at January 1	$ 376	$ 394
Current period accruals	122	163
Accrual adjustments to reflect actual experience	8	11
Charges incurred	(172)	(192)
Balance at June 30	$ 334	$ 376

Extended Warranty Liability

(Dollars in millions)	**2014**	**2013**
Aggregate deferred revenue at January 1	$ 579	$ 606
Revenue deferred for new extended warranty contracts	132	119
Amortization of deferred revenue	(145)	(148)
Other*	(8)	(11)
Aggregate deferred revenue at June 30	$ 558	$ 567
Current portion	$ 266	$ 271
Noncurrent portion	292	296
Aggregate deferred revenue at June 30	$ 558	$ 567

* Other primarily consists of foreign currency translation adjustments.

15. Subsequent Events: On July 29, 2014, the company announced that the Board of Directors approved a quarterly dividend of $1.10 per common share. The dividend is payable September 10, 2014 to shareholders of record on August 8, 2014.

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2014

Snapshot

Financial Results Summary:

(Dollars in millions except per share amounts) **For the three months ended June 30:**	**2014**	**2013**	**Yr. to Yr. Percent/ Margin Change**
Revenue	$ 24,364	$ 24,924	(2.2) %*
Gross profit margin	49.1 %	48.7 %	0.5 pts.
Total expense and other (income)	$ 6,804	$ 7,988	(14.8) %
Total expense and other (income)-to-revenue ratio	27.9 %	32.0 %	(4.1) pts.
Provision for income taxes	$ 1,034	$ 918	12.7 %
Net income	$ 4,137	$ 3,226	28.2 %
Net income margin	17.0 %	12.9 %	4.0 pts.
Earnings per share:			
Assuming dilution	$ 4.12	$ 2.91	41.6 %
Basic	$ 4.14	$ 2.93	41.3 %
Weighted-average shares outstanding:			
Assuming dilution	1,005.1	1,109.4	(9.4) %
Basic	999.6	1,100.9	(9.2) %

*2.5 percent decrease adjusted for currency

Currency:

The references to "adjusted for currency" or "at constant currency" in the Management Discussion do not include operational impacts that could result from fluctuations in foreign currency rates. Certain financial results are adjusted based on a simple mathematical model that translates current period results in local currency using the comparable prior year period's currency conversion rate. This approach is used for countries where the functional currency is the local country currency. This information is provided so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business performance. See "Currency Rate Fluctuations" on pages 75 and 76 for additional information.

Operating (non-GAAP) Earnings:

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

Management Discussion – (continued)

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

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

(Dollars in millions except per share amounts) For the three months ended June 30:	2014	2013	Yr. to Yr. Percent Change
Net income as reported	$ 4,137	$ 3,226	28.2 %
Non-operating adjustments (net of tax):			
Acquisition-related charges	163	173	(6.0)
Non-operating retirement-related costs/(income)	42	180	(76.8)
Operating (non-GAAP) earnings*	$ 4,341	$ 3,579	21.3 %
Diluted operating (non-GAAP) earnings per share	$ 4.32	$ 3.22	34.2 %

* See pages 84 and 85 for a more detailed reconciliation of net income to operating earnings.

Financial Performance Summary:

In the second quarter of 2014, the company reported $24.4 billion in revenue and delivered diluted earnings per share of $4.12 as reported and $4.32 on an operating (non-GAAP) basis. The company generated $3.6 billion in cash from operations and $3.0 billion in free cash flow in the second quarter driving shareholder returns of $4.8 billion in gross common stock repurchases and dividends.

The company's performance in the second quarter and the first half of 2014 reflected the stability of the overall business model as the company continued its transformation. From a portfolio perspective:

- The company continued to drive double-digit revenue growth in the parts of the business that address the emerging trends in enterprise IT.
- The core franchises were stable, where the company continues to drive innovation.

- The company is dealing with secular shifts in parts of its hardware business.
- The divested customer care business has had an impact as the company shifts to higher value.

In the first quarter of 2014, the company announced a number of initiatives to support the shift to the strategic imperatives of data, cloud and systems of engagement. These included:

- The launch of Bluemix, the company’s cloud platform-as-a-service for the enterprise.
- A $1.2 billion investment to globally expand SoftLayer cloud hubs.
- A $1 billion investment to bring Watson’s cognitive capabilities to the enterprise.

In the second quarter of 2014, the company made progress implementing these initiatives including:

- Bluemix becoming generally available in June.
- New SoftLayer data centers were opened.
- POWER8 began to ship, and the OpenPOWER consortium doubled its membership.
- Substantially completing the divestiture of the customer care business.

In July, the company announced additional actions to continue the shift to higher value, including:

- An investment of $3 billion over the next five years in research and early stage development to create the next generation of semiconductor chip technologies that will fuel the systems required for cloud, big data and cognitive systems.

Management Discussion – (continued)

- A strategic global partnership with Apple to provide a new level of business value from mobility for enterprise clients.

The underlying theme of these actions – from the expansion of the cloud platforms and capacity, to the OpenPOWER consortium, to the partnership with Apple for enterprise mobility, to next generation chip technologies – is that the company is leveraging its unique strengths in innovation and enterprise capabilities to maintain its differentiation in the emerging areas of enterprise IT. While some of these actions impact results in the short term, they position the business better for the long term.

In the second quarter, total consolidated revenue decreased 2.2 percent, 2.5 percent at constant currency. Adjusting for the divested customer care business, revenue decreased 1 percent at constant currency. From a segment perspective, Software revenue increased 1.0 percent (flat adjusted for currency), driven by middleware which increased 3.4 percent (3 percent adjusted for currency). The company is continuing to drive strong results in the strategic areas of mobile and security, as well as in some of the core franchises, including application servers and distributed databases. Global Services revenue declined 1.4 percent as reported and at constant currency; adjusting for the divested customer care business, Global Services revenue increased 1 percent at constant currency. Global Technology Services (GTS) revenue decreased 1.3 percent as reported and at constant currency; adjusting for the divested customer care business, GTS revenue increased 2 percent at constant currency from growth in cloud offerings and large outsourcing contracts signed in 2013. Global Business Services decreased 1.6 percent (2 percent adjusted for currency), with strong growth in the practices that address the digital front office, however performance in the traditional packaged application implementation offerings lagged. Systems and Technology revenue decreased 11.4 percent (12 percent adjusted for currency) but improved significantly sequentially compared to the first quarter of 2014 driven by System z mainframe, System x and Storage.

From a geographic perspective, revenue in the growth markets declined 6.8 percent as reported and 4 percent adjusted for currency, a 1 point sequential improvement from the first quarter at constant currency. Within the growth markets, the BRIC countries decreased 1.9 percent as reported, but increased 1 percent at constant currency; a 7 point improvement from the first quarter 2014.

The consolidated gross profit margin increased 0.5 points versus the second quarter of 2013 to 49.1 percent. The operating (non-GAAP) gross margin of 49.8 percent increased 0.1 points year to year. The improvement in gross margin was driven by margin expansion in Global Technology Services and an improved mix toward Software, partially offset by margin declines in Global Business Services and Systems and Technology. Operating (non-GAAP) gross profit of $12.1 billion declined approximately $250 million year to year driven entirely by Systems and Technology; excluding Systems and Technology, gross profit was flat year to year in the second quarter, including a $70 million impact from the divested customer care business, and while the company continues to transition to emerging areas where the profit and margins will benefit from scale.

Total expense and other (income) decreased 14.8 percent in the second quarter of 2014 compared to the prior year. Total operating (non-GAAP) expense and other (income) decreased 14.0 percent year to year. The year-to-year drivers were approximately:

	Total Consolidated		Operating (non-GAAP)	
Currency*	1	pt.	1	pt.
Acquisitions **	2	pts.	2	pts.
Base expense	(18)	pts.	(17)	pts.