

INTERNATIONAL BUSINESS MACHINES CORP

Form 10-Q

July 27, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10 - Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED JUNE 30, 2010

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State of incorporation)

13-0871985

(IRS employer identification number)

Armonk, New York

10504

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(Address of principal executive offices)

(Zip Code)

914-499-1900

(Registrant's telephone number)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

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

The registrant has 1,261,278,072 shares of common stock outstanding at June 30, 2010.

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Table of Contents**Part I - Financial Information****Item 1. Consolidated Financial Statements:****INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES****CONSOLIDATED STATEMENT OF EARNINGS****(UNAUDITED)**

| (Dollars in millions except per share amounts) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|-----------------|---------------------------|-----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Revenue: | | | | |
| Services | \$ 13,824 | \$ 13,479 | \$ 27,629 | \$ 26,656 |
| Sales | 9,349 | 9,198 | 17,857 | 17,147 |
| Financing | 550 | 574 | 1,095 | 1,158 |
| Total revenue | 23,724 | 23,250 | 46,581 | 44,962 |
| Cost: | | | | |
| Services | 9,328 | 9,145 | 18,712 | 18,208 |
| Sales | 3,313 | 3,221 | 6,537 | 6,123 |
| Financing | 273 | 303 | 546 | 618 |
| Total cost | 12,915 | 12,669 | 25,795 | 24,949 |
| Gross profit | 10,809 | 10,581 | 20,785 | 20,012 |
| Expense and other income: | | | | |
| Selling, general and administrative | 5,061 | 5,115 | 10,737 | 10,379 |
| Research, development and engineering | 1,475 | 1,434 | 2,984 | 2,914 |
| Intellectual property and custom development income | (297) | (302) | (558) | (570) |
| Other (income) and expense | (95) | (28) | (640) | (331) |
| Interest expense | 90 | 101 | 172 | 237 |
| Total expense and other income | 6,234 | 6,319 | 12,695 | 12,628 |
| Income before income taxes | 4,575 | 4,262 | 8,090 | 7,385 |
| Provision for income taxes | 1,190 | 1,159 | 2,103 | 1,986 |
| Net income | \$ 3,386 | \$ 3,103 | \$ 5,987 | \$ 5,398 |
| Earnings per share of common stock: | | | | |
| Assuming dilution | \$ 2.61 | \$ 2.32 | \$ 4.57 | \$ 4.02 |
| Basic | \$ 2.65 | \$ 2.34 | \$ 4.64 | \$ 4.04 |
| Weighted-average number of common shares outstanding: (millions) | | | | |
| Assuming dilution | 1,296.7 | 1,336.9 | 1,309.2 | 1,343.2 |
| Basic | 1,278.6 | 1,326.1 | 1,289.9 | 1,335.2 |

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| | | | | | | | | |
|---------------------------------------|----|------|----|------|----|------|----|------|
| Cash dividend per common share | \$ | 0.65 | \$ | 0.55 | \$ | 1.20 | \$ | 1.05 |
|---------------------------------------|----|------|----|------|----|------|----|------|

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(UNAUDITED)

ASSETS

| (Dollars in millions) | At June 30, 2010 | At December 31, 2009 |
|--|---------------------|-------------------------|
| Assets: | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 10,325 | \$ 12,183 |
| Marketable securities | 1,916 | 1,791 |
| Notes and accounts receivable - trade (net of allowances of \$291 in 2010 and \$217 in 2009) | 9,051 | 10,736 |
| Short-term financing receivables (net of allowances of \$376 in 2010 and \$438 in 2009) | 13,301 | 14,914 |
| Other accounts receivable (net of allowances of \$11 in 2010 and \$15 in 2009) | 1,140 | 1,143 |
| Inventories, at lower of average cost or market: | | |
| Finished goods | 493 | 533 |
| Work in process and raw materials | 2,102 | 1,960 |
| Total inventories | 2,595 | 2,494 |
| Deferred taxes | 1,444 | 1,730 |
| Prepaid expenses and other current assets | 5,124 | 3,946 |
| Total current assets | 44,895 | 48,935 |
| Plant, rental machines and other property | 38,292 | 39,596 |
| Less: Accumulated depreciation | 24,758 | 25,431 |
| Plant, rental machines and other property - net | 13,534 | 14,165 |
| Long-term financing receivables (net of allowances of \$84 in 2010 and \$97 in 2009) | 9,185 | 10,644 |
| Prepaid pension assets | 3,575 | 3,001 |
| Deferred taxes | 3,122 | 4,195 |
| Goodwill | 20,544 | 20,190 |
| Intangible assets - net | 2,526 | 2,513 |
| Investments and sundry assets | 6,038 | 5,379 |
| Total assets | \$ 103,420 | \$ 109,022 |

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION (CONTINUED)

(UNAUDITED)

LIABILITIES AND EQUITY

| (Dollars in millions) | At June 30, 2010 | At December 31, 2009 |
|--|-----------------------------|---------------------------------|
| Liabilities: | | |
| Current liabilities: | | |
| Taxes | \$ 2,895 | \$ 3,826 |
| Short-term debt | 5,633 | 4,168 |
| Accounts payable | 7,233 | 7,436 |
| Compensation and benefits | 4,022 | 4,505 |
| Deferred income | 10,671 | 10,845 |
| Other accrued expenses and liabilities | 4,539 | 5,223 |
| Total current liabilities | 34,993 | 36,002 |
| Long-term debt | 21,017 | 21,932 |
| Retirement and nonpension postretirement benefit obligations | 14,598 | 15,953 |
| Deferred income | 3,341 | 3,562 |
| Other liabilities | 8,295 | 8,819 |
| Total liabilities | 82,244 | 86,267 |
| Equity: | | |
| IBM stockholders' equity: | | |
| Common stock, par value \$0.20 per share, and additional paid-in capital | 43,522 | 41,810 |
| Shares authorized: 4,687,500,000 | | |
| Shares issued: | | |
| 2010 2,145,080,210 | | |
| 2009 2,127,016,668 | | |
| Retained earnings | 85,323 | 80,900 |
| Treasury stock - at cost | (89,276) | (81,243) |
| Shares: | | |
| 2010 883,802,138 | | |
| 2009 821,679,245 | | |
| Accumulated other comprehensive income/(loss) | (18,510) | (18,830) |
| Total IBM stockholders' equity | 21,059 | 22,637 |
| Noncontrolling interests | 117 | 118 |
| Total equity | 21,176 | 22,755 |
| Total liabilities and equity | \$ 103,420 | \$ 109,022 |

(Amounts may not add due to rounding.)

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

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AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF CASH FLOWS

FOR THE SIX MONTHS ENDED JUNE 30,

(UNAUDITED)

| (Dollars in millions) | 2010 | 2009 |
|---|------------------|------------------|
| Cash flow from operating activities: | | |
| Net income | \$ 5,987 | \$ 5,398 |
| Adjustments to reconcile net income to cash provided from operating activities: | | |
| Depreciation | 1,823 | 1,853 |
| Amortization of intangibles | 570 | 618 |
| Stock-based compensation | 320 | 269 |
| Net (gain)/loss on asset sales and other | (590) | (340) |
| Changes in operating assets and liabilities, net of acquisitions/divestitures | 93 | 1,330 |
| Net cash provided by operating activities | 8,203 | 9,127 |
| Cash flow from investing activities: | | |
| Payments for plant, rental machines and other property, net of proceeds from dispositions | (1,586) | (1,304) |
| Investment in software | (287) | (319) |
| Acquisition of businesses, net of cash acquired | (1,009) | (100) |
| Divestiture of businesses, net of cash transferred | 0 | 356 |
| Non-operating finance receivables net | 282 | 487 |
| Purchases of marketable securities and other investments | (3,883) | (2,330) |
| Proceeds from disposition of marketable securities and other investments | 3,838 | 1,314 |
| Net cash used in investing activities | (2,645) | (1,897) |
| Cash flow from financing activities: | | |
| Proceeds from new debt | 2,501 | 1,969 |
| Payments to settle debt | (3,744) | (5,040) |
| Short-term borrowings/(repayments) less than 90 days net | 1,973 | (934) |
| Common stock repurchases | (8,121) | (3,436) |
| Common stock transactions other | 1,827 | 522 |
| Cash dividends paid | (1,551) | (1,407) |
| Net cash used in financing activities | (7,114) | (8,326) |
| Effect of exchange rate changes on cash and cash equivalents | (301) | 33 |
| Net change in cash and cash equivalents | (1,858) | (1,063) |
| Cash and cash equivalents at January 1 | 12,183 | 12,741 |
| Cash and cash equivalents at June 30 | \$ 10,325 | \$ 11,678 |

(Amounts may not add due to rounding.)

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

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Notes to Consolidated Financial Statements:

1. Basis of Presentation: The accompanying Consolidated Financial Statements and footnotes thereto 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 of a normal recurring nature, necessary to present a fair statement of the company's results of operations, financial position and cash flows.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the assets, liabilities, revenue, costs, expenses and accumulated other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. Actual results may be different. See the company's 2009 Annual Report on pages 52 to 54 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 2009 Annual Report.

Noncontrolling interest amounts in income of \$1.0 million and \$0.4 million, net of tax, for the three months ended June 30, 2010 and 2009, respectively, and \$2.8 million for both the six months ended June 30, 2010 and 2009 are not presented separately in the Consolidated Statement of Earnings due to immateriality, but are reflected within the other (income) and expense line item. Additionally, changes to noncontrolling interests are presented in Note 10, Equity Activity, on pages 27 and 28.

Within the financial 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 July 2010, the Financial Accounting Standards Board (FASB) issued amendments to the disclosure requirements about the credit quality of financing receivables and the allowance for credit losses. The purpose of the additional disclosures is to enable users of financial statements to better understand the nature of credit risk inherent in an entity's portfolio of financing receivables and how that risk is analyzed. For end of period balances, the new disclosures are required to be made in all interim and annual periods ending on or after December 15, 2010. For activity during a reporting period, the disclosures are required to be made in all interim and annual periods after January 1, 2011. These changes will not have an impact on the consolidated financial results as this guidance only relates to additional disclosures.

In January 2010, the FASB issued additional disclosure requirements for fair value measurements. The guidance requires previous fair value hierarchy disclosures to be further disaggregated by class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. In addition, significant transfers between Levels 1 and 2 of the fair value hierarchy are required to be disclosed. These additional requirements became effective January 1, 2010 for quarterly and annual reporting. These amendments did not have an impact on the consolidated financial results as this guidance relates only to additional disclosures. See Note 4, Fair Value, on pages 11 to 13 for further information. In addition, the fair value disclosure amendments also require more detailed disclosures of the changes in Level 3

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instruments. These changes will be effective January 1, 2011 and will not have an impact on the consolidated financial results as this guidance only relates to additional disclosures.

In October 2009, the FASB issued amended revenue recognition guidance for arrangements with multiple deliverables. The new guidance requires the use of management's best estimate of selling price (BESP) for the deliverables in an arrangement when vendor specific objective evidence (VSOE), vendor objective evidence (VOE) or third party evidence (TPE) of the selling price is not available. In addition, excluding specific software revenue guidance, the residual method of allocating arrangement consideration is no longer permitted, and an entity is required to allocate arrangement consideration using the relative selling price method. In accordance with the guidance, the company elected to early adopt its provisions as of January 1, 2010 on a prospective basis for all new or materially modified arrangements entered into on or after that date. The adoption of this guidance did not have a material impact on the Consolidated Financial Statements.

Also, in October 2009, the FASB issued guidance which amended the scope of existing software revenue recognition guidance. Tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are no longer within the scope of software revenue guidance and are accounted for based on other applicable revenue recognition guidance. In addition, the amendments require that hardware components of a tangible product containing software components are always excluded from the software revenue guidance. This guidance must be adopted in the same period that the company adopts the amended guidance for arrangements with multiple

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Notes to Consolidated Financial Statements (continued)

deliverables described in the preceding paragraph. Therefore, the company elected to early adopt this guidance as of January 1, 2010 on a prospective basis for all new or materially modified arrangements entered into on or after that date. The adoption of this guidance did not have a material impact on the Consolidated Financial Statements.

See Note 3, Revenue Recognition for Arrangements with Multiple Deliverables, on pages 8 to 11 for the required disclosures and other information related to the adoption of these accounting standards.

In June 2009, the FASB issued amendments to the accounting rules for variable interest entities (VIEs). The new guidance eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity and requires ongoing qualitative reassessments of whether an enterprise is the primary beneficiary. The company adopted these amendments for interim and annual reporting periods beginning on January 1, 2010. The adoption of these amendments did not have a material impact on the Consolidated Financial Statements.

3. Revenue Recognition for Arrangements with Multiple Deliverables: As discussed in Note 2, Accounting Changes, on page 7, effective January 1, 2010 the company adopted on a prospective basis for all new or materially modified arrangements entered into on or after that date the amended accounting guidance for multiple-deliverable revenue arrangements and the amended guidance related to the scope of existing software revenue recognition guidance. The amended guidance does not generally change the units of accounting for the company's revenue transactions. Most of the company's products and services qualify as separate units of accounting.

The company enters into revenue arrangements that may consist of multiple deliverables of its products and services based on the needs of its clients. These arrangements may include any combination of services, software, hardware and/or financing. For example, a client may purchase a server that includes operating system software. In addition, the arrangement may include post-contract support for the software and a contract for post-warranty maintenance service for the hardware. These types of arrangements can also include financing provided by the company. These arrangements consist of multiple deliverables, with the hardware and software delivered in one reporting period and the software support and hardware maintenance services delivered across multiple reporting periods. In another example, a client may outsource the running of its datacenter operations to the company on a long term, multiple year basis and periodically purchase servers and/or software products from the company to upgrade or expand its facility. The outsourcing services are provided on a continuous basis across multiple reporting periods and the hardware and software products are delivered in one reporting period. To the extent that a deliverable in a multiple-deliverable arrangement is subject to specific guidance that deliverable is accounted for in accordance with such specific guidance. Examples of such arrangements may include leased hardware which is subject to specific leasing guidance or software which is subject to specific software revenue recognition guidance on whether and/or how to separate multiple deliverable arrangements into separate units of accounting (separability) and how to allocate the arrangement consideration among those separate units of accounting (allocation). For all other deliverables in multiple-deliverable arrangements, the guidance below is applied for separability and allocation. A multiple-deliverable arrangement is separated into more than one unit of accounting if the following criteria are met:

- The delivered item(s) has value to the client on a stand-alone basis; and
- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the company.

If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element and there is a relative selling price for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative selling price. The revenue recognition policies described below are then applied to each unit of accounting, as applicable.

Services

The company's primary services offerings include information technology (IT) datacenter and business process outsourcing, application management services, consulting and systems integration, technology infrastructure and system maintenance, Web hosting and the design and development of complex IT systems to a client's specifications (design and build). These services are provided on a time-and-material basis, as a fixed-price contract or as a fixed-price per measure of output contract and the contract terms range from less than one year to over 10 years.

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Notes to Consolidated Financial Statements (continued)

Revenue from IT datacenter and business process outsourcing contracts is recognized in the period the services are provided using either an objective measure of output or on a straight-line basis over the term of the contract. Under the output method, the amount of revenue recognized is based on the services delivered in the period.

Revenue from application management services, technology infrastructure and system maintenance and Web hosting contracts is primarily recognized on a straight-line basis over the terms of the contracts. Revenue from time-and-material contracts is recognized as labor hours are delivered and direct expenses are incurred. Revenue related to extended warranty and product maintenance contracts is recognized on a straight-line basis over the delivery period.

Revenue from fixed-price design and build contracts is recognized under the percentage-of-completion (POC) method. Under the POC method, revenue is recognized based on the labor costs incurred to date as a percentage of the total estimated labor costs to fulfill the contract. If circumstances arise that change the original estimates of revenues, costs, or extent of progress toward completion, revisions to the estimates are made. These revisions may result in increases or decreases in estimated revenues or costs, and such revisions are reflected in income in the period in which the circumstances that gave rise to the revision become known by management.

Hardware

The company's hardware offerings include the sale or lease of system servers, storage solutions, retail store systems and the sale of semiconductor design and manufacturing services. The company provides warranties for its hardware products that range up to three years, with the majority being either one year or three years. The company also offers installation services for its more complex products.

Revenue from hardware sales and sales-type leases is recognized when risk of loss has transferred to the client and there are no unfulfilled company obligations that affect the client's final acceptance of the arrangement. Any cost of standard warranties and remaining obligations that are inconsequential or perfunctory are accrued when the corresponding revenue is recognized. Revenue from extended warranty contracts, for which the company is obligated to perform, is recorded as deferred income and subsequently recognized on a straight-line basis over the delivery period. Revenue from rentals and operating leases is recognized on a straight-line basis over the term of the rental or lease.

Software

Revenue from perpetual (one-time charge) license software is recognized at the inception of the license term if all revenue recognition criteria have been met. Revenue from term (recurring license charge) license software is recognized on a subscription basis over the period that the client is entitled to use the license. Revenue from subscription and support, which includes unspecified upgrades on a when-and-if-available basis is recognized on a straight-line basis over the period such items are delivered. In multiple-deliverable revenue arrangements that include software that is more than incidental to the products or services as a whole (software multiple-deliverable arrangements), software and software-related elements are accounted for in accordance with software revenue recognition guidance. Software-related elements include

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software products and services for which a software deliverable is essential to its functionality. Tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are no longer within the scope of software revenue recognition guidance and are accounted for based on other applicable revenue recognition guidance.

A software multiple-deliverable arrangement is separated into more than one unit of accounting if all of the following criteria are met:

- The functionality of the delivered element(s) is not dependent on the undelivered element(s);
- There is VSOE of fair value of the undelivered element(s). VSOE of fair value is based on the price charged when the deliverable is sold separately by the company on a regular basis and not as part of the multiple-deliverable arrangement; and
- Delivery of the delivered element(s) represents the culmination of the earnings process for that element(s).

If any one of these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized on a straight-line basis or being deferred until the earlier of when such criteria are met or when the

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Notes to Consolidated Financial Statements (continued)

last undelivered element is delivered. If these criteria are met for each element and there is VSOE of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative VSOE of fair value. There may be cases, however, in which there is VSOE of fair value of the undelivered item(s) but no such evidence for the delivered item(s). In these cases, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate VSOE of fair value of the undelivered elements.

The company's multiple-deliverable arrangements may have a stand-alone software deliverable that is subject to the existing software revenue recognition guidance. The revenue for these multiple deliverable arrangements is allocated to the software deliverable and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy (VSOE, TPE or BESP) in the new amended revenue accounting guidance. In the limited circumstances where the company cannot determine VSOE or TPE of the selling price for all of the deliverables in the arrangement, including the software deliverable, BESP is used for the purposes of performing this allocation.

Financing

Financing income attributable to sales-type leases, direct financing leases and loans is recognized on the accrual basis using the effective interest method. Operating lease income is recognized on a straight-line basis over the term of the lease.

Determination of Best Estimate of Selling Price

In certain limited instances, the company is not able to establish VSOE for all elements in a multiple deliverable arrangement. When VSOE cannot be established, the company attempts to establish the selling price of each element based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately.

When the company is unable to establish selling price using VSOE or TPE, the company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the company would transact a sale if the product or service were sold on a stand-alone basis. Due to the fact that the company sells its products and services on a stand-alone basis, and therefore has established VSOE for its products and services offerings, the company expects to use BESP to determine the relative selling price for a product or service in a multiple-deliverable arrangement on an infrequent basis. An example of when BESP would be used is when the company sells a new product, for which VSOE and TPE does not exist, in a multiple deliverable arrangement prior to selling the new product on a stand-alone basis. During the second quarter and six month period ended June 30, 2010, BESP was used in seven and nine transactions, respectively, and the effects of its use were immaterial.

The company determines BESP for a product or service by considering multiple factors including, but not limited to, overall market conditions, including geographic or regional specific market factors, competitive positioning, competitor actions, internal costs, profit objectives and pricing

practices. The determination of BESP is a formal process within the company that includes review and approval by the company's management. In addition, the company regularly reviews VSOE and TPE for its products and services, in addition to BESP.

Effect of Adoption

For transactions entered into prior to January 1, 2010, the company recognized revenue based on established revenue recognition guidance as it related to the elements within the arrangement. For the vast majority of the company's arrangements involving multiple deliverables, the fee from the arrangement was allocated to each respective element based on its relative fair value, using VSOE. In the limited circumstances when the company was not able to determine VSOE for all of the elements of the arrangement, but was able to obtain VSOE for any undelivered elements, revenue was allocated using the residual method. Under the residual method, the amount of revenue allocated to delivered elements equaled the total arrangement consideration less the aggregate fair value of any undelivered elements, and no revenue was recognized until all elements without VSOE had been delivered. If VSOE of any undelivered items did not exist, revenue from the entire arrangement was initially deferred and recognized at the earlier of: (i) delivery of those elements for which VSOE did not exist or (ii) when VSOE was established. The residual method and recognition of revenue on a ratable basis were generally used in circumstances where VSOE, as applicable, was unavailable.

The new amended accounting standards for multiple-deliverable revenue arrangements and changes to the scope of existing software revenue recognition guidance if applied to transactions in the year ended December 31, 2009 would not have resulted in a material change to the company's reported revenue for that fiscal year period.

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Notes to Consolidated Financial Statements (continued)

In addition, there would not have been a material impact to revenue, as reported during the three and six months ended June 30, 2010, if the transactions entered into or materially modified on or after January 1, 2010 were subject to the previous accounting guidance.

As discussed in Note 2, Accounting Changes, on pages 7 and 8 there was no material impact in the second quarter or the first six months of 2010, respectively, from the adoption of the amended revenue recognition guidance. In terms of the timing and pattern of revenue recognition, the new accounting guidance for revenue recognition is not expected to have a material impact on revenue in future periods.

See the company's 2009 Annual Report, Note A, Significant Accounting Policies, on pages 70 and 71 and Critical Accounting Estimates, on pages 52 and 53 for additional information.

4. Fair Value: Exit prices are used to measure assets and liabilities that fall within the scope of the fair value measurements guidance. Under this guidance, the company is required to classify certain assets and liabilities based on the following fair value hierarchy:

- Level 1 Quoted prices in active markets that are unadjusted and accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 Quoted prices for identical assets and liabilities in markets that are not active, quoted prices for similar assets and liabilities in active markets or financial instruments for which significant inputs are observable, either directly or indirectly; and
- Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

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

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

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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 by a discounted cash flow model using 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 end of the period 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 public cost method 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.

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

Non-financial assets such as property plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. See Note A, Significant Accounting Policies, on pages 70 to 79 in the 2009 Annual Report for further information. There were no material impairments of non-financial assets for the six months ended June 30, 2010 and June 30, 2009.

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, 2010 and December 31, 2009.

| (Dollars in millions) | | | | | |
|---|-----------------|------------------|----------------|--------------|-----------------|
| At June 30, 2010 | Level 1 | Level 2 | Level 3 | Total | |
| Assets: | | | | | |
| Cash and cash equivalents(1) | | | | | |
| Time deposits and certificates of deposit | \$ | \$ | 3,057 | \$ | \$ 3,057 |
| Commercial paper | | | 2,273 | | 2,273 |
| Money market funds | 1,520 | | | | 1,520 |
| U.S. Federal Government securities | | | 934 | | 934 |
| Other securities | | | 14 | | 14 |
| Total | 1,520 | | 6,278 | | 7,798 |
| Debt securities – current(2) | | | | | |
| Time deposits and certificates of deposit | | | 313 | | 313 |
| Commercial paper | | | 1,101 | | 1,101 |
| U.S. Federal Government securities | | | 500 | | 500 |
| Other securities | | | 1 | | 1 |
| Total | | | 1,916 | | 1,916 |
| Debt securities – noncurrent(3) | 1 | | 6 | | 7 |
| Non-equity method alliance investments(3) | 344 | | 6 | | 350 |
| Derivative assets(4) | | | | | |
| Interest rate contracts | | | 677 | | 677 |
| Foreign exchange contracts | | | 1,482 | | 1,482 |
| Equity contracts | | | 3 | | 3 |
| Total | | | 2,162 | | 2,162(6) |
| Total Assets | \$ 1,865 | \$ 10,367 | \$ | \$ | 12,232 |
| Liabilities: | | | | | |
| Derivative liabilities(5) | | | | | |
| Foreign exchange contracts | \$ | \$ | 655 | \$ | \$ 655 |
| Equity contracts | | | 33 | | 33 |
| Total Liabilities | \$ | \$ | 688 | \$ | 688(6) |

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

(2) Included within marketable securities in the Consolidated Statement of Financial Position.

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

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- (4) The gross balances of derivative assets contained in prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at June 30, 2010 are \$861 million and \$1,301 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, 2010 are \$471 million and \$217 million, respectively.
- (6) 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 \$438 million each.

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

| (Dollars in millions) | | | | | |
|---|-----------------|-----------------|----------------|--------------|-----------------|
| At December 31, 2009 | Level 1 | Level 2 | Level 3 | Total | |
| Assets: | | | | | |
| Cash and cash equivalents(1) | | | | | |
| Time deposits and certificates of deposit | \$ | \$ | 4,324 | \$ | \$ 4,324 |
| Commercial paper | | | 2,099 | | 2,099 |
| Money market funds | 2,780 | | | | 2,780 |
| Other securities | | | 74 | | 74 |
| Total | 2,780 | | 6,497 | | 9,277 |
| Debt securities current(2) | | | | | |
| Commercial paper | | | 1,491 | | 1,491 |
| U.S. Federal Government securities | | | 300 | | 300 |
| Total | | | 1,791 | | 1,791 |
| Debt securities noncurrent(3) | 3 | | 6 | | 9 |
| Non-equity method alliance investments(3) | 366 | | 8 | | 374 |
| Derivative assets(4) | | | | | |
| Interest rate contracts | | | 426 | | 426 |
| Foreign exchange contracts | | | 407 | | 407 |
| Equity contracts | | | 5 | | 5 |
| Total | | | 838 | | 838(6) |
| Total Assets | \$ 3,149 | \$ 9,140 | \$ | \$ | 12,289 |
| Liabilities: | | | | | |
| Derivative liabilities(5) | | | | | |
| Interest rate contracts | \$ | \$ | 2 | \$ | \$ 2 |
| Foreign exchange contracts | | | 1,553 | | 1,553 |
| Total Liabilities | \$ | \$ 1,555 | \$ | \$ | 1,555(6) |

- (1) Included within cash and cash equivalents in the Consolidated Statement of Financial Position.
- (2) Included within 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, 2009 are \$273 million and \$565 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, 2009 are \$906 million and \$649 million, respectively.
- (6) 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 \$573 million each.

There were no significant transfers between Levels 1 and 2 for the six months ended June 30, 2010 and for the year ended December 31, 2009.

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

5. Financial Instruments (excluding derivatives): Cash and cash equivalents, debt and marketable equity securities are recognized and measured at fair value in the company's consolidated financial statements. 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 are financial liabilities with carrying values that approximate fair value. In the absence of quoted prices in active markets, considerable judgment is required in developing estimates of fair value. Estimates are not necessarily indicative of the amounts the company could realize in a current market transaction. The following methods and assumptions are used to estimate fair values:

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.

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 is \$21,017 million and \$21,932 million and the estimated fair value is \$22,612 million and \$23,748 million at June 30, 2010 and December 31, 2009, respectively.

Debt and Marketable Equity Securities

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

| (Dollars in millions) At June 30, 2010 | Adjusted Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|------------------|------------------------------|-------------------------------|---------------|
| Cash and cash equivalents* | | | | |
| Time deposits and certificates of deposit | \$ 3,057 | \$ | (0) | \$ 3,057 |
| Commercial paper | 2,273 | | (0) | 2,273 |
| Money market funds | 1,520 | | | 1,520 |
| U.S. Federal Government securities | 934 | | (0) | 934 |
| Other securities | 14 | | | 14 |
| Total | \$ 7,798 | \$ | (0) | \$ 7,798 |

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| | | | | | |
|---|----|-------|----|-----|------------|
| Debt securities current** | | | | | |
| Commercial paper | \$ | 1,101 | \$ | (0) | \$ 1,101 |
| Time deposits and certificates of deposit | | 313 | | (0) | 313 |
| Other securities | | 1 | | | 1 |
| U.S. Federal Government securities | | 500 | | (0) | 500 |
| Total | \$ | 1,916 | \$ | (0) | \$ 1,916 |
| Debt securities noncurrent*** | | | | | |
| Other securities | \$ | 6 | \$ | 1 | \$ 7 |
| Total | \$ | 6 | \$ | 1 | \$ 7 |
| Non-equity method alliance investments*** | \$ | 177 | \$ | 176 | \$ (3) 350 |

* Included within cash and cash equivalents in the Consolidated Statement of Financial Position.

** Reported as marketable securities within the Consolidated Statement of Financial Position.

*** Included within investments and sundry assets in the Consolidated Statement of Financial Position.

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

| (Dollars in millions) At December 31, 2009 | Adjusted Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|------------------|------------------------------|-------------------------------|---------------|
| Cash and cash equivalents* | | | | |
| Time deposits and certificates of deposit | \$ 4,324 | \$ 0 | \$ | \$ 4,324 |
| Commercial paper | 2,099 | | (0) | 2,099 |
| Money market funds | 2,780 | | | 2,780 |
| Other securities | 74 | | | 74 |
| Total | \$ 9,277 | \$ 0 | \$ (0) | \$ 9,277 |
| Debt securities current** | | | | |
| Commercial paper | \$ 1,491 | \$ | (0) | 1,491 |
| U.S. Federal Government securities | 300 | 0 | | 300 |
| Total | \$ 1,791 | \$ 0 | \$ (0) | \$ 1,791 |
| Debt securities noncurrent*** | | | | |
| Other securities | \$ 9 | \$ 0 | \$ (0) | \$ 9 |
| Total | \$ 9 | \$ 0 | \$ (0) | \$ 9 |
| Non-equity method alliance investments*** | \$ 183 | \$ 201 | \$ (10) | \$ 374 |

* Included within cash and cash equivalents in the Consolidated Statement of Financial Position.

** Reported as marketable securities within the Consolidated Statement of Financial Position.

*** Included within investments and sundry assets in the Consolidated Statement of Financial Position.

Based on an evaluation of available evidence as of June 30, 2010, the company believes that unrealized losses on debt and marketable equity securities are temporary and do not represent a need for an other-than-temporary impairment.

Proceeds from sales of debt securities and marketable equity securities were approximately \$4 million and \$13 million for the second quarter and first six months of 2010, respectively. The gross realized gains (before taxes) on these sales totaled \$1 million and \$5 million for the second quarter and first six months of 2010, respectively. The gross realized losses (before taxes) on these sales were less than \$1 million in the second quarter and first six months of 2010. Proceeds from the sales of debt securities and marketable equity securities were approximately \$6 million and \$11 million in the second quarter and first six months of 2009, respectively. The gross realized losses (before taxes) on these sales totaled \$12 million and \$21 million in the second quarter and first six months of 2009, respectively. The company determines the cost of the securities sold based on the specific identification method.

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

| (Dollars in millions) For the three months ended June 30: | 2010 | 2009 |
|---|----------------|--------------|
| Net unrealized gains/(losses) arising during the period | \$ (46) | \$ (7) |
| Less: Net (losses)/gains included in net income for the period* | 1 | (7) |
| Net unrealized gains/(losses) on marketable securities | \$ (47) | \$ 42 |

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* Includes writedowns of \$0.1 million and \$0.1 million for the three months ended June 30, 2010 and 2009, respectively.

(Dollars in millions)

For the six months ended June 30:

| | 2010 | | 2009 |
|---|-------------|------------|--------------|
| Net unrealized gains/(losses) arising during the period | \$ | (6) | \$ 23 |
| Less: Net (losses)/gains included in net income for the period* | | (0) | (13) |
| Net unrealized gains/(losses) on marketable securities | \$ | (6) | \$ 36 |

* Includes writedowns of \$3.2 million and \$0.1 million for the six months ended June 30, 2010 and 2009, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at June 30, 2010.

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

6. Financing Receivables: The following table presents financing receivables, net of allowances for doubtful accounts, including residual values.

| (Dollars in millions) | At June 30, 2010 | | At December 31, 2009 | |
|--|---------------------|--------|-------------------------|--------|
| Current: | | | | |
| Net investment in sales-type and direct financing leases | \$ | 3,850 | \$ | 4,105 |
| Commercial financing receivables | | 4,631 | | 5,604 |
| Client loan receivables | | 4,188 | | 4,475 |
| Installment payment receivables | | 632 | | 730 |
| Total | \$ | 13,301 | \$ | 14,914 |
| Noncurrent: | | | | |
| Net investment in sales-type and direct financing leases | \$ | 4,604 | \$ | 5,331 |
| Commercial financing receivables | | 48 | | 58 |
| Client loan receivables | | 4,064 | | 4,759 |
| Installment payment receivables | | 469 | | 496 |
| Total | \$ | 9,185 | \$ | 10,644 |

Net investment in sales-type and direct financing leases is for leases that relate 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 \$794 million and \$849 million at June 30, 2010 and December 31, 2009, respectively, and is reflected net of unearned income of \$779 million and \$905 million and of allowance for doubtful accounts receivable of \$149 million and \$159 million at those dates, respectively.

Commercial financing receivables relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and non-IBM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan receivables are loans that are provided by Global Financing primarily to clients to finance the purchase of software and services. Separate contractual relationships on these financing arrangements are for terms ranging generally from two to seven years. Each financing contract is priced independently at competitive market rates. The company has a history of enforcing the terms of these separate financing agreements.

The company utilizes certain of its financing receivables as collateral for non-recourse borrowings. Financing receivables pledged as collateral for borrowings were \$264 million and \$271 million at June 30, 2010 and December 31, 2009, respectively.

The company did not have any financing receivables held for sale as of June 30, 2010 and December 31, 2009.

7. Derivatives and Hedging Transactions: The company operates in multiple functional currencies and is a significant lender and borrower in the global markets. In the normal course of business, the company is exposed to the impact of interest rate changes and foreign currency fluctuations, and to a lesser extent equity and commodity price changes and client credit risk. The company limits these risks by following established risk management policies and procedures, including the use of derivatives, and, where cost effective, financing with debt in the currencies in which assets are denominated. For interest rate exposures, derivatives are used to better align rate movements between the interest rates associated with the company's lease and other financial assets and the interest rates associated with its financing debt. Derivatives are also used to manage the related cost of debt. For foreign currency exposures, derivatives are used to better manage the cash flow volatility arising from foreign exchange rate fluctuations.

As a result of the use of derivative instruments, the company is exposed to the risk that counterparties to derivative contracts will fail to meet their contractual obligations. To mitigate the counterparty credit risk, the company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors. 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

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Notes to Consolidated Financial Statements (continued)

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 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, 2010 and December 31, 2009 was \$173 million and \$779 million, respectively, for which the company has posted collateral of \$0 million and \$37 million, respectively. 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, 2010 and December 31, 2009 was \$2,162 million and \$838 million, respectively. This amount represents the maximum exposure to loss at the reporting date as a result of the counterparties failing to perform as contracted. This exposure is reduced by \$438 million and \$573 million at June 30, 2010 and December 31, 2009, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at June 30, 2010, this exposure is reduced by \$661 million of collateral received by the company. 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. At June 30, 2010, there were no amounts recognized in other receivables for the right to reclaim cash collateral. At December 31, 2009, \$37 million was recorded in prepaid expenses and other current assets for the right to reclaim cash collateral. The amounts recognized in accounts payable for the obligation to return cash collateral totaled \$661 million at June 30, 2010. The company had no obligation to return cash collateral at December 31, 2009. 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. At June 30, 2010, no collateral was rehypothecated.

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 the cash loss potential on an ongoing basis and may discontinue some of these hedging relationships by de-designating the derivative instrument to manage this liquidity risk. Although not designated as accounting hedges, the company may utilize derivatives to offset the changes in fair value of the de-designated instruments from the date of de-designation until maturity.

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

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

Interest Rate Risk

Fixed and Variable Rate Borrowings

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The company issues debt in the global capital markets, principally to fund its financing lease and loan portfolio. 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, 2010 and December 31, 2009, the total notional amount of the company's interest rate swaps was \$7.5 billion and \$9.1 billion, respectively.

Forecasted Debt Issuance

The company is exposed to interest rate volatility on forecasted 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, 2010 and December 31, 2009.

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Notes to Consolidated Financial Statements (continued)

Foreign Exchange Risk

Long-Term Investments in Foreign Subsidiaries (Net Investment)

A large portion of the company's foreign currency denominated debt portfolio is designated as a hedge of net investment 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, 2010 and December 31, 2009, the total notional amount of derivative instruments designated as net investment hedges was \$2.4 billion and \$1.0 billion, respectively. The weighted-average remaining maturity of these instruments at June 30, 2010 and December 31, 2009 was approximately 0.6 years and 1.6 years, respectively.

In addition, at June 30, 2010 and December 31, 2009, the company had liabilities of \$289 million and \$318 million, respectively, representing the fair value of derivative instruments that were previously designated in qualifying net investment hedging relationships but were de-designated prior to June 30, 2010 and December 31, 2009, respectively; of these amounts \$170 million and \$94 million are expected to mature over the next twelve months, respectively. The notional amount of these instruments at June 30, 2010 and December 31, 2009 was \$2.1 billion and \$2.3 billion, respectively, including original and offsetting transactions.

Anticipated Royalties and Cost Transactions

The company's operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company's non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is approximately four years. At June 30, 2010 and December 31, 2009, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$16.6 billion and \$18.7 billion, with a weighted-average remaining maturity of 1.1 years and 1.3 years, respectively.

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 is hedging its exposure to the variability in future cash flows is approximately 3.5 years. At June 30, 2010 and December 31, 2009, the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was \$0.2 billion and \$0.3 billion, respectively.

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 two years. 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, 2010 and December 31, 2009, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$13.1 billion and \$13.1 billion, respectively.

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Notes to Consolidated Financial Statements (continued)

Equity Risk Management

The company is exposed to market price changes primarily related to certain obligations to employees. These exposures are primarily related to market price movements in certain broad market indices and in the company's own stock. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company's common stock. They are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At June 30, 2010 and December 31, 2009, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$0.8 billion and \$0.8 billion, respectively.

Other Risks

The company holds 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 amount of shares to be purchased under these agreements was immaterial at June 30, 2010 and December 31, 2009. 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 is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company utilizes credit default swaps to economically hedge its credit exposures. These derivatives have terms of one year or less. 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, 2010 and December 31, 2009.

The following tables provide a quantitative summary of the derivative and non-derivative instrument related risk management activity as of June 30, 2010 and December 31, 2009 as well as for the three months and six months ended June 30, 2010 and 2009, respectively:

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Notes to Consolidated Financial Statements (continued)

Fair Value of Derivative Instruments

As of June 30, 2010

| (Dollars in millions) | <u>Fair value of derivative assets</u> | | | <u>Fair value of derivative liabilities</u> | | |
|---|--|--|--------------|---|--|--------------|
| | <u>Designated as hedging instruments</u> | <u>Not designated as hedging instruments</u> | <u>Total</u> | <u>Designated as hedging instruments</u> | <u>Not designated as hedging instruments</u> | <u>Total</u> |
| Interest rate contracts: | | | | | | |
| Prepaid expenses and other current assets | \$ 13 | \$ - | \$ 13 | \$ - | \$ - | \$ - |
| Investments and sundry assets | 664 | - | 664 | - | - | - |
| Other liabilities | - | - | - | - | - | - |
| Foreign exchange contracts: | | | | | | |
| Prepaid expenses and other current assets | 739 | 106 | 845 | - | - | - |
| Investments and sundry assets | 614 | 23 | 637 | - | - | - |
| Other accrued expenses and liabilities | - | - | - | 190 | 247 | 437 |
| Other liabilities | - | - | - | 93 | 125 | 218 |
| Equity contracts: | | | | | | |
| Prepaid expenses and other current assets | - | 3 | 3 | - | - | - |
| Other accrued expenses and liabilities | - | - | - | - | 33 | 33 |
| Fair value of derivative assets and liabilities | \$ 2,030 | \$ 132 | \$ 2,162 | \$ 283 | \$ 405 | \$ 688 |
| Total debt designated as hedging instruments: | | | | | | |
| Short-term debt | NA | NA | NA | \$ - | \$ - | \$ - |
| Long-term debt | NA | NA | NA | 2,362 | - | 2,362 |
| Total | | | \$ 2,162 | | | \$ 3,050 |

NA not applicable

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Notes to Consolidated Financial Statements (continued)

Fair Value of Derivative Instruments

As of December 31, 2009

| (Dollars in millions) | <u>Fair value of derivative assets</u> | | | <u>Fair value of derivative liabilities</u> | | |
|---|--|--|--------------|---|--|--------------|
| | <u>Designated as hedging instruments</u> | <u>Not designated as hedging instruments</u> | <u>Total</u> | <u>Designated as hedging instruments</u> | <u>Not designated as hedging instruments</u> | <u>Total</u> |
| Interest rate contracts: | | | | | | |
| Prepaid expenses and other current assets | \$ 43 | \$ - | \$ 43 | \$ - | \$ - | \$ - |
| Investments and sundry assets | 383 | - | 383 | - | - | - |
| Other liabilities | - | - | - | 2 | - | 2 |
| Foreign exchange contracts: | | | | | | |
| Prepaid expenses and other current assets | 74 | 151 | 225 | - | - | - |
| Investments and sundry assets | 156 | 26 | 182 | - | - | - |
| Other accrued expenses and liabilities | - | - | - | 602 | 304 | 906 |
| Other liabilities | - | - | - | 423 | 224 | 647 |
| Equity contracts: | | | | | | |
| Prepaid expenses and other current assets | - | 5 | 5 | - | - | - |
| Other accrued expenses and liabilities | - | - | - | - | 0 | 0 |
| Fair value of derivative assets and liabilities | \$ 656 | \$ 182 | \$ 838 | \$ 1,027 | \$ 528 | \$ 1,555 |
| Total debt designated as hedging instruments: | | | | | | |
| Short-term debt | NA | NA | NA | \$ 1,440 | \$ - | \$ 1,440 |
| Long-term debt | NA | NA | NA | 2,618 | - | 2,618 |
| Total | | | \$ 838 | | | \$ 5,613 |

NA not applicable

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Notes to Consolidated Financial Statements (continued)

The Effect of Derivative Instruments on the Consolidated Statement of Earnings

For the three months ended June 30, 2010 and 2009

(Dollars in millions)

| | Consolidated Statement of Earnings line item | Gain (loss) recognized in earnings | | | | | |
|--|---|---|--|--|---|--------|------|
| | | Recognized on derivatives (2) | | Attributable to risk being hedged (3) | | | |
| | | 2010 | 2009 | 2010 | 2009 | | |
| Derivative instruments in fair value hedges: | | | | | | | |
| Interest rate contracts | Cost of financing Interest expense | \$ 185 | \$ (138) | \$ (142) | \$ 177 | | |
| | | 109 | (84) | (84) | 108 | | |
| Derivative instruments not designated as hedging instruments: (1) | | | | | | | |
| Foreign exchange contracts | Other (income) and expense | (177) | (69) | NA | NA | | |
| Equity contracts | SG&A expense | (63) | 74 | NA | NA | | |
| Total | | \$ 54 | \$ (217) | \$ (226) | \$ 285 | | |
| Gain (loss) recognized in earnings and other comprehensive income | | | | | | | |
| | Effective portion recognized in AOCI | Consolidated Statement of Earnings line item | Effective portion reclassified from AOCI to earnings | | (Ineffectiveness) and amounts excluded from effectiveness testing (4) | | |
| | | | 2010 | 2009 | 2010 | 2009 | |
| | | | 2010 | 2009 | 2010 | 2009 | |
| Derivative instruments in cash flow hedges: | | | | | | | |
| Interest rate contracts | \$ - | \$ - | Interest income | \$ (2) | \$ (2) | \$ - | \$ - |
| Foreign exchange contracts | 760 | (909) | Other (income) and expense | 40 | 80 | (1) | 2 |
| | | | Cost of sales | 6 | 43 | - | - |
| | | | SG&A expense | 6 | 32 | - | - |
| Derivative instruments in net investment hedges: | | | | | | | |
| Foreign exchange contracts | 340 | (239) | Interest expense | 0 | - | (1) | 3 |
| Total | \$ 1,100 | \$ (1,148) | | \$ 50 | \$ 153 | \$ (2) | \$ 5 |

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

- (1) See Note 7 for additional information on the company's purpose for entering into derivatives not designated as hedging instruments and its overall risk management strategies.
- (2) 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.
- (3) 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.

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

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Notes to Consolidated Financial Statements (continued)

The Effect of Derivative Instruments on the Consolidated Statement of Earnings

For the six months ended June 30, 2010 and 2009

(Dollars in millions)

| | Consolidated Statement of Earnings line item | Gain (loss) recognized in earnings | | | |
|--|---|------------------------------------|----------|--|--------|
| | | Recognized on derivatives (2) | | Attributable to risk being hedged (3) | |
| | | 2010 | 2009 | 2010 | 2009 |
| Derivative instruments in fair value hedges: | | | | | |
| Interest rate contracts | Cost of financing | \$ 256 | \$ (184) | \$ (166) | \$ 250 |
| | Interest expense | 150 | (117) | (98) | 159 |
| Derivative instruments not designated as hedging instruments: (1) | | | | | |
| Foreign exchange contracts | Other (income) and expense | (305) | (242) | NA | NA |
| Equity contracts | SG&A expense | (42) | 47 | NA | NA |
| Total | | \$ 59 | \$ (496) | \$ (264) | \$ 409 |

| | Gain (loss) recognized in earnings and other comprehensive income | | | | | | | |
|---|---|----------|---|--|---------|---|------|--|
| | Effective portion recognized in AOCI | | Consolidated Statement of Earnings line item | Effective portion reclassified from AOCI to earnings | | (Ineffectiveness) and amounts excluded from effectiveness testing (4) | | |
| | 2010 | 2009 | | 2010 | 2009 | 2010 | 2009 | |
| Derivative instruments in cash flow hedges: | | | | | | | | |
| Interest rate contracts | \$ - | \$ (0) | Interest income | \$ (4) | \$ (11) | \$ - | \$ - | |
| Foreign exchange contracts | 1,390 | (130) | Other (income) and expense | (14) | 204 | (7) | 2 | |
| | | | Cost of sales | (83) | 102 | - | - | |
| | | | SG&A expense | (45) | 68 | - | - | |
| Derivative instruments in net investment hedges: | | | | | | | | |
| Foreign exchange contracts | 587 | (44) | Interest expense | 0 | - | (1) | 2 | |
| Total | \$ 1,977 | \$ (174) | | \$ (146) | \$ 363 | \$ (8) | \$ 4 | |

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

- (1) See Note 7 for additional information on the company's purpose for entering into derivatives not designated as hedging instruments and its overall risk management strategies.
- (2) 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.
- (3) 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.
- (4) The amount of gain (loss) recognized in income represents ineffectiveness on hedge relationships.

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

At June 30, 2010 and June 30, 2009, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net gains of \$817 million and net losses \$402 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts \$450 million of gains and \$182 million of losses, respectively, are expected to be reclassified to net income within the next twelve months, providing an offsetting economic impact against the underlying anticipated transactions. At June 30, 2010 and June 30, 2009, net losses of approximately \$17 million and net losses of approximately \$16 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 \$9 million and \$6 million of losses, respectively, are expected to be reclassified to net income within the next twelve months, providing an offsetting economic impact against the underlying transactions.

For the six months ending June 30, 2010, and June 30, 2009, 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.

During July 2010, the company unwound certain of its multi-year cash flow hedges (approximately \$3.7 billion notional amount), resulting in a cash inflow of \$257 million which will be reflected in the company's third quarter operating cash flows. This gain will be reclassified from accumulated other comprehensive income/(loss) to net income over a multi-year period consistent with the original maturity dates of these hedges.

Refer to the 2009 IBM Annual Report, Note A, Significant Accounting Policies on pages 76 and 77 for additional information on the company's use of derivative instruments.

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

| (Dollars in millions) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------|-----------------------------|-------|---------------------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Cost | \$ 24 | \$ 22 | \$ 49 | \$ 46 |
| Selling, general and administrative | 116 | 99 | 249 | 199 |
| Research, development and engineering | 12 | 11 | 24 | 23 |
| Other (income) and expense* | (1) | | (1) | |
| Pre-tax stock-based compensation cost | 151 | 132 | 320 | 269 |
| Income tax benefits | (55) | (46) | (117) | (94) |
| Total stock-based compensation cost | \$ 96 | \$ 86 | \$ 203 | \$ 175 |

* Reflects the one-time effects of the sale of the Product Lifecycle Management activities.

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The increase in pre-tax stock-based compensation cost for the three months ended June 30, 2010, as compared to the corresponding period in the prior year, was principally the result of an increase related to restricted and performance-based stock units (\$18 million). The increase in pre-tax stock-based compensation cost for the six months ended June 30, 2010, as compared to the corresponding period in the prior year, was principally the result of an increase related to restricted and performance-based stock units (\$67 million), partially offset by a reduction in the level of stock option grants (\$16 million).

As of June 30, 2010, the total unrecognized compensation cost of \$1,257 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately 2.5 years.

There were no significant capitalized stock-based compensation costs at June 30, 2010 and 2009.

9. Segments: The following tables reflect the results of operations of the segments consistent with the company's management and measurement system. These results are not necessarily a depiction that is in conformity with GAAP. 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.

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

| (Dollars in millions) For the three months ended June 30, 2010: | <u>Global Services</u> | | Software | Systems and Technology | Global Financing | Total Segments |
|---|----------------------------------|--------------------------------|----------|---------------------------|---------------------|-------------------|
| | Global Technology Services | Global Business Services | | | | |
| External revenue | \$ 9,234 | \$ 4,483 | \$ 5,277 | \$ 3,985 | \$ 544 | \$ 23,523 |
| Internal revenue | 332 | 197 | 690 | 202 | 431 | 1,852 |
| Total revenue | \$ 9,566 | \$ 4,680 | \$ 5,967 | \$ 4,187 | \$ 975 | \$ 25,376 |
| Pre-tax income | \$ 1,422 | \$ 683 | \$ 1,988 | \$ 221 | \$ 463 | \$ 4,777 |
| Revenue year-to-year change | 1.2% | 2.6% | 3.2% | 2.2% | (3.9)% | 1.9% |
| Pre-tax income year-to-year change | 1.2% | 12.3% | 7.4% | (33.8)% | (0.5)% | 2.4% |
| Pre-tax income margin | 14.9% | 14.6% | 33.3% | 5.3% | 47.4% | 18.8% |
| For the three months ended June 30, 2009: | | | | | | |
| External revenue | \$ 9,108 | \$ 4,338 | \$ 5,166 | \$ 3,855 | \$ 568 | \$ 23,035 |
| Internal revenue | 343 | 223 | 614 | 244 | 447 | 1,870 |
| Total revenue | \$ 9,451 | \$ 4,562 | \$ 5,780 | \$ 4,098 | \$ 1,014 | \$ 24,905 |
| Pre-tax income | \$ 1,405 | \$ 608 | \$ 1,852 | \$ 333 | \$ 465 | \$ 4,663 |
| Pre-tax income margin | 14.9% | 13.3% | 32.0% | 8.1% | 45.8% | 18.7% |

Reconciliations to IBM as Reported:

| (Dollars in millions) | Three Months Ended June 30, 2010 | Three Months Ended June 30, 2009 |
|---------------------------|-------------------------------------|-------------------------------------|
| Revenue: | | |
| Total reportable segments | \$ 25,376 | \$ 24,905 |
| Eliminations/other | (1,652) | (1,655) |
| Total IBM Consolidated | \$ 23,724 | \$ 23,250 |
| Pre-tax income: | | |
| Total reportable segments | \$ 4,777 | \$ 4,663 |
| Eliminations/other | (202) | (401)* |
| Total IBM Consolidated | \$ 4,575 | \$ 4,262 |

* Includes a provision for losses related to a joint venture investment.

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Notes to Consolidated Financial Statements (continued)

SEGMENT INFORMATION

(UNAUDITED)

| (Dollars in millions) For the six months Ended June 30, 2010: | <u>Global Services</u> | | Software | Systems and Technology | Global Financing | Total Segments |
|---|----------------------------------|--------------------------------|-----------|---------------------------|---------------------|-------------------|
| | Global Technology Services | Global Business Services | | | | |
| External revenue | \$ 18,540 | \$ 8,893 | \$ 10,296 | \$ 7,370 | \$ 1,081 | \$ 46,181 |
| Internal revenue | 652 | 400 | 1,448 | 376 | 834 | 3,710 |
| Total revenue | \$ 19,192 | \$ 9,293 | \$ 11,743 | \$ 7,746 | \$ 1,916 | \$ 49,891 |
| Pre-tax income | \$ 2,387 | \$ 1,128 | \$ 4,040 | \$ 51 | \$ 890 | \$ 8,496 |
| Revenue year-to-year change | 3.5% | 1.1% | 7.4% | 3.2% | (3.4)% | 3.6% |
| Pre-tax income year-to-year change | (4.9)% | (0.1)% | 26.8% | (85.9)% | 7.9% | 6.0% |
| Pre-tax income margin | 12.4% | 12.1% | 34.4% | 0.7% | 46.5% | 17.0% |
| For the six months ended June 30, 2009: | | | | | | |
| External revenue | \$ 17,862 | \$ 8,736 | \$ 9,705 | \$ 7,083 | \$ 1,146 | \$ 44,533 |
| Internal revenue | 685 | 456 | 1,227 | 420 | 836 | 3,624 |
| Total revenue | \$ 18,547 | \$ 9,191 | \$ 10,933 | \$ 7,503 | \$ 1,982 | \$ 48,156 |
| Pre-tax income | \$ 2,509 | \$ 1,130 | \$ 3,186 | \$ 361 | \$ 825 | \$ 8,011 |
| Pre-tax income margin | 13.5% | 12.3% | 29.1% | 4.8% | 41.6% | 16.6% |

Reconciliations to IBM as Reported:

| (Dollars in millions) | Six Months Ended June 30, 2010 | Six Months Ended June 30, 2009 |
|---------------------------|-----------------------------------|-----------------------------------|
| Revenue: | | |
| Total reportable segments | \$ 49,891 | \$ 48,156 |
| Eliminations/other | (3,310) | (3,195) |
| Total IBM Consolidated | \$ 46,581 | \$ 44,962 |
| Pre-tax income: | | |
| Total reportable segments | \$ 8,496 | \$ 8,011 |
| Eliminations/other | (406) | (627)* |
| Total IBM Consolidated | \$ 8,090 | \$ 7,385 |

* Includes a provision for losses related to a joint venture investment.

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Notes to Consolidated Financial Statements (continued)

10. Equity Activity:

| (Dollars in millions) | Common Stock and Additional Paid in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income/(Loss) | Total IBM Stockholders Equity | Noncontrolling Interests | Total Equity |
|---|---|-------------------|----------------|---|-------------------------------|--------------------------|--------------|
| Equity January 1, 2010 | \$ 41,810 | \$ 80,900 | \$ (81,243) | \$ (18,830) | \$ 22,637 | \$ 118 | \$ 22,755 |
| Net income | | 5,987 | | | 5,987 | | 5,987 |
| Other comprehensive income/(loss), net of tax (total) | | | | 320 | 320 | | 320 |
| Cash dividends declared common stock | | (1,551) | | | (1,551) | | (1,551) |
| Stock transactions related to employee plans net | 1,712 | (12) | 200 | | 1,899 | | 1,899 |
| Other treasury shares purchased not retired | | | (8,233) | | (8,233) | | (8,233) |
| Changes in noncontrolling interests | | | | | | (1) | (1) |
| Equity June 30, 2010 | \$43,522 | \$ 85,323 | \$ (89,276) | \$ (18,510) | \$ 21,059 | \$ 117 | \$ 21,176 |
| (Dollars in millions) | Common Stock and Additional Paid in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income/(Loss) | Total IBM Stockholders Equity | Noncontrolling Interests | Total Equity |
| Equity January 1, 2009 | \$39,129 | \$ 70,353 | \$ (74,171) | \$ (21,845) | \$ 13,465 | \$ 119 | \$ 13,584 |
| Net income | | 5,398 | | | 5,398 | | 5,398 |
| Other comprehensive income/(loss), net of tax (total) | | | | 802 | 802 | | 802 |
| Cash dividends declared common stock | | (1,407) | | | (1,407) | | (1,407) |
| Stock transactions related to employee plans net | 645 | (16) | 2 | | 631 | | 631 |
| Other treasury shares purchased not retired | | | (3,510) | | (3,510) | | (3,510) |
| | | | | | | (25) | (25) |

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| | | | | | | | | | | | | | | | | | | | |
|-------------------------------------|----------|-----------|------------|-------------|-----------|-------|-----------|--|--|--|--|--|--|--|--|--|--|--|--|
| Changes in noncontrolling interests | | | | | | | | | | | | | | | | | | | |
| Equity June 30, 2009 | \$39,774 | \$ 74,328 | \$(77,679) | \$ (21,043) | \$ 15,380 | \$ 94 | \$ 15,473 | | | | | | | | | | | | |

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

The following table summarizes Net income plus other comprehensive income/(loss), a component of IBM stockholders' equity in the Consolidated Statement of Financial Position:

| (Dollars in millions) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|----------|---------------------------|----------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income | \$ 3,386 | \$ 3,103 | \$ 5,987 | \$ 5,398 |
| Other comprehensive income/(loss) net of tax: | | | | |
| Foreign currency translation adjustments | (929) | 1,150 | (1,081) | 766 |
| Net change in retirement-related benefit plans | 168 | 118 | 392 | 351 |
| Net unrealized gains/(losses) on marketable securities | (47) | 42 | (6) | 36 |
| Net unrealized gains/(losses) on cash flow hedge derivatives | 475 | (704) | 1,015 | (351) |
| Total other comprehensive income/(loss) | (332) | 605 | 320 | 802 |
| Net income plus other comprehensive income/(loss) | \$ 3,053 | \$ 3,709 | \$ 6,306 | \$ 6,200 |

11. 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:

| For the three months ended June 30: (Dollars in millions) | 2010 | 2009* | Yr. to Yr. Percent Change |
|--|--------|--------|---------------------------------|
| Retirement-related plans cost | | | |
| Defined benefit and contribution pension plans | \$ 234 | \$ 229 | 2.0% |
| Nonpension postretirement plans | 86 | 88 | (2.3) |
| Total | \$ 319 | \$ 317 | 0.9% |

* Reclassified to conform with 2010 presentation.

| For the six months ended June 30: (Dollars in millions) | 2010 | 2009* | Yr. to Yr. Percent Change |
|--|--------|--------|---------------------------------|
| Retirement-related plans cost | | | |
| Defined benefit and contribution pension plans | \$ 555 | \$ 580 | (4.4)% |
| Nonpension postretirement plans | 173 | 173 | (0.1) |
| Total | \$ 728 | \$ 753 | (3.4)% |

* Reclassified to conform with 2010 presentation.

Table of Contents**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) For the three months ended June 30: | U.S. Plans | | Non-U.S. Plans | |
|--|------------|---------|----------------|--------|
| | 2010 | 2009* | 2010 | 2009* |
| Service cost | \$ | \$ | \$ 123 | \$ 145 |
| Interest cost | 648 | 666 | 444 | 464 |
| Expected return on plan assets | (1,001) | (1,002) | (592) | (620) |
| Amortization of prior service cost/(credits) | 3 | 3 | (42) | (31) |
| Recognized actuarial losses | 116 | 97 | 171 | 143 |
| Curtailments/settlements | | | 0 | (1) |
| Multiemployer plan/other costs | | | 20 | 21 |
| Total net periodic pension (income)/cost of defined benefit plans | (234) | (236) | 125 | 121 |
| Cost of defined contribution plans | 212 | 228 | 131 | 116 |
| Total pension plan cost recognized in the Consolidated Statement of Earnings | \$ (22) | \$ (8) | \$ 255 | \$ 238 |

* Reclassified to conform with 2010 presentation.

| (Dollars in millions) For the six months ended June 30: | U.S. Plans | | Non-U.S. Plans | |
|--|------------|---------|----------------|---------|
| | 2010 | 2009* | 2010 | 2009* |
| Service cost | \$ | \$ | \$ 251 | \$ 284 |
| Interest cost | 1,301 | 1,341 | 913 | 907 |
| Expected return on plan assets | (2,009) | (2,004) | (1,218) | (1,213) |
| Amortization of prior service cost/(credits) | 5 | 5 | (84) | (61) |
| Recognized actuarial losses | 235 | 205 | 349 | 303 |
| Curtailments/settlements | | | 27 | 8 |
| Multiemployer plan/other costs | | | 52 | 44 |
| Total net periodic pension (income)/cost of defined benefit plans | (468) | (453) | 290 | 270 |
| Cost of defined contribution plans | 478 | 534 | 255 | 228 |
| Total pension plan cost recognized in the Consolidated Statement of Earnings | \$ 10 | \$ 81 | \$ 545 | \$ 499 |

*Reclassified to conform with 2010 presentation.

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In 2010, the company expects to contribute to its non-U.S. defined benefit plans approximately \$900 million, which is the legally mandated minimum contribution. Total contributions to the non-U.S. plans in the first half of 2010 were \$440 million.

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

Cost of Nonpension Postretirement Plans

| (Dollars in millions) | U.S. Plan | | Non-U.S. Plans | |
|--|------------------|-------------|-----------------------|-------------|
| For the three months ended June 30: | 2010 | 2009 | 2010 | 2009 |
| Service cost | \$ 8 | \$ 10 | \$ 2 | \$ 2 |
| Interest cost | 65 | 73 | 15 | 13 |
| Expected return on plan assets | | | (2) | (2) |
| Amortization of prior service credits | (4) | (10) | (1) | (2) |
| Recognized actuarial losses | | | 3 | 3 |
| Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings | \$ 70 | \$ 74 | \$ 16 | \$ 14 |

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

| (Dollars in millions) | U.S. Plan | | Non-U.S. Plans | |
|--|-----------|--------|----------------|-------|
| For the six months ended June 30: | 2010 | 2009 | 2010 | 2009 |
| Service cost | \$ 17 | \$ 21 | \$ 4 | \$ 5 |
| Interest cost | 131 | 145 | 29 | 24 |
| Expected return on plan assets | | | (5) | (4) |
| Amortization of prior service credits | (7) | (20) | (3) | (3) |
| Recognized actuarial losses | | | 6 | 5 |
| Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings | \$ 141 | \$ 146 | \$ 32 | \$ 27 |

The company received a \$12.1 million subsidy in the second quarter of 2010 and a \$21.1 million subsidy for the first half of 2010 in connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003. A portion of this amount is used by the company to reduce its obligation and expense related to the plan, and the remainder is contributed to the plan to reduce contributions required by the participants. For further information related to the Medicare Prescription Drug Act, see page 121 in the company's 2009 Annual Report.

12. Acquisitions/Divestitures:

Acquisitions: During the six months ended June 30, 2010, the company completed six acquisitions at an aggregate cost of \$1,176 million.

The Software segment completed acquisitions of four privately held companies: in the first quarter, Lombardi Software, Inc., Intelliden Inc. and Initiate Systems, Inc.; and in the second quarter, Cast Iron Systems. Global Technology Services (GTS) completed one acquisition in the first quarter: the core operating assets of Wilshire Credit Corporation. Global Business Services (GBS) completed one acquisition in the first quarter: National Interest Security Company, LLC, a privately held company.

Each acquisition further complemented and enhanced the company's portfolio of product and services offerings. Lombardi is a leading provider of business process management software and services and will become part of the company's application integration software portfolio. Intelliden is a leading provider of intelligent network automation software and will extend the company's network management offerings. Initiate is a market leader in data integrity software for information sharing among health care and government organizations. Cast Iron Systems, the leading Software as a Service (SaaS) and cloud application integration provider, enhances the company's industry-leading WebSphere business integration software portfolio. Wilshire's mortgage servicing platform will continue the company's strategic focus on the mortgage services industry and strengthens its commitment to deliver mortgage business process outsourcing solutions. National Interest Security Company will strengthen the company's ability to deliver advanced analytics and IT solutions to the public sector. Purchase price consideration for all acquisitions was paid in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

The table below reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of June 30, 2010:

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| (Dollars in millions) | Amortization Life (yrs.) | Total Acquisitions |
|-------------------------------------|-----------------------------|-----------------------|
| Current assets | \$ | 182 |
| Fixed assets/noncurrent assets | | 36 |
| Intangible assets: | | |
| Goodwill | NA | 855 |
| Completed technology | 3-7 | 170 |
| Client relationships | 3-7 | 117 |
| In-Process Research and Development | NA | 4 |
| Patents/trademarks | 1-7 | 5 |
| Total assets acquired | | 1,370 |
| Current liabilities | | (147) |
| Noncurrent liabilities | | (47) |
| Total liabilities assumed | | (194) |
| Total purchase price | \$ | 1,176 |

NA not applicable

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Notes to Consolidated Financial Statements (continued)

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 entities were 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 5.1 years. With the exception of goodwill, these identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$855 million has been assigned to the Software (\$571 million), GTS (\$32 million) and GBS (\$252 million) segments. It is expected that approximately 25 percent of the goodwill will be deductible for tax purposes.

On May 24, 2010, the company announced that it has agreed to acquire business-to-business software and services company Sterling Commerce from AT&T, Inc. for approximately \$1.4 billion in cash. This acquisition, which is expected to close in the second half of 2010, will give the company new capabilities to help clients build dynamic networks that connect software across different servers.

On June 15, 2010, the company announced a definitive agreement to acquire Coremetrics, a leader in web analytics software. Coremetrics, a privately held company based in San Mateo, California, will expand the company's business analytics capabilities by enabling organizations to use a cloud-based delivery model to gain real-time insight into consumer interactions internally and through social media networks to develop faster, more targeted marketing campaigns. This acquisition is expected to close in the third quarter of 2010.

On July 1, 2010, the company announced it entered into an agreement to acquire BigFix, Inc., a privately-held company based in Emeryville, California. The move aims to accelerate the company's efforts to help organizations more intelligently secure the enterprise by managing and automating security and compliance updates on thousands of computers globally. This transaction closed on July 19, 2010. At the date of issuance of these financial statements, the initial purchase accounting was not complete.

Divestitures: On March 31, 2010, the company completed the sale of its activities associated with the sales and support of Dassault Systemes (Dassault) product lifecycle management (PLM) software, including customer contracts and related assets to Dassault. The company received net proceeds of \$459 million and recognized a net gain of \$591 million on the transaction in the first quarter of 2010. The gain was net of the fair value of certain contractual terms, certain transaction costs and the assets and liabilities sold. The gain was recorded in other (income) and expense on the Consolidated Statement of Earnings and the net proceeds are reflected in proceeds from disposition of marketable securities and other investments within cash flow from investing activities on the Consolidated Statement of Cash Flows.

On March 16, 2009, the company completed the sale of certain processes, resources, assets and third-party contracts related to its core logistics operations to Geodis. The company received cash proceeds of \$365 million and recognized a net gain of \$298 million on the transaction in the first quarter of 2009. The gain was net of the fair value of certain contractual terms, certain transaction costs and related real estate charges. As part of this transaction, the company outsourced its logistics operations to Geodis which will enable the company to leverage industry-leading skills and scale and improve the productivity of the company's supply chain.

In 2007, the company divested 51 percent of its printing business (InfoPrint) to Ricoh. The company also stated that it would divest its remaining ownership to Ricoh quarterly over a three year period from the closing date. At June 30, 2010, the company no longer has an

ownership interest in InfoPrint. See the company's 2009 Annual Report on pages 85 and 86 for additional information.

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

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

| (Dollars in millions) Intangible asset class | Gross Carrying Amount | At June 30, 2010 Accumulated Amortization | Net Carrying Amount |
|---|--------------------------|---|------------------------|
| Capitalized software | \$ 1,652 | \$ (784) | \$ 867 |
| Client-related | 1,244 | (538) | 706 |
| Completed technology | 1,373 | (546) | 826 |
| In-process R&D | 4 | 0 | 4 |
| Patents/trademarks | 174 | (66) | 108 |
| Other(a) | 47 | (32) | 14 |
| Total | \$ 4,494 | \$ (1,968) | \$ 2,526 |

| (Dollars in millions) Intangible asset class | Gross Carrying Amount | At December 31, 2009 Accumulated Amortization | Net Carrying Amount |
|---|--------------------------|---|------------------------|
| Capitalized software | \$ 1,765 | \$ (846) | \$ 919 |
| Client-related | 1,367 | (677) | 690 |
| Completed technology | 1,222 | (452) | 770 |
| Patents/trademarks | 174 | (59) | 115 |
| Other(a) | 94 | (75) | 19 |
| Total | \$ 4,622 | \$ (2,109) | \$ 2,513 |

(a) Other intangibles are primarily acquired proprietary and non-proprietary business processes, methodologies and systems.

The net carrying amount of intangible assets increased \$13 million during the first half of 2010, primarily due to acquired intangible asset additions, partially offset by amortization. The aggregate intangible amortization expense was \$284 million and \$570 million for the second quarter and first six months of 2010 respectively, versus \$307 million and \$618 million for the second quarter and first six months ended June 30, 2009, respectively. In addition, in the first half of 2010, the company retired \$692 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, 2010:

| (Dollars in millions) | Capitalized Software | Acquired Intangibles | Total |
|-----------------------|-------------------------|-------------------------|--------|
| 2010 (for Q3-Q4) | \$ 303 | \$ 232 | \$ 535 |
| 2011 | 394 | 423 | 817 |
| 2012 | 150 | 356 | 505 |
| 2013 | 20 | 318 | 338 |

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The changes in the goodwill balances by reportable segment, for the six months ended June 30, 2010 and for the year ended December 31, 2009 are as follows:

| (Dollars in millions) Segment | Balance 01/01/10 | Goodwill Additions | Purchase Price Adjustments | Divestitures | Foreign Currency Translation And Other Adjustments | Balance 06/30/10 |
|----------------------------------|---------------------|-----------------------|----------------------------------|--------------|--|---------------------|
| Global Business Services | \$ 4,042 | \$ 252 | \$ | \$ | \$ (231) | \$ 4,063 |
| Global Technology Services | 2,777 | 32 | (1) | | (179) | 2,629 |
| Software | 12,605 | 571 | (9) | | (79) | 13,088 |
| Systems and Technology | 766 | | (0) | | (2) | 764 |
| Total | \$ 20,190 | \$ 855 | \$ (10) | \$ | \$ (491) | \$ 20,544 |

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

| (Dollars in millions) Segment | Balance 01/01/09 | Goodwill Additions | Purchase Price Adjustments | Divestitures | Foreign Currency Translation And Other Adjustments | Balance 12/31/09 |
|----------------------------------|---------------------|-----------------------|----------------------------------|--------------|--|---------------------|
| Global Business Services | \$ 3,870 | \$ | \$ | \$ | \$ 172 | \$ 4,042 |
| Global Technology Services | 2,616 | 10 | 1 | | 150 | 2,777 |
| Software | 10,966 | 994 | (50) | (13) | 708 | 12,605 |
| Systems and Technology | 772 | | (7) | | 1 | 766 |
| Total | \$ 18,226 | \$ 1,004 | \$ (56) | \$ (13) | \$ 1,031 | \$ 20,190 |

Purchase price adjustments recorded in the first six months of 2010 and full year 2009 were related to acquisitions completed on or prior to December 31, 2009 or December 31, 2008, 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 2010 or the full year 2009, and the company has no accumulated impairment losses.

14. Restructuring-Related Liabilities: The following table provides a roll forward of the current and noncurrent liability balances for actions taken in the following periods: (1) the second quarter of 2005 associated with Global Services, primarily in Europe; (2) the fourth quarter of 2002 associated with the acquisition of the PricewaterhouseCoopers consulting business; (3) the second quarter of 2002 associated with the Microelectronics Division and the rebalancing of the company's workforce and leased space resources; (4) the 2002 actions associated with the hard disk drive (HDD) business for reductions in workforce, manufacturing capacity and space; (5) the actions taken in 1999; and (6) the actions that were executed prior to 1994.

| (Dollars in millions) | Liability as of 01/01/2010 | Payments | Other Adjustments* | Liability as of 06/30/2010 |
|-----------------------|----------------------------------|----------|-----------------------|----------------------------------|
| Current: | | | | |
| Workforce | \$ 71 | \$ (34) | \$ (1) | \$ 36 |
| Space | 16 | (10) | 6 | 12 |
| Total Current | \$ 87 | \$ (44) | \$ 5 | \$ 48 |
| Noncurrent: | | | | |
| Workforce | \$ 427 | \$ | \$ (58) | \$ 369 |
| Space | 14 | | (6) | 8 |
| Total Noncurrent | \$ 441 | \$ | \$ (64) | \$ 376 |

* Principally includes the reclassification of noncurrent to current, foreign currency translation adjustments and interest accretion.

15. Contingencies: As a company with a substantial employee population and with clients in more than 170 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 intellectual property (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

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

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Notes to Consolidated Financial Statements (continued)

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 Chapter 11 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. In July 2010, SCO filed an appeal in connection with this matter.

On November 29, 2006, the company filed a lawsuit against Platform Solutions, Inc. (PSI) in the United States District Court for the Southern District of New York, alleging that PSI violated certain intellectual property rights of IBM. PSI asserted counterclaims against IBM. On January 11, 2008, the court permitted T3 Technologies, a reseller of PSI computer systems, to intervene as a counterclaim-plaintiff. T3 claimed that IBM violated certain antitrust laws by refusing to license its patents and trade secrets to PSI and by tying the sales of its mainframe computers to its mainframe operating systems. On June 30, 2008, IBM acquired PSI. As a result of this transaction, IBM and PSI dismissed all claims against each other, and PSI withdrew a complaint it had filed with the European Commission in October 2007 with regard to IBM. On September 30, 2009, the court granted IBM's motion for summary judgment and dismissed T3's claims against IBM. This decision has been appealed by T3. In January 2009, T3 filed a complaint with the European Commission alleging that IBM violated European Union competition law based on the facts alleged in the above-referenced U.S. litigation involving T3. In March 2010, TurboHercules SAS filed a similar complaint with the European Commission. IBM has been notified that the U.S. Department of Justice (DOJ) is investigating possible antitrust violations by IBM, and the DOJ has requested certain information, including the production of materials from the litigation between T3 and IBM. In July 2010, the European Commission notified the company that it has decided to initiate proceedings to further investigate IBM regarding possible infringements of European Union competition law.

The company is a defendant in an action filed on December 14, 2009 in the United States District Court for the Western District of Texas by Neon Enterprise Software, LLC. Neon alleges that the company has interfered with Neon's efforts to license its zPrime software. It seeks damages and injunctive relief. In late January 2010, IBM filed its answer to Neon's complaint and asserted counterclaims against Neon. The case is set for trial in March 2012.

The company is a defendant in an action filed on April 2, 2009 in the United States District Court for the Eastern District of Texas by Acqis LLC, which alleges that certain IBM products infringe certain patents relating generally to modular computing devices. Acqis seeks damages and injunctive relief. The case is set for trial in February 2011.

The company is a defendant in an action filed on February 5, 2010 in the United States District Court for the Eastern District of Virginia by TecSec, Inc., which alleges that certain IBM products infringe certain patents relating generally to encryption. TecSec seeks damages and injunctive relief. A pretrial conference is scheduled for November 2010.

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In January 2004, the Seoul District Prosecutors Office in South Korea announced it had brought criminal bid-rigging charges against several companies, including IBM Korea and LG IBM (a joint venture between IBM Korea and LG electronics, which has since been dissolved, effective January, 2005) and had also charged employees of some of those entities with, among other things, bribery of certain officials of government-controlled entities in Korea and bid rigging. IBM Korea and LG IBM cooperated fully with authorities in these matters. A number of individuals, including former IBM Korea and LG IBM employees, were subsequently found guilty and sentenced. IBM Korea and LG IBM were also required to pay fines. Debarment orders were imposed at different times, covering a period of no more than a year from the date of issuance, which barred IBM Korea from doing business directly with certain government-controlled entities in Korea. All debarment orders have since expired and when they were in force did not prohibit IBM Korea from selling products and services to business partners who sold to government-controlled entities in Korea. In addition, the U.S. Department of Justice and the Securities and Exchange Commission (SEC) have both contacted the company in connection with this matter. In March 2008, the company received a request from the SEC for additional information.

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Notes to Consolidated Financial Statements (continued)

The company is a defendant in numerous actions filed after January 1, 2008 in the Supreme Court for the State of New York, county of Broome, on behalf of hundreds of plaintiffs. The complaints allege numerous and different causes of action, including for negligence and recklessness, private nuisance and trespass. Plaintiffs in these cases seek medical monitoring and claim damages in unspecified amounts for a variety of personal injuries and property damages allegedly arising out of the presence of groundwater contamination and vapor intrusion of groundwater contaminants into certain structures in which plaintiffs reside or resided, or conducted business, allegedly resulting from the release of chemicals into the environment by the company at its former manufacturing and development facility in Endicott. These complaints also seek punitive damages in an unspecified amount.

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

The company is also subject to ongoing tax examinations and governmental assessments in various jurisdictions. Along with many other U.S. companies doing business in Brazil, the company is involved in various challenges with Brazilian authorities regarding non-income tax assessments and non-income tax litigation matters. These matters include claims for taxes on the importation of computer software. In November 2008, the company won a significant case in the Superior Chamber of the federal administrative tax court in Brazil, and in late July 2009, the company received written confirmation regarding this decision. The total potential amount related to the remaining matters for all applicable years is approximately \$600 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

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. Claims and proceedings are reviewed at least quarterly and provisions are taken or adjusted to reflect the impact and status of settlements, rulings, advice of counsel and other information pertinent to a particular matter. Any recorded liabilities, including any changes to such liabilities for the quarter ended June 30, 2010, were not material to the Consolidated Financial Statements. Based on its experience, the company believes that the damage amounts claimed in the matters previously referred to are not a meaningful indicator of the potential liability. Claims, suits, investigations and proceedings are inherently uncertain and it is not possible to predict the ultimate outcome of the matters previously discussed. 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.

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

16. Commitments: The company's extended lines of credit to third-party entities include unused amounts of \$3,487 million and \$3,576 million at June 30, 2010 and December 31, 2009, 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 \$2,637 million and \$2,788 million at June 30, 2010 and December 31, 2009, 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,

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

specified environmental matters, third-party performance of non-financial 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, which procedures 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 \$82 million and \$85 million at June 30, 2010 and December 31, 2009, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position was 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:

Standard Warranty Liability

| (Dollars in millions) | 2010 | | 2009 | |
|--|------|-------|------|-------|
| Balance at January 1 | \$ | 316 | \$ | 358 |
| Current period accruals | | 189 | | 157 |
| Accrual adjustments to reflect actual experience | | 20 | | (3) |
| Charges incurred | | (217) | | (204) |
| Balance at June 30 | \$ | 308 | \$ | 308 |

Extended Warranty Liability

| (Dollars in millions) | 2010 | | 2009 | |
|--|------|-------|------|-------|
| Aggregate deferred revenue at January 1 | \$ | 665 | \$ | 589 |
| Revenue deferred for new extended warranty contracts | | 145 | | 147 |
| Amortization of deferred revenue | | (149) | | (122) |
| Other* | | (52) | | 7 |
| Aggregate deferred revenue at June 30 | \$ | 608 | \$ | 621 |
| Current portion | \$ | 283 | \$ | 281 |

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| | | | | |
|---------------------------------------|----|-----|----|-----|
| Noncurrent portion | | 325 | | 340 |
| Aggregate deferred revenue at June 30 | \$ | 608 | \$ | 621 |

* Other primarily consists of foreign currency translation adjustments.

17. Subsequent Events: On July 27, 2010, the company announced that the Board of Directors approved a quarterly dividend of \$0.65 per common share. The dividend is payable September 10, 2010 to stockholders of record on August 10, 2010.

Table of Contents**Item 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2010**

Snapshot

(Dollars in millions except per share amounts)

| | 2010 | 2009 | Yr. to Yr. Percent/ Margin Change |
|---|-------------|-------------|--|
| For the three months ended June 30: | | | |
| Revenue | \$ 23,724 | \$ 23,250 | 2.0%* |
| Gross profit margin | 45.6% | 45.5% | 0.1pts. |
| Total expense and other income | \$ 6,234 | \$ 6,319 | (1.4)% |
| Total expense and other income to revenue ratio | 26.3% | 27.2% | (0.9)pts. |
| Provision for income taxes | \$ 1,190 | \$ 1,159 | 2.6% |
| Net income | \$ 3,386 | \$ 3,103 | 9.1% |
| Net income margin | 14.3% | 13.3% | 0.9pts. |
| Earnings per share: | | | |
| Assuming dilution | \$ 2.61 | \$ 2.32 | 12.5% |
| Basic | \$ 2.65 | \$ 2.34 | 13.2% |
| Weighted-average shares outstanding: | | | |
| Assuming dilution | 1,296.7 | 1,336.9 | (3.0)% |
| Basic | 1,278.6 | 1,326.1 | (3.6)% |

* 1.6 percent adjusted for currency

Within the Management Discussion, selected references to adjusted for currency or at constant currency are made 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. Financial results adjusted for currency are calculated by translating current period activity in local currency using the comparable prior year period's currency conversion rate. This approach is based on the pricing currency for each country, which is typically the functional currency.

In the second quarter of 2010, the company continued the trend of improving business performance, increasing constant currency revenue growth, expanding margins and again delivering double-digit earnings per share growth.

The company has increased earnings per share in each of the last 30 quarters. Since early 2007, when the company first introduced its 2010 roadmap, the company has delivered double-digit earnings per share growth in 12 of the last 14 quarters. In each of these quarterly periods - which spanned a variety of economic environments - the company has faced unique opportunities and challenges. The many dimensions of the company's business model - business mix, global scale and structure, financial strength and flexibility - have enabled the company to overcome

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the challenges and capitalize on opportunities - and consistently deliver solid performance. In the second quarter, the company faced a significant currency impact driven by the sharp strengthening of the dollar and still delivered 13 percent earnings per share growth compared to a very strong second quarter of 2009 in which earnings per share increased 18 percent.

Total revenue increased 2.0 percent (2 percent adjusted for currency) compared to the second quarter of 2009. Overall, currency provided approximately 40 basis points of revenue growth versus the 200-300 basis points projected based on mid-April spot rates at the time the company released its first quarter financial results. That resulted in a 2-3 point impact to the company's as reported revenue growth. The revenue growth rate at constant currency was 2 points better than the constant currency performance in the first quarter of 2010 and 7 points better than the fourth quarter of 2009 growth rate. The first quarter 2010 sale of the company's Product Lifecycle Management (PLM) software activities impacted the second quarter revenue growth rate by approximately one point. On this basis, the improvement was broad based - across all the company's segments and geographies.

Revenue performance was strong in the company's key growth investment areas. Total revenue from the growth markets increased 13.7 percent (9 percent adjusted for currency) with performance driven by the BRIC countries of Brazil, Russia, India and China, which increased 21.9 percent (16 percent adjusted for currency) as the company has been investing heavily to build out the infrastructures in the emerging countries. The company is investing to extend its technology leadership.

Table of Contents**Management Discussion (continued)**

Earlier this year, Power7 technology was introduced to the company's mid-range Unix servers - in the second quarter, the mid-range grew 11 percent which drove share gains in Power Systems. In the third quarter, the company will have Power7 across its entire Unix product line and will introduce and begin shipping its next generation mainframe server. Business analytics is a key growth area for the company. In the second quarter, business analytics revenue increased 14 percent compared to the prior year which contributed to strong performance in the Software and Global Business Services segments. Global Business Services revenue growth improved to 3.3 percent (3 percent adjusted for currency) and key branded middleware in Software increased 9.4 percent (10 percent adjusted for currency) versus the prior year and gained share again in the quarter.

The consolidated gross profit margin increased 0.1 point versus the second quarter of 2009 to 45.6 percent driven by improved margins in Global Business Services and Software. Gross profit margin performance by segment and the impact to the consolidated gross margin was as follows:

| | Gross Margin | Yr.-to-Yr. Change | Consolidated Impact |
|--------------------------|-------------------------|------------------------------|--------------------------------|
| Global Technology | | | |
| Services | 34.6% | (0.2)pts. | (0.1)pts. |
| Global Business Services | 28.5% | 1.3pts. | 0.2pts. |
| Software | 87.1% | 1.2pts. | 0.3pts. |
| Systems & Technology | 36.1% | (1.0)pts. | (0.2)pts. |
| Global Financing | 50.1% | 3.0pts. | 0.1pts. |

Total expense and other income decreased 1.4 percent in the second quarter compared to the prior year. The year-to-year drivers were approximately:

- Operational expense, (5) points
- Currency, 2 points
- Acquisitions, 2 points

Pre-tax income grew 7.3 percent and the pre-tax margin was 19.3 percent, an increase of 1.0 point versus the second quarter of 2009. Net income increased 9.1 percent reflecting an improvement in the tax rate. The effective tax rate was 26.0 percent, compared with 27.2 percent in the prior year. Net income margin improved 0.9 points to 14.3 percent.

Diluted earnings per share improved 12.5 percent reflecting the growth in net income and the benefits of the common stock repurchase program. In the second quarter, the company repurchased 32.4 million shares of its common stock. Diluted earnings per share of \$2.61 increased \$0.29 from the prior year driven by the following factors:

| | |
|---------------------------------------|--------|
| - Revenue increase at actual rates: | \$0.05 |
| - Operating leverage: | \$0.16 |
| • Gross margin increase of 0.1 point: | \$0.01 |

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| | | |
|---|----------------------------------|--------|
| • | Expense productivity: | \$0.11 |
| • | Tax rate decrease of 1.2 points: | \$0.04 |
| - | Common stock repurchases: | \$0.08 |

In the second quarter, the improvement in earnings per share was driven by a combination of revenue growth, margin expansion and an effective use of cash.

The company generated \$3,766 million in cash flow provided by operating activities, a decrease of \$975 million compared to the second quarter of 2009, driven primarily by financing receivables (\$648 million) and a prior year foreign tax refund (\$360 million). Net cash used in investing activities of \$1,946 million increased \$97 million primarily due to increased capital investments (\$106 million). Net cash used in financing activities of \$3,746 million was essentially flat compared to the prior year.

Total Global Services signings of \$12,299 million were flat versus the first quarter and down 12.1 percent (12 percent adjusted for currency) compared to the second quarter of 2009. Signings performance was impacted by a decline in outsourcing signings of 19 percent (19 percent adjusted for currency) compared to a very strong prior year period. Based on an assessment of the larger outsourcing contracts, there was a significant decline in contract extensions as a number of large deals pushed out of the second quarter. Contract extensions have little to no benefit to near-term revenue. In contrast, the business had good growth in new business signings which will have a more immediate contribution to revenue. The Global Services backlog at June 30, 2010 was \$129 billion, a decrease of \$2 billion (up \$1 billion, adjusted for currency) versus the prior year.

Table of Contents**Management Discussion (continued)**

| (Dollars in millions except per share amounts) | | | | | Yr. to Yr. Percent/ Margin Change |
|---|-------------|-----------------|-------------|-----------------|--|
| For the six months ended June 30: | 2010 | | 2009 | | |
| Revenue | \$ | 46,581 | \$ | 44,962 | 3.6%* |
| Gross profit margin | | 44.6% | | 44.5% | 0.1pts. |
| Total expense and other income | \$ | 12,695 | \$ | 12,628 | 0.5% |
| Total expense and other income to revenue ratio | | 27.3% | | 28.1% | (0.8)pts. |
| Provision for income taxes | \$ | 2,103 | \$ | 1,986 | 5.9% |
| Net income | \$ | 5,987 | \$ | 5,398 | 10.9% |
| Net income margin | | 12.9% | | 12.0% | 0.8pts. |
| Earnings per share: | | | | | |
| Assuming dilution | \$ | 4.57 | \$ | 4.02 | 13.7% |
| Basic | \$ | 4.64 | \$ | 4.04 | 14.9% |
| Weighted-average shares outstanding: | | | | | |
| Assuming dilution | | 1,309.2 | | 1,343.2 | (2.5)% |
| Basic | | 1,289.9 | | 1,335.2 | (3.4)% |
| | | 06/30/10 | | 12/31/09 | |
| Assets | \$ | 103,420 | \$ | 109,022 | (5.1)% |
| Liabilities | \$ | 82,244 | \$ | 86,267 | (4.7)% |
| Equity | \$ | 21,176 | \$ | 22,755 | (6.9)% |

* 0.8 percent adjusted for currency

In the first half of 2010, the company delivered excellent financial performance with diluted earnings per share of \$4.57, an increase of 13.7 percent compared to the first six months of 2009. Performance was consistent with earnings per share growth of 15.9 percent in the first quarter and 12.5 percent in the second quarter. The company continues to demonstrate steady improvement in the business - in both revenue growth and margin expansion. The company utilizes its strong profit and cash position to invest and expand its base of opportunity while returning capital to its shareholders through dividends and common stock repurchases.

Total revenue increased 3.6 percent (1 percent adjusted for currency) compared to the first half of 2009. Revenue performance in the company's key growth areas was strong. Revenue from the growth markets increased 16.6 percent (8 percent adjusted for currency) driven by the BRIC countries which increased 22.4 percent (15 percent adjusted for currency). Key branded middleware software increased 11.1 percent (9 percent adjusted for currency). On a segment basis, Global Technology Services revenue increased 3.8 percent (flat adjusted for currency), Global Business Services 1.8 percent (down 1 percent adjusted for currency), Software 6.1 percent (4 percent adjusted for currency) and Systems and Technology 4.1 percent (3 percent adjusted for currency). Global Financing revenue declined 5.6 percent (9 percent adjusted for currency) versus the prior year.

The consolidated gross profit margin increased 0.1 point versus the first half of 2009 to 44.6 percent. Gross profit margin performance by segment and the impact to the consolidated gross margin for the year-to-date period was as follows:

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| | Gross Margin | Yr.-to-Yr. Change | Consolidated Impact |
|----------------------------|-------------------------|------------------------------|--------------------------------|
| Global Technology Services | 34.5% | 0.1pts. | 0.0pts. |
| Global Business Services | 27.9% | 1.0pts. | 0.3pts. |
| Software | 85.9% | 0.8pts. | 0.4pts. |
| Systems & Technology | 34.9% | (0.7)pts. | (0.1)pts. |
| Global Financing | 49.9% | 3.5pts. | 0.1pts. |

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Management Discussion (continued)

Total expense and other income increased 0.5 percent in the first six months of 2010 versus the prior year. The year-to-year drivers were approximately:

- Operational expense, (5) points
- Currency, 4 points
- Acquisitions, 2 points

Pre-tax income grew 9.6 percent and the pre-tax margin was 17.4 percent, an increase of 0.9 points versus the first half of 2009. Net income increased 10.9 percent reflecting an improvement in the tax rate. The effective tax rate was 26.0 percent, compared with 26.9 percent in the prior year. Net income margin improved 0.8 points to 12.9 percent.

Diluted earnings per share improved 13.7 percent reflecting the growth in net income and the benefits of the common stock repurchase program. In the first half, the company repurchased 64.6 million shares of its common stock. Diluted earnings per share of \$4.57 increased \$0.55 from the prior year driven by the following factors :

| | |
|---------------------------------------|--------|
| - Revenue increase at actual rates: | \$0.14 |
| - Operating leverage: | \$0.29 |
| • Gross margin increase of 0.1 point: | \$0.04 |
| • Expense productivity: | \$0.20 |
| • Tax rate decrease of 0.9 points: | \$0.05 |
| - Common stock repurchases: | \$0.12 |

In the first half, the improvement in earnings per share was balanced with contribution from all the key drivers - revenue growth, margin expansion and an effective use of cash.

At June 30, 2010, the company's balance sheet and liquidity positions remain strong and are well-positioned to support the company's objectives. Key drivers in the balance sheet and total cash flows are highlighted below.

Total assets decreased \$5,602 million (\$2,135 million adjusted for currency) from December 31, 2009 driven by:

- Decreases in total receivables (\$4,761 million), cash and marketable securities (\$1,732 million) and plant, rentals & other property (\$631 million), partially offset by;
- Increased pension assets (\$573 million), investments and sundry assets (\$659 million) and goodwill (\$354 million).

The company had \$12,241 million in cash and marketable securities at June 30, 2010.

Total liabilities decreased \$4,023 million (\$1,341 million adjusted for currency) from December 31, 2009 driven by:

- Decreases in other liabilities (\$1,207 million), taxes (\$931 million) and pension and retiree benefits (\$1,355 million), partially offset by;
- Increased debt (\$551 million).

Total equity of \$21,176 million decreased \$1,579 million from December 31, 2009 as a result of:

- Increased treasury stock (\$8,033 million) and lower foreign currency translation adjustments (\$1,081 million), partially offset by;
- Higher retained earnings (\$4,423 million), common stock (\$1,712 million), gains on cash flow hedge derivatives (\$1,015 million) and lower pension adjustments (\$392 million).

The company generated \$8,203 million in cash flow provided by operating activities, a decrease of \$924 million, compared to the first six months of 2009, primarily driven by financing receivables (\$1,131 million) and lower tax refunds in 2010 (approximately \$630 million), partially offset by an increase in net income (\$588 million). Net cash used in investing activities of \$2,645 million was \$748 million higher than the first six months of 2009, primarily due to increased acquisitions (\$909 million), decreased cash from divestitures (\$356 million) and higher capital investments (\$250 million), partially offset by the net benefit of \$767 million from purchases and sales of marketable securities and other investments in 2010 versus 2009. Net cash used in financing activities of \$7,114 million was \$1,212 million lower, compared to the first six months of 2009, primarily due to an increased net benefit associated with debt (\$4,736 million) and higher receipts of cash from other common stock transactions (\$1,305 million), partially offset by higher payments to repurchase common stock (\$4,685 million) and increased dividend payments (\$144 million).

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For the six months ended June 30:

| | | | | | Currency |
|----------------------------|----|--------|----|--------|------------|
| Revenue: | | | | | |
| Global Technology Services | \$ | 18,540 | \$ | 17,862 | 3.8% |
| Gross margin | | 34.5% | | 34.3% | 0.1pts. |
| Global Business Services | | 8,893 | | 8,736 | 1.8% |
| Gross margin | | 27.9% | | 26.8% | 1.0pts. |
| Software | | 10,296 | | 9,705 | 6.1% |
| Gross margin | | 85.9% | | 85.1% | 0.8pts. |
| Systems and Technology | | 7,370 | | 7,083 | 4.1% |
| Gross margin | | 34.9% | | 35.7% | (0.7)pts. |
| Global Financing | | 1,081 | | 1,146 | (5.6)% |
| Gross margin | | 49.9% | | 46.5% | 3.5pts. |
| Other | | 400 | | 429 | (6.8)% |
| Gross margin | | (8.9)% | | 50.1% | (59.0)pts. |
| Total revenue | \$ | 46,581 | \$ | 44,962 | 3.6% |
| Gross profit | \$ | 20,785 | \$ | 20,012 | 3.9% |
| Gross margin | | 44.6% | | 44.5% | 0.1pts. |

Table of Contents**Management Discussion (continued)**

The following table presents each reportable segment's external revenue as a percentage of total external segment revenue.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------|--|-------------|--------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Global Technology Services | 39.3% | 39.5% | 40.1% | 40.1% |
| Global Business Services | 19.1 | 18.8 | 19.3 | 19.6 |
| Total Global Services | 58.3 | 58.4 | 59.4 | 59.7 |
| Software | 22.4 | 22.4 | 22.3 | 21.8 |
| Systems and Technology | 16.9 | 16.7 | 16.0 | 15.9 |
| Global Financing | 2.3 | 2.5 | 2.3 | 2.6 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

The following table presents each reportable segment's pre-tax income as a percentage of total segment pre-tax income.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------|--|-------------|--------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Global Technology Services | 29.8% | 30.1% | 28.1% | 31.3% |
| Global Business Services | 14.3 | 13.0 | 13.3 | 14.1 |
| Total Global Services | 44.1 | 43.2 | 41.4 | 45.4 |
| Software | 41.6 | 39.7 | 47.6 | 39.8 |
| Systems and Technology | 4.6 | 7.1 | 0.6 | 4.5 |
| Global Financing | 9.7 | 10.0 | 10.5 | 10.3 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

The workforce rebalancing charges recorded in the first quarter of 2009 and 2010 and the PLM and Geodis transactions impact the year-to-year results of the company's reportable segments for the first half of 2010 compared to the first half of 2009. Workforce rebalancing charges were incurred in every segment in the first quarter of both years. The PLM transaction gain was recorded in Software in the first quarter of 2010 and the Geodis transaction gain was recorded in the following segments in the first quarter of 2009: Global Technology Services (\$81 million), Global Business Services (\$46 million), Software (\$106 million) and Systems and Technology (\$64 million). In the segment analysis below and in the Global Financing analysis on page 66, each segment's pre-tax income and pre-tax margin for the six months ended June 30 is presented on an as reported basis and on a basis normalized for these actions in both years to provide a better perspective of the underlying operational performance of the segments.

Global Services

The Global Services segments, Global Technology Services (GTS) and Global Business Services (GBS) returned to growth at constant currency in the second quarter, delivering \$13,717 million in combined revenue, an increase of 2.0 percent (1 percent adjusted for currency) compared to the second quarter of 2009. Adjusted for currency, the combined services revenue growth rate in the second quarter improved 3 points compared

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to the first quarter of 2010, largely driven by Global Business Services. In the first six months of 2010, total Global Services revenue was \$27,433 million, an increase of 3.1 percent (flat adjusted for currency) year to year. Total Global Services signings in the second quarter of \$12,299 million decreased 12.1 percent (12 percent adjusted for currency) year to year. In the second quarter, the company signed 15 deals greater than \$100 million. Outsourcing signings of \$6,470 million decreased 18.8 percent (19 percent adjusted for currency). Within outsourcing, based on an assessment of larger contracts, contract extensions declined year to year, as a number of large deals pushed out of the second quarter. Contract extensions have little to no benefit to near-term revenue. In contrast, new business signings in outsourcing increased year to year which will have a more immediate contribution to revenue. Based on this assessment, the company expects to yield more revenue over the next 12 months from this quarter's outsourcing signings of \$6,470 million than the second quarter of 2009 outsourcing signings of \$7,966 million. Total transactional signings of \$5,829 million decreased 3.2 percent (3 percent adjusted for currency), an improvement sequentially from first-quarter 2010 at constant currency. Transactional signings in Integrated Technology Services improved compared to the first quarter at constant currency and AMS Systems Integration signings increased year to year. Consulting signings declined year to year in the second quarter as a number of transactions moved out of the quarter, although signings in North America were up 17 percent (16 percent adjusted for currency). Total consulting signings increased in the first half of 2010 compared to the prior year. The estimated Global Services backlog at actual currency rates was \$129 billion at June 30, 2010,

Table of Contents**Management Discussion (continued)**

a decrease of \$2 billion (increase of \$1 billion adjusted for currency) from June 30, 2009 and a decrease of \$5 billion (\$1 billion adjusted for currency) from March 31, 2010.

| | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|--|----|-------------|--------------|---------------------------------|--|
| (Dollars in millions) | | | | | |
| For the three months ended June 30: | | 2010 | 2009* | | |
| Global Services external revenue: | \$ | 13,717 | \$ 13,446 | 2.0% | 1.1% |
| Global Technology Services | \$ | 9,234 | \$ 9,108 | 1.4% | 0.3% |
| Outsourcing | | 5,364 | 5,277 | 1.6 | 0.5 |
| Integrated Technology Services | | 2,098 | 2,137 | (1.8) | (2.2) |
| Maintenance | | 1,772 | 1,694 | 4.6 | 3.0 |
| Global Business Services | \$ | 4,483 | \$ 4,338 | 3.3% | 2.6% |

* Reclassified to conform with 2010 presentation.

| | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|--|----|-------------|--------------|---------------------------------|--|
| (Dollars in millions) | | | | | |
| For the six months ended June 30: | | 2010 | 2009* | | |
| Global Services external revenue: | \$ | 27,433 | \$ 26,598 | 3.1% | (0.3)% |
| Global Technology Services | \$ | 18,540 | \$ 17,862 | 3.8% | 0.1% |
| Outsourcing | | 10,818 | 10,341 | 4.6 | 0.6 |
| Integrated Technology Services | | 4,171 | 4,172 | (0.0) | (3.0) |
| Maintenance | | 3,551 | 3,350 | 6.0 | 2.2 |
| Global Business Services | \$ | 8,893 | \$ 8,736 | 1.8% | (1.2)% |

* Reclassified to conform with 2010 presentation.

Global Technology Services revenue increased 1.4 percent (flat adjusted for currency) to \$9,234 million and 3.8 percent (flat adjusted for currency) to \$18,540 million in the second quarter and first six months of 2010, respectively, versus the second quarter and first six months of 2009. GTS Outsourcing revenue increased 1.6 percent (flat adjusted for currency) in the second quarter and 4.6 percent (1 percent adjusted for currency) in the first six months of 2010, respectively, versus the same periods in 2009. Integrated Technology Services (ITS) revenue decreased 1.8 percent (2 percent adjusted for currency) in the second quarter and was flat (decreased 3 percent adjusted for currency) in the first six months of 2010 when compared to the same periods in 2009. Revenue in the growth markets was up over 8 percent year to year in each of these businesses in the second quarter, adjusted for currency.

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Global Business Services revenue increased 3.3 percent (3 percent adjusted for currency) and 1.8 percent (decreased 1 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, versus the prior year periods. Adjusted for currency, GBS improved its year-to-year growth rate by 8 points sequentially from first-quarter 2010. Consulting and AMS both had revenue growth in the second quarter of 2010, led by North America with constant currency growth of 8 percent. Revenue performance in the second quarter was broad based throughout the segment with year-to-year growth in both the major markets and growth markets, and in all sectors, with the exception of the communications sector. From an offering perspective, both business analytics and Smarter Planet had double-digit year to year revenue growth in the second quarter.

Table of Contents**Management Discussion (continued)**

| (Dollars in millions) | | | | Yr. to Yr. Percent/ Margin Change |
|--|-------------|----|-------------|--|
| For the three months ended June 30: | | | | |
| | 2010 | | 2009 | |
| Global Technology Services: | | | | |
| External gross profit | \$ 3,191 | \$ | 3,167 | 0.7% |
| External gross profit margin | 34.6% | | 34.8% | (0.2)pts. |
| Pre-tax income | \$ 1,422 | \$ | 1,405 | 1.2% |
| Pre-tax margin | 14.9% | | 14.9% | 0.0pts. |
| Global Business Services: | | | | |
| External gross profit | \$ 1,277 | \$ | 1,178 | 8.3% |
| External gross profit margin | 28.5% | | 27.2% | 1.3pts. |
| Pre-tax income | \$ 683 | \$ | 608 | 12.3% |
| Pre-tax margin | 14.6% | | 13.3% | 1.3pts. |
| (Dollars in millions) | | | | Yr. to Yr. Percent/ Margin Change |
| For the six months ended June 30: | | | | |
| | 2010 | | 2009 | |
| Global Technology Services: | | | | |
| External gross profit | \$ 6,387 | \$ | 6,135 | 4.1% |
| External gross profit margin | 34.5% | | 34.3% | 0.1pts. |
| Pre-tax income | \$ 2,387 | \$ | 2,509 | (4.9)% |
| Pre-tax margin | 12.4% | | 13.5% | (1.1)pts. |
| Pre-tax income normalized* | \$ 2,659 | \$ | 2,543 | 4.6% |
| Pre-tax margin normalized | 13.9% | | 13.7% | 0.1pts. |
| Global Business Services: | | | | |
| External gross profit | \$ 2,479 | \$ | 2,344 | 5.7% |
| External gross profit margin | 27.9% | | 26.8% | 1.0pts. |
| Pre-tax income | \$ 1,128 | \$ | 1,130 | (0.1)% |
| Pre-tax margin | 12.1% | | 12.3% | (0.2)pts. |
| Pre-tax income normalized** | \$ 1,257 | \$ | 1,207 | 4.1% |
| Pre-tax margin normalized | 13.5% | | 13.1% | 0.4pts. |

* Excludes \$273 million and \$115 million of workforce rebalancing charges in the first quarter of 2010 and 2009, respectively, and (\$81) million related to the Geodis gain in the first quarter of 2009.

** Excludes \$128 million and \$123 million of workforce rebalancing charges in the first quarter of 2010 and 2009, respectively, and (\$46) million related to the Geodis gain in the first quarter of 2009.

GTS segment pre-tax profit increased 1.2 percent to \$1,422 million in the second quarter with a margin of 14.9 percent, flat compared to the second quarter of 2009. On a normalized basis, segment pre-tax profit in the first six months of 2010 increased 4.6 percent with a pre-tax margin of 13.9 percent, an increase of 0.1 points year to year. Pre-tax margin is expected to expand in the second half of 2010 with the benefit of the first-quarter 2010 workforce rebalancing actions and a positive revenue growth trend.

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GBS gross profit margins improved 1.3 points and 1.0 point in the second quarter and first six months of 2010, respectively. Segment pre-tax profit increased 12.3 percent to \$683 million in the second quarter with a margin of 14.6 percent, an improvement of 1.3 points compared to the second quarter of 2009. On a normalized basis, segment pre-tax profit in the first six months of 2010 increased 4.1 percent with a pre-tax margin of 13.5 percent, an improvement of 0.4 points year to year. This margin expansion was driven by higher utilization and benefits from the continued implementation of globally integrated capabilities. Concurrently, GBS continues to add to its skill base and invest for future growth.

Table of Contents**Management Discussion (continued)**

Global Services Signings

The following table presents Global Services signings. Outsourcing signings include GTS Outsourcing and Application Outsourcing. Transactional signings include Integrated Technology Services, Consulting and AMS Systems Integration.

| (Dollars in millions) | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|--|----|-------------|----|---------------------------------|---|
| For the three months ended June 30: | | 2010 | | 2009 | |
| Outsourcing signings | \$ | 6,470 | \$ | 7,966 | (18.8)% (19.0)% |
| Transactional signings | | 5,829 | | 6,022 | (3.2) (2.6) |
| Total signings | \$ | 12,299 | \$ | 13,988 | (12.1)% (11.9)% |

| (Dollars in millions) | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|--|----|-------------|----|---------------------------------|---|
| For the six months ended June 30: | | 2010 | | 2009 | |
| Outsourcing signings | \$ | 13,246 | \$ | 14,957 | (11.4)% (13.9)% |
| Transactional signings | | 11,320 | | 11,565 | (2.1) (4.4) |
| Total signings | \$ | 24,565 | \$ | 26,522 | (7.4)% (9.8)% |

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

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

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

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

acquisition or divestiture.

Table of Contents**Management Discussion (continued)**Software

| (Dollars in millions) | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|-------------------------------------|----|-------|----------|---------------------------------|---|
| For the three months ended June 30: | | 2010 | 2009* | | |
| Software external revenue: | \$ | 5,277 | \$ 5,166 | 2.1% | 2.1% |
| Middleware: | \$ | 4,347 | \$ 4,103 | 6.0% | 6.1% |
| Key branded middleware: | | 3,269 | 2,988 | 9.4 | 9.8 |
| WebSphere Family | | | | 16.6 | 16.2 |
| Information Management | | | | 6.9 | 7.2 |
| Lotus | | | | (6.4) | (5.5) |
| Tivoli | | | | 18.4 | 19.2 |
| Rational | | | | 1.3 | 1.8 |
| Other middleware | | 1,078 | 1,115 | (3.3) | (3.9) |
| Operating systems | | 544 | 529 | 2.7 | 2.3 |
| Other | | 387 | 534 | (27.6) | (28.3) |

* Reclassified to conform with 2010 presentation.

| (Dollars in millions) | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|-----------------------------------|----|--------|----------|---------------------------------|---|
| For the six months ended June 30: | | 2010 | 2009* | | |
| Software external revenue: | \$ | 10,296 | \$ 9,705 | 6.1% | 3.7% |
| Middleware: | \$ | 8,351 | \$ 7,680 | 8.7% | 6.3% |
| Key branded middleware: | | 6,078 | 5,472 | 11.1 | 8.9 |
| WebSphere Family | | | | 15.0 | 12.7 |
| Information Management | | | | 9.0 | 6.6 |
| Lotus | | | | (2.8) | (4.4) |
| Tivoli | | | | 20.6 | 18.7 |
| Rational | | | | 3.8 | 2.1 |
| Other middleware | | 2,273 | 2,208 | 3.0 | (0.1) |
| Operating systems | | 1,043 | 1,021 | 2.1 | (0.3) |
| Other | | 902 | 1,004 | (10.2) | (13.0) |

* Reclassified to conform with 2010 presentation.

Software revenue of \$5,277 million increased 2.1 percent (2 percent adjusted for currency) year to year in the second quarter and increased 6.1 percent (4 percent adjusted for currency) to \$10,296 million in the first six months of 2010. Adjusting for the divested PLM activities, revenue grew at 6 percent, adjusted for currency, in both the second quarter and first six months of 2010. Revenue performance was led by key branded middleware. The Software business is capturing growth in key areas like business analytics, storage management and business integration. The

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breadth and diversity of the software portfolio, combined with strategic investments in high growth areas have enabled the company to achieve consistently strong results in the software segment.

Key branded middleware revenue increased 9.4 percent (10 percent adjusted for currency) in the second quarter of 2010 and increased 11.1 percent (9 percent adjusted for currency) in the first six months of 2010, when compared to the same periods in 2009. Key branded middleware accounted for 62 percent of total Software revenue in the second quarter, up 4 points from second-quarter 2009, and gained share for the 11th straight quarter. The share gain was broad-based across WebSphere, Information Management, Tivoli and Rational. Both WebSphere and Tivoli had double-digit revenue growth year to year and the business analytics product set had strong performance.

Table of Contents**Management Discussion (continued)**

WebSphere Family revenue increased 16.6 percent (16 percent adjusted for currency) in the second quarter of 2010 and gained share in all segments with strong performance across the portfolio. In the first six months of 2010, revenue increased 15.0 percent (13 percent adjusted for currency) versus the first six months of 2009. Application Servers, which provide customers with secure and resilient infrastructure for mission-critical business applications, had revenue growth of 32.2 percent (32 percent adjusted for currency) and 20.5 percent (18 percent adjusted for currency) in the second quarter and first six months, respectively. Business Integration software, which includes the ILOG and Lombardi acquisitions, had revenue growth of 12 percent in the second quarter and 15 percent for the first six months of 2010 adjusted for currency.

Information Management revenue increased 6.9 percent (7 percent adjusted for currency) in the second quarter and 9.0 percent (7 percent adjusted for currency) in the first six months of 2010, respectively. Information Management software offerings provide the foundation for the company's business analytics and optimization offerings.

Lotus revenue decreased 6.4 percent (6 percent adjusted for currency) and 2.8 percent (4 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, versus the same periods in 2009.

Tivoli revenue increased 18.4 percent and 20.6 percent (19 percent and 19 percent adjusted for currency) year over year in the second quarter and first six months of 2010, respectively. Enterprise Asset Management, within the systems management portfolio, had double digit revenue growth, adjusted for currency, in both the quarter and six month periods and continues to be a critical component of the Smarter Planet solutions. Security software had strength across the portfolio and in all geographies. Storage products also continued to perform well, growing double digits and gaining share. XIV software, which provides ease of use and lower total cost of ownership, more than doubled in the second quarter of 2010 versus the second quarter of 2009. Tivoli Storage Manager had revenue growth of 10 percent in the second quarter driven by its market leading data reduction capabilities and related cost benefits.

Rational revenue increased 1.3 percent (2 percent adjusted for currency) in the second quarter and 3.8 percent (2 percent adjusted for currency) in the first six months of 2010, respectively, versus the comparable prior year periods. Rational provides an integrated suite of products to manage the business process for software and systems delivery.

Other software revenue decreased 27.6 percent (28 percent adjusted for currency) and 10.2 percent (13 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, driven primarily by the PLM divestiture in the first quarter of 2010.

| (Dollars in millions) | | | Yr. to Yr. Percent/ Margin Change |
|--|-------------|-------------|--|
| For the three months ended June 30: | 2010 | 2009 | |
| Software: | | | |
| External gross profit | \$ 4,595 | \$ 4,436 | 3.6% |
| External gross profit margin | 87.1% | 85.9% | 1.2pts. |
| Pre-tax income | \$ 1,988 | \$ 1,852 | 7.4% |

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Pre-tax margin 33.3% 32.0% 1.3pts.

(Dollars in millions)

| For the six months ended June 30: | 2010 | 2009 | Yr. to Yr. Percent/ Margin Change |
|-----------------------------------|----------|----------|--|
| Software: | | | |
| External gross profit | \$ 8,839 | \$ 8,258 | 7.0% |
| External gross profit margin | 85.9% | 85.1% | 0.8pts. |
| Pre-tax income | \$ 4,040 | \$ 3,186 | 26.8% |
| Pre-tax margin | 34.4% | 29.1% | 5.3pts. |
| Pre-tax income normalized* | \$ 3,546 | \$ 3,097 | 14.5% |
| Pre-tax margin normalized | 30.2% | 28.3% | 1.9pts. |

* Excludes \$98 million and \$17 million of workforce rebalancing charges in the first quarter of 2010 and 2009, respectively, and (\$591 million) related to the PLM gain in the first quarter of 2010 and (\$106) million related to the Geodis gain in the first quarter of 2009.

Table of Contents**Management Discussion (continued)**

Software gross profit increased 3.6 percent to \$4,595 million for the second quarter and 7.0 percent to \$8,839 million for the first six months of 2010, driven primarily by higher revenue. Gross profit margins expanded 1.2 points and 0.8 points in the second quarter and first six months, respectively, versus the prior year periods. The divestiture of the lower gross margin PLM revenue drove the second quarter margin improvement. Software delivered pre-tax income of \$1,988 million in the second quarter of 2010, a growth of 7.4 percent compared to the second quarter of 2009. The pre-tax profit margin expanded 1.3 points to 33.3 percent. This is the 11th consecutive quarter of margin expansion in the Software segment. On a normalized basis, segment pre-tax profit for the first six months of 2010 increased 14.5 percent and segment pre-tax profit margin expanded 1.9 points to 30.2 percent.

Systems and Technology

| (Dollars in millions) | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|--|----------|----------|--|---------------------------------|---|
| For the three months ended June 30: | 2010 | 2009 | | | |
| Systems and Technology external revenue: | \$ 3,985 | \$ 3,855 | | 3.4% | 4.2% |
| System z | | | | (23.6)% | (22.3)% |
| Power Systems | | | | (10.2) | (9.6) |
| System x | | | | 30.3 | 30.5 |
| Storage | | | | 4.5 | 6.1 |
| Retail Store Solutions | | | | 30.6 | 33.4 |
| Total Systems | | | | 1.0 | 2.0 |
| Microelectronics OEM | | | | 23.2 | 23.2 |

| (Dollars in millions) | | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|--|----------|----------|--|---------------------------------|---|
| For the six months ended June 30: | 2010 | 2009 | | | |
| Systems and Technology external revenue: | \$ 7,370 | \$ 7,083 | | 4.1% | 3.1% |
| System z | | | | (20.4)% | (20.4)% |
| Power Systems | | | | (13.3) | (14.3) |
| System x | | | | 33.1 | 30.8 |
| Storage | | | | 7.4 | 6.5 |
| Retail Store Solutions | | | | 34.0 | 34.0 |
| Total Systems | | | | 2.4 | 1.3 |
| Microelectronics OEM | | | | 19.8 | 19.8 |

Systems and Technology revenue increased 3.4 percent (4 percent adjusted for currency) and 4.1 percent (3 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, versus the same periods in 2009. Revenue performance was driven by continued growth in System x, Storage, Retail Store Solutions and Microelectronics. In the second quarter, Systems and Technology had strong performance in the growth markets. BRIC countries grew 20 percent with growth in all brands, and the company expects this strength to continue in the second half of 2010.

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System z revenue decreased 23.6 percent and 20.4 percent (22 percent and 20 percent adjusted for currency) in the second quarter and first six months of 2010 versus the second quarter and first six months of 2009, respectively. MIPS (millions of instructions per second) shipments decreased 14 percent and 16 percent in the second quarter and first half of 2010 versus the second quarter and first half of 2009, respectively. This performance was consistent with what the company expected at this point in the product cycle. In mid July, the company announced the next generation of System z, the fastest and most scalable enterprise server in the industry. The new server will be the foundation for the company's first System of Systems, extending mainframe governance to other industry leading IBM technologies.

Power Systems revenue decreased 10.2 percent and 13.3 percent (10 percent and 14 percent adjusted for currency) in the second quarter and first six months of 2010 versus the second quarter and first six months of 2009, respectively. The decreases were primarily driven by high-end servers. In the second quarter, the company had 225 competitive UNIX displacements, of which approximately two-thirds were from Sun, that resulted in \$225 million of business and contributed

Table of Contents**Management Discussion (continued)**

to approximately four points of share gain. This is a sequential increase of over \$75 million from the first quarter where the company gained over seven points of share. In the past six quarters, the company has won 620 deals from Sun totaling nearly \$650 million of business. The displacement rate has been increasing and the company expects this to continue throughout the second half of 2010. The new Power7 mid-range and Power7 blades products drove mid-range revenue growth of 11 percent and blade revenue growth over 65 percent year over year. This performance drove four points of share gain in the quarter – the 9th consecutive quarter of share gains. In the third quarter, the company will announce Power7 high-end and entry systems products with availability in September and the company will have available a fully refreshed Power Systems product line in the quarter.

System x revenue increased 30.3 percent and 33.1 percent (30 percent and 31 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, versus the second quarter and first six months of 2009. High-end System x revenue increased 17 percent and 14 percent in the second quarter and first six months of 2010 versus the comparable periods of 2009, respectively, while total server revenue increased 30 and 33 percent for the second quarter and first six months of 2010 versus the same periods in 2009, respectively. System x blades revenue increased 16 percent and 32 percent in the second quarter and first half of 2010 versus the second quarter and first half of 2009, respectively. The high-end product performance, the growth of blades and improved operational performance contributed to improved gross margin in System x.

Storage revenue increased 4.5 percent and 7.4 percent (6 percent and 7 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, versus the comparable periods in 2009. Total disk revenue increased 12 percent and 15 percent in the second quarter and the first six months of 2010 versus the second quarter and first six months of 2009, respectively. These increases were driven by continued strength in high-end offerings, XIV and DS8000. XIV added over 130 new customers in the second quarter and revenue more than doubled versus the second quarter of 2009. Tape revenue declined 14 percent and 10 percent in the second quarter and the first six months of 2010, respectively, versus the comparable periods of 2009, respectively.

Microelectronics OEM revenue increased 23.2 percent and 19.8 percent (23 percent and 20 percent adjusted for currency), respectively, for the second quarter and first six months of 2010 versus the comparable periods of 2009, respectively. The primary mission of this business is to provide leadership technology for the systems business. Both the 300 millimeter and 200 millimeter semiconductor fabrication facilities are fully utilized.

Retail Stores Solutions revenue increased 30.6 percent and 34.0 percent (33 percent and 34 percent adjusted for currency) in the second quarter and first six months of 2010, respectively, versus the same periods in 2009, respectively, reflecting an improvement in the retail industry.

| (Dollars in millions) | | | Yr. to Yr. Percent/ Margin Change |
|--|-------------|-------------|--|
| For the three months ended June 30: | 2010 | 2009 | |
| Systems and Technology: | | | |
| External gross profit | \$ 1,439 | \$ 1,431 | 0.6% |
| External gross profit margin | 36.1% | 37.1% | (1.0)pts. |
| Pre-tax income | \$ 221 | \$ 333 | (33.8)% |
| Pre-tax margin | 5.3% | 8.1% | (2.9)pts. |

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| (Dollars in millions) | | | | | Yr. to Yr. Percent/ Margin Change |
|-----------------------------------|------|-------|------|-------|--|
| For the six months ended June 30: | 2010 | | 2009 | | |
| System and Technology: | | | | | |
| External gross profit | \$ | 2,576 | \$ | 2,528 | 1.9% |
| External gross profit margin | | 34.9% | | 35.7% | (0.7)pts. |
| Pre-tax income | \$ | 51 | \$ | 361 | (85.9)% |
| Pre-tax margin | | 0.7% | | 4.8% | (4.2)pts. |
| Pre-tax income normalized* | \$ | 108 | \$ | 301 | (64.1)% |
| Pre-tax margin normalized | | 1.4% | | 4.0% | (2.6)pts. |

* Excludes \$57 million and \$4 million of workforce rebalancing charges in the first quarter of 2010 and 2009, respectively, and (\$64) million related to the Geodis gain in the first quarter of 2009.

Table of Contents**Management Discussion (continued)**

Gross margin decreased 1.0 point in the second quarter of 2010 versus the prior year. The decline was driven by impacts due to revenue mix (4.1 points), margin declines in Power Systems (0.5 points) and System z (0.4 points), partially offset by margin improvements in Microelectronics (1.9 points) and System x (1.3 points). First half gross margin decreased 0.7 points compared to the first half of 2009. The decline was driven by impacts due to revenue mix (4.4 points), margin declines in Power Systems (0.7 points) and System z (0.4 points), partially offset by margin improvements in Microelectronics (1.9 points) and System x (1.5 points).

Systems and Technology's pre-tax income decreased 33.8 percent in the second quarter, and 64.1 percent for the first six months on a normalized basis when compared to the prior year. Pre-tax margin decreased 2.9 points in the second quarter and 2.6 points on a normalized basis in the first six months, respectively, versus the prior year periods.

Global Financing

See pages 65 to 71 for a discussion of Global Financing's segment results.

Geographic Revenue

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

| (Dollars in millions) | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|-------------------------------------|-------------|-------------|---------------------------------|---|
| For the three months ended June 30: | 2010 | 2009 | | |
| Total Revenue | \$ 23,724 | \$ 23,250 | 2.0% | 1.6% |
| Geographies: | \$ 23,047 | \$ 22,713 | 1.5% | 1.0% |
| Americas | 10,195 | 9,891 | 3.1 | 1.6 |
| Europe/Middle East/Africa | 7,443 | 7,879 | (5.5) | (0.9) |
| Asia Pacific | 5,410 | 4,943 | 9.4 | 3.0 |
| Major markets | | | (1.3)% | (0.7)% |
| Growth markets | | | 13.7% | 8.7% |
| BRIC countries | | | 21.9% | 16.4% |
| | 2010 | 2009 | | Yr. to Yr. Percent |

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(Dollars in millions)

| | | | | Yr. to Yr. Percent Change | Change Adjusted for Currency | |
|--|----|--------|----|---------------------------------|------------------------------------|--------|
| For the six months ended June 30: | | | | | | |
| Total Revenue | \$ | 46,581 | \$ | 44,962 | 3.6% | 0.8% |
| Geographies: | \$ | 45,360 | \$ | 43,963 | 3.2% | 0.3% |
| Americas | | 19,677 | | 19,145 | 2.8 | 0.8 |
| Europe/Middle East/Africa | | 14,996 | | 15,056 | (0.4) | (1.5) |
| Asia Pacific | | 10,688 | | 9,762 | 9.5 | 2.1 |
| Major markets | | | | | 0.3% | (1.4)% |
| Growth markets | | | | | 16.6% | 8.2% |
| BRIC countries | | | | | 22.4% | 15.2% |

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Management Discussion (continued)

Total geographic revenue increased 1.5 percent (1 percent adjusted for currency) in the second quarter of 2010 compared to the second quarter of 2009. The rate of growth improved 2 points from the constant currency performance in the first quarter of 2010. The improving revenue trend was across all geographies with the Americas and Asia Pacific better by 2 points and Europe/Middle East/Africa (EMEA) better by 1 point.

Revenue from the major markets decreased 1.3 percent (1 percent adjusted for currency) year to year in the second quarter, however the rate of growth improved 1 point sequentially compared to the first quarter of 2010 at constant currency. Revenue performance was led by the U.K. with year to year growth of 11 percent in the second quarter, adjusted for currency. Revenue from the growth markets increased 13.7 percent (9 percent adjusted for currency). Adjusted for currency, revenue growth outpaced the major markets by 9 points in the quarter. Revenue growth was led by the BRIC countries, which represent over one third of the growth markets, with growth of 21.9 percent (16 percent adjusted for currency), with double-digit growth in each of the four countries as reported and at constant currency. The strong revenue performance in the quarter extended beyond the BRIC countries with over 35 countries delivering double-digit revenue growth at constant currency, up from 30 countries in the first quarter of 2010.

Americas revenue increased 3.1 percent (2 percent adjusted for currency) in the second quarter of 2010. Within the major market countries, the U.S. increased 0.7 percent, returning to growth for the first time in seven quarters, and Canada increased 7.3 percent (decreased 5 percent adjusted for currency). Revenue in the Latin America growth markets increased 16.6 percent (14 percent adjusted for currency), led by growth in Brazil which increased 23.8 percent (12 percent adjusted for currency).

EMEA revenue decreased 5.5 percent (1 percent adjusted for currency) in the second quarter of 2010 with mixed performance across the major market countries. The U.K. continued to be the strongest contributor with revenue growth of 6.1 percent (11 percent adjusted for currency) in the quarter. Revenue declined in the other major market countries with Germany down 11.9 percent (6 percent adjusted for currency), France 10.0 percent (3 percent adjusted for currency), Italy 18.0 percent (12 percent adjusted for currency), and Spain 6.3 percent (flat adjusted for currency).

Asia Pacific revenue increased 9.4 percent (3 percent adjusted for currency) year over year. Revenue from the Asia Pacific growth market countries increased 13.9 percent (7 percent adjusted for currency), led by growth in China of 19.4 percent (19 percent adjusted for currency) and India of 19.5 percent (12 percent adjusted for currency). Japan revenue increased 4.6 percent (decreased 1 percent adjusted for currency).

OEM revenue of \$677 million in the second quarter of 2010 increased 25.9 percent (26 percent adjusted for currency) led by growth in Microelectronics and System x.

Total geographic revenue for the first six months of 2010 increased 3.2 percent (flat adjusted for currency) versus the same period of 2009. Revenue from the growth markets increased 16.6 percent (8 percent adjusted for currency) and revenue from the major markets increased 0.3 percent (decreased 1 percent adjusted for currency). Total revenue from the growth markets represented approximately 20 percent of the company's total geographic revenue in the first six months of 2010, with revenue growth, adjusted for currency, approximately 10 points higher than the major markets. Within the BRIC countries revenue increased 22.4 percent (15 percent adjusted for currency) in the first six months of

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2010 versus the first six months of 2009 with double-digit growth in each of the four countries.

Americas revenue for the first six months of 2010 increased 2.8 percent (1 percent adjusted for currency) compared to the same period of 2009. Within the major market countries, the U.S. declined 0.3 percent and Canada increased 12.9 percent (decreased 3 percent adjusted for currency). Revenue in the Latin America growth markets increased 19.2 percent (14 percent adjusted for currency), led by Brazil which was up 32.2 percent (15 percent adjusted for currency).

EMEA revenue was down 0.4 percent (1 percent adjusted for currency) in the first six months of 2010 versus the same period in 2009. Within the major market countries, the U.K. was up 11.3 percent (10 percent adjusted for currency) while revenue decreased in Germany 4.5 percent (4 percent adjusted for currency), France 5.5 percent (5 percent adjusted for currency), Italy 10.9 percent (10 percent adjusted for currency), and Spain 0.8 percent (1 percent adjusted for currency). Revenue from the growth markets increased 11.7 percent (7 percent adjusted for currency).

Asia Pacific revenue increased 9.5 percent (2 percent adjusted for currency) in the first six months of 2010 when compared to the first six months of 2009. Revenue in the growth market countries increased 17.1 percent (7 percent adjusted for currency) and Japan increased 2.1 percent (decreased 2 percent adjusted for currency).

Table of Contents**Management Discussion (continued)**

OEM revenue of \$1,220 million in the first six months of 2010 increased 22.2 percent (22 percent adjusted for currency) year to year, driven by growth in Microelectronics and System x.

ExpenseTotal Expense and Other Income**(Dollars in millions)**

| | 2010 | | 2009 | Yr. to Yr. Percent Change |
|--|-------------|----|-------------|--|
| For the three months ended June 30: | | | | |
| Total expense and other (income) | \$ 6,234 | \$ | 6,319 | (1.4)% |
| Expense to revenue ratio | 26.3% | | 27.2% | (0.9)pts. |

(Dollars in millions)

| | 2010 | | 2009 | Yr. to Yr. Percent Change |
|--|-------------|----|-------------|--|
| For the six months ended June 30: | | | | |
| Total expense and other (income) | \$ 12,695 | \$ | 12,628 | 0.5% |
| Expense to revenue ratio | 27.3% | | 28.1% | (0.8)pts. |

The key drivers of the year-to-year change in total expense and other income were approximately:

| For the three and six months ended June 30, 2010: | Three Months | Six Months |
|--|---------------------|-------------------|
| Operational expense | (5) pts. | (5) pts. |
| Currency** | 2 pts. | 4 pts. |
| Acquisitions* | 2 pts. | 2 pts. |

* Includes acquisitions completed in prior 12 month period.

** Reflects impacts of translation and hedging programs.

The company has had an ongoing focus on increasing efficiency and driving productivity across the business this was the 8th consecutive quarter of operational expense improvement. Savings from productivity initiatives result in improved profitability and reinvestments back in the business in key growth areas.

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For additional information regarding total expense and other income, see the following analyses by category.

Selling, general and administrative expense

(Dollars in millions)

| For the three months ended June 30: | 2010 | 2009* | Yr. to Yr. Percent Change |
|--|-----------------|-----------------|--|
| Selling, general and administrative expense: | | | |
| Selling, general and administrative base | \$ 4,409 | \$ 4,434 | (0.6)% |
| Advertising and promotional expense | 329 | 302 | 8.9 |
| Workforce reductions | 17 | 69 | (75.0) |
| Amortization expense acquired intangibles | 56 | 73 | (23.3) |
| Retirement-related expense | 113 | 114 | (0.5) |
| Stock-based compensation | 116 | 99 | 17.3 |
| Bad debt expense | 22 | 24 | (10.2) |
| Total | \$ 5,061 | \$ 5,115 | (1.1)% |

* Reclassified to conform with 2010 presentation.

Table of Contents**Management Discussion (continued)****(Dollars in millions)**

| | 2010 | | 2009* | Yr. to Yr. Percent Change |
|--|-------------|----|--------------|--|
| For the six months ended June 30: | | | | |
| Selling, general and administrative expense: | | | | |
| Selling, general and administrative base | \$ 8,884 | \$ | 8,729 | 1.8% |
| Advertising and promotional expense | 629 | | 590 | 6.6 |
| Workforce reductions | 576 | | 335 | 71.9 |
| Amortization expense acquired intangibles | 115 | | 146 | (21.0) |
| Retirement-related expense | 257 | | 259 | (0.6) |
| Stock-based compensation | 249 | | 199 | 24.7 |
| Bad debt expense | 28 | | 121 | (77.0) |
| Total | \$ 10,737 | \$ | 10,379 | 3.5% |

* Reclassified to conform with 2010 presentation.

Total Selling, general and administrative (SG&A) expense decreased 1.1 percent (2 percent adjusted for currency) in the second quarter of 2010 versus the second quarter of 2009. Overall, the decrease was driven by reductions in operational expense (down 4 points) as the company continues to focus on disciplined expense management, while investing for future growth. As an example, while overall operational SG&A was down 4 points in the quarter, operational SG&A in the growth markets was up 10 percent. Over the past two years, the company's operational SG&A in the growth markets has been 10 or more points higher than the major markets. Currency impacts (1 point) and acquisition-related spending (2 points), partially offset the decline in operational expense in the second quarter.

Total SG&A expense increased 3.5 percent (essentially flat adjusted for currency) in the first six months of 2010 versus the first six months of 2009. Overall, the increase was driven by currency impacts (4 points) and acquisition-related spending (2 points), partially offsetting the decline in operational expense (2 points). Workforce reductions expense increased \$241 million due primarily to actions taken by the company in the first quarter of 2010, with the majority of the spending in Europe and Asia Pacific. The company expects most of the benefit from these actions in the second half of 2010, with payback by the end of the year. Bad debt expense decreased \$93 million reflecting the improving credit environment. The accounts receivable provision coverage is 2.2 percent, a decrease of 20 basis points from the prior year and an increase of 20 basis points from year-end 2009.

Other (income) and expense**(Dollars in millions)**

| | 2010 | | 2009 | Yr. to Yr. Percent Change |
|---|-------------|----|-------------|--|
| For the three months ended June 30: | | | | |
| Other (income) and expense: | | | | |
| Foreign currency transaction (gains)/losses | \$ (158) | \$ | (82) | 92.1% |
| (Gains)/losses on derivative instruments | 139 | | (12) | nm |
| Interest income | (23) | | (19) | 20.6 |
| Net losses/(gains) from securities and investment assets | 2 | | 21 | (91.8) |
| Net realized (gains)/losses from certain real estate activities | (1) | | (3) | (56.7) |
| Other | (53) | | 68 | nm |

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| | | | | | |
|-------|----|------|----|------|--------|
| Total | \$ | (95) | \$ | (28) | 241.1% |
|-------|----|------|----|------|--------|

nm not meaningful

Table of Contents**Management Discussion (continued)**

| (Dollars in millions) | | | | | Yr. to Yr. Percent Change |
|---|-------------|-------|-------------|-------|--|
| For the six months ended June 30: | 2010 | | 2009 | | |
| Other (income) and expense: | | | | | |
| Foreign currency transaction (gains)/losses | \$ | (279) | \$ | (110) | nm% |
| Losses/(gains) on derivative instruments | | 326 | | 37 | nm |
| Interest income | | (42) | | (45) | (5.2) |
| Net losses/(gains) from securities and investment assets | | 17 | | 41 | (57.6) |
| Net realized (gains)/losses from certain real estate activities | | (1) | | (3) | (56.4) |
| Other | | (661) | | (252) | nm |
| Total | \$ | (640) | \$ | (331) | 93.2% |

nm not meaningful

Other (income) and expense was income of \$95 million and \$28 million in the second quarter of 2010 and 2009, respectively. The increase in income in the second quarter of 2010 was primarily driven by a provision for losses related to a joint venture investment (\$119 million) recorded in the second quarter 2009 and higher foreign currency transaction gains (\$76 million). These increases were partially offset by increased losses on derivative instruments (\$151 million). Included within the foreign currency hedging activity, the company hedges its major anticipated cross-border cash flows to mitigate the effect of currency volatility in its global cash planning (the hedge of anticipated royalties and cost transactions programs as discussed in Note 7, Derivatives and Hedging Transactions, on pages 16 to 24), which also reduces volatility in the year-over-year results. The total impact of these specific hedging programs was a \$136 million year-to-year impact and is reflected in expense and cost of goods sold. The expense impacts from these hedge programs reflected in other (income) and expense was income of \$29 million in the second quarter of 2010 versus income of \$102 million in the second quarter of 2009, an increase in expense of \$73 million year to year.

Other (income) and expense was income of \$640 million and \$331 million for the first six months of 2010 and 2009, respectively. The increase in income for the first six months of 2010 was primarily driven by the net gain from the PLM transaction in the first quarter of 2010 (\$591 million) reflected in Other in the table above, versus a gain from the divestiture of the core logistics operations to Geodis in the first quarter of 2009 (\$298 million), a provision for losses related to a joint venture investment (\$119 million) recorded in the second quarter 2009 and higher foreign currency transaction gains (\$169 million) versus the prior year. These items were partially offset by higher losses on derivative instruments (\$289 million) as discussed above.

Research, Development and Engineering

| (Dollars in millions) | | | | | Yr. to Yr. Percent Change |
|--|-------------|-------|-------------|-------|--|
| For the three months ended June 30: | 2010 | | 2009 | | |
| Research, development and engineering | \$ | 1,475 | \$ | 1,434 | 2.9% |

| (Dollars in millions) | | | | | Yr. to Yr. Percent Change |
|--|-------------|--|-------------|--|--|
| For the six months ended June 30: | 2010 | | 2009 | | |
| | | | | | |

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| | | | | | |
|---------------------------------------|----|-------|----|-------|------|
| Research, development and engineering | \$ | 2,984 | \$ | 2,914 | 2.4% |
|---------------------------------------|----|-------|----|-------|------|

The company continues to invest in research and development, focusing its investments on high value, high growth opportunities and to extend its technology leadership. Total Research, development and engineering (RD&E) expense increased 2.9 percent in the second quarter of 2010 versus the second quarter of 2009 primarily driven by: currency impacts (up 1 point), acquisitions (up 1 point) and operational expense (up 1 point). RD&E expense increased 2.4 percent for the first six months of 2010 versus the same period of 2009 primarily driven by: currency impacts (up 2 points) and acquisitions (up 1 point), partially offset by operational expense (down 1 point).

Table of Contents**Management Discussion (continued)**Intellectual Property and Custom Development Income**(Dollars in millions)**

| | 2010 | | 2009 | | Yr. to Yr. Percent Change |
|--|------|-----|------|-----|---------------------------------|
| For the three months ended June 30: | | | | | |
| Intellectual Property and Custom Development Income: | | | | | |
| Sales and other transfers of intellectual property | \$ | 46 | \$ | 83 | (45.0)% |
| Licensing/royalty-based fees | | 95 | | 73 | 29.8 |
| Custom development income | | 157 | | 147 | 6.9 |
| Total | \$ | 297 | \$ | 302 | (1.8)% |

(Dollars in millions)

| | 2010 | | 2009 | | Yr. to Yr. Percent Change |
|--|------|-----|------|-----|---------------------------------|
| For the six months ended June 30: | | | | | |
| Intellectual Property and Custom Development Income: | | | | | |
| Sales and other transfers of intellectual property | \$ | 87 | \$ | 128 | (32.3)% |
| Licensing/royalty-based fees | | 173 | | 172 | 1.0 |
| Custom development income | | 298 | | 270 | 10.4 |
| Total | \$ | 558 | \$ | 570 | (2.1)% |

The timing and amount of Sales and other transfers of IP may vary significantly from period to period depending upon the timing of divestitures, economic conditions, industry consolidation and the timing of new patents and know-how development. There were no significant IP transactions in the second quarter or first six months of 2010 and 2009.

Interest Expense**(Dollars in millions)**

| | 2010 | | 2009 | | Yr. to Yr. Percent Change |
|--|------|----|------|-----|---------------------------------|
| For the three months ended June 30: | | | | | |
| Interest expense | \$ | 90 | \$ | 101 | (11.1)% |

(Dollars in millions)

| | 2010 | | 2009 | | Yr. to Yr. Percent Change |
|--|------|-----|------|-----|---------------------------------|
| For the six months ended June 30: | | | | | |
| Interest expense | \$ | 172 | \$ | 237 | (27.5)% |

The decrease in interest expense for the second quarter and first six months of 2010 versus the same periods of 2009 was primarily driven by lower average debt. Interest expense is presented in cost of financing in the Consolidated Statement of Earnings only if the related external borrowings are to support the Global Financing external business. See page 70 for additional information regarding Global Financing debt and interest expense. Overall interest expense for the second quarter and first six months of 2010 was \$230 million and \$461 million, respectively, a decrease of \$52 million and \$156 million, respectively, year to year.

Retirement-Related Plans

The following tables provide the total pre-tax cost for all retirement-related plans. These amounts are included in the Consolidated Statement of Earnings within the caption (e.g., Cost, SG&A, RD&E) relating to the job function of the plan participants.

(Dollars in millions)

| For the three months ended June 30: | 2010 | | 2009* | | Yr. to Yr. Percent Change |
|--|-------------|-----|--------------|-----|--|
| Retirement-related plans cost: | | | | | |
| Defined benefit and contribution pension plans | \$ | 234 | \$ | 229 | 2.0% |
| Nonpension postretirement plans | | 86 | | 88 | (2.3) |
| Total | \$ | 319 | \$ | 317 | 0.9% |

* Reclassified to conform with 2010 presentation.

Table of Contents**Management Discussion (continued)****(Dollars in millions)**

| | 2010 | | 2009* | Yr. to Yr. Percent Change |
|--|-------------|----|--------------|--|
| For the six months ended June 30: | | | | |
| Retirement-related plans cost: | | | | |
| Defined benefit and contribution pension plans | \$ 555 | \$ | \$ 580 | (4.4)% |
| Nonpension postretirement plans | 173 | | 173 | (0.1) |
| Total | \$ 728 | \$ | 753 | (3.4)% |

* Reclassified to conform with 2010 presentation.

In the second quarter, total retirement-related plan cost increased by \$3 million compared to the second quarter of 2009, driven by an increase in the cost of defined benefit plans of \$5 million. Total cost for the first six months of 2010 decreased \$25 million versus the first half of 2009 driven by a decrease in the cost of defined contribution plans of \$30 million.

As discussed in the Looking Forward section on pages 61 to 63, the company has begun to characterize certain retirement-related costs as operating and others as non-operating. Utilizing this characterization, operating retirement-related costs in the second quarter were \$432 million, a reduction of \$30 million compared to the second quarter of 2009, driven by a \$24 million reduction in total service cost. Non-operating costs of (\$113 million) increased \$32 million in the second quarter compared to the prior year driven primarily by an increase in recognized actuarial losses. For the first six months of 2010, operating retirement-related costs were \$916 million, a decrease of \$77 million compared to the first six months of 2009. This decrease was driven by a \$37 million reduction in total service cost and a \$30 million reduction in the cost of defined contribution plans. Non-operating costs of (\$189 million) increased \$51 million in the first half compared to the prior year driven primarily by an increase in recognized actuarial losses of \$77 million.

See Note 11, Retirement-Related Benefits on pages 28 to 30 for additional plan cost detail.

Business Acquisition Acquired Intangible Asset Amortization

The company has been investing in targeted acquisitions to increase its capabilities in high value businesses. The following tables present the total acquired intangible asset amortization included in the Consolidated Statement of Earnings. See Note 12, Intangible Assets Including Goodwill, on pages 32 and 33 for additional information.

(Dollars in millions)

| | 2010 | | 2009 | Yr. to Yr. Percent Change |
|--|-------------|----|-------------|--|
| For the three months ended June 30: | | | | |
| Cost: | | | | |
| Software (Sales) | \$ 54 | \$ | 38 | 41.0% |
| Global Technology Services (Services) | 2 | | 8 | (81.2) |

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| | | | | | |
|-------------------------------------|----|-----|----|-----|--------|
| Systems and Technology (Sales) | | 3 | | 3 | (1.0) |
| Selling, general and administrative | | 56 | | 73 | (23.3) |
| Total | \$ | 114 | \$ | 122 | (6.4)% |

(Dollars in millions)

| For the six months ended June 30: | | 2010 | | 2009 | Yr. to Yr. Percent Change |
|---------------------------------------|----|------|----|------|---------------------------------|
| Cost: | | | | | |
| Software (Sales) | \$ | 105 | \$ | 79 | 32.5% |
| Global Technology Services (Services) | | 3 | | 17 | (81.7) |
| Systems and Technology (Sales) | | 5 | | 5 | (2.9) |
| Selling, general and administrative | | 115 | | 146 | (21.0) |
| Total | \$ | 229 | \$ | 247 | (7.5)% |

Taxes

The effective tax rate for the second quarter of 2010 was 26.0 percent versus an effective tax rate of 27.2 percent for the second quarter of 2009. The effective tax rates for the first six months of 2010 and 2009 were 26.0 percent and 26.9 percent, respectively. The decrease in the rate for the second quarter and for the six months ended June 30, 2010, compared to the prior year periods, was primarily due to the charge recorded in the prior year related to a joint venture and an increase in foreign tax credit benefits.

Table of Contents**Management Discussion (continued)**

With limited exception, the company is no longer subject to U.S. federal, state and local or non-U.S. income tax audits by taxing authorities for years through 2003. The years subsequent to 2003 contain matters that could be subject to differing interpretations of applicable tax laws and regulations as it relates to the amount and/or timing of income, deductions and tax credits. Although the outcome of tax audits is always uncertain, the company believes that adequate amounts of tax and interest have been provided for any adjustments that are expected to result for these years.

The amount of unrecognized tax benefits at December 31, 2009 increased by \$1,002 million for the first six months of 2010 to \$5,792 million.

The amount of unrecognized tax benefits increased by \$1,412 million during the second quarter of 2010. During the first quarter, the amount of unrecognized tax benefits had decreased by \$410 million, primarily driven by a payment of \$370 million on an assessment received related to a foreign audit. Additionally, the company had certain foreign tax loss carryforwards that had not been reflected in the Consolidated Statement of Financial Position. In April 2010, the company decided to seek benefit for these losses and appeal the assessment mentioned above. The second quarter increase of \$1,412 million in unrecognized tax benefits includes \$1,320 million related to this item. The total amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate is \$5,210 million at June 30, 2010.

The Internal Revenue Service (IRS) commenced its audit of the company's U.S. tax returns for 2006 and 2007 in the first quarter of 2009. The company anticipates that the final settlement of the 2006-2007 IRS audit will be completed by the end of 2010. In the fourth quarter of 2008, the company was unable to reach agreement with the IRS related to valuation matters associated with the intercompany transfer of certain intellectual property in 2005. See the company's 2009 Annual Report on page 103 for additional information. The company believes it may be able to reach a resolution with the IRS by the end of 2010 on this matter.

Earnings Per Share

Basic earnings per share is computed on the basis of the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted-average number of shares of common stock outstanding plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and stock awards.

| For the three months ended June 30: | 2010 | 2009 | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| Earnings per share: | | | |
| Assuming dilution | \$ 2.61 | \$ 2.32 | 12.5% |
| Basic | \$ 2.65 | \$ 2.34 | 13.2% |
| Weighted-average shares outstanding: (in millions) | | | |
| Assuming dilution | 1,296.7 | 1,336.9 | (3.0)% |
| Basic | 1,278.6 | 1,326.1 | (3.6)% |
| | | | Yr. to Yr. Percent |

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| For the six months ended June 30: | 2010 | | 2009 | | Change |
|--|------|---------|------|---------|--------|
| Earnings per share: | | | | | |
| Assuming dilution | \$ | 4.57 | \$ | 4.02 | 13.7% |
| Basic | \$ | 4.64 | \$ | 4.04 | 14.9% |
| Weighted-average shares outstanding: (in millions) | | | | | |
| Assuming dilution | | 1,309.2 | | 1,343.2 | (2.5)% |
| Basic | | 1,289.9 | | 1,335.2 | (3.4)% |

Actual shares outstanding at June 30, 2010 were 1,261.3 million. The weighted-average number of common shares outstanding assuming dilution during the second quarter and first six months of 2010 was 40.3 million and 34.1 million lower, respectively, than the same periods in 2009 primarily as a result of the company's common share repurchase program.

Table of Contents**Management Discussion (continued)**Financial PositionDynamics

At June 30, 2010, the company's balance sheet and liquidity positions remain strong. Cash on hand at quarter end was \$10,325 million. Total debt of \$26,650 million increased \$551 million from prior year-end levels. The commercial paper balance at June 30, 2010 was \$2,250 million, up from \$235 million at year end. The company continues to have substantial flexibility in the market. In the first six months, the company generated \$8,203 million in cash from operations, a decrease of \$924 million compared to the first six months of 2009 (see cash flow analysis on page 59). The company has consistently generated strong cash flow from operations and continues to have access to additional sources of liquidity through the capital markets and its \$10 billion global credit facility. The company's strong cash flow and substantial cash position permits the company to invest and deploy capital to areas with the most attractive long-term opportunities.

The assets and debt associated with the Global Financing business are a significant part of the company's financial position. The financial position amounts appearing on pages 4 and 5 are the consolidated amounts including Global Financing. The amounts appearing in the separate Global Financing section, beginning on page 65, are supplementary data presented to facilitate an understanding of the Global Financing business.

Working Capital

| (Dollars in millions) | At June 30, 2010 | At December 31, 2009 |
|-----------------------|---------------------|-------------------------|
| Current assets | \$ 44,895 | \$ 48,935 |
| Current liabilities | 34,993 | 36,002 |
| Working capital | \$ 9,902 | \$ 12,933 |
| Current ratio | 1.28:1 | 1.36:1 |

Working capital decreased \$3,031 million from the year-end 2009 position. The key changes are described below:

Current assets decreased \$4,040 million (\$2,353 million adjusted for currency), due to:

- A decline of \$3,300 million in short-term receivables driven by:

- a decrease of \$2,138 million primarily due to collections of higher year-end balances, and
- approximately \$1,163 million of currency impact.
- A decline of \$1,858 million in cash and cash equivalents (see cash flow analysis on page 59); partially offset by
- An increase of \$1,178 million in prepaid expenses and other current assets driven by derivative assets and corresponding collateral as a result of changes in foreign currency rates primarily for instruments in cash flow hedging relationships.

Current liabilities decreased \$1,009 million, including a \$934 million benefit from currency, as a result of:

- A decrease of \$931 million in taxes payable primarily due to foreign tax payments,
- A decrease of \$683 million in other accrued expenses and liabilities mainly due to a decrease of \$436 million in derivative liabilities as a result of changes in foreign currency rates primarily for instruments in cash flow hedging relationships, and
- A decrease of \$483 million in compensation and benefits reflecting declines from typically higher year-end balances, a decrease in deferred income of \$173 million and a decrease in accounts payable of \$203 million; partially offset by

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Management Discussion (continued)

- An increase in short-term debt of \$1,465 million primarily driven by:
- a net increase of \$2,015 million in commercial paper and \$2,280 million in new debt issuances; and
- reclasses of \$1,054 million from long-term to short-term debt to reflect maturity dates; partially offset by
- \$3,828 million in debt repayments.

Cash Flow

The company's cash flow from operating, investing and financing activities, as reflected in the Consolidated Statement of Cash Flows on page 6, is summarized in the table below. These amounts include the cash flows associated with the Global Financing business.

(Dollars in millions)

For the six months ended June 30:

| | 2010 | 2009 |
|--|-------------|-------------|
| Net cash provided by/(used in) operations: | | |
| Operating activities | \$ 8,203 | \$ 9,127 |
| Investing activities | (2,645) | (1,897) |
| Financing activities | (7,114) | (8,326) |
| Effect of exchange rate changes on cash and cash equivalents | (301) | 33 |
| Net change in cash and cash equivalents | \$ (1,858) | \$ (1,063) |

Net cash from operating activities decreased \$924 million as compared to the first six months of 2009 driven by the following key factors:

- A decrease in cash provided by Global Financing receivables of \$1,131 million as a result of improved volumes in 2010;
- Higher net income tax payments of approximately \$700 million driven by foreign tax payments; and

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- A decrease in cash of approximately \$630 million as a result of lower tax refunds in 2010 versus the previous year; partially offset by
- Improved net income of \$588 million;
- A decrease in cash used by accounts payable of \$527 million; and
- Increased cash provided by advanced billings of \$357 million.

Net cash used in investing activities increased \$748 million driven by:

- An increase of \$909 million in cash used for acquisitions;
- Increased net capital spending of \$282 million primarily for new hardware products and semiconductor technology ;
- A decrease in cash from divestitures of \$356 million as a result of the Geodis transaction in 2009; and,
- A decrease in cash provided by Global Financing non-operating receivables of \$204 million as a result of improved volumes in 2010; partially offset by
- A net benefit of \$972 million from purchases and sales of marketable securities and other investments, primarily due to proceeds from short-term marketable securities of \$559 million and proceeds from the PLM transaction in the first quarter of 2010 of \$460 million.

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Management Discussion (continued)

Net cash used in financing activities decreased \$1,212 million as a result of:

- Net benefit of \$4,736 million from debt that resulted from net cash proceeds from debt in the current year of \$731 million in comparison to net cash payments to settle debt of \$4,006 million in 2009; and
- An increase of \$1,305 million in cash generated from other common stock transactions primarily due to higher stock option exercises; partially offset by
- Higher common stock repurchases of \$4,685 million.

Noncurrent Assets and Liabilities

| (Dollars in millions) | At June 30, 2010 | At December 31, 2009 |
|---|-----------------------------|---------------------------------|
| Noncurrent assets | \$ 58,525 | \$ 60,087 |
| Long-term debt | 21,017 | 21,932 |
| Noncurrent liabilities (excluding debt) | 26,234 | 28,334 |

The decrease in noncurrent assets of \$1,562 million (an increase of \$219 million adjusted for currency) was driven by:

- A decrease of \$1,458 million in long-term financing receivables (\$1,136 million adjusted for currency) driven by maturities exceeding originations;
- A decrease of \$1,072 million in noncurrent deferred taxes (\$1,055 million adjusted for currency) primarily driven by derivative related activity; and
- A decrease of \$631 million in plant, rental machines and other property (\$241 million adjusted for currency); partially offset by

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- An increase of \$659 million in investments and sundry assets primarily driven by increased derivative assets.
- An increase of \$573 million in prepaid pension assets; and
- An increase of \$354 million (\$845 million adjusted for currency) in goodwill as a result of the current year acquisitions.

Long-term debt decreased \$915 million primarily due to reclasses to short-term debt as certain instruments approach maturity.

Other noncurrent liabilities, excluding debt, decreased \$2,100 million (\$1,432 million due to currency) primarily driven by:

- A decrease in retirement and nonpension benefit obligations of \$1,355 million (\$584 million adjusted for currency) primarily driven by contributions to non-U.S. plans; and
- A decrease of \$524 million in other noncurrent liabilities mainly due to a decrease in derivative liabilities as a result of changes in foreign currency rates primarily for instruments in cash flow hedging relationships.

Table of Contents**Management Discussion (continued)**Debt

The company's funding requirements are continually monitored and strategies are executed to manage the overall asset and liability profile. Additionally, the company maintains sufficient flexibility to access global funding sources as needed.

| (Dollars in millions) | At June 30, 2010 | At December 31, 2009 |
|-------------------------------------|-----------------------------|---------------------------------|
| Total company debt | \$ 26,650 | \$ 26,099 |
| Total Global Financing segment debt | \$ 21,189 | \$ 22,383 |
| Debt to support external clients | 18,057 | 19,091 |
| Debt to support internal clients | 3,132 | 3,292 |

Global Financing provides financing predominantly for the company's external client assets as well as for assets under contract by other IBM units. These assets, primarily for Global Services, generate long-term, stable revenue streams similar to the Global Financing asset portfolio. Based on their attributes, these Global Services assets are leveraged with the balance of the Global Financing asset base. The debt analysis above is further detailed in the Global Financing section on page 70.

Given the significant leverage, the company presents a debt-to-capitalization ratio which excludes Global Financing debt and equity as management believes this is more representative of the company's core business operations. This ratio can vary from period to period as the company manages its global cash and debt positions.

Core debt-to-capitalization ratio (excluding Global Financing debt and equity) was 23.1 percent at June 30, 2010 compared to 16.0 percent at December 31, 2009. The increase was primarily driven by an increase in non-Global Financing debt of \$1,744 million and a decrease in non-Global Financing equity of \$1,397 million from December 31, 2009 balances.

Consolidated debt-to-capitalization ratio at June 30, 2010 was 55.7 percent versus 53.4 percent at December 31, 2009.

Equity

Total equity decreased \$1,579 million primarily as a result of an increase in treasury stock of \$8,033 million, driven by common stock repurchases in the first six months of 2010, and a reduction in foreign currency translation adjustments of \$1,081 million, partially offset by an increase in retained earnings of \$4,423 million, an increase of \$1,712 million in common stock, increased gains on cash flow hedge derivatives of \$1,015 million and a lower pension adjustment of \$392 million.

Looking Forward

The company entered 2010 in excellent operational and financial position. Going-forward, the company will continue to transform the business by executing its strategy to shift to higher-value areas, improving operating leverage through productivity and investing where management sees the best long-term opportunities. This transformation delivered solid performance in the first half of 2010 and continues to position the company for growth going forward.

In January 2010, the company disclosed that it expected earnings of at least \$11.00 per diluted share for the full year 2010, with consistent earnings per share growth throughout the year. In April 2010, the company increased its expectation for 2010 to at least \$11.20 in earnings per diluted share for the full year.

In May 2010, the company met with investors and analysts and provided an update on its 2010 earnings per share road map; discussed changes that it is making to the way the company will report on its performance; and, introduced a new road map for earnings per share in 2015. With respect to the 2010 earnings per share road map objective of \$10 to \$11 per share, the company remains well ahead of pace - achieving the low end of its objective one year ahead of schedule with diluted earnings per share of \$10.01 in 2009. For 2010, the company reiterated its expectation of at least \$11.20 in earnings per diluted share for 2010.

Looking forward to the second half of 2010, the company will have several new product introductions in the Systems and Technology business; investments in growth initiatives will continue to be leveraged; acquisitions announced in the second quarter will close and integration efforts will begin; the company will yield the benefits of the first-quarter workforce rebalancing actions; and the company will continue to drive efficiencies and increase productivity. In July 2010, the company increased its expectation for 2010 to at least \$11.25 in earnings per diluted share for the full year.

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Management Discussion (continued)

Within the Global Services business, in the second quarter the revenue growth rate improved sequentially with a return to revenue growth at constant currency for total Global Services. GBS revenue increased 3 percent, adjusted for currency, with 8 points of improvement in the growth rate. The business improved AMS signings and delivered good new business signings within outsourcing. The backlog at \$129 billion, increased \$1 billion, adjusted for currency, compared to the prior year. In addition, the business has a good pipeline of services deals going into the third quarter. In the second half of 2010, the company expects the total Global Services revenue growth rate to improve, driven by GBS with its higher transactional content. With improved revenue growth rates in the second half and the benefits of the workforce rebalancing actions in the first quarter, the company also expects to achieve margin expansion in the second half of 2010.

The breadth and diversity of the company's software portfolio, combined with strategic investments in high growth areas, have enabled the company to achieve consistently strong results in the Software segment. Clients continue to rely on the extensive middleware portfolio to help them transform their business, streamline costs and seek new business opportunities. The company will continue to focus on expanding its software capabilities through a combination of internal development and strategic acquisitions. In the third quarter, the company expects the Software business to deliver similar levels of revenue performance as the second quarter.

The Systems and Technology business will continue to invest for continued technology leadership in areas that contribute to high value growth opportunities. It will focus on technologies that differentiate its offerings, including industry-leading microprocessor technology, workload optimized systems and infrastructure-wide virtualization capabilities with tools that help clients consolidate resources, manage workloads, automate processes, improve energy efficiency and optimize delivery of IT services. In the third quarter, the company will announce the Power7 entry and high-end systems with availability in September. In addition, in July, the company announced the next generation System z mainframe which provides 40 percent more performance on a mix of workloads than the equivalent z10 mainframe. In the second quarter, the Systems and Technology business continued to improve its revenue growth rate. With the introduction of the new high-end systems in the third quarter, the company expects the segment's revenue growth rate to improve (adjusted for currency) in the third and fourth quarters and the segment's pre-tax income to increase at a double-digit rate for the second half of the year.

In 2010, Global Financing will continue to focus on expanding its core business by accelerating growth in the participation rates for IBM products and services transactions. In addition, the business will drive increased operational efficiency and sales productivity through the deployment of its single operating model initiative. This global initiative is focused on simplifying processes, standardizing operations and optimizing business performance.

The company expects 2010 pre-tax retirement-related plan cost to be approximately \$1.5 billion, an increase of approximately \$100 million compared to 2009. This estimate reflects current pension plan assumptions and the impacts of recent non-U.S. pension plan redesign efforts. See the company's 2009 Annual Report, note U, Retirement-Related Benefits, on pages 109 through 121 for additional information.

The company expects in the normal course of business that its effective tax rate in 2010 will be approximately 26.0 - 26.5 percent. The rate will change period to period based on non-recurring events, such as the settlement of income tax audits and changes in tax laws, as well as recurring factors including the geographic mix of income before taxes, the timing and amount of foreign dividend repatriation, state and local taxes and the effects of various global income tax strategies.

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In an effort to provide better transparency into the operational results of the business, beginning in 2011, the company will separate business results into operating and non-operating categories. Operating earnings is a non-GAAP measure that excludes the effects of acquisition-related charges and certain retirement-related costs and one time charges. For acquisitions, operating earnings will 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 plan changes resulting from acquisitions. In the technology sector, it is common practice to provide earnings information on a non-GAAP basis that excludes acquisition-related items. Within retirement-related, given the significant impact that the debt and equity markets can have on the company's retirement-related costs and the fact that these market forces are not under direct management control and are non-operational, the company has characterized certain items as operating and others as non-operating. The company will include 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 will include 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/pension

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Management Discussion (continued)

insolvency/other costs. These costs are primarily those related to changes in pension plan assets and liabilities which are tied to market performance and the company considers these costs to be outside the operational performance of the business.

Overall, the company believes that providing investors with a view of operating earnings beginning in 2011 will provide better transparency into both the operational results of the business and the performance of the company's pension plans; improve visibility to management decisions and their impacts on operational performance; enable better comparison to peer companies; and, allow the company to provide a long term strategic view of the business going forward. There will be no changes to balance sheet or cash flow presentation. The company will provide this view of its performance in addition to its GAAP reporting.

For the 2015 road map, the company will utilize operating earnings to establish its objectives and track its progress. The company's 2015 road map continues to focus on the key financial drivers of long term earnings per share growth. The company will continue to leverage its base business model for revenue growth by entering new markets and launching new offerings and products, both organically developed and acquired. The company will remain focused on margin expansion through productivity and portfolio management. The company will deploy cash to fund growth initiatives and provide returns to shareholders through dividends and common stock repurchases. This road map results in an operating earnings per share objective of at least \$20 per share for 2015.

Currency Rate Fluctuations

Changes in the relative values of non-U.S. currencies to the U.S. dollar affect the company's results. At June 30, 2010, currency changes resulted in assets and liabilities denominated in local currencies being translated into fewer dollars than at year-end 2009. The company uses financial hedging instruments to limit specific currency risks related to financing transactions and other foreign currency-based transactions. Further discussion of currency and hedging appears in the 2009 IBM Annual Report in Note L, Derivatives and Hedging Transactions, on pages 92 through 96.

In the first six months of 2010, the company's revenue increased 3.6 percent as reported and 0.8 percent adjusted for currency. In the second quarter, revenue increased 2.0 percent as reported and 1.6 percent adjusted for currency. These currency differences were driven from the company's operations in currencies other than the U.S. dollar. The company maintains currency hedging programs for cash planning purposes which mitigate, but do not eliminate, the volatility of currency impacts on the company's financial results. In addition to the translation of earnings, the impact of currency changes also may affect the company's pricing and sourcing actions. For example, the company may procure components and supplies in multiple functional currencies and sell products and services in other currencies. The company believes that some of these currency-based changes in cost impacts the price charged to clients. However, the company estimates that the maximum effect of currency, before taking pricing or sourcing actions into account, and net of hedging activity, decreased total diluted earnings per share growth by \$0.10 to \$0.11 in the second quarter of 2010.

For non-U.S. subsidiaries and branches that operate in U.S. dollars or whose economic environment is highly inflationary, translation adjustments are reflected in results of operations. Generally, the company manages currency risk in these entities by linking prices and contracts to U.S. dollars. The company continues to monitor the economic conditions in Venezuela. In Venezuela, there are official currency rates that are

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fixed by the government and a parallel market of currency exchange that enables companies to obtain foreign currency, including U.S. dollars. The parallel rate is variable and may differ significantly from the official rates. Accounting guidance requires that the translation of a non-U.S. entity's financial statements into the company's consolidated financial statements be at the rate applicable to dividend remittances. Due to the significant reduction of currency approvals by the Venezuela government, in December 2009, the company determined that the rate for translation should be changed to the parallel rate at December 31, 2009.

In addition, due to the fact that the blended CPI/NCPI three year cumulative inflation rate in Venezuela reached 100 percent, the country is considered highly inflationary, consistent with accounting standards, effective January 1, 2010. The company's operations in Venezuela are not significant (less than 1 percent of total 2008 and 2009 revenue).

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Management Discussion (continued)

On January 8, 2010, a devaluation of the Venezuelan currency was announced. The currency market in Venezuela will continue to be fully controlled by the government through the Central Bank. A two-tiered official rate structure was implemented and will be managed by the Central Bank. In the first quarter of 2010, the ability to obtain U.S. dollars remained severely restricted, even at the new devalued rates. The parallel market remained the primary method to obtain U.S. dollars. Therefore, in the first quarter, the company continued to remeasure utilizing the parallel rate.

On May 17, 2010, the parallel market was suspended by the Venezuela government. The new parallel fluctuating market (SITME) opened on June 9, 2010, controlled by the Central Bank, and with a set daily trading rate band that was significantly lower than the previous parallel market rate. Tight volume restrictions have been established for the new banded market, which has been thinly traded since being opened. The SITME market is the current viable option for obtaining currency exchange as the official rates have not been accessible. Therefore, in the second quarter, the company utilized the banded rate for remeasurement purposes. This resulted in the recording of an immaterial gain in the quarter.

Future gains or losses from changes in the banded rate are not expected to have a material impact given the size of the company's operations in Venezuela.

Liquidity and Capital Resources

In the company's 2009 Annual Report, on pages 49 through 51, there is a discussion of the company's liquidity including two tables that present five years of data. The table presented on page 49 includes net cash from operating activities, cash and marketable securities and the size of the company's global credit facilities for each of the past five years. For the six months ended, or as of, as applicable, June 30, 2010, those amounts are \$8.2 billion for net cash from operating activities, \$12.2 billion of cash and marketable securities and \$10 billion in global credit facilities, respectively.

The major rating agencies' ratings on the company's debt securities at June 30, 2010 appear in the table below and remain unchanged from December 31, 2009. The company's debt securities do not contain any acceleration clauses which could change the scheduled maturities of the obligation. In addition, the company does not have ratings trigger provisions in its debt covenants or documentation, which would allow the holders to declare an event of default and seek to accelerate payments thereunder in the event of a change in credit rating. The company's contractual agreements governing derivative instruments contain standard market clauses which can trigger the termination of the agreement if the company's credit rating were to fall below investment grade. At June 30, 2010, the fair value of those instruments that were in a liability position was \$688 million, before any applicable netting, and this position is subject to fluctuations in fair value period to period based on the level of the company's outstanding instruments and market conditions. The company has no other contractual arrangements that, in the event of a change in credit rating, would result in a material adverse effect on its financial position or liquidity.

| | STANDARD AND POOR'S | MOODY'S INVESTORS SERVICE | FITCH RATINGS |
|-----------------------|------------------------------------|--|--------------------------|
| Senior long-term debt | A+ | A1 | A+ |

The table appearing on page 50 of the 2009 Annual Report presents the format in which management reviews cash flows for each of the past five years and is accompanied by a description of the way cash flow is managed, measured and reviewed. The company prepares its Consolidated Statement of Cash Flows in accordance with applicable accounting standards for cash flow presentation on page 6 of this Form 10-Q and highlights causes and events underlying sources and uses of cash in that format on pages 59 and 60. The following is management's view of cash flows for the first half of 2010 and 2009 prepared in a manner consistent with the table and description on pages 49 and 50 of the 2009 Annual Report:

Table of Contents**Management Discussion (continued)****(Dollars in millions)****For the six months ended June 30:**

| | 2010 | 2009 |
|---|-------------|-------------|
| Net cash from operating activities per GAAP: | \$ 8,203 | \$ 9,127 |
| Less: Global Financing receivables | 1,883 | 3,014 |
| Net cash from operating activities, excluding Global Financing receivables | 6,320 | 6,113 |
| Capital expenditures, net | (1,873) | (1,624) |
| Free cash flow (excluding Global Financing receivables) | 4,446 | 4,490 |
| Acquisitions | (1,009) | (100) |
| Divestitures | | 356 |
| Share repurchase | (8,121) | (3,436) |
| Dividends | (1,551) | (1,407) |
| Non-Global Financing debt | 1,261 | (2,181) |
| Other (includes Global Financing receivables and Global Financing debt) | 3,241 | 1,898 |
| Change in cash, cash equivalents and short-term marketable securities | \$ (1,732) | \$ (381) |

Free cash flow for the first six months of 2010 decreased \$43 million versus the first six months of 2009. The decline year to year was primarily driven by higher capital investments and a year-to-year impact for tax refunds (approximately \$630 million), partially offset by higher net income and sales cycle working capital improvements. Also, in the first six months of 2010, \$9,672 million was returned to shareholders through share repurchases and dividends.

Events that could temporarily change the historical cash flow dynamics discussed above and in the 2009 Annual Report include significant changes in operating results, material changes in geographic sources of cash, unexpected adverse impacts from litigation or future pension funding during periods of severe downturn in the capital markets. Whether any litigation has such an adverse impact will depend on a number of variables, which are more completely described in Note 15, Contingencies, on pages 33 to 35 of this Form 10-Q. The company expects to make legally mandated pension plan contributions to certain non-U.S. plans of approximately \$900 million in 2010. The company is not quantifying any further impact from pension funding because it is not possible to predict future movements in the capital markets or pension plan funding regulations.

Global Financing

Global Financing is a reportable segment that is measured as if it were a standalone entity. Accordingly, the information presented in this section is consistent with this separate company view. The mission of Global Financing is to facilitate clients' acquisition of IBM systems, software and services with the objective of generating consistently strong returns on equity.

*Results of Operations***Three Months Ended****Six Months Ended**

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| (Dollars in millions) | June 30, | | June 30, | |
|-----------------------|----------|--------|----------|----------|
| | 2010 | 2009 | 2010 | 2009 |
| External revenue | \$ 544 | \$ 568 | \$ 1,081 | \$ 1,146 |
| Internal revenue | 431 | 447 | 834 | 836 |
| Total revenue | 975 | 1,014 | 1,916 | 1,982 |
| Total cost | 342 | 382 | 676 | 749 |
| Gross profit | \$ 633 | \$ 632 | \$ 1,239 | \$ 1,233 |
| Gross profit margin | 64.9% | 62.3% | 64.7% | 62.2% |
| Pre-tax income | \$ 463 | \$ 465 | \$ 890 | \$ 825 |
| After-tax income* | \$ 306 | \$ 305 | \$ 590 | \$ 540 |
| Return on equity* | 39.6% | 36.8% | 37.8% | 32.0% |

* See page 70 for the details of the after-tax income and the return on equity calculation.

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Management Discussion (continued)

The decrease in revenue in the second quarter, as compared to the same period in 2009, was primarily due to:

- A decline in external revenue of 4.1 percent (5 percent adjusted for currency), due to a decrease in financing revenue (down 9.9 percent to \$384 million), partially offset by an increase in used equipment sales revenue (up 13.5 percent to \$160 million); and
- A decline in internal revenue of 3.5 percent driven by decreases in internal financing revenue (down 3.9 percent to \$132 million) and used equipment sales revenue to the System and Technology segment (down 3.3 percent to \$299 million).

The decrease in revenue in the first six months of 2010, as compared to the same period in 2009, was primarily due to:

- A decline in external revenue of 5.6 percent (9 percent adjusted for currency) due to a decrease in financing revenue (down 8.8 percent to \$799 million), partially offset by an increase in used equipment sales revenue (up 4.7 percent to \$282 million); and
- A decline in internal revenue of 0.3 percent driven by a decrease in internal financing revenue (down 5.8 percent to \$281 million), partially offset by an increase in used equipment sales revenue to the Global Technology Services segment (up 2.8 percent to \$553 million).

The decreases in financing revenue in the second quarter and the first six months of 2010, compared to the same periods in 2009, were due to both lower asset yields and lower average asset balances.

Gross profit increased 0.2 percent in the second quarter of 2010 compared to the same period in 2009, with gross margin increasing 2.6 points. Gross profit increased 0.5 percent in the first six months of 2010 compared to the prior year, with gross margin increasing 2.5 points. The gross profit increase in both periods was due to higher used equipment sales revenue. The margin improvement in both periods was due to an improvement in both financing and used equipment sales margins.

Pre-tax income was flat in the second quarter of 2010 compared to the same period in 2009. Pre-tax income increased 7.9 percent in the first six months of 2010 compared to the prior year, primarily driven by lower financing receivables provisions of \$70 million. The decrease in financing receivables provisions in 2010 was primarily due to lower specific reserve requirements. Excluding \$2 million and \$5 million of workforce rebalancing charges in the first quarter of 2010 and 2009, respectively, pre-tax income on a normalized basis increased 7.5 percent for the first six months of 2010 versus the prior year period.

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Pre-tax margins of 47.4 percent and 46.5 percent, increased 1.6 points and 4.9 points, versus the second quarter and first six months of 2009, respectively. Pre-tax margins on a normalized basis were 46.6 percent and 41.9 percent for the first six months of 2010 and 2009, respectively.

The increase in return on equity for the second quarter 2010 compared to the same period in 2009 was primarily due to a lower average equity balance. The increase in return on equity for the first six months of 2010 compared to the first six months of 2009 was due to a lower average equity balance and higher after-tax income.

Table of Contents**Management Discussion (continued)**Financial Condition

Balance Sheet

| (Dollars in millions) | | At June 30, 2010 | | At December 31, 2009 |
|--|----|-----------------------------|----|---------------------------------|
| Cash and cash equivalents | \$ | 1,126 | \$ | 1,285 |
| Net investment in sales-type and direct financing leases | | 8,496 | | 9,482 |
| Equipment under operating leases: | | | | |
| External clients (a) | | 1,738 | | 1,863 |
| Internal clients (b) (c) | | 743 | | 994 |
| Client loans | | 9,319 | | 10,413 |
| Total client financing assets | | 20,295 | | 22,752 |
| Commercial financing receivables | | 4,680 | | 5,662 |
| Intercompany financing receivables(b) (c) | | 3,381 | | 3,660 |
| Other receivables | | 306 | | 370 |
| Other assets | | 1,032 | | 877 |
| Total assets | \$ | 30,820 | \$ | 34,605 |
| Intercompany payables (b) | \$ | 3,845 | \$ | 5,879 |
| Debt (d) | | 21,189 | | 22,383 |
| Other liabilities | | 2,797 | | 3,174 |
| Total liabilities | | 27,832 | | 31,435 |
| Total equity | | 2,988 | | 3,170 |
| Total liabilities and equity | \$ | 30,820 | \$ | 34,605 |

(a) Includes intercompany mark-up, priced on an arms-length basis, on products purchased from the company's product divisions, which is eliminated in IBM's consolidated results.

(b) Entire amount eliminated for purposes of IBM's consolidated results and therefore does not appear on pages 4 and 5.

(c) These assets, along with all other financing assets in this table, are leveraged at the value in the table using Global Financing debt.

(d) Global Financing debt is comprised of intercompany loans and external debt. A portion of Global Financing debt is in support of the company's internal business, or related to intercompany mark-up embedded in the Global Financing assets. See table on page 70.

Sources and Uses of Funds

The primary use of funds in Global Financing is to originate client and commercial financing assets. Client financing assets for end users consist primarily of IBM systems, software and services, but also include non-IBM equipment, software and services to meet IBM clients' total solutions

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requirements. Client financing assets are primarily sales-type, direct financing and operating leases for systems products, as well as loans for systems, software and services with terms generally from two to seven years. Global Financing's client loans are primarily for software and services and are unsecured. These loans are subjected to additional credit analysis to evaluate the associated risk and, when deemed necessary, actions are taken to mitigate risks in the loan agreements which include covenants to protect against credit deterioration during the life of the obligation. Client financing also includes internal activity as described on page 24 of the 2009 IBM Annual Report.

Commercial financing receivables arise primarily from inventory and accounts receivable financing for dealers and remarketers of IBM and non-IBM products. Payment terms for inventory financing and accounts receivable financing generally range from 30 to 90 days. These short-term receivables are primarily unsecured and are also subjected to additional credit analysis in order to evaluate the associated risk.

At June 30, 2010, substantially all financing assets are IT related assets, and approximately 64 percent of the external portfolio is with investment grade clients with no direct exposure to consumers or mortgage assets.

Table of Contents**Management Discussion (continued)**

Originations

The following are total external and internal financing originations.

| (Dollars in millions) | Three Months Ended June 30, | | | Six Months Ended June 30, | | | | |
|-----------------------|--------------------------------|--------|------|------------------------------|----|--------|----|--------|
| | 2010 | | 2009 | 2010 | | 2009 | | |
| Client financing: | | | | | | | | |
| External | \$ | 2,778 | \$ | 2,806 | \$ | 4,975 | \$ | 5,182 |
| Internal | | 2 | | 200 | | 64 | | 398 |
| Commercial financing | | 7,536 | | 6,030 | | 14,234 | | 11,963 |
| Total | \$ | 10,316 | \$ | 9,036 | \$ | 19,273 | \$ | 17,543 |

New financing originations exceeded cash collections of commercial financing assets, while cash collections exceeded new originations of client financing assets; resulting in a net decrease in financing assets in the second quarter of 2010. Cash collections of both client and commercial financing assets exceeded new financing originations in the first six months of 2010, which resulted in a net decline in financing assets from December 31, 2009. The increase in originations in both periods was due to improving volumes in commercial financing.

Cash generated by Global Financing was primarily deployed to pay the intercompany payables and dividends to IBM.

Global Financing Receivables and Allowances

The following table presents external financing receivables excluding residual values, and the allowance for doubtful accounts.

| (Dollars in millions) | | At June 30, 2010 | | At December 31, 2009 |
|---|----|---------------------|----|-------------------------|
| Gross financing receivables | \$ | 22,368 | \$ | 25,508 |
| Specific allowance for doubtful accounts | | 387 | | 416 |
| Unallocated allowance for doubtful accounts | | 73 | | 120 |
| Total allowance for doubtful accounts | | 460 | | 536 |
| Net financing receivables | \$ | 21,908 | \$ | 24,972 |
| Allowance for doubtful accounts coverage | | 2.1% | | 2.1% |

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Roll-Forward of Financing Receivables Allowance for Doubtful Accounts

(Dollars in millions)

| January 1, 2010 | Allowance Used * | Additions/ (Reductions) Bad Debt Expense | Other** | June 30, 2010 |
|-----------------|---------------------|---|---------|------------------|
| \$ 536 | \$ (57) | \$ 13 | \$ (31) | \$ 460 |

* Represents reserved receivables, net of recoveries, that were disposed of during the period.

** Primarily represents translation adjustments.

The percentage of Global Financing receivables reserved was 2.1 percent at December 31, 2009 and June 30, 2010. Specific reserves decreased 7.0 percent from \$416 million at December 31, 2009 to \$387 million at June 30, 2010 driven by the disposition of receivables previously reserved. Unallocated reserves decreased \$47 million from \$120 million at December 31, 2009 to \$73 million at June 30, 2010 due to the decline in gross financing receivables.

Global Financing's bad debt expense was an increase of \$13 million for the six months ended June 30, 2010, compared to an increase of \$83 million for the six months ended June 30, 2009. The decrease in bad debt expense was attributed to the decline in required specific reserve additions. In the second quarter of 2010, compared to the second quarter of 2009, bad debt expense was flat.

Table of Contents**Management Discussion (continued)**

Residual Value

Residual value is a risk unique to the financing business and management of this risk is dependent upon the ability to accurately project future equipment values at lease inception. Global Financing has insight into product plans and cycles for the IBM products under lease. Based upon this product information, Global Financing continually monitors projections of future equipment values and compares them with the residual values reflected in the portfolio.

Global Financing optimizes the recovery of residual values by selling assets sourced from end of lease, leasing used equipment to new clients, or extending lease arrangements with current clients. Sales of equipment, which are primarily sourced from equipment returned at the end of a lease, represented 47.1 percent and 43.6 percent of Global Financing's revenue in the second quarter and first six months, respectively, of 2010 and 44.4 percent and 40.7 percent in the second quarter and first six months, respectively, of 2009. The percentage increase in the second quarter of 2010 and the first six months of 2010 was driven primarily by the decrease in financing revenue. The gross margins on these sales were 55.5 percent and 53.7 percent in the second quarter of 2010 and 2009, respectively. The gross margins were 53.3 percent and 52.0 percent for the first six months of 2010 and 2009, respectively. The increase in both periods was driven primarily by an improvement in internal sales margins.

The following table presents the recorded amount of unguaranteed residual value for sales-type, direct financing and operating leases at January 1, 2010 and June 30, 2010. In addition, the table presents the residual value as a percentage of the related original amount financed and a run out of when the unguaranteed residual value assigned to equipment on leases at June 30, 2010 is expected to be returned to the company. In addition to the unguaranteed residual value below, on a limited basis, Global Financing will obtain guarantees of the future value of the equipment to be returned at end of lease. These third-party guarantees are included in minimum lease payments as provided for by accounting standards in the determination of lease classifications for the covered equipment and provide protection against risk of loss arising from declines in equipment values for these assets. The residual value guarantee increases the minimum lease payments that are utilized in determining the classification of a lease as a sales-type lease or operating lease. The aggregate asset values associated with the guarantees were \$125 million and \$160 million for the financing transactions originated during the quarters ended June 30, 2010 and June 30, 2009, respectively, and \$216 million and \$266 million for the six months ended June 30, 2010 and June 30, 2009, respectively. The associated aggregate guaranteed future values at the scheduled end of lease were \$7 million and \$10 million for the financing transactions originated during the quarters ended June 30, 2010 and June 30, 2009, respectively, and \$12 million and \$16 million for the financing transactions originated during the six months ended June 30, 2010 and June 30, 2009, respectively. The cost of guarantees was \$0.7 million for the quarter ended June 30, 2010 and \$1.3 million for the quarter ended June 30, 2009, and \$1.2 million and \$2.1 million for each of the six month periods ended June 30, 2010 and June 30, 2009, respectively.

Unguaranteed Residual Value

| (Dollars in millions) | January 1, 2010 | June 30, 2010 | 2010 | Estimated Run Out of June 30, 2010 balance | | 2013 and Beyond |
|--|--------------------|------------------|-------|---|--------|--------------------|
| | | | | 2011 | 2012 | |
| Sales-type and direct financing leases | \$ 849 | \$ 794 | \$ 94 | \$ 255 | \$ 269 | \$ 176 |
| Operating leases | 351 | 326 | 102 | 113 | 75 | 36 |

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| | | | | | | | | | | | | |
|-----------------------------------|----|--------|----|--------|----|-----|----|-----|----|-----|----|-----|
| Total unguaranteed residual value | \$ | 1,200 | \$ | 1,120 | \$ | 196 | \$ | 368 | \$ | 344 | \$ | 212 |
| Related original amount financed | \$ | 20,526 | \$ | 19,312 | | | | | | | | |
| Percentage | | 5.8% | | 5.8% | | | | | | | | |

Table of Contents**Management Discussion (continued)**

Debt

| | At June 30, 2010 | | At December 31, 2009 | |
|----------------------|-----------------------------|------|---------------------------------|------|
| Debt-to-equity ratio | | 7.1X | | 7.1X |

The company funds Global Financing through borrowings using a debt-to-equity ratio target of approximately 7 to 1. The debt used to fund Global Financing assets is composed of intercompany loans and external debt. The terms of the intercompany loans are set by the company to substantially match the term and currency underlying the financing receivable and are based on arm's-length pricing. Both assets and debt are presented in the Global Financing balance sheet on page 67.

The Global Financing business provides funding predominantly for the company's external clients but also provides intercompany financing for the company. As previously stated, the company measures Global Financing as if it were a standalone entity and accordingly, interest expense relating to debt supporting Global Financing's external client and internal business is included in the Global Financing Results of Operations on page 65 and in Segment Information on pages 24 to 26.

In the company's Consolidated Statement of Earnings on page 3, however, the external debt-related interest expense supporting Global Financing's internal financing to the company is reclassified from cost of financing to interest expense.

The following table provides additional information on total company debt. In this table, intercompany activity includes internal loans and leases at arm's-length pricing in support of Global Services' long-term contracts and other internal activity. The company believes these assets should be appropriately leveraged in line with the overall Global Financing business model.

| (Dollars in millions) | At June 30, 2010 | | At December 31, 2009 | |
|----------------------------------|-------------------------|-----------|-----------------------------|-----------|
| Global Financing Segment | | \$21,189 | | \$ 22,383 |
| Debt to support external clients | \$18,057 | | \$ 19,091 | |
| Debt to support internal clients | 3,132 | | 3,292 | |
| Non-Global Financing Segments | | 5,461 | | 3,717 |
| Debt supporting operations | 8,593 | | 7,008 | |
| Intercompany activity | (3,132) | | (3,292) | |
| Total company debt | | \$ 26,650 | | \$26,099 |

Liquidity and Capital Resources

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Global Financing is a segment of the company and therefore, is supported by the company's overall liquidity position and access to capital markets. Cash generated by Global Financing was primarily deployed to pay intercompany payables and dividends to the company in order to maintain an appropriate debt-to-equity ratio.

Return on Equity

| (Dollars in millions) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--|--------------------------------|-------|------|------------------------------|----|-------|
| | 2010 | | 2009 | 2010 | | 2009 |
| Numerator : | | | | | | |
| Global Financing after tax income* | \$ | 306 | \$ | 305 | \$ | 540 |
| Annualized after-tax income (A) | \$ | 1,224 | \$ | 1,220 | \$ | 1,180 |
| Denominator : | | | | | | |
| Average Global Financing equity (B)** | \$ | 3,090 | \$ | 3,315 | \$ | 3,374 |
| Global Financing return on equity(A)/(B) | | 39.6% | | 36.8% | | 37.8% |
| | | | | | | 32.0% |

* Calculated based upon an estimated tax rate principally based on Global Financing's geographic mix of earnings as IBM's provision for income taxes is determined on a consolidated basis.

** Average of the ending equity for Global Financing for the last 2 quarters and 3 quarters, for the three months ended June 30, and for the six months ended June 30, respectively.

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Management Discussion (continued)

Looking Forward

Global Financing's financial position provides flexibility and funding capacity which enables the company to be well positioned in the current environment. Global Financing's assets and new financing volumes are primarily IBM products and services financed to the company's clients and business partners, and substantially all financing assets are IT related assets which provide a stable base of business for future growth. Global Financing's offerings are competitive and available to clients as a result of the company's borrowing cost and access to the capital markets. Overall, Global Financing's originations will be dependent upon the demand for IT products and services as well as client participation rates.

IBM continues to access both the short-term commercial paper market and the medium and long-term debt markets. A protracted period where IBM could not access the capital markets would likely lead to a slowdown in originations.

Interest rates and the overall economy (including currency fluctuations) will have an effect on both revenue and gross profit. The company's interest rate risk management policy, however, combined with the Global Financing pricing strategy should mitigate gross margin erosion due to changes in interest rates.

The economy could impact the credit quality of the Global Financing receivables portfolio and therefore the level of provision for bad debts. Global Financing will continue to apply rigorous credit policies in both the origination of new business and the evaluation of the existing portfolio.

As discussed on page 69, Global Financing has historically been able to manage residual value risk both through insight into the company's product cycles, as well as through its remarketing business.

Global Financing has policies in place to manage each of the key risks involved in financing. These policies, combined with product and client knowledge, should allow for the prudent management of the business going forward, even during periods of uncertainty with respect to the global economy.

Forward Looking and Cautionary Statements

Except for the historical information and discussions contained herein, statements contained in this release may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on the company's current assumptions regarding future business and financial performance. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, including the following: a downturn in the economic environment and corporate IT

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spending budgets; the company's failure to meet growth and productivity objectives; a failure of the company's innovation initiatives; risks from investing in growth opportunities; failure of the company's intellectual property portfolio to prevent competitive offerings and the failure of the company to obtain necessary licenses; breaches of data security; fluctuations in revenues and purchases; impact of local legal, economic, political and health conditions; adverse effects from environmental matters, tax matters and the company's pension plans; ineffective internal controls; the company's use of accounting estimates; the company's ability to attract and retain key personnel and its reliance on critical skills; impact of relationships with critical suppliers; currency fluctuations and customer financing risks; impact of changes in market liquidity conditions and customer credit risk on receivables; reliance on third party distribution channels; the company's ability to successfully manage acquisitions and alliances; risk factors related to IBM securities; and other risks, uncertainties and factors discussed in the company's Form 10-Q, Form 10-K and in the company's other filings with the U.S. Securities and Exchange Commission (SEC) or in materials incorporated therein by reference. Any forward-looking statement in this Form 10-Q speaks only as of the date on which it is made. The company assumes no obligation to update or revise any forward-looking statements.

Item 4. Controls and Procedures

The company's management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the company's disclosure controls and procedures were effective as of the end of the period covered by this report. There has been no change in the company's internal control over financial reporting that occurred during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Table of Contents**Part II Other Information****Item 1. Legal Proceedings**

Refer to Note 15, Contingencies, on pages 33 to 35 of this Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds and Issuer Repurchases of Equity Securities

The following table provides information relating to the company's repurchase of common stock for the second quarter of 2010.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program(*) |
|--------------------------------|----------------------------------|------------------------------|--|---|
| April 1, 2010 - April 30, 2010 | 9,342,000 | \$ 129.46 | 9,342,000 | \$ 8,809,019,309 |
| May 1, 2010 - May 31, 2010 | 9,233,500 | \$ 126.58 | 9,233,500 | \$ 7,640,234,583 |
| June 1, 2010 - June 30, 2010 | 13,793,747 | \$ 127.59 | 13,793,747 | \$ 5,880,299,781 |
| Total | 32,369,247 | \$ 127.84 | 32,369,247 | |

* On October 27, 2009 and April 27, 2010, the Board of Directors authorized \$5.0 billion and \$8.0 billion, respectively, in funds for use in the company's common stock repurchase program. The October 27, 2009 authorization was fully utilized by late May 2010. In each case, the company stated that it would repurchase shares on the open market or in private transactions depending on market conditions and it expects to use cash from operations for the repurchases. The common stock repurchase program does not have an expiration date. This table does not include shares tendered to satisfy the exercise price in connection with cashless exercises of employee stock options or shares tendered to satisfy tax withholding obligations in connection with employee equity awards.

Item 5. Other Information

Taizo Nishimuro retired from the IBM Board of Directors, effective July 27, 2010. In June 2010, Mr. Nishimuro stepped down as chairman of the Tokyo Stock Exchange Group, Inc. IBM is including this disclosure in this Form 10-Q rather than filing a Form 8-K under Item 5.02(b) at a later date. In connection with Mr. Nishimuro's retirement, Article III, Section 2 of IBM's By-laws was amended to decrease the number of directors to thirteen, effective July 27, 2010. The full text of IBM's By-laws, as amended, is included as Exhibit 3 to this report.

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Item 6. Exhibits

Exhibit Number

- 3 The By-laws of IBM as amended through July 27, 2010.
- 11 Statement re: computation of per share earnings.
- 12 Statement re: computation of ratios.
- 31.1 Certification by principal executive officer pursuant to Rule 13A-14(a) or 15D-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by principal financial officer pursuant to Rule 13A-14(a) or 15D-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification by principal executive officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification by principal financial officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Statement of Earnings for the three and six month periods ended June 30, 2010 and 2009, (ii) the Consolidated Statement of Financial Position at June 30, 2010 and December 31, 2009, (iii) the Consolidated Statement of Cash Flows for the six months ended June 30, 2010 and 2009 and (iv) the notes to the Consolidated Financial Statements.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

International Business Machines Corporation
(Registrant)

Date: July 27, 2010

By: /s/ James J. Kavanaugh
James J. Kavanaugh
Vice President and Controller

