

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

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**

**FORM 10 - Q**

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

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2013**

**1-2360**

(Commission file number)

**INTERNATIONAL BUSINESS MACHINES CORPORATION**

(Exact name of registrant as specified in its charter)

**New York**

(State of incorporation)

**13-0871985**

(IRS employer identification number)

**Armonk, New York**

(Address of principal executive offices)

**10504**

(Zip Code)

**914-499-1900**

(Registrant's telephone number)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

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	Three Months Ended September 30,				Nine Months Ended September 30,			
(Dollars in millions except per share amounts)	2013		2012		2013		2012	
<b>Revenue:</b>								
Services	\$	14,225	\$	14,626	\$	42,811	\$	44,279
Sales		8,987		9,642		27,735		29,424
Financing		509		479		1,506		1,500
<b>Total revenue</b>		23,720		24,747		72,052		75,203
<b>Cost:</b>								
Services		9,098		9,515		27,950		29,285
Sales		2,975		3,242		9,108		10,003
Financing		268		258		805		784
<b>Total cost</b>		12,341		13,016		37,863		40,072
<b>Gross profit</b>		11,380		11,732		34,189		35,131
<b>Expense and other income:</b>								
Selling, general and administrative		5,255		5,908		17,512		17,632
Research, development and engineering		1,468		1,534		4,661		4,722
Intellectual property and custom development income		(191)		(303)		(621)		(847)
Other (income) and expense		(62)		(606)		(214)		(796)
Interest expense		97		124		289		350
<b>Total expense and other income</b>		6,567		6,657		21,627		21,060
<b>Income before income taxes</b>		4,812		5,074		12,562		14,071
Provision for income taxes		772		1,251		2,263		3,300
<b>Net income</b>	\$	4,041	\$	3,824	\$	10,299	\$	10,771
<b>Earnings per share of common stock:</b>								
Assuming dilution	\$	3.68	\$	3.33	\$	9.27	\$	9.27
Basic	\$	3.70	\$	3.36	\$	9.35	\$	9.38
<b>Weighted-average number of common shares outstanding: (millions)</b>								
Assuming dilution		1,098.8		1,149.3		1,110.7		1,161.8
Basic		1,090.9		1,137.2		1,101.8		1,148.4
<b>Cash dividend per common share</b>	\$	0.95	\$	0.85	\$	2.75	\$	2.45
(Amounts may not add due to rounding.)								
(The accompanying notes are an integral part of the financial statements.)								





	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2013	2012	2013	2012
<b>Net income</b>	\$ 4,041	\$ 3,824	\$ 10,299	\$ 10,771
<b>Other comprehensive income/(loss), before tax:</b>				
<b>Foreign currency translation adjustments</b>	382	501	(959)	164
<b>Net changes related to available-for-sale securities:</b>				
Unrealized gains/(losses) arising during the period	3	11	0	13
Reclassification of (gains)/losses to net income	(5)	(27)	(5)	(43)
Subsequent changes in previously impaired securities arising during the period	1	(7)	3	20
<b>Total net changes related to available-for-sale securities</b>	(1)	(24)	(1)	(10)
<b>Unrealized gains/(losses) on cash flow hedges:</b>				
Unrealized gains/(losses) arising during the period	(409)	(54)	(58)	65
Reclassification of (gains)/losses to net income	(27)	(112)	(130)	(246)
<b>Total unrealized gains/(losses) on cash flow hedges</b>	(436)	(165)	(188)	(181)
<b>Retirement-related benefit plans:</b>				
Prior service costs/(credits)	0	0	33	0
Net (losses)/gains arising during the period	105	1	300	66
Curtailments and settlements	0	(2)	0	(1)
Amortization of prior service (credits)/costs	(28)	(37)	(86)	(112)
Amortization of net (gains)/losses	872	613	2,623	1,846
<b>Total retirement-related benefit plans</b>	949	575	2,869	1,799
<b>Other comprehensive income/(loss), before tax</b>	895	887	1,721	1,771
<b>Income tax (expense)/benefit related to items of other comprehensive income</b>	(91)	(109)	(933)	(606)
<b>Other comprehensive income/(loss)</b>	804	778	788	1,165
<b>Total comprehensive income/(loss)</b>	\$ 4,844	\$ 4,601	\$ 11,087	\$ 11,936
(Amounts may not add due to rounding.)				
(The accompanying notes are an integral part of the financial statements.)				



(Dollars in millions)		2013	2012
<b>Assets:</b>			
Current assets:			
	Cash and cash equivalents	\$ 10,072	\$ 10,412
	Marketable securities	160	717
	Notes and accounts receivable - trade (net of allowances of \$273 in 2013 and \$255 in 2012)	9,865	10,667
	Short-term financing receivables (net of allowances of \$280 in 2013 and \$288 in 2012)	16,786	18,038
	Other accounts receivable (net of allowances of \$29 in 2013 and \$17 in 2012)	1,683	1,873
	Inventories, at lower of average cost or market:		
	Finished goods	528	475
	Work in process and raw materials	1,964	1,812
	Total inventories	2,492	2,287
	Deferred taxes	1,752	1,415
	Prepaid expenses and other current assets	4,723	4,024
	<b>Total current assets</b>	<b>47,533</b>	<b>49,433</b>
	Property, plant and equipment	40,808	40,501
	Less: Accumulated depreciation	26,931	26,505
	Property, plant and equipment — net	13,877	13,996
	Long-term financing receivables (net of allowances of \$72 in 2013 and \$66 in 2012)	11,675	12,812
	Prepaid pension assets	1,476	945
	Deferred taxes	3,682	3,973
	Goodwill	30,882	29,247
	Intangible assets — net	4,003	3,787
	Investments and sundry assets	4,718	5,021
	<b>Total assets</b>	<b>\$ 117,845</b>	<b>\$ 119,213</b>
(Amounts may not add due to rounding.)			
(The accompanying notes are an integral part of the financial statements.)			



<b>(Dollars in millions)</b>					
<b>Liabilities:</b>					
Current liabilities:					
	Taxes	\$	4,746	\$	4,948
	Short-term debt		7,702		9,181
	Accounts payable		6,263		7,952
	Compensation and benefits		4,210		4,745
	Deferred income		11,658		11,952
	Other accrued expenses and liabilities		4,643		4,847
	<b>Total current liabilities</b>		<b>39,222</b>		<b>43,625</b>
	Long-term debt		28,478		24,088
	Retirement and nonpension postretirement benefit obligations		17,994		20,418
	Deferred income		4,087		4,491
	Other liabilities		8,057		7,607
	<b>Total liabilities</b>		<b>97,837</b>		<b>100,229</b>
<b>Equity:</b>					
IBM stockholders' equity:					
	Common stock, par value \$0.20 per share, and additional paid-in capital		51,203		50,110
	Shares authorized: 4,687,500,000				
	Shares issued: 2013 - 2,205,819,186				
	2012 - 2,197,561,159				
	Retained earnings		124,885		117,641
	Treasury stock - at cost		(131,240)		(123,131)
	Shares: 2013 - 1,119,964,803				
	2012 - 1,080,193,483				
	Accumulated other comprehensive income/(loss)		(24,971)		(25,759)
	<b>Total IBM stockholders' equity</b>		<b>19,877</b>		<b>18,860</b>
	Noncontrolling interests		131		124
	<b>Total equity</b>		<b>20,008</b>		<b>18,984</b>
	<b>Total liabilities and equity</b>	\$	<b>117,845</b>	\$	<b>119,213</b>
(Amounts may not add due to rounding.)					
(The accompanying notes are an integral part of the financial statements.)					



(Dollars in millions)		2013	2012
<b>Cash flows from operating activities:</b>			
Net income		\$ 10,299	\$ 10,771
Adjustments to reconcile net income to cash provided by operating activities			
Depreciation		2,457	2,572
Amortization of intangibles		1,007	952
Stock-based compensation		455	510
Net (gain)/loss on asset sales and other		(139)	(697)
Changes in operating assets and liabilities, net of acquisitions/divestitures		(3,121)	(868)
<b>Net cash provided by operating activities</b>		<b>10,957</b>	<b>13,240</b>
<b>Cash flows from investing activities:</b>			
Payments for property, plant and equipment		(2,559)	(3,082)
Proceeds from disposition of property, plant and equipment		256	233
Investment in software		(406)	(476)
Acquisition of businesses, net of cash acquired		(2,562)	(2,266)
Divestitures of businesses, net of cash transferred		247	587
Non-operating finance receivables — net		284	718
Purchases of marketable securities and other investments		(3,718)	(2,596)
Proceeds from disposition of marketable securities and other investments		4,035	1,971
<b>Net cash used in investing activities</b>		<b>(4,423)</b>	<b>(4,912)</b>
<b>Cash flows from financing activities:</b>			
Proceeds from new debt		10,066	9,589
Payments to settle debt		(7,740)	(4,991)
Short-term borrowings/(repayments) less than 90 days — net		1,074	(2,177)
Common stock repurchases		(8,062)	(8,988)
Common stock transactions — other		826	1,198
Cash dividends paid		(3,033)	(2,816)
<b>Net cash used in financing activities</b>		<b>(6,870)</b>	<b>(8,185)</b>
Effect of exchange rate changes on cash and cash equivalents		(4)	(156)
Net change in cash and cash equivalents		(340)	(13)
Cash and cash equivalents at January 1		10,412	11,922
<b>Cash and cash equivalents at September 30</b>		<b>\$ 10,072</b>	<b>\$ 11,909</b>
(Amounts may not add due to rounding.)			
(The accompanying notes are an integral part of the financial statements.)			







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

**Notes to Consolidated Financial Statements:**

**1. Basis of Presentation:** The accompanying Consolidated Financial Statements and footnotes of the International Business Machines Corporation (IBM or the company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial statements and footnotes are unaudited. In the opinion of the company's management, these statements include all adjustments, which are only of a normal recurring nature, necessary to present a fair statement of the company's results of operations, financial position and cash flows.

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

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

Noncontrolling interest amounts in income of \$1.8 million and \$3.0 million, net of tax, for the three months ended September 30, 2013 and 2012, respectively, and \$4.2 million and \$8.6 million, net of tax, for the nine months ended September 30, 2013 and 2012, respectively, are included in the Consolidated Statement of Earnings within the other (income) and expense line item.

Within the financial statements and tables presented, certain columns and rows may not add due to the use of rounded numbers for disclosure purposes. Percentages presented are calculated from the underlying whole-dollar amounts. Certain prior year amounts have been reclassified to conform to the current year presentation. This is annotated where applicable.

**2. Accounting Changes:** In July 2013, the Financial Accounting Standards Board (FASB) issued guidance allowing the use of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark interest rate for hedge accounting purposes in addition to interest rates on direct Treasury obligations of the United States government and the LIBOR. In addition, the guidance removes the restriction on using different benchmark rates for similar hedges. The guidance became effective on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013, and did not have a material impact in the consolidated financial results.

In July 2013, the FASB issued guidance regarding the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Under certain circumstances,

unrecognized tax benefits should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The guidance is a change in financial statement presentation only and has no material impact in the consolidated financial results. The guidance is effective beginning January 1, 2014 on either a prospective or retrospective basis.

In March 2013, the FASB issued guidance on when foreign currency translation adjustments should be released to net income. When a parent entity ceases to have a controlling financial interest in a subsidiary or group of assets that is a business within a foreign entity, the parent is required to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The guidance is effective prospectively beginning January 1, 2014. It is not expected to have a material impact in the consolidated financial results.

In February 2013, the FASB issued guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of the guidance is fixed at the reporting date. Examples include debt arrangements, other contractual obligations and settled litigation. The guidance requires an entity to measure such obligations as the sum of the amount that the reporting entity agreed to pay on the basis of its arrangement among its co-obligors plus additional amounts the reporting entity expects to pay on behalf of its co-obligors. The guidance is effective January 1, 2014 and is not expected to have a material impact in the consolidated financial results.

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

### **3. Financial Instruments:**

#### **Fair Value Measurements**

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

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

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

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

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

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

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

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

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

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

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

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

The following tables present the company's financial assets and financial liabilities that are measured at fair value on a recurring basis at September 30, 2013 and December 31, 2012.



## Notes to Consolidated Financial Statements – (continued)

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

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

(2) Commercial paper and certificates of deposit reported as marketable securities in the Consolidated Statement of Financial Position.

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

(4) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments

and sundry assets in the Consolidated Statement of Financial Position at September 30, 2013 were \$396 million and

\$397 million, respectively.

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

liabilities in the Consolidated Statement of Financial Position at September 30, 2013 were \$432 million and \$150

million, respectively.

(6) Available-for-sale securities with carrying values that approximate fair value.

(7) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by \$343 million each.

## Notes to Consolidated Financial Statements – (continued)

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

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

(2) Commercial paper and certificates of deposit reported as marketable securities in the Consolidated Statement of Financial Position.

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

(4) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments

and sundry assets in the Consolidated Statement of Financial Position at December 31, 2012 were \$333 million and

\$585 million, respectively.

(5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other liabilities in the Consolidated Statement of Financial Position at December 31, 2012 were \$426 million and \$78

million, respectively.

(6) Available-for-sale securities with carrying values that approximate fair value.

(7) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by \$262 million each.

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

### **Financial Assets and Liabilities Not Measured at Fair Value**

#### Short-Term Receivables and Payables

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

#### Loans and Long-term Receivables

Fair values are based on discounted future cash flows using current interest rates offered for similar loans to clients with similar credit ratings for the same remaining maturities. At September 30, 2013 and December 31, 2012, the difference between the carrying amount and estimated fair value for loans and long-term receivables was immaterial. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

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

## Long-term Debt

Fair value of publicly-traded long-term debt is based on quoted market prices for the identical liability when traded as an asset in an active market. For other long-term debt for which a quoted market price is not available, an expected present value technique that uses rates currently available to the company for debt with similar terms and remaining maturities is used to estimate fair value. The carrying amount of long-term debt was \$28,478 million and \$24,088 million and the estimated fair value was \$30,409 million and \$27,119 million at September 30, 2013 and December 31, 2012, respectively. If measured at fair value in the financial statements, long-term debt (including the current portion) would be classified as Level 2 in the fair value hierarchy.

**Debt and Marketable Equity Securities**

The company's cash equivalents and current debt securities are considered available-for-sale and recorded at fair value, which is not materially different from carrying value, in the Consolidated Statement of Financial Position. The following tables summarize the company's noncurrent debt and marketable equity securities which are also considered available-for-sale and recorded at fair value in the Consolidated Statement of Financial Position.

<b>(Dollars in millions)</b>		<b>Adjusted</b>		<b>Gross Unrealized</b>		<b>Gross Unrealized</b>		<b>Fair</b>			
<b>At September 30, 2013:</b>		<b>Cost</b>		<b>Gains</b>		<b>Losses</b>		<b>Value</b>			
Debt securities – noncurrent(1)		\$	7	\$	2	\$	—	\$	9		
Available-for-sale equity investments(1)		\$	29	\$	4	\$	1	\$	32		
(1) Included within investments and sundry assets in the Consolidated Statement of Financial Position.											

<b>(Dollars in millions)</b>		<b>Adjusted</b>		<b>Gross Unrealized</b>		<b>Gross Unrealized</b>		<b>Fair</b>			
<b>At December 31, 2012:</b>		<b>Cost</b>		<b>Gains</b>		<b>Losses</b>		<b>Value</b>			
Debt securities – noncurrent(1)		\$	8	\$	2	\$	—	\$	10		
Available-for-sale equity investments(1)		\$	31	\$	4	\$	1	\$	34		
(1) Included within investments and sundry assets in the Consolidated Statement of Financial Position.											

Based on an evaluation of available evidence as of September 30, 2013 and December 31, 2012, the company believes that unrealized losses on debt and available-for-sale equity investments were temporary and did not represent a need for an other-than-temporary impairment.

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

<b>(Dollars in millions)</b>					
<b>For the three months ended September 30:</b>					
		<b>2013</b>		<b>2012</b>	
Proceeds	\$	8	\$	36	
Gross realized gains (before taxes)		5		27	
Gross realized losses (before taxes)		0		—	

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

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

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

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

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

### Derivative Financial Instruments

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

As a result of the use of derivative instruments, the company is exposed to the risk that counterparties to derivative contracts will fail to meet their contractual obligations. To mitigate the counterparty credit risk, the company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit profile. The company's established policies and procedures for mitigating credit risk on principal transactions include reviewing and establishing limits for credit exposure and continually assessing the creditworthiness of counterparties. The right of set-off that exists under certain of these arrangements enables the legal entities of the company subject to the arrangement to net amounts due to and from the counterparty reducing the maximum loss from credit risk in the event of counterparty default.

The company is also a party to collateral security arrangements with most of its major derivative counterparties. These arrangements require the company to hold or post collateral (cash or U.S. Treasury securities) when the derivative fair values exceed contractually established thresholds. Posting thresholds can be fixed or can vary based on



credit default swap pricing or credit ratings received from the major credit agencies. The aggregate fair value of all derivative instruments under these collateralized arrangements that were in a liability position at September 30, 2013 and December 31, 2012 was \$222 million and \$94 million, respectively, for which no collateral was posted at September 30, 2013 and December 31, 2012. Full collateralization of these agreements would be required in the event that the company's credit rating falls below investment grade or if its credit default swap spread exceeds 250 basis points, as applicable, pursuant to the terms of the collateral security arrangements. The aggregate fair value of derivative instruments in net asset positions as of September 30, 2013 and December 31, 2012 was \$793 million and \$918 million, respectively. This amount represents the maximum exposure to loss at the reporting date as a result of the counterparties failing to perform as contracted. This exposure was reduced by \$343 million and \$262 million at September 30, 2013 and December 31, 2012, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at September 30, 2013 and December 31, 2012, this exposure was reduced by \$45 million and \$69 million of cash collateral, respectively, received by the company. At September 30, 2013 and December 31, 2012, the net exposure related to derivative assets recorded in the Statement of Financial Position was \$404 million and \$587 million respectively. At September 30, 2013 and December 31, 2012, the net amount related to derivative liabilities recorded in the Statement of Financial Position was \$239 million and \$242 million, respectively.

In the Consolidated Statement of Financial Position, the company does not offset derivative assets against liabilities in master netting arrangements nor does it offset receivables or payables recognized upon payment or receipt of cash collateral against the fair values of the related derivative instruments. No amount was recognized in other receivables at September 30, 2013 or December 31, 2012 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral totaled \$45 million and \$69 million at September 30, 2013 and December 31, 2012,

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

respectively. The company restricts the use of cash collateral received to rehypothecation, and therefore reports it in prepaid expenses and other current assets in the Consolidated Statement of Financial Position. No amount was rehypothecated at September 30, 2013 or at December 31, 2012. Additionally, the company's exposure is further reduced by holding non-cash collateral. At September 30, 2013, no amounts of non-cash collateral were held, and at December 31, 2012, \$31 million was held in U.S. Treasury securities. Per accounting guidance, non-cash collateral is not recorded on the Statement of Financial Position.

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

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

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

### **Interest Rate Risk**

#### **Fixed and Variable Rate Borrowings**

The company issues debt in the global capital markets, principally to fund its financing lease and loan portfolios. Access to cost-effective financing can result in interest rate mismatches with the underlying assets. To manage these mismatches and to reduce overall interest cost, the company uses interest-rate swaps to convert specific fixed-rate debt issuances into variable-rate debt (i.e., fair value hedges) and to convert specific variable-rate debt issuances into fixed-rate debt (i.e., cash flow hedges). At September 30, 2013 and December 31, 2012, the total notional amount of the company's interest rate swaps was \$4.5 billion and \$4.3 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2013 and December 31, 2012 was approximately 7.5 years and 5.1 years, respectively.

## **Forecasted Debt Issuance**

The company is exposed to interest rate volatility on future debt issuances. To manage this risk, the company may use forward starting interest-rate swaps to lock in the rate on the interest payments related to the forecasted debt issuance. These swaps are accounted for as cash flow hedges. The company did not have any derivative instruments relating to this program outstanding at September 30, 2013 and December 31, 2012.

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

## **Foreign Exchange Risk**

### **Long-Term Investments in Foreign Subsidiaries (Net Investment)**

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

## Notes to Consolidated Financial Statements – (continued)

### Anticipated Royalties and Cost Transactions

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

At September 30, 2013 and December 31, 2012, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of \$326 million and net losses of \$138 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$197 million of losses and \$79 million of losses, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

### Foreign Currency Denominated Borrowings

The company is exposed to exchange rate volatility on foreign currency denominated debt. To manage this risk, the company employs cross-currency swaps to convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. At September 30, 2013 and December 31, 2012, no instruments relating to this program were outstanding.

### Subsidiary Cash and Foreign Currency Asset/Liability Management

The company uses its Global Treasury Centers to manage the cash of its subsidiaries. These centers principally use currency swaps to convert cash flows in a cost-effective manner. In addition, the company uses foreign exchange forward contracts to economically hedge, on a net basis, the foreign currency exposure of a portion of the company's nonfunctional currency assets and liabilities. The terms of these forward and swap contracts are generally less than one year. The changes in the fair values of these contracts and of the underlying hedged exposures are generally offsetting and are recorded in other (income) and expense in the Consolidated Statement of Earnings. At September 30, 2013 and December 31, 2012, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$14.6 billion and \$12.9 billion, respectively.

## Equity Risk Management

The company is exposed to market price changes in certain broad market indices and in the company's own stock primarily related to certain obligations to employees. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company's common stock. They are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At September 30, 2013 and December 31, 2012, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.2 billion for both periods.

## Other Risks

The company may hold warrants to purchase shares of common stock in connection with various investments that are deemed derivatives because they contain net share or net cash settlement provisions. The company records the changes in the fair value of these warrants in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any warrants qualifying as derivatives outstanding at September 30, 2013 and December 31, 2012.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company utilizes credit default swaps to economically hedge its credit exposures. The swaps are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any derivative instruments relating to this program outstanding at September 30, 2013 and December 31, 2012.

## Notes to Consolidated Financial Statements – (continued)

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

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

<b>Total</b>		\$	793	\$	918		\$	4,097	\$	4
N/A-not applicable										

## Notes to Consolidated Financial Statements – (continued)

<b>The Effect of Derivative Instruments in the Consolidated Statement of Earnings</b>									
<b>For the three months ended September 30, 2013 and 2012</b>									
<b>(Dollars in millions)</b>	<b>Gain (Loss) Recognized in Earnings</b>								
	<b>Consolidated</b>	<b>Recognized on</b>				<b>Attributable to Risk</b>			
	<b>Statement of</b>	<b>Derivatives(1)</b>				<b>Being Hedged(2)</b>			
	<b>Earnings Line Item</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
<b>For the three months ended September 30:</b>									
<b>Derivative instruments in fair value hedges:</b>									
Interest rate contracts	Cost of financing	\$ 5	\$ 13	\$ 19	\$ 19				
	Interest expense	3	11	12	16				
<b>Derivative instruments not designated as hedging instruments(1):</b>									
Foreign exchange contracts	Other (income) and expense	254	148	N/A	N/A				
Equity contracts	SG&A expense	46	54	N/A	N/A				
Total		\$ 308	\$ 226	\$ 31	\$ 35				

<b>Gain (Loss) Recognized in Earnings and Other Comprehensive Income</b>									
<b>Consolidated</b>									