

INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
April 26, 2016

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 MARCH 31, 2016

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State of incorporation)

13-0871985

(IRS employer identification number)

Armonk , New York

(Address of principal executive offices)

10504

(Zip Code)

914-499-1900

(Registrant's telephone number)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The registrant had 959,961,852 shares of common stock outstanding at March 31, 2016.

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

| | Three Months Ended March 31, | |
|--|---|-----------------|
| | 2016 | 2015 |
| (Dollars in millions except per share amounts) | | |
| Revenue: | | |
| Services | \$ 12,391 | \$ 12,366 |
| Sales | 5,879 | 6,757 |
| Financing | 414 | 467 |
| Total revenue | 18,684 | 19,590 |
| Cost: | | |
| Services | 8,382 | 8,278 |
| Sales | 1,378 | 1,625 |
| Financing | 238 | 235 |
| Total cost | 9,999 | 10,138 |
| Gross profit | 8,686 | 9,452 |
| Expense and other (income): | | |
| Selling, general and administrative | 6,012 | 5,362 |
| Research, development and engineering | 1,458 | 1,298 |
| Intellectual property and custom development income | (217) | (173) |
| Other (income) and expense | 253 | (143) |
| Interest expense | 147 | 108 |
| Total expense and other (income) | 7,652 | 6,451 |
| Income from continuing operations before income taxes | 1,034 | 3,001 |
| Provision for/(benefit from) income taxes | (983) | 585 |
| Income from continuing operations | \$ 2,016 | \$ 2,415 |
| Loss from discontinued operations, net of tax | (3) | (88) |
| Net income | \$ 2,014 | \$ 2,328 |
| Earnings/(loss) per share of common stock: | | |
| Assuming dilution: | | |
| Continuing operations | \$ 2.09 | \$ 2.44 |
| Discontinued operations | 0.00 | (0.09) |
| Total | \$ 2.09 | \$ 2.35 |
| Basic: | | |
| Continuing operations | \$ 2.09 | \$ 2.45 |
| Discontinued operations | 0.00 | (0.09) |
| Total | \$ 2.09 | \$ 2.36 |

Weighted-average number of common shares outstanding: (millions)

| | | |
|-------------------|-------|-------|
| Assuming dilution | 964.4 | 992.3 |
| Basic | 961.7 | 988.1 |

Cash dividend per common share \$ 1.30 \$ 1.10

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(UNAUDITED)**

| (Dollars in millions) | Three Months Ended | |
|--|---------------------------|-------------|
| | March 31, | |
| | 2016 | 2015 |
| Net income | \$ 2,014 | \$ 2,328 |
| Other comprehensive income/(loss), before tax: | | |
| Foreign currency translation adjustments | 239 | (452) |
| Net changes related to available-for-sale securities: | | |
| Unrealized gains/(losses) arising during the period | (36) | 32 |
| Reclassification of (gains)/losses to net income | 37 | 0 |
| Total net changes related to available-for-sale securities | 1 | 32 |
| Unrealized gains/(losses) on cash flow hedges: | | |
| Unrealized gains/(losses) arising during the period | (265) | 619 |
| Reclassification of (gains)/losses to net income | (91) | (249) |
| Total unrealized gains/(losses) on cash flow hedges | (356) | 370 |
| Retirement-related benefit plans: | | |
| Prior service costs/(credits) | — | 5 |
| Net (losses)/gains arising during the period | (147) | (77) |
| Curtailments and settlements | 5 | 4 |
| Amortization of prior service (credits)/costs | (25) | (26) |
| Amortization of net (gains)/losses | 690 | 835 |
| Total retirement-related benefit plans | 522 | 740 |
| Other comprehensive income/(loss), before tax | 406 | 690 |
| Income tax (expense)/benefit related to items of other comprehensive income | 202 | (657) |
| Other comprehensive income/(loss) | 608 | 33 |
| Total comprehensive income/(loss) | \$ 2,622 | \$ 2,361 |

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(UNAUDITED)**

ASSETS

| (Dollars in millions) | At March 31, 2016 | At December 31, 2015 |
|---|----------------------|-------------------------|
| Assets: | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 14,354 | \$ 7,686 |
| Marketable securities | 515 | 508 |
| Notes and accounts receivable - trade (net of allowances of \$336 | | |
| in 2016 and \$367 in 2015) | 8,527 | 8,333 |
| Short-term financing receivables (net of allowances of \$529 in 2016 | | |
| and \$490 in 2015) | 16,646 | 19,020 |
| Other accounts receivable (net of allowances of \$55 in 2016 and | | |
| \$51 in 2015) | 1,557 | 1,201 |
| Inventories, at lower of average cost or market: | | |
| Finished goods | 393 | 352 |
| Work in process and raw materials | 1,296 | 1,199 |
| Total inventories | 1,690 | 1,551 |
| Prepaid expenses and other current assets | 4,334 | 4,205 |
| Total current assets | 47,623 | 42,504 |
| Property, plant and equipment | 29,627 | 29,342 |
| Less: Accumulated depreciation | 18,717 | 18,615 |
| Property, plant and equipment — net | 10,910 | 10,727 |
| Long-term financing receivables (net of allowances of \$154 in 2016 and \$118 in 2015) | 9,266 | 10,013 |
| Prepaid pension assets | 2,332 | 1,734 |
| Deferred taxes | 4,809 | 4,822 |
| Goodwill | 34,322 | 32,021 |
| Intangible assets — net | 4,373 | 3,487 |
| Investments and sundry assets | 5,223 | 5,187 |
| Total assets | \$ 118,856 | \$ 110,495 |

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF FINANCIAL POSITION – (CONTINUED)
(UNAUDITED)**

LIABILITIES AND EQUITY

| (Dollars in millions) | At March 31, 2016 | At December 31, 2015 |
|--|----------------------|-------------------------|
| Liabilities: | | |
| Current liabilities: | | |
| Taxes | \$ 2,203 | \$ 2,847 |
| Short-term debt | 5,303 | 6,461 |
| Accounts payable | 5,302 | 6,028 |
| Compensation and benefits | 3,444 | 3,560 |
| Deferred income | 12,609 | 11,021 |
| Other accrued expenses and liabilities | 5,804 | 4,353 |
| Total current liabilities | 34,664 | 34,269 |
| Long-term debt | 40,254 | 33,428 |
| Retirement and nonpension postretirement benefit obligations | 16,939 | 16,504 |
| Deferred income | 3,662 | 3,771 |
| Other liabilities | 8,264 | 8,099 |
| Total liabilities | 103,784 | 96,071 |
| Equity: | | |
| IBM stockholders' equity: | | |
| Common stock, par value \$0.20 per share, and additional paid-in capital | 53,439 | 53,262 |
| Shares authorized: 4,687,500,000 | | |
| Shares issued: | 2016 - 2,222,272,532 | |
| | 2015 - 2,221,223,449 | |
| Retained earnings | 146,888 | 146,124 |
| Treasury stock - at cost | (156,404) | (155,518) |
| Shares: | 2016 - 1,262,310,680 | |
| | 2015 - 1,255,494,724 | |
| Accumulated other comprehensive income/(loss) | (28,998) | (29,607) |
| Total IBM stockholders' equity | 14,925 | 14,262 |
| Noncontrolling interests | 147 | 162 |
| Total equity | 15,072 | 14,424 |
| Total liabilities and equity | \$ 118,856 | \$ 110,495 |

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF CASH FLOWS
(UNAUDITED)**

| (Dollars in millions) | Three Months Ended March 31, | |
|---|---|-----------------|
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,014 | \$ 2,328 |
| Adjustments to reconcile net income to cash provided by operating activities | | |
| Depreciation | 677 | 670 |
| Amortization of intangibles | 347 | 298 |
| Stock-based compensation | 133 | 127 |
| Net (gain)/loss on asset sales and other | 172 | 352 |
| Changes in operating assets and liabilities, net of acquisitions/divestitures | 2,302 | (165) |
| Net cash provided by operating activities | 5,645 | 3,610 |
| Cash flows from investing activities: | | |
| Payments for property, plant and equipment | (956) | (857) |
| Proceeds from disposition of property, plant and equipment | 129 | 47 |
| Investment in software | (144) | (113) |
| Acquisition of businesses, net of cash acquired | (2,590) | (148) |
| Divestitures of businesses, net of cash transferred | 47 | 19 |
| Non-operating finance receivables — net | 1,358 | 1,615 |
| Purchases of marketable securities and other investments | (1,041) | (819) |
| Proceeds from disposition of marketable securities and other investments | 1,169 | 816 |
| Net cash (used in)/provided by investing activities | (2,028) | 560 |
| Cash flows from financing activities: | | |
| Proceeds from new debt | 8,085 | 2,290 |
| Payments to settle debt | (2,211) | (2,824) |
| Short-term borrowings/(repayments) less than 90 days — net | (910) | (776) |
| Common stock repurchases | (939) | (1,165) |
| Common stock transactions — other | 59 | 161 |
| Cash dividends paid | (1,250) | (1,088) |
| Net cash provided by/(used in) financing activities | 2,834 | (3,402) |
| Effect of exchange rate changes on cash and cash equivalents | 217 | (449) |
| Net change in cash and cash equivalents | 6,668 | 319 |
| Cash and cash equivalents at January 1 | 7,686 | 8,476 |
| Cash and cash equivalents at March 31 | \$ 14,354 | \$ 8,796 |

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(UNAUDITED)**

| | Common Stock and | | Accumulated | | | Non- Controlling Interests | Total Equity |
|---|----------------------------------|----------------------|-------------------|---|--------------------------------|----------------------------------|-----------------|
| | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Other Comprehensive Income/(Loss) | IBM Stockholders' Equity | | |
| (Dollars in millions) | | | | | | | |
| Equity - January 1, 2016 | \$ 53,262 | \$ 146,124 | \$ (155,518) | \$ (29,607) | \$ 14,262 | \$ 162 | \$ 14,424 |
| Net income plus other comprehensive income/(loss) | | | | | | | |
| Net income | | 2,014 | | | 2,014 | | 2,014 |
| Other comprehensive income/(loss) | | | | 608 | 608 | | 608 |
| Total comprehensive income/(loss) | | | | | \$ 2,622 | | \$ 2,622 |
| Cash dividends paid – common stock | | (1,250) | | | (1,250) | | (1,250) |
| Common stock issued under employee plans (1,049,083 shares) | 185 | | | | 185 | | 185 |
| Purchases (216,803 shares) and sales (40,129 shares) of treasury stock under employee plans – net | | | 0 | (22) | (22) | | (22) |
| Other treasury shares purchased, not retired (6,639,282 shares) | | | | (863) | (863) | | (863) |
| Changes in other equity | (9) | | | | (9) | | (9) |
| Changes in noncontrolling interests | | | | | | (14) | (14) |
| Equity - March 31, 2016 | \$ 53,439 | \$ 146,888 | \$ (156,404) | \$ (28,998) | \$ 14,925 | \$ 147 | \$ 15,072 |

| | Common Stock and | | Accumulated | | | Non- Controlling Interests | Total Equity |
|---|----------------------------------|----------------------|-------------------|---|--------------------------------|----------------------------------|-----------------|
| | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Other Comprehensive Income/(Loss) | IBM Stockholders' Equity | | |
| (Dollars in millions) | | | | | | | |
| Equity - January 1, 2015 | \$ 52,666 | \$ 137,793 | \$ (150,715) | \$ (27,875) | \$ 11,868 | \$ 146 | \$ 12,014 |
| Net income plus other comprehensive income/(loss) | | | | | | | |
| Net income | | 2,328 | | | 2,328 | | 2,328 |
| Other comprehensive income/(loss) | | | | 33 | 33 | | 33 |
| Total comprehensive income/(loss) | | | | | \$ 2,361 | | \$ 2,361 |
| Cash dividends paid – common stock | | (1,088) | | | (1,088) | | (1,088) |
| Common stock issued under | | | | | | | |

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| | | | | | |
|--|-----------|------------|--------------|-------------|-----------|
| employee plans (2,125,560 shares) | 259 | | | 259 | 259 |
| Purchases (363,779 shares) and sales (187,271 shares) of treasury stock under employee plans – net | | (3) | (33) | (35) | (35) |
| Other treasury shares purchased, not retired (7,738,744 shares) | | | (1,227) | (1,227) | (1,227) |
| Changes in other equity | 3 | | | 3 | 3 |
| Changes in noncontrolling interests | | | | | 3 |
| Equity - March 31, 2015 | \$ 52,928 | \$ 139,030 | \$ (151,975) | \$ (27,842) | \$ 12,141 |
| | | | | | \$ 148 |
| | | | | | \$ 12,289 |

(Amounts may not add due to rounding.)

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

Notes to Consolidated Financial Statements:

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

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amount of assets, liabilities, revenue, costs, expenses and other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management's best knowledge of current events, historical experience, actions that the company may undertake in the future and on various other assumptions that are believed to be reasonable under the circumstances. As a result, actual results may be different from these estimates. Refer to the company's 2015 Annual Report on pages 64 to 67 for a discussion of the company's critical accounting estimates.

In January 2016, the company made a number of changes to its organizational structure and management system. These changes impacted the company's reportable segments, but did not impact the company's Consolidated Financial Statements. Refer to note 6, "Segments," on pages 26 to 27 for additional information on the changes in reportable segments. The periods presented in this Form 10-Q are reported on a comparable basis. The company intends to file a revised 2015 Annual Report in a Form 8-K in the second quarter of 2016 to reclassify its historical segment information to reflect these changes.

In the first quarter 2016, the company classified certain properties, primarily office space, as held for sale. As a result of the company's reassessment of its real estate portfolio, certain properties were approved for sale and are being actively marketed. The sales are expected to be completed within twelve months. A pre-tax impairment charge of \$252 million was recorded to other income (expense) related to the applicable land, buildings and furniture and fixtures. The pre-tax charge reflected the difference between the net book value and the fair value (estimated proceeds) less the estimated costs to sell the properties. The fair value of these assets was not material at March 31, 2016.

In the first quarter of 2016, the company reported a benefit from income taxes of \$983 million, and its effective tax rate was (95.1) percent. This was primarily driven by the resolution of a long-standing non-U.S. tax matter in February 2016. See Taxes on pages 56 to 57 for additional information.

On October 20, 2014, the company announced a definitive agreement to divest its Microelectronics business and manufacturing operations to GLOBALFOUNDRIES. The assets and liabilities of the Microelectronics business were reported as held for sale at December 31, 2014, and the operating results of the Microelectronics business have been reported as discontinued operations. The transaction closed on July 1, 2015. Refer to note 9, "Acquisitions/Divestitures," for additional information on the transaction.

Noncontrolling interest amounts of \$1.3 million and \$1.2 million, net of tax, for the three months ended March 31, 2016 and 2015, respectively, are included in the Consolidated Statement of Earnings within the other (income) and expense line item.

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 2015 Annual Report.

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:

New Standards to be Implemented

In March 2016, the Financial Accounting Standards Board (FASB) issued guidance which changes the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification in the Consolidated Statement of Cash Flows. The guidance is effective January 1, 2017 and early adoption is permitted. The company is currently evaluating the impact of the new guidance.

Notes to Consolidated Financial Statements – (continued)

In February 2016, the FASB issued guidance which changes the accounting for leases. The guidance requires lessees to recognize right-of-use assets and lease liabilities for most leases in the Consolidated Statement of Financial Position. The guidance makes some changes to lessor accounting and aligns with the new revenue recognition guidance. The guidance also requires qualitative and quantitative disclosures to assess the amount, timing and uncertainty of cash flows arising from leases. The guidance is effective January 1, 2019 and early adoption is permitted. The company is currently evaluating the impact of the new guidance and the effective date. The company's operating lease commitments were \$6.4 billion at December 31, 2015.

In January 2016, the FASB issued guidance which addresses aspects of recognition, measurement, presentation and disclosure of financial instruments. Certain equity investments will be measured at fair value with changes recognized in net income. The amendment also simplifies the impairment test of equity investments that lack readily determinable fair value. The guidance is effective January 1, 2018 and early adoption is not permitted except for limited provisions. The guidance is not expected to have a material impact in the consolidated financial results.

The FASB issued guidance on the recognition of revenue from contracts with customers in May 2014 with amendments in 2015 and 2016. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the cumulative catch-up transition method). The guidance was initially effective January 1, 2017 and early adoption was not permitted. The amended guidance provides for a one-year deferral of the effective date to January 1, 2018, with an option of applying the standard on the original effective date. The company will adopt the guidance on January 1, 2018 and apply the cumulative catch-up transition method. The company is continuing to evaluate the impact of the new guidance in the consolidated financial results.

Standards Implemented

In November 2015, the FASB issued guidance which requires deferred tax liabilities and assets be classified as noncurrent in the statement of financial position. The guidance was effective January 1, 2016 with early adoption permitted. The company adopted the guidance in the fourth quarter of 2015 on a retrospective basis. The company reclassified current deferred tax assets of \$2.0 billion at December 31, 2014 to deferred tax assets and current deferred tax liabilities of \$19 million at December 31, 2014 to other liabilities from other accrued expenses and liabilities in the Consolidated Statement of Financial Position. In order to offset deferred tax assets and liabilities for presentation as a single noncurrent amount by tax jurisdiction, the company also reclassified \$178 million at December 31, 2014 from deferred tax assets to other liabilities in the Consolidated Statement of Financial Position.

In September 2015, the FASB issued guidance eliminating the requirement that an acquirer in a business combination account for a measurement-period adjustment retrospectively. Instead, an acquirer will recognize a measurement-period adjustment during the period in which the amount of the adjustment is determined. In addition, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date should be presented separately on the face of the income statement or disclosed in the notes. The guidance was effective January 1, 2016 on a prospective basis. The guidance did not have a material impact in the consolidated financial results.

In May 2015, the FASB issued guidance which removed the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also removed the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The guidance was effective January 1, 2016. The guidance was a change in disclosure only and did not have an impact in the consolidated financial results.

In April 2015, the FASB issued guidance about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a services contract. All software licenses recognized under this guidance will be accounted for consistent with other licenses of intangible assets. The guidance was effective January 1, 2016 and the company adopted it on a prospective basis. The guidance did not have a material impact in the consolidated financial results.

Notes to Consolidated Financial Statements – (continued)

In April 2015, the FASB issued guidance which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The guidance was effective January 1, 2016 with early adoption permitted. The company adopted the guidance in the fourth quarter of 2015 on a retrospective basis. The company had debt issuance costs of \$95 million and \$74 million at March 31, 2016 and December 31, 2015, respectively. Debt issuance costs were previously included in investments and sundry assets in the Consolidated Statement of Financial Position.

3. Financial Instruments:

Fair Value Measurements

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

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

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

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

The determination of fair value considers various factors including interest rate yield curves and time value underlying the financial instruments. For derivatives and debt securities, the company uses a discounted cash flow

analysis using discount rates commensurate with the duration of the instrument.

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

- Counterparty credit risk adjustments are applied to financial instruments, taking into account the actual credit risk of a counterparty as observed in the credit default swap market to determine the true fair value of such an instrument.
- Credit risk adjustments are applied to reflect the company’s own credit risk when valuing all liabilities measured at fair value. The methodology is consistent with that applied in developing counterparty credit risk adjustments, but incorporates the company’s own credit risk as observed in the credit default swap market.

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

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

Non-financial assets such as property, plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. During the three months ended March 31, 2016, the company recorded an impairment on certain

Notes to Consolidated Financial Statements – (continued)

assets that are classified as held for sale. See note 1, “Basis of Presentation,” for additional information. There were no material impairments of non-financial assets for the three months ended March 31, 2015.

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

The following tables present the company’s financial assets and financial liabilities that are measured at fair value on a recurring basis at March 31, 2016 and December 31, 2015.

(Dollars in millions)**At March 31, 2016**

| | Level 1 | Level 2 | Level 3 | Total |
|---|-----------------|-----------------|----------------|---------------------|
| Assets: | | | | |
| Cash equivalents (1) | | | | |
| Time deposits and certificates of deposit | \$ | —\$ 5,784 | \$ | —\$ 5,784 |
| Commercial paper | | — 325 | | — 325 |
| Money market funds | 3,076 | — | | 3,076 |
| U.S. government securities | | — 1,300 | | — 1,300 |
| Canadian government securities | | — 463 | | — 463 |
| Other securities | | — 162 | | — 162 |
| Total | 3,076 | 8,034 | | 11,109(6) |
| Debt securities - current (2) | | — 514 | | — 514(6) |
| Debt securities - noncurrent (3) | 1 | 7 | | 8 |
| Available-for-sale equity investments (3) | 9 | — | | 9 |
| Derivative assets (4) | | | | |
| Interest rate contracts | | — 876 | | — 876 |
| Foreign exchange contracts | | — 206 | | — 206 |
| Equity contracts | | — 48 | | — 48 |
| Total | | — 1,129 | | — 1,129(7) |
| Total assets | \$ 3,086 | \$ 9,685 | \$ — | \$ 12,770(7) |
| Liabilities: | | | | |
| Derivative liabilities (5) | | | | |
| Foreign exchange contracts | \$ | —\$ 460 | \$ | —\$ 460 |
| Equity contracts | | — 1 | | — 1 |
| Interest rate contracts | | — 0 | | — 0 |
| Total liabilities | \$ — | \$ 461 | \$ — | \$ 461(7) |

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

(2) U.S. government securities, time deposits 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 March 31, 2016 were \$165 million and \$964 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 March 31, 2016 were \$443 million and \$18 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 each would have been reduced by \$270 million.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)

At December 31, 2015

| | Level 1 | Level 2 | Level 3 | Total |
|---|----------|----------|---------|----------|
| Assets: | | | | |
| Cash equivalents (1) | | | | |
| Time deposits and certificates of deposit | \$ — | 2,856 | \$ — | 2,856 |
| Money market funds | 2,069 | — | — | 2,069 |
| Other securities | — | 18 | — | 18 |
| Total | 2,069 | 2,874 | — | 4,943(6) |
| Debt securities - current (2) | — | 506 | — | 506(6) |
| Debt securities - noncurrent (3) | 1 | 6 | — | 8 |
| Trading security investments (3) | 28 | — | — | 28 |
| Available-for-sale equity investments (3) | 192 | — | — | 192 |
| Derivative assets (4) | | | | |
| Interest rate contracts | — | 656 | — | 656 |
| Foreign exchange contracts | — | 332 | — | 332 |
| Equity contracts | — | 6 | — | 6 |
| Total | — | 994 | — | 994(7) |
| Total assets | \$ 2,290 | \$ 4,381 | \$ — | 6,671(7) |
| Liabilities: | | | | |
| Derivative liabilities (5) | | | | |
| Foreign exchange contracts | \$ — | 164 | \$ — | 164 |
| Equity contracts | — | 19 | — | 19 |
| Interest rate contracts | — | 3 | — | 3 |
| Total liabilities | \$ — | 186 | \$ — | 186(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, 2015 were \$292 million and

\$702 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, 2015 were \$164 million and \$22 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 each would have been reduced by \$139 million.

There were no transfers between Levels 1 and 2 for the three months ended March 31, 2016 and the year ended December 31, 2015.

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 March 31, 2016 and December 31, 2015, 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 \$40,254 million and \$33,428 million, and the estimated fair value was \$42,980 million and \$35,220 million at March 31, 2016 and December 31, 2015, 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 considered available-for-sale and recorded at fair value in the Consolidated Statement of Financial Position.

| (Dollars in millions) At March 31, 2016: | Adjusted Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|------------------|------------------------------|-------------------------------|---------------|
| Debt securities – noncurrent(1) | \$ 5 | \$ 3 | \$ — | \$ 8 |
| Available-for-sale equity investments(1) | \$ 1 | \$ 8 | \$ 0 | \$ 9 |

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

| (Dollars in millions) At December 31, 2015: | Adjusted Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|------------------|------------------------------|-------------------------------|---------------|
| Debt securities – noncurrent(1) | \$ 5 | \$ 3 | \$ — | \$ 8 |
| Available-for-sale equity investments(1) | \$ 186 | \$ 6 | \$ 0 | \$ 192 |

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

During the fourth quarter of 2014, the company acquired equity securities in conjunction with the sale of the System x business which were classified as available-for-sale securities. Based on an evaluation of available evidence as of December 31, 2015, the company recorded an other-than-temporary impairment loss of \$86 million resulting in an adjusted cost basis of \$185 million as of December 31, 2015. In the first quarter of 2016, the company recorded a gross realized loss of \$37 million (before taxes) related to the sale of all the outstanding shares. The loss on this sale was recorded in other (income) and expense in the Consolidated Statement of Earnings.

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

(Dollars in millions)

For the three months ended March 31:

| | 2016 | | 2015 |
|--------------------------------------|-------------|----|-------------|
| Proceeds | \$ 148 | \$ | 4 |
| Gross realized gains (before taxes) | — | | 0 |
| Gross realized losses (before taxes) | 37 | | 0 |

Notes to Consolidated Financial Statements – (continued)

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

(Dollars in millions)

For the three months ended March 31:

| | | 2016 | | 2015 |
|---|----|-------------|----|-------------|
| Net unrealized gains/(losses) arising during the period | \$ | (22) | \$ | 20 |
| Net unrealized (gains)/losses reclassified to net income* | | 23 | | 0 |

* There were no writedowns for the three months ended March 31, 2016 and 2015, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at March 31, 2016.

Derivative Financial Instruments

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

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

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

derivative instruments under these collateralized arrangements that were in a liability position at March 31, 2016 and December 31, 2015 was \$166 million and \$28 million, respectively, for which no collateral was posted at March 31, 2016 and December 31, 2015. 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 asset positions as of March 31, 2016 and December 31, 2015 was \$1,129 million and \$994 million, respectively. This amount represents the maximum exposure to loss at the reporting date if the counterparties failed to perform as contracted. This exposure was reduced by \$270 million and \$139 million at March 31, 2016 and December 31, 2015, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at March 31, 2016 and December 31, 2015, this exposure was reduced by \$131 million and \$90 million of cash collateral, and \$71 million and \$40 million of non-cash collateral in U.S. Treasury securities, respectively, received by the company. At March 31, 2016 and December 31, 2015, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was \$657 million and \$726 million, respectively. At March 31, 2016 and December 31, 2015, the net exposure related to derivative liabilities recorded in the Consolidated Statement of Financial Position was \$191 million and \$47 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 March 31, 2016 or December 31, 2015 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral was \$131 million and \$90 million at March 31, 2016 and December 31, 2015, respectively. The company restricts the use of cash collateral received to rehypothecation, and therefore reports it in prepaid

Notes to Consolidated Financial Statements – (continued)

expenses and other current assets in the Consolidated Statement of Financial Position. No amount was rehypothecated at March 31, 2016 and December 31, 2015.

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

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

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

Interest Rate Risk

Fixed and Variable Rate Borrowings

The company issues debt in the global capital markets to fund its operations and financing business. 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 March 31, 2016 and December 31, 2015, the total notional amount of the company's interest rate swaps was \$7.3 billion at both periods. The weighted-average remaining maturity of these instruments at March 31, 2016 and December 31, 2015 was approximately 7.0 years and 7.2 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 March 31, 2016 and December 31, 2015.

At March 31, 2016 and December 31, 2015, net gains of less than \$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, less than \$1 million of gains, 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 March 31, 2016 and December 31, 2015, the total notional amount of derivative instruments designated as net investment hedges was \$6.6 billion and \$5.5 billion, respectively. The weighted-average remaining maturity of these instruments at March 31, 2016 and December 31, 2015 was approximately 0.2 years for both periods.

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

Notes to Consolidated Financial Statements – (continued)

for as cash flow hedges. The maximum length of time over which the company has hedged its exposure to the variability in future cash flows is four years. At March 31, 2016 and December 31, 2015, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$8.2 billion for both periods. The weighted-average remaining maturity of these instruments at March 31, 2016 and December 31, 2015 was 0.7 years for both periods.

At March 31, 2016 and December 31, 2015, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of \$193 million and net gains of \$147 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$232 million of losses and \$121 million of gains, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

Foreign Currency Denominated Borrowings

The company is exposed to exchange rate volatility on foreign currency denominated debt. To manage this risk, the company employs cross-currency swaps to convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. The maximum length of time over which the company has hedged its exposure to the variability in future cash flows is approximately nine years. At March 31, 2016 the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was \$1.4 billion. At December 31, 2015, no amounts were outstanding under this program.

At March 31, 2016 and December 31, 2015, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of \$18 million and net losses of \$2 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$19 million of gains and less than \$1 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 exposure.

Subsidiary Cash and Foreign Currency Asset/Liability Management

The company uses its Global Treasury Centers to manage the cash of its subsidiaries. These centers principally use currency swaps to convert cash flows in a cost-effective manner. In addition, the company uses foreign exchange forward contracts to economically hedge, on a net basis, the foreign currency exposure of a portion of the company's nonfunctional currency assets and liabilities. The terms of these forward and swap contracts are generally less than one year. The changes in the fair values of these contracts and of the underlying hedged exposures are generally offsetting and are recorded in other (income) and expense in the Consolidated Statement of Earnings. At March 31, 2016 and December 31, 2015, the total notional amount of derivative instruments in economic hedges of foreign

currency exposure was \$9.7 billion and \$11.7 billion, respectively.

Equity Risk Management

The company is exposed to market price changes in certain broad market indices and in the company's own stock primarily related to certain obligations to employees. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company's common stock, and are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At March 31, 2016 and December 31, 2015, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.1 billion and \$1.2 billion, respectively.

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 March 31, 2016 and December 31, 2015.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company may utilize credit default swaps to economically hedge its credit exposures. The swaps are recorded at fair value with gains

Notes to Consolidated Financial Statements – (continued)

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 March 31, 2016 and December 31, 2015.

The company is exposed to market volatility on certain investment securities. The company may utilize options or forwards to economically hedge its market exposure. The derivatives are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. At March 31, 2016 the company did not have any derivative instruments relating to this program outstanding. At December 31, 2015 the total notional amount of derivative instruments in economic hedges of investment securities was less than \$0.1 billion.

The following tables provide a quantitative summary of the derivative and non-derivative instrument-related risk management activity as of March 31, 2016 and December 31, 2015, as well as for the three months ended March 31, 2016 and 2015, respectively.

Notes to Consolidated Financial Statements – (continued)

Fair Values of Derivative Instruments in the Consolidated Statement of Financial Position
As of March 31, 2016 and December 31, 2015

| (Dollars in millions) | Fair Value of Derivative Assets | | Fair Value of Derivative Liabilities | | |
|--|---|-----------------|--------------------------------------|---|-----------------|
| | Balance Sheet | | Balance Sheet | | |
| | Classification | 3/31/2016 | 12/31/2015 | 3/31/2016 | 12/31/2015 |
| Designated as hedging instruments: | | | | | |
| Interest rate contracts: | | | | | |
| | Prepaid expenses and other current assets | \$ | — | Other accrued expenses and liabilities | \$ |
| | Investments and sundry assets | 876 | 656 | Other liabilities | — |
| Foreign exchange contracts: | | | | | |
| | Prepaid expenses and other current assets | 37 | 197 | Other accrued expenses and liabilities | 363 |
| | Investments and sundry assets | 47 | 5 | Other liabilities | 11 |
| Fair value of derivative assets | | \$ 960 | \$ 858 | Fair value of derivative liabilities | \$ 374 |
| Not designated as hedging instruments: | | | | | |
| Foreign exchange contracts: | | | | | |
| | Prepaid expenses and other current assets | \$ | 81 | Other accrued expenses and liabilities | \$ |
| | Investments and sundry assets | 41 | 40 | Other liabilities | 7 |
| Equity contracts: | | | | | |
| | Prepaid expenses and other current assets | 48 | 6 | Other accrued expenses and liabilities | 1 |
| | Investments and sundry assets | — | — | Other liabilities | — |
| Fair value of derivative assets | | \$ 170 | \$ 136 | Fair value of derivative liabilities | \$ 87 |
| Total debt designated as hedging instruments: | | | | | |
| Short-term debt | | N/A | N/A | | \$ 386 |
| Long-term debt | | N/A | N/A | | \$ 8,947 |
| Total | | \$ 1,129 | \$ 994 | | \$ 9,794 |

N/A-not applicable

Notes to Consolidated Financial Statements – (continued)

**The Effect of Derivative Instruments in the Consolidated Statement of Earnings
For the three months ended March 31, 2016 and 2015**

| (Dollars in millions) | Gain (Loss) Recognized in Earnings | | | | |
|---|--|---------------------------------|--------|---|----------|
| | Consolidated Statement of Earnings Line Item | Recognized on Derivatives(1) | | Attributable to Risk Being Hedged(2) | |
| | | 2016 | 2015 | 2016 | 2015 |
| For the three months ended March 31: | | | | | |
| Derivative instruments in fair value hedges(5): | | | | | |
| Interest rate contracts | Cost of financing | \$ 137 | \$ 97 | \$ (112) | \$ (66) |
| | Interest expense | 147 | 74 | (120) | (51) |
| Derivative instruments not designated as hedging instruments(1): | | | | | |
| Foreign exchange contracts | Other (income) and expense | 121 | 17 | N/A | N/A |
| Interest rate contracts | Other (income) and expense | 0 | (1) | N/A | N/A |
| Equity contracts | SG&A expense | 21 | 24 | N/A | N/A |
| | Other (income) and expense | (1) | 0 | N/A | N/A |
| Total | | \$ 426 | \$ 211 | \$ (233) | \$ (118) |

| (Dollars in millions) | Gain (Loss) Recognized in Earnings and Other Comprehensive Income (Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3) | | | | | | |
|--|---|------|--|--|------|------|------|
| | Effective Portion Recognized in OCI | | Consolidated Statement of Earnings Line Item | Effective Portion Reclassified from AOCI | | | |
| | 2016 | 2015 | | 2016 | 2015 | | |
| For the three months ended March 31: | | | | | | | |
| Derivative instruments in cash flow hedges: | | | | | | | |
| Interest rate contracts | \$ — | \$ — | —Interest expense | \$ (2) | \$ 0 | \$ — | \$ — |
| Foreign exchange contracts | (265) | 619 | Other (income) and expense | 87 | 160 | 1 | 0 |
| | | | Cost of sales | 3 | 50 | — | — |
| | | | SG&A expense | 3 | 40 | — | — |
| Instruments in net investment hedges(4): | | | | | | | |
| Foreign exchange contracts | (693) | 694 | Interest expense | — | — | 10 | 0 |

| | | | | | | | | | | | | |
|-------|----|-------|----|-------|----|----|----|-----|----|----|----|---|
| Total | \$ | (959) | \$ | 1,313 | \$ | 91 | \$ | 249 | \$ | 11 | \$ | 1 |
|-------|----|-------|----|-------|----|----|----|-----|----|----|----|---|

N/A-not applicable

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

- (1) The amount includes changes in clean fair values of the derivative instruments in fair value hedging relationships and the periodic accrual for coupon payments required under these derivative contracts.
- (2) The amount includes basis adjustments to the carrying value of the hedged item recorded during the period and amortization of basis adjustments recorded on de-designated hedging relationships during the period.
- (3) The amount of gain/(loss) recognized in income represents ineffectiveness on hedge relationships.
- (4) Instruments in net investment hedges include derivative and non-derivative instruments.
- (5) For the three month periods ended March 31, 2016 and March 31, 2015, fair value hedges resulted in gains of \$2 million in ineffectiveness for both periods.

Notes to Consolidated Financial Statements – (continued)

For the three months ending March 31, 2016 and 2015, 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.

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

| (Dollars in millions) | | At March 31, 2016 | | At December 31, 2015 |
|--|----|------------------------------|----|---------------------------------|
| <u>Current:</u> | | | | |
| Net investment in sales-type and direct financing leases | \$ | 3,145 | \$ | 3,057 |
| Commercial financing receivables | | 6,906 | | 8,948 |
| Client loan and installment payment receivables (loans) | | 6,596 | | 7,015 |
| Total | \$ | 16,646 | \$ | 19,020 |
| <u>Noncurrent:</u> | | | | |
| Net investment in sales-type and direct financing leases | \$ | 4,350 | \$ | 4,501 |
| Client loan and installment payment receivables (loans) | | 4,915 | | 5,512 |
| Total | \$ | 9,266 | \$ | 10,013 |

Net investment in sales-type and direct financing leases relates principally to the company's systems products and are for terms ranging generally from two to six years. Net investment in sales-type and direct financing leases includes unguaranteed residual values of \$627 million and \$645 million at March 31, 2016 and December 31, 2015, respectively, and is reflected net of unearned income of \$588 million and \$536 million, and net of allowance for credit losses of \$246 million and \$213 million at those dates, respectively.

Commercial financing receivables, net of allowance for credit losses of \$14 million and \$19 million at March 31, 2016 and December 31, 2015, respectively, relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and OEM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan and installment payment receivables (loans), net of allowance for credit losses of \$420 million and \$377 million at March 31, 2016 and December 31, 2015, respectively, are loans that are provided primarily to clients to finance the purchase of hardware, software and services. Payment terms on these financing arrangements are generally for terms up to seven years.

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

The company utilizes certain of its financing receivables as collateral for nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were \$600 million and \$545 million at March 31, 2016 and December 31, 2015, respectively.

The company did not have any financing receivables held for sale as of March 31, 2016 and December 31, 2015.

Financing Receivables by Portfolio Segment

The following tables present financing receivables on a gross basis, excluding the allowance for credit losses and residual value, by portfolio segment and by class, excluding commercial financing receivables and other miscellaneous financing receivables at March 31, 2016 and December 31, 2015. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further segments the portfolio into two classes: major markets and growth markets.

Notes to Consolidated Financial Statements – (continued)

| (Dollars in millions) At March 31, 2016 | Major Markets | Growth Markets | Total |
|--|------------------|-------------------|-----------|
| Financing receivables: | | | |
| Lease receivables | \$ 5,461 | \$ 1,566 | \$ 7,027 |
| Loan receivables | 9,034 | 2,897 | 11,931 |
| Ending balance | \$ 14,495 | \$ 4,463 | \$ 18,959 |
| Collectively evaluated for impairment | \$ 14,404 | \$ 4,005 | \$ 18,409 |
| Individually evaluated for impairment | \$ 92 | \$ 458 | \$ 550 |
| <u>Allowance for credit losses:</u> | | | |
| Beginning balance at January 1, 2016 | | | |
| Lease receivables | \$ 25 | \$ 188 | \$ 213 |
| Loan receivables | 83 | 293 | 377 |
| Total | \$ 109 | \$ 481 | \$ 590 |
| Write-offs | (1) | (17) | (19) |
| Provision | 6 | 74 | 80 |
| Other | 4 | 10 | 14 |
| Ending balance at March 31, 2016 | \$ 118 | \$ 548 | \$ 666 |
| Lease receivables | \$ 32 | \$ 214 | \$ 246 |
| Loan receivables | \$ 86 | \$ 334 | \$ 420 |
| Collectively evaluated for impairment | \$ 39 | \$ 105 | \$ 144 |
| Individually evaluated for impairment | \$ 79 | \$ 443 | \$ 522 |

| (Dollars in millions) At December 31, 2015 | Major Markets | Growth Markets | Total |
|---|------------------|-------------------|-----------|
| Financing receivables: | | | |
| Lease receivables | \$ 5,517 | \$ 1,524 | \$ 7,041 |
| Loan receivables | 9,739 | 3,165 | 12,904 |
| Ending balance | \$ 15,256 | \$ 4,689 | \$ 19,945 |
| Collectively evaluated for impairment | \$ 15,180 | \$ 4,227 | \$ 19,406 |
| Individually evaluated for impairment | \$ 76 | \$ 462 | \$ 539 |
| <u>Allowance for credit losses:</u> | | | |
| Beginning balance at January 1, 2015 | | | |
| Lease receivables | \$ 32 | \$ 133 | \$ 165 |
| Loan receivables | 79 | 317 | 396 |
| Total | \$ 111 | \$ 450 | \$ 561 |
| Write-offs | (14) | (48) | (62) |
| Provision | 20 | 122 | 141 |
| Other | (8) | (43) | (51) |
| Ending balance at December 31, 2015 | \$ 109 | \$ 481 | \$ 590 |
| Lease receivables | \$ 25 | \$ 188 | \$ 213 |
| Loan receivables | \$ 83 | \$ 293 | \$ 377 |
| Collectively evaluated for impairment | \$ 43 | \$ 36 | \$ 79 |
| Individually evaluated for impairment | \$ 65 | \$ 445 | \$ 511 |

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

Financing Receivables on Non-Accrual Status

The following table presents the recorded investment in financing receivables which were on non-accrual status at March 31, 2016 and December 31, 2015.

Notes to Consolidated Financial Statements – (continued)

| (Dollars in millions) | At March 31, 2016 | | At December 31, 2015 | |
|-------------------------|----------------------|-----|----------------------------|-----|
| Major markets | \$ | 2 | \$ | 2 |
| Growth markets | | 49 | | 63 |
| Total lease receivables | \$ | 52 | \$ | 65 |
| Major markets | \$ | 15 | \$ | 13 |
| Growth markets | | 107 | | 91 |
| Total loan receivables | \$ | 123 | \$ | 104 |
| Total receivables | \$ | 174 | \$ | 168 |

Impaired Loans

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

The following tables present impaired client loan receivables.

| (Dollars in millions) | At March 31, 2016 | | At December 31, 2015 | |
|-----------------------|------------------------|----------------------|------------------------|----------------------|
| | Recorded Investment | Related Allowance | Recorded Investment | Related Allowance |
| Major markets | \$ 66 | \$ 63 | \$ 50 | \$ 47 |
| Growth markets | 296 | 281 | 297 | 284 |
| Total | \$ 362 | \$ 343 | \$ 347 | \$ 331 |

| (Dollars in millions) For the three months ended March 31, 2016: | Average | Interest | Interest Income Recognized on Cash Basis | |
|---|------------------------|----------------------|--|---|
| | Recorded Investment | Income Recognized | | |
| Major markets | \$ 58 | \$ 0 | \$ | — |
| Growth markets | 296 | 0 | \$ | — |
| Total | \$ 354 | \$ 0 | \$ | — |

| Average | Interest | Interest Income | |
|---------|----------|--------------------|--|
|---------|----------|--------------------|--|

| (Dollars in millions) | | | | | |
|---|-------------------|------|-------------------|----|-------------------|
| For the three months ended March 31, 2015: | Recorded | | Income | | Recognized |
| | Investment | | Recognized | | on |
| | | | | | Cash Basis |
| Major markets | \$ 52 | \$ 0 | \$ 0 | \$ | — |
| Growth markets | 315 | 0 | 0 | \$ | — |
| Total | \$ 367 | \$ 0 | \$ 0 | \$ | — |

Credit Quality Indicators

The company's credit quality indicators, which are based on rating agency data, publicly available information and information provided by customers, are reviewed periodically based on the relative level of risk. The resulting indicators are a numerical rating system that maps to Moody's Investors Service credit ratings as shown below. The company uses information provided by Moody's, where available, as one of many inputs in its determination of customer credit ratings.

The following tables present the gross recorded investment for each class of receivables, by credit quality indicator, at March 31, 2016 and December 31, 2015. Receivables with a credit quality indicator ranging from Aaa to Baa3 are considered investment grade. All others are considered non-investment grade. The credit quality indicators do not reflect mitigation actions that the company takes to transfer credit risk to third parties.

Notes to Consolidated Financial Statements – (continued)

| (Dollars in millions) At March 31, 2016: | Lease Receivables | | Loan Receivables | |
|---|-------------------|----------------|------------------|----------------|
| | Major Markets | Growth Markets | Major Markets | Growth Markets |
| Credit Rating: | | | | |
| Aaa – Aa3 | \$ 514 | \$ 40 | \$ 850 | \$ 73 |
| A1 – A3 | 1,230 | 138 | 2,035 | 254 |
| Baa1 – Baa3 | 1,506 | 246 | 2,491 | 455 |
| Ba1 – Ba2 | 1,240 | 385 | 2,051 | 712 |
| Ba3 – B1 | 543 | 414 | 899 | 765 |
| B2 – B3 | 391 | 245 | 648 | 454 |
| Caa – D | 37 | 99 | 61 | 183 |
| Total | \$ 5,461 | \$ 1,566 | \$ 9,034 | \$ 2,897 |

At March 31, 2016, the industries which made up Global Financing's receivables portfolio consisted of: Financial (35 percent), Government (14 percent), Manufacturing (14 percent), Services (10 percent), Retail (8 percent), Communications (7 percent), Healthcare (7 percent) and Other (6 percent).

| (Dollars in millions) At December 31, 2015: | Lease Receivables | | Loan Receivables | |
|--|-------------------|----------------|------------------|----------------|
| | Major Markets | Growth Markets | Major Markets | Growth Markets |
| Credit Rating: | | | | |
| Aaa – Aa3 | \$ 538 | \$ 39 | \$ 949 | \$ 80 |
| A1 – A3 | 1,324 | 162 | 2,338 | 336 |
| Baa1 – Baa3 | 1,493 | 392 | 2,635 | 813 |
| Ba1 – Ba2 | 1,214 | 352 | 2,143 | 732 |
| Ba3 – B1 | 513 | 277 | 905 | 576 |
| B2 – B3 | 403 | 215 | 711 | 447 |
| Caa – D | 33 | 87 | 59 | 181 |
| Total | \$ 5,517 | \$ 1,524 | \$ 9,739 | \$ 3,165 |

At December 31, 2015, the industries which made up Global Financing's receivables portfolio consisted of: Financial (36 percent), Manufacturing (14 percent), Government (11 percent), Services (11 percent), Retail (9 percent), Communications (7 percent), Healthcare (6 percent) and Other (6 percent).

Notes to Consolidated Financial Statements – (continued)

Past Due Financing Receivables

| (Dollars in millions) | Total | Fully Reserved | <90 Days or Unbilled | Total | Recorded Investment > 90 Days and Accruing |
|---------------------------|------------------------|-----------------------|-----------------------|-----------------------|--|
| | Past Due > 90 days (1) | Financing Receivables | Financing Receivables | Financing Receivables | (2) |
| At March 31, 2016: | | | | | |
| Major markets | \$ 7 | \$ 33 | \$ 5,420 | \$ 5,461 | \$ 128 |
| Growth markets | 26 | 182 | 1,358 | 1,566 | 64 |
| Total lease receivables | \$ 33 | \$ 215 | \$ 6,779 | \$ 7,027 | \$ 192 |
| Major markets | \$ 10 | \$ 36 | \$ 8,989 | \$ 9,034 | \$ 150 |
| Growth markets | 33 | 279 | 2,585 | 2,897 | 74 |
| Total loan receivables | \$ 42 | \$ 315 | \$ 11,574 | \$ 11,931 | \$ 224 |
| Total | \$ 76 | \$ 530 | \$ 18,353 | \$ 18,959 | \$ 416 |

(1) Only the portion of a financing receivable which is greater than 90 days past due, excluding amounts that are fully reserved.

(2) At a contract level, which includes total billed and unbilled amounts for aged financing receivables greater than 90 days.

| (Dollars in millions) | Total | Fully Reserved | <90 Days or Unbilled | Total | Recorded Investment > 90 Days and Accruing |
|-------------------------------|------------------------|-----------------------|-----------------------|-----------------------|--|
| | Past Due > 90 days (1) | Financing Receivables | Financing Receivables | Financing Receivables | (2) |
| At December 31, 2015*: | | | | | |
| Major markets | \$ 5 | \$ 33 | \$ 5,479 | \$ 5,517 | \$ 108 |
| Growth markets | 30 | 140 | 1,355 | 1,524 | 60 |
| Total lease receivables | \$ 35 | \$ 173 | \$ 6,834 | \$ 7,041 | \$ 168 |
| Major markets | \$ 7 | \$ 35 | \$ 9,696 | \$ 9,739 | \$ 134 |
| Growth markets | 31 | 309 | 2,825 | 3,165 | 86 |
| Total loan receivables | \$ 38 | \$ 344 | \$ 12,521 | \$ 12,904 | \$ 220 |
| Total | \$ 73 | \$ 517 | \$ 19,355 | \$ 19,945 | \$ 388 |

(1) Only the portion of a financing receivable which is greater than 90 days past due, excluding amounts that are fully reserved.

(2) At a contract level, which includes total billed and unbilled amounts for aged financing receivables greater than 90 days.

* Reclassified to conform with 2016 presentation.

Troubled Debt Restructurings

The company did not have any troubled debt restructurings during the three months ended March 31, 2016 and for the year ended December 31, 2015.

Notes to Consolidated Financial Statements – (continued)

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

(Dollars in millions)

| For the three months ended March 31: | 2016 | | 2015 | |
|---|-------------|------|-------------|------|
| Cost | \$ | 21 | \$ | 27 |
| Selling, general and administrative | | 99 | | 87 |
| Research, development and engineering | | 13 | | 14 |
| Other (income) and expense* | | — | | (1) |
| Pre-tax stock-based compensation cost | | 133 | | 127 |
| Income tax benefits | | (43) | | (42) |
| Total net stock-based compensation cost | \$ | 90 | \$ | 85 |

* Reflects the one-time effects related to divestitures.

Pre-tax stock-based compensation cost for the three months ended March 31, 2016 increased \$6 million compared to the corresponding period in the prior year. This was due to increases related to performance share units (\$12 million), conversion of stock-based awards previously issued by acquired entities (\$3 million) and stock options (\$1 million), partially offset by decreases related to restricted stock units (\$10 million).

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

As of March 31, 2016, the total unrecognized compensation cost of \$777 million related to non-vested awards was expected to be recognized over a weighted-average period of approximately 2.6 years.

There was no significant capitalized stock-based compensation cost at March 31, 2016 and 2015.

6. Segments: The table on page 27 reflects the results of continuing operations of the company's segments consistent with the management and measurement system utilized within the company. Performance measurement is based on operating pre-tax income from continuing operations. These results are used, in part, by the chief operating decision maker, both in evaluating the performance of, and in allocating resources to, each of the segments.

In January 2016, the company made a number of changes to its organizational structure and management system consistent with its ongoing transformation to a cognitive solutions and cloud platform business. With these changes,

the company has revised its reportable segments. The company continues to have five reportable segments as follows:

The Cognitive Solutions segment includes solutions units that address many of the company's strategic areas, including analytics, commerce and security, several of the new initiatives around Watson, Watson Health, Watson Internet of Things and Transaction Processing software. The Technology Services & Cloud Platforms segment includes the company's cloud infrastructure and platform capabilities, the Global Technology Services business and Integration software. Operating systems software has been aligned with the underlying hardware platforms in the Systems segment. The Global Business Services and Global Financing segments remain unchanged.

The company also realigned a portion of its software support revenue, which was previously managed and reported in Integrated Technology Services within Global Technology Services, to the underlying software product areas.

The following tables reflect these reclassifications for the prior-year period.

Notes to Consolidated Financial Statements – (continued)

SEGMENT INFORMATION

| (Dollars in millions) For the three months ended March 31, 2016: | Cognitive Solutions & Industry Services | | Technology Services & Cloud Platforms | | Systems | Global Financing | Total Segments |
|--|--|--------------------------------|---|----------|----------|---------------------|-------------------|
| | Cognitive Solutions | Global Business Services | | | | | |
| External revenue | \$ 3,979 | \$ 4,131 | \$ 8,424 | \$ 1,675 | \$ 410 | \$ 18,619 | |
| Internal revenue | 668 | 113 | 165 | 212 | 486 | 1,645 | |
| Total revenue | \$ 4,647 | \$ 4,245 | \$ 8,589 | \$ 1,888 | \$ 896 | \$ 20,264 | |
| Pre-tax income/(loss) from continuing operations | \$ 1,013 | \$ 190 | \$ 258 | \$ (10) | \$ 386 | \$ 1,837 | |
| Revenue year-to-year change | (0.8)% | (4.6)% | (1.5)% | (18.4)% | (14.5)% | (4.5)% | |
| Pre-tax income year-to-year change | (33.7)% | (67.7)% | (77.2)% | nm | (25.0)% | (54.3)% | |
| Pre-tax income margin | 21.8% | 4.5% | 3.0% | (0.5)% | 43.1% | 9.1% | |
| For the three months ended March 31, 2015*: | | | | | | | |
| External revenue | \$ 4,047 | \$ 4,318 | \$ 8,554 | \$ 2,142 | \$ 461 | \$ 19,523 | |
| Internal revenue | 635 | 131 | 166 | 173 | 586 | 1,690 | |
| Total revenue | \$ 4,682 | \$ 4,449 | \$ 8,720 | \$ 2,314 | \$ 1,048 | \$ 21,213 | |
| Pre-tax income from continuing operations | \$ 1,528 | \$ 588 | \$ 1,131 | \$ 261 | \$ 515 | \$ 4,023 | |
| Pre-tax income margin | 32.6% | 13.2% | 13.0% | 11.3% | 49.2% | 19.0% | |

* Reclassified to conform with 2016 presentation.
nm - not meaningful

Reconciliations to IBM as Reported:

| (Dollars in millions) For the three months ended March 31: | 2016 | 2015* |
|---|-----------|-----------|
| Revenue: | | |
| Total reportable segments | \$ 20,264 | \$ 21,213 |
| Eliminations of internal transactions | (1,645) | (1,690) |
| Other revenue | 66 | 67 |
| Total consolidated revenue | \$ 18,684 | \$ 19,590 |
| Pre-tax income from continuing operations: | | |
| Total reportable segments | \$ 1,837 | \$ 4,023 |
| Amortization of acquired intangible assets | (211) | (170) |

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| | | | | |
|---|----|-------|----|-------|
| Acquisition-related (charges)/income | | 27 | | 0 |
| Non-operating retirement-related (costs)/income | | (142) | | (442) |
| Eliminations of internal transactions | | (355) | | (363) |
| Unallocated corporate amounts | | (122) | | (48) |
| Total pre-tax income from continuing operations | \$ | 1,034 | \$ | 3,001 |

* Reclassified to conform with 2016 presentation.

Notes to Consolidated Financial Statements – (continued)

7. Equity Activity:**Reclassifications and Taxes Related to Items of Other Comprehensive Income**

| (Dollars in millions) | Before Tax | Tax | Net of Tax |
|---|-------------------|-------------------|-------------------|
| For the three months ended March 31, 2016: | Amount | (Expense)/ | Amount |
| Other comprehensive income/(loss): | | Benefit | |
| Foreign currency translation adjustments | \$ 239 | \$ 266 | \$ 505 |
| Net changes related to available-for-sale securities: | | | |
| Unrealized gains/(losses) arising during the period | \$ (36) | \$ 14 | \$ (22) |
| Reclassification of (gains)/losses to other (income) and expense | 37 | (14) | 23 |
| Total net changes related to available-for-sale securities | \$ 1 | \$ 0 | \$ 0 |
| Unrealized gains/(losses) on cash flow hedges: | | | |
| Unrealized gains/(losses) arising during the period | \$ (265) | \$ 91 | \$ (174) |
| Reclassification of (gains)/losses to: | | | |
| Cost of sales | (3) | 0 | (3) |
| SG&A expense | (3) | 0 | (3) |
| Other (income) and expense | (87) | 33 | (53) |
| Interest expense | 2 | (1) | 1 |
| Total unrealized gains/(losses) on cash flow hedges | \$ (356) | \$ 124 | \$ (232) |
| Retirement-related benefit plans(1): | | | |
| Net (losses)/gains arising during the period | \$ (147) | \$ 53 | \$ (94) |
| Curtailments and settlements | 5 | (2) | 3 |
| Amortization of prior service (credits)/costs | (25) | 9 | (16) |
| Amortization of net (gains)/losses | 690 | (248) | 442 |
| Total retirement-related benefit plans | \$ 522 | \$ (187) | \$ 335 |
| Other comprehensive income/(loss) | \$ 406 | \$ 202 | \$ 608 |

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

Notes to Consolidated Financial Statements – (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

| (Dollars in millions) | Before Tax | Tax | Net of Tax |
|---|------------|-----------------------|------------|
| For the three months ended March 31, 2015: | Amount | (Expense)/ Benefit | Amount |
| Other comprehensive income/(loss): | | | |
| Foreign currency translation adjustments | \$ (452) | \$ (266) | \$ (718) |
| Net changes related to available-for-sale securities: | | | |
| Unrealized gains/(losses) arising during the period | \$ 32 | \$ (12) | \$ 20 |
| Reclassification of (gains)/losses to other (income) and expense | 0 | 0 | 0 |
| Total net changes related to available-for-sale securities | \$ 32 | \$ (12) | \$ 20 |
| Unrealized gains/(losses) on cash flow hedges: | | | |
| Unrealized gains/(losses) arising during the period | \$ 619 | \$ (218) | \$ 401 |
| Reclassification of (gains)/losses to: | | | |
| Cost of sales | (50) | 15 | (35) |
| SG&A expense | (40) | 11 | (28) |
| Other (income) and expense | (160) | 61 | (98) |
| Interest expense | 0 | 0 | 0 |
| Total unrealized gains/(losses) on cash flow hedges | \$ 370 | \$ (131) | \$ 239 |
| Retirement-related benefit plans(1): | | | |
| Prior service costs/(credits) | \$ 5 | \$ (2) | \$ 3 |
| Net (losses)/gains arising during the period | (77) | 26 | (52) |
| Curtailments and settlements | 4 | (1) | 3 |
| Amortization of prior service (credits)/costs | (26) | 9 | (17) |
| Amortization of net (gains)/losses | 835 | (280) | 555 |
| Total retirement-related benefit plans | \$ 740 | \$ (248) | \$ 492 |
| Other comprehensive income/(loss) | \$ 690 | \$ (657) | \$ 33 |

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

Notes to Consolidated Financial Statements – (continued)

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

| | Net Unrealized Gains/(Losses) on Cash Flow Hedges | Foreign Currency Translation Adjustments* | Net Change Retirement- Related Benefit Plans | Net Unrealized Gains/(Losses) on Available- For-Sale Securities | Accumulated Other Comprehensive Income/(Loss) |
|--|--|--|--|---|--|
| (Dollars in Millions) | | | | | |
| January 1, 2016 | \$ 100 | \$ (3,463) | \$ (26,248) | \$ 5 | \$ (29,607) |
| Other comprehensive income before reclassifications | (174) | 505 | (91) | (22) | 218 |
| Amount reclassified from accumulated other comprehensive income | (58) | 0 | 426 | 23 | 391 |
| Total change for the period | (232) | 505 | 335 | 0 | 608 |
| March 31, 2016 | \$ 133 | \$ (2,958) | \$ (25,913) | \$ 5 | \$ (28,998) |

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

| | Net Unrealized Gains/(Losses) on Cash Flow Hedges | Foreign Currency Translation Adjustments* | Net Change Retirement- Related Benefit Plans | Net Unrealized Gains/(Losses) on Available- For-Sale Securities | Accumulated Other Comprehensive Income/(Loss) |
|--|--|--|--|---|--|
| (Dollars in Millions) | | | | | |
| January 1, 2015 | \$ 392 | \$ (1,742) | \$ (26,509) | \$ (15) | \$ (27,875) |
| Other comprehensive income before reclassifications | 401 | (718) | (46) | 20 | (343) |
| Amount reclassified from accumulated other comprehensive income | (162) | 0 | 538 | 0 | 376 |
| Total change for the period | 239 | (718) | 492 | 20 | 33 |
| March 31, 2015 | \$ 631 | \$ (2,461) | \$ (26,017) | \$ 5 | \$ (27,842) |

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

8. Retirement-Related Benefits: The company offers defined benefit pension plans, defined contribution pension plans, as well as nonpension postretirement plans primarily consisting of retiree medical benefits. The following tables provide the pre-tax cost for all retirement-related plans.

| (Dollars in millions) | | | | |
|---|----|-------------|-------------|--|
| For the three months ended March 31: | | 2016 | 2015 | Yr. to Yr. Percent Change |
| Retirement-related plans – cost | | | | |
| Defined benefit and contribution pension plans – cost | \$ | 439 | \$ 749 | (41.4)% |
| Nonpension postretirement plans – cost | | 60 | 71 | (15.9) |
| Total | \$ | 499 | \$ 820 | (39.2)% |

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 March 31: | <u>U.S. Plans</u> | | <u>Non-U.S. Plans</u> | |
|---|--------------------------|-------------|------------------------------|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$ — | \$ — | \$ 104 | \$ 108 |
| Interest cost | 513 | 508 | 262 | 271 |
| Expected return on plan assets | (922) | (989) | (470) | (483) |
| Amortization of prior service costs/(credits) | 3 | 2 | (25) | (25) |
| Recognized actuarial losses | 333 | 415 | 347 | 401 |
| Curtailments and settlements | — | — | 5 | 4 |
| Multi-employer plans/other costs | — | — | 18 | 248 |
| Total net periodic pension (income)/cost of defined benefit plans | (74) | (64) | 241 | 524 |
| Cost of defined contribution plans | 165 | 173 | 106 | 115 |
| Total defined benefit and contribution plans cost recognized | | | | |
| in the Consolidated Statement of Earnings | \$ 91 | \$ 109 | \$ 348 | \$ 640 |

On March 24, 2014, the Supreme Court of Spain issued a ruling against IBM Spain in litigation involving its defined benefit and defined contribution plans. As a result of the ruling, the company recorded pre-tax retirement-related obligations of \$233 million in 2015 (\$230 million in the first quarter of 2015) in selling, general and administrative expense in the Consolidated Statement of Earnings. These obligations are reflected in "Non-U.S. Plans - Multi-employer plans/other costs" in the table above.

In March 2016, the company initiated a change to the investment strategy of its U.S. defined benefit plan. The 2016 target asset allocation was modified by reducing equity securities from 34 percent to 21 percent, other investments from 10 percent to 9 percent and increasing debt securities from 56 percent to 70 percent of total plan assets. This change is designed to reduce the risk associated with the potential negative impact that equity markets might have on the funded status of the U.S. defined benefit plan. The change is expected to reduce the 2017 expected long-term rate of return on assets from 7.00 percent to approximately 6.25 percent. See note S, "Retirement-Related Benefits," on page 135 in the company's 2015 Annual Report for additional information regarding the company's investment strategy.

In 2016, the company expects to contribute approximately \$500 million to its non-U.S. defined benefit and multi-employer plans, the largest of which will be contributed to the defined benefit pension plans in the UK and Japan. This amount represents the legally mandated minimum contribution. Total net contributions to the non-U.S. plans in the first three months of 2016 were \$107 million, of which \$65 million was in cash and \$42 million in U.S. Treasury securities. The contribution of U.S. Treasury securities is considered a non-cash transaction in the Consolidated Statement of Cash Flows.

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

Cost of Nonpension Postretirement Plans

| (Dollars in millions) For the three months ended March 31: | <u>U.S. Plan</u> | | <u>Non-U.S. Plans</u> | |
|---|-------------------------|-------------|------------------------------|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$ 5 | \$ 6 | \$ 1 | \$ 2 |
| Interest cost | 41 | 41 | 10 | 14 |
| Expected return on plan assets | — | 0 | (1) | (2) |
| Amortization of prior service costs/(credits) | (2) | (2) | (1) | (1) |
| Recognized actuarial losses | 5 | 11 | 2 | 3 |
| Total nonpension postretirement plan cost recognized in | | | | |
| Consolidated Statement of Earnings | \$ 49 | \$ 56 | \$ 11 | \$ 15 |

The company contributed \$100 million in U.S. Treasury securities and \$126 million in cash to the U.S. nonpension postretirement benefit plan during the first quarter ended March 31, 2016 and 2015, respectively. The contribution of U.S. Treasury securities is considered a non-cash transaction in the Consolidated Statement of Cash Flows.

Notes to Consolidated Financial Statements – (continued)**9. Acquisitions/Divestitures:**

Acquisitions: During the three months ended March 31, 2016, the company completed six acquisitions at an aggregate cost of \$2,642 million.

The Weather Company (TWC) – On January 29, 2016, the company completed the acquisition of TWC’s B2B, mobile and cloud-based web-properties, weather.com, Weather Underground, The Weather Company brand and WSI, its global business-to-business brand, for cash consideration of \$2,284 million. The cable television segment was not acquired by IBM, but will license weather forecast data and analytics from IBM under a long-term contract. TWC was a privately held business. Goodwill of \$1,723 million has been assigned to the Cognitive Solutions segment. At the acquisition date, it was expected that none of the goodwill would be deductible for tax purposes. The overall weighted-average useful life of the identified intangible assets acquired is 6.9 years.

Other Acquisitions – The Technology Services & Cloud Platforms segment completed acquisitions of two businesses in the first quarter: Ustream, Inc. (Ustream), a privately held business, and AT&T’s application and hosting services business. Global Business Services (GBS) completed acquisitions of three privately held businesses in the first quarter: Resource/Ammirati, ecx.io and Optevia.

Each acquisition is expected to enhance the company’s portfolio of product and services capabilities. Ustream provides cloud-based video streaming to enterprises and broadcasters. Resource/Ammirati is a leading U.S. based digital marketing and creative agency, addressing the rising demand from businesses seeking to reinvent themselves for the digital economy. Ecx.io will enhance IBM Interactive Experience (IBM iX) with new digital marketing, commerce and platform skills to accelerate clients’ digital transformations. Optevia is a Software-as-a Service systems integrator specializing in CRM solutions for public sector organizations. The acquisition of AT&T’s application and hosting services business is expected to strengthen the company’s cloud portfolio.

Purchase price consideration for all acquisitions as reflected in the following table, was paid primarily in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

The following table reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of March 31, 2016.

| (Dollars in millions) | Amortization | The Weather Company | Other Acquisitions |
|------------------------------|---------------------|------------------------------------|-------------------------------|
|------------------------------|---------------------|------------------------------------|-------------------------------|

| | Life (in yrs.) | | | |
|--------------------------------|---------------------------|----|-------|--------|
| Current assets | | \$ | 76 | \$ 31 |
| Fixed assets/noncurrent assets | | | 123 | 68 |
| Intangible assets: | | | | |
| Goodwill | N/A | | 1,723 | 192 |
| Completed technology | 2-7 | | 160 | 24 |
| Client relationships | 3-7 | | 313 | 135 |
| Patents/trademarks | 2-7 | | 349 | 4 |
| Total assets acquired | | | 2,744 | 455 |
| Current liabilities | | | (88) | (21) |
| Noncurrent liabilities | | | (372) | (35) |
| Total liabilities assumed | | | (460) | (57) |
| Bargain purchase gain | | | — | (40)* |
| Total purchase price | | \$ | 2,284 | \$ 358 |

N/A - not applicable

* Bargain purchase gain relating to AT&T's application and hosting services business was recognized in selling,

general and administrative expense in the Consolidated Statement of Earnings. This gain was excluded from

the company's operating (non-GAAP) earnings.

The acquisitions were accounted for as business combinations using the acquisition method, and accordingly, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired entity were recorded at their estimated fair values at the date of acquisition. The primary items that generated the goodwill are the value of the

Notes to Consolidated Financial Statements – (continued)

synergies between the acquired businesses and IBM and the acquired assembled workforce, neither of which qualify as an amortizable intangible asset.

For the “Other Acquisitions”, the overall weighted-average life of the identified amortizable intangible assets acquired is 6.2 years. These identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$91 million was assigned to the Technology Services & Cloud Platforms segment and goodwill of \$101 million was assigned to the GBS segment. It is expected that 40 percent of the goodwill will be deductible for tax purposes.

On March 31, 2016, the company announced its intent to acquire Bluewolf Group LLC (Bluewolf), a globally recognized leader in cloud consulting and implementation services. Bluewolf will extend the company’s analytics, experience design and industry consulting leadership with one of the world’s leading Salesforce consulting practices to deliver differentiated, consumer-grade experiences via the cloud. The transaction is expected to close in the second quarter of 2016 and the business will be integrated within the GBS segment.

On April 6, 2016, the company announced that it had acquired Resilient Systems Inc. (Resilient), a provider of incident response solutions. Resilient’s technology automates and orchestrates the many processes needed when dealing with cyber incidents, from breaches to lost devices. The business will be integrated within the Cognitive Solutions segment.

On April 8, 2016, the company announced that it had acquired Truven Health Analytics (Truven), a leading provider of healthcare analytics solutions, for cash consideration of \$2.6 billion. Truven has developed proprietary analytic methods and assembled analytic content assets, creating extensive national healthcare utilization, performance, quality, and cost data. The business will be integrated within the Cognitive Solutions segment.

On April 19, 2016, the company announced that it had acquired Aperto, a digital agency with headquarters in Berlin, Germany. Aperto will join the IBM iX team. IBM iX provides clients a unique fusion of services spanning strategy, analytics and systems integration for scalable digital, commerce, mobile and wearable platforms. The business will be integrated within the GBS segment.

At the date of issuance of the financial statements, the initial purchase accounting for the Resilient, Truven and Aperto transactions was not complete.

Divestitures:

Microelectronics – On October 20, 2014, IBM and GLOBALFOUNDRIES announced a definitive agreement in which GLOBALFOUNDRIES would acquire the company’s Microelectronics business, including existing semiconductor manufacturing assets and operations in East Fishkill, NY and Essex Junction, VT. The commercial OEM business acquired by GLOBALFOUNDRIES includes custom logic and specialty foundry, manufacturing and related operations. The transaction closed on July 1, 2015.

The transaction includes a 10-year exclusive manufacturing sourcing agreement in which GLOBALFOUNDRIES will provide server processor semiconductor technology for use in IBM Systems. The agreement provides the company with capacity and market-based pricing for current semiconductor nodes in production and progression to nodes in the future for both development and production needs. As part of the transaction, the company will provide GLOBALFOUNDRIES with certain transition services, including IT, supply chain, packaging and test services and lab services. The initial term for these transition services is one to three years, with GLOBALFOUNDRIES having the ability to renew.

In the third quarter of 2014, the company recorded a pre-tax charge of \$4.7 billion related to the sale of the Microelectronics disposal group, which was part of the Systems reportable segment. The pre-tax charge reflected the fair value less the estimated cost of selling the disposal group including an impairment to the semiconductor long-lived assets of \$2.4 billion, \$1.5 billion representing the cash consideration expected to be transferred to GLOBALFOUNDRIES and \$0.8 billion of other related costs. Additional pre-tax charges of \$116 million were recorded during 2015 related to the disposal, and a pre-tax credit of \$1 million was recorded during the first three months of 2016. The cumulative pre-tax charge was \$4.8 billion as of March 31, 2016. Additional charges may be recorded in future periods.

All assets and liabilities of the business, classified as held for sale at June 30, 2015, were transferred at closing. The company transferred \$515 million of net cash to GLOBALFOUNDRIES in the third quarter of 2015. This amount included \$750 million of cash consideration, adjusted by the amount of working capital due from GLOBALFOUNDRIES and other miscellaneous items. The remaining cash consideration will be transferred over two years.

Notes to Consolidated Financial Statements – (continued)

Reporting the related assets and liabilities initially as held for sale at September 30, 2014 was based on meeting all of the criteria for such reporting in the applicable accounting guidance. While the company met certain criteria for held for sale reporting in prior periods, it did not meet all of the criteria until September 30, 2014. In addition, at September 30, 2014, the company concluded that the Microelectronics business met the criteria for discontinued operations reporting. The disposal group constitutes a component under accounting guidance. The continuing cash inflows and outflows with the discontinued component are related to the manufacturing sourcing arrangement and the transition, packaging and test services. These cash flows are not direct cash flows as they are not significant and the company will have no significant continuing involvement.

Summarized financial information for discontinued operations is shown in the table below.

| (Dollars in millions) | Three Months Ended March 31, | | | |
|---|------------------------------|------|----|-------|
| | | 2016 | | 2015 |
| Total revenue | \$ | — | \$ | 339 |
| Income/(loss) from discontinued operations | \$ | (5) | \$ | (105) |
| Gain/(loss) on disposal, before tax | | 1 | | (14) |
| Total loss from discontinued operations, before income taxes | \$ | (5) | \$ | (119) |
| Provision/(benefit) for income taxes | | (2) | | (31) |
| Loss from discontinued operations, net of tax | \$ | (3) | \$ | (88) |

Industry Standard Server – On January 23, 2014, IBM and Lenovo Group Limited (Lenovo) announced a definitive agreement in which Lenovo would acquire the company's industry standard server portfolio (System x) for an adjusted purchase price of \$2.1 billion, consisting of approximately \$1.8 billion in cash, with the balance in Lenovo common stock. The stock represented less than 5 percent equity ownership in Lenovo. The company would sell to Lenovo its System x, BladeCenter and Flex System blade servers and switches, x86-based Flex integrated systems, NeXtScale and iDataPlex servers and associated software, blade networking and maintenance operations.

IBM and Lenovo entered into a strategic relationship which included a global OEM and reseller agreement for sales of IBM's industry-leading entry and midrange Storwize disk storage systems, tape storage systems, General Parallel File System software, SmartCloud Entry offering, and elements of IBM's system software, including Systems Director and Platform Computing solutions. Effective with the initial closing of the transaction, Lenovo assumed related customer service and maintenance operations. IBM will continue to provide maintenance delivery on Lenovo's behalf for an extended period of time. In addition, as part of the transaction agreement, the company will provide Lenovo with certain transition services, including IT and supply chain services. The initial term for these transition services ranges from less than one year to three years. Lenovo can renew certain services for an additional year.

The initial closing was completed on October 1, 2014. A subsequent closing occurred in most other countries in which there was a large business footprint on December 31, 2014. The remaining countries closed on March 31, 2015. An assessment of the ongoing contractual terms of the transaction resulted in the recognition of a pre-tax gain of \$63 million in 2015 and \$29 million in the first quarter of 2016.

Overall, the company expects to recognize a total pre-tax gain on the sale of approximately \$1.6 billion, which does not include associated costs related to transition and performance-based costs. Net of these charges, the pre-tax gain was approximately \$1.3 billion, of which the cumulative gain recorded as of March 31, 2016 is \$1.2 billion. The balance of the gain is expected to be recognized in 2019 upon conclusion of the maintenance agreement.

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

The initial closing was completed on January 31, 2014, with subsequent closings occurring during 2014. For the full year of 2014, the company recorded a pre-tax gain of \$202 million related to this transaction.

Notes to Consolidated Financial Statements – (continued)

In the second quarter of 2015, resolution of the final balance sheet adjustments was concluded. An assessment of the ongoing contractual terms of the transaction resulted in the recognition of a pre-tax gain of \$7 million in 2015. Through March 31, 2016, the cumulative pre-tax gain attributed to this transaction was \$209 million.

Others In the first quarter of 2016, the company completed four software product-related divestitures. The financial terms related to these transactions were not material. Overall, the company recorded a pre-tax gain of \$36 million related to these transactions in the first three months of 2016.

10. 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 March 31, 2016 | |
|---|--------------------------|-----------------------------|------------------------|
| | | Accumulated Amortization | Net Carrying Amount |
| Capitalized software | \$ 1,465 | \$ (593) | \$ 872 |
| Client relationships | 2,297 | (987) | 1,310 |
| Completed technology | 3,121 | (1,486) | 1,635 |
| Patents/trademarks | 683 | (160) | 523 |
| Other* | 44 | (11) | 33 |
| Total | \$ 7,610 | \$ (3,237) | \$ 4,373 |

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

| (Dollars in millions) Intangible asset class | Gross Carrying Amount | At December 31, 2015 | |
|---|--------------------------|-----------------------------|------------------------|
| | | Accumulated Amortization | Net Carrying Amount |
| Capitalized software | \$ 1,348 | \$ (581) | \$ 767 |
| Client relationships | 1,856 | (927) | 929 |
| Completed technology | 2,960 | (1,397) | 1,563 |
| Patents/trademarks | 335 | (142) | 193 |
| Other* | 44 | (10) | 35 |
| Total | \$ 6,543 | \$ (3,057) | \$ 3,487 |

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

The net carrying amount of intangible assets increased \$886 million during the first quarter of 2016, primarily due to intangible asset additions resulting from acquisitions, partially offset by amortization. The aggregate intangible amortization expense was \$347 million and \$298 million for the quarters ended March 31, 2016 and 2015, respectively. In addition, in the first three months of 2016, the company retired \$163 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 March 31, 2016:

| (Dollars in millions) | | Capitalized Software | | Acquired Intangibles | | Total |
|------------------------------|----|---------------------------------|----|---------------------------------|----|--------------|
| 2016 (for Q2-Q4) | \$ | 365 | \$ | 674 | \$ | 1,039 |
| 2017 | | 340 | | 792 | | 1,132 |
| 2018 | | 160 | | 645 | | 805 |
| 2019 | | 8 | | 484 | | 492 |
| 2020 | | — | | 384 | | 384 |

The change in the goodwill balances by reportable segment, for the three months ended March 31, 2016 and for the year ended December 31, 2015 are as follows:

Notes to Consolidated Financial Statements – (continued)

| (Dollars in millions) Segment | Balance 1/1/2016* | Goodwill Additions | Purchase Price | | Divestitures | Foreign Currency Translation And Other Adjustments** | Balance 3/31/16 |
|--|----------------------|-----------------------|-------------------|---------|--------------|--|--------------------|
| | | | Adjustments | | | | |
| Cognitive Solutions | \$ 15,621 | \$ 1,723 | \$ 1 | \$ (12) | \$ 199 | \$ 17,533 | |
| Global Business Services | 4,396 | 101 | 1 | (1) | 72 | 4,569 | |
| Technology Services & Cloud Platforms | 10,156 | 91 | 1 | (5) | 115 | 10,358 | |
| Systems | 1,848 | — | 1 | — | 12 | 1,861 | |
| Total | \$ 32,021 | \$ 1,915 | \$ 4 | \$ (17) | \$ 398 | \$ 34,322 | |

* Reclassified to conform with 2016 presentation.

** Primarily driven by foreign currency translation.

| (Dollars in millions) Segment | Balance 1/1/2015* | Goodwill Additions* | Purchase Price | | Divestitures* | Foreign Currency Translation And Other Adjustments** | Balance 12/31/15* |
|--|----------------------|------------------------|-------------------|---------|---------------|--|----------------------|
| | | | Adjustments* | | | | |
| Cognitive Solutions | \$ 15,156 | \$ 1,020 | \$ (2) | \$ (18) | \$ (535) | \$ 15,621 | |
| Global Business Services | 4,555 | 74 | 0 | (1) | (232) | 4,396 | |
| Technology Services & Cloud Platforms | 9,373 | 1,087 | (1) | (7) | (296) | 10,156 | |
| Systems | 1,472 | 410 | 0 | — | (33) | 1,848 | |
| Total | \$ 30,556 | \$ 2,590 | \$ (3) | \$ (26) | \$ (1,096) | \$ 32,021 | |

* Reclassified to conform with 2016 presentation.

** Primarily driven by foreign currency translation.

In January 2016, the company made a number of changes to its organizational structure and management system consistent with the ongoing transformation to a cognitive solutions and cloud platform business. With these changes, the company revised its reportable segments. Goodwill was reallocated to the new reporting segments, and as a result, an impairment assessment was performed. There were no goodwill impairment losses recorded during the first three months of 2016 or the full year of 2015 and the company has no accumulated impairment losses. For further information regarding the segment change, refer to note 6, “Segments”.

Purchase price adjustments recorded in the first three months of 2016 and full year 2015 were related to acquisitions that were completed on or prior to December 31, 2015 or December 31, 2014, 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. Purchase price adjustments of \$4 million were recorded in the first three months of 2016 related to various asset and liability adjustments.

11. Borrowings:**Short-Term Debt**

| (Dollars in millions) | At March 31, | | At December 31, | |
|-------------------------------------|---------------------|-------|------------------------|-------|
| | 2016 | | 2015 | |
| Commercial paper | \$ | — | \$ | 600 |
| Short-term loans | | 302 | | 590 |
| Long-term debt – current maturities | | 5,000 | | 5,271 |
| Total | \$ | 5,303 | \$ | 6,461 |

The weighted-average interest rate for commercial paper at December 31, 2015 was 0.4 percent. The weighted-average interest rate for short-term loans was 8.6 percent and 5.2 percent at March 31, 2016 and December 31, 2015, respectively.

Notes to Consolidated Financial Statements – (continued)

Long-Term Debt

Pre-Swap Borrowing

| (Dollars in millions) | Maturities | Balance 3/31/2016 | Balance 12/31/2015 |
|---|------------|----------------------|-----------------------|
| U.S. dollar notes and debentures (average interest rate at March 31, 2016): | | | |
| 3.00% | 2016–2017 | \$ 8,239 | \$ 9,351 |
| 3.17% | 2018–2019 | 8,826 | 7,591 |
| 1.71% | 2020–2021 | 4,940 | 3,717 |
| 2.35% | 2022 | 1,901 | 1,900 |
| 3.38% | 2023 | 1,500 | 1,500 |
| 3.63% | 2024 | 2,000 | 2,000 |
| 7.00% | 2025 | 600 | 600 |
| 3.45% | 2026 | 1,350 | — |
| 6.22% | 2027 | 469 | 469 |
| 6.50% | 2028 | 313 | 313 |
| 5.88% | 2032 | 600 | 600 |
| 8.00% | 2038 | 83 | 83 |
| 5.60% | 2039 | 745 | 745 |
| 4.00% | 2042 | 1,107 | 1,107 |
| 7.00% | 2045 | 27 | 27 |
| 4.70% | 2046 | 650 | — |
| 7.13% | 2096 | 316 | 316 |
| | | \$ 33,667 | \$ 30,319 |
| Other currencies (average interest rate at March 31, 2016, in parentheses): | | | |
| Euros (1.6%) | 2016–2028 | \$ 7,691 | \$ 4,892 |
| Pound sterling (2.7%) | 2017–2022 | 1,514 | 1,555 |
| Japanese yen (0.4%) | 2017–2022 | 1,262 | 1,180 |
| Swiss francs (6.3%) | 2020 | 9 | 9 |
| Canadian (2.2%) | 2017 | 386 | 360 |
| Other (13.6%) | 2016–2020 | 658 | 506 |
| | | \$ 45,188 | \$ 38,820 |
| Less: net unamortized discount | | 861 | 838 |
| Less: net unamortized debt issuance cost | | 95 | 74 |
| Add: fair value adjustment* | | 1,022 | 790 |
| | | \$ 45,254 | \$ 38,699 |
| Less: current maturities | | 5,000 | 5,271 |
| Total | | \$ 40,254 | \$ 33,428 |

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

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

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

Notes to Consolidated Financial Statements – (continued)

Pre-swap annual contractual maturities of long-term debt outstanding at March 31, 2016, are as follows:

| (Dollars in millions) | | Total |
|------------------------------|----|--------------|
| 2016 (for Q2-Q4) | \$ | 3,198 |
| 2017 | | 6,798 |
| 2018 | | 4,777 |
| 2019 | | 5,271 |
| 2020 | | 4,873 |
| 2021 and beyond | | 20,272 |
| Total | \$ | 45,188 |

Interest on Debt**(Dollars in millions)****For the three months ended March 31:**

| | 2016 | 2015 |
|------------------------------------|-------------|-------------|
| Cost of financing | \$ 138 | \$ 140 |
| Interest expense | 157 | 108 |
| Net investment derivative activity | (10) | 0 |
| Interest capitalized | 1 | (2) |
| Total interest paid and accrued | \$ 286 | \$ 245 |

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

The company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Any recorded liabilities, including any changes to such liabilities for the quarter ended March 31, 2016 were not material to the Consolidated Financial Statements.

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

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

Notes to Consolidated Financial Statements – (continued)

and status of settlement discussions, discovery, procedural and substantive rulings, reviews by counsel and other information pertinent to a particular matter.

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

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

The company is a defendant in an action filed on March 6, 2003 in state court in Salt Lake City, Utah by the SCO Group (SCO v. IBM). The company removed the case to Federal Court in Utah. Plaintiff is an alleged successor in interest to some of AT&T's UNIX IP rights, and alleges copyright infringement, unfair competition, interference with contract and breach of contract with regard to the company's distribution of AIX and Dynix and contribution of code to Linux and the company has asserted counterclaims. On September 14, 2007, plaintiff filed for bankruptcy protection, and all proceedings in this case were stayed. The court in another suit, the SCO Group, Inc. v. Novell, Inc., held a trial in March 2010. The jury found that Novell is the owner of UNIX and UnixWare copyrights; the judge subsequently ruled that SCO is obligated to recognize Novell's waiver of SCO's claims against IBM and Sequent for breach of UNIX license agreements. On August 30, 2011, the Tenth Circuit Court of Appeals affirmed the district court's ruling and denied SCO's appeal of this matter. In June 2013, the Federal Court in Utah granted SCO's motion to reopen the SCO v. IBM case. In February 2016, the Federal Court ruled in favor of IBM on all of SCO's remaining claims, and in March 2016, SCO filed a notice of appeal to the Tenth Circuit Court of Appeals.

On May 13, 2010, IBM and the State of Indiana (acting on behalf of the Indiana Family and Social Services Administration) sued one another in a dispute over a 2006 contract regarding the modernization of social service program processing in Indiana. After six weeks of trial, on July 18, 2012, the Indiana Superior Court in Marion County rejected the State's claims in their entirety and awarded IBM \$52 million plus interest and costs. On February 13, 2014, the Indiana Court of Appeals reversed portions of the trial judge's findings, found IBM in material breach, and ordered the case remanded to the trial judge to determine the State's damages, if any. The Indiana Court of Appeals also affirmed approximately \$50 million of the trial court's award of damages to IBM. On March 22, 2016, the Indiana Supreme Court affirmed the outcome of the Indiana Court of Appeals and remanded the case to the Indiana Superior Court.

On April 16, 2014, Iusacell SA de C.V. (Iusacell) sued IBM, claiming that IBM made fraudulent misrepresentations that induced Iusacell to enter into an agreement with IBM Mexico. Iusacell claims damages for lost profits. Iusacell's

complaint relates to a contractual dispute in Mexico, which is the subject of a pending arbitration proceeding in Mexico initiated by IBM Mexico against Iusacell for breach of the underlying agreement. On November 14, 2014, the District Court in the Southern District of New York granted IBM's motion to stay Iusacell's action against the company pending the arbitration in Mexico between Iusacell and IBM Mexico.

IBM United Kingdom Limited (IBM UK) initiated legal proceedings in May 2010 before the High Court in London against the IBM UK Pensions Trust (the UK Trust) and two representative beneficiaries of the UK Trust membership. IBM UK is seeking a declaration that it acted lawfully both in notifying the Trustee of the UK Trust that it was closing its UK defined benefit plans to future accruals for most participants and in implementing the company's new retirement policy. In April 2014, the High Court acknowledged that the changes made to its UK defined benefit plans were within IBM's discretion, but ruled that IBM breached its implied duty of good faith both in implementing these changes and in the manner in which it consulted with employees. Proceedings to determine remedies were held in July 2014, and in February 2015 the High Court held that for IBM to make changes to accruals under the plan would require a new consultation of the participants, but other changes (including to early retirement policy) would not require such consultation. IBM UK has appealed both the breach and remedies judgments. If the appeal is unsuccessful, the Court's rulings would require IBM to reverse the changes made to the UK defined benefit plans retroactive to their effective dates. This could result in an estimated non-operating one-time pre-tax charge of approximately \$250 million, plus ongoing defined benefit related accruals. In addition, IBM UK is a defendant in approximately 290 individual actions brought since early 2010 by participants of the defined benefits plans who left IBM UK. These actions, which allege constructive dismissal and age discrimination, are pending before the Employment Tribunal in Southampton UK.

Notes to Consolidated Financial Statements – (continued)

In March 2011, the company announced that it had agreed to settle a civil enforcement action with the Securities and Exchange Commission (SEC) relating to alleged violations of the Foreign Corrupt Practices Act of 1977 (FCPA). On July 25, 2013, the court approved that 2011 settlement and required that for a two-year period IBM make reports to the SEC and the court on certain matters, including those relating to compliance with the FCPA. The two-year period expired in July 2015. In early 2012, IBM notified the SEC of an investigation by the Polish Central Anti-Corruption Bureau involving allegations of illegal activity by a former IBM Poland employee in connection with sales to the Polish government. IBM is cooperating with the SEC and Polish authorities in this matter. In April 2013, IBM learned that the U.S. Department of Justice (DOJ) is also investigating allegations related to the Poland matter, as well as allegations relating to transactions in Argentina, Bangladesh and Ukraine. The DOJ is also seeking information regarding the company's global FCPA compliance program and its public sector business. The company is cooperating with the DOJ in this matter.

In March 2015, putative class action litigation was commenced in the United States District Court for the Southern District of New York related to the company's October 2014 announcement that it was divesting its global commercial semiconductor technology business. The company and three of its officers are named as defendants. Plaintiffs allege that defendants violated Sections 20(a) and 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. In May 2015, a related putative class action was also commenced in the United States District Court for the Southern District of New York based on the same underlying facts, alleging violations of the Employee Retirement Income Security Act. The company, management's Retirement Plans Committee, and three current or former IBM executives are named as defendants.

In August 2015, IBM learned that the SEC is conducting an investigation relating to revenue recognition with respect to the accounting treatment of certain transactions in the U.S., UK and Ireland. The company is cooperating with the SEC in this matter.

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 tax authorities regarding non-income tax assessments and non-income tax litigation matters. The total potential amount related to these matters for all applicable years is approximately \$520 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

13. Commitments: The company's extended lines of credit to third-party entities include unused amounts of \$6,014 million and \$5,477 million at March 31, 2016 and December 31, 2015, 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 \$2,069 million and \$2,097 million at March 31, 2016 and December 31, 2015, respectively.

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

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

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to

Notes to Consolidated Financial Statements – (continued)

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 \$32 million and \$34 million at March 31, 2016 and December 31, 2015, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position is not material.

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

Standard Warranty Liability

| (Dollars in millions) | 2016 | | 2015 | |
|--|-------------|------|-------------|------|
| Balance at January 1 | \$ | 181 | \$ | 197 |
| Current period accruals | | 27 | | 35 |
| Accrual adjustments to reflect actual experience | | (2) | | 10 |
| Charges incurred | | (41) | | (51) |
| Balance at March 31 | \$ | 164 | \$ | 192 |

Extended Warranty Liability

| (Dollars in millions) | 2016 | | 2015 | |
|--|-------------|------|-------------|------|
| Aggregate deferred revenue at January 1 | \$ | 538 | \$ | 536 |
| Revenue deferred for new extended warranty contracts | | 49 | | 45 |
| Amortization of deferred revenue | | (66) | | (63) |
| Other* | | 9 | | (15) |
| Aggregate deferred revenue at March 31 | \$ | 531 | \$ | 503 |
| Current portion | \$ | 247 | \$ | 245 |
| Noncurrent portion | \$ | 284 | \$ | 258 |

* Other primarily consists of foreign currency translation adjustments.

14. Subsequent Events: On April 26, 2016, the company announced that the Board of Directors approved a quarterly dividend of \$1.40 per common share. The dividend is payable June 10, 2016 to shareholders of record on May 10, 2016. The dividend declaration represents an increase of \$0.10 per common share, which is 8 percent higher than the prior quarterly dividend of \$1.30 per common share.

Item 2.

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION
FOR THE THREE MONTHS ENDED MARCH 31, 2016**

SnapshotFinancial Results Summary - Three Months Ended March 31:

| (Dollars and shares in millions except per share amounts) For the three months ended March 31: | 2016 | 2015 | Yr. to Yr. Percent/ Margin Change |
|---|----------------|-----------------|---|
| Revenue | \$ 18,684 | \$ 19,590 | (4.6)%* |
| Gross profit margin | 46.5% | 48.2% | (1.8)pts. |
| Total expense and other (income) | \$ 7,652 | \$ 6,451 | 18.6% |
| Total expense and other (income)-to-revenue ratio | 41.0% | 32.9% | 8.0pts. |
| Income from continuing operations, before income taxes | \$ 1,034 | \$ 3,001 | (65.6)% |
| Provision for/(benefit from) income taxes from continuing operations | \$ (983) | \$ 585 | nm% |
| Income from continuing operations | \$ 2,016 | \$ 2,415 | (16.5)% |
| Income from continuing operations margin | 10.8% | 12.3% | (1.5)pts. |
| Loss from discontinued operations, net of tax | \$ (3) | \$ (88) | (96.8)% |
| Net income | \$ 2,014 | \$ 2,328 | (13.5)% |
| Earnings per share from continuing operations: | | | |
| Assuming dilution | \$ 2.09 | \$ 2.44 | (14.3)% |
| Basic | \$ 2.09 | \$ 2.45 | (14.7)% |
| Consolidated earnings per share - assuming dilution | \$ 2.09 | \$ 2.35 | (11.1)% |
| Weighted-average shares outstanding: | | | |
| Assuming dilution | 964.4 | 992.3 | (2.8)% |
| Basic | 961.7 | 988.1 | (2.7)% |
| | 3/31/16 | 12/31/15 | |
| Assets | \$ 118,856 | \$ 110,495 | 7.6% |
| Liabilities | \$ 103,784 | \$ 96,071 | 8.0% |
| Equity | \$ 15,072 | \$ 14,424 | 4.5% |

* (2.0) percent adjusted for currency
nm - not meaningful

Organization of Information:

In January 2016, the company made a number of changes to its organizational structure and management system. These changes impacted the company's reportable segments, but did not impact the company's Consolidated Financial Statements. Refer to note 6, "Segments," on pages 26 to 27 for additional information on the changes in reportable segments. The periods presented in this Form 10-Q are reported on a comparable basis. The company intends to file a revised 2015 Annual Report in a Form 8-K in the second quarter of 2016 to reclassify its historical segment information to reflect these changes.

In October 2014, the company announced a definitive agreement to divest its Microelectronics business. The assets and liabilities of the Microelectronics business were reported as held for sale at December 31, 2014 and June 30, 2015. The operating results of the Microelectronics business are reported as discontinued operations. The transaction closed on July 1, 2015.

Currency:

The references to "adjusted for currency" or "at constant currency" in the Management Discussion do not include operational impacts that could result from fluctuations in foreign currency rates. Certain financial results are adjusted based on a simple mathematical model that translates current period results in local currency using the comparable prior year period's currency conversion rate. This approach is used for countries where the functional currency is the local country currency. This information is provided so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business performance. See "Currency Rate Fluctuations" on pages 62 and 63 for additional information.

Management Discussion – (continued)Operating (non-GAAP) Earnings:

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

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

The following table provides the company's (non-GAAP) operating earnings for the first quarter of 2016 and 2015.

| (Dollars in millions except per share amounts) | | | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Net income as reported | \$ 2,014 | \$ 2,328 | (13.5)% |
| Loss from discontinued operations, net of tax | (3) | (88) | (96.8) |
| Income from continuing operations | \$ 2,016 | \$ 2,415 | (16.5)% |
| Non-operating adjustments (net of tax): | | | |
| Acquisition-related charges | 138 | 142 | (2.4) |
| Non-operating retirement-related costs/(income) | 115 | 333 | (65.3) |
| Operating (non-GAAP) earnings* | \$ 2,270 | \$ 2,890 | (21.4)% |
| Diluted operating (non-GAAP) earnings per share | \$ 2.35 | \$ 2.91 | (19.2)% |

* See page 71 for a more detailed reconciliation of net income to operating earnings.

Financial Performance Summary – Three Months Ended March 31:

In the first quarter of 2016, the company delivered \$18.7 billion in revenue, \$2.0 billion in income from continuing operations and \$2.3 billion in operating (non-GAAP) earnings, resulting in diluted earnings per share from continuing operations of \$2.09 as reported and \$2.35 on an operating (non-GAAP) basis. The company generated \$5.6 billion in cash from operations and \$2.3 billion in free cash flow in the first quarter of 2016 driving shareholder returns of \$2.2 billion in gross common stock repurchases and dividends. The company made significant investments in the first quarter and took significant actions to accelerate its transformation and shift the business into new markets.

Total consolidated revenue decreased 4.6 percent as reported and 2 percent year to year adjusted for currency in the first quarter of 2016 consistent with performance in the fourth quarter of 2015 on an adjusted basis.

Enterprise clients are looking for greater value from their data and IT environments. They are looking to become digital enterprises that are differentiated by cognitive, using data to improve decision making and outcomes. The company's strategy is based on the point of view that solving clients' needs requires solutions, industry expertise, and innovative technology, all supported by leading edge skills. The company has been making significant changes to its business by transforming existing businesses, building new markets and addressing new opportunity areas. The company is creating cognitive solutions that join digital business with digital intelligence, bringing its industry expertise together with these cognitive solutions, and building it all on cloud platforms. The company is in a unique position to move its clients to the future as it's already running

Management Discussion – (continued)

their most critical business processes. The company has continued its acceleration of shifting investments and resources to be more aligned with its strategy.

In the first quarter of 2016, the company had continued strong double-digit growth in the strategic imperatives, which includes cloud, analytics, mobile, social and security solutions, with revenue growth of 14 percent year to year as reported and 17 percent adjusted for currency. Revenue performance was consistent with the fourth quarter of 2015 on a constant currency basis and continued to outpace the market growth. Over the past 12 months, the strategic imperatives generated \$29.8 billion in revenue, which represents approximately 37 percent of the company's total revenue, an increase of 2 points from full-year 2015. Total Cloud revenue of \$2.6 billion increased 34 percent as reported in the first quarter and 36 percent adjusted for currency, with as-a-Service revenue up 42 percent as reported (46 percent adjusted for currency). The company exited the first quarter of 2016 with an annual run rate for as-a-Service revenue of \$5.4 billion. Analytics revenue of \$4.2 billion in the first quarter increased 7 percent as reported and 9 percent year to year adjusted for currency. Security revenue increased 18 percent as reported (20 percent adjusted for currency) and mobile revenue increased 88 percent (93 percent adjusted for currency). The company continues to invest and add capabilities to buildout its cognitive and cloud platforms. In the first quarter, the company:

- Completed or announced several acquisitions which enhance its existing capabilities in cloud video services, cloud consulting and digital experience and added new capabilities, including the digital assets of The Weather Company and further expansion into healthcare with the Truven acquisition.
- Entered into key partnerships to accelerate adoption of enterprise hybrid clouds.
- Expanded the build, use and deployment of Watson.

From a segment perspective, Cognitive Solutions revenue declined 1.7 percent as reported, but increased 0.4 percent adjusted for currency, with growth in Solutions Software mitigated by a decline in Transaction Processing Software. Global Business Services (GBS) revenue decreased 4.3 percent as reported and 2 percent adjusted for currency, driven by declines in Consulting. GBS strategic imperatives revenue increased 19 percent as reported and 22 percent at constant currency with strong growth in the cloud, analytics, mobility and security practices. Technology Services & Cloud Platforms revenue declined 1.5 percent as reported, but increased 2 percent adjusted for currency, led by Infrastructure Services. Strategic imperatives grew 41 percent as reported and 45 percent adjusted for currency, driven by cloud revenue. Systems revenue decreased 21.8 percent as reported and 21 percent adjusted for currency, primarily reflecting the z Systems product cycle.

From a geographic perspective, Americas revenue decreased 6.9 percent as reported and 4 percent adjusted for currency. Performance was consistent sequentially compared with the fourth quarter of 2015 on an adjusted for currency basis, with improvement in the U.S. and a decline in Latin America driven by Brazil. EMEA revenue

decreased 3.6 percent (1 percent adjusted for currency) and Asia Pacific revenue decreased 0.7 percent as reported, but increased 1 percent adjusted for currency.

The consolidated gross profit margin of 46.5 percent decreased 1.8 points year to year. The operating (non-GAAP) gross margin of 47.5 percent also decreased 1.8 points compared to the prior year primarily driven by higher levels of investment and a mix impact within the segments. Margin declines in Cognitive Solutions, Technology Services & Cloud Platforms and GBS, were partially offset by margin improvement in Systems consistent with the product cycle dynamics in z Systems and improvements in Power and Storage.

Total expense and other (income) increased 18.6 percent in the first quarter of 2016 compared to the prior year. Total operating (non-GAAP) expense and other (income) increased 24.2 percent year to year. In the first quarter of 2016 the company took significant actions to accelerate the transformation of its workforce and shift its skill base to new areas, and also to improve its structure primarily outside the U.S. The increased expense was primarily driven by charges for these actions. The key year-to-year drivers were approximately:

Management Discussion – (continued)

| | Total Consolidated | | Operating (non-GAAP) | |
|--------------|-----------------------|--------|-------------------------|--------|
| Currency* | (1) | point | (1) | point |
| Acquisitions | 3 | points | 3 | points |
| Base | 16 | points | 22 | points |

* Reflects impacts of translation and hedging programs.

The increase in base expense was driven primarily by a higher level of workforce rebalancing charges of \$998 million in the first quarter of 2016 compared to \$285 million in the first quarter of 2015 to accelerate the company's transformation, charges in the first quarter of 2016 for real estate actions of \$328 million and actions taken to reposition the company's business in Latin America. The increase in operating (non-GAAP) expense was driven primarily by the same factors. The company is continuing to shift resources and spending within its operational expense base, driving productivity and efficiency while increasing investment in support of the strategic imperatives.

Pre-tax income from continuing operations of \$1.0 billion in the first quarter of 2016 decreased 65.6 percent year to year and the pre-tax margin was 5.5 percent, a decrease of 9.8 points. The continuing operations effective tax rate for the first quarter of 2016 was (95.1) percent compared to an effective tax rate of 19.5 percent in the first quarter of 2015. The negative tax rate in the first quarter of 2016 is primarily the result of a refund (\$1.0 billion) of previously paid non-U.S. taxes, plus interest. Income from continuing operations of \$2.0 billion decreased 16.5 percent and the net income margin was 10.8 percent, a decrease of 1.5 points versus the first quarter of 2015. Losses from discontinued operations, net of tax, were \$3 million in the first quarter of 2016 compared to \$88 million in the first quarter of 2015. Net income of \$2.0 billion decreased 13.5 percent year to year. Operating (non-GAAP) pre-tax income from continuing operations of \$1.4 billion decreased 62.3 percent year to year and the operating (non-GAAP) pre-tax margin from continuing operations decreased 11.2 points to 7.3 percent. The charges for actions to accelerate the transformation of the company's business impacted operating (non-GAAP) pre-tax income from continuing operations by \$1.5 billion and pre-tax margin by 8 points in the quarter. These charges also impacted as-reported pre-tax income and pre-tax margin. Operating (non-GAAP) income from continuing operations of \$2.3 billion decreased 21.4 percent. The operating (non-GAAP) income margin from continuing operations of 12.1 percent decreased 2.6 points. The operating (non-GAAP) effective tax rate from continuing operations in the first quarter of 2016 was (66.8) percent versus 20.0 percent in the prior year. The first quarter of 2016 profit and margin performance reflects the actions taken to transform the business while improving the company's position for the future.

Diluted earnings per share from continuing operations of \$2.09 in the first quarter of 2016 decreased 14.3 percent year to year. In the first quarter of 2016, the company repurchased 6.6 million shares of its common stock at a cost of \$0.9 billion. Operating (non-GAAP) diluted earnings per share of \$2.35 decreased 19.2 percent versus the first quarter of 2015. Diluted earnings per share from discontinued operations was (\$0.00) in the first quarter of 2016 compared to (\$0.09) in the first quarter of 2015.

At March 31, 2016, the company continued to have the financial flexibility to support the business over the long term. Cash and marketable securities at quarter end were \$14.9 billion, an increase of \$6.7 billion from December 31, 2015. Key drivers in the balance sheet and total cash flows were:

Total assets increased \$8.4 billion (\$6.1 billion adjusted for currency) from December 31, 2015 driven by:

- Increases in cash (\$6.7 billion), goodwill (\$2.3 billion), acquired intangible assets (\$0.9 billion) and pension assets (\$0.6 billion); partially offset by
- Decreases in total receivables (\$2.6 billion).

Total liabilities increased \$7.7 billion (\$5.6 billion adjusted for currency) from December 31, 2015 driven by:

- Increases in total debt (\$5.7 billion), deferred income (\$1.5 billion) and workforce accruals (\$0.9 billion); partially offset by
- Decreases in accounts payable (\$0.7 billion) and income taxes (\$0.6 billion).

Total equity of \$15.1 billion increased \$0.6 billion from December 31, 2015 as a result of:

Management Discussion – (continued)

- Higher retained earnings (\$0.8 billion) and lower accumulated other comprehensive losses (\$0.6 billion); partially offset by
- Increased treasury stock (\$0.9 billion).

The company generated \$5.6 billion in cash flow provided by operating activities, an increase of \$2.0 billion when compared to the first quarter of 2015, driven primarily by lower income tax payments. Investing activities was a use of cash of \$2.0 billion in the first quarter of 2016 compared to a \$0.6 billion source of cash in the first quarter of 2015. This year-to-year decrease in cash flow was primarily driven by an increase in net cash used for acquisitions (\$2.4 billion) in the key areas of Watson Internet of Things, cloud, digital design and analytics. Financing activities provided \$2.8 billion of cash flow in the first quarter of 2016 compared to a use of cash of \$3.4 billion in the first quarter of 2015. This year-to-year increase in cash flow was primarily driven by higher net debt issuances (\$6.3 billion).

In April 2016, the company disclosed that it now expects GAAP earnings per share from continuing operations to be at least \$12.35 and continues to expect operating (non-GAAP) earnings of at least \$13.50 per diluted share for 2016. In addition, the company updated its outlook and now expects 2016 free cash flow to be at the high end of the \$11 billion to \$12 billion range. Refer to the Looking Forward section on pages 61 and 62 for additional information on the company's expectations.

First Quarter in Review

Results of Continuing Operations

Segment Details

The following is an analysis of the first quarter of 2016 versus the first quarter of 2015 reportable segment external revenue and gross margin results. Segment pre-tax income includes transactions between the segments that are intended to reflect an arm's-length transfer price and excludes certain unallocated corporate items.

Yr. to Yr.

| (Dollars in millions) For the three months ended March 31: | | | Yr. to Yr. Percent/Margin | Percent Change Adjusted For |
|--|-----------|-----------|------------------------------|-----------------------------------|
| | 2016 | 2015* | Change | Currency |
| Revenue: | | | | |
| Cognitive Solutions | \$ 3,979 | \$ 4,047 | (1.7)% | 0.4% |
| Gross margin | 82.0% | 84.5% | (2.5)pts. | |
| Global Business Services | 4,131 | 4,318 | (4.3)% | (2.3)% |
| Gross margin | 25.8% | 27.4% | (1.6)pts. | |
| Technology Services & Cloud Platforms | 8,424 | 8,554 | (1.5)% | 1.9% |
| Gross margin | 40.9% | 42.1% | (1.1)pts. | |
| Systems | 1,675 | 2,142 | (21.8)% | (20.6)% |
| Gross margin | 57.2% | 54.8% | 2.4pts. | |
| Global Financing | 410 | 461 | (11.2)% | (6.4)% |
| Gross margin | 42.4% | 49.6% | (7.1)pts. | |
| Other | 66 | 67 | (2.3)% | 0.7% |
| Gross margin | (342.0)% | (224.6)% | (117.3)pts. | |
| Total consolidated revenue | \$ 18,684 | \$ 19,590 | (4.6)% | (2.0)% |
| Total consolidated gross profit | \$ 8,686 | \$ 9,452 | (8.1)% | |
| Total consolidated gross margin | 46.5% | 48.2% | (1.8)pts. | |
| Non-operating adjustments: | | | | |
| Amortization of acquired intangible assets | 112 | 91 | 23.6% | |
| Retirement-related costs/(income) | 79 | 121 | (34.7)% | |
| Operating (non-GAAP) gross profit | \$ 8,877 | \$ 9,664 | (8.1)% | |
| Operating (non-GAAP) gross margin | 47.5% | 49.3% | (1.8)pts. | |

* Reclassified to conform with 2016 presentation.

Management Discussion – (continued)Cognitive Solutions

| (Dollars in millions) For the three months ended March 31: | 2016 | 2015* | Yr. to Yr. | Yr. to Yr. |
|--|----------|----------|------------|--------------|
| | | | Percent | Percent |
| | | | Change | Adjusted For |
| | | | Change | Currency |
| Cognitive Solutions external revenue: | \$ 3,979 | \$ 4,047 | (1.7)% | 0.4% |
| Solutions Software | \$ 2,691 | \$ 2,655 | 1.4% | 3.3% |
| Transaction Processing Software | 1,287 | 1,393 | (7.6) | (5.2) |

* Reclassified to conform with 2016 presentation.

Cognitive Solutions revenue of \$3,979 million decreased 1.7 percent as reported, but increased 0.4 percent year to year adjusted for currency. While Solutions Software grew year to year, it was offset by a decline in Transaction Processing Software.

Solutions Software addresses many of the company's strategic areas including analytics, security and social. Analytics is the largest part of the Solutions portfolio and includes the traditional analytics platform, industry solutions, commerce and Watson related businesses. In the first quarter, Solutions Software revenue of \$2,691 million grew 1.4 percent as reported and 3 percent adjusted for currency driven by strong double-digit growth (adjusted for currency) in cloud-based offerings leveraging Watson and from acquisitions. This performance represents significant sequential improvement from the fourth quarter of 2015. From an offering perspective, the first-quarter growth was led by security and analytics solutions. In both of these areas, the company has highly differentiated strategies and capabilities. Momentum continued in the first quarter of 2016 with high single-digit growth adjusted for currency in security software, outpacing the market. The company continues to invest to build its security platform, including recent acquisitions such as Resilient Systems, which provides leading incident response capabilities and expands the company's overall leadership in security. The company's approach to analytics is also unique and differentiated, building on an industrial-strength cognitive platform that is cloud-based and leverages Watson. It is also supported by industry-specific data to help provide new insights in key industries. Watson Healthcare further expands the company's revenue opportunities through targeted industry focus. In the past 12 months, the company has invested \$4 billion in four acquisitions in this industry. In early April, the Truven acquisition closed, which brings more than 8,500 clients to the Watson Health portfolio.

Transactions Processing Software of \$1,287 million declined 7.6 percent as reported and 5 percent adjusted for currency in the first quarter of 2016 compared to the prior year. This software primarily runs mission critical systems in industries such as banking, airlines and retail. It includes certain offerings running on z Systems, which were primarily reflected in Other Middleware in the previously reported Software segment. Most of this software is on-premises and annuity in nature, which is not a growing part of the software opportunity.

Within Cognitive Solutions, total first-quarter strategic imperatives revenue of \$2,473 million grew 2.2 percent as reported and 4 percent adjusted for currency year to year. Within the strategic imperatives, Cloud revenue of \$402 million grew 32.1 percent as reported and 34 percent adjusted for currency, with an as-a-Service exit run rate of \$1,154 million.

| (Dollars in millions) | | | | Yr. to Yr. Percent/ Margin Change |
|---|-------------|--------------|--|--|
| For the three months ended March 31: | 2016 | 2015* | | |
| Cognitive Solutions: | | | | |
| External gross profit | \$ 3,262 | \$ 3,418 | | (4.6)% |
| External gross profit margin | 82.0% | 84.5% | | (2.5)pts. |
| Pre-tax income | \$ 1,013 | \$ 1,528 | | (33.7)% |
| Pre-tax margin | 21.8% | 32.6% | | (10.8)pts. |

* Reclassified to conform with 2016 presentation.

The Cognitive Solutions gross profit margin decreased 2.5 points to 82.0 percent in the first quarter of 2016 compared to the prior year. The margin was impacted by a lower level of transactional revenue and higher cloud-based content.

Management Discussion – (continued)

Pre-tax income of \$1,013 million decreased 33.7 percent and pre-tax margin declined 10.8 points to 21.8 percent. This performance reflects a higher level of investments in areas such as the Watson Platform, Health and Internet of Things, currency impact and the year to year impact of the workforce rebalancing charges. In the first quarter of 2016, there were \$231 million of charges primarily related to workforce rebalancing and real estate actions compared to \$44 million of workforce rebalancing charges in the prior year period.

Global Business Services

| (Dollars in millions) | | | Yr. to Yr. | Yr. to Yr. |
|---|-------------|--------------|-------------------|-------------------|
| For the three months ended March 31: | 2016 | 2015* | Percent | Percent |
| | | | Change | Change |
| | | | | Adjusted |
| | | | | For |
| | | | | Currency |
| Global Business Services external revenue: | \$ 4,131 | \$ 4,318 | (4.3)% | (2.3)% |
| Consulting | \$ 1,835 | \$ 1,946 | (5.7)% | (4.4)% |
| Global Process Services | 348 | 360 | (3.4) | (1.2) |
| Application Management | 1,949 | 2,012 | (3.1) | (0.6) |

* Reclassified to conform with 2016 presentation.

In the first quarter of 2016, Global Business Services revenue of \$4,131 million decreased 4.3 percent as reported and 2 percent adjusted for currency as the company continues to shift away from traditional businesses, such as ERP, to more strategic areas. Application Management, which represents 47 percent of GBS revenue, continued to have relatively stable performance in the first quarter consistent with the prior year. The ongoing shift to new areas in Consulting continued to impact year-to-year growth rates.

Consulting revenue of \$1,835 million declined 5.7 percent as reported and 4 percent adjusted for currency, with sequential improvement compared to the prior quarter. Application Management revenue of \$1,949 million decreased 3.1 percent as reported and 1 percent adjusted for currency compared to the prior year. Global Process Services revenue of \$348 million decreased 3.4 percent as reported and 1 percent adjusted for currency. The company expanded its digital design capabilities with three acquisitions in the first quarter, that will be integrated into the IBM Interactive Experience, the largest global digital agency, and expanded skills in other areas. The company announced its intent to acquire Bluewolf, which will extend GBS's industry consulting leadership with one of the world's leading Salesforce consulting practices. The company's Apple partnership continues to redesign workflows and drive productivity for clients.

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Within GBS, total first quarter strategic imperatives revenue of \$1,991 million grew 19.3 percent as reported and 22 percent adjusted for currency year to year. In the first quarter, the strategic imperatives generated nearly 50 percent of the total GBS segment revenue, with strong growth across cloud, analytics, mobility and security practices. Within the strategic imperatives, Cloud revenue of \$550 million grew 53.5 percent as reported and 55 percent adjusted for currency, with an as-a-Service exit run rate of \$493 million.

| (Dollars in millions) | | | | Yr. to Yr. Percent/ Margin Change |
|---|-------------|--|--------------|--|
| For the three months ended March 31: | 2016 | | 2015* | |
| Global Business Services: | | | | |
| External gross profit | \$ 1,068 | | \$ 1,184 | (9.8)% |
| External gross profit margin | 25.8% | | 27.4% | (1.6)pts. |
| Pre-tax income | \$ 190 | | \$ 588 | (67.7)% |
| Pre-tax margin | 4.5% | | 13.2% | (8.7)pts. |

* Reclassified to conform with 2016 presentation.

The GBS gross profit margin decreased 1.6 points to 25.8 percent in the first quarter of 2016 compared to the prior year as the company continues to invest to drive its transformation, strategically shifting resources to higher value services which is impacting margin. Continued price and profit pressure in certain parts of the portfolio is also impacting margin.

Management Discussion – (continued)

Pre-tax income of \$190 million decreased 67.7 percent and pre-tax margin declined 8.7 points to 4.5 percent. This performance not only reflects the impact of the investment made in new areas, such as digital, but also includes the impacts of structural actions, including workforce rebalancing taken this quarter which will help progress the transformation in GBS. In the first quarter of 2016, there were \$328 million of charges primarily related to workforce rebalancing and real estate actions compared to \$52 million of workforce rebalancing charges in the prior year period.

Technology Services & Cloud Platforms

| (Dollars in millions) | | | Yr. to Yr. | Yr. to Yr. |
|---|-------------|--------------|---------------------|-------------------|
| For the three months ended March 31: | 2016 | 2015* | Percent | Percent |
| Technology Services & Cloud Platforms | | | Change | Change |
| external revenue: | | | Adjusted For | |
| | | | Currency | |
| Technology Services & Cloud Platforms external revenue: | \$ 8,424 | \$ 8,554 | (1.5)% | 1.9% |
| Infrastructure Services | \$ 5,626 | \$ 5,614 | 0.2% | 3.5% |
| Technical Support Services | 1,786 | 1,881 | (5.1) | (0.8) |
| Integration Software | 1,012 | 1,059 | (4.5) | (2.4) |

* Reclassified to conform with 2016 presentation.

Technology Services & Cloud Platforms revenue of \$8,424 million decreased 1.5 percent as reported, but grew 2 percent adjusted for currency in the first quarter of 2016 compared to the prior year. Infrastructure Services revenue of \$5,626 million grew 0.2 percent as reported and 4 percent adjusted for currency. This includes the company's previous Strategic Outsourcing and Integrated Technology Services lines. Technical Support Services revenue of \$1,786 million decreased 5.1 percent as reported and 1 percent adjusted for currency. Integration Software revenue of \$1,012 million decreased 4.5 percent as reported and 2 percent adjusted for currency.

In Infrastructure Services, hybrid cloud solutions provide value to enterprises as they enable new business models while leveraging existing systems and data. In the first quarter, clients continued to turn to the company as the trusted partner to modernize their most critical IT systems and move them to hybrid. There was also continued strong momentum in SoftLayer which again grew at strong double digits adjusted for currency this quarter as the company continues to invest to build out its global capability. In the first quarter, there was also continued expansion of cloud capabilities with the acquisition of Ustream and the formation of the IBM Cloud Video Services Unit that will provide clients with a powerful portfolio of video services and digital analytics.

In Integration Software, the company is cloud-enabling the portfolio to make it easy for clients to unlock large investments in existing data and application systems. It was recently announced that 100 percent of the company's

relevant software is now available in the cloud through a series of offerings, such as WebSphere Connect, and that several important strategic partnerships have been formed as the company continues to build out its ecosystem. Annuity content in Integration Software is growing, with stability in on-premises content and acceleration in the adoption of SaaS, specifically in the products that integrate a hybrid cloud environment.

Within Technology Services & Cloud Platforms, total first quarter strategic imperatives revenue of \$1,848 million grew 41.2 percent as reported and 45 percent adjusted for currency year to year driven by hybrid cloud infrastructure engagements. Within the strategic imperatives, Cloud revenue of \$1,173 million grew 46.0 percent as reported and 50 percent adjusted for currency with an as-a-Service exit run rate of \$3,717 million.

Management Discussion – (continued)

| (Dollars in millions) | | | Yr. to Yr. Percent/ Margin Change |
|---|-------------|--------------|--|
| For the three months ended March 31: | 2016 | 2015* | |
| Technology Services & Cloud Platforms: | | | |
| External Technology Services gross profit | \$ 2,605 | \$ 2,699 | (3.5)% |
| External Technology Services gross profit margin | 35.1% | 36.0% | (0.9)pts. |
| External Integration Software gross profit | \$ 843 | \$ 898 | (6.2)% |
| External Integration Software gross profit margin | 83.3% | 84.8% | (1.5)pts. |
| External total gross profit | \$ 3,447 | \$ 3,597 | (4.2)% |
| External total gross profit margin | 40.9% | 42.1% | (1.1)pts. |
| Pre-tax income | \$ 258 | \$ 1,131 | (77.2)% |
| Pre-tax margin | 3.0% | 13.0% | (10.0)pts. |

* Reclassified to conform with 2016 presentation.

The Technology Services & Cloud Platforms gross profit margin decreased 1.1 points to 40.9 percent in the first quarter of 2016 compared to the prior year, with year-to-year declines in both Technology Services and Integration Software. Margin was impacted by the revenue trajectory of Integration Software as more of the portfolio moves to an as-a-Service model delivered through the cloud and, within Integration Services, the company is investing to contemporize clients' IT systems as it signs new contracts. Gross profit detail is provided within this segment for additional information due to the new alignment of software content into this segment beginning this quarter.

Pre-tax income of \$258 million decreased 77.2 percent and pre-tax margin declined 10.0 points to 3.0 percent driven by workforce transformational actions taken during the quarter, continued investment to build out platforms such as Bluemix and SoftLayer and currency impacts. In the first quarter of 2016, there were \$695 million of charges primarily related to workforce rebalancing and real estate actions compared to \$169 million of workforce rebalancing charges in the prior year period.

Services Backlog and Signings

| Yr. to Yr. | Yr. to Yr. Percent Change |
|-------------------|--|
|-------------------|--|

| (Dollars in billions) | At March 31, 2016 | At March 31, 2015 | Percent Change | Adjusted For Currency |
|------------------------------|----------------------------------|----------------------------------|---------------------------|----------------------------------|
| Total backlog | \$ 122.4 | \$ 122.6* | (0.2)% | (0.9)% |

* Reclassified to conform with 2016 presentation.

The estimated total services backlog at March 31, 2016 was \$122 billion, a decrease of 0.2 percent as reported and 1 percent adjusted for currency compared to the March 31, 2015 balance. Global Technology Services, within the Technology Services & Cloud Platforms segment, grew 1.6 percent as reported and 1 percent adjusted for currency. GBS declined 4.4 percent as reported and 5 percent adjusted for currency, which is a reflection of the company's shift from large ERP implementations to the new strategic opportunities.

Total services backlog includes Infrastructure Services, Consulting, Global Process Services, Application Management and Technical Support Services. Total backlog is intended to be a statement of overall work under contract and therefore includes Technical Support Services. It does not include as-a-Service offerings given the flexibility in contractual commitment terms provided to these clients. 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.

Services signings are management's initial estimate of the value of a client's commitment under a services contract. 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.

Management Discussion – (continued)

Signings include Infrastructure Services, Consulting, Global Process Services and Application Management contracts. Contract extensions and increases in scope are treated as signings only to the extent of the incremental new value. Technical Support Services is not included in signings as maintenance contracts tend to be more steady state, where revenues equal renewals.

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.

| (Dollars in millions) | | | Yr. to Yr. Percent | Yr. to Yr. Percent Change Adjusted For |
|-----------------------------------|-------------|-------------|-------------------------------|---|
| For the three months ended | | | | |
| March 31: | 2016 | 2015 | Change | Currency |
| Total signings | \$ 8,024 | \$ 10,329* | (22.3)% | (17.5)% |

* Reclassified to conform with 2016 presentation.

Systems

| (Dollars in millions) | | | Yr. to Yr. Percent | Yr. to Yr. Percent Change Adjusted For |
|---|-------------|--------------|-------------------------------|---|
| For the three months ended March | | | | |
| 31: | 2016 | 2015* | Change | Currency |
| Systems external revenue: | \$ 1,675 | \$ 2,142 | (21.8)% | (20.6)% |
| Systems Hardware | \$ 1,235 | \$ 1,657 | (25.5)% | (24.6)% |
| z Systems | | | (43.4) | (42.2) |
| Power Systems | | | (14.4) | (13.6) |
| Storage Systems | | | (6.7) | (6.1) |
| Operating Systems Software | 440 | 484 | (9.1) | (6.9) |

* Reclassified to conform with 2016 presentation.

In the first quarter of 2016, Systems revenue of \$1,675 million decreased 21.8 percent as reported and 21 percent adjusted for currency compared to the prior year. Systems Hardware revenue of \$1,235 million decreased 25.5 percent as reported and 25 percent adjusted for currency primarily reflecting the z Systems product cycle. Operating Systems Software revenue of \$440 million decreased 9.1 percent as reported and 7 percent adjusted for currency.

Within Systems Hardware, z Systems decreased 43.4 percent as reported and 42 percent adjusted for currency compared to the first quarter of 2015. This is attributed to strong performance in the prior year when the z13 mainframe was launched and revenue grew 118.4 percent as reported (130 percent adjusted for currency).

After four consecutive quarters of constant currency growth, Power Systems decreased 14.4 percent as reported and 14 percent adjusted for currency in the first quarter of 2016. This is attributed to the strong performance in Unix-based entry system in the prior-year period. In the first quarter, there was continued momentum in Linux offerings and expansion of the company's Open POWER efforts. There was focus on the growth of Power-based Linux systems which have now grown to about 10 percent of the overall Power Systems revenue base. There was also continued traction with the OpenPOWER foundation-based innovations.

Storage Systems revenue decreased 6.7 percent as reported and 6 percent adjusted for currency in the first quarter compared to the prior year reflecting continued weakness in the overall storage market. However, the company is well positioned to capture the strategic growth areas of Flash, Software Defined Storage and Object Storage.

Within Systems, total first quarter strategic imperatives revenue of \$653 million decreased 6.1 percent as reported and 5 percent adjusted for currency year to year. Within the strategic imperatives, Cloud revenue of \$509 million grew 1.3 percent as reported and 2 percent adjusted for currency.

Management Discussion – (continued)

| (Dollars in millions) | | | Yr. to Yr. Percent/ Margin Change |
|---|-------------|--------------|--|
| For the three months ended March 31: | 2016 | 2015* | |
| Systems: | | | |
| External Systems Hardware gross profit | \$ 572 | \$ 739 | (22.6)% |
| External Systems Hardware gross profit margin | 46.4% | 44.6% | 1.7pts. |
| External Operating Systems Software gross profit | \$ 387 | \$ 435 | (11.0)% |
| External Operating Systems Software gross profit margin | 87.8% | 89.7% | (1.9)pts. |
| External total gross profit | \$ 959 | \$ 1,174 | (18.3)% |
| External total gross profit margin | 57.2% | 54.8% | 2.4pts. |
| Pre-tax income/(loss) | \$ (10) | \$ 261 | nm |
| Pre-tax margin | (0.5)% | 11.3% | (11.8)pts. |

* Reclassified to conform with 2016 presentation.

nm - not meaningful

The Systems gross profit margin increased 2.4 points to 57.2 percent in the first quarter of 2016 compared to the prior year. This increase was due to margin (3.7 points) with improvements across all hardware brands, partially offset by a less favorable product mix (1.3 points). Gross profit detail is provided within this segment for additional information due to the new alignment of software content into this segment beginning this quarter.

Systems had a pre-tax loss of \$10 million in the first quarter of 2016 compared with pre-tax income of \$261 million in the prior year with a decrease in pre-tax margin of 11.8 points year to year. This decline reflects the improved gross profit margin on lower revenue and the impact of transformation actions, including workforce rebalancing, which is about half the year-to-year decline. In the first quarter of 2016, there were \$130 million of charges primarily related to real estate and workforce rebalancing actions compared to \$20 million of workforce rebalancing charges in the prior year period.

Global Financing

See pages 65 through 70 for a discussion of Global Financing's segment results.

Total Software

Under the company's new segment structure, total Software no longer exists as a segment, instead the company's software revenue is included within the Technology Services & Cloud Platforms, Cognitive Solutions, and Systems segments. Given the current focus on IBM's software revenue performance, the company will continue to report total software revenue performance throughout 2016. Total Software revenue, which includes Cognitive Solutions, Integration Software and Operating Systems Software, of \$5,431 million decreased 2.9 percent as reported and 1 percent adjusted for currency in the first quarter of 2016 compared to the prior year period. Performance reflected improvement at constant currency of 5 points from the fourth quarter of 2015 driven by a higher mix of annuity revenue versus transactional content. In addition, the company has been adding new capabilities, both organically and through acquisitions. This quarter's software performance reflects the acquisitions that closed over the last year, and while these acquisitions contribute to revenue growth, they initially impact profit performance. The annuity revenue was up 2 percent adjusted for currency, with steady renewal rates and growth in the SaaS business.

From a product offering perspective, revenue growth in Solutions Software was offset by continued headwinds in Operating Systems and Transaction Processing Software. Total software includes a portion of software support line revenue that was previously reported in Integrated Technology Services. Support line did not have an impact on the software revenue growth rate at constant currency.

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.

Management Discussion – (continued)

| (Dollars in millions) | | | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted For Currency |
|--------------------------------------|-----------|-----------|---------------------------------|---|
| For the three months ended March 31: | 2016 | 2015 | | |
| Total Revenue | \$ 18,684 | \$ 19,590 | (4.6)% | (2.0)% |
| Geographies: | \$ 18,611 | \$ 19,498 | (4.6)% | (1.9)% |
| Americas | 8,673 | 9,312 | (6.9) | (4.0) |
| Europe/Middle East/Africa (EMEA) | 5,906 | 6,125 | (3.6) | (0.6) |
| Asia Pacific | 4,031 | 4,061 | (0.7) | 0.7 |

Total geographic revenue of \$18,611 million decreased 4.6 percent as reported and 2 percent adjusted for currency in the first quarter of 2016 compared to the prior year. Americas revenue of \$8,673 million decreased 6.9 percent as reported and 4 percent adjusted for currency. EMEA first quarter revenue of \$5,906 million decreased 3.6 percent as reported with a modest decline of 1 percent adjusted for currency. Asia Pacific revenue of \$4,031 million decreased 0.7 percent as reported, but returned to growth of 1 percent adjusted for currency.

Within Americas, the U.S. decreased 3.6 percent compared to the prior year and improved sequentially from the prior quarter. Canada was down 10.7 percent as reported and 1 percent adjusted for currency. Latin America decreased 23.8 percent as reported and 8 percent adjusted for currency, driven by Brazil. Although the company has built a strong business in Brazil over the years, recent quarters' performance have been more volatile. This quarter, Brazil revenue declined, partially due to a strong prior year first quarter, but also due to an economic environment that appears uncertain. The company has taken certain portfolio actions in this business which impacts growth in the short term. On an adjusted basis, the decline in Brazil was partially offset by growth in other Latin American countries, including Mexico, Argentina, Chile and Colombia.

Within EMEA, there was continued growth in the UK on an adjusted basis, with revenue declining 4.3 percent as reported, but growing 1 percent adjusted for currency. Germany decreased 2.3 percent as reported and France decreased 2.1 percent as reported, but both countries were flat year to year adjusted for currency. Italy was flat year to year as reported, but had growth of 2 percent adjusted for currency. The Middle East and Africa region grew 1.4 percent as reported and 8 percent adjusted for currency. However, there was a decline in the Central and Eastern European region including a year-to-year decline in Russia of 34.2 percent.

Within Asia Pacific, Japan grew 5.3 percent as reported and 2 percent adjusted for currency. Australia decreased 3.2 percent as reported, but grew 6 percent adjusted for currency. India grew 4.7 percent as reported and 13 percent adjusted for currency. China decreased 7.7 percent as reported and 5 percent adjusted for currency.

ExpenseTotal Expense and Other (Income)

| (Dollars in millions) | | | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Total consolidated expense and other (income) | \$ 7,652 | \$ 6,451 | 18.6% |
| Non-operating adjustments: | | | |
| Amortization of acquired intangible assets | (99) | (79) | 25.3 |
| Acquisition-related charges | 27 | 0 | nm |
| Non-operating retirement-related (costs)/income | (63) | (321) | (80.2) |
| Operating (non-GAAP) expense and other (income) | \$ 7,516 | \$ 6,051 | 24.2% |
| Total consolidated expense-to-revenue ratio | 41.0% | 32.9% | 8.0pts. |
| Operating (non-GAAP) expense-to-revenue ratio | 40.2% | 30.9% | 9.3pts. |

nm - not meaningful

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

Management Discussion – (continued)

| | Total Consolidated | | Operating (non-GAAP) | |
|--------------|-----------------------|--------|-------------------------|--------|
| Currency* | (1) | point | (1) | point |
| Acquisitions | 3 | points | 3 | points |
| Base | 16 | points | 22 | points |

* Reflects impacts of translation and hedging programs.

For additional information regarding total expense and other (income) for both expense presentations, see the following analyses by category.

Selling, general and administrative expense

| (Dollars in millions) | | | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Selling, general and administrative expense: | | | |
| Selling, general and administrative – other | \$ 4,192 | \$ 4,077 | 2.8% |
| Advertising and promotional expense | 348 | 313 | 11.2 |
| Workforce rebalancing charges | 998 | 285 | 250.0 |
| Retirement-related costs | 179 | 438 | (59.3) |
| Amortization of acquired intangible assets | 99 | 79 | 25.3 |
| Stock-based compensation | 99 | 87 | 14.1 |
| Bad debt expense | 97 | 83 | 17.1 |
| Total consolidated selling, general and administrative expense | \$ 6,012 | \$ 5,362 | 12.1% |
| Non-operating adjustments: | | | |
| Amortization of acquired intangible assets | (99) | (79) | 25.3 |
| Acquisition-related charges | 32 | 0 | nm |
| Non-operating retirement-related (costs)/income | (55) | (308) | (82.2) |
| Operating (non-GAAP) selling, general and administrative expense | \$ 5,890 | \$ 4,975 | 18.4% |

nm – not meaningful

Total selling, general and administrative (SG&A) expense increased 12.1 percent in the first quarter of 2016 versus the prior year driven primarily by the following factors:

- Higher workforce rebalancing charges (14 points); and
- Acquisition-related spending (2 points); partially offset by
- A prior year pension obligation related to litigation in Spain (4 points); and

- The effects of currency (2 points).

Operating (non-GAAP) expense increased 18.4 percent year to year driven by primarily the same factors excluding the benefit from the prior-year pension obligation which was not reflected in operating (non-GAAP) expense.

Bad debt expense increased \$14 million year to year. The receivables provision coverage was 2.8 percent at March 31, 2016, an increase of 20 basis points from both December 31, 2015 and March 31, 2015.

Research, Development and Engineering

| (Dollars in millions) | | | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Total consolidated research, development and engineering expense | \$ 1,458 | \$ 1,298 | 12.3% |
| Non-operating adjustment: | | | |
| Non-operating retirement-related (costs)/income | (9) | (13) | (33.9) |
| Operating (non-GAAP) research, development and engineering expense | \$ 1,449 | \$ 1,285 | 12.8% |

Management Discussion – (continued)

Research, development and engineering (RD&E) expense was 7.8 percent of revenue in the first quarter of 2016 compared to 6.6 percent of revenue in the first quarter of 2015.

RD&E expense in the first quarter of 2016 increased 12.3 percent year to year primarily driven by:

- Increased base spending (9 points); and
- Higher expense due to acquisitions (5 points); partially offset by
- The effects of currency (2 points).

Operating (non-GAAP) RD&E expense increased 12.8 percent in the first quarter of 2015 compared to the prior year driven primarily by the same factors.

Intellectual Property and Custom Development Income

| (Dollars in millions) | | | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Intellectual Property and Custom Development Income: | | | |
| Sales and other transfers of intellectual property | \$ 125 | \$ 71 | 75.1% |
| Licensing/royalty-based fees | 41 | 31 | 31.5 |
| Custom development income | 51 | 70 | (27.2) |
| Total | \$ 217 | \$ 173 | 25.7% |

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 individual IP transactions in the first quarter of 2016 and 2015.

Other (income) and expense

| (Dollars in millions) | | | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Other (income) and expense: | | | |
| Foreign currency transaction losses/(gains) | \$ 226 | \$ 90 | 150.5% |
| (Gains)/losses on derivative instruments | (207) | (177) | 17.3 |
| Interest income | (24) | (19) | 30.7 |
| Net (gains)/losses from securities and investment assets | 39 | (1) | nm |
| Other | 219 | (37) | nm |
| Total consolidated other (income) and expense | \$ 253 | \$ (143) | nm% |

Non-operating adjustment:

| | | | | | |
|---|----|-----|----|-------|-----|
| Acquisition-related charges | | (6) | | 0 | nm |
| Operating (non-GAAP) other (income) and expense | \$ | 247 | \$ | (143) | nm% |

nm - not meaningful

Total consolidated other (income) and expense was expense of \$253 million in the first quarter of 2016 compared to income of \$143 million in the prior year. The decrease in income of \$396 million year over year was primarily driven by:

- Real estate capacity charges related to the first-quarter 2016 workforce transformation (\$328 million); and
- Higher foreign currency transaction losses (\$136 million), including a current year devaluation in Venezuela (\$43 million); and
- Increased losses from securities and investment assets (\$40 million) primarily related to the sale of Lenovo shares (\$37 million); partially offset by
- Increased gains on derivative instruments (\$31 million); and

Management Discussion – (continued)

- Higher gains on divestitures (\$36 million).

Interest Expense

| (Dollars in millions) | | | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Interest expense | \$ 147 | \$ 108 | 36.8% |

The increase in interest expense in the first quarter of 2016 compared with the first quarter of 2015 was primarily driven by higher average debt levels and higher average interest rates. 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. Overall interest expense (excluding capitalized interest) for the first quarter of 2016 was \$285 million, an increase of \$38 million year to year.

Retirement-Related Plans

The following table provides 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) | | | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| For the three months ended March 31: | 2016 | 2015 | |
| Retirement-related plans – cost: | | | |
| Service cost | \$ 110 | \$ 116 | (4.7)% |
| Amortization of prior service costs/(credits) | (25) | (26) | (0.3) |
| Cost of defined contribution plans | 271 | 288 | (5.9) |
| Total operating costs/(income) | \$ 356 | \$ 379 | (5.9)% |
| Interest cost | \$ 827 | \$ 834 | (0.8)% |
| Expected return on plan assets | (1,394) | (1,474) | (5.4) |
| Recognized actuarial losses | 687 | 829 | (17.2) |
| Curtailments/settlements | 5 | 4 | 13.6 |
| Multi-employer plans/other costs | 18 | 248 | (92.7) |
| Total non-operating costs/(income) | \$ 142 | \$ 442 | (67.8)% |
| Total retirement-related plans – cost | \$ 499 | \$ 820 | (39.2)% |

In the first quarter of 2016, total pre-tax retirement-related plan cost decreased by \$322 million compared to the first quarter of 2015, primarily driven by a prior year pension obligation related to litigation (\$230 million), a decrease in recognized actuarial losses (\$143 million) and lower defined contribution plans costs (\$17 million); partially offset by lower expected return on plan assets (\$80 million).

As discussed in the “Snapshot” on page 43, the company characterizes certain retirement-related costs as operating and others as non-operating. Utilizing this characterization, operating retirement-related costs in the first quarter of 2016 were \$356 million, a decrease of \$22 million compared to the first quarter of 2015, primarily driven by lower defined contribution plans cost (\$17 million). Non-operating costs of \$142 million in the first quarter of 2016 decreased \$299 million year to year, driven primarily by a prior year pension obligation related to litigation (\$230 million) and a decrease in recognized actuarial losses (\$143 million); partially offset by lower expected return on plan assets (\$80 million).

Taxes

The continuing operations effective tax rate for the first quarter of 2016 was (95.1) percent, a decrease of 114.6 points compared to the first quarter of 2015. The operating (non-GAAP) tax rate for the first quarter of 2016 was (66.8) percent, a decrease of 86.8 points compared to the first quarter of 2015. The lower continuing operations effective tax rate in the first quarter of 2016 was primarily driven by the favorable resolution of a long-standing tax matter in February 2016 related to the determination of certain foreign tax losses incurred by the company in Japan (113.3 points), a favorable settlement of the

Management Discussion – (continued)

remaining open items on the company's U.S. income tax returns for 2011 and 2012 (3.6 points), and a benefit related to the first-quarter 2016 real estate capacity actions (5.2 points). These benefits were partially offset by a tax charge related to intercompany royalties from foreign subsidiaries (6.9 points). The decline in the operating (non-GAAP) tax rate was primarily driven by the same factors.

In April 2010, the company appealed the determination of the Japanese Tax Authorities with respect to certain foreign tax losses. The tax benefit of these losses, approximately \$1.0 billion adjusted for currency, had been included in unrecognized tax benefits as of December 2015. In April 2011, the company received notification that the appeal was denied, and in June 2011, the company filed a lawsuit challenging this decision. In May 2014, the Tokyo District Court ruled in favor of the company. The Japanese government appealed the ruling to the Tokyo High Court. On March 25, 2015, the Tokyo High Court ruled in favor of IBM and, on April 7, 2015, the Japanese government appealed the ruling to the Japan Supreme Court. On February 18, 2016, the Supreme Court denied the government appeal thereby upholding the Tokyo High Court's decision in favor of the company as the final judgment in this matter. This led to a refund of the taxes previously paid of \$1.0 billion, which the company received in the first quarter and included in the effective tax rate. Interest of \$0.2 billion was also received.

With respect to major U.S. state and foreign taxing jurisdictions, the company is generally no longer subject to tax examinations for years prior to 2011. The company is no longer subject to income tax examination of its U.S. federal tax return for years prior to 2013. The open years 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, 2015 decreased by \$908 million in the first quarter of 2016 to \$3,666 million. The decrease was primarily due to the first quarter favorable resolution of the Japan tax matter. The total amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate was \$2,796 million at March 31, 2016.

In the fourth quarter of 2013, the company received a draft tax assessment notice for approximately \$866 million (approximately \$809 million at first quarter 2016 currency rates) from the Indian Tax Authorities for 2009. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability. At March 31, 2016, the company has recorded \$553 million as prepaid income taxes in India. A significant portion of this balance represents cash tax deposits paid over time to protect the company's right to appeal various income tax assessments made by the Indian Tax Authorities.

In the first quarter of 2016, the IRS commenced its audit of the company's U.S. tax returns for 2013 and 2014. The company anticipates that this audit will be completed by the end of 2017.

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.

| | | | | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|--|
| For the three months ended March 31: | 2016 | 2015 | | |
| Earnings per share of common stock from continuing operations: | | | | |
| Assuming dilution | \$ 2.09 | \$ 2.44 | | (14.3)% |
| Basic | \$ 2.09 | \$ 2.45 | | (14.7)% |
| Diluted operating (non-GAAP) | \$ 2.35 | \$ 2.91 | | (19.2)% |
| Weighted-average shares outstanding: (in millions) | | | | |
| Assuming dilution | 964.4 | 992.3 | | (2.8)% |
| Basic | 961.7 | 988.1 | | (2.7)% |

Management Discussion – (continued)

Actual shares outstanding at March 31, 2016 were 960.0 million. The weighted-average number of common shares outstanding assuming dilution during the first quarter of 2016 was 28.0 million shares lower than the first quarter of 2015. The decrease was primarily the result of the common stock repurchase program.

Results of Discontinued Operations

The loss from discontinued operations, net of tax, was \$3 million in the first quarter of 2016 compared to \$88 million in the first quarter of 2015. The discontinued operations effective tax rate in the first quarter of 2016 was 38.4 percent compared to 26.3 percent in the first quarter of 2015.

Financial PositionDynamics

At March 31, 2016, the company continued to have the financial flexibility to support the business over the long term. Cash and marketable securities at quarter end were \$14,869 million. Total debt of \$45,557 million increased \$5,667 million from prior year-end levels, driven by new debt issuances of \$8,062 million, partially offset by maturities of \$2,184 million. Within total debt, \$26,782 million, or approximately 59 percent, is in support of the Global Financing business. The company continues to manage the investment portfolio to meet its capital preservation and liquidity objectives. In the first three months of 2016, the company generated \$5,645 million in cash from operations, an increase of \$2,035 million compared to the first three months of 2015. 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. In October 2015, the term of the five-year global credit facility was extended by one year, and now expires on November 10, 2020.

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 5 and 6 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 March 31, 2016 | At December 31, 2015 |
|------------------------------|------------------------------|---------------------------------|
| Current assets | \$ 47,623 | \$ 42,504 |

| | | | | |
|---------------------|----|--------|----|--------|
| Current liabilities | | 34,664 | | 34,269 |
| Working capital | \$ | 12,959 | \$ | 8,235 |
| Current ratio | | 1.37:1 | | 1.24:1 |

Working capital increased \$4,724 million from the year-end 2015 position. The key changes are described below:

Current assets increased \$5,119 million (\$4,133 million adjusted for currency), due to:

- An increase of \$6,668 million (\$6,451 million adjusted for currency) in cash and cash equivalents; partially offset by
- A decline of \$2,374 million (\$2,805 million adjusted for currency) in financing receivables primarily due to collections of higher year-end balances.

Current liabilities increased \$395 million (a decrease of \$363 million adjusted for currency), as a result of:

- An increase in deferred income of \$1,588 million (\$1,298 million adjusted for currency) driven by annual customer billings; and
- An increase in other accrued expenses and liabilities of \$1,451 million (\$1,268 million adjusted for currency) driven by workforce rebalancing accruals and derivative positions; partially offset by

Management Discussion – (continued)

- A decrease in short-term debt of \$1,159 million (\$1,186 million adjusted for currency) primarily as a result of maturities of \$2,184 million and a decrease in commercial paper of \$600 million, partially offset by reclassifications of \$1,771 million from long term to reflect upcoming maturities; and
- A decrease in accounts payable of \$725 million (\$824 million adjusted for currency) reflecting declines from typically higher year-end balances; and
- A decrease in taxes payable of \$644 million (\$724 million adjusted for currency) primarily driven by income tax payments.

Cash Flow

The company's cash flows from operating, investing and financing activities, as reflected in the Consolidated Statement of Cash Flows on page 7, are summarized in the following table. These amounts include the cash flows associated with the Global Financing business.

(Dollars in millions)**For the three months ended March 31:**

| | 2016 | | 2015 |
|--|-------------|----|-------------|
| Net cash provided by/(used in) continuing operations: | | | |
| Operating activities | \$ 5,645 | \$ | 3,610 |
| Investing activities | (2,028) | | 560 |
| Financing activities | 2,834 | | (3,402) |
| Effect of exchange rate changes on cash and cash equivalents | 217 | | (449) |
| Net change in cash and cash equivalents | \$ 6,668 | \$ | 319 |

Net cash provided by operating activities increased by \$2,035 million as compared to the first three months of 2015 driven by the following factors:

- A decline in income tax payments of \$1,852 million driven by the Japan tax refund received; and
- A decline in cash payments for workforce rebalancing of \$294 million; and

- A decline in performance based compensation payments of \$185 million; partially offset by
- A decrease in cash sourced from sales cycle working capital of \$447 million.

Investing activities was a use of cash of \$2,028 million in the first quarter of 2016 compared to a source of cash of \$560 million in the first quarter of 2015. This year-to-year decrease in cash flow of \$2,588 million was driven by:

- An increase in net cash used related to acquisitions of \$2,442 million.

Financing activities was a source of cash of \$2,834 million in the first quarter of 2016 compared to a use of cash of \$3,402 million in the first quarter of 2015. This year-to-year increase in cash flow of \$6,235 million was driven by:

- An increase in net cash sourced from debt transactions of \$6,273 million primarily driven by higher levels of issuances in the current period.

Noncurrent Assets and Liabilities

| (Dollars in millions) | At March 31, 2016 | At December 31, 2015 |
|---|------------------------------|---------------------------------|
| Noncurrent assets | \$ 71,233 | \$ 67,991 |
| Long-term debt | \$ 40,254 | \$ 33,428 |
| Noncurrent liabilities (excluding debt) | \$ 28,865 | \$ 28,374 |

The increase in noncurrent assets of \$3,242 million (\$1,974 million adjusted for currency) was driven by:

Management Discussion – (continued)

- An increase of \$2,300 million in goodwill (\$1,902 million adjusted for currency) and \$886 million in net intangible assets driven by acquisitions; and
- An increase in retirement plans assets of \$598 million (\$562 million adjusted for currency) driven by the expected returns on plan assets; partially offset by
- A decrease of \$748 million in long-term financing receivables (\$1,022 million adjusted for currency) reflecting seasonal reductions from higher year-end balances.

Long-term debt increased \$6,826 million (\$6,433 million adjusted for currency) from the year-end balance primarily driven by:

- Issuances of \$7,960 million; partially offset by
- Reclassification to short term debt of \$1,771 million to reflect upcoming maturities.

The increase in noncurrent liabilities (excluding debt) of \$491 million (a decrease of \$489 million adjusted for currency) was driven by:

- An increase in retirement and nonpension postretirement liabilities of \$436 million driven by a currency impact of \$534 million.

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 March 31, | | At December 31, | |
|-------------------------------------|---------------------|--------|------------------------|--------|
| | 2016 | | 2015 | |
| Total company debt | \$ | 45,557 | \$ | 39,890 |
| Total Global Financing segment debt | \$ | 26,782 | \$ | 27,205 |
| Debt to support external clients | | 23,225 | | 23,934 |
| Debt to support internal clients | | 3,558 | | 3,271 |
| Non-Global Financing debt | \$ | 18,774 | \$ | 12,684 |

Total debt of \$45,557 million was up \$5,667 million from December 31, 2015, consistent with the increase in the cash balance over that period, driven by the timing of the company's current year term debt issuances.

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 Technology Services & Cloud Platforms, generate long-term, stable revenue streams similar to the Global Financing asset portfolio. Based on their attributes, these Technology Services & Cloud Platforms 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 69.

Non-Global Financing debt of \$18,774 million was up \$6,090 million from December 31, 2015 and up \$6,269 million from the first quarter of 2015.

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 62.2 percent at March 31, 2016 compared to 54.3 percent at December 31, 2015 and 59.4 percent at March 31, 2015.

Consolidated debt-to-capitalization ratio at March 31, 2016 was 75.1 percent versus 73.4 percent at December 31, 2015 and 75.9 percent at March 31, 2015.

Management Discussion – (continued)

Equity

Total equity increased by \$649 million from December 31, 2015 as a result of an increase in retained earnings of \$764 million, an increase in retirement-related pension amounts of \$335 million and an increase of \$505 million related to currency translation, partially offset by an increase in treasury stock of \$886 million primarily due to common stock repurchases.

Looking Forward

The company's strategies, investments and actions are all taken with an objective of optimizing long-term performance. A long-term perspective ensures that the company is well-positioned to take advantage of major shifts occurring in technology, business and the global economy.

Within the IT industry, there are major shifts occurring—driven by data and analytics, cloud and changes in the ways individuals and enterprises are engaging. In January 2016, to support this ongoing transformation, the company made a number of changes to its management system and organizational structure. In February, the company met with investors to discuss the progress of the transformation, and detailed how IBM is becoming more than a hardware, software and services company; it is emerging as a cognitive solutions and cloud platform company.

In the first quarter of 2016, the company had continued strong performance in its strategic imperatives that are focused on these market shifts. The company's strategic imperatives - cloud, analytics, mobile, social and security solutions revenue grew 14 percent year to year as reported and 17 percent adjusted for currency. Over the past 12 months, the strategic imperatives generated \$29.8 billion in revenue, which represents approximately 37 percent of the company's total revenue, an increase of 2 points from full-year 2015. In the first quarter, the company continued to take significant actions to drive the shift towards its strategic imperatives with targeted investments, including acquisitions in Cognitive Solutions and GBS, as well as taking actions to transform the workforce and accelerate the move away from non-strategic areas. While these actions impacted profit and margins in the first quarter, they improve the position for the future.

The company's strategic direction is clear and compelling, and the company continues its shift to the higher value areas of enterprise IT. The strong revenue growth in the strategic imperatives confirms that, as does the overall profitability of the business. The company expects revenue from its strategic imperatives to continue to deliver strong growth. These offerings are as high value as other parts of the business, which continue to manage clients' most critical business processes. In addition, the company expects to continue to allocate its capital efficiently and effectively to investments, and to return value to its shareholders through a combination of dividends and share repurchases. Over

the longer term, in consideration of the opportunities it will continue to develop, the company expects to have the ability to generate low single-digit revenue growth, and with a higher value business mix, high single-digit operating (non-GAAP) earnings per share growth, with free cash flow realization in the 90's percent range.

In the near term, there are a few dynamics that are inconsistent with that longer term trajectory. Specifically, in 2016, the company will be continuing to manage and drive the ongoing transformation of the business. As an example, GBS continues its transition, with strong growth in strategic imperatives offset by declines in the more traditional areas. The company will continue to engineer this shift. The company expects a continued impact to its software transaction revenue growth, as many of its largest customers continue to utilize the flexibility that the company has provided, as they commit to the company's platform for the longer term. In addition, while the company is fully participating in the shift to cloud, the margins in that business are impacted by the level of investment the company is making, and the fact that the business is not yet at scale.

The company continues to expect a significant impact to profit from currency in 2016 due to year-to-year impacts from hedging. The company previously reported a full-year expectation of \$1.3 billion of negative profit impact (or \$1.00 of earnings per share) from currency. At mid-April 2016 spot rates, modest improvement over previous expectations could result.

Overall, looking forward, the company expects to continue to grow in many areas of the business, including continued strong growth in the strategic imperatives. Recent acquisitions are beginning to contribute to revenue and while they impact profit negatively initially, the acquisitions will provide profit contribution over time. The company will continue to invest at a high level, shifting to areas that have the best opportunity. Many of the capabilities being built are cloud-based and delivered as a service. This profile and level of investment will impact margin in the short-term, but achieve the company's long-term strategy and profit model. In January 2016, the company provided expectations for the year that it would acquire key capabilities, rebalance its workforce, resolve various matters including tax matters, and return value to shareholders. This was

Management Discussion – (continued)

all taken into account in the full-year view of earnings per share. With the successful resolution of a significant tax matter and large workforce rebalancing action, the company made significant progress in the first quarter. Overall, the company now expects GAAP earnings per share from continuing operations for 2016 to be at least \$12.35. The company continues to expect operating (non-GAAP) earnings per share to be at least \$13.50, which excludes acquisition-related charges of \$0.76 per share and non-operating retirement-related items of \$0.39 per share. For the first half of 2016, the company expects operating (non-GAAP) earnings per share to be between 38 and 39 percent of the full year expectation.

As the company continues to build new businesses in areas such as Watson Health and Watson IoT, this requires different skills and in different locations. The first quarter workforce rebalancing actions are about transforming the workforce. Savings from the \$1 billion of workforce actions are expected to be approximately \$500 million or slightly more in 2016 and close to \$2 billion on an annualized basis.

From a segment perspective, in the first quarter, mainframe revenues decreased consistent with product cycle dynamics. Mainframe margins are expected to improve in 2016 in line with that cycle. Services backlog declined slightly to \$122.4 billion with decreased signings in the quarter. Both Technology Services & Cloud Platforms and GBS expect to continue to move clients into hybrid environments. GBS gross margins declined in the quarter, aligned with the shift to higher value services, which has a near term impact on margin. Under the new segment structure, software value has been integrated into three of the segments: Cognitive Solutions, Technology Services & Cloud Platforms, and Systems. The software annuity base continued to grow with steady renewal rates and growth in the Software-as-a-Service business. As expected, transactional mix was not as impactful in the first quarter of 2016 as it was in the fourth quarter of 2015. The company expects acquisitions to drive improvement in the software revenue trajectory in 2016.

Free cash flow realization, defined as free cash flow to income from continuing operations (GAAP), was 98 percent as reported in 2015 and is expected to remain in the 90's percent level in 2016. At the profit level associated with the earnings per share expectations, this translates to a free cash flow range of \$11 billion to \$12 billion in 2016. The company now expects free cash flow for 2016 at the high end of that range at the expected profit level.

Looking forward to the second quarter of 2016, the company expects the typical seasonal increase in profit improvement from the first to second quarter, with further improvement as a result of significant first quarter charges for workforce rebalancing, real estate actions, and actions in Latin America. The company will have partially offsetting impacts as a result of acquisitions, and quarter-to-quarter impact from currency hedges. As a result, the company expects approximately \$2 billion of improvement in pre-tax profit from first to second quarter 2016.

The company expects, in the normal course of business, that its operating (non-GAAP) tax rate will be 19 percent, plus or minus a couple of percentage points, for 2016. The GAAP tax rate is expected to be approximately 1 point

lower. The rate will change year to year based on nonrecurring 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.

The company expects 2016 pre-tax retirement-related plan cost to be approximately \$2.0 billion, a decrease of approximately \$600 million compared to 2015. This estimate reflects current pension plan assumptions at December 31, 2015. Within total retirement-related plan cost, operating retirement-related plan cost is expected to be approximately \$1.4 billion, a decrease of approximately \$100 million versus 2015. Non-operating retirement-related plan cost is expected to be approximately \$500 million, a decrease of approximately \$500 million compared to 2015, driven by decreased recognized actuarial losses and the Spanish pension litigation impacts in 2015. Contributions for all retirement-related plans are expected to be approximately \$2.6 billion in 2016, approximately flat compared to 2015.

The company uses December 31 as the year-end measurement date for all its retirement-related plans. If a significant event, such as curtailment occurs, a remeasurement would be performed. No curtailment gains or losses were recorded as of March 31, 2016 and the company continues to evaluate the impact of actions on its worldwide postretirement defined benefit plans.

Currency Rate Fluctuations

Changes in the relative values of non-U.S. currencies to the U.S. dollar (USD) affect the company's financial results and financial position. At March 31, 2016, currency changes resulted in assets and liabilities denominated in local currencies being translated into more dollars than at year-end 2015. The company uses financial hedging instruments to limit specific currency risks related to financing transactions and other foreign currency-based transactions.

Management Discussion – (continued)

Foreign currency fluctuations often drive operational responses that mitigate the simple mechanical translation of earnings. During periods of sustained movements in currency, the marketplace and competition adjust to the changing rates. For example, when pricing offerings in the marketplace, the company may use some of the advantage from a weakening U.S. dollar to improve its position competitively, and price more aggressively to win the business, essentially passing on a portion of the currency advantage to its customers. Competition will frequently take the same action. Consequently, the company believes that some of the currency-based changes in cost impact the prices charged to clients. The company also maintains currency hedging programs for cash management purposes which mitigate, but do not eliminate, the volatility of currency impacts on the company's financial results.

The company translates revenue, cost and expense in its non-U.S. operations at current exchange rates in the reported period. References to "adjusted for currency" or "constant currency" reflect adjustments based upon a simple constant currency mathematical translation of local currency results using the comparable prior period's currency conversion rate. However, this constant currency methodology that the company utilizes to disclose this information does not incorporate any operational actions that management could take to mitigate fluctuating currency rates. Currency movements impacted the company's year-to-year revenue and earnings per share growth in the first three months of 2016. Based on the currency rate movements in the first three months of 2016, total revenue decreased 4.6 percent as reported and decreased 2.0 percent at constant currency versus the first three months of 2015. On an income from continuing operations before income tax basis, these translation impacts offset by the net impact of hedging activities resulted in a theoretical maximum (assuming no pricing or sourcing actions) decrease of approximately \$20 million in the first three months of 2016 on both an as-reported basis and an operating (non-GAAP) basis. The same mathematical exercise resulted in a decrease of approximately \$175 million in the first three months of 2015 on an as-reported basis and a decrease of approximately \$320 million on an operating (non-GAAP) basis. The company views these amounts as a theoretical maximum impact to its as-reported financial results. Considering the operational responses mentioned above, movements of exchange rates, and the nature and timing of hedging instruments, it is difficult to predict future currency impacts on any particular period, but the company believes it could be substantially less than the theoretical maximum given the competitive pressure in the marketplace.

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 mid-February 2016, changes to the currency exchange systems were announced which eliminated the SICAD exchange rate and replaced the SIMADI rate with DICOM, which is expected to be a floating exchange rate. The company recorded a pre-tax loss of \$43 million in the first quarter of 2016 in other (income) and expense in the Consolidated Statement of Earnings as a result of the elimination of SICAD and devaluation in the new exchange. The company's net assets denominated in local currency were \$2 million at March 31, 2016. The company's operations in Venezuela comprised less than 1 percent of total 2015 and 2014 revenue, respectively.

Liquidity and Capital Resources

In the company's 2015 Annual Report, on pages 61 to 64, there is a discussion of the company's liquidity including two tables that present five years of data. The table presented on page 61 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 three months ended, or as of, as applicable, March 31, 2016, those amounts are \$5.6 billion for net cash from operating activities, \$14.9 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 March 31, 2016 appear in the table below. The agency ratings remain unchanged from December 31, 2015. Standard and Poor's, Moody's Investors Service and Fitch Ratings reaffirmed their credit ratings on April 21, 2015, March 30, 2016 and June 24, 2015, respectively. 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 March 31, 2016, the fair value of those instruments that were in a liability position was \$461 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.

Management Discussion – (continued)

| | STANDARD AND POOR'S | MOODY'S INVESTORS SERVICE | FITCH RATINGS |
|-----------------------|------------------------------------|--|--------------------------|
| Senior long-term debt | AA- | Aa3 | A+ |
| Commercial paper | A-1+ | Prime-1 | F1 |

The table appearing on page 62 of the company's 2015 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 7 of this Form 10-Q and highlights causes and events underlying sources and uses of cash in that format on page 59. The following is management's view of cash flows for the first three months of 2016 and 2015 prepared in a manner consistent with the table and description on pages 62 and 63 of the company's 2015 Annual Report.

(Dollars in millions)**For the three months ended March 31:**

| | 2016 | 2015 |
|--|-------------|-------------|
| Net cash from operating activities per GAAP | \$ 5,645 | \$ 3,610 |
| Less: the change in Global Financing receivables | 2,378 | 1,605 |
| Net cash from operating activities, excluding Global Financing receivables | 3,266 | 2,004 |
| Capital expenditures, net | (971) | (923) |
| Free cash flow | 2,295 | 1,081 |
| Acquisitions | (2,590) | (148) |
| Divestitures | 47 | 19 |
| Share repurchases | (939) | (1,165) |
| Dividends | (1,250) | (1,088) |
| Non-Global Financing debt | 5,871 | 361 |
| Other (includes Global Financing receivables and Global Financing debt) | 3,239 | 1,266 |
| Change in cash, cash equivalents and short-term marketable securities | \$ 6,674 | \$ 327 |

Free cash flow of \$2.3 billion for the first three months of 2016 increased \$1.2 billion year to year. The increase was driven primarily by a refund of previously paid taxes in Japan of \$1.0 billion and a year-to-year decline in U.S. income tax payments of \$0.9 billion; partially offset by a decline in cash sourced from sales cycle working capital (\$0.4 billion). Net capital expenditures of \$1.0 billion were essentially flat year to year, with continued investment in cloud capacity. In the first three months of 2016, the company continued to focus its cash utilization on returning value to shareholders including \$1.2 billion in dividends and \$0.9 billion in gross common stock repurchases.

Events that could temporarily change the historical cash flow dynamics discussed above and in the company's 2015 Annual Report include significant changes in operating results, material changes in geographic sources of cash, unexpected adverse impacts from litigation, future pension funding requirements during periods of severe downturn in the capital markets or the timing of tax payments. Whether any litigation has such an adverse impact will depend on a

number of variables, which are more completely described in note 12, "Contingencies," in this Form 10-Q. With respect to pension funding, the company expects to make legally mandated pension plan contributions to certain non-U.S. plans of approximately \$500 million in 2016. Contributions related to all retirement-related plans are expected to be approximately \$2.6 billion in 2016. Financial market performance could increase the legally mandated minimum contributions in certain non-U.S. countries that require more frequent remeasurement of the funded status. 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.

The company's U.S. cash flows continue to be sufficient to fund its current domestic operations and obligations, including investing and financing activities such as dividends and debt service. The company's U.S. operations generate substantial cash flows, and, in those circumstances where the company has additional cash requirements in the U.S., the company has several liquidity options available. These options may include the ability to borrow additional funds at reasonable interest rates, utilizing its committed global credit facility, repatriating certain foreign earnings and utilizing intercompany loans with certain foreign subsidiaries.

Management Discussion – (continued)

The company does earn a significant amount of its pre-tax income outside the U.S. The company's policy is to indefinitely reinvest the undistributed earnings of its foreign subsidiaries, and accordingly, no provision for federal income taxes has been made on accumulated earnings of foreign subsidiaries. The company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability. Quantification of the deferred tax liability, if any, associated with indefinitely reinvested earnings is not practicable. While the company currently does not have a need to repatriate funds held by its foreign subsidiaries, if these funds are needed for operations and obligations in the U.S., the company could elect to repatriate these funds which could result in a reassessment of the company's policy and increased tax expense.

Global Financing

Global Financing is a reportable segment that is measured as a stand-alone entity. Global Financing facilitates IBM clients' acquisition of information technology systems, software and services by providing financing solutions in the areas where the company has the expertise, while generating strong returns on equity.

Results of Operations

| (Dollars in millions) | Three Months Ended | | | |
|-----------------------|--------------------|-----------|------|-------|
| | 2016 | March 31, | 2015 | |
| External revenue | \$ | 410 | \$ | 461 |
| Internal revenue | | 486 | | 586 |
| Total revenue | | 896 | | 1,048 |
| Cost | | 272 | | 342 |
| Gross profit | \$ | 624 | \$ | 706 |
| Gross profit margin | | 69.6% | | 67.4% |
| Pre-tax income | \$ | 386 | \$ | 515 |
| After-tax income | \$ | 261 | \$ | 345 |
| Return on equity* | | 28.2% | | 35.6% |

* See page 69 for the details of the return on equity calculation.

The decrease in revenue in the first quarter, as compared to the same period in 2015, was due to:

- A decline in internal revenue of 17.1 percent, due to decreases in used equipment sales revenue (down 18.6 percent to \$402 million) and financing revenue (down 9.0 percent to \$85 million); and

- A decline in external revenue of 11.2 percent as reported (6.4 percent adjusted for currency), due to a decrease in financing revenue (down 14.0 percent to \$318 million).

The decreases in external and internal financing revenue in the first quarter of 2016, compared to the same period in 2015, were due to lower asset yields and a decrease in the average asset balance.

Global Financing gross profit decreased 11.6 percent in the first quarter of 2016, compared to the same period in 2015, due to decreases in used equipment sales gross profit and financing gross profit. The gross profit margin increased 2.3 points in the first quarter of 2016, compared to the same period in 2015, due to an increase in the financing margin.

Global Financing pre-tax income decreased 25.0 percent to \$386 million in the first quarter of 2016, compared to the same period in 2015, due to a lower gross profit (\$82 million) as well as increases in financing receivables provisions (\$24 million) and in selling, general and administrative expenses (\$24 million). The increase in financing receivables provisions was due to higher unallocated reserve requirements primarily in Brazil, partially offset by lower specific reserve requirements in the current year.

The decrease in return on equity in the first quarter of 2016, compared to the same period of 2015, was due to the decrease in net income, partially offset by the decrease in equity.

Management Discussion – (continued)Financial Position

Balance Sheet

| (Dollars in millions) | At March 31, | | At December 31, | |
|--|---------------------|--------|------------------------|--------|
| | 2016 | | 2015 | |
| Cash and cash equivalents | \$ | 1,662 | \$ | 1,555 |
| Net investment in sales-type and direct financing leases | | 7,533 | | 7,594 |
| Equipment under operating leases — external clients (1) | | 597 | | 605 |
| Client loans | | 11,512 | | 12,525 |
| Total client financing assets | | 19,641 | | 20,725 |
| Commercial financing receivables | | 6,905 | | 8,948 |
| Intercompany financing receivables (2) (3) | | 4,358 | | 4,245 |
| Other receivables | | 346 | | 308 |
| Other assets | | 457 | | 378 |
| Total assets | \$ | 33,369 | \$ | 36,157 |
| Intercompany payables (2) | \$ | 1,048 | \$ | 3,089 |
| Debt (4) | | 26,782 | | 27,205 |
| Other liabilities | | 1,870 | | 2,134 |
| Total liabilities | | 29,701 | | 32,428 |
| Total equity | | 3,669 | | 3,729 |
| Total liabilities and equity | \$ | 33,369 | \$ | 36,157 |

(1) Includes intercompany mark-up, priced on an arm's-length basis, on products purchased from the company's product

divisions which is eliminated in IBM's consolidated results.

(2) Entire amount eliminated for purposes of IBM's consolidated results and therefore does not appear on pages 5 and 6.

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

debt.

(4) 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.

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 OEM equipment, software and services to meet IBM clients' total solutions requirements. Client financing assets are primarily sales-type, direct financing and operating leases for systems products, as well as loans and installment payment plans for systems, software and services, with terms up to seven years. Global Financing's client loans and installment payment plans are primarily for software and services and are unsecured. These agreements are subjected to credit analysis to evaluate the associated risk and, when deemed necessary, actions are taken to mitigate risks, which include covenants to protect against credit deterioration during the life of the obligation.

Commercial financing receivables arise primarily from inventory and accounts receivable financing for dealers and remarketers of IBM and OEM 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.

In addition to the actions previously described, the company has a long-standing practice of taking mitigation actions, in certain circumstances, to transfer credit risk to third parties, including credit insurance, financial guarantees, non-recourse borrowings, transfers of receivables recorded as true sales in accordance with accounting guidance or sales of equipment under operating lease.

At March 31, 2016, substantially all financing assets were IT related assets, and approximately 51 percent of the total external portfolio was with investment grade clients with no direct exposure to consumers. The reduction in investment grade year to year (4 points) was driven primarily by rating changes within the existing portfolio, not by changing the company's approach to the market. This investment grade percentage is based on the credit ratings of the companies in the portfolio.

Management Discussion – (continued)

Additionally, as noted above, the company takes actions to transfer exposure to third parties. On that basis, the investment grade content would increase by 14 points to 65 percent.

Originations

The following are total financing originations:

| (Dollars in millions) | Three Months Ended | |
|------------------------------|---------------------------|-------------|
| | March 31, | |
| | 2016 | 2015 |
| Client financing | \$ 2,546 | \$ 3,004 |
| Commercial financing | 9,323 | 8,828 |
| Total | \$ 11,869 | \$ 11,831 |

Cash collections of both commercial financing and client financing assets exceeded new financing originations in the first quarter of 2016 and 2015 which resulted in a net decline in financing assets in these periods. The increase in originations in 2016 versus 2015 was due to an increase in commercial financing volumes. Internal loan financing with Technology Services & Cloud Platforms is executed under a loan facility and is not considered originations.

Cash generated by Global Financing was deployed to pay intercompany payables and dividends to IBM as well as business partners and OEM suppliers.

Global Financing Receivables and Allowances

The following table presents external financing receivables excluding residual values and the allowance for credit losses.

| (Dollars in millions) | At March 31, | At December 31, |
|---|---------------------|------------------------|
| | 2016 | 2015 |
| Gross financing receivables | \$ 26,095 | \$ 29,086 |
| Specific allowance for credit losses | 527 | 517 |
| Unallocated allowance for credit losses | 155 | 93 |
| Total allowance for credit losses | 681 | 610 |
| Net financing receivables | \$ 25,413 | \$ 28,475 |

| | | |
|--------------------------------------|------|------|
| Allowance for credit losses coverage | 2.6% | 2.1% |
|--------------------------------------|------|------|

Roll Forward of Global Financing Receivables Allowance for Credit Losses

| (Dollars in millions) | | | Allowance Used* | | | Additions/ (Reductions) | | | Other** | | | March 31, 2016 |
|------------------------------|-----|----|------------------------|----|----|--------------------------------|----|----|----------------|--|--|-----------------------|
| January 1, 2016 | | | | | | | | | | | | |
| \$ | 610 | \$ | (19) | \$ | 76 | \$ | 14 | \$ | 681 | | | |

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

** Primarily represents translation adjustments.

The percentage of Global Financing receivables reserved increased from 2.1 percent at December 31, 2015, to 2.6 percent at March 31, 2016, primarily due to an increase in unallocated reserve requirements. Unallocated reserves increased 66 percent from \$93 million at December 31, 2015, to \$155 million at March 31, 2016, primarily due to Brazil. Specific reserves increased 2 percent from \$517 million at December 31, 2015, to \$527 million at March 31, 2016.

Global Financing's bad debt expense was \$76 million for the first three months ended March 31, 2016, compared to \$52 million for the same period in 2015. The year-to-year increase in bad debt expense was due to higher unallocated reserve requirements in Brazil driven by deteriorating economic conditions, partially offset by lower specific reserve requirements in China.

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 include equipment returned at the end of a lease, surplus internal equipment, or used equipment purchased externally. These sales represented 55.1 percent in the first quarter of 2016, and 55.9 percent in the first quarter of 2015. The gross profit margins on these sales were 63.8 percent and 63.6 percent in the first quarter of 2016 and 2015, respectively.

The table below presents the recorded amount of unguaranteed residual value for sales-type, direct financing and operating leases at January 1, 2016 and March 31, 2016. 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 March 31, 2016 is expected to be returned to the company. In addition to the unguaranteed residual value, on a limited basis, Global Financing will obtain guarantees of the future value of the equipment to be returned at end of lease. While primarily focused on IBM products, guarantees are also obtained for certain OEM products. 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, direct financing lease or operating lease. The aggregate asset values associated with the guarantees of sales-type leases were \$91 million and \$101 million for the financing transactions originated during the quarters ended March 31, 2016 and 2015, respectively. The aggregate asset values associated with the guarantees of direct financing leases were \$39 million and \$50 million for the financing transactions originated during the quarters ended March 31, 2016 and 2015, respectively. The associated aggregate guaranteed future values at the scheduled end of lease were \$3 million and \$8 million for the financing transactions originated in the quarters ended March 31, 2016 and 2015, respectively. The cost of guarantees was \$0.3 million and \$0.8 million for the quarters ended March 31, 2016 and 2015, respectively.

Unguaranteed Residual Value

| (Dollars in millions) | At | | Estimated Run Out of | | | 2019 and Beyond |
|---|--------------------|-------------------|----------------------|--------|--------|--------------------|
| | January 1, 2016 | March 31, 2016 | 2016 | 2017 | 2018 | |
| Sales-type and direct financing leases | \$ 645 | \$ 627 | \$ 123 | \$ 161 | \$ 198 | \$ 145 |
| Operating leases | 144 | 140 | 56 | 46 | 25 | 13 |
| Total unguaranteed residual value | \$ 789 | \$ 767 | \$ 179 | \$ 207 | \$ 223 | \$ 158 |
| Related original amount financed | \$ 14,223 | \$ 14,147 | | | | |
| Percentage | 5.6% | 5.4% | | | | |

| Debt | At March 31, 2016 | At December 31, 2015 |
|----------------------|----------------------|-------------------------|
| Debt-to-equity ratio | 7.3x | 7.3x |

The debt used to fund Global Financing assets is composed of intercompany loans and external debt. Total debt changes generally correspond with the level of client and commercial financing receivables, the level of cash and cash equivalents, the change in intercompany and external payables and the change in intercompany investment from IBM. The terms of the

Management Discussion – (continued)

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.

Global Financing provides financing predominantly for the company's external client assets, as well as for assets under contract by other IBM units. As previously stated, the company measures Global Financing as a stand-alone 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 page 27.

In the company's Consolidated Statement of Earnings, 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 long-term services 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 March 31, 2016 | | At December 31, 2015 | |
|----------------------------------|--------------------------|-----------|-----------------------------|-----------|
| Global Financing Segment | | \$ 26,782 | | \$ 27,205 |
| Debt to support external clients | \$ 23,225 | | \$ 23,934 | |
| Debt to support internal clients | 3,558 | | 3,271 | |
| Non-Global Financing Segments | | 18,774 | | 12,684 |
| Debt supporting operations | 22,332 | | 15,955 | |
| Intercompany activity | (3,558) | | (3,271) | |
| Total company debt | | \$ 45,557 | | \$ 39,890 |

Liquidity and Capital Resources

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 deployed to pay dividends to the company in order to maintain an appropriate debt-to-equity ratio.

Return on Equity

| (Dollars in millions) | Three Months Ended March 31, | |
|---|---------------------------------|----------|
| | 2016 | 2015 |
| Numerator | | |
| Global Financing after-tax income* | \$ 261 | \$ 345 |
| Annualized after-tax income (1) | \$ 1,042 | \$ 1,382 |
| Denominator | | |
| Average Global Financing equity (2)** | \$ 3,698 | \$ 3,881 |
| Global Financing return on equity (1)/(2) | 28.2% | 35.6% |

* 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.

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 IBM and OEM 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.

Management Discussion – (continued)

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 credit losses. Global Financing will continue to apply rigorous credit policies in both the origination of new business and the evaluation of the existing portfolio.

As previously discussed, 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.

Management Discussion – (continued)**GAAP Reconciliation**

The tables below provide a reconciliation of the company's income statement results as reported under GAAP to its operating earnings presentation which is a non-GAAP measure. The company's calculation of operating (non-GAAP) earnings, as presented, may differ from similarly titled measures reported by other companies. Refer to the "Snapshot" section on page 43 for the company's rationale for presenting operating earnings information.

(Dollars in millions except per share amounts)**For the three months ended March 31, 2016**

| | GAAP | Acquisition-related adjustments | Retirement-related adjustments | Operating (Non-GAAP) |
|---|-------------|--|---------------------------------------|-----------------------------|
| Gross profit | \$ 8,686 | \$ 112 | \$ 79 | \$ 8,877 |
| Gross profit margin | 46.5% | 0.6pts. | 0.4pts. | 47.5% |
| S,G&A | \$ 6,012 | \$ (67) | \$ (55) | \$ 5,890 |
| R,D&E | 1,458 | — | (9) | 1,449 |
| Other (income) and expense | 253 | (6) | — | 247 |
| Total expense and other (income) | 7,652 | (73) | (63) | 7,516 |
| Pre-tax income from continuing operations | 1,034 | 185 | 142 | 1,361 |
| Pre-tax margin from continuing operations | 5.5% | 1.0pts. | 0.8pts. | 7.3% |
| Provision for/(benefit from) income taxes* | \$ (983) | \$ 47 | \$ 27 | \$ (909) |
| Effective tax rate | (95.1)% | 18.2pts. | 13.8pts. | (66.8)% |
| Income from continuing operations | \$ 2,016 | \$ 138 | \$ 115 | \$ 2,270 |
| Income margin from continuing operations | 10.8% | 0.7pts. | 0.6pts. | 12.1% |
| Diluted earnings per share from continuing operations | \$ 2.09 | \$ 0.14 | \$ 0.12 | \$ 2.35 |

* The tax impact on operating (non-GAAP) pre-tax income from continuing operations is calculated under the same accounting principles applied to the GAAP pre-tax income which employs an annual effective tax rate method to the results.

(Dollars in millions except per share amounts)**For the three months ended March 31, 2015**

| | GAAP | Acquisition-related adjustments | Retirement-related adjustments | Operating (Non-GAAP) |
|---|-------------|--|---------------------------------------|-----------------------------|
| Gross profit | \$ 9,452 | \$ 91 | \$ 121 | \$ 9,664 |
| Gross profit margin | 48.2% | 0.5 pts. | 0.6 pts. | 49.3% |
| S,G&A | \$ 5,362 | \$ (79) | \$ (308) | \$ 4,975 |
| R,D&E | 1,298 | — | (13) | 1,285 |
| Other (income) and expense | (143) | 0 | — | (143) |
| Total expense and other (income) | 6,451 | (79) | (321) | 6,051 |
| Pre-tax income from continuing operations | 3,001 | 170 | 442 | 3,612 |
| Pre-tax margin from continuing operations | 15.3% | 0.9 pts. | 2.3 pts. | 18.4% |

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| | | | | |
|---|----------|------------|----------|----------|
| Provision for income taxes* | \$ 585 | \$ 28 | \$ 109 | \$ 722 |
| Effective tax rate | 19.5% | (0.2) pts. | 0.7 pts. | 20.0% |
| Income from continuing operations | \$ 2,415 | \$ 142 | \$ 333 | \$ 2,890 |
| Income margin from continuing operations | 12.3% | 0.7 pts. | 1.7 pts. | 14.8% |
| Diluted earnings per share from continuing operations | \$ 2.44 | \$ 0.14 | \$ 0.33 | \$ 2.91 |

* The tax impact on operating (non-GAAP) pre-tax income from continuing operations is calculated under the same accounting principles applied to the GAAP pre-tax income which employs an annual effective tax rate method to the results.

Management Discussion – (continued)

Forward-Looking and Cautionary Statements

Except for the historical information and discussions contained herein, statements contained in this Form 10-Q 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 client 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; cybersecurity and data privacy considerations; fluctuations in financial results; 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; impacts of relationships with critical suppliers; product quality issues; impacts of business with government clients; 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 and ecosystems; the company's ability to successfully manage acquisitions, alliances and dispositions; risks from legal proceedings; risk factors related to IBM securities; and other risks, uncertainties and factors discussed in the company's Form 10-Qs, Form 10-K and in the company's other filings with the U.S. Securities and Exchange Commission (SEC) or in materials incorporated therein or herein by reference. 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.

Part II – Other Information

Item 1. Legal Proceedings

Refer to note 12, "Contingencies," on pages 38 to 40 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 first quarter of 2016.

| 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* |
|--------------------------------------|---|---|---|--|
| January 1, 2016 - January 31, 2016 | 5,127,561 | \$ 128.49 | 5,127,561 | \$ 4,904,554,402 |
| February 1, 2016 - February 29, 2016 | 749,042 | \$ 127.20 | 749,042 | \$ 4,809,279,365 |
| March 1, 2016 - March 31, 2016 | 762,679 | \$ 143.31 | 762,679 | \$ 4,699,982,264 |
| Total | 6,639,282 | \$ 130.04 | 6,639,282 | |

* On October 28, 2014, the Board of Directors authorized \$5.0 billion in funds for use in the company's common stock repurchase program. On October 27, 2015 the Board of Directors authorized an additional \$4.0 billion in funds for use in such program. In each case, the company stated that it would repurchase shares on the open market or in private transactions depending on market conditions. 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 6. Exhibits

Exhibit Number

| | |
|---------|--|
| 10.1 | Terms and Conditions of IBM LTTP Equity Awards, effective June 8, 2016. |
| 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.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

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: April 26, 2016

By: /s/ Stanley J. Sutula III
Stanley J. Sutula III
Vice President and Controller