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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10 - Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED JUNE 30, 2014

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

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

914-499-1900

(Registrant’s telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section l3 or l5(d) of the Securities Exchange Act of 1934 during the preceding l2 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No

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

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

Large accelerated filer ý	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company

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

The registrant had 997,592,162 shares of common stock outstanding at June 30, 2014.

Index

Part I - Financial Information

Item 1. Consolidated Financial Statements:

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF EARNINGS
(UNAUDITED)

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

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

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

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

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

(Amounts may not add due to rounding.)

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

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(UNAUDITED)

ASSETS

(Dollars in millions)	At June 30, 2014	At December 31, 2013
Assets:		
Current assets:		
Cash and cash equivalents	$ 9,715	$ 10,716
Marketable securities	5	350
Notes and accounts receivable - trade (net of allowances of $294 in 2014 and $291 in 2013)	9,902	10,465
Short-term financing receivables (net of allowances of $404 in 2014 and $308 in 2013)	18,620	19,787
Other accounts receivable (net of allowances of $45 in 2014 and $36 in 2013)	1,555	1,584
Inventories, at lower of average cost or market:		
Finished goods	449	444
Work in process and raw materials	1,889	1,866
Total inventories	2,338	2,310
Deferred taxes	1,783	1,651
Prepaid expenses and other current assets	4,263	4,488
Total current assets	48,182	51,350
Property, plant and equipment	40,936	40,475
Less: Accumulated depreciation	27,188	26,654
Property, plant and equipment — net	13,748	13,821
Long-term financing receivables (net of allowances of $68 in 2014 and $80 in 2013)	12,140	12,755
Prepaid pension assets	6,894	5,551
Deferred taxes	2,828	3,051
Goodwill	31,568	31,184
Intangible assets — net	3,585	3,871
Investments and sundry assets	5,369	4,639
Total assets	$ 124,314	$ 126,223

(Amounts may not add due to rounding.)

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

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

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

LIABILITIES AND EQUITY

(Dollars in millions)	At June 30, 2014	At December 31, 2013
Liabilities:		
Current liabilities:		
Taxes	$ 2,335	$ 4,633
Short-term debt	12,462	6,862
Accounts payable	6,271	7,461
Compensation and benefits	4,037	3,893
Deferred income	12,591	12,557
Other accrued expenses and liabilities	4,737	4,748
Total current liabilities	42,433	40,154
Long-term debt	34,008	32,856
Retirement and nonpension postretirement benefit obligations	15,984	16,242
Deferred income	4,152	4,108
Other liabilities	10,224	9,934
Total liabilities	106,801	103,294
Equity:		
IBM stockholders' equity:		
Common stock, par value $0.20 per share, and additional paid-in capital	52,163	51,594
Shares authorized: 4,687,500,000		
Shares issued: 2014 - 2,212,895,614		
2013 - 2,207,522,548		
Retained earnings	134,483	130,042
Treasury stock - at cost	(148,900)	(137,242)
Shares: 2014 - 1,215,303,453		
2013 - 1,153,131,611		
Accumulated other comprehensive income/(loss)	(20,369)	(21,602)
Total IBM stockholders' equity	17,377	22,792
Noncontrolling interests	136	137
Total equity	17,513	22,929
Total liabilities and equity	$ 124,314	$ 126,223

(Amounts may not add due to rounding.)

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

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

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

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

(Amounts may not add due to rounding.)

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

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

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

(Dollars in millions)	Common Stock and Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders' Equity	Non-Controlling Interests	Total Equity
Equity - January 1, 2013	$ 50,110	$ 117,641	$ (123,131)	$ (25,759)	$ 18,860	$ 124	$ 18,984
Net income plus other comprehensive income/(loss)							
Net income		6,258			6,258		6,258
Other comprehensive income/(loss)				(16)	(16)		(16)
Total comprehensive income/(loss)					$ 6,242		$ 6,242
Cash dividends paid – common stock		(1,996)			(1,996)		(1,996)
Common stock issued under employee plans (7,367,440 shares)	668				668		668
Purchases (1,399,751 shares) sales (1,480,251 shares) of treasury							

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

(Amounts may not add due to rounding.)

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

Notes to Consolidated Financial Statements:

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

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amount of assets, liabilities, revenue, costs, expenses and other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management’s best knowledge of current events, historical experience, actions that the company may undertake in the future and on various other assumptions that are believed to be reasonable under the circumstances. As a result, actual results may be different from these estimates. Refer to the company's 2013 Annual Report on pages 67 to 70 for a discussion of the company's critical accounting estimates.

Interim results are not necessarily indicative of financial results for a full year. The information included in this Form 10-Q should be read in conjunction with the company's 2013 Annual Report.

Noncontrolling interest amounts in income of $2.4 million and $0.9 million, net of tax, for the three months ended June 30, 2014 and 2013, respectively, and $1.9 million and $2.3 million, net of tax, for the six months ended June 30, 2014 and 2013, respectively, are included in the Consolidated Statement of Earnings within the other (income) and expense line item.

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

2. Accounting Changes: In May 2014, the Financial Accounting Standards Board (FASB) issued guidance on the recognition of revenue from contracts with customers. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. The guidance is effective January 1, 2017 and early adoption is not permitted. The company is currently evaluating the impact of the new guidance and the method of adoption in the consolidated financial results.

In April 2014, the FASB issued guidance that changed the criteria for reporting a discontinued operation. Only disposals of a component that represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results is a discontinued operation. The guidance also requires expanded disclosures about discontinued operations and disposals of a significant part of an entity that does not qualify for discontinued operations reporting. The guidance is effective January 1, 2015 with early adoption permitted, but only for disposals (or classifications as held for sale) that have not been reported in previously-issued financial statements. The impact to the company will be dependent on any transaction that is within the scope of the new guidance.

In July 2013, the FASB issued guidance regarding the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Under certain circumstances, unrecognized tax benefits should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The guidance was effective January 1, 2014. The guidance was a change in financial statement presentation only and did not have a material impact in the consolidated financial results.

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

In February 2013, the FASB issued guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of the guidance is

Notes to Consolidated Financial Statements – (continued)

fixed at the reporting date. Examples include debt arrangements, other contractual obligations and settled litigation matters. The guidance requires an entity to measure such obligations as the sum of the amount that the reporting entity agreed to pay on the basis of its arrangement among its co-obligors plus additional amounts the reporting entity expects to pay on behalf of its co-obligors. The guidance was effective January 1, 2014 and did not have a material impact in the consolidated financial results.

3. Financial Instruments:

Fair Value Measurements

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

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

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

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

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

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

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

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

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

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

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

Notes to Consolidated Financial Statements – (continued)

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

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

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

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

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

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

(4) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at June 30, 2014 were $176 million and $596 million respectively.

(5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other Liabilities in the Consolidated Statement of Financial Position at June 30, 2014 were $309 million and $32 million, respectively.

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

(7) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by $184 million each.

Notes to Consolidated Financial Statements – (continued)

(Dollars in millions)